

# **THE DAVID HUME INSTITUTE**



## **Scotland in Europe**

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Andrew Scott  
Rory O'Donnell  
Ulf Sverdrup  
Toby Archer

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## **The Authors**

**Andrew Scott** is Professor of European Union Studies in the School of Law, and Co-Director of the Europa Institute, at the University of Edinburgh. Prior to joining the University of Edinburgh he was Lecturer in Economics at Heriot-Watt University. From 1992-1999 he was co-Editor of the Journal of Common Market Studies. His research covers various aspects of European integration, including the relationship between sub-state policy competences within EU member states and the wider EU legal order.

**Rory O'Donnell** is Director of the National Economic and Social Council of Ireland (NESC) and Chief Officer of the newly-established National Economic and Social Development Office (NESDO). In his work as Economist and later Director at NESC he has prepared the analysis that underpins Ireland's social partnership approach to economic and social policy and has written extensively on partnership. He was Jean Monnet Professor of Business at the Smurfit Business School, University College Dublin; where he edited a review of Ireland's first 25 years in the EU, *Europe – The Irish Experience* (Institute of European Affairs, 2000) and co-authored *Europe's Experimental Union: Rethinking Integration* (Routledge, 2000).

**Ulf Sverdrup** is a political scientist and holds a doctoral degree from the Department of Political Science, University of Oslo. His main field of study is the institutional dynamics in the EU, and the Europeanisation of national administrative systems. He is a senior researcher at ARENA, University of Oslo. He has been a Jean Monnet Fellow at the European University Institute in Florence, and has worked in the Norwegian Ministry of Foreign Affairs. He is also affiliated with the Norwegian School of Management (BI). Ulf Sverdrup is on leave until the end of 2011, acting as the head of the secretariat for the Europe Review Committee appointed by the Norwegian government. The views presented in this paper are his own and do not in any way represent the views of either the Europe Review Committee or the Norwegian government.

**Toby Archer** is a researcher at the Finnish Institute for International Affairs. He has been Advisor to the Chairman of the UN environment Programme Post-Conflict Environmental Assessment Unit and is a graduate of Glasgow and Leeds Universities

## **Foreword**

Several months ago the David Hume Institute was approached by John Brand, Chairman of the European Movement in Scotland, suggesting that we should work together to organise a seminar on the broad topic of Scotland in Europe. This was a topic that I had for some time seen as suitable for a DHI event, being of importance for Scotland and also an area where an informed and objective examination should inform the policy debate.

So, having agreed in principle that we should proceed, we immediately contacted Professor Drew Scott of Edinburgh University's Europa Institute, who is acknowledged as Scotland's leading expert in this field. He kindly agreed to work with us and we decided that we should endeavour to produce a paper on Scotland in Europe as well as organising a seminar.

On the seminar front our first choice speaker was Sir John Grant and our first choice for chair Sir David Edward. They both accepted our invitations. Sir John was Britain's man at Brussels and special adviser to Tony Blair when the latter was Prime Minister. Sir David is a past President of the David Hume Institute, now Chair of the Europa Institute and was the UK's Judge at the European Court. That seminar was arranged for Monday 29<sup>th</sup> November at the Royal Society of Edinburgh.

For this publication we sought from Drew Scott two background chapters on the Scottish story; one explaining past and present arrangements and the other looking at how such arrangements might differ with changes in Scotland's constitutional position. It transpires that, for the latter, the really significant changes would flow from independence rather than any further enhancement of the devolution settlement.

Then we sought case studies on the experience of other relevant European countries. Ireland was the first obvious example. Rory O'Donnell, Director of the Irish National Economic and Social Council and a long time contact of Drew Scott's, kindly agreed not only to contribute but to join us for the seminar and participate in the Q&A session with Sir John and Drew Scott. Rory's chapter is essentially extracts from a significantly larger paper that he prepared for us on 'Reflections on Ireland's Experience in the Euro', which is also available via our web site. Given recent developments in Ireland we felt that this fuller paper would be of interest.

John Brand made good use of his extensive European contacts to arrange for chapters on Finland and Norway to be prepared by Toby Archer (of the Finnish Institute for International Affairs) and Dr Ulf Sverdrup (of the University of Oslo) respectively.

We believe that these three case studies, following on from Drew's Scotland chapters, provide significant food for thought for all interested in Scotland's actual and potential relationship with Europe. The experiences of the three selected countries are very different, as was intended when they were selected.

Whilst expressing our sincere thanks for these excellent contributions, and emphasising that we believe that this whole document fulfils its intention in informing the policy debate, I should also stress that the views expressed are not those of the Institute. The DHI is an independent charitable organisation and as such has no views of its own on such topics. Our role is to support informed, objective and preferably sceptical debate.

**Jeremy Peat, Director, The David Hume Institute**

## **The UK and the European Union**

**Andrew Scott**

In this section I consider the relationship between the UK and Scottish Governments since the 1999 devolution settlement. In the first part I discuss how this developed during the period up to 2007, when there were Labour or Labour-led administrations at Westminster and Holyrood; and then in the second part I discuss developments since 2007, taking account of both the emergence of a SNP minority government at Holyrood and, subsequently, a Conservative/LibDem coalition at Westminster. Of course it is still far from clear how the relationship between the existing governments will develop so far as European matters are concerned.

### **(a) The Post-Devolution Situation**

As is well known, the 1999 devolution settlement reserved competence for all aspects of the UK's EU policy to the British Government. Formally the position was straightforward. Under the governing EU Treaties the UK was the member state and, as such, had ultimate authority to represent UK interests in the EU's legislative and policy processes. However the practical difficulty was that devolution had transferred to the newly created Scottish administration sole competence over a range of policies that were subject to EU-level legislation. Therefore should the European Commission bring forward a proposal for EU legislation to be enacted in a policy area that had been devolved, the formal position implied that the UK Government would "re-acquire" authority over this otherwise devolved policy, if only throughout the EU legislative process.

Under the 1998 devolution legislation that remains the "constitutional" position. The Scottish Parliament is empowered to transpose into Scots law any EU Directive for which the issue concerned has been devolved (although it can opt to utilise UK secondary legislation if it wishes). Any failure to honour EU obligations will result in the UK government enacting the requisite secondary legislation. Notwithstanding the terms of the devolution legislation, it was agreed that intra-UK inter-governmental mechanisms should be established that would allow all of the devolved administrations to input to the UK government's EU policy procedures where the matter under consideration impacted on a devolved competence. Moreover it was also deemed desirable for counterpart Ministers from UK and the devolved governments to meet periodically to discuss broader questions relating to the UK's relations with the EU, including on matters that were not devolved.

Accordingly in 1999 a wide-ranging Memorandum of Understanding was agreed which included, inter alia, a Concordat on Co-ordination of European Union Policy Issues setting out the terms under which the devolved governments would input to the UK government's EU policy process:

“Any disagreement over an EU issue between one (or more) of the devolved administrations and UK government would be referred to a new Joint Ministerial Committee (Europe) (JMC (E)) consisting of UK government, Scottish, Welsh and Northern Ireland Ministers. That Committee would seek to resolve the matter, although any consensus position it reached was not binding on UK government. For the majority of EU policy issues the expectation was that any differences between the respective administrations would be resolved by the relevant officials. The remit of the JMC(E) extended beyond dispute resolution. In the early post-devolution years it came to be the UK-level forum at which UK Ministers and their devolved counterparts would convene to discuss the broad EU strategy that the UK Government intended to pursue. Typically these meetings were convened ahead of the bi-annual gatherings of the European Council (i.e. the EU summits).”

Of course internal UK discussions on EU policy proposals were not only a matter of reconciling, where necessary, different policy preferences of the constituent governments of the UK. The fact that Scotland is a separate legal entity from the rest of the UK requires that proper attention is given to the implications for Scots law from various EU legislative initiatives. This is especially true with regard to EU-level initiatives around the themes of freedom, security and justice.

Finally it is worth noting that the post-devolution situation in the UK with regard to EU policy was far from unusual. In a number of EU member states with long-standing federal political systems internal provision had been made to protect the policy prerogatives of sub-national governments (SNG) in response to the progressive extension of EU-level policy competences. Indeed, beginning with the 1993 Treaty on European Union a number of reforms had been implemented that enhanced the role of SNGs across the EU – most notably the development of the principle of subsidiarity<sup>1</sup> as a Treaty provision and enhancing the role of SNGs in the EU’s broad policy process<sup>2</sup>. Finally the recently enacted Lisbon Treaty empowers national parliaments in the area of subsidiarity such that if one-third of national parliaments object to an EU legislative proposal on the grounds that it violates subsidiarity the Commission is obliged to respond.

Notwithstanding these EU-level changes, it remained the case that, for the large part, member state governments remain the main conduit for SNG interests to be represented in EU legislative and policy discussions.<sup>3</sup>

From the perspective of the UK this seems to have created relatively few conflicts between the devolved and central governments since devolution. Three explanations can be offered for this.

First the post-devolution mechanisms for reconciling the EU policy interests of the devolved and UK governments worked relatively smoothly.

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<sup>1</sup> The principle of subsidiarity asserts that decisions should be taken as close to the citizen as possible. This principle has been developed through successive Treaty reforms such that it now requires the Commission to show that the objectives of an EU legislative proposal impacting on SNG competences could not be achieved by member states working together and legislating independently.

<sup>2</sup> Ministers from SNG may represent the Member State in the Council of Ministers provided they are authorised to conclude agreements on behalf of the Member State. Although not widely used, this provision has been invoked by Scottish Ministers from time to time, especially in the context of EU debates on agriculture and fisheries.

<sup>3</sup> The European Parliament (EP) divides along political lines not national lines. Accordingly neither “national” nor “sub-national” interest is fully expressed within the EP legislative arrangements.

In Scotland's case the pre-devolution era was in any case one of considerable administrative devolution. As a result the former Scottish Office had acquired considerable expertise in specific aspects of EU policies – agriculture, fisheries, structural funds, etc. – and post-1999 the same officials continued to interact with their Whitehall counterparts much as before. Certainly in some policy areas new EU-related expertise had to be created – for instance in environmental policy where the new Scottish Executive had little experience to draw upon – but this appears to have been managed relatively efficiently. This is not to assert there were no problems in the early years, but rather to imply that where inter-governmental disputes did arise that they reflected the inevitable and probably unavoidable teething difficulties associated with the new arrangements. The JMC machinery was established as the centre-piece of a wide range of inter-governmental accords designed to manage EU business smoothly. Counterpart officials in each administration enjoyed virtually unfettered access to the relevant policy information of the other, while the newly established Scottish government EU office in Brussels was commonly described as part of the UKReP family.<sup>4</sup>

Second over a wide range of EU policy issues the interests of the UK government and the devolved administrations coincided. Consequently one would not have anticipated significant inter-governmental disagreements to characterise the UK's EU policy processes. Like most government policies, EU policies tend to change relatively infrequently and proposals for new common policies typically are signposted well ahead of being published. In this type of environment we would not expect to see significant intra-state disputes over the broad direction of EU policy, albeit there could be considerable discussion between officials over precise details. However this coincidence of interests may not persist. On issues such as fisheries policy, the future of the structural funds, energy policy and the further reform of the Common Agricultural Policy increasingly we are seeing different positions being taken by the UK and Scottish governments. This is not surprising. Over the past decade, devolution has progressively re-oriented the locus of political debate in Scotland from Westminster to Holyrood. Any Scottish government now feels obliged to defend Scotland's interests even in policy areas over which it has no formal competence, including EU policy. There is however an additional influence at work in the arena of EU policy. As EU policies are reformed and the "Brussels" footprint recedes, often it is the Scottish administration that is empowered because the policy area concerned is devolved.

Similarly should the EU acquire new competences in a policy area not expressly reserved to the UK Government under the devolution legislation (and climate change legislation is a prime example) then it will fall to the devolved administrations to represent the interests of the devolved jurisdictions when the UK Government is developing a collective UK policy over such EU legislative initiatives.

Third from 1999 to 2007 the UK and devolved Scottish Labour governments were politically aligned. This ensured that where disputes over EU policy did arise, there was a very high likelihood that these would be resolved in private. Given the status of the SNP as the main opposition party in Scotland, any impression that the UK government was ignoring Scotland's interests in EU policy would be politically damaging to the Labour-led Executive. For whatever reason, during the period 1999-2007 there was no significant conflict between London and Edinburgh over EU policy.

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<sup>4</sup> UKReP is the Permanent Representation of the UK Government in Brussels, and is responsible for managing the UK business in the Committee of Permanent Representatives and, ultimately, the interests of the UK Government in the EU.

Indeed for some of that time EU policy issues seemed to be dealt with solely by officials with no specific office of Europe Minister existing within the then Executive. Moreover from 2004 the JMC (Europe) met increasingly infrequently and to all intents and purposes ceased to function other than at an almost ceremonial level. As we note below matters changed in the wake of the SNP electoral victory in May 2007, whereupon the JMC (E) machinery was both resuscitated and reformed.

A final point is worth noting. Strictly speaking the devolved administrations have a locus in EU policy issues only to the extent that the EU policy under consideration is devolved. Where the policy being debated at EU level is not devolved, then the case for a separate or distinctive contribution from the devolved administrations in principle is less persuasive. Notwithstanding this, however, post 1999 successive UK governments have demonstrated a readiness to include the devolved administrations in UK-level discussions of non-devolved policy issues. Indeed it appears that officials from the devolved administrations may be included in any EU policy issue being discussed in Whitehall, with the principal constraint regarding their involvement being the resources they have available to take up such opportunities. Moreover this “inclusiveness” is not confined to the level of officials. As noted above, the JMC machinery has been – and is – used to ensure the devolved administrations remain “in the loop” on prospective UK policy positions across the range of EU issues and not solely those with a clear devolved dimension.

#### **(b) The Post-2007 Situation**

In May 2007 the SNP became the party of government in Scotland. Following the UK general election of May 2010 a Conservative-Liberal Democrat coalition government assumed power. Both results changed significantly the context in which UK policy towards the EU operated.

In Scotland the election of the first SNP government since devolution was expected in some quarters to heighten tension with UK government over EU issues. The SNP had long argued that Scotland’s EU policy interests would be better served as an independent country with its own representation inside the EU. Now an SNP government found it had to work alongside UK government in developing a consensus approach in areas where Scotland’s interests were affected. However the new Scottish government demonstrated that while it would strongly represent Scotland’s interests in UK discussions wherever necessary, it would not use EU policy issues as an excuse to “pick fights” with UK government.

In general the SNP’s main complaint was that the UK government was not prepared to allow a Scottish government Minister to lead the UK delegation to the Council of Ministers, even where the issue under debate principally impacted on Scottish interests. Unsurprisingly the two key policy areas involved were fishing and agriculture.<sup>5</sup>

Elsewhere the main EU-related inter-governmental dispute prior to the change in the UK government was the failure of the latter to conduct a referendum on the ratification of the Lisbon Treaty, a Treaty which the SNP opposed because it formally entrenched protection of maritime stocks as an exclusive competence of the EU.

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<sup>5</sup> The SNP had been a persistent and vociferous critic of the EU common fisheries policy (CFP), arguing that competence for protecting the stocks of North Sea fish should be under Scotland’s (not the EU’s) control.

Although the post-2007 SNP government worked constructively with UK government in ensuring Scotland's EU-policy interests were mainstreamed in Whitehall deliberations, it continued to argue that "independence within the EU" remained the ultimate objective. Certainly the SNP government devoted more resources to EU policy issues than had previous post-devolution administrations. In addition to the appointment of a Minister specifically charged with overseeing EU policy, the first time this had happened since 2003, the SNP government published regular European strategy documents which set out their medium term EU-related policy objectives and framed these against a backdrop of overall economic and social priorities. Moreover the SNP government was prominent in reviving and reforming the JMC(E) inter-governmental machinery, a machinery as already noted that had fallen into abeyance since 2004. There is now considerably more interaction between Edinburgh and London, especially at the Ministerial level, than has been the case for a number of years.

The broad approach of the SNP government to EU issues was one of comparative support, the notable exception being with respect to the CFP where they continued to oppose EU conservation measures which they regarded as excessively prohibitive. However outside of the CFP there was no indication that the Scottish government had a particularly Euro-sceptic pre-disposition. More unsettling it seemed was the junior position that Scottish ministers occupied in terms of influencing UK-level EU policy positions. Accordingly efforts, led by Scotland's First Minister, were made to enhance the "standing" of the devolved administration in the UK's EU policy architecture. The result was a revised Memorandum of Understanding agreed upon in March 2010, the key element of which was a new protocol on dispute avoidance and resolution in EU-related matters. Therefore with respect to EU policy the SNP government demonstrated a broad readiness to engage with UK government in a constructive manner.

Arguably a more significant challenge to the coherence of UK policy towards the EU emerged in the aftermath of the UK general election of 2010. That election resulted in the emergence of a coalition government that was, in its Conservative wing, appeared to be fundamentally hostile to various aspects of the EU and EU policies. This contrasted with the traditional Liberal-Democratic approach which was, in British terms, the most pro-EU of all the main parties. The Tory manifesto had set the tone:

"...there should be no further extension of the EU's power over the UK without the British people's consent. We will ensure that by law no future government can hand over areas of power to the EU or join the Euro without a referendum of the British people. We will work to bring back key powers over legal rights, criminal justice and social and employment legislation to the UK."

The Euro-sceptic tone of the Tory manifesto was further reinforced when, on 9<sup>th</sup> May, the text of a draft memo was leaked which set out the negotiating strategy of a prospective Tory Government in forthcoming EU discussions. In that memo, William Hague asserts he will demand repatriation from the EU of powers over criminal justice as well as social and employment policy during the first term of a Tory government, demands that were certain to bring the UK into conflict with many (if not all) other EU member states.

The memo also reasserted that the Tory Government would place a "referendum lock" on any further powers being transferred to the EU, including the so-called ratchet provisions of the Lisbon Treaty, and stated that the UK "would never join the euro". In the event the new coalition government agreement of 12<sup>th</sup> May settled on a less confrontational approach to EU policy.

Membership of the euro was now ruled out only “in this parliament”, while the demand for repatriation of existing EU competences was watered down to an intention to “examine the balance of the EU’s existing competences”. Doubtless the dilution of elements of the Tory manifesto on EU matters is attributable to the influence of the Liberal Democrats. Nonetheless the so-called “referendum lock” was retained, as was the intention to bring forward a European Union bill that would enshrine in law both the “lock” and the principle of UK parliamentary sovereignty.

It is of course too early to know how relations between the new UK government and the EU will develop. However, if past experience is a guide to the future, one can expect the UK approach to be pragmatic and constructive insofar as UK’s economic and international objectives can best – and in some instances may only – be realised working within the institutional architecture of the European Union. This is true for policies as diverse as concluding international trade agreements, that are clearly to the UK’s benefit, to utilising the EU’s foreign policy authority to achieve outcomes such as preventing Iran acquiring nuclear weaponry, which simply could not be attempted acting singly. If one hallmark of UK membership of the EU since 1973 has been a degree of “awkwardness”, an equally prominent characteristic has been pragmatism. There is little evidence that the new coalition government will depart from tradition in either respect.

Needless to say over the next few years a number of extremely difficult policy issues will have to be tackled by the EU. The aftermath of the 2008 collapse of the financial services sector will continue to bring forward sometimes controversial EU-level regulation and supervisory proposals that will re-shape what has traditionally been member state autonomy in this area. In addition the EU is presently embarking upon negotiations to determine the EU budget post-2013 and we expect this to be an extremely difficult and lengthy process. Not only are the net contributing member states likely to seek to reduce, in real terms, the net size of the EU financial envelope but one can anticipate considerable debate over the continuation of the UK rebate.

Clearly Scotland has a stake in these broader EU issues, albeit in some cases they do not touch directly on devolved policy competences. As noted the current SNP government fully utilises the JMC(E) machinery to ensure Scotland’s EU interests are reflected in the decision-making process within UK government.

## **Section 2: Scotland and the EU – alternative scenarios**

**Andrew Scott**

In this section we consider three alternative scenarios regarding “Scotland in Europe” under different assumptions about the future constitutional position. The first is the business as usual case, although recognising the impact of the Lisbon Treaty reforms of the role of the UK’s devolved administrations in the EU legislative process via the enhancement of the subsidiarity provisions as elaborated in the new Treaty. The second scenario is one in which Scotland sought significant new powers within the devolution settlement and the extent to which EU rules might impact on that discussion. The final scenario is one in which Scotland achieved independence and had to determine its relations with the EU.

### **1. The Status Quo Ante**

As we have already noted, as matters stand Scotland’s EU interests are channelled through the UK Government as the member state. And while Scottish politicians are not entirely devoid of influence on EU matters acting unilaterally – for instance through the legislative activities of her 6 MEPs or via advisory channels such as the Committee of the Regions – in practice the principle route whereby Scotland’s EU interests are represented is via the UK Government. Of course should the UK Government decide to reform the UK internal machinery under which the UK negotiating position on EU legislative and policy proposals is determined to give greater influence to the sub-state nations and regions, this would be entirely within its competence to do so. However other than recognising the importance of this element in the internal EU policy process, and ensuring that all Whitehall Departments adhere to best practice in that regard, it is unlikely that the UK Government would assign to the devolved administrations specific prerogatives which would have to be observed by UK Government ahead of a national negotiating line being agreed.

However with the entry into force of the Treaty of Lisbon, both national and sub-state parliaments across the EU have been given an enhanced role in the EU legislative process. Under the Protocol on the Application of the Principles of Subsidiarity and Proportionality the following provisions apply:

- All draft legislation should contain a statement explaining why the proposal is compliant with the principle of subsidiarity;
- Within eight weeks of the transmission of a proposal for legislation to national parliaments in all the official languages of the EU, any chamber of any national parliament would have the right to send the Council, European Parliament and Commission a reasoned opinion saying why it considers that the proposal does not comply with the principle of subsidiarity. Importantly the Protocol provides that; “...[it] will be for each national parliament or each chamber of a national parliament to consult, where appropriate, regional parliaments with legislative powers.”;
- Where reasoned opinions stating that the proposal is not compliant with the principle of subsidiarity represent one-third of the votes, the Council, European Parliament and Commission (and any other institution which has proposed the legislation) would be required to review the proposal;

- After review, it would be open to the institution which originated the proposal to maintain, amend or withdraw the proposal. It would be required to give reasons for its decision. (i.e. issue a ‘yellow card’.);
- Where the Commission originated a proposal and the proposal was subject to qualified majority voting and co-decision by the Council and the European Parliament, if a majority of national parliaments gave reasoned opinions explaining why they believed that the draft legislation was not compliant, it would be open to the Commission to maintain, amend or withdraw the proposal;
- If it decided to maintain the proposal, the Commission would be required to refer its own and the national parliaments’ reasoned opinions to the Council and the European Parliament. If 55% of the members of the Council or a majority of the European Parliament concluded that the proposal did not comply with the principle of subsidiarity, the draft legislation would fall;
- The European Court of Justice would have jurisdiction to decide cases brought by a Member State on behalf of its national parliament on the grounds that EU legislation infringes the principle of subsidiarity.

The new Protocol has been criticised, principally on the basis that as a matter of parliamentary practice it provides a very narrow window – only 8 weeks – for national and (where appropriate) sub-state parliaments to comment on the EU legislative proposal. Notwithstanding that criticism, as a matter of principle the Protocol notionally empowers both national and sub-state parliaments over prospective EU legislation directly in a new way. Of course the new Treaty does not empower sub-state parliaments as the manner in which these parliaments are consulted – indeed whether they are consulted at all – is a matter for individual member states. However the UK government and parliament has made clear its intention to involve the devolved parliaments and assemblies in the new subsidiarity procedure, although no detailed plans have yet been provided as to how this can be achieved in an effective and timely manner, bearing in mind that the entire process must be completed within an 8-week cycle.

It is therefore premature to assess the impact of the Lisbon Treaty reform on the internal UK EU policy process, or the position of Scotland in that process. Realistically it probably is overly optimistic to expect the new procedure to significantly alter current practice insofar as it empowers parliaments rather than governments (or executives). However we should not exclude the possibility that by empowering the UKs sub-state parliaments and assemblies the new Treaty provisions will also enhance the EU policy bargaining role of the devolved administrations insofar as having overt parliamentary support for their negotiating position would strengthen their hand.

## **2. The EU Dimension of Enhanced Devolution**

The intention of the UK Government to introduce legislation to give effect to the recommendations of the Calman Commission introduces the question of how far devolution of policy competences might be able to proceed while remaining compliant with EU law.

This question has come to the fore particularly in the context of the demands that have been made in some quarters, including by the author, that Scotland's government should have comprehensive authority over the taxes that apply in Scotland with the main exception being Value Added Tax which, it is universally accepted, cannot be levied at different rates across a single member state.<sup>6</sup> Therefore an important issue is to what extent tax devolution might proceed while remaining consistent with EU law.

It is to be stated at the outset that although direct taxation is a matter that remains within the exclusive competence of member states, the EU has in practice acquired not inconsiderable influence over direct taxation through two principle routes. The first is through the jurisprudence of the European Court of Justice when presiding over cases involving tax obstacles to the proper functioning of the EU internal market. That jurisprudence has demonstrated that the EU can require a member state to change its tax laws where these laws impede the free movement of goods, services, capital or labour.

The second route involves the compliance of the direct tax laws of EU member states with EU state aid legislation. Over a number of years, and in a number of cases before the European Court of Justice (ECJ), the European Commission has argued successfully that intra-member state variations in corporation taxation is not consistent with EU rules on state aid. This interpretation has long been upheld by the ECJ, with the result that any decision by a sub-state authority to change favourably the rules governing the application of corporation tax in one jurisdiction may be contested by the European Commission on the grounds that it constitutes a state aid, and is therefore illegal under Art. 107 of the Treaty on the Functioning of the European Union (ex Art. 87 TEC).<sup>7</sup> It is to be stressed that EU state aid rules apply even when a sub-state administration is properly exercising the direct tax powers it enjoys according to the constitution of the member state.

The question therefore arises whether any increase in the direct tax powers available to the Scottish government and parliament, especially corporation tax, would be compatible with EU state aid rules. In a now famous judgement in the Azores Case, the ECJ helpfully elaborated a number of conditions that, should each be met, would represent a situation in which intra-member state variations in direct tax would be consistent with EU state aid provisions.<sup>8</sup> In that ruling the ECJ stated that this would require that the "regional or local authority" must be sufficiently autonomous if the tax measure was to be compliant, with "sufficiently autonomous" being defined as meaning:

- The decision must have been taken by a regional or local authority which has, from a constitutional point of view, a political and administrative status separate from that of the central government;
- It must have been adopted without the central government being able to directly intervene as regards its content;

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<sup>6</sup> This does not preclude formal competence for VAT being devolved, or the yield from the levy of VAT accruing to Scotland's government. However it does preclude Scotland's government setting a different rate of VAT in Scotland than prevails in the rest of the UK.

<sup>7</sup> Of course the exemptions to the state aid provisions of the Treaty also apply with regard to any decision to lower the rate of corporation tax in one part of a member state below that prevailing elsewhere.

<sup>8</sup> Portuguese Republic v. Commission of the European Communities, Case C-88/03

- The financial consequences of a reduction of the national tax rate for undertakings in the region must not be offset by aid or subsidies from other regions or central government. The regional or local authority must assume the political and financial consequences of such a measure.

While these three conditions might still be open to interpretation, in setting them out the ECJ clarified considerably the circumstances under which a sub-state government might apply a corporation tax regime that differed from that applicable across the member state as a whole. The conclusion one would reach with regard to Scotland is that while full fiscal autonomy would be meet the ECJ test of “sufficiently autonomous”, it is unlikely that any model of funding the devolved administrations that combined a direct grant from UK Government with corporation tax varying powers would be compliant. Of course this does not alter the situation in which such a combination would be deemed to be acceptable under one of the exemptions to state aid rules that are set out in Article 107 (3) TFEU.

It is beyond the scope of this paper to conjecture further about various combinations of tax autonomy that might be proposed within the devolved settlement in terms of compliance with EU rules. Two general points are worth noting. First that indeed any such devolved tax powers do have to comply with EU state aid rules as a matter of law. Second it is fairly certain that a situation of full fiscal autonomy – with a Scottish Government responsible for the vast majority of tax and spending decisions made in Scotland would meet the “sufficiently autonomous” test set out by the ECJ in the Azores ruling.

### **3. An Independent Scotland**

It is widely accepted that were Scotland to become an independent nation then as a matter of practical politics it would face a decision regarding its continued membership of the EU. As an independent country Scotland would have three options - (i) full EU membership as an independent member state; (ii) membership of the European Economic Area (EEA) alongside [Iceland](#), [Liechtenstein](#) and [Norway](#); (iii) opting to remain outside either of these arrangements and instead forge a new (free trade based) economic relationship with the EU. In this section we briefly consider the main economic issues that would arise under each of these alternatives.

#### **(a) Independent Membership of the EU**

In economic terms the least disruptive option would be for an independent Scotland to remain inside the EU under virtually identical conditions as exist at present, albeit now as a fully-fledged member state. Scotland would therefore remain an integral part of the single European market and would enjoy all the privileges that flow from, and assume all the obligations that attach to, uninterrupted membership of the world’s largest internal market. As matters stand this is the most likely outcome insofar as there is no significant domestic political movement advocating that an independent Scotland should either leave the EU or join the EEA, or that it should stand outside both the EU and EEA elements of the current European economic architecture. Accordingly this option would, for the main part, appear to be consistent with a “business as usual” strategy at least from the perspective of on-going economic and commercial activity. If this option was preferred, then there is no reason to believe independence would create any new business (and so trading or investment) uncertainties about continued unfettered access to the single EU market – and vice versa.

Independent membership of the EU would, however, impact significantly on the economic policy options facing a Scottish government. This is most obviously the case in terms of macroeconomic policy – i.e. monetary and fiscal policy.

The post-independence monetary policy landscape would be determined principally by the currency question. It is arguable that an independent Scotland would, as an EU member state, find itself bound to join the euro-zone at some later date. However as there is no EU-level mechanism – either constitutional or effective – to enforce any such obligation, we suggest that Scotland’s government would be able to implement its own policy in this area.

Would Scotland join the euro-zone with the euro replacing sterling as legal tender, or would it seek to be of a newly established sterling zone? It is important to recognise that neither option could be delivered unilaterally by a Scottish government. Membership of the euro-zone would (in principal) require that Scotland’s fiscal position conformed to the so-called Maastricht convergence criteria (deficit-to-GDP ratio below 3%: debt-to-GDP ratio below 60%), while membership of a (new) sterling-zone would require a new currency union to be established between Scotland and the rest of the UK which presumably would have its own operating rules with respect to permissible budget deficits and debt levels.

The third option whereby Scotland would establish a new currency separate from sterling or the euro is likely to be regarded as the most risky strategy in economic terms in that, as a small open economy, this would introduce a new set of (currency) risks for those involved in international trade, especially intra-EU trade. However if this option was to be preferred it would in all probability be deemed desirable, from the economic perspective, that the new Scottish currency joined the wider European Monetary System (EMS) in which all other non-euro currencies (except sterling) participate and which ensures any subsequent currency volatility is curtailed by multilateral intervention in the currency market.

As a member of either a “UK” or EU currency union the rate of interest prevailing in an independent Scotland would be determined elsewhere – London, as at present, or in Frankfurt in the European Central Bank. In either case one would expect that Scotland’s monetary policy interests would be represented as is common practice in most “monetary unions” comprising multiple federal (or trans-national) interests. Whether membership of either monetary union would benefit Scotland in strict economic terms is unknowable. Much would depend on the costs and benefits of the economic (especially fiscal policy) rules attaching to membership and, of course, the extent to which the monetary policy decisions taken for the monetary union as a whole are appropriate for the economic conditions in Scotland.

In terms of fiscal policy, Scotland would acquire from independent EU membership considerably more powers to determine the structure and rates of domestic taxes. With the exception of VAT, where membership imposes obligations both on tax rates and tax base, the EU treaties recognise the sovereignty of member states in the area of tax policy. However, as has become clear, this does not mean that EU membership has no implications for national rules on taxation. There are two areas where EU membership directly and significantly impacts on national tax systems. The first are tax measures that interfere with the operation of the single internal market; the second are tax measures that run counter to EU state aid laws. A third area concerns the informal discussions between EU member states since the late 1990s to avoid engaging in competitive measures to reduce the burden of direct taxes – particularly corporation tax – in order to attract internationally mobile capital.

However to date no “hard law” has emerged from these discussions with the result that any agreements reached under these discussions are in essence voluntary.

The most significant fiscal policy opportunity that would accompany “independence in the EU” is the ability to establish a direct tax regime (income and corporation taxes) that is consistent with the economic objectives of a Scottish government. In other words the restrictions to the exercise over autonomy in tax matters bearing upon Scotland as a devolved administration no longer would apply. However it is fair to suggest that the rate of taxation that applies in member states – particularly corporation tax – increasingly has become an issue of “common concern” to other member states in recognition of the scope for a country to adjust corporation tax in order to attract internationally mobile capital to the detriment of their partner member states. In terms of macroeconomic policy it is clear that independent membership of the EU would not bestow on a Scottish government an absolute effective sovereignty with respect to monetary and fiscal policy. As an independent EU member state both monetary and fiscal policy decisions would be constrained by familiar EU-wide obligations which are reflective of the economic interdependencies attaching to membership of a single EU market and the aspirations of the EU as defined by the Treaties. Of course most of these obligations already determine the economic and commercial environment in which Scotland operates.

The EU microeconomic environment refers to the wide range of economic policies for which competence is shared between the national and EU levels of government, and those policies over which the EU enjoys exclusive competence. The principal change that would arise under “independence in the EU” is that Scotland’s policy interests would be directly represented at the EU level by Scotland’s government rather than as one element in the overall UK policy stance as is presently the case. The issue of whether an independent Scotland “at the top EU table” would be better placed to represent its interests, or whether being part of the delegation of one of the EU’s largest members gives it policy leverage that otherwise would not be available, is a matter of debate. However, from a strictly economic perspective, given that an independent Scotland would always have the opportunity of aligning itself with the negotiating position of the “new” UK delegation when circumstances dictated this to be the optimal strategy but taking an alternative position when this was not the case, it is difficult to argue that independence would lead to a diminution of Scotland’s influence over EU policy negotiations.

Clearly there is a substantial range of EU economic (and other) policy issues over which negotiating competence would fall to a Scottish government under independence, many of which presently are outwith the remit of the on-going EU policy-related discussions between the devolved administration and UK government that were established in 1999. It is beyond the scope of this paper to examine these.

#### (b) Membership of the European Economic Area

Dating from 1992, the European Economic Area (EEA) agreement was negotiated between the EU and the (then) six members of the European Free Trade Area (EFTA). The EEA is an economic agreement under which the (now) three EEA countries (Iceland, Liechtenstein and Norway – Austria, Finland and Sweden having joined the EU in 1995) enjoy full participation in the EU internal market despite their status as non-member states. Accordingly the EEA provides for the free movement of goods, persons, services, and capital between the EEA countries and the EU.

However the counterpart obligation is that the EEA countries adopt all EU laws relating to the operation of the internal EU market – including competition and state aid law, environmental policy, consumer protection, social obligations, etc. The EEA countries are also required to make a financial contribution to the EU budget under the aegis of contributing to social and economic cohesion in the internal market.

A recurring critique of the EEA is that its member states are obliged to accept the economic laws of the EU insofar as these relate to the internal market but have no influence over the content of these laws. While the EEA countries – singly and collectively – engage in wide ranging economic diplomacy with the EU institutions, the stark fact remains that the EEA countries are not represented in the EU institutions and therefore take no part in the EU legislative (or judicial) process.

On the other hand EEA countries are not bound by the wide range of EU economic policies that lie outside the internal market remit. On issues such as international trade, climate change policy, energy policy, and agricultural and fisheries policies these countries are able to pursue their own strategies which may, or may not, be consistent with EU measures in these areas. Accordingly as an EEA member Scotland would be in a position to conduct its own international commercial diplomacy over almost all matters that did not touch on internal market prerogatives.

Similarly EEA countries are not subject to EU-level constraints to the operation of their macroeconomic policies. Fiscal policy decisions therefore need not conform to the edicts of the EU Stability and Growth Pact, albeit these will be restricted by the normal financial tests applied by the international capital markets as reflected in the premium attached to changes in the level of outstanding public debt. However as many of the restrictions impacting upon direct taxes are directly related to the internal market, EU obligations do constrain specific elements of national tax arrangements in EEA countries.

Similarly monetary and exchange rate policies will not be subject to the direct or indirect consequences of membership of the euro-zone or of the looser EMS. At the same time, of course, monetary and exchange rate policy will not benefit from the certainties provided by such membership. Accordingly membership of the EEA would necessitate Scotland's government making a decision between following a monetary policy aimed at achieving a domestic economic objective (such as stable prices) or a monetary policy that was targeted at delivering exchange rate stability against a particular currency, almost certainly the euro. If the EEA option was pursued this would be one of the key economic decisions confronting a Scottish government.

An important point to note is that EEA members have no influence on the direction in which EU internal market legislation is moving, or on the speed at which it is moving. This is important insofar as the EU is recognised as a very powerful economic regulator with competence to enact measures that regulate – or re-regulate – the internal EU market. Presently the EU is active in fundamentally overhauling the manner in which the single EU financial market is regulated and supervised. The new arrangements will be binding on an extensive range of financial services and financial service providers, regardless of their country of origin. Inevitably this will have consequences for financial service providers in the EEA countries, as it has done in the past (especially in the area of harmful tax competition).

This reinforces the view of many commercial concerns in the EEA countries that they have no influence in designing the new regulations that will impact considerably on specific sectoral interests. And while financial re-regulation may be regarded as a special case, it nonetheless illustrates very starkly the role of the EEA countries as “law-takers” rather than “law-makers”. An independent Scotland in the EEA would find itself in exactly this situation.

(c) Independence outside the EU and EEA

In economic terms this is probably the least desirable option in that it is likely to introduce the greatest degree of uncertainty to – and therefore be the most disruptive of – Scotland’s on-going commercial and trading interests. This is important in that it is estimated that over one-half of Scotland’s trade presently takes place with other EU member states. Any decision that raises uncertainty as to the future economic relations between an independent Scotland and the EU inevitably will create uncertainties that will impinge on the wider economy.

Switzerland perhaps provides a parallel for the position in which an independent Scotland might find itself as neither an EU member state nor a member of the EEA. Economic relations between Switzerland and the EU are determined by a series of bilateral treaties and dispute resolution arrangements, which augment the EU-related economic agreements that extend to Switzerland as a member of the European Free Trade Agreement (EFTA). Were Scotland to join EFTA it would retain free trade relations with the EFTA countries and, like Switzerland, secure certain free trade arrangements with the EU that while important fall short of those available as a member of the EEA.

In practice, as far as economic issues are concerned, the position that Switzerland holds vis-à-vis the EU is little different from that of the EEA members. Where there are differences these tend to be inter-institutional and reflect the particular democratic tradition of Switzerland in terms of with whom the ultimate locus of constitutional power resides. Moreover the Swiss-EU situation reflects the long history of economic and political engagement between the two partners and in that sense may not represent a relationship that would meet the economic interests of a Scottish government. Nonetheless it provides an option short of EEA membership that could be considered.

If for whatever reason the option of EEA or EFTA membership was to be rejected, an independent Scotland would find itself in the position of negotiating a new set of agreements with the EU with all the difficulties this entailed. Unlike membership of an existing external country grouping, this approach would be subject to possibly lengthy negotiations and surrounded by considerable uncertainty. It is very likely that such a stance would deter foreign investment coming to Scotland, and compromise that investment already in Scotland. Indeed, such are the economic risks associated with such a strategy that it is unlikely to be one advocated by any mainstream political party.

# Ireland's Experience in the Euro

Rory O'Donnell

## 1. Introduction

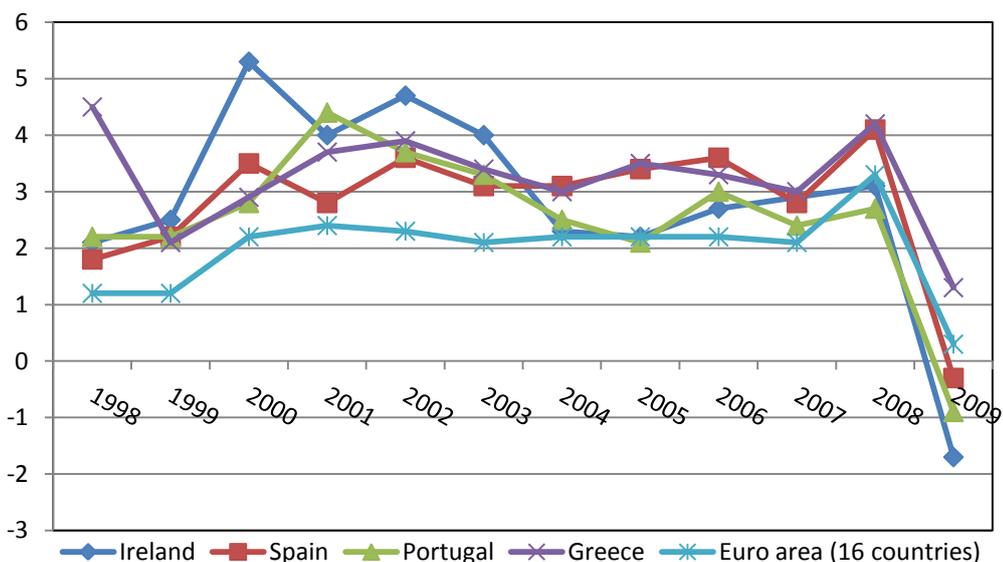
The text below describes and discusses Ireland's experience within the euro since its creation in 1999. It consists of extracts from the recent report of the Ireland's National Economic and Social Council *The Euro: and Irish Perspective* (NESC, 2010). Section 2 outlines the key elements of Ireland's experience in the euro from 1999 to 2010. Section 3 considers the policy instruments that Ireland could have used to address the emerging imbalances in the national economy. The factors that shaped Irish fiscal policy are explored in more depth in Section 4, highlighting the combination of technical issues that were *uncertain* and political economy issues that were *unresolved*. The full report can be downloaded at [http://www.nesc.ie/dynamic/docs/NESC\\_121\\_Euro.pdf](http://www.nesc.ie/dynamic/docs/NESC_121_Euro.pdf)

## 2. Key Aspects of Ireland's Experience in EMU

In the late 1990s, the Irish economy was experiencing strong growth, balanced between growth of exports and domestic demand. Over the subsequent decade, growth became increasingly driven by domestic demand, although growth of services exports remained strong.

The first decade following the establishment of monetary union in 1999 saw moderate economic growth in the euro area; GDP grew by an annual average of just over 2 per cent over the period 1999 to 2008. Germany and Italy had below average growth, while three of the four geographically peripheral countries of the euro area (Ireland, Spain, and Greece) experienced above average growth; Portugal had weak growth. Inflation in the euro-area averaged 2.2 per cent over the first decade (1999 to 2008), according to the standard EU measure, the Harmonised Index of Consumer Prices (HICP). Ireland, Spain, Greece and Portugal all experienced above average inflation rates. Ireland's inflation averaged 3.4 per cent (as measured by the HICP) over the period 1999 to 2008 (see Figure 1). The cumulative increase in consumer prices over the period 1999 to 2008 was almost 36 per cent in Ireland, considerably higher than the cumulative increase of 23 per cent in the euro area.

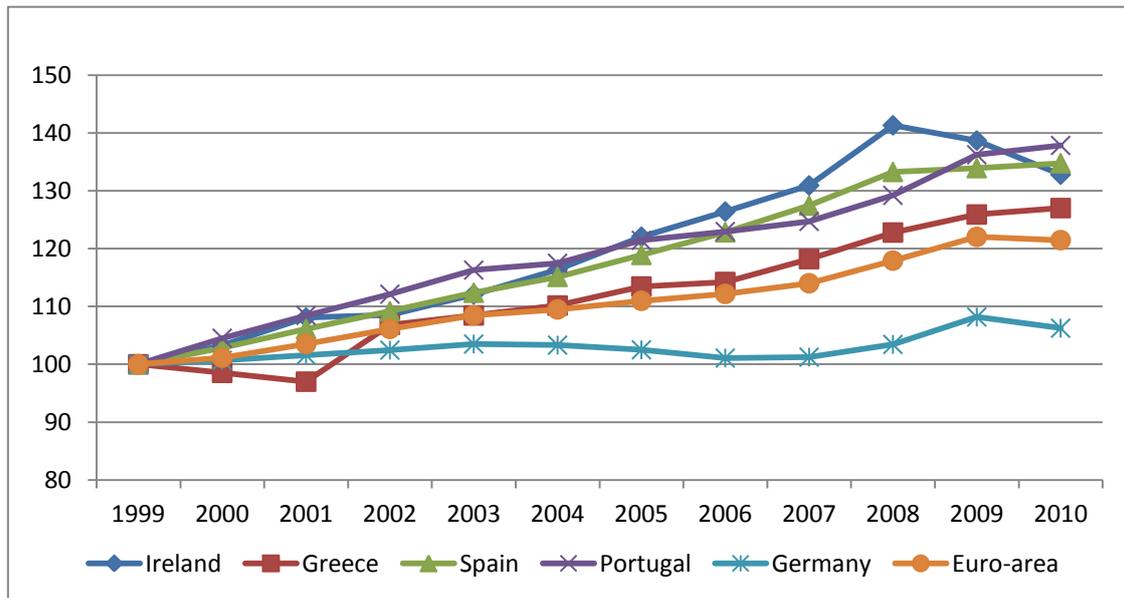
**Figure 1: Annual Rate of Inflation (HICP) 1998 to 2009**



**Source:** Eurostat

Ireland experienced a loss of cost competitiveness in monetary union. In varying degrees, a loss of cost competitiveness was also the experience of the other peripheral countries. Between 1999 and 2008, nominal unit labour costs in Ireland on an economy-wide basis (i.e. nominal labour costs per employee adjusted for growth in GDP per capita) increased by over 41 per cent, far more than the average increase in the euro-area of 19 per cent. Wage growth in the euro-area was depressed by the exceptionally low wage growth in Germany in this period. Since 2007, sterling weakness has meant a pronounced loss in cost competitiveness for Ireland against the UK. The euro/sterling exchange rate increased from 0.66 in January 2007 to 0.83 in June 2010, an appreciation of 26 per cent. During 2009 and 2010, Ireland has experienced a significant reduction in unit wage costs.

**Figure 2: Index of Nominal Unit Labour Costs in Euros 1999=100**

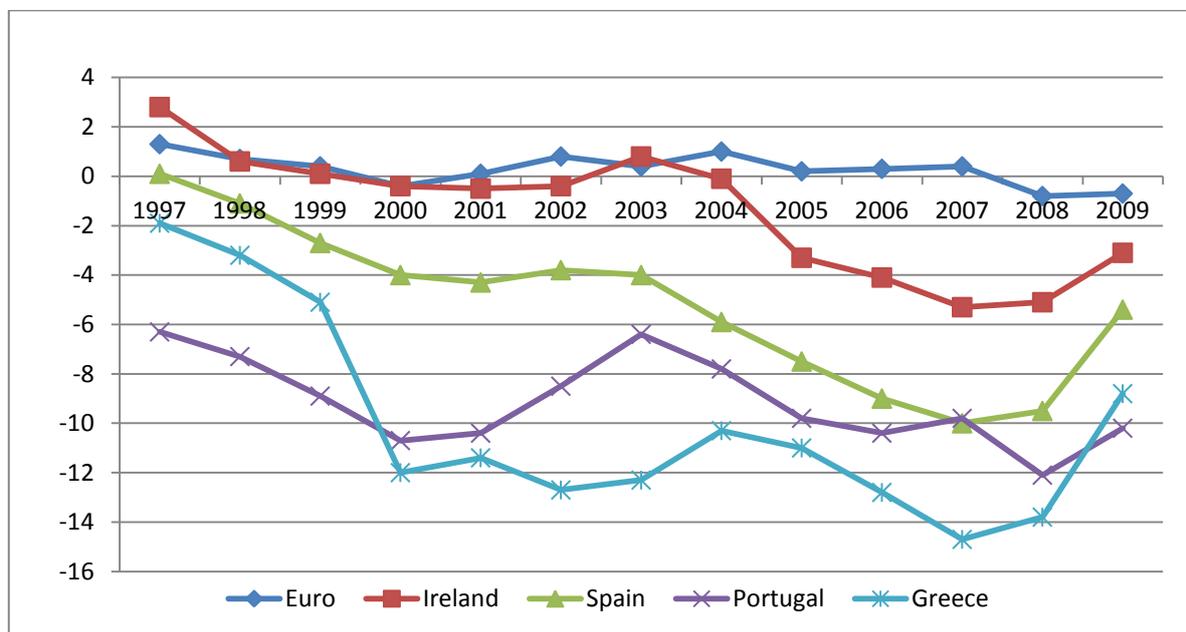


**Source:** European Commission, AMECO database.

Ireland's export growth slowed considerably in the past decade, compared to the exceptionally strong growth of the 1990s, but remained ahead of the euro-area average. Greece also experienced above average export growth (6.2 per cent), while Spain and Portugal had below average growth.

The euro-area has had approximate balance in its current account balance of payments since the establishment of monetary union. However, as noted above, surpluses in countries such as Germany have been offset by deficits in some of the peripheral member of the euro-area (Ireland, Spain, Greece and Portugal). Ireland's deficit peaked at over 5 per cent of GDP in 2007, a lower level than that experienced in the other peripheral countries. The balance of payments moved into substantial deficit in both Greece and Portugal in the late 1990s.

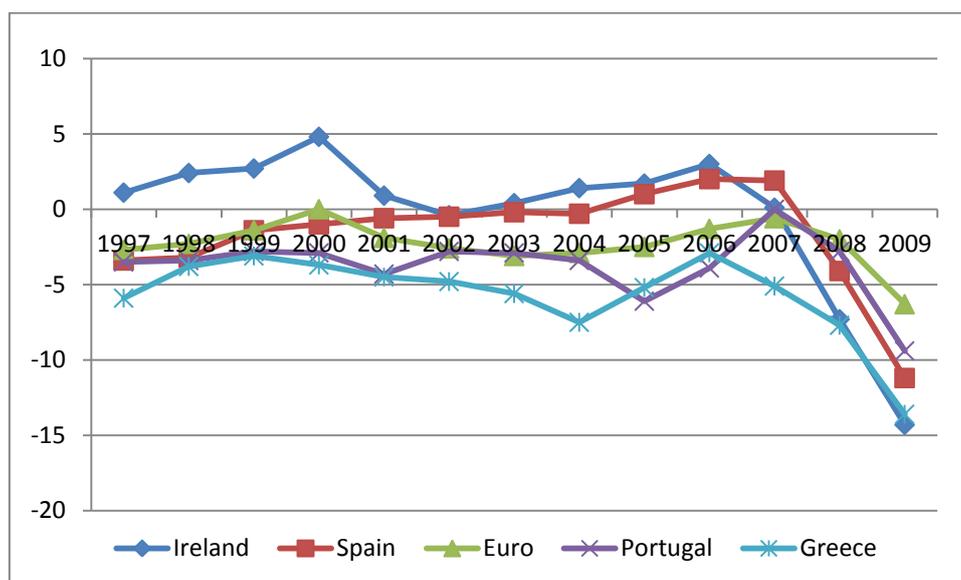
**Figure 3: Current Account of the Balance of Payments Percentage of GDP**



**Source:** European Commission, *European Economy*, Statistical Annex Autumn 2009.

Across the euro-area, the public finances typically showed moderate deficits up to the current crisis (see Figure 4). Ireland and Spain did not have obvious problems in the public finances up to the crisis; in the case of Ireland, the public finances were in surplus for virtually every year since 1999, although there was a sharp fall in the surplus in 2001. Ireland's surplus existed after paying for annual public capital investment of 4 to 5 per cent of GNP. Ireland's government savings (an EU measure of the state's current budget balance) averaged 6 per cent of GDP over the period 1999 to 2007, while the corresponding figure for Spain was 5 per cent of GDP. Greece and Portugal had deficits throughout this period. The German public finances were also in deficit for most of the past decade; the German public finance balance closely tracked the euro-area average.

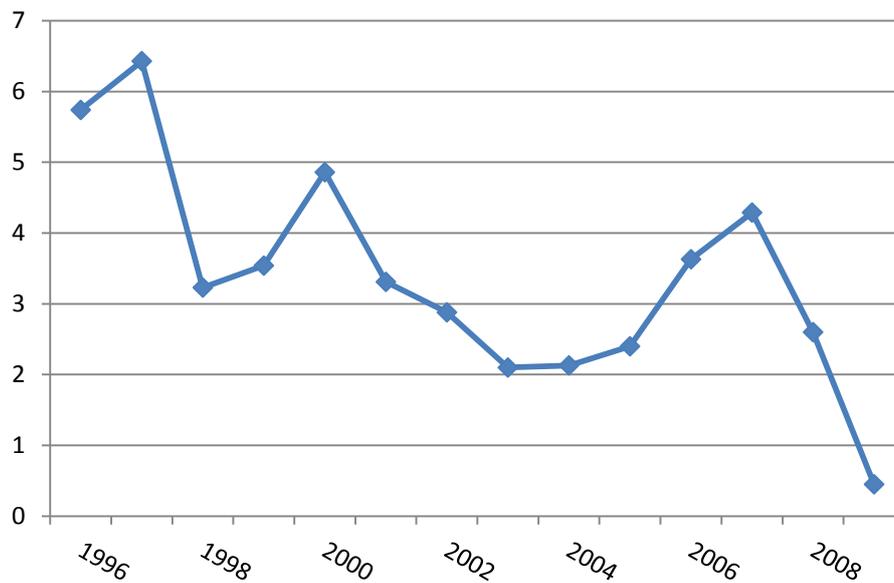
**Figure 4: General Government Deficit as a percentage of GDP 1997 to 2009**



**Source:** European Commission, *European Economy*, Statistical Annex Autumn 2009 and Eurostat news release, 22 April 2010.

A fall in interest rates, in both nominal and real terms, was the most significant channel through which membership of monetary union influenced Ireland and the other countries on the periphery (see Figure 5). Conefrey and FitzGerald, 2010 identify two ways in which monetary union affected borrowing in Ireland and Spain. First, it eliminated the exchange rate premium over Germany rates. Second, the banking systems in both Ireland and Spain were not constrained by exchange rate risks in raising funds abroad. There was a sharp increase in the net foreign liabilities of Irish banks from 2003 onwards. In the case of Spain, the timing of financial liberalization was different and there was an increase in net foreign liabilities of the banking sector from the late 1990s. The ability to raise funds abroad at low costs facilitated the funding of large housing and construction booms countries. Above average inflation also contributed to lower real interest rates and further reinforced demand pressures. In addition, the liquidity in the global monetary system contributed to sustaining low interest rates and the availability of funds.

**Figure 5: Ireland: One-month Interbank Interest Rate**

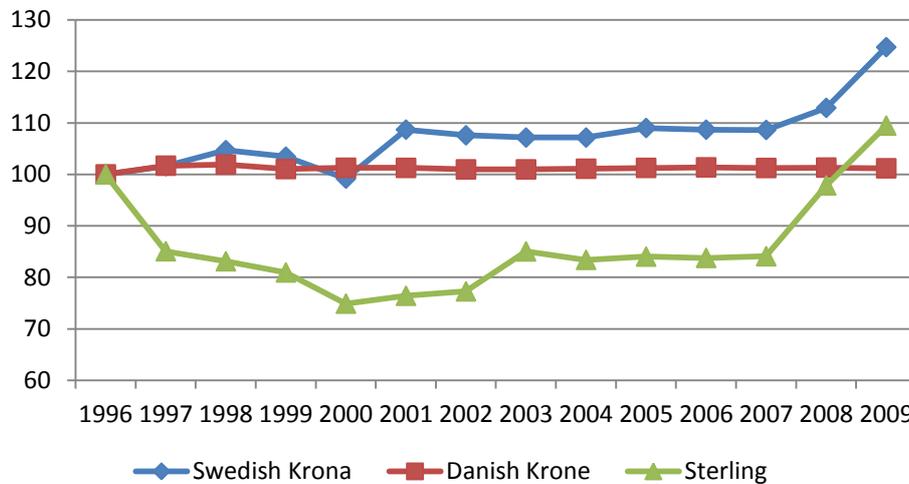


**Source:** Central Bank and Financial Services Authority of Ireland, *Quarterly Bulletin*, various issues.

In the transition to the euro in late 1990s and continuing into 2000, Ireland experienced a substantial depreciation in its exchange rate. Ireland's nominal effective exchange rate depreciated by 17 per cent from late 1996 to 2000, due to the strength of the dollar and sterling, as well as a policy decision to manage down Ireland's exchange rate within the ERM in preparation for monetary union (Lynch, 2008). This boosted economic growth and is identified by Honohan and Lane 2004 as the driver of Ireland's above-average inflation in the early years of the euro. Low interest rates also contributed to inflationary pressure, as did fiscal policy. In particular, the sharp fall in the general government deficit in 2001, of almost four percentage points of GDP, created inflationary pressure in advance of the housing and construction boom.

In the past decade there was considerable volatility in the euro/sterling exchange rate. Between January 2007 and June 2010, the net increase in the value of the euro against sterling was 26 per cent. The exchange rates of the euro against other EU member state currencies have typically been more stable. Some EU currencies have been tightly managed to closely track the euro; the example of Denmark is shown in Figure 6. The Swedish krona has not been managed within a tight band but has been less volatile than sterling.

**Figure 6: Index of the euro against the Swedish Krona, Danish Krone and Sterling 1996=100**



**Source:** European Commission, *European Economy*, Statistical Annex Spring 2010.

A major feature of the Irish economy during the current decade was the housing and construction boom and subsequent collapse. Second-hand house prices doubled between 1999 and 2005. Irish incomes had approximately converged with the EU average by the turn of the century but the housing stock relative to the population was substantially below the EU average. Growth in house prices stimulated a major increase in housing output. By 2005 construction accounted for 13.9 per cent of Irish GDP. This was exceptionally high both by historical Irish standards and compared to other countries. The share of construction in Spain which also had a housing boom reached 8.9 per cent of the economy in 2005 while in the UK housing was only 3.9 per cent of GDP (Conefrey and Fitz Gerald, 2010).

While there were good reasons for strong growth in house prices in Ireland, Irish house prices grew well ahead of what could be explained in terms of fundamental economic factors. Kelly, 2009 has emphasized the extent to which house prices were driven by very strong growth in credit (see Table 2). Lending by Irish banks to the Irish private sector (individuals and businesses) increased almost five fold between 1999 and 2008 to reach €367.1 billion by 2008. This was far ahead of the expansion of the economy. In 1999, lending represented approximately 100 per cent of GNP while by 2008 it had risen to 237 per cent of GNP. The expansion of lending relative to the size of the economy was particularly strong between 2003 and 2008. Lending outstripped the growth in deposits of Irish banks so banks became increasingly reliant on lending from abroad. The net indebtedness of Irish banks to the rest of the world increased from 10 per cent of GDP at end of 2003 to 60 per cent of GDP by 2008 (Honohan, 2009). A particular feature of bank lending was a high concentration in commercial property.

**Table 2: Trends in Lending of Irish Banks**

	<b>1999</b>	<b>2003</b>	<b>2008</b>	<b>2010 (April)</b>	<b>% change 2003 to 2008</b>
Loans to Irish private sector	€76.9	€143.8	€367.1	€328.4	155.3
Loan to GNP ratio	100.1	121.8	237.5	255.6	95.0

**Source:** Central Bank, *Quarterly Bulletins*, Tables C4 and C5; based on balance sheets of retail clearing banks and non clearing domestic banks. The private sector in this table excludes the government sector and monetary financial institutions.

Why did Ireland experience such a pronounced expansion in credit and associated housing and property bubble? This has been the subject of two reports commissioned by the Minister for Finance (Honohan, 2010; Regling and Watson, 2010). These reports identified a series of domestic and external factors that caused the crisis. The report by Honohan, Governor of the Central Bank, identifies both global, contextual, factors and domestic conditions. First, the period after 2003 was characterised by very liquid conditions in global financial markets, in which financial intermediaries searched for higher yields. Second, as noted above Ireland's entry to the euro saw Irish interest rates fall. The euro made it easier for Irish banks to raise funds across borders. Third, there was also increased competition at retail level in European countries, particularly in peripheral countries and the new member states. In Ireland, this took the form of the subsidiaries of UK banks becoming more active in the Irish market; these subsidiaries offered mortgages at a small premium to money market rates and also offered 100 per cent loan to value mortgages (Regling and Watson, 2010). Internally, the major banks in Ireland also experienced strong competitive pressure from Anglo Irish Bank. Fourth, globally the fashion in financial regulation saw 'some shift away from intrusive supervision, and also a relative neglect of liquidity risks' (Regling and Watson, 2010: 36).

This environment posed major challenges for Irish banks and it is clear that the challenges were not met. Irish banks relaxed their lending standards and funded the huge housing and property bubbles. The role of Irish policy in contributing to these problems is discussed in Section below.

### **3. Potential Irish Policy Instruments in EMU**

#### **3.1 Focus on National Policies and Systems**

During the boom of the past decade, membership of monetary union implied that neither the exchange rate nor Irish interest rates could not be adjusted to moderate the boom or alter relative prices.

There are a number of alternative policy instruments that could have been used for this purpose: aggregate fiscal policy, targeted fiscal policy, financial regulation and planning and land management. Each of these is now discussed.

### **3.2 Aggregate Fiscal Policy**

First, fiscal policy could have been used to offset some of the very strong private demand in the economy. (Fitz Gerald, 2010) has pointed out that, given the conditions in the Irish economy during the recent boom, a rising surplus would have been appropriate: ‘a continuing structural surplus has a neutral impact on the economy. It is only as the structural surplus rises, and as increasing sums of money are taken out of an economy, that the impact of fiscal policy is to reduce (excessive) demand’ (Fitz Gerald, 2010: 3). It is interesting to consider what policy and/or analytical process might have led to such a policy in real time. The fiscal policy pursued during Ireland’s economic boom is discussed in Section 4 below.

### **3.3 Targeted Fiscal Policy to Moderate the Construction Boom**

Second, it would have been possible to use instruments targeted at the excess demand in the housing market. Relevant measures include: the ending of property tax reliefs or mortgage interest relief, the introduction of a property tax (Fitz Gerald, 2001 and Fitz Gerald *et al.*, 2005). In the discussion of possible UK entry to monetary union, Muellbauer, (2003) pointed to the beneficial stabilising effects of both property and land taxes; he suggested that the Danish land tax helped to increase land supply counter cyclically. Muellbauer proposed that the rate of the property tax would be set by Monetary Policy Committee of the Bank of England, analogous to the setting of interest rates.

### **3.4 Better Financial Regulation and Supervision**

Third, in view of the critical role of excessive credit creation in driving the economy, better financial regulation could potentially have helped limit the excessive growth of demand. Financial regulation is also critical in terms of maintaining the solvency of the financial system.

The role of financial regulation in Ireland’s banking crisis is the central focus of the Honohan (2010) report and also features in the Regling and Watson (2010) report. While placing the major responsibility for the banking crisis on directors senior bank management as well as significant responsibility on fiscal policy, Honohan’s report states that ‘it is clear that a major failure in terms of bank regulation and maintenance of financial stability failure occurred’ (Honohan, 2010: 7). Significant weaknesses in both micro-prudential and macro-prudential regulation are identified. Honohan found that there was awareness of risks internally from excessive expansion of property related credit and actions were initiated to address these risks. The Regling and Watson report noted that the Irish authorities were more active than many supervisors in other property boom economies in their decision to impose heavier capital weights on high loan-to-value mortgages. However, Honohan considered that the actions taken were ‘tentative and timid’ and ‘implemented too late and were wholly inadequate to alter behavior’ (112). Honohan found that there was a tension, never fully resolved, ‘between the need to stop the excesses and the fear that too sharp an intervention would send the economy into an avoidable tailspin’ (122). Key actions such as banning 100 per cent mortgages would have encountered consumer resistance and run counter to the then prevailing international regulatory fashion.

In addition, Honohan identifies three specific interrelated concerns that seem to have militated against more decisive action by the Financial Regulator:

- that stronger regulatory action would have adversely affected the competitiveness of credit institutions in Ireland;
- that stronger regulation would have adversely affected Ireland as a location for financial services investment; and

- that more aggressive use of key instruments to restrain lending would have been contrary to the spirit of principles-based regulation.

Honohan does not accept that these were valid reasons for avoiding stronger action.

### **3.5 Planning and Active land Management**

The impact of investment in housing was shaped by policies on planning and land management and more effective policy in this area could have secured better outcomes. Housing demand was artificially stimulated in areas of low underlying demand while the supply response was slower than desirable in and close to Dublin city (NESC, 2004).

### **3.6 A Combination of Fiscal, Regulatory and Structural Measures**

With a range of possible tools available during the economic boom, the question arises as to what would have been the best combination of measures to adopt. There is no doubt that higher surpluses in the public finances during the boom years would have been desirable and some euro-area members had higher surpluses. However, what was distinctive about Ireland's experience was not the surplus in the public finances during the boom, but the speed of decline in the economy and the public finances when the economic crisis occurred. This suggests that in the first instance it would have more important to avoid the excessive private lending and property investment rather than seeking to offset excessive private lending and property investment with higher government saving. This implies measures targeted at restraining the housing boom and stronger financial regulation. A potential limit to the scope of regulation within Ireland arises from the ability of institutions not regulated by the Irish central bank/financial regulator to meet demand for credit, if it were not provided by Irish-regulated institutions (Conefrey and Fitz Gerald, 2010). Honohan considered the issue of the competitiveness of Irish regulated institutions, but nonetheless found that 'decisive intervention could have made a major difference to the length and extent of the property boom' (Honohan, 2010: 13).

In the crisis of 2008-10, the pace of decline in the public finances was even greater than the decline in the economy. Ireland's tax structure had become increasingly dependent on cyclically-sensitive taxes (corporation tax, stamp duty and capital gains tax): the share of these taxes in exchequer tax revenue increased from 8 per cent in 1987 to 30 per cent in 2006 (Honohan, 2010). A more stable tax structure could have significantly reduced the extent of the revenue downturn in the economic crisis.

## **4. Factors Shaping Ireland's Fiscal Policy in EMU**

The principles which should govern the fiscal policy of a small member state in EMU are relatively clear. First, as noted above, fiscal policy must be seen as the major instrument for stabilisation. Second, the ideal is to run sufficiently large surpluses during boom periods in order to finance the loss of revenue and increased spending commitments during downturns. This means that automatic stabilisers will be available.

Third, the optimal deployment of fiscal policy for macroeconomic stabilisation is consistent with either a large or small public sector and tax share of GDP. Fourth, in addition to the overall macroeconomic stance, fiscal policy can also operate via microeconomic channels, such as incentives to the property sector, taxes on employment and measures to influence consumption.

The application of these principles was not straightforward in the past decade, for reasons discussed below. NESC argues that if we are to learn from this episode it is important to reflect carefully on the thinking and pressures that shaped fiscal policy. Reflecting on the experience of the past decade, it suggests that while some things were *uncertain*, other, closely related, issues were *unresolved*. Technically, there was *uncertainty* about three related, but critically important, factors:

- The difficulty of judging the temporary and permanent elements of GDP growth (i.e., estimating the ‘output gap). This required assessing the relative size of three possible drivers of output growth: the genuine expansion of Ireland as a regional economy, the economic cycle and an asset price bubble;
- Distinguishing the temporary versus permanent components in the tax base—a partially separate question because of reliance on asset-based taxes; and
- The timing of the end of the housing boom and, among some, disbelief that it was fundamentally temporary in nature.
- These technical uncertainties interacted with, and partly reflected, lack of agreement on key dimensions of Ireland’s political economy concerning:
- The appropriate scale of the public sector—since part of the expenditure growth since the late 1990s may be attributed to catch-up dynamics and trend shifts in the size of the Irish public sector;
- The organisational and accountability system necessary for high-quality, responsive, public services, the scale of which was increasing;
- The appropriate level and incidence of taxation;
- The best way of meeting increased housing need and the associated approaches to housing and land management; and
- The sources of Ireland’s long-term prosperity and the steps necessary to move to the innovation-driven stage of development.

The tax windfall created by the property boom allowed the contested issues to be glossed over and the bigger picture to fade from view. The abundance of tax revenue, the employment and income effects of hyper-growth and the surge in construction meant that many of the pressures, listed above, could be partially met, but in ways that were ultimately inconsistent and unsustainable.

Indeed, the eventual crisis revealed both the mistaken assumptions which underpinned fiscal policy at certain moments and, once again, the cost which the country pays for lack of shared understanding and effective policy on key macroeconomic, distributional and structural issues. In this context, *aggregate fiscal policy was shaped by its components*: capital spending, current spending, public saving and taxation. In the context in which technical issues were uncertain and political economy issues were unresolved, the macroeconomic perspective on fiscal policy was relatively muted.

Consequently, the policy lessons of Ireland’s first decade in EMU are both hard and wide. While they apply, first and foremost, at national level, there are undoubtedly important lessons for EU-level policy actors. At national and euro level they would seem to include both medium-term and immediate elements:

- (a) The need to adhere to principles of counter-cyclical and sustainable fiscal management;
- (b) The need to ensure disciplined banking supervision in a context of capital mobility;

- (c) A more thorough resolution of the distributional tensions and structural weaknesses that tend to create pressure for pro-cyclical fiscal policy and, indeed, crowd-out clear analysis of the macroeconomic context.
- (d) The need to avoid destabilising bubbles and cross-border imbalances in both the national and European economy.

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## European integration – Norwegian experiences

Ulf Sverdrup

### Introduction

Norway is not a member of the European Union (EU). However, during the last two decades the Norwegian economy and society have been hooked up to the European integration process, blurring the distinction between member states and this non-member state. It is well documented that the EU and the integration process have had a significant impact on the policies, politics and polities of its member states: and Norway's experience demonstrates that the EU also impacts strongly on non-member states.

According to a range of parameters, Norway has become closely integrated with Europe - in fact, in certain areas Norway is more integrated with the EU than some of the member states. In this short article I will briefly present how the EFTA countries are linked to the EU. I will also report on some of the experiences of this mode of association. Towards the end I will briefly discuss the sustainability of these ties, and reflect a bit on the attractiveness or feasibility of this "model" for other countries.

### I

The EFTA countries are members of an exotic "club" in Europe. Norway, Switzerland, Iceland and Liechtenstein are rich, industrialized, democratic countries, with open economies that are highly dependent upon international institutions and rules. Their cultures are (West) European. Switzerland and Liechtenstein are in the geographical centre of Europe, while Norway and Iceland are on its northern periphery.

One of the things that set these countries apart from other non-EU member states is that they have so far preferred to stay outside of the Union, although they would have qualified for EU membership, at least in the sense that they all meet the Copenhagen criteria. At a first glance these countries could be regarded as mice of a special breed in a political laboratory conducting experiments on the significance of different ties to the EU. (Un)fortunately, the metaphor does not hold.

During the last two decades these countries have developed very close ties to the EU, disqualifying them from being sorted as a being of a special kind. Due to their membership in the European Economic Area (EEA) and a range of other bilateral agreements, they are almost half-way member states. (Switzerland is not a member of the EEA but has 120 bilateral agreements with the EU).

Moreover, we should be careful not to overrate the significance of formal ties to the EU for the developments in domestic economy and society. Whereas Norway has experienced a long period with strong economic development, high growth, low unemployment and expansion of welfare benefits, Iceland, another EEA EFTA country, is currently experiencing a deep financial, economic and political crisis.

The wide-ranging EEA agreement was created in response to the development of the internal market in the early 1990s. It ensures that Norway is more or less a member of the internal market – with free movement of goods, services, persons and capital.

However, major areas are not covered by the agreement, the most important being agriculture, fishery, taxation, structural funds and the economic and monetary union.

The basic purpose and principle of the EEA is the notion of homogeneity, that is, rules should be similar and they should be interpreted in a similar fashion. In order to achieve homogeneity the EEA agreement is dynamic. This means that as soon as the EU makes rules and regulations that are considered relevant for the EEA, these rules should be incorporated into the EEA.

Norway and the other EEA EFTA countries have no formal vote in the decision making bodies of the European Commission, the Council or the European Parliament, although the EFTA countries – acting with one voice - have a formal right to reserve themselves against new rules and regulations. So far, this right has never been used.

Since the signing of the agreement almost two decades ago we have observed a considerable expansion of the scale and scope of the EEA legislation. At the time of signature the EEA covered around 1500 legal acts, and since then more than 6000 legal acts have been added at a fairly steady and stable rate. As such, the EEA is an innovative framework for, on the one hand, transferring, or “downloading legislation”, and on the other hand, monitoring and surveillance. In order to ensure compliance with EEA rules and regulations two independent institutions were set up, the EFTA Surveillance Authority – a “mini” European Commission – and the EFTA court, a “mini” European Court of Justice. These bodies are also supposed to follow the same procedures and to make decisions and rulings that are in harmony with their larger EU brothers and sisters.

The EEA is by far the most important and extensive formal agreement between Norway and the EU. However, during the last decade a number of other agreements have been established linking Norway closely to the EU with cooperation in the field of Justice and Home Affairs, as well as the Common Security and Defence policies. Norway is for instance a member of the Schengen Agreement and the Dublin Agreement, and even participates in the EU’s military operations and battle groups. By contrast, some EU member states do not participate in this kind of co-operation.

## II

Let me now turn to some of the experiences with the EEA. The general assessment is that this agreement has served Norway fairly well. It has served as a stable framework reducing uncertainty and transaction costs in Norway’s relationship with the EU. As such the EEA has been an effective problem solving mechanism.

In addition, and perhaps equally important, the EEA has served as a stable compromise in a deeply contested issue in domestic politics. Although most parties and most of the government coalitions have been split on the issue of full membership in the EU, the EEA has been seen as a good compromise between the Yes and No voters, in spite of some of the obvious democratic and functional weaknesses of the EEA. No serious attempts have been made to renegotiate or terminate the agreement.

The EU also expresses satisfaction with the EEA. For the EU, the EEA is a smooth running arrangement that triggers little noise and requires few resources.

One reason for the few conflicts between EU and Norway are similarities in goals and values. As a non-member state, Norway has not decided to move on to an alternative political path or trajectory. For a period of fifteen years the country has consistently adapted to EU rules and norms at a high rate. Public policies and politics in the non-member states have converged with policies and politics in the member states, primarily because this is seen as consistent with national preferences, interests and values. There have of course been instances of disputes and conflicts related to specific legal acts, but they have been quite few when we take into account the total scale of the agreement.

Another striking development is the extent of integration between Norway and the EU. Most Norwegian exports go to the EU and most Norwegian imports originate in the EU. Norway also implements and complies with EU rules to a higher degree than the average EU member state. Having similar texts in national law books does not necessarily mean that the EU/EEA rules and regulations are applied and used in a similar fashion. However, if we examine the number of infringement cases, we observe that Norway receives fewer letters of formal notice, has fewer reasoned opinions and has fewer cases referred to the EFTA court than the EU average. As such, Norway is a “good European”.

A third observation is that the EEA agreement is not an economic free-rider position. At the time of the signing, the Agreement had a small and limited economic component. This has changed recently, particularly after the EU enlargement in 2004, and is now quite significant. It is obviously difficult to compare the contributions from the member states to the contributions from the EEA EFTA states. However, if we compare the net budgetary balance in the EU (2007 numbers), that is, what the EU budget reports as net transfers of money from the EU to the member states, with the net contributions by the EEA EFTA states, in the EEA grants, we see that Norway is a larger net contributor per capita than member states like France, Italy and Finland.

### III

Is the EEA suitable for export? I believe it is a “not for export” kind of model. So far, EFTA itself has never advocated an enlargement of EFTA. In fact, the history of EFTA is very much a history of an organization in decline when it comes to the number of member states. However, this might change. For instance, the Swiss president has called for a review of the future of EFTA, Iceland has applied for membership of the EU, and some of the micro states in the EU have considered membership in the EEA. Some voices in the EU have also examined the possibilities of streamlining the relationship with non-member states.

An expansion of the EEA EFTA is still not very likely. The main reason for this is that the EEA is a special construction resting upon some underlying political, historical, geographical and institutional factors that are not met in many other non-member states.

First, one big difference between EEA countries and most states which are not EU members, is that the EFTA countries have not sought EU membership, partly because they want to shield off central sectors of their economies such as banking, agriculture, fisheries or petroleum. Many non-member states want full EU membership, not EEA. In Norway the EEA has always been considered as a kind of “second best” solution and a compromise between the Yes and No voters.

Secondly, EEA is probably most suited for fairly rich states that are not interested in receiving financial transfers or supports.

Many of the non-member states seek closer ties to the EU because they want to have access to funds. Agriculture policy and cohesion- and regional policy are not part of the EEA. There is no redistributive mechanism in the EEA, and in fact, the EEA EFTA countries are net contributors.

A third factor is linked to democracy. There is a democratic deficit in the EEA, since the EEA countries have limited formal influence on legislation. This extensive delegation of actual sovereignty, in some sense, presupposes quite a lot of trust in own democratic institutions and in the EU. In states with limited trust, I suspect, such a radical delegation might be problematic and potentially destabilizing. Moreover, it is probably easier to delegate competence to the EU in fields linked to market regulation, but as the EU's policies are increasingly linked to issues such as immigration policies, security policies etc, it is even more democratically challenging.

Finally, the issue of geography and size. All EEA states are currently small, some are very small. For a small state there is nothing new in adopting to rules and regulations not decided by themselves. This is what small states in open economies are used to. Small states are not used to influencing decisions, but they are instead quite good at adapting and utilizing new rules and regulations. For larger states, with more ambitions and powers, an institutional mechanism providing limited room for influence and voice would probably be deemed inadequate.

## **Finland in the EU: 15 years as small state within the European Union**

**Toby Archer**

Every country joins the European Union with different historical experiences, different socio-political contexts and with differing motivations. Finland joined in 1995 along with Sweden, but despite both being advanced Nordic welfare states with not dissimilar economies, the two countries have had very different “European experiences” over the next decade and a half. In the 15 years since accession Finland has become an active and engaged player in the EU. EU membership has become a central reference point across all state policies and also very important to how Finland conducts its relations with the countries of the world beyond the EU’s borders. The Finnish private sector also sees EU membership as vital to its current and future strength.

As a self-defined ‘small state’ within the Union, Finland has generally supported a strong Commission and the community method in the belief that this will protect the interests of all members, not allowing larger states to hold too much sway over the EU’s direction. Finland adopted the Euro at the new currency’s birth and hence has become an active player in the politics and the economics of the Eurozone, unlike its Nordic EU neighbours, Sweden and Denmark, who remained outside of the Euro experiment. Similarly, Finland has become an active within Europe’s Common Foreign and Security Policy (CFSP) and Common Security and Defence Policy (CSDP). Again this can be contrasted to Denmark’s opt outs and, at times, Swedish reticence in those fields.

### **Economics**

There is still debate over whether economic, security or other considerations were central to Finland joining the EU. Indeed, from the political leadership being lobbied to make the application, to the debate over membership at the parliamentary and elite level, finishing with the public debate in the run up to the referendum to endorse the decision to join, there was opportunity for all opinions to be expressed. To a great extent, Finnish business and industry were early advocates and supporters of EU membership and remain so today. The Finnish economy has performed strongly over the last decade, particularly considering the depths of depression it had to climb out of in the early 1990s and is currently ranked by World Economic Forum as the seventh most competitive economy in the world.

Finland is a trading nation; not only are exports central to the country’s economic success but due to having few raw material resources beyond wood, it has always had to import much of the needed raw materials and components for its manufacturers. Market access remains vital for the country’s economic well being and the EU is the dominant market. In 2009, 55.6 percent of Finnish exports went to other EU members with next biggest trading partner being Russia at only 9 percent.

The importance of market access to Europe was accentuated in the early 1990s by the collapse of the Soviet Union. During the Cold War, due to Finland’s geo-strategic position and neutrality, it had developed extensive trading links with the USSR that in peak years accounted for a quarter of the country’s GDP. This created a significant sector of the economy that was protected from global realities by the preferential agreements with the neighbouring superpower.

This trade collapsed at the end of the Cold War occurring just as the bubble burst on an economy hugely overheated by cheap borrowing spurred by currency deregulation leading to excessive debt.

These two factors combined to push Finland into a deep depression, so when Sweden announced its intention to join the EU in 1991 Finnish industry was quick to argue that Finland must also seek membership so as not to be placed at a disadvantage in gaining access to the now even more important western markets. The business community argued that the alternative – the creation of the European Economic Area (the EEA) between the EU and EFTA (the European Free Trade Association, of which Finland was a member), was not enough. The EEA would mean adopting the EU's *aquis communautaire* but, for the EFTA states, no opportunity of shaping it. Hence being a full member of the EU came to be seen as vital.

With the exception of certain sectors such as retail, food processing and agriculture which have faced new competition due to the EU (with obvious benefits for Finnish consumers), the majority of Finnish business and industry remains committed to the belief that EU membership is vital for a small European state with a relatively small economy. This support has extended to Finland's membership of the Euro and has led to price stability for both importers and exporters. With the onset of the global downturn in 2009, it has been noted that Swedish exporters have had some advantage over their Finnish rivals with the Swedish Krona having depreciated in value making their exports more competitive. But even the Krona's depreciation against the Euro has not caused Finnish businesses the difficulties that it might have once due to the transnational nature of many bigger companies now, particularly within the single market. For example, some Finnish firms have been able to use their Swedish subsidiaries or parent companies to take advantage of the Krona's devaluation.

Being within the EU also gives influence over certain aspects of the global economy that Finland could not have expected to have had on its own. Most obviously with the EU being the largest economy in the world, Finland now has some influence on the EU's position on matters of global policy, such as the setting of standards that are often followed worldwide. But also being within the EU brings influence to bilateral trading relations. This has most recently been seen in the dispute over tariffs on wood imports from Russia. The Confederation of Finnish Industries, EK, argues that this, in becoming an issue for EU-Russian trade relations rather than just Finnish-Russian trade, has provided considerably more influence over Russian actions. Additionally, the fact that Finland is 'over-represented' amongst the EU staff also brings further indirect influence in these fields.

The corporatist model between government, employers and unions that has developed in Finland has produced a legacy of open and transparent relations between the private sector and government. A spokesman for EK stated that, despite a few areas of disagreement, this institutional legacy has meant that Finnish industry and business believes that the Finnish government has done a very good job of representing their interests on the European level. Nevertheless he noted that cooperation with other national federations of industry within the EU, through their joint representative body Business Europe, now requires the majority of their human resources. This working directly with the EU central institutions demonstrates the importance of the single market on the Finnish economy, with approximately 70 percent of relevant regulation originating in Brussels, not Helsinki.

## **Foreign and Security Policy**

Finland has been an active player in the creation of the EU's foreign and security policies. The Finns have sought influence through inclusion, resisting plans for more closely integrated 'cores' within the EU where the first members? could set rules to exclude others. Hence, it has been reticent about some models suggested for Permanent Structured Cooperation.

This is particularly so because Finland is not a NATO member and would not like to see integration happening only amongst EU NATO allies. Taking this active role in CSDP structures, particularly the formation of the Battlegroups, has required major changes and investments on the part of the Finnish Defence Forces. This has included some limited professionalization of what was previously a solely conscript-manned military beyond the officer corp. This change has symbolic importance beyond the relatively small number of troops concerned. Nevertheless, EU membership has not been enough to force change when the country has, for its own reasons, not agreed with attempts to build EU common positions on security matters. For example, Finland is the only EU member that has not signed the Ottawa Convention banning anti-personnel landmines, saying these weapons remain vital to the nation's defence until alternative systems are procured.

In foreign policy issues Finland has often shown flexibility in putting the existence of a single European policy ahead of its own national perspectives. This has been particularly visible with Finland prioritising the EU's Russia policy ahead of its own bi-lateral relations with Russia. Membership of the EU has also given Finland confidence to broach sensitive issues in its relations with Russia that may have been avoided previously.

## **Public Euroscepticism**

The 1994 referendum on joining the EU was won by a clear but not overwhelming margin (57-43%) and Euroscepticism has remained a constant factor since. Eurobarometer has consistently shown that since joining, less than half the Finnish population believes that membership has been a good thing for the country, a notable contrast to support from elites both in the public and private sectors. Nevertheless there is little political activity spurred by those negative feelings towards the EU and until recently this scepticism was never vocalised? by political parties, in part as a result of the wide governing coalitions that the Finnish system tends to produce. But the last couple of years has seen the rapid rise of the True Finns, a rightwing, Eurosceptic populist party. If they maintain their current level of support to the 2011 general election, they will probably join the next government. Nevertheless, Europeanisation might even be at work here as there are signs that they may already be toning down their outspokenness on the EU in the hope of being asked to join the next government.

## **Conclusion**

Being a member of the European Union has arguably been of significant value for Finland. It has helped the country navigate the difficult waters of both post-Cold War European power politics and of the rapidly changing global economy. EU membership has bolstered Finnish identity as a 'normal' European country after its Cold War isolation.

It has given Finland a voice and influence on the world stage that it would not have had otherwise, notably in its relations to its huge eastern neighbour.

And it has provided the conditions for the Finnish economy to flourish. The 'European project' still has little emotional commitment from the Finnish people, but on an instrumental level membership can be seen as a success.

**Toby Archer, the Finnish Institute of International Affairs.**