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Faculty of Social Sciences

Institute of Economic Studies

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Faculty of Social Science**

Institute of Economic Studies

Bachelor Thesis

**European Free Trade Association and its Current
Significance**



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June 2006

Hereby I claim that I elaborated this bachelor thesis on my own, and that the only literature and sources I used are those listed in references.

4 of July 2006

Author's signature

Prohlášení

Prohlašuji, že jsem bakalářskou práci vypracoval samostatně a použil pouze uvedené prameny a literaturu

V Praze, 4.6. 2006

podpis autora

I would like to thank to my supervisor PhDr. Jana Marková for her support, valuable comments and patience, while I was writing this thesis. However, the author is fully responsible for all the possible mistakes.

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Projekt bakalářské práce

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Téma: Evropské sdružení volného obchodu a jeho dnešní význam

Cíl práce:

ESVO - Evropské sdružení volného obchodu (EFTA – European Free Trade Association) bylo založeno na konventu ve Stockholmu v roce 1960. Kladlo si za cíl liberalizovat obchod mezi členskými státy a dospět tak k volnému obchodu. Integrační procesy však nikdy neměly dosáhnout a také nedosáhly vyšších stupňů (měnová, politická unie). Za více než čtyři desetiletí trvání tohoto sdružení se velmi proměnily státy, které do ESVA patřily. V první části práce bych se tedy rád zaměřil na historii ESVA a kooperaci s Evropským společenstvím, která vyústila ve vznik Evropského hospodářského prostoru (EHP, EEA) v roce 1994. V další části bych se chtěl zaměřit na současnou situaci tohoto sdružení, jeho fungování, přínos evropskému zahraničnímu obchodu a na ekonomické vztahy se třetími zeměmi. V závěru práce bych rád zhodnotil přínosy a negativní dopady existence ESVA na vývoj evropského hospodářství a obchodu.

V práci bude hledána odpověď na následující otázky:

- Kdy a jak bylo ESVO založeno ?
- Jaké má toto sdružení instituce ?
- Jak probíhala kooperace s Evropským společenstvím ?
- Proč vznikl EHP ?
- S kterými dalšími zeměmi ESVO spolupracuje ?
- Je ESVO přínosné pro evropský obchod ?

Osnova:

1. Historie ESVO
2. Kooperace s Evropským společenstvím a vznik EHP
3. Fungování a instituce ESVO
4. Zahraniční obchod a spolupráce s třetími zeměmi
5. Přínosy ESVO pro evropský obchod

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V Praze dne

Podpis vedoucího bakalářské práce

Podpis autora

Abstract

This thesis deals with European Free Trade Association (EFTA) and its significance in current world. The author has chosen some important and interesting aspects of functioning of EFTA, and he tries to analyse them in the thesis. The introduction of this paper is devoted to the theory of economic integration in general and to different approaches towards that integration. There is also mentioned trade creation and trade diversion concept. In the following section the history of EFTA is examined and the emphasis is placed on relations of EFTA with European Communities. Next chapters deal with activities of EFTA. Primarily is discussed EFTA's involvement in the European Economic Area (EEA), and trade relations of EFTA with third countries. Chapter about institutional background of EFTA and EEA is also included into this paper. In conclusion author evaluates EFTA's significance in contemporary world. The prospects of further development of EFTA are also mentioned and discussed in the closing chapter.

Abstrakt

Tato práce pojednává o Evropském sdružení volného obchodu (ESVO) a jeho významu v dnešním světě. Autor si vybral některé zajímavé a důležité aspekty fungování ESVO a v průběhu práce se je snaží analyzovat. Úvod práce je věnován teorii ekonomické integrace obecně a rozdílným přístupům k ní. Také je zmíněn koncept trade creation a trade diversion. V následující části je zkoumána historie ESVO s důrazem na vztah k Evropským společenstvím. Další kapitoly pojednávají o aktivitách ESVO. Zejména je diskutována angažovanost ESVO v Evropském hospodářském prostoru (EHP) a také obchodní vztahy ESVO s třetími zeměmi. V práci je dále zahrnuta kapitola týkající se institucionálního rámce ESVO a EHP. V závěru autor hodnotí význam ESVO v dnešním světě. Závěrečná kapitola také zmiňuje a zabývá se možnostmi dalšího vývoje a směřování ESVO.

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List of Abbreviations

CACM - Central American Common Market

CU - Customs Union

EC - European Communities

ECJ - EC Court of Justice

ECSC - European Coal and Steel Community

EEA - European Economic Area

EEA EFTA – Iceland, Lichtenstein, Norway

EES - European Economic Space

EEC - European Economic Community

EFTA - European Free Trade Association

EU - European Union

Euroatom - European Atomic Energy Community

ESA - EFTA Surveillance Authority

FTA - Free Trade Agreement, Free Trade Area

GATT - General Agreement on Trade and Tariffs

GCC - Gulf Cooperation Council, comprises Saudi Arabia, Bahrain, Kuwait, Qatar, United Arab Emirates and Oman

GDP – Gross Domestic Product

IMF - International Monetary Fund

ITO - International Trade Organization

LAFTA – Latin American Free Trade Area

MEP - Member of the European Parliament

MERCOSUR – Southern Common Market comprises Argentina, Brazil, Paraguay and Uruguay

MFN - Most Favoured Nation principle

NG - Negotiating Group

OECD – Organization for Cooperation and Development

OEEC - Organization for European Economic Cooperation

PTA - Preferential Free Trade Agreement

ROO – Rules of Origin

SACU - Southern African Customs Union, comprises Botswana, Lesotho, Namibia,
Swaziland and South Africa.

WG - Working Group

WTO - World Trade Organization

1. Introduction

The term European economic integration usually evokes the integration of European Communities (EC) which was to some extent concluded by establishing the European Union (EU)¹ in the year 1992 by Maastricht Treaty. General knowledge about another economic grouping which evolved and developed in Europe in parallel with EU is not that widespread. However, European Free Trade Association (EFTA) deserves our attention as well, because it played a significant role in the development of Europe after its creation in year 1960 and for the whole second part of the last century.

Currently this association is composed by four rather heterogenous member states and is active in number of areas, which influence world economy and political issues. The most profound area of activities of EFTA is the cooperation with EU member states in the European Economic Area (EEA).

1.1 Aim of the thesis

The aim of this thesis is to give comprehensive overview of history, main fields of actions and institutions of EFTA. Therefore, the author will examine the development and current significance of the EFTA grouping. The emphasis will be put to the relationship of two regional economic groupings in Europe which evolved in the close proximity and their relationship developed into some formes of cooperation. These groupings are certainly EFTA and EU. Because it is a broad theme with many aspects and features, the author is going to deal only with chosen aspects. Those are mainly aspects which deal with economic integration and international trade. On the other hand, another features of EFTA are also mentioned, but they are not worked out into details.

1.2 Structure of this thesis

¹ The autor is aware of the differences between EC and EU. Therefore the distinction is done in the text and to the terms is reffered usually separately.

The first part of this paper will be devoted to the economic integration in general and to some important features of it. Then the history of EFTA will be examined and the development of relations with EC (EU) which culminated by the creation of EEA will be stressed. Other part of this thesis is concerned with EFTA's activities. Therefore the main principles and characteristics of EEA will be examined as well as the relations among member states of EFTA. That is going to be followed by the description of institutional background of EFTA and EEA. In one of the final chapters, the trade of EFTA countries with their trading partners will be explained and discussed. The thesis itself will be concluded by the prospects of EFTA grouping for the future and possible development outlined by the author.

1.3 Language of the paper

The official language of EFTA as well as EU is English. Therefore most of the publications concerning EFTA are being published in English language. That is one of the reasons why this thesis is in English. However, the author would like to state that English is not his native language and he would like to apologise to the reader for all the possible mistakes and confusions caused by this language barrier.

2. Economic Integration and its Effects

In this introductory chapter I have selected some interesting topics concerning economic integration and mainly regional economic integration. These will help us to understand the reasons for the creation and functioning of EFTA. The chapter itself is divided into three main parts. In the first part I explore the term economic integration and I also state different approaches towards stages of economic integration. In the second part I will briefly analyse the effects of economic integration and mention reasons why countries devote themselves to those integration schemes. In the last part of this chapter I will examine the opinion of the World Trade Organisation (WTO) about the formation of regional economic groups.

2.1 Economic integration as a term

The term *economic integration*² could have many interpretations and meanings. When we focus on international economic relations, we find several definitions of economic integration. As one of the first definitions, first stated in the 1950s, we can consider the following one: “economic integration is a state of affairs or a process which involves the amalgamation of separate economies into larger free trading regions.”³ The sense of this definition is somehow limited only to free trading regions and presently we understand this term in wider sense.

Economic integration in these days could be seen as “gradual elimination of economic frontiers between independent states; as a result the economies of these states end up functioning as one entity.”⁴ Pelkmans⁵ states this simple definition: “economic integration is defined as the elimination of economic frontiers between two or more economies.” He argues that economic frontiers do not have to coincide with territorial frontiers as it was in the previous definition. However, when we concentrate

² According to Machlup (1977) this term was at first used in 1942. However Molle (2001) points out that the opposite term economic disintegration was already used in 1930.

³ In El-Agraa (1998).

⁴ In Molle (2001).

⁵ In Pelkmans (2001).

on the integration of national economies we consider economic and territorial frontiers to be identical.

Another definition I would like to mention is more specific than the previous ones and already notices the establishment of elements of cooperation, which are needed in the further stages of integration. "Economic integration is concerned with the discriminatory removal of all trade impediments between at least two participating nations and with the establishment of certain elements of cooperation and coordination between them."⁶

2.1.1 Divisions of economic integration

We can divide economic integration into two parts. One would be *market integration* and second is *policy integration*. The basic element of market integration is the free movement of goods and services.⁷ According to Pelkmans:⁸ "market integration is a behaviour notion indicating that activities of market participants...are geared to supply-and-demand conditions in the relevant area."

On the other hand policy integration is not that precise a concept. It could cover different economic policies and use different kinds of instruments to achieve the exercising of such policies. This integration is also very difficult to measure and aggregate and could have ambiguous effects on welfare.⁹

Another division of economic integration could be seen as that of *negative and positive integration*.¹⁰ Negative integration refers to the removal of barriers and elimination of restriction in trade between the participating areas or nations. On the other hand, positive integration is described as modification and creation of instruments and institutions in order to enable the market of the integrated area to function properly.¹¹

We should also distinguish *global integration* and *regional integration*.¹² The former mentioned is executed by the World Trade Organization (WTO) and promotes

⁶ In El-Agraa (1988).

⁷ In Molle (2001).

⁸ In Pelkmans (2001).

⁹ In Pelkmans

¹⁰ This distinction was mentioned for the first time in Tinbergen (1954).

¹¹ In El-Agraa (1998).

¹² In Turnovec (2003)

free trade in the world. The latter is integration only of certain number of countries, which usually discriminates against third countries. I will concentrate on regional integration; however, I will mention a few words about global integration as well.

2.1.2 Stages of economic integration

Distinguishing between the stages of economic integrations dates back to the 1960s.¹³ Since then there has been some changes and development in the understanding of those stages. However the basic concept is still valid today. I have chosen an approach which has five stages of economic integration and I will briefly describe those stages.¹⁴

- **Free trade area (FTA):** members of this grouping remove all barriers and impediments in trade among themselves. However, they retain their freedom to determine trade policies for the outside world. As an example we could name the Latin American Free Trade Area (LAFTA).¹⁵
- **Customs union (CU):** do not differ that much from the above stage. The main difference is that member states have to enforce common external trade relations *vis-a-vis* third countries. They should, *inter alia*, adopt common external tariffs on imports from third countries. As an example of this stage we could name the Central American Common Market (CACM).
- **Common market:** here in addition to customs union is introduced a free factor mobility (capital, labour, services) and freedom of establishment in the member states of that grouping. Here I would state the countries gathered in EEA as an example.

¹³ In Balassa (1961) this economic stages approach was introduced. He distinguished five basic stages of economic integration and those do not differ much from the distinction I use in this paper.

¹⁴ This division is based on El-Agraa (1998).

¹⁵ Although the name of EFTA would suggest to state it as an example here as well, you will see further in the text that after the creation of EEA, went beyond a simple FTA.

- **Complete economic union:** that is common market with complete unification of monetary and fiscal policies. The EU has achieved a certain degree of this stage, but it is not complete economic union and the development of the convergence of these policies is rather unclear.
- **Complete political union:** also other non-economic policies are executed from one central authority and participating countries became literally one nation as a confederation or federal state. The example of this could be unification of two Germanies in 1990. However, we have to take into account that this unification was not driven by economic reasons but mostly by historical and political reasons.

In Table 2.1, we see a list of all these stages of integration and their different characteristics.

Table 2.1: Economic integration schemes

Scheme	Free intrascheme trade	Common commercial policy	Free factor mobility	Common monetary and fiscal policy	One government
Free trade area	Yes	No	No	No	No
Customs union	Yes	Yes	No	No	No
Common market	Yes	Yes	Yes	No	No
Economic union	Yes	Yes	Yes	Yes	No
Political union	Yes	Yes	Yes	Yes	Yes

Source: El-Agraa (1998).

2.1.3 Different approaches to stages of economic integration

As I already mentioned this is not the only division of these stages of integration. For example Turnovec¹⁶ adds certain stages. He introduces preferential trade agreements (PTA) which only lower the tariffs and quotas on trade between contracting parties in comparison with the outside world. After a customs union he also posits a single market where all restriction on mutual trade among contracting parties are abolished. That also means that different norms and standards for goods are forbidden. This is actually a crucial fact, because sometimes these invisible restrictions to trade could have greater impact on reducing trade than quotas or tariffs. As another stage of integration he adds monetary union which is basically a common market with the free flow of money without any exchange rate risks. In the literature, we also find some modified approaches with to some extent different stages of integration.

I should also emphasize that each of these stages could be introduced on its own; therefore it inevitably does not have to be evolving process of integration, which would lead to economic or even political union.

When we have a closer look on negative and positive integration. Balassa¹⁷ stated that in FTA, CU and Common market there is no positive integration. However in the latest literature¹⁸ this approach is somehow corrected. Usually only a FTA does not include positive integration. Other stages need at least to establish some new institutions to deal with the situation and therefore they include positive integration. Sometimes even a FTA embraces certain elements of positive integration. It varies from case to case.

2.2 Reasons for economic integration

This issue is crucial and I would like to briefly examine the effects of the creation of some regional economic integration and why countries form such groupings.

¹⁶ In Turnovec (2003).

¹⁷ In Balassa (1961)

¹⁸ See e.g. Pelkmans (2001) or El-Agraa (1998)

2.2.1 Arguments for the preservation of barriers

From economic theory we know that the best solution for the welfare of the whole society would be free trade without any impediments in the whole world. However, this solution is not feasible in today's world due to historical reasons and the protectionism of some countries. There are also other arguments for the preservation of obstacles to free trade. I would mention at least some of them.¹⁹

- Some countries would like to be strategically independent, which means that a country should not depend on other countries in the production of strategic goods.
- The barriers to free trade are also defence against dumping. The industry in a country could be spoiled if the dumping of imports from different countries were allowed.
- Some economists also suggest the *infant industries theory*. It basically says that young sectors of the economy should be protected from international competition in order to allow them to develop and gain competitiveness.
- Import restrictions also allow the smoothing of problems with the balance of payments. They reduce the amount of money to be paid abroad and therefore improve the balance of payments.
- Countries that specialise in one or only a few products can be very vulnerable to any international changes in economy and marketing. Therefore there is a tendency to diversify the economic structure of a country.

Among others, all these arguments contribute to the preservation of trade barriers in world trade. On the other hand, the General Agreement on Trade and

¹⁹ For more extensive analysis of these arguments see e.g. Molle (2001).

Tariffs (GATT) and its successor the WTO are trying to reduce trade barriers in the world trade since their creation.²⁰ They have achieved significant results but there is still a long track leading to free trade worldwide.

The forms of regional economic integration which were described above are therefore *the second best option*. Now I would like to state some advantages and disadvantages of forming such groupings from the economic point of view.

2.2.2 Possible advantages of integration

When examining the pros and cons of forming regional integration groups, we have to bear in mind that the reason of their creation was usually not solely economic. As will be described in chapter 3, the political reasons and historical consequences have also played an important role in European integration since World War II. We must not forget that political reasons were in some stages even greater driving engines than economic reasoning.

As far as FTA and CU are concerned here are some **possible** sources of economic gain when forming those two groupings:²¹

- According to the law of comparative advantage the specialization in production would bring increased efficiency.
- The increased size of the market can lead to increased production due to economies of scale.
- A larger market would also stimulate competition in the area and it could lead to enhanced economic efficiency.
- A larger-size economy leads to an improved international bargaining position and that could lead to more favourable terms of trade²².

When we progress to further stages of economic integration such as common market some additional gains could be possible. The factor mobility or coordination of monetary and fiscal policies are other aspects which could lead to further economic growth.

²⁰ See chapter 3 below.

²¹ Those gains are based on El-Agraa (1998).

²² That is the price of exports divided by the price of imports.

2.2.3 Trade creation and diversion

Economists have argued whether the creation of a FTA or CU would lead to improvement of welfare. The concept of *trade creation* and *trade diversion* was introduced in 1950²³ and I will briefly describe this concept in a very simple example.

Table 2.2: Trade creation effect

	Country A	Country B	Country C
The cost per unit	100	80	70
Price for country A with 50% tariff rate	100	120	105
Price for country A after establishing CU with country B	100	80	105

Source: own computations.

In Table 2.2 you can see that if the trade policy of a country A is a 50% tariff rate for imports, country A would produce the good for the price of 100 itself. After the creation of a CU with country B and leaving the tariff rate for country C at 50%, country A would import the good from country B for the price of 80.²⁴ Here we can therefore observe the trade creation effect. It is welfare change due to replacement of higher-cost domestic production of goods with imported goods.²⁵

²³ In Viner (1950).

²⁴ Let us omit the transportation costs in this simple example.

²⁵ In Pelkmans (2001).

Table 2.3: Trade diversion effect

	Country A	Country B	Country C
The cost per unit	100	80	70
Price for country A after reducing tariffs to only 10%	100	88	77
Price for country A after establishing CU with country B	100	80	105

Source: own computations.

In Table 2.3 you can see the basic example of trade diversion. If country A were to establish a CU with country B and leave the tariff rate for the rest of the world at 50%, country A would import the good from country B for the price of 80. However, if the country A were to lower its initial non-discriminatory tariff rate to only 10% they could purchase the good from country C for the price of 77. Trade diversion is therefore welfare change due to the replacement of imports from a low-cost source by imports from a high cost source. Trade creation is beneficial to the allocation of resources in the world; on the other hand, trade diversion worsens this allocation.²⁶

A lot of economists examined these effects within FTA and CU. They used different approaches and techniques in their studies and they arrived at in some way different results. Pelkmans²⁷ summarize these studies on trade creation and diversion in the EC in the 1960s and 1970s. Most of the studies recorded both of these effects; and trade creation was the effect which prevailed in them. In some of these cases the differences were rather significant, leading to high trade creation and negligible trade diversion. However, this was not the case in all of them and in one study trade diversion effect even outweighed the latter one.²⁸

Conversely, Krugman²⁹ suggests that FTAs and CUs are formed among neighbouring countries which are usually traditional trading partners. Therefore, the transaction costs of the exports from third countries such as transportation costs and language barriers are other impediments in trade. In conclusion he states that the trade diversion effect would be smaller than is expected.

²⁶ Ibid.

²⁷ Ibid.

²⁸ In Resnick & Trutman (1975).

²⁹ In Krugman (1997).

In analysing the economic impacts of the formation of such groupings we cannot forget that some effects have a static character which would become manifest immediately. On the other hand, we also have dynamic effects and their significance could be seen and examined only in the long term.

2.2.4 Total effects of integration

Robson³⁰ summarizes it: “Membership of an economic grouping cannot of itself guarantee to a member state or the group a satisfactory economic performance, or even a better performance than in the past.”

The effects of forming a FTA or CU could be beneficial, but they could also harm the economic environment and could lead to losses of welfare. We should bear in mind that it differs from case to case and it depends on the nature of the particular integration scheme.³¹ However, most economists agree that the supposition that possible economic gains would outweigh losses of the grouping is based on the competitive behaviour of its participants.

2.3 FTA and CU from the perspective of GATT

The two most important features of GATT are the principle of non-discrimination and the drive for multilateral trade liberalization.³² As an assurance of non-discrimination the *Most Favoured Nation* (MFN) principle was introduced by the member states of GATT. It simply means that every member state of GATT (WTO) is obliged to give the same treatment to other member states of GATT (WTO) as it offers to any other state, even if that one is not the member of GATT (WTO). Therefore the creation of such clubs as FTAs or CUs must simply lead to the violation of this principle. The member states of those groupings have different treatment among themselves and *vis-a-vis* third countries.

³⁰ In Robson (1985).

³¹ In El-Agraa (1998).

³² In Pelkmans (2001).

2.3.1 The opinion of GATT (WTO) on FTAs and CUs

The position of this organization concerning this issue could be found in Article XXIV of the GATT. In particular Article XXIV:4 says:³³ “The contracting parties recognize the desirability of increasing freedom by the development, through voluntary agreements, of closer integration between the economies of the parties (countries) to such agreements. They also recognize that the purpose of a customs union or of a free trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories.”

The creation of a FTA or CU is therefore seen as a step towards trade liberalization in the world and not as a violation of non-discriminatory principle. However, Article XXIV states the requirements which need to be fulfilled in order to be able to establish a FTA or CU. These are:³⁴

- “trade barriers after integration do not rise on average (Article XXIV:5);
- all tariffs and other regulations of commerce are removed on substantially all intra-regional exchanges of goods within a reasonable length of time (Article XXIV:8);
- FTAs and CUs are notified to the WTO Council.”

As far as the first requirement is concerned it is obvious that the member countries of a FTA are not allowed to increase their duties and other trade barriers for third countries after the introduction of a FTA. When we take into account the CU, the situation is rather more difficult, because the member states are creating the common external tariff. Article XXIV:5a says: “duties and other barriers to imports from outside the union may not be on the whole higher or more restrictive than those preceding the establishment of the customs union.” This provision brought a lot of discussion about its interpretation among contracting parties of GATT.³⁵

³³ In General Agreement on Trade and Tariffs, Article XXIV.

³⁴ In Hoekman & Kostecki (2001).

³⁵ See Hoekman & Kostecki (2001).

The second condition ensures that participants in regional liberalization would go all the way.³⁶ However, developing countries may establish agreements where those conditions do not have to be met. Since the introduction of GATT's Decision on Different and More Favorable Treatment of Developing Countries in 1979 full removal of internal barriers within CU or FTA is not required.³⁷

The WTO should determine whether these conditions are met in practice. However, in the past we have witnessed some formations of FTAs and CUs which did not meet these conditions.³⁸ It should be also mentioned that the WTO has no enforcing powers and therefore it cannot prevent contracting countries from creating such formations.³⁹ In addition, even if the conditions are fulfilled, the creation of such a grouping could harm producers in the rest of the world as was explained above in the example of trade diversion.

2.3.2 Nature of GATT and Article XXIV

To conclude this part I would like to state that it is very questionable how Article XXIV fits into the principles of GATT. Some might say that it is in contradiction with the nature of GATT. However, the international trade is full of PTAs, FTAs, CUs and there is not such an authority which could hinder their creation. I should also once again mention that the reasons for forming such groupings are not only economic but also political. Sometimes the political reasons even prevail as you can see in the next chapter where the creation and development of EFTA will be examined.

³⁶ In Finger (1993).

³⁷ In Hoekman & Kostecki (2001).

³⁸ For further analysis see e.g. Hoekman & Kostecki (2001).

³⁹ In El Agra (1998)

3. The History of EFTA

In order to fully understand the significance and importance of EFTA, we should first take a look at its brief history and historical consequences. In this chapter I would like to exhibit how and why was EFTA created, then I will focus on its relations with the EC and the creation of the EEA. I will also state the changes in membership of states in EFTA

3.1 Development after World War II

Almost six years of war, in which millions of human beings had lost their lives, had left Europe in devastating conditions. Most European countries had high tariffs, quotas and other effective instruments to protect their domestic markets. Therefore, there was a need for economic cooperation and development in Europe. The United States played one of the major roles in this cooperation. They wanted to achieve an economic order which would support technological development, ensure free access to raw materials, and enable international distribution of labour. Another major reason the United States supported integration in Europe was the preservation of the period of peace.⁴⁰

Countries chose the multilateral approach⁴¹ towards economic integration in the first period after the war. This resulted into the creation of three worldwide institutions under the United Nations. The International Monetary Fund (IMF) was established in 1945 in order to stabilize currencies and eliminate monetary restrictions. The World Bank⁴² was also established in 1945 with the aim of providing countries with long-term loans for reconstruction after the war. The third institution was named International Trade Organization (ITO) in a draft; although it was successfully agreed, it did not lead to the establishment of ITO.⁴³ However, in the year 1947 the contracting parties⁴⁴ signed an inter-governmental treaty called the

⁴⁰ In Gerbet (1999).

⁴¹ See Pelkmans (2001).

⁴² Its official name was: International Bank for Reconstruction and Development.

⁴³ See Hoekman & Kostecki (2001).

⁴⁴ 23 countries including even countries such as Cuba, China or Pakistan.

General Agreement on Tariffs and Trade (GATT). The goal of this treaty was to decrease tariffs and other non-tariff impediments in the trade among contracting parties.⁴⁵ However, various reasons led to the discovery that this multilateral approach was far too ambitious for that time period.⁴⁶ The United States changed their policy and introduced direct financial help for European countries to assist them with reconstruction after the Second World War. This idea was first mentioned by Foreign Secretary of the United States, Mr. George Marshall, in his speech in June 1947 and therefore it was named the Marshall Plan. This financial help did not exclude any European country and was open even to the Soviet Union and its satellites. The United States had one condition: to ensure the fair distribution of that financial help. European countries were supposed to create an intergovernmental organization for economic cooperation, which would supervise the distribution of money from the United States. The Soviet Union was against the creation of such an organization, and it also forbade participation to its satellites.⁴⁷ Europe was now divided into two different blocks, and integration proceeded in both parts separately. I will now concentrate only on the development in Western Europe.

3.2 The creation of the OEEC

After some negotiations the Organization for European Economic Cooperation (OEEC)⁴⁸ was established on 16 April 1948. The cooperation was merely of an intergovernmental character, and therefore it did not interfere with the sovereignty of participating countries.⁴⁹ Member states of this organization were as follows: Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxemburg, the Netherlands, Norway, Portugal, the United Kingdom, Sweden, Switzerland and Turkey. In October 1949 the Federal Republic of Germany joined this organization and Spain became a permanent member in 1959. The headquarters was in Paris. Other than the distribution of Marshall Plan aid of almost 13 billion US dollars in four years, the member states decided further to develop cooperation

⁴⁵ For more information see e.g. Hoekman, Kostecki (2001) or Kock (1969).

⁴⁶ See Pelkmans (2001).

⁴⁷ See Gerbet (1999).

⁴⁸ In year 1961 OEEC was expanded by non-European countries and therefore the name was also changed to the Organization for Economic Cooperation and Development (OECD).

⁴⁹ In Norberg et al. (1993).

between themselves, to study the possibility of a customs union or free trade area and to reduce barriers to trade and money flow. The member states also decided to abolish quotas to some extent in their mutual trade.

Now we shall have a closer look at the countries participating in the OEEC and their attitude towards further economic cooperation with the prospect of a customs union. Countries such as France, Italy and the Benelux countries⁵⁰ were ready to sacrifice some national powers and their sovereignty in order to transfer those powers to a higher level. This approach to integration is called supranational. The organ of supranational organisation independently executes policies and prepares decisions, which could be approved only by the majority rule of national governments.⁵¹

However, not all countries of the OEEC were so eager to sacrifice their national powers. Other countries preferred an intergovernmental organisation characterised by a small secretariat with the representatives of the national governments taking decisions unanimously.⁵² The main representative of these ideas was United Kingdom. We can characterize the position of this former colonial superpower as very ambiguous. On the one hand, there was a will of European countries towards closer integration. On the other hand, the United Kingdom did not want to lose its special relationship with the United States. Moreover, its new government⁵³ was more oriented on the Commonwealth than on further integration in Europe.⁵⁴ Other countries which for different reasons did not want to participate in further integration were the Scandinavian countries and certainly the neutral countries such as Austria or Switzerland.

The group of countries in favour of further integration was trying to find a solution among themselves. The first attempt was a proposed customs union between the Benelux countries⁵⁵, France, and Italy. This project was called Fritalux and although the customs union treaty was signed, it never entered into force.⁵⁶

⁵⁰ Belgium, the Netherlands and Luxemburg.

⁵¹ These two views on integration in Molle (2001)

⁵² Ibid.

⁵³ From August 1945 the Labour Party with Clement Attlee as a prime minister was governing the country.

⁵⁴ For detailed information about British position in that time see e.g. Beloff (1996) or Lambert (1968).

⁵⁵ The three Benelux countries had already examined a customs union among themselves in 1944.

⁵⁶ In Norberg et al. (1993).

3.3 The establishment of the EC⁵⁷

Another attempt was already successful. The bases of subsequent European integration are in the Schuman Plan, which was presented by French Foreign Secretary Robert Schuman on 9 May 1950. This plan (inspired by French politician Jean Monnet) intended to join the metallurgical and mining industry in Western Europe and therefore to create a common European market for coal and steel. This plan was accepted by six countries⁵⁸ and the treaty establishing the European Coal and Steel Community (ECSC) was signed on 18 April 1951 in Paris. After the ratification processes, it came into force on 23 July 1952 for a period of 50 years. The creation of this community was the first step in the integration process towards European Union. The continuance of the integration process was supposed to be in the fields of political and national defence, but the process of ratification of the European Defence Community and European Political Community failed.⁵⁹

Because of this failure, the integration process turned its attention again to economic integration. Member states of the ECSC started to negotiate once more, because they wanted to extend cooperation to all the areas of the economy. These negotiations resulted in the Treaties of Rome, which were signed in 1957 and came into force on 1 January 1958. These treaties established the European Economic Community (EEC) and the European Atomic Energy Community (Euroatom). Both treaties were again on a supranational basis and established ambitious goals and aims.⁶⁰

3.4 The creation of the EFTA

The countries which preferred an intergovernmental approach towards integration did not want to be left behind. Therefore, under British leadership, cooperation in the field of economic policy was created. This cooperation was called Uniscan and came into practise in 1950. Besides the United Kingdom, the other

⁵⁷ For detailed development of the EC see e.g. El-Agraa (1998), Tsoukalis (1993) or any other book concerning European integration.

⁵⁸ Namely: Federal Republic of Germany, France, Italy, and Benelux countries.

⁵⁹ See e.g. Gerbert (1999).

⁶⁰ Creation of a customs union and afterwards also a single market by 1970.

participating countries were the three Scandinavian countries. Although the creation of this cooperation caused worries about another splitting of Europe, they were highly exaggerated. The activities of Uniscan were actually limited to regular consultations on economic policy of the participating countries and the cooperation was replaced by the EFTA in 1960.⁶¹

During the second half of the 1950s there were still attempts to achieve a wider West European free trade area. The negotiations were conducted mainly in 1957 and their ambition was to create such a free trade area agreement in accordance with Article XXIV of the GATT which would concern all seventeen European member states of the OEEC. The idea was that EEC would form one part of this agreement.⁶² However, this idea of a large free trade area was unacceptable for some countries which had already formed the EEC. The most important country in this issue was France and she refused to create this area because the French and British positions were contradictory.⁶³

The United Kingdom with other members of OEEC started negotiations about a free trade agreement which would serve as a counterbalance to the EEC. The first meeting was held in Oslo in February 1959 and then the situation developed rapidly. Countries participating in these negotiations were as follows: Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom. At the beginning of June officials from these European countries assembled at Saltsjöbaden near Stockholm. At this meeting a draft plan for the European Free Trade Association was drawn up. The final text of the Convention which established EFTA was completed at the beginning of September. The Convention was signed on 4 January 1960. The Convention had to be approved by the Parliaments of six countries and a national referendum in Switzerland. This ratification process was completed on 3 May 1960 and therefore the Convention entered into force.⁶⁴

The small secretariat was placed into Paris, which was considered to be appropriate seat of EFTA due to the location of the seat of the OEEC there. Later negative reactions from the French government caused the relocation of the seat of EFTA to Geneva in Switzerland.

⁶¹ For more information concerning Uniscan see e.g. Norberg et al. (1993).

⁶² In Norberg et al. (1993).

⁶³ For better understanding of French attitude see e.g. Guyomarch, Machin, Ritchie (1998).

⁶⁴ In EFTA (1980).

3.5 The Stockholm Convention

The convention that established EFTA consists of 44 articles and is quite pragmatic. The authors of the Convention established a framework with a necessary minimum set of rules. For another situations they stated certain guiding principles and procedures which could be used when the real situation arises.⁶⁵ The second article of this Convention states the objectives of the Association and those are as follows:⁶⁶

- to promote in the Area of the Association and in each Member State a sustained expansion of economic activity, full employment, increased productivity and the rational use of resources, financial stability and continuous improvement in living standards,
- to secure that trade between Member States takes place in conditions of fair competition,
- to avoid significant disparity between Member States in the conditions of supply of raw materials produced within the Area of the Association, and
- to contribute to the harmonious development and expansion of world trade and the progressive removal of barriers to it.

Apart from constitutional provisions, the Convention contained mainly those which would ensure full free trade in industrial goods between the contracting parties. The main provisions concerned the abolition and prohibition of import duties, quantitative restrictions and equivalent measures on imports and exports among member states. Furthermore, we could find in the Convention provisions prohibiting state aid, restrictive business practices, et cetera.⁶⁷ In the field of agriculture some liberalization was also introduced, but some products remained protected. The

⁶⁵ Ibid.

⁶⁶ In the Convention establishing the European Free Trade Association, Article II.

⁶⁷ See Norberg et al. (1993) or the Convention establishing the European Free Trade Association.

Convention went into detail in tariff restrictions in foreign trade between member states and in the elimination of quantitative restrictions. For example import duties were supposed to be cut 20 per cent, by 1 July 1960, 50 per cent by 31 October 1962 and a complete abolition of import duties was planned after 31 December 1966.⁶⁸ Overall it was planned that the complete abolition of tariffs and quantitative restrictions would last ten years, and it was parallel with the similar process of the elimination of trade restrictions within the EEC. When the latter decided to speed up this process, EFTA did it likewise. As a result, the total abolition of quantitative restrictions was brought to completion by the middle of 1965 and tariffs on industrial goods were abolished three years ahead of schedule on 31 December 1966.⁶⁹

3.5.1 The Relations of EFTA with Finland and Iceland

Due to the global situation and its proximity to Soviet Union, Finland could not become a full member of EFTA. However Finland showed a great desire to participate in this integration process. The foreign trade of Finland depended heavily on those seven countries of EFTA. At first Finland had to negotiate its trade relationship with the Soviet Union. In November 1960 Finland signed a trade agreement with the Soviet Union, which granted most-favoured-nation treatment to the Soviet Union. That meant that Finland would grant the Soviet Union the same trade liberalization as would be achieved with EFTA countries.⁷⁰ After this settlement EFTA member states started to negotiate some forms of Finnish participation. The result of this was an agreement signed on 27th March 1961 in Helsinki. The Finland – EFTA Agreement established a new free trade area on the basis that Finland had the same rights and obligations towards the EFTA Member States as they had among themselves.⁷¹

Most of the provisions which contained trade and economic aspects from the Stockholm Convention were also applicable to the relations between Finland and EFTA countries. However, Finland obtained a slower reduction of tariffs and quantitative restriction on certain goods due to the special characteristics of the

⁶⁸ In the Convention establishing the European Free Trade Association, Article III.

⁶⁹ In EFTA (1980).

⁷⁰ In Norberg et al. (1993).

⁷¹ See Agreement creating an Association between the member states of the European Free Trade Association and the republic of Finland.

Finnish economy. Total abolition of trade tariffs between Finland and EFTA countries was finished in December 1967 and Finland became a full member of EFTA on 1 January 1968.⁷²

After some negotiations and the establishment of the Industrialization Fund for Iceland,⁷³ this Nordic state also entered EFTA in 1970. Immediately after accession Iceland was granted quota and tariff-free entry to the EFTA markets of industrial products. On the other hand, Iceland could enjoy a ten-year transitional period for the reduction of its tariffs on imports from other member states of EFTA.⁷⁴ With the entrance of Iceland, the number of EFTA member states reached nine, which was the most in the history of EFTA.

3.6 The development of EFTA – EC relationship

Norberg et al.⁷⁵ states five different stages in the EFTA - EC relationship. Now I would like to explore them a bit more. The first phase took place from 1960 until 1972 and could be characterized by almost no relations at all. There were two regional economic groups operating in Western Europe and that could not help the economic development of countries in this region. Already at the beginning of the 1960s, the United Kingdom⁷⁶, Denmark and Norway submitted applications for membership in the EC. Other countries such as Austria, Sweden and Switzerland asked for association agreements with the EC. The negotiations started, but it did not take long before it was apparent that the EC would not accept any new member states at that time. Charles de Gaulle, the then-president of France, was against the membership of the United Kingdom in the EC. One of his reasons was also the exclusive relations of the United Kingdom with the United States and their link to the Commonwealth.⁷⁷ Therefore the negotiations of accession were interrupted in the year 1963 not only with the United Kingdom but with all EFTA countries.

⁷² In EFTA (1980).

⁷³ This fund was created to foster the industrial development of Iceland, other Nordic states provided capital of 14 million USD for this fund and Iceland could repay that after 1980 with no interest charged.

⁷⁴ In EFTA (1980).

⁷⁵ In Norberg et al. (1993).

⁷⁶ The application was accompanied by the condition that the interests of the Commonwealth and EFTA countries should be taken care of. The reasons why the United Kingdom wanted to join the EC were economic and also political for their deeper analysis see e.g. Gerbert (1999).

⁷⁷ For better understanding of French opinions see e.g. Gerbert (1999) or Guyomarch, Machin, Ritchie (1998).

EFTA member states tried to “build bridges” with the EC several times during the 1960s. However it became obvious that the status quo would be preserved during that time period. The United Kingdom even submitted the application for membership in the EC once again, but president de Gaulle refused it repeatedly in 1967. The situation changed when Mr. Georges Pompidou became president of France in June 1969. In December 1969 at the meeting of EC countries a decision was taken that the negotiation process on Community membership would be open in 1970 for four countries which had applied for that. Those were: Denmark, Ireland⁷⁸, Norway and the United Kingdom. It was also agreed that talks about trading arrangements would start with the six EFTA countries which were not applicants for membership the EC.⁷⁹

Accession treaties were signed in January 1972 and signing countries were supposed to join EC at the beginning of 1973. However, the referendum in Norway ended up with a surprising result. The majority of people⁸⁰ voted against membership of Norway in the EC. Afterwards the result of the Danish referendum was awaited with suspense. But the majority of Danish voters, 63 percent, were for EC membership. Therefore, the United Kingdom and Denmark, along with Ireland, became members of the European Communities on 1 January 1973. Norway did not become a member of the EC and it negotiated the same type of Free Trade Agreements as other EFTA countries not aspiring for EC membership.

3.6.1 Second stage of relationship - Free Trade Agreements (FTAs)

The EC decided at its summit in 1969 that:

- the enlargement of the Communities should not involve the re-erection of tariff barriers in Europe;
- the Agreements with the non-candidate countries should, if possible, enter into force at the same time as the candidate countries took up

⁷⁸ Note that Ireland was not part of EFTA.

⁷⁹ In EFTA (2000).

⁸⁰ 53.5 per cent.

membership of the Communities.⁸¹

From that time the negotiation process started. Together there were fourteen FTAs - seven were those of EFTA countries with the EEC and the other seven those of EFTA countries and the ECSC. The first FTAs were signed on 22 July 1972. Those were the ones with Austria, Iceland, Portugal, Sweden and Switzerland. After the failure of accession of Norway into the EC, Norway concluded the same FTAs as other EFTA countries in March 1973. The last FTAs with Finland were signed in the autumn of 1973. The first FTAs came into force on 1 January 1973 at the same time the new member states acceded to the EC. The last ones with Finland entered into force a year later. Duties and other trade barriers on industrial goods were removed under these FTAs by 1 July 1977. However for some sensitive goods the transitional periods were longer. The last duties on some goods were abolished by the end of 1983. At that time the real objective of the FTAs, which was the creation of a free trade area in industrial goods, was finally achieved.⁸²

If we take a look at agricultural production, the degree of liberalization was not as large as in EFTA. This period from 1973 until 1983 could be seen as a second phase of the EFTA - EC relationship. This period is characterized by the implementation of FTAs and the achievement of this phase is certainly full free trade in industrial goods between EFTA and EC member states.

The FTAs with the EC also applied to trade with any new member states of the Communities. That happened when Greece and Spain, which had negotiated FTAs with EFTA in 1979, joined the EC in 1981 and 1986, respectively. In 1986 Portugal also left EFTA to join EC, however the trade liberalization achieved between Portugal and EFTA remained the same.⁸³

During the second phase of relationship between EFTA and the EC, the fulfilment of FTAs functioned well. On the other hand we have to see global economic conditions which were rather unfavourable to develop further the relationship. This stagnation was mainly influenced by two oil crises in 1973 and 1979. In the early 1980s the general economic world situation had improved, and both institutions could continue in their larger economic cooperation. At that time Western European

⁸¹ In EFTA (2000).

⁸² In Norberg et al. (1993).

⁸³ In EFTA (2000).

countries were also aware that they needed to improve their competitiveness in relation to the United States and Japan.⁸⁴

Although trade tariffs and quantitative restrictions were eliminated, there was even an increasing number of different rules and requirements which restrained foreign trade between countries of the EC and EFTA. These rules and restrictions had different reasons such as health protection or consumer protection, but they all complicated trade between EFTA and the EC countries. They also varied from country to country and therefore they were an even greater impediment to trade than relatively modest tariff rates.⁸⁵

3.6.2 Third stage of relationship – Luxemburg Declaration

In those circumstances the first multilateral meeting at ministerial level between member states of EFTA and the EC and the EC Commission was held in Luxemburg in April 1984. This could be seen as the beginning of the third phase of the EFTA - EC relationship.

At that meeting a programme for the development of future European economic cooperation was laid down. Ministers concluded the Luxembourg Declaration which expressed strong political will on both sides to create a dynamic European Economic Space (EES). However in that declaration they did not specify what exactly the EES should contain. On the other hand a number of issues for further cooperation were listed. They mentioned for example the need to put forward efforts towards improving the free circulation of industrial products, sustainment of the economic recovery and reducing the unacceptably high level of unemployment, et cetera.⁸⁶ Also cooperation in non-trade areas, such as research and development, telecommunication sector and new information technologies, was also mentioned. When more concrete measures which restrained trade were taken into account, mostly these subjects were discussed: harmonisation of standards, elimination of

⁸⁴ In Norberg et al. (1993).

⁸⁵ In EFTA (2000).

⁸⁶ See Norberg et al. (1993).

technical barriers, simplification of border facilities and rules of origin, elimination of unfair trade practices and abolition of state aid.⁸⁷

In the following years, the cooperation between EFTA and the EC developed. I would like to mention only a few important issues which were discussed and events which took place.⁸⁸ In 1985 EC Commission published a White Paper regarding the completion of the internal market. Later the member states of EC decided to adopt the Single European Act. The idea was to complete an internal market within the EC by 1992. The EFTA states would be therefore discriminated against if they did not constitute closer cooperation with EC countries through the creation of EES. In autumn 1986 both parties agreed that the cooperation had to develop in accordance with the development in the Community. This would prevent new barriers being created after the completion of EC internal market.

One of the major problems to arise was the risk of legal imbalances between the EC and EFTA states. Member states of the Community in their application of international agreements were subject to the legal control of the Commission and the EC Court of Justice (ECJ). This, on the other hand, did not exist on the EFTA side. Also the cooperating parties chose only fields where the agreement was not so difficult to achieve and they left other fields of cooperation aside. This approach is known as "*raisin picking policy*"⁸⁹ and it was criticised greatly at that time. Moreover the development showed that the legislation in different fields of EC law is very much connected and depends on each other. Therefore there was a need for a different approach towards this convergence which would require the elaboration of a definition of EES. That had never been done jointly.

3.6.3 Fourth stage of relationship – preparation of EEA

This new approach of cooperation was first mentioned by the then-president of the EC Commission, Mr. Jacques Delors. He proposed: "a new, more structured partnership, with common decision-making and administrative institutions with the EFTA countries".⁹⁰ Of course that was not the only way to complete this cooperation.

⁸⁷ In EFTA (2000).

⁸⁸ For detailed information about that period see Norberg et al. (1993).

⁸⁹ In Norberg et al. (1993).

⁹⁰ On 17 January 1989, in a speech before the European Parliament.

Another possibility was to continue in the previous policy of mainly bilateral agreements and to end up with a free trade area between EFTA and the EC states. The first approach, which was mentioned above, is far more challenging and would have required certain actions be taken. They would need to establish a new form of association which would be more structured institutionally with common organs for decisions and administration. He questioned the EFTA states whether they were prepared to accept a common trade policy, to harmonize their legislation with EC legislation to ensure the free movement of goods, to accept judicial control by the ECJ and to accept the same discipline on state aid and rules of competition as EC member states.⁹¹

The Delors proposal was reviewed by the EFTA countries at a meeting of Heads of Government at Holmenkollen in March 1989. In the declaration EFTA states stated their readiness “to initiate negotiations with the Community leading to the fullest possible realization of free movement of goods, services, capital and persons, with the aim of creating a dynamic and homogeneous European Economic Space.”⁹²

For the purposes of negotiations a structure of working groups was created. At the top of this structure was a High-Level Steering Group (HLSG) for chief negotiators from EFTA states and the EC Commission. Five Working Groups (WG) for different areas were also created. WG I for goods, WG II for services, WG III for persons, WG IV for so called horizontal and flanking areas and WG V for legal and institutional questions. The horizontal and flanking areas in WG IV covered areas such as research and development, environment, consumer protection, education, programmes for small and medium-sized enterprises, social policy aspects and statistical cooperation.⁹³ In the area of free movement of goods the politicians were discussing mutual recognition of national requirements and harmonization of testing and certification as was valid in EC countries mainly because of the Cassis de Dijon principle.⁹⁴

⁹¹ In Norberg et al. (1993).

⁹² In Declaration of EFTA states from Holmenkollen meeting in March 1989.

⁹³ In Norberg et al. (1993).

⁹⁴ This and some previous judgements of ECJ led to the mutual recognition of national requirements in trade of the industrial goods between EC countries in 1970s. Some products and goods have common requirements in all countries of EU and accordingly to that also in the EEA countries. For more details see e.g. Craig & De Búrca (2003).

3.6.4 The year 1990

On 20 June 1990 the formal negotiations between EFTA member states and the EC on the creation of the European Economic Area⁹⁵ were initiated in Brussels. The same structure of working groups as had been used before was preserved. Only for the Working Groups, their name was changed to Negotiating Groups (NG). The position of EFTA states for the upcoming negotiations could be expressed by formula “*EFTA speaking with one voice*”⁹⁶. It means that EFTA states would firstly discuss their position on the issue among themselves and afterwards they would present their opinion to the EC countries.

The negotiating parties had to at first agree on the joint identification of all the relevant parts of the “*acquis communautaire*”⁹⁷ which would be incorporated into the EEA agreement.⁹⁸ Afterwards the negotiations focused on two key issues: the requests of the EFTA countries for a certain number of permanent derogations from the “*acquis communautaire*”; and substantive talks on the institutional arrangements for the EEA.⁹⁹ Another joint Ministerial meeting in December 1990 in Brussels brought progress in a number of key areas. However there were still some crucial questions to be solved such as agriculture and fisheries, the participation of EFTA countries in EC committees, the composition and competence of a joint judicial body. Ministers also expressed their wish to see the EEA agreement entering into force on 1 January 1993.

3.6.5 Progress in years 1991 and 1992

The next joint Ministerial meeting was held again in Brussels in May 1991 and many important questions were solved there. The independent judicial mechanism for EEA was created at this meeting. There was supposed to be an independent EEA Court with five judges from the ECJ and three EFTA judges. This

⁹⁵ The term European Economic Space was changed to European Economic Area for linguistic reasons at the opening meeting of these negotiations.

⁹⁶ In Norberg et al. (1993).

⁹⁷ This term is used to cover the legal basis of EC and that concerns the signing treaties, case law of the ECJ and all secondary legislation.

⁹⁸ In FETA (2000).

⁹⁹ Ibid.

court would be competent to give rulings on certain issues concerning EEA countries. Other progress was seen at the acceptance of relevant *acquis communautaire* by the EFTA countries and therefore limitation of the derogations from them. The only major problem which remained unresolved was the issue of trade in fish.

This issue however was settled at the joint Ministerial meeting in Luxembourg in October 1991. Additionally a financial mechanism for economic assistance from the EFTA states to the less developed EC countries was established. The initialisation of the Agreement was supposed to take place in November. But the process had been postponed because the ECJ found serious legal questions in the draft of the Agreement. In the ECJ Opinion¹⁰⁰ on the EEA Agreement, the ECJ stated that the system of judicial supervision mentioned in the Agreement, the creation of an independent EEA Court, was incompatible with the Treaty of Rome.

At the beginning of 1992 even this problem was solved. Instead of a joint judicial mechanism, a new EFTA Court with corresponding competences for EFTA countries as those of the ECJ with regard to the EC states was created.¹⁰¹ Furthermore some additional provisions were included into the Agreement to ensure legal homogeneity. The EEA Agreement was then signed in Oporto on 2 May 1992 by representatives at the ministerial level of all contracting parties. The EFTA Ministers also on that day signed the agreements establishing the EFTA Surveillance Authority (ESA), the EFTA Court of Justice and the Standing Committee of EFTA States.¹⁰²

3.6.6 Ratification process

After the signature of the Agreement, the process of approval and formal ratification took place. But the Agreement could not enter into force on 1 January 1993, because the referendum in Switzerland in December rejected ratification of the EEA Agreement.¹⁰³ In accordance with Article 129 of the EEA Agreement, the consequent Adjusting Protocol, signed on 17 March 1993, was created. This

¹⁰⁰ Opinion 1/91 published in the Official Journal 1992, C110.

¹⁰¹ In Norberg et al. (1993).

¹⁰² More about these institutions in chapter 5.

¹⁰³ The majority of people (50.3%) and majority of cantons (18 out of 26) were against the ratification.

Adjusting Protocol had to go through the complete ratification process, with the result that the EEA finally entered into force on 1 January 1994. All the references to Switzerland were deleted in the Agreement. However, Switzerland ensured almost the same rights as the other EEA EFTA countries by signing several agreements.¹⁰⁴

Liechtenstein had to sort out its relations with Switzerland concerning a customs union and therefore it became a full member of the EEA on 1 May 1995.

3.7 Changes in EFTA member states

The situation in Europe changed dramatically in the late 1980s after the fall of the Iron Curtain. The neutrality of some EFTA states lost significance at that time and therefore some of the EFTA states wanted to progress further. Moreover the EFTA countries through the EEA negotiations examined the functioning of the EC. They considered the advantages and disadvantages of EC membership and most of them applied for membership. Austria and Sweden applied in 1989 and 1991, Finland in March 1992, Switzerland in May 1992 and Norway in March 1993. As a result of the negative referendum on EEA membership, Switzerland decided not to continue with its application. Membership in the EU¹⁰⁵ was again turned down in the Norwegian referendum in November 1994. Therefore only Sweden, Finland and Austria became members of the EU in January 1995.

On the other hand Liechtenstein became a full EFTA member on 1 September 1991. Before that Liechtenstein's interests were represented in EFTA by Switzerland. In Table 3.1 I list the former and present members of EFTA states and the dates of their accession and exit.

¹⁰⁴ See chapter IV for detailed information.

¹⁰⁵ Since the Maastricht Treaty already established European Union in 1993, I use the term EU instead of EC.

Table 3.1: Summary of EFTA member states

EFTA member states	Date of accession	Date and reason of exit
Austria	Founding member (1960)	Left to join EC in 1995
Denmark	Founding member (1960)	Left to join EC in 1973
Norway	Founding member (1960)	Still member
Portugal	Founding member (1960)	Left to join EC in 1986
Sweden	Founding member (1960)	Left to join EC in 1995
Switzerland	Founding member (1960)	Still member
United Kingdom	Founding member (1960)	Left to join EC in 1973
Finland	1968	Left to join EC in 1995
Iceland	1970	Still member
Lichtenstein	1991	Still member

3.8 The EFTA after Creation of the EEA

This could be seen as the fifth phase of the EFTA – EC relationship. After the creation of the EEA, the EFTA states concentrated on making the EEA function well. I will focus on the EEA and its performance in Chapter 5. Another important milestone in EFTA history was the enlargement of the EEA. According to Article 128 of the EEA Agreement any state to become a member of EU shall apply to become a party of the EEA. Therefore after some negotiations with Liechtenstein, the ten

candidate countries of the EU¹⁰⁶ became on 1 May 2004 also part of the EEA. Other important issue for EFTA was and certainly still is its relation to other countries. I will deal with that in the following chapters.

Another important milestone in history of EFTA states was year 2001 and acceptance of the updated EFTA Convention in Vaduz. I focus on this Convention and reasons why it was created in the next chapter.

¹⁰⁶ Those were: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia, and Slovakia.

4. Functioning of EFTA

This chapter will examine some important features of functioning of EFTA and will state some basic facts about EFTA member states. “EFTA is an intergovernmental organisation for the promotion of free trade and economic integration”.¹⁰⁷ Its main activities are focused in three areas. The first area of EFTA’s activities is the mutual cooperation between member states within the association. That is done on the basis of EFTA Convention which was created in 1960 and updated in 2001 in Vaduz. I will concentrate on this activity in the first part of this chapter.

The other two areas of EFTA’s activities can both be seen as relationships with non-member countries. The first of these spheres is the creation and development of the EEA, where EFTA countries¹⁰⁸ can fully participate in the EU’s common market. The EEA will be discussed in the second part of this chapter.

As a third area of activities we can consider relations with countries outside the EEA. With some of these countries, EFTA has signed and implemented a FTA or partnership agreements. These relations will be examined in Chapter 7 of this paper.

4.1 A need for a new convention

We have to bear in mind that the former Convention establishing EFTA was signed in 1960. Therefore, as was mentioned in Chapter 3, the main objective was to provide a framework for the liberalization of trade in goods among member states.¹⁰⁹ Forty years later, the situation in Europe had dramatically changed. The creation of the EEA had been brought into practise not only free trade in goods, but also free trade in services, free movement of persons and capital and freedom of establishment for the contracting parties. From that point of view, we can figure out that the original Convention did not have relevant significance anymore.

¹⁰⁷ In EFTA (2006-b).

¹⁰⁸ Note that Switzerland is not formally part of the EEA; however after signing bilateral agreement with the EU, it enjoys most of the privileges of EEA member states. See the discussion below.

¹⁰⁹ In EFTA (2004-a).

Moreover, we can find a second reason, which is probably not that evident, why the Convention was changed. It concerns the only EFTA state not to participate in the EEA – Switzerland. The reasons why Switzerland did not join EEA were stated in the previous chapter. This caused quite unexpected complications in the EFTA – EU relationship. However, this uncomfortable situation was solved in the late 1990s and in the first years of new millenium. Switzerland and EU have signed several bilateral agreements during those years, which enabled Switzerland to enjoy most of the advantages that other EFTA states are enjoying in the EEA. On the other hand, Switzerland has never concluded any agreements with other EFTA states concerning these areas of a common market.

Quite paradoxically, Switzerland would have had therefore closer relationship concerning a common market with EU states than with other EFTA countries. This problem is also solved by this new Convention. According to this Convention EFTA member states have now between themselves virtually the same relations as they have with EU countries in the EEA.¹¹⁰

As a third reason we can mention that in the 1990s, EFTA started to build new FTAs with countries outside Europe. This international cooperation is also mentioned and supported by the new Convention.

4.1.1 Updated EFTA Convention

Now I would like to take a closer look on the new Convention. I will not analyse it in detail, I will only mention some important features and characteristics of this Convention. However, the improvements which were agreed in the new Convention are rather extensive, we must not forget that Iceland, Liechtenstein and Norway already derived benefits from them after the creation of the EEA.¹¹¹

What is new then? This question is mostly answered by Article 2 of this Convention which states objectives of EFTA. Besides free trade in goods, it mentions these as other objectives of EFTA:¹¹²

- “to progressively liberalise the free movement of persons;

¹¹⁰ In EFTA (2006-b).

¹¹¹ See EFTA (2001).

¹¹² In Convention Establishing the European Free Trade Association (2001), Article 2.

- the progressive liberalisation of trade in services and of investment;
- to provide fair conditions of competition affecting trade between the Member States;
- to open the public procurement markets of the Member States;
- to provide appropriate protection of intellectual property rights, in accordance with the highest international standards.”

In the part concerning free trade in goods, the Convention incorporates the rules and provisions of the EEA Agreement. They are related to, *inter alia*, consumer protection and safety and mutual recognition of conformity assessment.¹¹³ Furthermore, the Convention introduces the free movement of persons and freedom of establishment. It also includes social security issues and mutual recognition of professional diplomas.¹¹⁴ However, there are a few special provisions regarding mainly Switzerland, which settle several transitional periods.¹¹⁵ The Convention also liberalizes trade in services and flows of capital among member states. Among others, the Convention furthermore includes provisions about public procurement, intellectual property rights, state aid and rules of competition.

To put it in a nutshell, the Convention covers all areas which are included in the EU-Switzerland bilateral agreements and therefore Switzerland can have the same relationship with other EFTA states as it has with EU countries.

4.2 Basic facts about EFTA

Since 1995 European Free Trade Association has consisted of only four member states, which are different in size and geographic location. In Figure 4.1 the location of EFTA states in Europe are shown and also the location of member states

¹¹³ See Chapter 2 and 3 of Convention Establishing the European Free Trade Association (2001).

¹¹⁴ In EFTA (2003-a).

¹¹⁵ See Chapter 8 of the Convention Establishing the European Free Trade Association (2001).

of the EU-25, which are marked in blue. The reasons for this heterogeneous constitution of EFTA are mainly historical as was discussed in Chapter 3. Some states decided to leave EFTA and to join the EC (EU); on the other hand, other states came to join EFTA. However in some cases that was only a changing station on their way to EU. Although it might seem that EFTA states have little in common, except their non-membership in the EU, some other especially economic features link them together. Now I will state some basic facts about the member states of EFTA, and about their economic performance in the global world in this part of this chapter.

Figure 4.1 Member states of EFTA and EU



Source: EFTA (2006).

EFTA states generate together a population of only about 12 million, however they are leaders or dominant players in some industries and sectors. The economic environment for companies and enterprises is praised by worldwide institutions as you will see below. Overall, the member states of EFTA belong to the group of the most advanced world countries. In Table 4.2 I decided to state some basic facts and data about the four EFTA member states.

Table 4.2 Basic facts about EFTA member states

	Iceland	Lichtenstein	Norway	Switzerland
Official name	Republic of Iceland	Principality of Liechtenstein	Kingdom of Norway	Swiss Confederation
Government	Parliamentary Republic	Constitutional Monarchy	Constitutional Monarchy	Federal State
Area (in km²)	103 000	160	323 802	41 284
Capital city	Reykjavik	Vaduz	Oslo	Berne
Population (in thousand)	300	35	4 606	7 422
Population density (per km²)	2.9	216.3	14.2	179.8
Official languages	Icelandic	German	Norwegian	German, French, Italian, Romansh
Currency	Icelandic Krone (ISK)	Swiss Franc (CHF)	Norwegian Krone (NOK)	Swiss Franc (CHF)

Source: EFTA (2006), Eurostat data and national government websites.

As you can see from the table, those four states differ even in governmental constitution and they do not even have a common official language. However, even those at first sight very different countries could be bound and in fact they are in the EFTA.

4.3 Economic features of EFTA

Table 4.3 shows some important economic indicators and facts about our four countries. Note that most of the information for Liechtenstein is not available due to its customs union with Switzerland. Therefore those figures are covered by Switzerland's figures.

Table 4.3 Economic indicators of EFTA states in year 2005

	Iceland	Lichtenstein	Norway	Switzerland
GDP (in million USD)	10 100	n.a.	184 900	258 600
GDP per capita (in USD)¹¹⁶	33 667	n.a.	40 143	34 842
GDP growth (% change from year 2004)	5.6%	n.a.	2.3%	1.9%
Inflation¹¹⁷	1.4%	1.0%	1.5%	1.0%
Unemployment rate	3.1%	2.4%	4.5%	4.2%
Government financial balance (in% of GDP)¹¹⁸	0.1%	n.a.	11.5%	-1.0%
Total debt of the country (in % of GDP)¹¹⁹	36.8%	n.a.	46.5%	27.8%

Source: OECD data, Eurostat data, EFTA (2006); n.a. stands for not available.

We can see that EFTA countries have very high GDP per capita and are among the group of countries with the highest GDP per capita in the world. If we take a look at other figures, we discover that most of them could be regarded as satisfactory. We can see low inflation and mainly low unemployment, which is in all four states among the lowest in Europe.¹²⁰ On the other hand, the total debt of EFTA

¹¹⁶ Based on Purchasing Power Parities (PPP).

¹¹⁷ Annual average rate of change in Harmonized Indices of Consumer Prices.

¹¹⁸ Based on EU definition: it is the difference between the revenue and the expenditure of the general government sector. The general government sector comprises the following subsectors: central government, state government, local government, and social security funds.

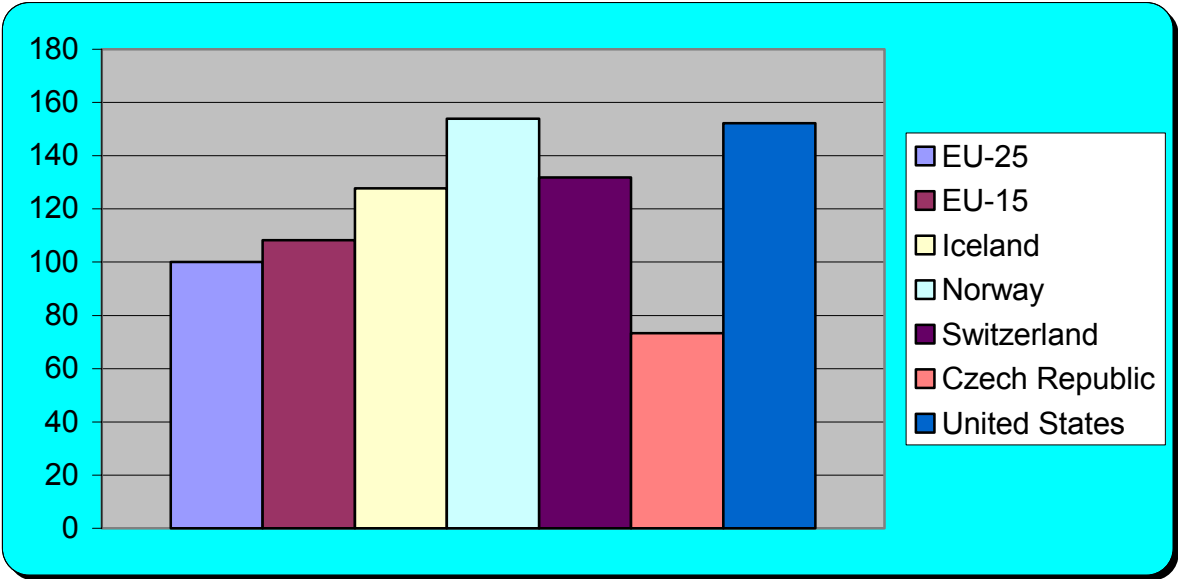
¹¹⁹ Measurement is based on EU definition: again general government sector is comprised as above.

¹²⁰ See Figure 4.6 for comparison.

countries is not as low as one would expect, however it still does not reach critical values.

In Figure 4.4 GDP per capita in chosen countries is compared. The basis is EU-25 which have 100%. As you can see EFTA countries exceed not only the GDP per capita in the EU-25 but also in the EU-15. Norway, the state with the best performance in this indicator, reaches 153.9% of EU-25 and it even exceeds the USA by 1.7 per cent.

Figure 4.4 GDP per capita in selected countries in the year 2005.



Source: Eurostat data.

4.3.1 Comparism with EU

As you may witness from the Tables and Figures the EFTA countries do have significantly better economic performance than the EU 25 and even then EU 15 average. GDP per capita is considerably bigger and EFTA states belong to the countries with highest GDP per capita in the world. Also other economic indicators show significant level of economic prosperity the inflation and unemployment are low. For the inflation this also holds in the EU, but unemployment is much higher in EU as you can see in Figure 4.6.

4.4 Business environment in EFTA countries

According to several international institutions, EFTA countries are among the countries with remarkable productivity and an appropriate environment for setting up a business – see Table 4.5 for more details. The two EFTA Alpine countries - Liechtenstein and Switzerland - are famous financial centres as well as hosts of major multinational companies. In addition Switzerland is a world leader in pharmaceuticals, machinery, watch-making, insurance and banking.¹²¹

On the other hand, Norway and Iceland exceed in fish production and in the metal industry. Moreover, thanks to its appreciable mineral resources, Norway is the world's third largest exporter of oil and gas.¹²²

Table 4.5 Environment for Entrepreneurs and Companies in 2005

	Iceland	Norway	Switzerland
Competitiveness (rank in the world)	4.	15.	8.
Overall productivity (rank in the world; GDP per person employed in USD)	16. (61 122USD)	5. (77 204USD)	18. (60 301USD)
World's friendliest business locations (rank in the world)	12.	5.	17.

Source: Institute for Management Development, OECD and the World Bank.

According to Business Week 16 out of 500 largest companies¹²³ in the world are based in EFTA member states. Five of them could be found even in the first hundred of the largest companies in the world. These are:¹²⁴

- Novartis (Pharmaceuticals, 23rd in the world);
- Nestlé (Food, 28th);
- Roche Holding (Pharmaceuticals, 34th);

¹²¹ In EFTA (2006).

¹²² Ibid.

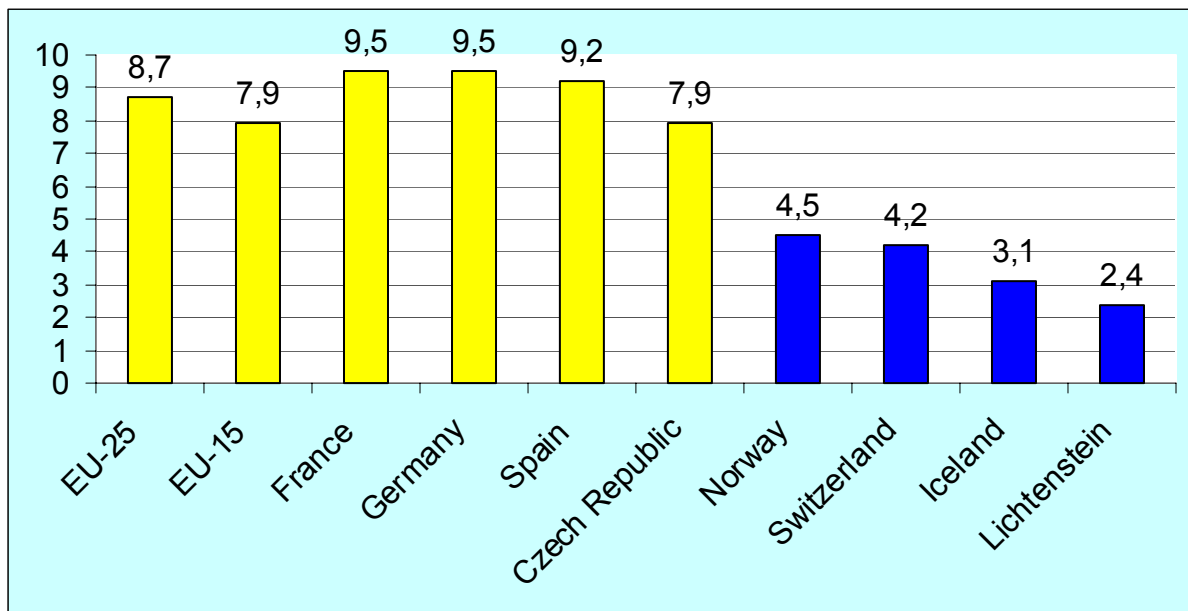
¹²³ According to their market value.

¹²⁴ In Business Week 2005.

- UBS (Banking, 35th);
- Credit Suisse Group (Banking, 94th).

Evidently the conditions for firms and companies in EFTA states are quite satisfactory and that is one of the reasons why rates of unemployment in these countries are that low. In Figure 4.6 the rates of unemployment in the year 2005 for selected EU countries, the EU-25, the EU-15 and EFTA member states are compared. You can see that unemployment rates in EFTA countries are fundamentally lower than the average in the EU.

Figure 4.6 Rates of unemployment in selected countries in year 2005



Source: Eurostat data.

4.5 EFTA Budget

In the end of this section I would like to look more closely at the EFTA budget. In Table 4.7 the expenditures of EFTA states in year 2005 can be found. Almost one third of the budget is allocated for cooperation within the EEA. Other parts of the budget go to different areas and you can see their distribution in the table. As shown in Table 4.8 the total budget of EFTA constitutes over 14 million EURO, which is not that disproportionate a number. Almost 95% of the budget is paid by the two largest EFTA states – Norway and Switzerland.

Table 4. 7 EFTA Budget for the year 2005

Budget posts	Budget 2005 (in CHF)
Intra-EFTA relations	85 528
Management of FTAs with third countries	768 118
Free trade negotiations	1 933 641
Prospective FTA partners	328 837
Servicing the EFTA Council and programmes	855 554
EEA matters	7 272 330
Statistical co-operation - Luxembourg	615 708
Organisation management and administration	4 483 600
Horizontal activities	2 718 975
EU-EFTA and EFTA co-operation activities	3 202 967
TOTAL	22 265 257

Source: EFTA (2006).

Table 4. 8 Contributions to the EFTA Budget in the year 2005

Member state	Contributions in CHF	Contributions in EURO ¹²⁵	Total share
Iceland	922 547	595 999,1	4.14%
Liechtenstein	227 975	147 280,2	1.02%
Norway	11 416 307	7 375 352	51.27%
Switzerland	9 698 428	6 265 539	43.56%
TOTAL	22 265 257	14 384 170	100%

Source: EFTA (2006), own computations.

¹²⁵ As an exchange rate the referenced rate of Swiss Franc per Euro of the ECB as an average reference rate in December 2005 has been used.

5. Interesting features of EEA

Since 2004 the European Economic Area is constituted by 25 EU states and 3 EFTA member states – Iceland, Lichtenstein and Norway. With regard to the divisions of regional economic integration we can conclude that EEA covers all the functions of free trade area. As was already described in previous chapters, EEA also goes beyond the simple FTA and it satisfy most of the features of common market (internal market). However, we must bare in mind, that EEA countries do not have a common trade policy and therefore they do not constitute CU.

5.1 Agreement on the European Economic Area

The EEA Agreement states objectives of EEA and that is: “to promote a continuous and balanced strengthening of trade and economic relations between the Contracting Parties with equal conditions of competition, and the respect of the same rules with the view to creating a homogenous European Economic Area.”¹²⁶ The same article also articulate that EEA stall entail free movement of goods, persons, services and capital – so called four freedoms and closer cooperation in other fields.¹²⁷

I should also mention which areas are not covered by the EEA Agreement and therefore are not exercised by the EEA, although they are executed by EU. As was already mention it is customs union and common trade policy. Common Agriculture and Fisheries Policies are also not incorporated into EEA Agreement. EEA member states did not also cover into activities of EEA the second and third pillar of EU. It means that Common Foreign and Security Policy as well as Justice and Home Affairs do not take place in EEA Agreement as well.

¹²⁶ In Agreement on the European Economic Area, Article 1.

¹²⁷ This cooperation in so called *flanking areas* is discussed below.

5.1.1 Free movement of goods

The duties and quotas in trade between EU countries and EFTA countries were already abolished in 1970s and 1980s.¹²⁸ However there were other technical barriers to trade, which had to be solved in order to organize free trade in goods. As was outlined in Chapter 3, the negotiations on EEA Agreement and the incorporation of relevant *acquis communautaire* into this agreement led to the mutual recognition of requirements for most of the goods. It simply means that, if a good is legally produced in one country of EEA, it could be distributed in other member states, no matter the technical barriers to trade in that country.¹²⁹

For the remaining goods where this principle of mutual recognition is not in practise¹³⁰ the countries are negotiating common requirements, which would be valid in the whole area of EEA. However, those negotiations do take a lot of time and therefore some products are still missing those common standards. That influence the trade of those goods in the EEA. On the other hand, it is only a small percentage of all possible products and therefore we can conclude that “with very few exceptions economic operators in all the EEA States are subject to the same conditions when placing a product on the EEA market”.¹³¹ As the legislation of EU in this area develop, Annex II of the EEA Agreement, which deals with technical regulation, standards and certification, is updated and ammended simultaneously.¹³²

5.1.2 Competition rules

Another important aspects of free trade of goods are also competition rules in the countries. Legislation in this field was to some extent unified, and therefore all the economic actors are liable to the same competition rules within whole EEA area. The competition rules for the common market of EEA cover four main areas and those are these.¹³³

¹²⁸ See Chapter 3 for details.

¹²⁹ Of course there are some exceptions, where this free trade do not have to be allowed. Government could ban or limit the import of products on the grounds of environment, consumer interests, health and life of human beings, et. cetera. For further details see e.g. Craig & De Búrca (2002) or Týč (2004).

¹³⁰ Those are usually ones that are manufactured according to strict rules such as pharmaceutical or chemical products.

¹³¹ In EFTA (2004-e).

¹³² See the Chapter 6 and the discussion of implementation of new EU legislation into EEA Agreement.

¹³³ In EFTA (2004-e).

- elimination of agreements that restrict competition and the abuse of a dominant position (e.g., price-fixing agreements between competitors);
- control of mergers between firms (e.g., a merger between two large groups which results in their dominating the market);
- liberalisation of monopolistic economic sectors;
- prohibition of state aid that would distort competition by selectively favouring certain firms or national industrial sectors.

These strict rules forbid measures which could result into distortion of trade within EEA countries. They also cover trade in most of the products. However, trade in fisheries sector and obviously also agricultural products is not covered by those rules and EEA EFTA member states have their own legislation for these areas.

5.1.3 Trade in agricultural products

This trade is neither part of the cooperation within EFTA, nor it is included in the EEA Agreement. The reasons for this situation are rather transparent. EU has its own agricultural policy which is not in accordance with policies of EEA EFTA member states. The latter states do have also different approaches towards this policy among each other. On the other hand, EEA Agreement suggests that member states of EEA should: “continue their efforts with a view to achieving progressive liberalization of agricultural trade”.¹³⁴ That is to some extent achieved through bilateral agreements between the EEA EFTA States and the EU in the trade of basic agricultural products.¹³⁵

5.1.4 Fisheries sector

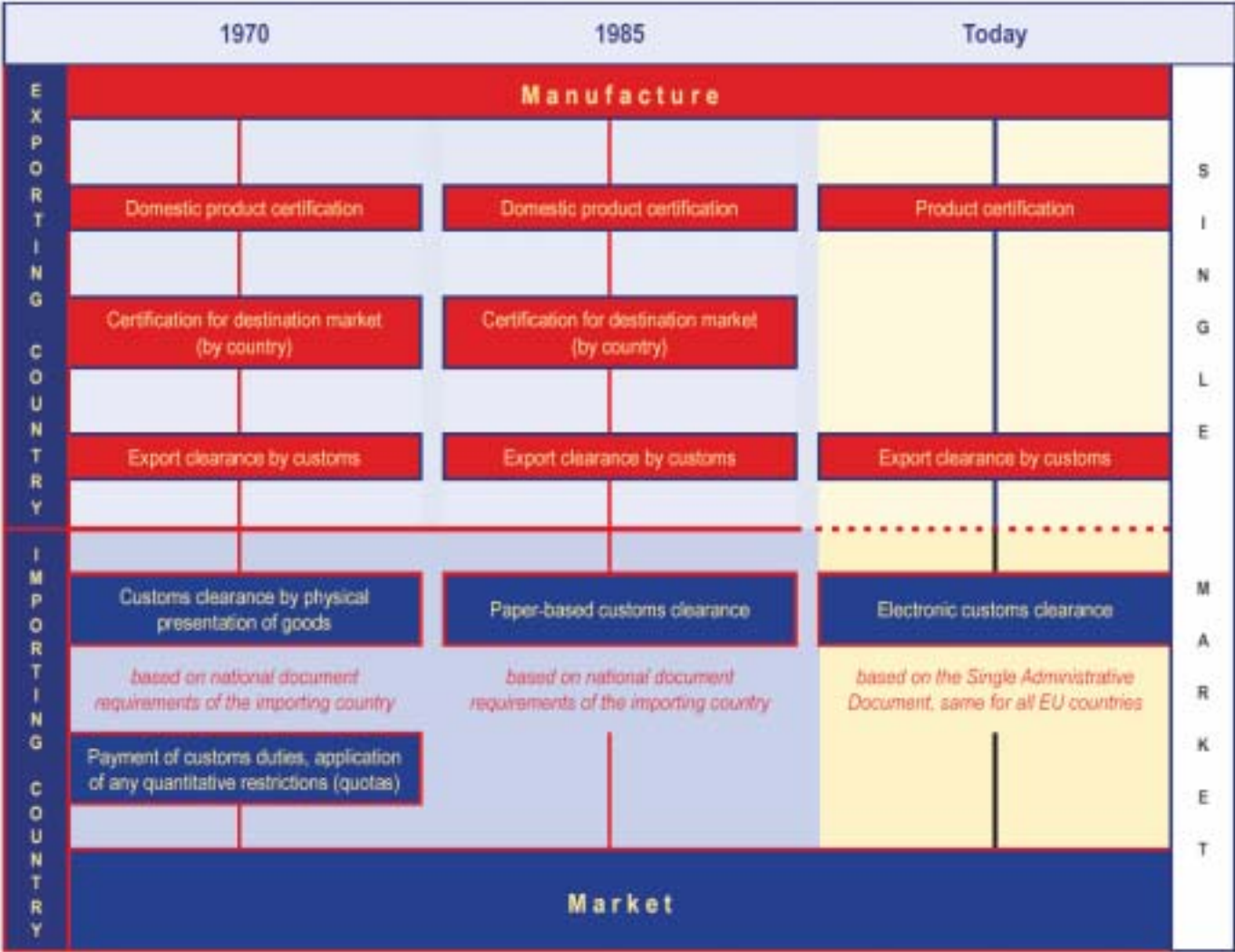
This sector is crucial for EEA EFTA member states, because Norway and Iceland are traditional exporters of these sea products. It represents almost a half of

¹³⁴ In Agreement on the European Economic Area, Article 19.

¹³⁵ For further details see e.g. EFTA (2004-e).

the total exports of Iceland, and even for Norway it is not a negligible part of their exports. Also in this area, EEA EFTA states did not take over the EU legislation. However, there are special arrangements for trade in this field mentioned in EEA Agreement.¹³⁶ Through that provisions and other bilateral agreements some customs duties and other impediments to trade were abolished or reduced. On the contrary, for some important species to EEA EFTA countries, duties persist and they are not likely to be changed. This area is far too sensitive for EU and EEA EFTA countries, and therefore it is almost impossible to achieve the consensus and liberalization.

Figure 5.1 Development of rules for export in industrial goods from EFTA country to the EC (EU) country



Source: EFTA (2004-a).

¹³⁶ See Protocol 9 of the Agreement on the European Economic Area.

In the end of this part concerning free movement of goods I am attaching the Figure 5.1, which shows how the creation of EEA Agreement led to the removal of procedures and technical barriers to trade. As you can see from that figure, customs procedures were preserved. It implies that not all barriers were removed and it will be explained and discussed below.¹³⁷

5.1.5 Free movement of persons

EEA EFTA and EU inhabitants are according to EEA Agreement allowed to enter the territory of any EEA state in order to work or look for a work.¹³⁸ Students, pensioners and non-working persons have also the right to move to another EEA state. Therefore the provisions are supported by a system of social security benefit schemes and mutual recognition of diplomas.¹³⁹

5.1.6 Free movement of services

Sector of services represents almost 70% of GDP and employment in the economy of Europe.¹⁴⁰ Therefore it is essential that trade in services will also be without any barriers. This area is closely linked to the free movement of persons and freedom of establishment. However, the aim of this action is clear, in the practise free movement of services in EEA is still somehow restricted. The rules for providing services are often different in various EEA countries and their harmonisation takes time. This agenda could be considered as unfinished and there is still some work which needs to be done in order to achieve complete free movement of services in EEA area.

¹³⁷ See section concerning rules of origin in this chapter.

¹³⁸ That is not the case for the new accession countries into EU and into EEA (accession took place in 2004). Most of the countries from original EEA have introduced transitional periods for accession countries. These are still in practise, although some countries have already changed their opinion and allowed full free movement of persons from those countries

¹³⁹ In EFTA (2003-b).

¹⁴⁰ Ibid.

5.1.7 Free movement of capital

This is another essential concept for the establishment of common market. In last few years there has been rather fast development in this area, which now allows capital to move with only small number of impediments.

In addition to that I consider important to mention that the maintenance of four freedoms is an ongoing process. There are always new problems or tasks which need to be solved and accomplished.

5.1.8 Flanking areas

The cooperation among EEA member states does not cover only four freedoms, but it also covers cooperation in other areas, which are called *flanking areas*. Co-operation in those areas is to be carried out through common activities of various types, ranging from dialogue between respective parties, common efforts to encourage certain activities in the EEA to the participation by the EEA EFTA States in EC programmes, and the establishment of joint activities in specific areas.¹⁴¹ These areas represent among others: research and technological development, information services, the environment, education, training and youth, social policy, consumer protection, energy, employment, enterprise and entrepreneurship, civil protection and public health. EEA member states can also add some other areas into this field of cooperation.

In the EEA Agreement¹⁴² is set out also financial participation of EEA EFTA countries for participation in these programmes. Most of the financial contributions are calculated according to a proportionality factor based on the GDP. That simply means to divide the sum of GDP in EEA EFTA countries by the sum of GDP of all EEA countries.¹⁴³ In 2004 the contributions of EEA EFTA countries constituted 2.19% of the total contributions of all EEA countries and that represented 130 million EUR.¹⁴⁴

¹⁴¹ In EFTA (2004-a).

¹⁴² In Agreement on the European Economic Area, Article 82.

¹⁴³ See EFTA (2002).

¹⁴⁴ In EFTA (2004-a).

5.2 Basic understanding of Rules of Origin (ROO)

According to Hoekman & Kostecki we can understand a rule of origin to be: “a criterion used by customs authorities to determine the nationality of a product or a producer”¹⁴⁵. Although, in the basic textbooks of international trade they are usually mentioned like a technical formality, according to latest studies they do influence rather significantly the trade between countries. It is essential in the concept of FTA, because member states of such groupings preserve their rates of duties and quotas towards third countries. These rates are not fully harmonised as it is the case for CU. Therefore ROO are necessary to establish which goods could obtain the tariff preference in order to prevent tariff fraud. If there were no rules of origin, importers into FTA would import the goods *via* country with the lowest tariff, and then transfer it to other FTA countries without paying any additional tariff. Therefore, ROO determines in which country the product was made and if it is subject to the preferential tariff rate or it is not.

According to Herin and his study¹⁴⁶, during 1980's where the trade between EFTA and EC countries was treated by FTA, companies paid for substantial part of the trade the non-preferential tariff, although they could have claimed duty free trade. That indicates that administrative costs of ROO for some firms and companies were greater than the tariff itself. Companies therefore decided to pay it, rather than to go through the administrative procedure of ROO. There are also some recent studies, which show and indicate that ROO are impediment to trade and they reduce the amount of trade.¹⁴⁷

5.2.1 Losses from ROO

ROO distort trade and they are also accompanied by administrative costs mainly in these ways:¹⁴⁸

¹⁴⁵ In Hoekman & Kostecki (2001).

¹⁴⁶ In Herin (1986).

¹⁴⁷ See e.g. Brenton & Machin (2003) or Estevadeordal (2000).

¹⁴⁸ First two ways in Augier et al. (2005).

- They impose administrative costs on exporters. In this way they act as transactions costs that tend to offset the bilateral trade creation.
- They may induce firms to switch suppliers in order to meet the rules of origin. Firms would supply their material from more expensive producers from FTA partner in order to qualify for preferential tariff. In this way, they tend to exaggerate the classic trade diverting effect of preferential liberalization.
- If one state is a member of more than one FTA with different approaches towards ROO¹⁴⁹ there have to be more different ROO for the same product in order to fulfill the rules in different FTA.

As you can see ROO are necessary evil in the FTA, and they influence and have negative effects on the world trade.

According to Augier et al.: “the standard convention is that a good is considered as having been made in the last country in which it underwent a substantial transformation”.¹⁵⁰ Substantial transformation would therefore mean that it gave the product its essential character.¹⁵¹ There are certain tests and criteria used to determine if that transformation occurred¹⁵² and that brings high level of complexity and number of problems for the producers. They have to be aware and ensure that their products satisfy all those tests and rules in order to claim preferential tariff. Otherwise they can choose to avoid all those administrative costs and pay the non-preferential tariff as was mentioned above. As ROO vary in different criterias they have also different economic effects. Setting the ROO and their criterias could be therefore accompanied even by rent-seeking activities of different importer lobbying groups.¹⁵³

There are other problems and complications connected with ROO¹⁵⁴. My intention was to give a short overview of this issue and state how they affect and

¹⁴⁹ These differences which could occur are explained below.

¹⁵⁰ In Augier et al. (2005).

¹⁵¹ In Hoekman & Kostecki (2001).

¹⁵² Change in tariff classification, value added content, specific production process rule. See Augier et al. (2005) for their detailed description.

¹⁵³ In Hoekman & Kostecki (2001).

¹⁵⁴ See e.g. Augier et al. (2005) or Kruger (1993).

distort world trade. The way how to reduce at least some of the administrative costs is the unification and harmonization of ROO in all the FTA. The WTO Agreement on ROO is trying to: “foster the harmonization of these rules used by members”.¹⁵⁵ However, the aim of it is unattainable, because some states or groups of states do not want to give up their own rules and criteria in ROO.

5.2.2 Harmonization of ROO in EEA

As far as EFTA and EEA are concerned, the harmonization to some extent took place already. The harmonization was concluded in year 1997 and ROO were therefore harmonized in 30 European countries (including member states of EEA) in the system called European cumulation system.¹⁵⁶ The development then continued and in July 2003 the harmonization of ROO was extended to countries in the Mediterranean region. This further harmonisation covers also Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, the Palestinian Authority, Syria and Tunisia.¹⁵⁷ ROO for FTA of EU and EFTA are therefore substantially identical and changes in them have to be agreed on by all the participating and partner countries. This has economic and political consequences and this development is also praised in some studies¹⁵⁸ as well as among trading partners.

To conclude this part I would state that ROO are important feature in the trade among partners of FTA. There are empirical evidences showing that ROO constitute barriers to trade and also bring additional administrative costs. They even stimulate the effect of trade diversion and decrease the effect of trade creation. Some countries and groupings, however, want to preserve this system of different ROO for various reasons. When we focus on situation in EEA we conclude that EEA countries agreed on harmonization of ROO for FTA with third countries and it brings advantages to the trade for their trading partners.

¹⁵⁵ In Hoekman & Kostecki (2001).

¹⁵⁶ In EFTA (2004-e).

¹⁵⁷ In EFTA (2004-c).

¹⁵⁸ See e.g. Augier et al. (2005).

5.3 Enlargement of EEA

In the last part of this chapter I will briefly summarize the enlargement of EEA, which took place in 2004, and its consequences. As was already mentioned in Chapter 3, EEA Agreement presents that any state accessing the EU should also negotiate its membership to EEA. The EEA enlargement negotiations with ten accession countries started in January 2003 and focused on the financial contributions of the EEA EFTA states towards reducing social and economic disparities within the EEA.¹⁵⁹ The Agreement on enlargement of the EEA was signed in November 2003 and entered into force on 1 May 2004.

EEA EFTA states have agreed to financially support not that developed regions of EU. EEA EFTA contributions are established in the EEA Agreement¹⁶⁰ and they took place in two five year Financial Mechanism programme already (1994-1998; 1999-2003). That is in accordance with the policy of EU, which also created certain funds to provide financial help to not that developed regions. For the third phase of this programme (2004-2009) the budget of that Financial Mechanism rose five times in order to provide help for the new accession countries.

The EEA EFTA States are supposed to provide a multilateral contribution of 600 million EUR from 2004 to 2009 to the ten accession countries as well as to Greece, Portugal and Spain.¹⁶¹ In addition to that Norway will make a bilateral contribution of 567 million EUR through a Norwegian Mechanism benefiting the ten new EU members over the same period of time.¹⁶² EEA member states and the European Commission declared list of priority sectors where the money from those programmes will be flowing. Those are mainly:¹⁶³

- Protection of the environment, including the human environment, through, *inter alia*, reduction of pollution and promotion of renewable energy.

¹⁵⁹ In EFTA (2004-d).

¹⁶⁰ See Agreement on the European Economic Area, Articles 115-117.

¹⁶¹ In EFTA (2004-b).

¹⁶² Ibid.

¹⁶³ Based on Erdal (2004).

- Promotion of sustainable development through improved resources use and management.
- Conservation of European cultural heritage, including public transport and urban renewal.
- Human resources development through, *inter alia*, promotion of education and training, strengthening of administrative or public service capacities of local government or its institutions as well as the democratic processes, which support it.
- Health and childcare issues.

Norwegian Financial Mechanism gives additional priorities to other sectors.¹⁶⁴ Beneficiary states are responsible for making projects within those priority sectors. The contributions are preferably given to projects which are on a non-commercial basis in order to avoid effects of distortion of competition in the market.¹⁶⁵

I cannot forget to mention that accession of ten new countries into EEA expand the territory of common market into 28 countries and over 450 million of inhabitants. On the other hand, there are some limitations in the four freedoms in the EEA area as was explained above. In the next chapter I will focus on institutional background of EFTA itself and of EEA as well.

¹⁶⁴ For more details see Erdal (2004).

¹⁶⁵ In EFTA (2004 -a).

6. Institutional Background of EFTA and EEA

In this shorter chapter I would like to examine the institutional framework and decision-making process in EFTA itself and also in the EEA. For thirty years the institutional background of EFTA was rather small. The entire agenda was executed by a small secretariat and the EFTA Council. I will look at the current functioning and role of these institutions in the first part of this chapter. The creation of the EEA brought an extension of institutions. The so-called *two-pillar structure* was introduced which will be examined in the second part of this chapter. I will focus on the decision-making process in the EEA and the role of EFTA in this process. I will also examine and compare EFTA and EU institutions in the EEA.

6.1 EFTA Institutions

6.1.1 EFTA Council

This institution governs EFTA member states, their inner relationships and the relationship of EFTA towards third countries. It means that the EFTA Council is not responsible for relations within the EEA.¹⁶⁶

The EFTA Council meets at the highest ministerial level usually only twice a year. Additionally, it also meets almost every month at the level of Heads of Permanent Delegations to EFTA. In the decision-making process, each state is given one vote, therefore it does not matter how powerful the state itself is. All four states represented in EFTA in this time have equal voting rights. However, decisions are taken mostly by consensus. There is a strong political will to accept decisions unanimously.

Of course, the EFTA Council has to act in accordance with the EFTA Convention, which was updated in 2001. In addition to that, the EFTA Convention serves: “a broad mandate to consider possible policies to promote the overall objectives of the Association and to facilitate the development of links with other states, unions of states or international organisations.”¹⁶⁷ The presidency in the Council is on a rotating basis. In the first half of 2006 Iceland is in the Council

¹⁶⁶ See below.

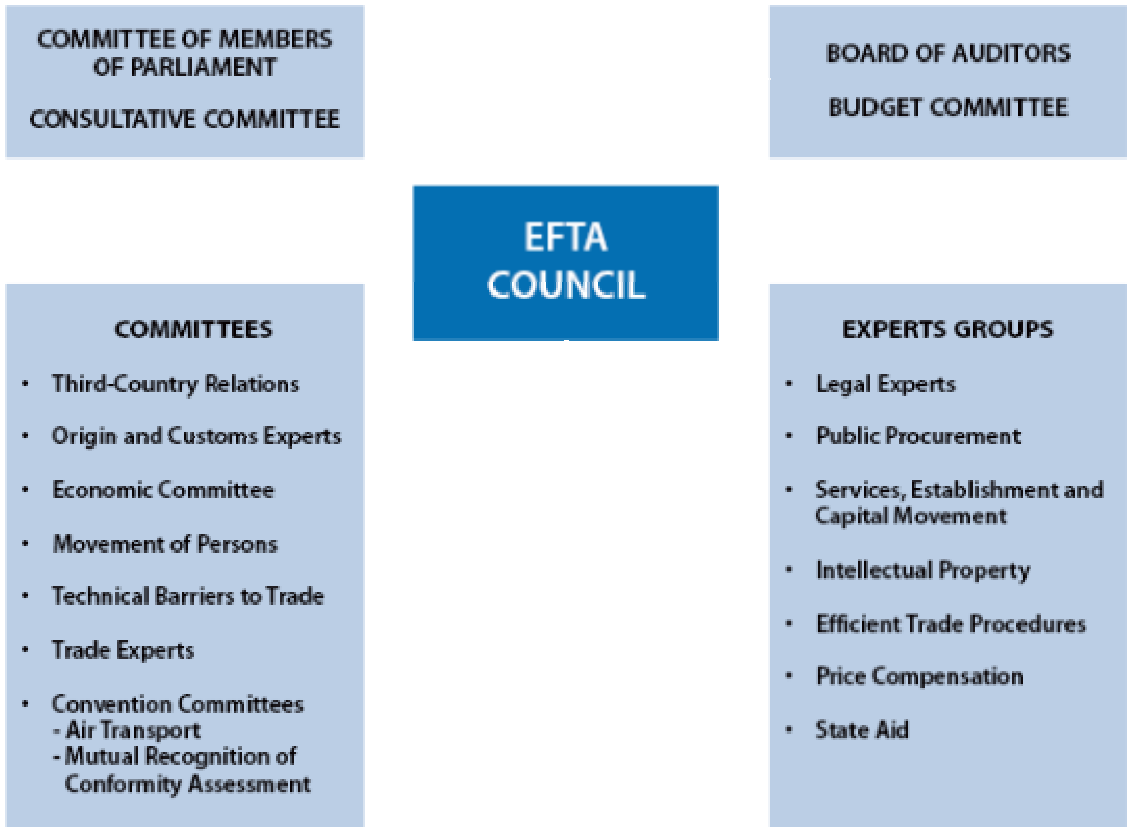
¹⁶⁷ In EFTA (2005-a).

chairmanship and for second half of the year Switzerland will be in the chair. We cannot forget that the EFTA Council is also responsible for administrative matters and for the EFTA budget.

6.1.2 Committees and Expert Groups

Under the EFTA Council a number of specialized committees and expert groups have been created over the years. These committees and expert groups deal with special issues and report their conclusions to the Council. For example the Economic Committee exchanges views on economic policy within the Member States and engages in a dialogue with the EU.¹⁶⁸ Other committees and working groups focus on different issues which concern EFTA member states and their fields of interest are shown in Figure 6.1.

Figure 6.1: The EFTA Council structure



Source: EFTA (2005-a).

¹⁶⁸ In <<http://secretariat.efta.int/Web/EFTAAtAGlance/institutions/StructureEFTACouncil>>, [cit. 2006-06-01].

6.1.3 Important committees and their functioning

Two committees have more important roles as you can see in the Figure 6.1. These are the Consultative Committee and Parliamentary Committee. When we take a look at the former one, we find that its main activity is to consult on the developments in labour policy in the member states. Therefore labour unions and employer's organizations take part in this committee. Members of the committee also work to advise the Council about current issues and development in the field of labour policy.¹⁶⁹ This committee also cooperates with the EU mostly in the EEA Consultative Committee.¹⁷⁰

The latter committee is formed by the Members of Parliament (MP's) of the four EFTA countries as the name would suggest. In this committee all relevant issues concerning the EFTA states, the EEA, and third country relationships are discussed. Also cooperation with the EU is mostly covered by the EEA Joint Parliamentary Committee, which will be discussed below.

The Budget Committee assists the Council on matters related to the EFTA budget.¹⁷¹ Another important role is served by Board of Auditors. It acts as the supreme auditing authority for the EFTA Secretariat, the EFTA Surveillance Authority and the EFTA Court.¹⁷² It also cooperates with the European Court of Auditors regarding EFTA contributions to the EEA budget.¹⁷³

6.1.4 EFTA Secretariat¹⁷⁴

The management of EFTA and its daily routine is exercised by the EFTA Secretariat. Its headquarters are based in Geneva where the negotiations and management of free trade agreements take place. Another residency of the Secretariat is in Brussels, where the issues concerning the EEA Agreement are exercised. The third part of this Secretariat is constituted by the Statistical Adviser's

¹⁶⁹ In EFTA (2006-b).

¹⁷⁰ See below.

¹⁷¹ In <<http://secretariat.efta.int/Web/EFTAAtAGlance/institutions/StructureEFTACouncil>>, [cit. 2006-06-01].

¹⁷² These institutions will be examined below.

¹⁷³ In <<http://secretariat.efta.int/Web/EFTAAtAGlance/institutions/StructureEFTACouncil>>, [cit. 2006-06-01].

¹⁷⁴ The information about the EFTA Secretariat is mostly taken from EFTA (2006-b).

Office, which is based in Luxembourg. Overall the Secretariat employs approximately one hundred staff members. All staff members are servants of the Association and therefore are not responsible to their national governments. They are headed by the Secretary General and his two deputies.

As can be seen, the only real EFTA institution dealing with EFTA matters for a long period of time was the Council with support from the Secretariat. It is in sharp contrast with the quantity of EU institutions. However, we must not forget that areas of EU's interests are wider and concern more issues and problems. After the creation of the EEA, the situation changed significantly. In order to manage the rules in the EEA, new institutions were established which are dealt with in the following part of this chapter.

6.2 Institutional background in the EEA

Now I would like to have a closer look at the decision-making process and institutions in the EEA.

6.2.1 Homogeneity of the EEA

The EEA is governed by the EEA Agreement, which entered into force in 1994. There was a long period of negotiations in order to include the relevant parts of *acquis communautaire* into the Agreement.¹⁷⁵ That ensured the homogeneity of the EEA. However, this *principle of homogeneity*¹⁷⁶, which is crucial for functioning of the EEA, has to be observed all the time. The legislation of the EC concerning the common market areas where the EEA is in effect does not have direct impact on EFTA states and their legislation.¹⁷⁷ Nevertheless, the homogeneity is ensured by the adoption of the EEA Agreement amendments.¹⁷⁸ These amendments and annexes of the Agreement are executed by EEA institutions. This is to ensure that: "the ensuing text is as close as possible to the adopted legislation on the EU side."¹⁷⁹ This existence of common rules in certain areas does not in itself fulfil the principle of

¹⁷⁵ See Chapter 3 for details.

¹⁷⁶ As described it means that new EU laws concerning the common market should be incorporated into the EEA Agreement in order to have the same treatment for each member state of the EEA and for their inhabitants.

¹⁷⁷ In EFTA (2006-b).

¹⁷⁸ Articles 101 and 102 of the EEA Agreement provide the legal basis for these amendments and state how they should be approved.

¹⁷⁹ In EFTA (2006-b).

homogeneity. That rules have to also be interpreted and applied in a same way within the whole EEA territory.

If there were some difference in interpretation or application of these common rules, it could lead to a distortion of the conditions of competition.¹⁸⁰ In order to prevent such distortions, EEA institutions must have mechanisms for surveillance and dispute settlement.¹⁸¹

6.2.2 EFTA's participation in decision-making process

We can see that EEA EFTA countries should be interested in the proposed and discussed EU legislation concerning common market. However, they do not have any formal rights to participate in the decision-making process of EU. The EEA Agreement states on the other hand, the opportunity of EEA EFTA states to influence the emergent EU legislation by participation in Commission's expert groups and committees. Those expert groups and committees prepare the background papers for the new legislation and then advise and assist the Commission in drafting that new legislation. However, the final step in the process is the ratification of those drafts of EU legislation and in that phase EEA EFTA states do not take a part.¹⁸² Overall EEA EFTA states have little influence on the decision-making phase in the EU but they can actively participate in the decision-shaping process of EU legislation concerning activities within the EEA.¹⁸³

6.2.3 Two-pillar structure institutions

In order to ensure the smooth functioning of the EEA and also the aforementioned conditions, the EEA is governed by two-pillar structure institutions. As shown in Figure 6.2 one pillar could be understood as the EEA EFTA states and their institutions. The right pillar in Figure 6.2 shows the side of the EU and in the middle

¹⁸⁰ In Norberg et al. (1993).

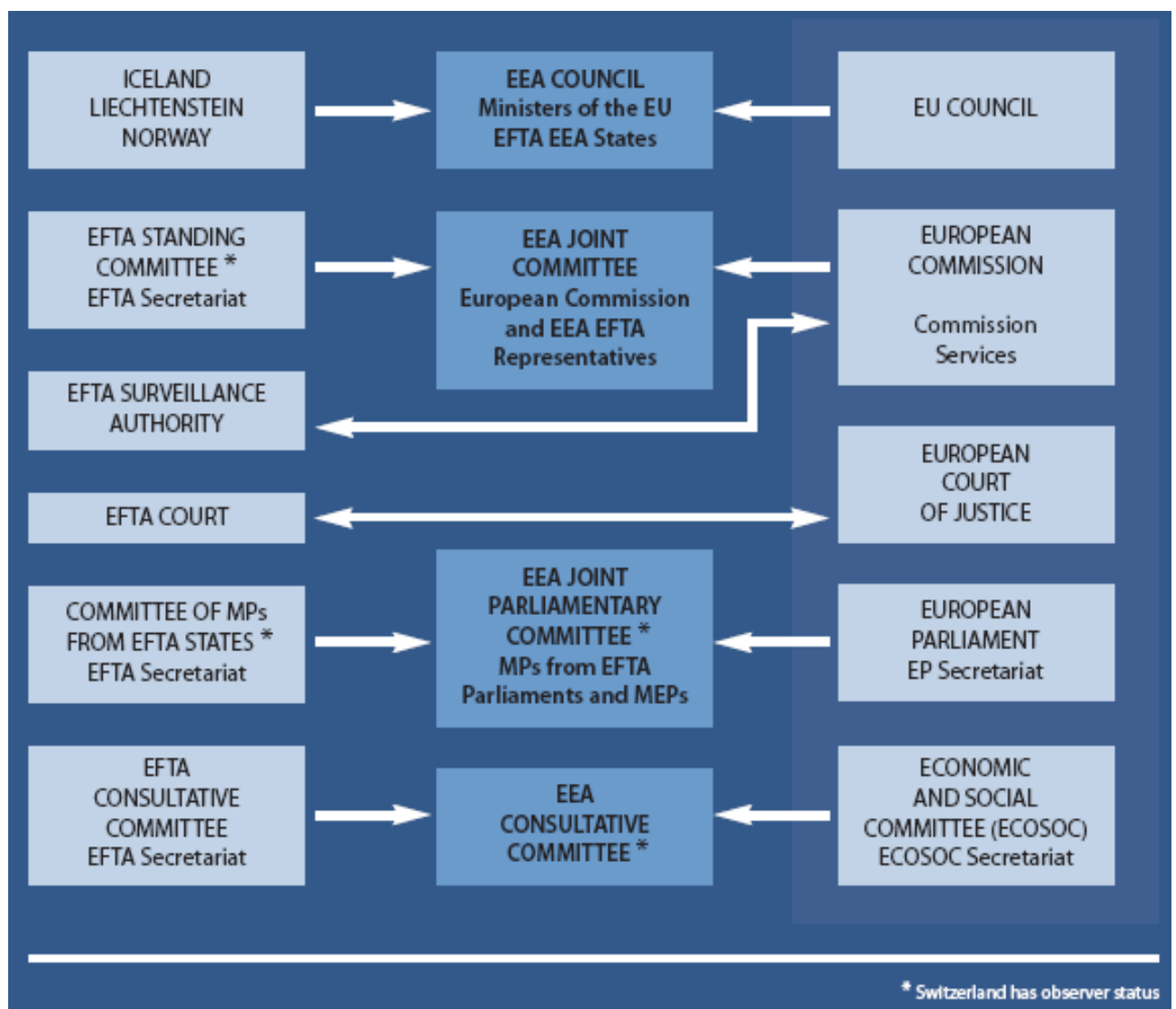
¹⁸¹ Described below.

¹⁸² The decision-making process of new EU legislation is done mostly by EU Council, European Parliament and Commission where EFTA states do not have their representatives.

¹⁸³ In <<http://secretariat.efta.int/Web/EuropeanEconomicArea/institutions/DecisionMaking>>, [cit. 2006-06-01].

joint EEA bodies can be seen. In joint EEA institutions both EFTA and the EU send their representatives and the main decisions concerning EEA are taken there. It should be pointed out that Switzerland does not take part in EEA joint bodies as a legal member, but it has observer status in most of them. I would now briefly state the roles and functions of those institutions.

Figure 6.2 Two-Pillar EEA Structure



Source: EFTA (2005-a).

6.3 Joint bodies of the EEA:

6.3.1 EEA Council

It is the highest political organ under the EEA Agreement. It is composed of EEA EFTA foreign ministers, the EU foreign minister of the current and forthcoming EU Council Presidencies, the EU Commissioner for External Relations and the High Representative for the EU's Common Foreign and Security Policy.¹⁸⁴ It meets twice a year and is responsible for providing the political impetus, implementation, and development of the Agreement. It also provides guidelines for the EEA Joint Committee.¹⁸⁵ It has a very similar function and role to that of the Council of Ministers in the EU. That also meets only a couple of times a year and gives political impetus for the direction of the European Union.

6.3.2 The EEA Joint Committee

It is responsible for the ongoing management of the EEA Agreement. This committee is made up of ambassadors of the EEA EFTA States, representatives from the European Commission and EU member states.¹⁸⁶ It generally meets once a month in Brussels. Its role is important in the maintenance of the principle of homogeneity. As discussed above, the new EU legislation concerning the common market should be incorporated into the EEA Agreement. This procedure is implemented by this Joint Committee. Preparatory work is done by EFTA working groups and afterwards the formal decision is taken by the Joint Committee. Then this EEA Joint Decision could be incorporated into the EEA Agreement. We could compare this institution to the Council of the European Union (Council of Ministers) in the field of the EU. The Council of the EU usually approves, sometimes together with the European Parliament, all the directives and decisions. The EEA Joint Committee

¹⁸⁴ In <<http://secretariat.efta.int/Web/EuropeanEconomicArea/institutions/EEACouncil>>, [cit. 2006-06-01].

¹⁸⁵ In EFTA (2004-a).

¹⁸⁶ In <<http://secretariat.efta.int/Web/EuropeanEconomicArea/institutions/EEAJointCommittee>>, [cit. 2006-06-01].

then accepts those rules which concern the EEA and afterwards they are incorporated into the EEA Agreement.

6.3.3 EEA Joint Parliamentary Committee and EEA Consultative Committee

Both these committees are of an advisory character and do not directly participate in the decision-making of the EEA. The Joint Parliamentary Committee consists of MPs of EEA EFTA states and on the other hand Members of the European Parliament (MEPs). This should somehow strengthen the role of national parliaments of EEA EFTA countries. We can understand the role of this committee as similar to the role of European Parliament within the EU legislative framework. However, the European Parliament enjoys greater decision-making powers in the field of the EU.

The latter committee consists of members of the EFTA Consultative Committee and the European Economic and Social Committee from the EU side. This committee works on improving the relations between social partners such as labour unions and employers' organizations.¹⁸⁷

6.4 EEA-EFTA Bodies:

6.4.1 EFTA Standing Committee

In this committee EFTA states consult their positions and opinions to be able to present a common view on certain issues in the EEA Joint Committee. It consists of representatives from Iceland, Liechtenstein and Norway and observers from Switzerland and the EFTA Surveillance Authority.¹⁸⁸ The committee itself is further divided into five subcommittees and several working groups.

¹⁸⁷ In EFTA (2006).

¹⁸⁸ In <<http://secretariat.efta.int/Web/EuropeanEconomicArea/institutions/EFTAStandingCommittee>>, [cit. 2006-06-01].

6.4.2 EFTA Surveillance Authority

The ESA should ensure that EEA EFTA states fulfil their obligations, which are stated in the EEA Agreement. It has similar competences to the Commission in the EU. The ESA monitors that provisions from EEA Agreement and their amendments are properly incorporated into the legal system of EEA EFTA countries.¹⁸⁹ In the fields of public procurement, state aid and competition, the ESA has extended competence as can also be seen in the Commission on the EU side.¹⁹⁰

6.4.3 EFTA Court

Here again we can see the parallel with the EU system. The EFTA Court corresponds to the Court of Justice of the EU. Its main role is the judicial control of EEA rules, which are stated in the EEA Agreement. The EFTA Court deals with actions brought by ESA against an EEA EFTA state with regard to the implementation, application or interpretation of EEA law.¹⁹¹ This court also solves dispute settlements between two or more EEA EFTA states. Another important role is giving opinions to the courts in EEA EFTA states on the interpretation of EEA law. I would like to point out that this court deals only with EEA EFTA countries; other countries of the EEA are dealt with under the Court of Justice.

¹⁸⁹ In EFTA (2006).

¹⁹⁰ In <<http://secretariat.efta.int/Web/EuropeanEconomicArea/institutions/ESA>>, [cit. 2006-06-01].

¹⁹¹ In <<http://secretariat.efta.int/Web/EuropeanEconomicArea/institutions/EFTACourt>>, [cit. 2006-06-01].

7. EFTA's Trade

In this chapter I focus on the trade of EFTA countries with rest of the world. We can divide this trade into three segments. First and the greatest one is the trade of EFTA countries with EU countries, which is practised mostly in the EEA.¹⁹² Second segment of EFTA's trade constitutes the trade with FTA partners. We can understand the third part being the trade of EFTA countries with the rest of the world, where are not applied any FTA. In the first part of this chapter I will describe the trade and relationships of EFTA countries with their FTA partners. The second part will be devoted to the trade of EFTA member states in general.

7.1 Negotiation of partnership

Hoekman & Kostecki¹⁹³ perceive some possibilities for states outside any discriminatory grouping. The most obvious reaction would be to seek a reduction in the grouping's external barriers. That is at the first place task of WTO and it was to some extent accomplished in several rounds of the negotiations.¹⁹⁴ However, barriers in the world trade still persist. Therefore, another possibility of the state outside the discriminatory grouping is to negotiate with the grouping itself. The negotiations could result into the accession of the country into the grouping. That is probably not the situation of EFTA and its trading partners as will be discussed in the last chapter.¹⁹⁵ On the other hand, the country can negotiate reduction or even abolishment of trade barriers. That is mostly done by FTA or by other different forms of partnership.

The negotiations and cooperation of EFTA with the third countries go back to the year 1967, when EFTA states as a group established cooperation with former Yugoslavia. The first FTA, however, was concluded in year 1979 with Spain. Since then the development in this area of relations took rapid pace, mostly after the end of

¹⁹² That does not apply for the trade between EU and Switzerland, however, as was described above this trade flow is handled by bilateral agreements, which constitute almost the same conditions for trade between EU and Switzerland as are applied in the trade inside EEA.

¹⁹³ In Hoekman & Kostecki (2001).

¹⁹⁴ For detailed analysis of these rounds see e.g. Hoekman & Kostecki (2000) or GATT (1994).

¹⁹⁵ Of course a different situation is when European country joins EU and as a consequence it also joins EEA. However, that country is obviously not joining EFTA by that.

the Cold War. That allowed to EFTA initiate FTA with Central and Eastern European and other countries from different parts of the world.

The main reason why EFTA states act together in negotiations for FTA and other forms of partnership is that they together constitute more weight as economic players in the world economy. Therefore their negotiating power is greater than if they would act alone. Together EFTA network consist of 16 FTA's and 7 Joint Declarations, other agreements are still under negotiation.¹⁹⁶ Remark the Table 7.1 which shows FTA and Joint Declarations of EFTA with other countries.

Table 7.1 FTA and Joint Declarations of EFTA¹⁹⁷

Country	Joint Declaration	Free Trade Agreement	
	Signature	Signature	Entry into force
Albania	10 December 1992		
Algeria	12 December 2002		
Bulgaria	10 December 1991	29 March 1993	1 July 1993
Chile		26 June 2003	1 December 2004
Croatia	19 June 2000	21 June 2001	1 April 2002
Egypt	8 December 1995		
Gulf Cooperation Council (GCC)	23 May 2000		
Israel		17 September 1992	1 January 1993
Jordan	19 June 1997	21 June 2001	1 September 2002
Korea (Rep.)		15 December 2005	
Lebanon	19 June 1997	24 June 2004	
Macedonia	29 March 1996	19 June 2000	1 May 2002
Mexico		27 November 2000	1 July 2001
Southern Common Market (MERCOSUR)	12 December 2000		
Morocco	8 December 1995	19 June 1997	1 December 1999
Palestinian Authority	16 December 1996	30 November 1998	1 July 1999
Romania	10 December 1991	10 December 1992	1 May 1993
Southern African Customs Union (SACU)		Spring 2006	
Serbia & Montenegro	12 December 2000		
Singapore		26 June 2002	1 January 2003
Tunisia	8 December 1995	17 December 2004	1 June 2005
Turkey		10 December 1991	1 April 1992
Ukraine	19 June 2000		

Source: EFTA (2006-a).

¹⁹⁶ In EFTA (2006-b).

¹⁹⁷ The groupings of states such as GCC are described below in Table 7.4.

7.2 Joint Declarations

The first step towards FTA are usually Joint Declarations on Cooperation. At the present time EFTA has seven of those with individual states and also with groupings of states as you can see in Table 7.1. The participating parties of those declarations meet and discuss the further development of their relationship. You can see the basic description of those declarations in Table 7.2

Table 7.2 Basic features of Joint Declarations

Joint declarations on cooperation (JDCs)
Are a first step towards free trade relations between the partners concerned. They aim to promote the harmonious development of economic relations; create an environment supportive of private entrepreneurship, free competition and economic activity based on market forces; examine ways and means to expand and liberalise trade relations.
Cover cooperation on trade-related issues such as: technical and other barriers to trade; information on foreign trade; competition; trade in services; public procurement markets; intellectual property rights.
Aim to improve conditions for the implementation of private sector cooperation projects.

Source: EFTA (2006-b).

7.3 Free Trade Agreements

Trade with FTA partners represents only 3.7% of EFTA's total trade.¹⁹⁸ However, it is an important area of activity for EFTA and EFTA is also proceeding negotiations with other states and groupings. For FTA I am also attaching the Table 7.3 which describes basic attributes of them. In addition to that I would like to point out several interesting features of those FTA. As you can witness from Table 7.1, countries which have negotiated FTA with EFTA are to some extent still developing countries in most of the cases. Therefore, EFTA sometimes exercise assymetrical approach. Which means that EFTA countries normally abolish all tariffs and other restrictions on industrial products at the entry into force of the agreement. The partner countries concerned may enjoy transition periods, when they can still claim duties from EFTA imports.¹⁹⁹ The transitional periods allow to the economies of less

¹⁹⁸ See the second part of this chapter.

¹⁹⁹ In EFTA (2004-c).

developed countries to adapt on free trade situation and they usually do not exceed ten years.²⁰⁰

Some FTA also includes provisions on services and investment. The aim of those provisions is to insure gradual liberalisation and mutual opening of the markets for these areas. Those provisions on services build on the General Agreement on Trade in Services (GATS) and follow a similar approach which is used in that agreement.²⁰¹

To conclude this part I would like to mention that FTA and Joint Declarations are important area of EFTA activities, although they do not constitute a significant part of EFTA's trade. Approach towards FTA is not that limited to trade of industrial goods and it covers different areas of cooperation and liberalization in fields such as competition rules or trade in services.

Table 7.3 Basic features of FTA

Free Trade Agreements (FTAs)
Establish a free trade area between the partners. They provide for free trade in industrial goods, including fish and other marine products; cover trade with processed agricultural products; provide for trade disciplines; governing the preferential trade in goods under the FTA; contain elaborate rules on customs and origin matters, including as regards cumulation ¹ ; trade in basic agricultural products is covered in separate bilateral agreements relating to the FTA.
Liberalise trade in services, investments and public procurement in more recent agreements, including those with Mexico, Singapore, Chile and South Korea. Other agreements contain rules allowing for the further development and deepening of relations in these fields through evolutionary clauses, e.g. with partners in the Mediterranean region.
Include rules on competition to avoid adverse effect in the case of restraints of competition which frustrate the liberalisation benefits of the FTA.
Provide for the protection of intellectual property rights in accordance with high standards.
Contain provisions for the avoidance and the settlement of disputes between the Parties.
Are regularly adapted and upgraded to: make them as efficient as possible; take into account developments in the World Trade Organization (WTO); make them compatible with developments within the wider European economic integration framework.

Source: EFTA (2006-b).

²⁰⁰ In EFTA (2006-b).

²⁰¹ Ibid.

7.4 Basic aspects of EFTA's trade

EFTA member states belong to one of the most active trading nations in the world. Their population constitute only 0.2% of the world population, however, their share in the global trade is around 2%.²⁰²

In Table 7.4 you can see the foreign trade of EFTA countries in year 2005. In the table you can also find figures of exports and imports with the main trading partners of EFTA. Each of those columns is associated by percentage share on the total trade (export, import) of EFTA.

Table 7.4 EFTA's main trading partners in trade in year 2005²⁰³ (in million USD)

	Total trade	Share	Exports	Share	Imports	Share
World	411 211	100,0%	230 849	100,0%	180 362	100,0%
1. Free Trading Partners	317 893	77,3%	172 870	74,9%	145 023	80,4%
EU (25)	300 220	73,0%	162 164	70,2%	138 056	76,5%
Third Country Partners (21) ²⁰⁴	15 096	3,7%	9 468	4,1%	5 628	3,1%
Intra-EFTA (4)	2 577	0,6%	1 237	0,5%	1 340	0,7%
2. United States	31 129	7,6%	21 368	9,3%	9 761	5,4%
3. China, (including Hong Kong and Macau)	14 323	3,5%	7 005	3,0%	7 318	4,1%
4. Japan	10 107	2,5%	5 830	2,5%	4 277	2,4%
5. Canada	7 942	1,9%	5 828	2,5%	2 114	1,2%
6. Russia	4 141	1,0%	2 099	0,9%	2 042	1,1%
7. GCC ²⁰⁵	3 176	0,8%	2 660	1,2%	516	0,3%
8. MERCOSUR ²⁰⁶	2 869	0,7%	1 673	0,7%	1 196	0,7%
Rest of the World	19 631	4,8%	11 516	5,0%	8 115	4,5%

Source: World Trade Atlas, own computations.

²⁰² In EFTA (2004-e).

²⁰³ The number in the brackets represents number of member states of that specific grouping.

²⁰⁴ FTA partners including Southern African Customs Union which comprises Botswana, Lesotho, Namibia, Swaziland and South Africa.

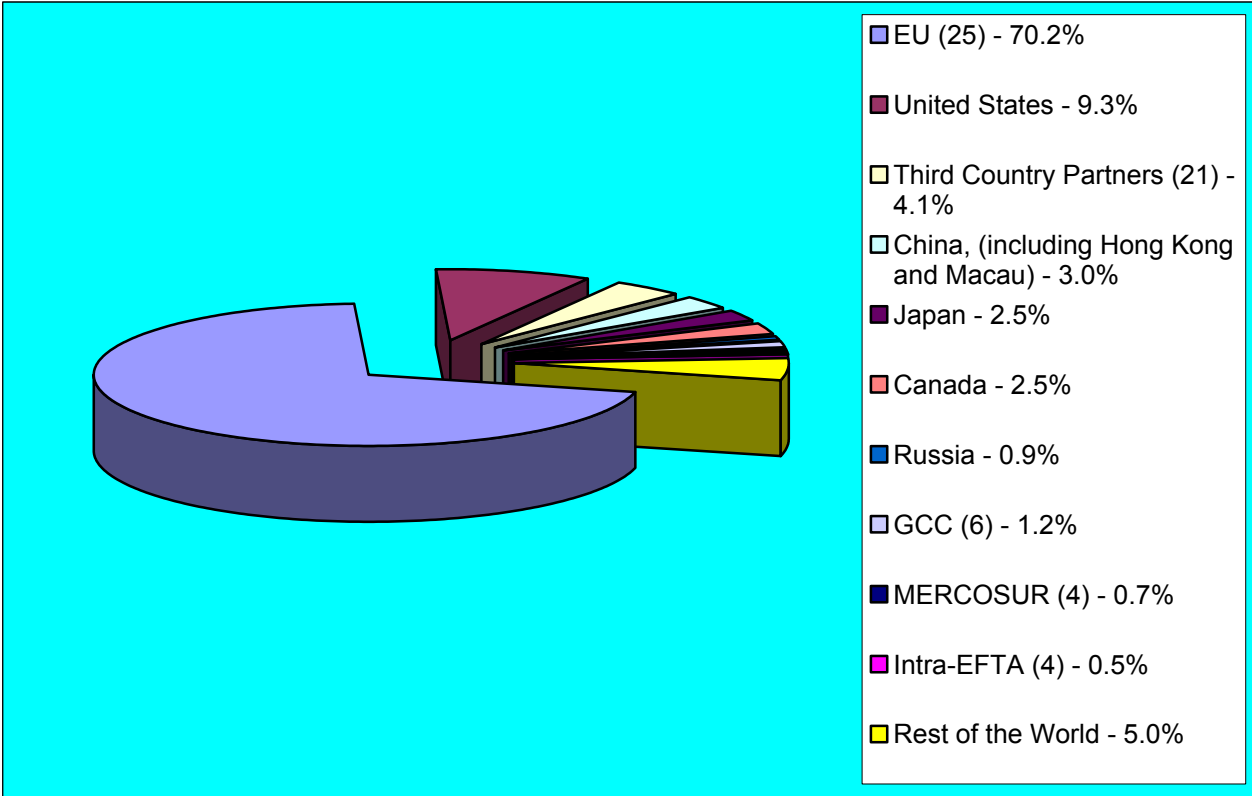
²⁰⁵ Gulf Cooperation Council is constituted by Saudi Arabia, Bahrain, Kuwait, Qatar, United Arab Emirates and Oman.

²⁰⁶ MERCOSUR – Southern Common Market comprises Argentina, Brazil, Paraguay and Uruguay.

As you can witness from the table, the biggest trading partner for EFTA countries is EU, and the trade among those two groupings represent 73% of total EFTA trade. Other important trading partners are United States, China, Japan, Canada and Russia. FTA partners which includes 21 countries constitute a share of 3.7% on EFTA's total trade. Another important aspect, which is worth mentioning, is that EFTA countries record rather substantial trade surplus. The year 2005 was not the exception in this trend as you will see below.

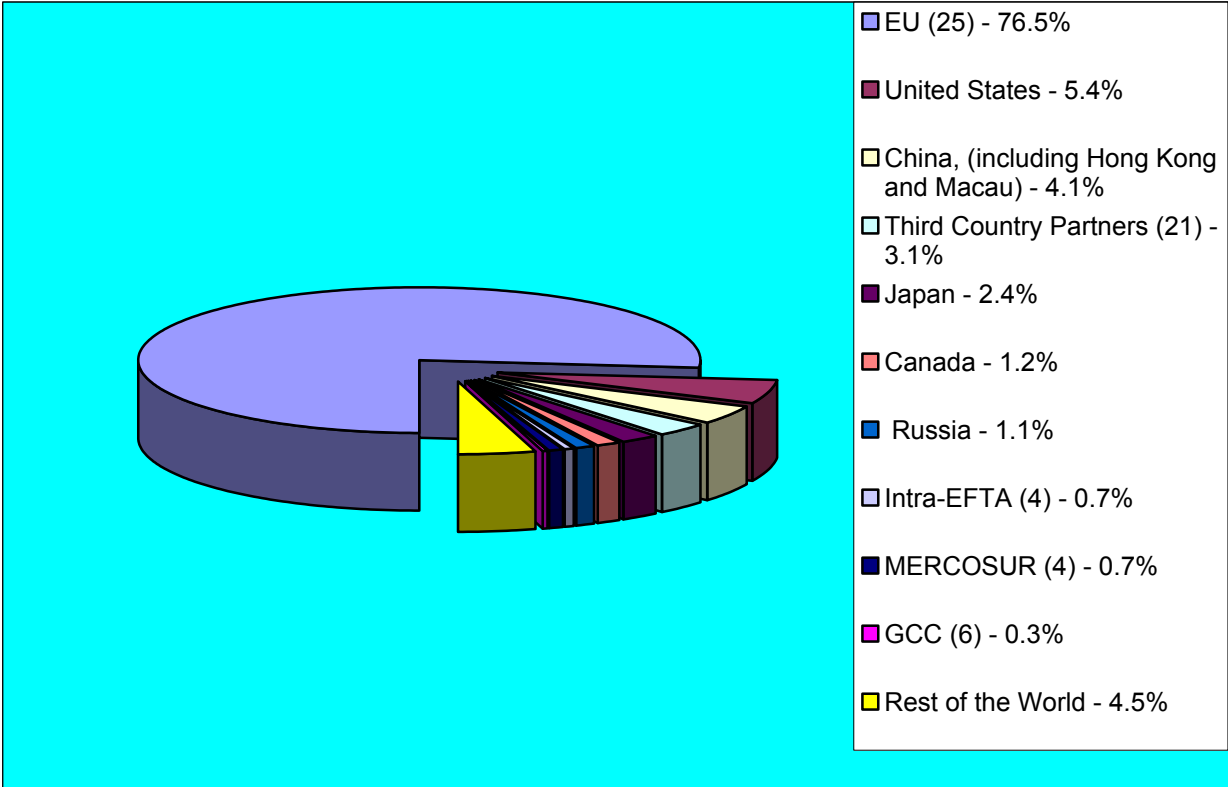
In Figures 7.5 and 7.6 you can see a graphic distribution of EFTA's foreign trade in year 2005. Again there are those main trading partners as are covered in Table 7.4. The percentage points states the share of imports (exports) from that country on the total imports (exports).

Figure 7.5 EFTA's exports in year 2005



Source: World Trade Atlas, own computations.

Figure 7.6 EFTA's imports in year 2005



Source: World Trade Atlas, own computations.

7.5 Development of EFTA's trade in the new millenium

In the last part of this chapter I will explore the foreign trade of EFTA countries in first years of a new millenium.²⁰⁷ In Tables 7.7 and 7.8 you can perceive the export and import of EFTA countries respectively. In years 2003 and 2004 the increase of exports and imports in all of the EFTA countries is rather significant. Those figures rose approximately by 15 per cent. This could be to some extend explained by the extension of common market of EEA by ten new accession countries. However, that

²⁰⁷ Again Lichtenstein's figures are not stated in these tables, because their trading figures are covered in Switzerland's results due to customs union among those states.

is only one reason and we cannot predicate how much it influenced the total trade numbers.²⁰⁸

Table 7.7 Total exports of EFTA countries in years 2001 – 2004 (in million USD)

	2001	2002	% Change (02/01)	2003	% Change (03/02)	2004	% Change (04/03)
Iceland	2 014	2 228	10.6%	2 378	6.7%	2 887	21,4%
Norway	59 205	59 649	0.7%	68 324	14.5%	81 660	19,5%
Switzerland	82 057	87 967	7.2%	100 773	14.6%	118 700	17,8%
EFTA	143 276	149 844	4.6%	171 475	14.4%	203 247	18,5%

Source: World Trade Atlas, own computations.

Table 7.8 Total imports of EFTA countries in years 2001 – 2004 (in million USD)

	2001	2002	% Change (02/01)	2003	% Change (03/02)	2004	% Change (04/03)
Iceland	2 092	2 092	0.0%	2 603	24.4%	3 423	31.5%
Norway	32 946	34 865	5.8%	40 056	14.9%	48 011	19.9%
Switzerland	84 065	83 772	-0.3%	96 535	15.2%	111 777	15.8%
EFTA	119 103	120 729	1.4%	139 194	15.3%	163 211	17.3%

Source: World Trade Atlas, own computations.

In Table 7.9 you can find trade balances of EFTA states in recent years and their share to total trade of that state. Norway embodied every year large trade surplus and therefore also EFTA in total embodied a surplus. It is to some extent caused by the structure of Norway's exports and by the abundance of natural resources. Norway is on the first place exporting mineral fuels and oil which constitutes over 60 per cent of total exports.²⁰⁹ If we take a look on Iceland and

²⁰⁸ The similar increase in EFTA's trade numbers was recorded in the middle 1990s, after creation of EEA. Again the creation of EEA was only one of the reasons why those trade numbers rose. See the discussion about Norway's trade in Longva (2003).

²⁰⁹ See EFTA (2005-b).

Switzerland, we find out that their trade balances fluctuate and they sometimes experience surplus at another time they experience trade deficit.

Table 7.9 Trade balances of EFTA member states in years 2001-2004 (in million USD)

	Trade balance in 2001	% Share of total trade	Trade balance in 2002	% Share of total trade	Trade balance in 2003	% Share of total trade	Trade balance in 2004	% Share of total trade
Iceland	-0.078	-1.9%	0.136	3.1%	-0.225	-4.0%	-0.536	-8.5%
Norway	26.259	28.5%	24.784	26.2%	28.268	26.1%	33.649	25.9%
Switzerland	-2.008	-1.2%	4.195	2.4%	4.238	2.1%	6.923	3.0%
EFTA	24.173	9.2%	29.115	10.8%	31.461	10.1%	40.036	10.9%

Source: World Trade Atlas, own computations.

To conclude this part with I would like to state that EFTA's trade would certainly deserve more sophisticated analysis. On the other hand, it was not the main purpose of this thesis, and therefore I have decided to formulate only basic principles and features of trade in EFTA countries. In the following chapter I am going to evaluate the prospects of EFTA grouping.

8. Conclusion – the Prospects of EFTA

The EFTA grouping represents in current world rather unique formation of member states. Those countries would probably never join together in such a grouping if there was not the development and the history of their relations in the past. However, those states might seem really different they do have some features in common and they cooperate very actively in the EFTA itself or in the EEA with EU countries. Most of all, EFTA countries are developed European countries with respectable economic performance as was outlined in the Chapter 4. They are also very active in the world trade and therefore they closely cooperate in this field with many countries as was explained in Chapter 7.

8.1 Future prospects of EFTA

It is rather complicated to predict the future development of this grouping. However, I will try to mention at least some certain aspects and possibilities. The main question would probably be if the member states are going to stay in the EFTA, and whether there are some other states which could negotiate membership. Concerning the second part of the problem I would say that it is very unlikely to happen. The new member state of EFTA would have to be from the European continent. All the remaining countries from Europe, which are not part of EU or EFTA, are actually directing towards EU.

I will, however, articulate two rather hypothetical cases, in which some European state would try to negotiate its membership in EFTA. The one possibility would be a country that for certain reasons leave EU. If we accept this hypothesis, which has actually never taken place in the history of EU, there are still some doubts about joining EFTA. The EFTA member states do not have to agree with that kind of process and they would not enable accession to that state.

The second very improbable possibility is that a state which is negotiating a membership with EU would not be for certain reasons admitted to this grouping or its

accession would be postponed. Then this state may also try to negotiate the membership in EFTA in order to achieve at least some liberalization in trade and other fields with European countries. Those two examples were rather unrealistic and therefore the author of this thesis assumes that the number of member states in EFTA will not rise in the near future.

To answer the first part of the question we can have a look on Norway, which would be the most profound example. Let me assume that if a member state of EFTA will leave this grouping the reason would be joining of EU as it has happened every single time a country was leaving EFTA.²¹⁰ Norway already tried to enter the EU twice in the past and in both cases the accession was not approved in the referendum.²¹¹ However, at the current situation, when Norway has access to the common market of EEA the demand to join EU is not that great.

However, according to my opinion Norway would be the state which would accede to EU most probable from the four EFTA states. Therefore, it appears that EFTA member states are not likely to leave EFTA in order to join EU. Leaving EFTA without entering EU seems even more unrealistic and impossible.

My conclusions are therefore that EFTA member states are not likely to change in the near future. They will continue its cooperation with EU states and one day they will hopefully achieve complete common market. EFTA member states are also going to continue their negotiations of FTA and other forms of partnership with foreign countries and groupings.

8.2 Contribution of existence of EFTA

At first we have to understand the circumstances and conditions in today's world. According to the majority of the economists the best solution for world's trade would be cancellation of all trade barriers and impediments in the market. Therefore, there would be almost no need for such a grouping as EFTA. However, the situation in the world economy does not allow this to be done. As a conclusion there is a great deal of PTA which are usually considered as being **second best option**. These

²¹⁰ See the Chapter 3.

²¹¹ See Eliason & Sitter (2003) for detailed description and interesting discussion about Norway's attitudes towards integrated Europe.

discriminatory groupings do not create only welfare, but they could also reduce it. That was explained on the example of trade diversion and ROO in previous chapters.

The relationship of EFTA with EU brought some significant improvements which are visible. On the other hand, it could have been accompanied by some of those deteriorations, which are not that visible. More detailed analysis should be done in order to discover real consequences of functioning of EFTA and creation of EEA. That could be even a suggestion for master thesis.

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