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Keskusteluaiheita **Discussion papers**

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WHAT PRICE INTEGRATION?
PRICE DIFFERENTIALS IN EUROPE:
THE CASE OF FINLAND

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ABSTRACT: The paper examines the extent of Finland's economic integration with its seventeen partner countries in the European Community and EFTA by utilising data on differences in price levels in European countries.

The main conclusion is the following: a certain degree of integration of the Finnish economy and its Western European trading partners has been achieved by abolishing tariffs and quantitative restrictions on industrial goods in trade between Finland and the EC and other EFTA countries. The degree of integration is lower, however, than usually assumed - at the expense of Finnish consumers. It is also lower than that of most other countries in the area.

Barriers to trade have been substantially abolished in trade between Finland and its EFTA and EC trading partners. Nevertheless, remaining barriers have a substantial impact on trade between EFTA and EC countries. Such barriers also exist among the twelve EC member states. They have already been lowered considerably, however, and will be further reduced in the course of the completion of the internal market. Increased competitiveness of EC economies amounts to a terms-of-trade loss for Finland as for other EFTA countries - unless policies are implemented that ensure a higher degree of integration.

The paper presents an overview of policy options that Finnish integration policy could face over the next few years. The main issue will be the trade-off between further integration and the associated loss of autonomy over policy - especially economic policy.

KEY WORD: Economic integration

I. Introduction and background

The paper examines on the basis of data on price differentials in Western Europe the degree of integration of the Finnish economy with the economies of its main trading partners - the seventeen other countries of the European Economic Space, formed by EFTA and the European Community. It is an extension of Wieser (1989) where related issues are treated in a more general fashion for EFTA as a whole.

Finland has participated actively in the institutions and processes of post-war European integration. It is a member of OECD, since recently of the Council of Europe, a member of EFTA, and since 1973 it has been tied to the European Community by its Free Trade Agreement (FTA).

Through its membership in EFTA, Finland has taken part in the regional lowering and then abolishing of tariffs and quantitative restrictions first in that group, and then vis-à-vis the European Community. Finland, as the other EFTA countries, is now integrated into the area which is called the European Economic Space (EES), formed by the eighteen countries of the EC and EFTA, where industrial goods can circulate free of tariffs and quantitative restrictions.

Going beyond the FTAs, Finland's cooperation with the Community has been based on two elements: other relations of a bilateral nature, and - through EFTA - a multilateral approach, which since 1984 has been pursued under the umbrella of the so-called Luxemburg Declaration. In the Luxemburg process some twenty-five EFTA-EC working groups are discussing ways and means of reducing or eliminating practices or policies that discriminate between members of

the two groups. These are so-called 'second-generation' issues of EFTA-EC cooperation.

Following the speech by President Delors on 17 January 1989, where he called for a deeper and more structured relation with EFTA countries, discussions between EFTA countries and the EC Commission have been ongoing on how this could be achieved. It is too early at this stage to judge the outcome, but it has been repeatedly stated that no options are excluded, and that institutional reforms might be one of the outcomes of this process. These one might call 'third-generation' issues.

The aim of ongoing cooperation between Finland and the European Community, be it bilaterally or multilaterally through EFTA, is to reduce discrimination of Finnish goods and services in the Community market. In other words, the aim is to deepen the degree of Finnish integration with the EES economies. At this stage and against this background it is thus of interest to analyse the degree to which Finland is already integrated with the other seventeen countries of the EES.

The description of a country's degree of integration with partner countries is usually undertaken by measuring the share of trade with these countries as a share in total trade. By this measure, Finland is fairly well integrated with the Community, with which it conducts around half of its foreign trade. If the degree of integration is understood as being the degree to which partner countries' goods and services (and possibly labour and capital) can enter and circulate in the other country under equivalent conditions as domestic goods and services do, this approach is, however, unsatisfactory. Geographical proximity, country size, industrial structure and level of per capita GDP are main determinants of trade shares, and not

exclusively or largely the degree of integration.

The approach used in this paper is to measure the degree of integration by the dispersion of prices in the EES in a given sector. We utilise data on price levels in around fifty different sectors of the economy. Differences in prices between countries then show the degree of integration of Finland with its partner countries in the EES. The principle behind this approach is that net of transport and similar costs, the law of one price should hold for traded goods internationally. Whilst a number of other factors that are treated in the paper preclude from the outset that this holds strictly true, a significant part of deviations of prices can be explained by policies that act as barriers to arbitrage by economic agents, and thus to further integration.

This paper is organised as follows: Section II gives a short overview of the underpinnings of this paper. Section III gives a description of the main types of external and domestic barriers that have a bearing on Finland's further integration into the EES. Section IV provides the data together with an attempt to identify main impediments to further integration for key sectors. Section V gives an overview of options for Finnish integration policy, whilst a final section summarises and concludes the paper.

II. Price Dispersion as a measure of Integration

For internationally traded identical goods, prices should in principle be equal internationally. This has to be qualified by a few observations. The existence of price differentials due to transport costs and exchange rate risk are obvious. Also, even for traded goods differences in national per capita GDP induce differences in price levels,

since distribution and similar costs in low-price countries will invariably be cheaper.

However, apart from these factors, the law of one price should hold internationally if barriers do not impede trade. The higher such barriers are, the larger differences in price levels will be.

Ideally, we should be able to use producer prices for our analysis, i.e. net of taxes. Due to constraints posed by the data set, this not possible. Differences of consumer prices between countries as shown here thus partially reflect differences of levels of tariffs or indirect taxes. This is taken into account as far as possible.

The basic hypothesis of the paper is the following: the higher the degree of integration between a set of countries, the lower price disparities for identical goods will be between them. The degree of price divergencies between countries is thus a function of the height of barriers to arbitrage between them, and of the time span since they were last reduced.

Thus, integration should be highest, i.e. price divergencies lowest, between the six original members of the EC (EC 6). The next closest degree of integration should be that of the EC 9, i.e. countries with EC membership as of 1973. Within the Community as it is today, the two successive enlargements can be expected to have successively further reduced the degree of integration as measured by price dispersion. The degree of integration of European non-EC members is a priori not determined, but in any case lower than that of the EC 9.

The data in this paper is derived from OECD (1987). It covers all EES countries except Iceland and Switzerland.

Price levels have been standardised so that the Community price level for GDP and all separate contributions to final demand are set at 100. The data is for the year 1985. However, price movements in Western Europe have not diverged to such a degree as to render the conclusions invalid.

III. Barriers to arbitrage

As already mentioned, a number of factors preclude a priori that the law of one price holds internationally. The main factor underlying systematic deviations is the relative level of income, and thus also consumption patterns. Income and wage levels correlate significantly with overall price levels. In the low-price countries of the South labour intensive services are provided at relatively lower costs than in the North. Local sales and retail costs for internationally traded goods are cheaper, thus providing for such goods being systematically cheaper in Greece or Portugal than in Finland.

For non-tradeables these differences are significant. For tradeables, however, they can explain only to a limited extent differences in prices.

Usually, the extent of barriers to trade is regarded as one of the main determinants of domestic price levels. A liberal external trade regime, however, is only a precondition for achieving downward effects on prices through international trade, but it is not sufficient. All measures, regulations or practices that hinder arbitrage across borders by economic agents - i.e. a trading away of international price differentials - tend to increase domestic prices. A short overview over the main types of

barriers to arbitrage is given below. It is perforce a general overview; not all such barriers, let alone all factors influencing price disparities, can be filtered out within the scope of this paper. However, the effects of barriers to arbitrage are significant.

They can be classified into three separate groups. Firstly, the trade policy regime proper, i.e. tariffs and quantitative restrictions. Secondly, measures made possible through the existence of borders and border controls. This group encompasses national tax systems, state monopolies, and restrictive business practices by private enterprises, but also effects of differing trade regimes between countries. Thirdly, domestic measures of similar effect. These are the application of competition policies, technical barriers to trade (TBTs) and barriers to entry to markets.

These policies and measures have in common that they segment markets from each other. Sectors or firms are sheltered either from foreign or from domestic competition. Hindering competition, they give an upward bias to the domestic price level.

Tariffs and quantitative restrictions - the classical trade barriers - have been abolished between Finland and the other seventeen countries of the EES in trade in industrial products. However, whilst the EC member countries are bound by an in principle common external regime, Finland, as the other EFTA countries, has retained its autonomy over trade policy. In the Community, exemptions from the common trade regime are possible under Article 115 of the Rome Treaty. Such differing quantitative restrictions will have to be abolished before borders are eliminated post-1992.

The continued existence of Finland's tariffs and QRs vis-à-vis non-EES countries as such, however, is not a barrier to arbitrage within the EES.

Rather, it is the existence of different trade policy regimes within the EES vis-à-vis third countries that require intra-EES border controls in order to ensure that imports from third countries do not enter via countries with a liberal external regime and are then distributed to more protectionist EES member states. This regime enables firms to compartmentalise national markets, i.e. to set prices individually for each and every market. This effect will be the larger the greater the share of non-EES imports in apparent consumption is, since the volume of EES products that circulate freely will be insufficient for arbitraging price differentials away.

As with differing EES trade regimes differing tax regimes require the existence of borders. **Indirect and excise taxes** have a twofold effect on price levels. The first is straightforward, namely the amount of taxes themselves levied on a given product. In many countries especially alcohol and tobacco are subject to high rates. Price differentials between EES countries for these products are to a great extent due to differences in taxation levels. Throughout the EES, the base and rates for indirect taxation in general vary considerably.

The second effect of tax systems is that due to the restrictions that border procedures impose, the incidence of taxes may be different between countries. Borders are necessary for levying domestic indirect taxes on imports, and for proof of export in order to claim tax refunds. For high-tax countries they are necessary to prevent smuggling. However, through limitations on imports by private persons their existence allows firms to segment markets.

State monopolies on the production and/or distribution of certain goods and services have a long tradition in many countries. They include natural monopolies, such as distribution of electricity, or railways. They also include production or sometimes only distribution of dismerit goods such as alcohol or cigarettes, where - at least traditionally - health reasons were the main reason for their introduction. In time their function may have become more and more that of revenue raising.

State monopolies require the existance of borders, and strict regulations or even the prohibition of parallel imports in order to ensure their effectiveness. Usually their existance goes hand in hand with very high excise rates.

The last of the main categories of measures that rely upon the existance of borders is not a policy measure, but **strategic behaviour by firms**. Pricing to markets by firms enables them to capture rents in national markets that would be arbitraged away by consumers if border controls and regulations would not hinder them to do so. Exclusive licensing agreements have similar effects, i.e. mark-ups are considerable, since there is no competition that could reduce them.

Of domestic measures with similar effect, **competition policies** and their national application are closely connected to pricing to markets by firms. The philosophy concerning policies on restrictive business practices by firms vary considerably within Europe. On the one hand, Articles 85 et sequ. of the Treaty of Rome prohibit such practices in principle, unless it can be demonstrated that they would have e.g. a beneficial effect for consumers.

An opposite view is taken say in Switzerland, where cartels are in principle allowed. Exceptions can then be made for specific sectors, i.e. it may be considered to be in the public interest not to allow them in certain situations. Whilst in theory the effects of these two approaches may be identical, in practice it is clear that the Community approach ensures a considerably higher degree of competition. That the application of the law is the crucial factor, however, is demonstrated by the data in this paper, which proves that Community competition policies have not been a success in a number of sectors.

A strict and rigorous application of competition policies can exert a downward pressure on domestic prices. There are, however, limits to what can be achieved by competition policies, since the degree of national competition correlates strongly with the degree of competition by imports that is permitted.

Differing **standards and norms** between trading partners are technical barriers to trade, even though often enough they are due to historical developments, and not to a conscious attempt to separate national markets from each other. Their effect is that efficient national producers can not achieve scale economies in production, whilst at the same time small national markets are sheltered from outside competition. Within the limits posed by health and safety considerations, the highest overall welfare effects are achieved through harmonising standards throughout an as wide an area as possible.

Finally, **barriers to entry** play an important role in that firms or undertakings already established in a given sector are not threatened by new entries. Such restrictions usually apply to a number of service activities, where the fact that they can not be traded internationally compounds

the effects on the structure of national markets. They serve to retain an oligopolistic market structure that recalls the Middle Ages when most professions could self-regulate the quantity of new entrants to their métier.

To sum up: a number of different policies and private strategies act as barriers to arbitrage. They often ensure that price differentials between countries can not be traded away, or that the costs of trading are very high. Having a liberal trading regime in the sense that tariffs and QRs are low is not a sufficient condition for achieving lower national price levels across a wide range of sectors. Numerous other barriers to arbitrage can achieve the seeming paradox - especially in the small country case - that a liberal trade regime can go hand in hand with high price levels. It was pointed out, however, that some other factors also contribute to this outcome. The most obvious is of course a high per capita GDP.

IV. Price levels in Finland

Table 1 is taken from Wieser (1989). It is reproduced here as an indication of differences of degrees of integration of various subgroupings of countries in the EES. Price dispersion is measured by a corrected standard deviation around the Community average. The last line, GDP, shows the degree of dispersion of overall price levels within different sets of countries within the EES.

The general conclusion is that the EC 6 (S 6, column I) are by far the best integrated with each other, and that every successive enlargement of the Community reduced the degree of its integration.

PRICE DISPERSION IN EUROPE

Table 1

	S 6	S 9	S 10	S 12	S 16	S 13
FOOD						
Food	4.9	10.7	11.9	12.7	30.7	28.8
Bread and Cereals	10.3	14.9	14.7	14.5	36.0	34.8
Meat	9.3	12.9	16.0	17.4	42.0	39.0
Fish	13.6	19.8	13.5	14.3	16.4	16.9
Milk, cheese and eggs	8.0	13.3	8.8	8.9	18.0	17.8
Oils and fats	10.5	12.3	11.1	10.2	37.2	37.0
Fruits, vegetables, potatoes	14.9	22.5	28.8	27.2	46.8	44.6
Other food	6.4	12.9	10.0	9.3	26.9	26.3
Beverages	9.7	32.0	35.2	34.6	84.2	79.9
Non-alcoholic beverages	15.9	25.2	26.3	24.4	53.1	51.3
Alcoholic beverages	8.9	33.1	36.6	36.5	93.2	88.5
Tobacco	21.9	41.5	44.2	43.9	47.2	44.6
NON-TRADEABLES						
Gross rent, water charges	37.9	33.2	34.6	42.9	46.3	39.7
Medical and health services	17.0	22.2	19.0	26.7	24.1	17.3
Public medical and health care	19.0	20.8	24.1	25.5	23.4	21.6
Operation of transport equipment	7.8	10.5	11.3	16.7	17.3	12.6
Purchased transport services	23.9	31.6	38.5	37.7	46.5	42.8
Communication	35.7	39.1	41.5	38.2	41.6	41.6
Education, recreation, culture	15.0	14.1	18.1	26.8	26.9	17.1
Recreation and cultural services	16.3	15.1	24.4	26.9	23.7	13.9
Education	24.0	19.3	22.9	31.8	32.0	23.4
Restaurants, cafes, hotels	6.1	15.4	18.8	20.5	37.1	34.0
Other goods and services	14.5	15.4	15.1	23.5	24.3	17.2
Collective Consumption by Government	17.7	12.6	15.9	26.9	29.3	21.2
Construction	7.6	12.5	12.7	17.6	18.5	14.7
Residential buildings	14.8	18.6	19.0	24.5	25.8	21.4
Non-residential buildings	7.0	13.6	10.6	18.3	18.9	13.5
Civil engineering works	7.3	12.4	13.5	13.1	15.4	15.7
TRADEABLES						
Clothing, Footwear	10.8	14.0	11.3	11.6	23.1	22.5
clothing, incl. repairs	10.7	14.2	11.0	11.5	22.3	21.7
footwear, incl. repairs	15.2	15.1	17.1	16.5	28.2	26.7
fuel and power	10.8	13.6	12.4	17.6	19.1	15.0
Household equipment & operation	5.3	9.5	8.4	13.5	15.3	10.9
Furniture, floor covering, repairs	8.5	8.7	10.0	11.6	12.0	9.9
Household textiles, repairs	16.4	14.0	16.6	17.0	16.8	15.2
Household appliances, repairs	8.5	12.1	11.7	12.9	12.8	11.1
Other household goods and services	9.4	13.0	10.8	20.0	30.4	25.9
Recreation equipment and repairs	10.0	13.1	13.5	12.5	18.1	16.4
Medical and pharmaceutical products	29.3	28.3	29.4	30.7	31.5	28.5
Transport and communication	10.5	16.4	20.2	21.1	23.7	19.1
Personal transport equipment	12.0	23.7	27.2	26.1	32.4	29.6
Books, magazines, newspapers	21.4	25.7	26.9	32.6	53.4	48.4
Gross fixed capital formation	6.2	12.0	8.1	11.5	13.3	10.9
Machinery and equipment	9.9	14.6	8.9	8.2	12.9	13.6
Transport equipment	19.6	23.5	24.5	23.3	31.9	30.1
Non-electrical equipment	5.3	11.5	5.3	4.9	7.9	8.6
Electrical equipment	6.2	14.0	10.0	9.3	19.1	19.6
GROSS DOMESTIC PRODUCT	7.7	10.5	12.3	18.9	21.3	15.1

The fifth column (S 16) shows that if the four EFTA countries for whom data is available are added to the EC 12, the degree of integration is even further reduced. This implies that for EFTA as a whole, of which Finland forms an important part, integration with the European Community is less complete than it would appear if integration is measured by trade shares only.

This paper is, however, concerned with the actual degree of price divergencies between Finnish and non-Finnish price levels. Table 2 shows indices of price levels for around fifty different contributions to final demand. They have been standardised to show the Community average as equal to one-hundred for every sector. The last line, GDP, shows the overall indices of price levels of the sixteen EES economies for whom data is available. Against the background of the preceding section we will attempt to identify main barriers to arbitrage for the Finnish economy.

Overall, Finland is after Norway the second-most expensive country of Europe - nearly one-third above the Community average. Considering that per capita GDP in Germany is well beyond that of Finland, a Finnish price level that is 14% higher than that of Germany calls for a more profound explanation.

The goods and services shown in Table 2 include both tradeables and non-tradeables. The categorisation of the data as in the table does not in all instances lend itself to unequivocal classifications into these two groups. As far as possible we will however attempt to separate them.

Agricultural products are a category of goods by themselves. The differing agricultural policies in EES countries have led to large differences in price levels,

**Index of Price Levels in the EES
(EC=100)**

Table 2

	Fin	Swe	Nor	Aut	B	Dk	F	FRG	Gr	Ire	I	Lux	NL	P	Esp	GB
INDIVIDUAL CONSUMPTION BY HOUSEHOLDS	137	127	143	112	103	128	109	115	76	105	91	97	100	55	72	97
Food, Beverages and Tobacco	172	172	183	116	104	142	104	105	79	126	96	95	99	80	84	104
Food	162	165	169	116	106	131	108	106	84	106	99	103	100	79	91	95
Bread and Cereals	183	180	168	117	100	129	122	109	80	102	100	98	92	85	88	83
Meat	179	177	210	116	109	140	103	112	81	98	104	110	113	73	81	92
Fish	104	131	129	96	98	105	110	94	104	86	118	83	81	75	100	78
Milk, cheese and eggs	131	139	136	121	103	116	104	88	96	111	103	92	88	89	107	99
Oils and fats	206	185	135	135	115	115	115	103	116	92	87	105	102	102	97	94
Fruits, vegetables, potatoes	178	202	197	114	123	167	109	120	70	138	88	103	113	78	89	111
Other food	161	153	163	105	92	124	104	101	110	104	108	101	90	95	104	92
Beverages	291	255	296	109	113	173	105	95	77	171	84	91	102	88	57	130
Non-alcoholic beverages	237	195	200	114	114	156	111	104	89	146	67	91	104	89	91	105
Alcoholic beverages	298	263	339	105	111	174	102	91	70	172	88	89	100	86	51	137
Tobacco	133	145	191	132	81	176	73	121	52	176	90	66	91	68	49	153
Clothing, footwear	146	152	143	116	119	111	108	106	92	89	99	112	90	82	104	84
clothing, incl. repairs	142	151	142	115	118	107	108	106	92	88	102	111	88	82	107	84
footwear, incl. repairs	162	154	149	116	126	135	112	109	85	96	91	120	99	82	95	91
Gross rent, fuel, power	118	135	128	119	111	132	126	144	84	75	77	105	116	23	47	91
gross rent, water charges	139	163	176	130	113	141	128	174	87	61	70	122	128	17	43	96
fuel and power	72	78	71	98	108	107	122	104	79	105	105	90	96	62	73	82
Household equipment & operation	134	105	120	98	100	115	111	101	83	105	98	102	94	68	79	101
Furniture, floor covering, repairs	108	79	105	87	108	110	115	94	80	106	94	108	102	89	78	106
Household textiles, repairs	106	129	108	111	135	106	97	115	71	85	97	112	103	86	77	105
Household appliances, repairs	114	111	115	109	115	124	108	100	112	114	91	101	92	123	89	97
Other household goods and serv.	185	135	139	104	88	116	112	106	82	108	102	94	87	44	78	100
Medical and health care	116	100	114	98	78	139	98	124	75	112	104	88	94	49	80	80
Medical and pharmaceutical products	132	102	139	145	91	127	73	152	61	123	80	91	134	61	66	73
Medical and health services	93	81	98	81	72	130	102	107	78	100	119	81	87	30	93	78
Public medical and health care	122	104	120	111	89	152	109	141	83	122	115	107	100	57	89	87
Transport and communication	139	107	143	115	100	129	110	104	58	127	91	80	92	70	81	109
Personal transport equipment	168	102	163	100	83	156	100	91	149	129	93	79	100	126	109	113
Operation of transport equip.	124	112	103	126	104	114	112	102	79	116	102	88	107	60	78	95
Purchased transport services	155	164	202	105	125	162	124	138	51	171	73	93	100	65	69	111
Communication	121	61	189	116	134	84	96	124	34	124	70	47	53	110	86	166
Education, recreation, culture	128	122	137	116	109	118	114	115	63	86	86	125	105	30	78	95
Recreation equipment and repairs	132	126	137	117	112	118	111	102	128	108	94	102	83	101	106	92
Recreation and cultural services	102	96	116	100	132	118	115	103	40	81	103	118	99	48	94	92
Books, magazines, newspapers	253	138	189	112	86	164	90	118	93	107	109	104	145	27	86	83
Education	126	137	140	124	107	113	122	131	66	79	78	135	116	24	66	101
Miscellaneous goods and services	141	127	162	105	105	132	111	115	84	106	91	95	102	59	71	104
Restaurants, cafes, hotels	162	154	201	108	111	149	105	107	87	126	104	97	99	71	74	107
Other goods and services	122	118	145	101	99	123	116	121	78	99	77	94	101	46	62	100
COLLECTIVE CONSUMPTION BY GOVERNMENT	126	143	149	113	108	116	118	126	82	100	89	123	113	26	74	92
GROSS FIXED CAPITAL FORMATION	112	127	119	98	93	115	102	104	88	96	96	89	105	73	86	106
Construction	109	140	108	96	93	119	103	108	78	86	95	100	114	59	79	115
Residential buildings	123	143	129	114	95	135	102	121	81	74	90	104	127	49	68	105
Non-residential buildings	109	135	113	86	87	109	105	99	82	92	90	101	100	54	72	119
Civil engineering works	87	138	100	88	93	107	100	93	75	107	112	93	105	85	100	128
Machinery and equipment	120	108	137	98	93	110	102	99	108	106	98	77	98	102	104	100
Transport equipment	169	129	164	106	87	133	95	91	147	117	100	55	97	112	119	110
Non-electrical equipment	114	93	121	95	95	107	105	98	96	107	98	90	97	99	99	102
Electrical equipment	110	165	121	100	97	95	108	110	123	90	95	94	100	106	98	89
GROSS DOMESTIC PRODUCT	130	128	135	108	101	124	109	114	76	103	92	99	104	53	76	99

■ maximum

□ minimum

Source: own calculations based on OECD (1987)

and the structure of relative prices among countries. The effects of the EFTA countries' agricultural policies compared to those of the European Community can be assessed by comparing prices for food and its separate components.

For food, the three Nordic EFTA countries form a group of their own within Europe. The price level is around a quarter higher than that of Denmark, the most expensive Community country. The price level for food in Finland is more than twice that of the cheapest EC country, Portugal.

The separate components of this aggregate reflect in general the conceptions about agricultural regimes in the Nordic countries. Finland is the most expensive country in Europe for bread and cereals, as well as for oils and fats. For the latter, the price level in Finland is a good ten per cent above that of the second-most expensive country, Sweden, and more than twice the EC average.

Price levels for meat, fruit and vegetables also reflect the comparative disadvantage of Finland in the production of these goods, and the effective rate of protection afforded to producers.

For fish it is of interest to note that Sweden and Norway have price levels that are a good quarter above that of Finland. The recently concluded agreement to liberalise intra-EFTA trade in fish may be expected to bring about a downward convergence of Nordic price levels for these products.

The non-tradeables sectors shown in the table consist in general of services and construction. Three observations are obvious at a first glance: Firstly, the price level for a number of non-tradeables is well above the Community average, but in most instances not considerably beyond what

one would expect given the level of per capita GDP. Secondly, in none of these sectors is Finland the most expensive country of Europe. Thirdly, construction as business investment, i.e. excluding residential buildings, is considerably cheaper than comparative income and wage levels would indicate.

The level of rents in Finland is comparable to that of Denmark, but still well below that of Germany, Sweden and Norway. Given the number of special regulations, incentives and disincentives in this sector it is hard to filter out the main determinants of price levels. It is safe to assume, however, that relative income levels play a decisive role. Increased European integration would thus hardly affect rent levels in Finland.

The relatively high price of restaurants and similar services is presumably derived from high input prices on the one hand and high indirect taxes on part of the products, notably alcohol. Specific regulations on working hours in this sector may also play an important role.

Construction, as mentioned above, appears as an oddity in Finland. Whilst the price for residential buildings is in the expected range, non-residential construction is less than ten per cent beyond the Community average. Civil engineering works in Finland belong to the cheapest within Europe. Only Greece shows a significantly lower price level. Relative to the overall price level, Finland is for this sector the cheapest country within Europe.

As pointed out at the outset, the law of one price can not be expected to hold for non-tradeables for a number of reasons, notably so due to wage differentials. For tradeables, however, the law of one price should hold as an approximation, especially between countries with similar

wage levels, or per capita GDP. Differentials between similar countries are then due to one or more of the barriers to arbitrage outlined in Section III.

Prices of beverages in Finland are a case in point. Alcoholic beverages miss being the most expensive in Europe thanks to the even higher level of deterrence in Norway. The Nordic countries have of course a long history of tax-induced discouragement of drinking and are thus not easily comparable to other European countries. Nevertheless, it is of interest to note that the price level for these products is six times that of Portugal. Within the Community itself there remain large variations that may be expected to decline significantly after 1992. Most importantly, the convergence of indirect and excise taxes will bring about an increase in prices in the South, and a large decrease in Ireland and the UK. Another aspect is that state monopolies will not be able to discriminate between domestic and foreign beverages, and that private market sharing agreements will be considerably more contested by the Commission than they are today.

One of the most interesting features to be gleaned from Table 2 is that of price levels of non-alcoholic beverages in Finland. At not quite four times the price level of Italy, soft drinks in Finland are the most expensive in Europe. Prices are extremely high in Norway and Sweden as well, since the high alcohol prices in the three countries make these products more of a substitute than in the rest of Europe. Obviously, producers and/or distributors of non-alcoholic beverages have managed to segment national markets. Thus, excess profits are considerable. In this context the rationale of policies that attempt to discourage alcohol consumption by high taxes must be questioned if at the same time they fail to ensure through competition or other policies that substitutes are

reasonably priced.

Trade in clothing and footwear is largely regulated by the quantitative restrictions of the MFA. The effects of such regimes, especially on small economies, can be seen from the data in the table. Again, the three Nordic EFTA countries are the three most expensive countries in Europe, some forty percent beyond Germany. Thus, wage levels for retail and repair services do not suffice as an explanation. For Member countries of the European Community with an about equal level of protection to that of Finland, the main difference of course is that trade between high and low-price members of the Community flows with considerably less restrictions than between Finland and, say, Portugal. In trade in these products, origin rules play a certain role in impeding low-price imports into Finland.

Fuel and power in Finland are among the cheapest in Europe. As in the other Nordic EFTA countries, it can not be discerned at this level of aggregation if comparative advantage alone determines this, or if other factors play a role.

Prices of furniture in Finland, if compared to the EC average, are in the expected range. However, a puzzling feature in the Nordic area is that the Swedish price level is a quarter lower than in Norway and Finland. Since external barriers for these goods within the Nordic area do not exist, the most likely explanation is a combination of differing trade regimes vis-à-vis low cost suppliers, e.g. Eastern European countries, and barriers to entry, i.e. limits to setting up new retail outlets. It can not be excluded that collusion at the retail level also plays a certain role in this sector. It is of interest to note that a very similar situation prevails between the neighbouring

countries France and Germany; the main reason appears to be that the German retail sector is considerably more competitive than the French.

A very similar situation exists in the case of medical and pharmaceutical products. Prices in Finland are a third beyond the EC average. Again, prices for these products in Norway are about as high as in Finland, and considerably lower in Sweden. A certain part of such price differentials is due to differences between countries of registration procedures and reimbursements by social security institutions. However, the larger part of price differences in Europe can be attributed to market segmentation by pharmaceutical producers. Excess profits in such countries as Finland are considerable. Pricing strategies of firms obviously take into account the overall ability to pay and are not associated with costs. This is illustrated by the fact that prices for comparable products in Portugal are only forty percent of those in Germany. In this context one could argue that Finnish consumers are subsidising users of medical and pharmaceutical products in Southern Europe.

The price level of personal transport equipment is a well-known aspect of Finnish life. Given the share of such purchases in consumers' budgets, real income effects of cheaper vehicles would be considerable. If one compares Finland, which is the most expensive country in Europe for cars with Luxemburg, one realizes that the price level is more than twice as high. Obviously, the main determinant is the rate of taxation that is applied - it is considerable in Finland and zero in Luxemburg.

The price level in Finland of machinery and equipment is the second-highest in Europe after Norway. Effects on investment levels are obvious. The high price level is

however largely determined by prices of commercial vehicles. This implies that all transport intensive sectors operate at considerably more unfavourable conditions than in most other European countries. Since, quite often, this concerns such activities as distribution which is not subject to international competition, the ultimate effects are predominantly in the overall prices of products and not necessarily on operating margins. For internationally traded goods this does not hold of course.

For electrical and non-electrical equipment differences in price levels between Finland and other European countries are considerably smaller. For non-electrical equipment prices in Finland are 14 % beyond Community average - nevertheless the second-most expensive country in EFTA or the EC. Especially the large difference to Sweden is striking. For electrical equipment differences are even smaller, Finland being in fact the cheapest of the Nordic EFTA countries and at the same level as Germany. This points to the fact that the Finnish market for electrical equipment is comparatively open, whilst for non-electrical equipment firms have managed to achieve a higher degree of market segmentation.

Overall, and with a number of obvious exceptions, one can say that especially for investment goods most Finnish firms are quite well integrated with partner countries in the EES, though not to the extent of EC countries. The sheltered sectors in Finland, and thus first and foremost Finnish consumers, are amongst the least integrated within Western Europe.

V. Finland's Policy Options for further European Integration

The previous Section showed us that Finland is one of the most expensive countries in Western Europe. Partially, this reflects a comparatively high standard of living as measured by per capita GDP. To a large extent, however, it is a result of barriers to arbitrage that economic agents face. These barriers are higher than in most other European countries, though they are comparable to those of the other Nordic EFTA countries, Sweden and Norway. In certain sectors Finland can be described as being comparatively well integrated with its Nordic neighbours but not very well integrated with the rest of Europe.

Against the background of the current deepening of integration of the European Community through its Internal Market programme, Finland, together with other EFTA countries has embarked on an ambitious programme in order to minimise costs of staying outside the Community. The economic rationale is straightforward: As Community firms become more efficient through a better exploitation of economies of scale, a cheapening of input prices, and a reduction of costs of trading within the Community, this amounts to a terms-of-trade loss that Finnish firms face. To minimise this loss, Finnish firms would have to operate in framework conditions that are not too dissimilar from those of Community competitors.

In addition, deepening integration that is accompanied by a lowering of prices results in real income gains to consumers. This gain, as calculations by the EC Commission show (see EC Commission 1988), could be considerable but depend, however, crucially on the policy bundle chosen, and its implementation. Finland's consumers could benefit from a further strengthening of integration with the Community

to an extent that might be considerably beyond that of the consumers in EC countries themselves. In this Section several policy areas are outlined where Finland could achieve these results by lowering barriers to arbitrage mentioned in Section III.

It is assumed that Membership in the European Community is not an option that Finland will pursue. This is a position shared by most observers in other EFTA countries. At present, the obvious exception is Austria, that despite its status of neutrality has applied for membership in the EC on 17 July of this year .

After abolishing tariffs and quantitative restrictions on industrial goods among the eighteen countries of the EES trade in these goods is nominally barrier-free within the EES. However, borders are required to serve as checkpoints for determining the originating status of goods. The rationale behind this is that only goods that are predominantly produced in Finland of predominantly Finnish components have duty-free access to other EES markets. When exporting to Germany, this fact has to be proved at the German border. If too many non-Finnish components are included in the product, the good becomes liable to tariff treatment. Due to the administrative burdens of this procedure, exporters often do not even bother with proving originating status but rather pay the MFN rates applicable.

Within the EC, the situation is in principle, but not always, different. Since the Community has a common external regime, it is sufficient for a good or its components to have entered the Community through any of the 12 countries in order to circulate freely within the EC. However, exceptions exist. Under Article 115 of the Treaty of Rome, national import restrictions can still be upheld that do not form part of the common external regime. Among

the more known examples are the national restrictions on the import of cars of Japanese origin placed in a number of Community countries . These measures allow national producers - but also other Community producers - to reap rents that would not have accrued to them with full international competition. These exceptions rely on the continued existence of intra-EC borders. Otherwise, these goods could be imported through countries without such restrictions, and then be shipped without any further hindrance to the EC Member country with the more restrictive regime. This of course would render useless or futile any national quantitative restriction against non-EC imports. Thus, the process of doing away with intra-EC borders in the course of the Internal Market programme will imply complete harmonisation of the Community's external regime.

What are the possibilities for Finland to reap comparable benefits, and what do these benefits consist of? The only means of totally doing away with present costs of intra-EES trading as far as they are related to proving originating status of Finnish goods would be to have a common trade regime with the Community. This would imply taking over EC trade policy, and following potential future changes of Community trade policy.

In comparative static terms, the welfare effect on Finland can without further analysis be stated as being negative, since the Finnish external regime is considerably more liberal than that of the EC. However, the dynamic effects could prove to be positive, and that to a great extent.

Obviously, administrative costs of border controls that Finnish exporters face would be reduced in trade with the Community, thus increasing their competitiveness on the EC market. For Finnish consumers, the benefit would be the

decrease in prices of EC products. Moreover, the reduction of border controls would exert a strong pro-competitive pressure on a number of sectors of the Finnish economy. Finnish producers, sheltered by the fact that the access of foreign products is made more difficult through the border procedures described above, would face additional competition. This would result in lower prices for traded goods. Other goods that are not traded internationally today would then be traded. A precondition for these benefits to come about would, however, be a strict application of competition policies. Without these, benefits would accrue merely to firms, but would not necessarily be passed on to consumers. We will return to the issue of competition policies below.

A further barrier to arbitrage that could be reduced relates to the issue of differentials within the EES in indirect tax bases and rates. Due to such differences, borders are required in order to refund VAT upon exportation, and reimpose it upon importation.

The only possible way of changing tax systems so that they do not any longer require borders for their enforcement is to align national systems as concerns both rates and base, and to have a formal revenue sharing/redistribution arrangement or agency. That does not appear to be a realistic solution for Finland to pursue.

However, benefits to consumers could be appreciably increased by allowing unlimited imports from other EES countries, provided that the indirect taxes on these products are refunded/reimposed at the Finnish border. Such a policy would increase the degree of competition in a number of sectors and mark-ups of producers or retailers would be considerably lower.

Certain taxes are clearly linked to the existence of state monopolies. This concerns mostly alcohol and tobacco. The abolition or reform of state monopolies is usually hard to countenance for countries, since at least in their popular conception they are linked to health reasons. The lowering of excise tax rates on such goods on the other hand has large impacts on real disposable income and inversely on central government revenues. A solution could be to allow undiscriminated access of EES goods, and a certain lowering over time of tax rates. This area is a good example of the problems faced by the Nordic countries in discussing the fullest possible integration with the EC's Internal Market. Completely free circulation of goods again is only possible if excise rates converge, and state monopolies do not favour domestically produced goods.

Concerning technical barriers to trade, the non-harmonisation of standards and norms, or the lack of their mutual recognition, entails a further existence of borders in order to check for compliance. The results of non-harmonisation are that firms operate at sub-optimal scale, or with higher fixed costs. Again, completely free circulation of such commodities is only possible with far-reaching agreements on at least the mutual acceptance of test and certification results, and of standards and norms.

A barrier to arbitrage that is not connected with the existence or the form of borders is posed by barriers to entry. Large parts of the service sector are usually affected by such barriers. They affect both domestic but also foreign nationals. A wide reaching solution for Finland would be to give non-discriminatory treatment to all EES-nationals. This would be in line with rules envisaged by the Community. It is, however, an ambitious plan, closely connected to the mutual recognition of diplomas, university degrees and professional

qualifications but also to an overall free movement of labour. It does not, however, require that trade policies are aligned, and borders thus reformed, in order to reduce arbitrage-barriers posed by the existence of border procedures.

A policy that would facilitate the entry into certain professions in Finland for people with the right to work in Finland under present conditions would be an intermediate solution requiring no great policy changes, though presumably raising resistance by special interest groups. It would act in two ways by providing both additional employment in these sectors and a lowering of price levels. Sectors affected mostly would be the retail sector, banking, transport, insurances and the services provided by such professions as accountants or lawyers.

As this paper has tried to show, pricing to markets by firms is facilitated by a number of policies that are definitely not designed for this purpose. Usually, and to differing degrees, national competition policies endeavour to constrain such strategies by firms. The smaller a country is, the less competition policies by themselves are able to fulfill their role.

The strongest impact on the degree of competition can be achieved by having uniform rules and uniform interpretations over an as wide as possible area. In this case, the degree of competition in Finland would be most strengthened by having common competition policies with the Community. This entails however a loss of policy autonomy that Finland might not be willing to concede. An additional advantage would be that Finnish companies would no longer be subject to anti-dumping procedures in the EC market.

This of course is a policy decision that has to be seen in

the context of even wider-reaching decisions on the future of Finnish integration policy and could only form part of an overall package. Given the desire to retain formal policy autonomy also in this area, a considerably stricter application of Finnish competition policy would be a desirable solution. It would exert a strong influence on price levels in such sectors as medical and pharmaceutical products, non-alcoholic beverages and non-electrical equipment.

The above paragraphs gave a short outline of policy solutions that are possible if the option of a common trade policy with the Community is pursued. Since this would be a major change of the Finnish policy stance towards West European integration, the following paragraphs show what could be done if partners in the EES retain differing external regimes.

Quite obviously the main difference is the retention of Finnish-determined tariffs and QRs. As already mentioned, retaining the more liberal Finnish trade regime has its merits. However, the reform of borders in order to facilitate cross-border arbitrage by firms and consumers would under these circumstances not be possible to the degree that is made possible by common trade policies. The principle of unlimited private imports from other EES countries by paying the (net) differentials in taxation would in practice be impossible. Thus, an important pro-competitive pressure on Finnish markets would be missing under this option. In the short run, the current account effects would be positive compared to the policy option with common trade policies. Second round effects, taking into account the real income and wage effects of the disinflationary impact of stronger integration may, however, well be negative.

Under such circumstances, aligning tax regimes with other EES countries would not any longer be part of a viable policy package. The potentially most beneficial reform option would be an autonomous change in the Finnish tax system, concentrating on a reduction in certain indirect and excise taxes, notably on vehicles, alcohol and tobacco. Discussions of reforms of tax systems in other European countries have recently centered on mostly considerable but overall revenue-neutral increases in taxes on environmentally polluting processes. Such a process could have positive repercussions on the pace of structural change in Finland, and could thus lead to significant increases in real income of consumers.

Further elements of an autonomous strategy to increase the degree of integration between Finland and its partner countries in the EES would consist mainly of reductions and then the abolishment of technical barriers to trade through common standards and norms and mutually accepted test and certification results throughout the EES. This is at present one of the more promising areas of Finland's cooperation with the European Community.

Further policy areas that should be pursued are a stricter application of Finnish competition policies, and a loosening of barriers to entry. They would by themselves have a certain sectoral impact.

However, the sum of the effects of the policy measures outlined in this paper is larger than the effects of the separate components. Thus, the adoption of an as wide as possible ranging policy set would bring about considerable benefits for the Finnish economy. However, the reverse side is that structural adjustment requirements are the larger the more ambitious Finnish policy for increased integration within the EES is.

VI. Summary and Conclusions

Finland is being challenged by the deepening of the European Community's integration. This challenge is among the most demanding on the design of policy of the last decades. To a certain degree, it steers Finnish policy into new and uncharted areas, where questions about the feasibility of continued unlimited economic and other policy autonomy are posed. This is disconcerting to many people, but also an opportunity - as in other European countries - for reforms of policies that appear to be possible only if outside challenges are sufficiently large.

Finland has to work on the basic assumption that the Community's Internal Market programme will ultimately be a success. This implies, other things being equal, a relative loss in Finnish competitiveness on its main markets.

The paper has attempted to show that the present degree of Finnish integration with its EES partners is still, relatively speaking, fairly low. Increasing the degree of Finnish integration would imply a gain in competitiveness for efficient Finnish producers, and significant real income gains by Finnish consumers. It would imply a convergence in a number of policy fields throughout the EES. If correctly designed, market segmentation by firms would be considerably reduced from a fairly high level today.

What are the options available to Finnish policy makers? The dilemma that Finnish policy faces is whether the restrictions on the autonomy in certain fields of Finnish policy is worth the risk. This is a question that unfortunately can only be answered ex post. A natural limit

to possibilities of being as integrated as European core countries is the peripheral location of Finland. A small intermediate step would be attempting a more deeper going EFTA or Nordic integration. From the point of view of policy makers this would have the large advantage of avoiding too extensive policy decisions in the field of tax policies. The overall effects would however be presumably very small compared to a solution that encompasses the EC countries.

To sum up: Finland requires a change in the strategy of its integration policy if it wants to avoid a relative deterioration of its competitive position in Europe. The more autonomy Finland wants to retain over central fields of policy, especially economic policy, the smaller the gains from further integration will be. Full economic integration in the EES could imply very large benefits for certain Finnish firms, but especially for consumers. This, however, involves policy choices that are amongst the most wrenching ones of post-war Finland.

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