

JOURNAL

of Applied Economic Sciences



Volume XII
Issue 6 (52) Fall 2017

ISSN-L 1843 - 6110
ISSN 2393 - 5162

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Journal of Applied Economic Sciences

ISSN-L 1843 – 6110

ISSN 2393 – 5162

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Iceland's Integration Process into the European Union and Assessment of its Economic and Political Alignment with European Legislation

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Suggested Citation:

Hovorková, K., Lipková, Ľ. 2017. Iceland's integration process into the European Union and assessment of its economic and political alignment with European legislation. *Journal of Applied Economic Sciences*, Volume XII, Fall 6(52): 1805 – 1812.

Abstract:

This research presents the analysis of the integration process of Iceland into the European Union from the outbreak of the global financial crisis until the official withdrawal of the membership application in 2013, particularly in context of the European Commission assessment of alignment of Icelandic legislation with the EU law. Our aim was to describe the methodology of assessment the alignment of laws and point out on the main issues of integration process of Iceland into the EU. Furthermore, this paper indicates the political and economic reasons for the level of alignment of Icelandic law with the EU law supported by figures. Results of this research indicates that the limited progress in 2-years lasting negotiation process was influenced by unwillingness of political elite to align the legislation in the country, not the economical or administrative inability of doing so.

Keywords: Iceland; European Union; *acquis*; Icesave dispute

JEL Classification: F50

Introduction

Before the outbreak of the global financial crisis, Iceland belonged to the most reluctant country in context of the membership in the European Union (the EU). The closest step towards the EU integration was the membership in European Economic Area (the EEA) in 1994 that provides the free movement of goods, services, capital and persons within the European Single Market. However, the global financial crisis caused the most significant shock of Icelandic economy in recent years, mainly due to open market, liberalized financial services, economic boom on real estate market and fragile Icelandic krona, what resulted in collapse of three major banks in Iceland.

Integration into the regional economic or political organization belongs to one of the stabilization tool in times of crises. After the outbreak of the financial crisis, newly elected Icelandic parliament (Althingi) decided to apply for the EU membership in order to mitigate consequences of the crisis. Therefore, the aim of this paper is to analyse the process of integration of Iceland into the European Union in context of the assessment of alignment Icelandic legislation with the EU law (*acquis*) provided by the European Commission. We will also focus on negotiation process itself, beginning from the screening stage, and state of negotiation chapters to the point, when Althingi decided to withdraw the membership application. Our partial aim is to analyse the most difficult issue in opened negotiation chapters, the Financial services chapter – the Icesave dispute.

1. Literature review

The data used for this research are based on relevant official documents and research publications. As this paper focuses on the assessment of alignment of Icelandic legislation with *acquis*, our basis is the official website of the European Commission (the EC) and the Commission's staff papers – Progress Reports. For the purpose to create figures necessary to explain state of negotiation chapters, we have used also official documents provided by EC.

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For separate Icesave dispute issue we use various sources concerning this object matter. Our basis is mainly a legal study The Resolution of Cross-Border Banking Crises in the European Union by Seraina Neva Grünewald, official documents published by the UK HM Treasury and the Dutch Ministry of Finance, but also the law of the EU or the Deposit Guarantee Scheme Directive. Important sources were also several research articles of Baldur Thorhallsson, an Icelandic professor and researcher.

2. Methodology

The methodological and theoretical bases for this paper are conditions set by the European Commission. The EC developed chapters of *acquis* that are the ground stone for accession negotiations and thus the integration process of each candidate country in general. The content of negotiation chapters corresponds to various areas where economic, judicial and political reforms are needed to adapt the country's administrative and institutional framework in line with the legislation of the European Union, which means to meet the accession conditions (European Commission 2016b). In so called screening process, an analysis and examination of the *acquis* negotiation chapters are performed by the EC, in order to familiarize the country with the EU legislation, indicate the level of alignment with this legislation and therefore setting plans for the full compliance with the EU law (European Commission 2016d). Only after this process is completed, the candidate country may enter EU and become EU member state.

Once the country is perceived as a candidate country, the accession negotiations between the candidate country and ambassadors and ministers of the EU governments may start. These negotiations stand on following steps that have to be fulfilled by the candidate country as well as by the EC (European Commission 2016e):

- screening process: in this stage the candidate country has to adapt the EU legislation. However, during this process, also the EC has to determine the country's preparedness to the legislation alignment. The EC findings are then presented to the Member States chapter by chapter in the form of a screening report with a conclusion to open the accession negotiations;
- submission of negotiation positions: before opening of negotiations with a candidate country, the national position must be submitted and the EC has to adopt a common one. However, for the most of the negotiation chapters the EC used to set closing benchmarks in such position that have to be met in order to close the chapters.

Currently, the *acquis* contains 35 negotiation chapters where the candidate country has to align its legislation with the EU law. In case of Iceland, the EC assessed 33 negotiation chapters (see Table 1), since in the period of integration process of Iceland, only these chapters were developed. The duration of closing these chapters varies due to different speed of performing reforms and their quantity.

Table 1. Negotiation chapters of *acquis* (European Commission 2016a)

Negotiation chapters of European legislation in integration process			
1.	Free movement of goods	18.	Statistics
2.	Freedom of movement for workers	19.	Social policy and employment
3.	Right of establishment and freedom to provide	20.	Enterprise and industrial policy
4.	Free movement of capital	21.	Trans-European networks
5.	Public procurement	22.	Regional policy and coordination of structural
6.	Company law	23.	Judiciary and fundamental rights
7.	Intellectual property law	24.	Justice, Freedom and security
8.	Competition policy	25.	Science and research
9.	Financial services	26.	Education and culture
10.	Information society and media	27.	Environment
11.	Agriculture and rural development	28.	Consumer and health protection
12.	Food safety, veterinary and phytosanitary policy	29.	Customs union
13.	Fisheries	30.	External relations
14.	Transport policy	31.	Foreign, security and defense policy
15.	Energy	32.	Financial control
16.	Taxation	33.	Financial and budgetary provisions
17.	Economic and monetary policy		

The negotiation chapters might be closed and reopened several times during the screening process. This depends on the readiness of the candidate country to perform reforms in such field and their full compliance with the EU legislation. The negotiation chapters are perceived as closed and the process finished as whole, only after the EC assessment and agreement of all the member states of the alignment of candidate's country in every chapter with the EU law. Only afterwards the Accession treaty of the country, which includes the conditions of membership as well as transitional agreements and details of financial agreements, might be signed and the negotiation process is considered as finished.

3. Case studies

The negotiation process of Iceland started a year after the new pro-European Icelandic parliament of Social Democratic Alliance and the Left Green Movement (Bailes and Thorhallsson 2013) officially applied for the EU membership in order to stabilize the country's economic situation. The Council decided to open accession negotiations with Iceland on 17.06.2010 (European Commission 2016c) and one month later the 1st intergovernmental conference on the EU integration of Iceland took place. In November 2010, when the screening process started, the European Commission begun with the assessment of *acquis* implementation. Since Iceland was already a member of the EEA, the European Free Trade Association (the EFTA) and the Schengen Area, the country has already implemented a significant part of the EU legislation. Therefore, during the integration process, Iceland complied with the EU law in many areas. Also due to the fact that Iceland was an economically and politically advanced country, but significantly influenced by a global financial crisis in 2008, its accession negotiations were oriented mostly on fulfilment of economic criteria.

In November 2011 the European Commission published 1st Progress Report on the compliance of Iceland's legislation with the EU law where the period from November 2010 to June 2011 was assessed. The EC identified three main areas, where further alignment with the *acquis* was necessary (European Commission 2011):

- firstly, improvement in the field of economy, namely in free movement of capital, financial services and economic and monetary policy needs to be undertaken. The EC assessed developments in free movement of capital as incomplete due to perceiving capital restrictions. The Commission also requested for the improvement in financial services, due to slow implementation of EU legislation in areas as insurance, securities and supervisory capacities. Incomplete independence of the Central Bank of Iceland and the monetary financing prohibition on the public sector in area of economic and monetary policy remained insufficient;
- other obstacles were identified in agriculture and rural development, as well as veterinary policy, regional policy and coordination of structural instruments, where any new legislative alignment has been undertaken. The EC also requested for further alignment in area of consumer protection;
- the most significant problem remained fisheries. According to the EC, no developments were reported mainly in inspections and control of fisheries and resources and fleet management. The EC also called for revision of Iceland's legislation that restricts foreign investment in fisheries. Further improvement in the field of environment was also necessary, due to insufficient protection of whales and seals and conservation of natural habitats, fauna and flora.

In the rest of negotiation chapters assessed the EC on full or sufficient level of alignment with *acquis* in many cases as a result of implementation of significant part of the EU legislation due to the membership in EEA.

Table 2. The European Commission's assessment of negotiation chapters, state from June 2011

Further alignment with <i>acquis</i> is	High level of alignment	
Free movement of capital	Free movement of goods	Social policy and employment
Financial services	Freedom of movement for workers	Enterprise and industrial policy
Agriculture and rural development	Right of establishment and freedom to	Trans-European networks
Food safety, veterinary and	Public procurement	Judiciary and fundamental rights
Fisheries	Company law	Justice, freedom and security
Economic and monetary policy	Intellectual property law	Science and research
Regional policy and coordination of	Competition policy	Education and culture

Further alignment with acquis is	High level of alignment	
Environment	Information society and media	Customs union
Consumer and health protection	Transport policy	External relations
Financial control	Energy	Foreign, security and defense
	Taxation	Financial and budgetary provisions
	Statistics	

Source: Own processing based on European Commission 2011

The following year the Commission published the 2nd Progress Report on Icelandic alignment with the EU law that covered period from October 2011 to September 2012 during which more attention to political issues was brought. After the economic breakdown in 2008, Althingi changed the foreign policy towards the EU membership and simultaneously focused on structural reforms. However, 4 years after the global financial crisis, the economic situation turned up to be relatively stabilized and euro-skeptical tendencies in Iceland started to be supported again.

Being closer to the end of this assessed period, the accession negotiations remained slowly, also due to the fact that after the membership in the EEA, the EFTA and the Schengen area, Iceland's parliament expected faster integration process, but no compromises in the most sensitive negotiation chapters were reported. During 2nd assessed period, 14 negotiation chapters were opened, of which 8 chapters were provisionally closed and the EC called for alignment with acquis in the same 3 main areas (European Commission 2012):

- similarly, to previous assessed period, the EC called for further alignment of acquis on free movement of capital, mainly in continuous investment restrictions in e.g. fisheries and capital controls. On the other hand, important steps in the field of economic and monetary policy were reported, due to significant progress in insurance, banking and securities policy, but Iceland was challenged for further improvement in supervision and resolving of Icesave dispute. Also the independence of Central Bank and limitations in public sector monetary financing remained insufficient;
- in the field of agriculture and rural development and veterinary and regional policy, the EC did not report any new legislative proposal in order to comply with the EU law, as it was during the 1st assessed period;
- the main obstacle remained fisheries, since this chapter has stayed unopened.

On the other hand, negotiations in a number of areas were assessed as relatively fully aligned with acquis. Mainly in the field of company law, freedom of movement of workers, intellectual property law, health and consumer protection, foreign security, fundamental and judiciary rights and defence policy (European Commission 2012) negotiations, and due to successful reforms, these were provisionally closed.

The slow pace of Iceland's accession negotiations remained until April 2013, when the parliamentary elections took place and a new government should have decided, whether the country would continue in integration process or not, due to extensive call for withdrawing the EU application from politicians, as well as citizens. The newly elected government, which took office in May 2013, decided to withdraw the membership application and officially informed the Commission that the country should not be perceived as the EU candidate country (Hilmarrsson 2017). Still, the EC published 3rd Report in 2013, which contained Iceland's state of alignment with acquis from September 2013 until May 2013 with following conclusions (European Commission 2013):

- Iceland fully meets the political criteria for the EU membership;
- with regards to fulfilment of economic criteria, Iceland is considered as a functioning market economy. Since the breakdown during the financial crisis, the economy has continued to recover, further reforms are needed in order to become in line with international standards. Further improvement is necessary mainly in removing the capital market restrictions, increase of investments, reduction of unemployment, inflation decrease, efficiency in supervision over financial market, or reduction of public debt;
- Iceland has reached a significant level of alignment with the EU legislation as a result of its membership in the EEA, the EFTA or the Schengen Area. Due to its size and therefore administrative capacity, Iceland is not effective enough in implementation of the EU law;
- with regards to alignment of Iceland's legislation to acquis, in many areas or negotiation chapters Iceland do not comply with the EU law, but on the other hand, in many areas Iceland is highly aligned with acquis due to already mentioned membership in the EEA, but also due to successful reforms during its negotiation

process (see Table 3). The most significant progress in 2-years negotiation process was made in the field of Financial services, Economic and monetary policy and Consumer and health protection, since the EC assessed Iceland's alignment with acquis as good or satisfactory during the last assessment process while in the 1st and the 2nd Progress Report were assessed as not aligned.

Table 3. The European Commission's assessment of negotiation chapters, state from May 2013 compared to state from June 2011

Further alignment with acquis is	High level of alignment without	Progress in compliance with acquis
Free movement of capital	Free movement of goods	Public procurement
Agriculture and rural development	Freedom of movement for workers	Company law
Food safety, veterinary and	Intellectual property law	Competition policy
Fisheries	Energy	Financial services
Regional policy and coordination of	Taxation	Information society and media
Environment	Statistics	Transport policy
Financial control	Enterprise and industrial policy	Economic and monetary policy
	Trans-European networks	Social policy and employment
	Judiciary and fundamental rights	Consumer and health protection
	Science and research	Customs union
	Education and culture	External relations
	Foreign, security and defense policy	
	Financial and budgetary provisions	
	Right of establishment and freedom to	
	Justice, freedom and security	

Source: Own processing based on European Commission 2013.

- according to the Table 4, the most of the negotiation chapters, where further progress in order to be aligned with acquis, needs to be done, were not even opened during the 2-years negotiation process, in particular in Free movement of capital, Agriculture and rural development, Food safety, veterinary and phytosanitary policy and Fisheries. These negotiation chapters are the most burdensome political issues where Icelandic parliament is not willing to be aligned with the EU due to its political importance and national interest.

Table 4. State of negotiation chapters from May 2013

	Open negotiation chapters	Provisionally closed negotiation	Never opened negotiation chapters
1.	Free movement of goods	Freedom of Movement for Workers	Right of establishment and freedom
2.	Public procurement	Company law	Free movement of capital
3.	Competition policy	Intellectual Property Law	Agriculture and rural development
4.	Financial services	Enterprise and Industrial Policy	Food safety, veterinary and
5.	Information society and media	Trans-European Networks	Fisheries
6.	Transport policy	Judiciary and Fundamental Rights	Justice, Freedom and security
7.	Energy	Science and Research	
8.	Taxation	Education and Culture	
9.	Economic and monetary policy	Consumer and health protection	
10.	Statistics	Foreign, security and defense policy	
11.	Social policy and employment		
12.	Regional policy and coordination		
13.	Customs union		
14.	Environment		
15.	External relations		
16.	Financial control		
17.	Financial and budgetary		

Source: Own processing based on Source: European Commission 2016c.

The serious obstacle in financial service chapter was the Icesave dispute. Icesave was an online saving accounts provider of Icelandic Landsbanki, which offered its products in the UK and the Netherlands through

branches and attracted many savers due to abnormal high interest rates. However, the global financial crisis in 2008 caused absolute collapse in a banking system of Iceland, including Landsbanki and its branches. National authority of Iceland took control over Landsbanki and split it off; new domestic bank Landsbankinn took over all the assets and some amount of liabilities and the rest, including foreign liabilities and derivatives, went into liquidation (Grünewald 2014). In this scenario, former Landsbanki's domestic depositors were automatically transferred to new Landsbankinn and on the other hand, foreign insured depositors of Landsbanki's UK and Dutch branches supposed to be refunded by deposit guarantee scheme of Iceland (DGS) (Deposit Guarantee Scheme Directive 94/19/EC).

Due to lack of funding, Icelandic DGS was not able to reimburse foreign insured depositors, therefore the Dutch and British governments accessed their national DGSs to Icesave depositors. In total, the UK DGS paid out 4,5 billion GBP of which 2,3 billion GBP was the reimbursement responsibility of Icelandic DGS (Financial Services Compensation Scheme 2012) and the Dutch DGS paid out 1,53 billion EUR of which 1,34 billion EUR remained the Icelandic DGS responsibility (De Nederlandse Bank 2009).

Following the negotiations between the government of Iceland and governments of the UK and the Netherlands, Iceland concluded that there is an obligation to reimburse Dutch insured depositors of Landsbanki branch (The Government of Iceland and the Government of the Netherlands 2008), however in referendum Icelanders rejected the outcome of these negotiations (Grünewald 2014). Moreover, Icelandic DGS was not still able to repay foreign depositors due to collapse of other 3 major banks in Iceland whose depositors were not fully paid out that time. This is also the reason, why Icelanders rejected in referendum to reimburse depositors of the UK and the Netherlands.

Therefore, the governments of the UK and the Netherlands blocked Icelandic deposits allocated in these countries and conditioned the opening of the financial services negotiation chapter by the judgement of the court. The EFTA Court on 28.01.2013 surprisingly concluded in its judgement that Iceland had not infringed its obligations laid down in Deposit Guarantee Scheme Directive 94/19/EC (The EFTA Court 2013), when the DGS of Iceland was not able to pay out insured depositors of Landsbanki's branches.

The European Commission, when assessing alignment of Icelandic legislation with *acquis*, pointed several times on Icesave dispute issue, due to lack of capitalization of DGS of Iceland and thus non-compliance with the EU legislation (Deposit Guarantee Scheme Directive 94/19/EC) in the field of financial services. Also, as already mentioned above, financial services negotiation chapter has not been opened until the official judgement of the EFTA Court was published, due to unwillingness of the UK and the Netherlands because of unresolved Icesave dispute (Avery *et al.* 2011). Although, after publishing this judgement, the financial services chapter was opened and the EC assessed that the significant progress was made in context of alignment in this field. However, at the final stage, all member states would have to agree with the membership with candidate's country, also the UK and the Netherlands, which depositors were not reimbursed by Icelandic DGS.

Conclusion

After the outbreak of the global financial crisis, newly elected Althingi almost immediately applied for the EU membership in order to stabilize its economy, since the country was experiencing the most significant financial shock in recent years. As Iceland was an economically and politically well developed and functioning country, a smooth integration process was expected, also given Icelandic membership in the EEA, the EFTA and the Schengen Area, which means the law of Iceland was highly aligned with *acquis* in many areas.

The screening process, where alignment of candidate's country with *acquis* of the European Union is assessed in separate fields via negotiation chapters, took 2 years in case of Iceland. The European Commission published after the 1st assessment so called Progress report on Icelandic alignment with the EU law in 2011. Out of 33 negotiation chapters, 23 were highly aligned with *acquis*, however in 10 areas further alignment would have needed to be done. These areas included mainly financial issues, which legislation the EC perceived as insufficient and might have caused the economic destabilization during the global financial crisis and also those areas, which were significant and sensitive for Icelandic economy, such as Free movement of capital, Financial services, Agriculture and rural development, Fisheries, Economic and monetary policy or Free movement of capital.

The 2nd Progress report on Iceland published in 2012 contained the same issues as the 1st one, namely in the field of financial issues (Financial services, Free movement of capital, Economic and monetary policy), rural development (Agriculture and rural development, Food safety, veterinary and phytosanitary policy, Environment, Consumer and health protection) and Fisheries. However, the Commission assessed that Iceland made an important step in alignment its legislation with *acquis*, but mostly in those fields, where its alignment was already perceived as highly or partially aligned. Due to upcoming parliamentary elections in 2013, the accession negotiations were slowed down and newly elected members of Althingi supposed to deal with sensitive areas from the political point of view.

After the parliamentary elections in 2013, euroskeptical Independence and Progressive Party (Thorhallsson 2014) formed a new coalition; therefore, reluctance towards the EU membership of Icelanders and also political elite was increasing, which resulted in withdrawal of the application for an EU membership in May 2013. Still, the EC published the 3rd Progress report, where all the negotiation chapters were assessed. Even if the negotiation process was officially closed, due to the withdrawal of Icelandic application for the EU membership, the EC assessed areas of Financial services, Economic and monetary policy and Consumer and health protection as aligned with the EU *acquis*, even if these fields were assessed negatively in the 1st and the 2nd Progress reports, what shows economic and administrative ability of doing compromises and aligning Icelandic law with *acquis*.

Although Iceland's administration made a significant progress within 2 years of negotiations with the EU, the progress might be smoother given the high alignment of the EU and Icelandic legislation due to membership in the EEA. The burden stone of these negotiations were following negotiation chapters: Agriculture and rural development, Food safety, veterinary and phytosanitary policy, free movement of capital and Fisheries, since these chapters have never been opened during 2-years period of negotiations. Such a development shows that the failure to open these chapters was a political unwillingness to accomplish compromise in these fields, not the inability of doing so. Agriculture and rural development and Food safety, veterinary and phytosanitary policy are connected with preferred treatment of Icelandic agriculture policy due to arctic climate conditions. Fisheries is the main obstacle, due to this industry is the most important one in Iceland and Free movement of capital is connected with Fisheries, since Iceland imposes capital controls in the field of fisheries.

Another important issue in financial services was the Icesave dispute. Icesave, as an online branch of the biggest bank in Iceland, Landsbanki, offered its products mainly in the UK and the Netherlands. After the outbreak of the global financial crisis and collapse in banking system, the state had to take control over this bank and foreign secured depositors lost their savings and at the same time, the Deposit guarantee scheme of Iceland was not able to repay its losses. Even if the governments of the UK and the Netherlands reimbursed their secured depositors, they were asking also to retroactively repay these losses from Iceland and until this issue would not have been resolved by the court, the British and the Dutch governments froze Icelandic deposits in these countries and also have not allowed Iceland to open negotiation chapter of Financial services. Surprisingly, in 2013 the EFTA Court concluded that Iceland did not break the law and thus is not responsible for pay out. Even if such a development solved this issue and the EC assessed the area of financial services as highly aligned with *acquis* in 2013, the political issue remains on place. It is still questionable, whether in case Iceland would have continued in negotiations and would have fulfilled all criteria, the UK and the Netherlands would agree with the membership at the final stage.

To conclude, Iceland was a candidate to become the EU member, however the slow integration process was affected by political unwillingness. The Icelandic administration made a significant progress in negotiations given the smallness of the country and progress the EC assessed. But the failure to open most important negotiation chapters and high alignment of the Icelandic legislation with *acquis* prior to application for the EU membership, shows evident reluctance of the EU membership of political elite in the country.

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