OVERVIEW

Turkey first applied for associate membership in the European Union (EU)—then the European Economic Community (EEC)—in 1959. The application resulted in an association agreement in 1963, whereby Turkey and the EU would, in principle, gradually create a customs union by 1995 at the latest. The customs union was seen as a step toward full EU membership at an unspecified future date. The EU unilaterally granted Turkey preferential tariffs and financial assistance, but the process of staged, mutual reductions in tariffs and nontariff barriers was delayed because of the economic and political conditions in Turkey. After pursuing inward-oriented development strategies throughout the 1960s and 1970s, Turkey switched over to a more outward-oriented policy stance in 1980. The opening up of the economy was pursued in part with the aim of integrating the country into the EU.

Turkey applied for full membership in the EU in 1987. The response in 1990 was that accession negotiations could not be undertaken at the time because the EU was engaged in major internal changes, and that matters were further complicated by developments in Eastern Europe and the Soviet Union. However, the EU was prepared to extend and deepen economic relations without explicitly rejecting the possibility of full membership at a future date. Thus the plans for a customs union were revived.

On March 6, 1995, it was agreed at an Association Council meeting in Brussels that a customs union would be created between Turkey and the EU as of January 1, 1996, to be fully phased in by 2001.[1] As a result, Turkey currently imposes no quotas or tariffs on imports of industrial goods from the EU. The associated liberalization for Turkey has been estimated as implying a 7 percent average reduction in tariffs (Harrison, Rutherford, and Tarr 1997). The major exception to free trade is agriculture—neither party liberalized completely. The average tariff rate on imports of agricultural commodities from the EU is 21.4 percent. Agricultural trade is also subject to tariff quotas and price regulation, which have produced a high degree of protection in both the EU and Turkey. Thus, in terms of further liberalization of merchandise trade, accession will primarily have an effect on agriculture.

A major development under the customs union was that Turkey implemented the European Union's Common Customs Tariff on imports of industrial goods from third countries. It has also adopted most of the preferential trade agreements concluded by the EU, as well as other measures covered by the EU's commercial policy (such as antidumping). Turkey has adopted EU competition policies, established a Competition Board, adopted EU rules on protection of intellectual and industrial property rights, set up a Patent Office, and initiated a process of harmonizing technical standards for industrial products and strengthening internal conformity assessment and market surveillance structures.

On December 10–11, 1999, the European Council meeting held in Helsinki produced a breakthrough in Turkey-EU relations. At Helsinki, Turkey was officially recognized as a candidate state for accession, on an equal footing with other candidate states. The result was the creation of a so-called Accession Partnership with the EU, which means that the EU is working together with Turkey to enable it to adopt the *acquis communautaire,* the legal framework of the EU. But, in contrast to other candidate countries, Turkey did not receive a timetable for accession. After the approval of the Accession Partnership by the Council and the adoption of the Framework Regulation on February 26, 2001, the Turkish government announced on March 19, 2001, its own National Program for the adoption of the *acquis communautaire.* Progress toward accession continues along the path set by the National Program.

In late 2004 another milestone was reached with the recommendation of the European Commission that the European Council endorse the launching of formal accession negotiations with Turkey and establish a timetable for accession (European

Commission 2004b). In December 2002, the Copenhagen European Council had concluded that "if the European Council in December 2004, on the basis of a report and a recommendation from the Commission, decides that Turkey fulfills the Copenhagen political criteria, the European Union will open accession negotiations with Turkey without delay." At a December 2004 Council meeting, it was decided to launch negotiations.

Although the process has now been launched, great uncertainties continue to prevail about whether Turkey will be able to achieve its goal of accession to the EU.[2] Some of these uncertainties are economic, and they are the subject of this book. Other uncertainties are more political in nature. Some of these are in the hands of the Turkish government—for example, realization of the EU political and human rights criteria formalized by the European Council in Copenhagen in 1993, and acceptance of restrictions on immigration post-accession.[3] Others are not. Arguably, the greatest uncertainty is whether EU governments and societies are willing to accept a large secular but nonetheless Muslim state as part of the EU. Time will reveal the ultimate outcome. What matters in the short to medium term is the impact that continued progress toward achieving the conditions for membership will have on Turkey. The EU is the focal point for reforms in a large number of policy areas, and the preaccession process, which has been ongoing for several years, is a unique experiment in using international harmonization as a tool in implementing a comprehensive reform strategy.

Much has been achieved by Turkey in recent years, including progress in implementing the customs union—which covers many policy areas, not just trade but also nontariff barriers and competition policies—despite severe macroeconomic shocks and instability. The 1999 European Council decision affirming that Turkey is a candidate for membership was followed by far-reaching constitutional and legislative reforms, ranging from improved civil liberties and human rights to enhanced civilian control of the military. A Department for EU Affairs was set up in 2000 to coordinate all of Turkey's policies related to the preaccession process. A series of constitutional and legislative changes were adopted during 2001–04, some of them major, as well as numerous regulations, decrees, and circulars detailing how these reforms should be implemented. A Reform Monitoring Group, under the chairmanship of the deputy prime minister responsible for human rights, was established to supervise the reforms across the board and to solve practical problems, including bureaucratic inertia and bottlenecks at both the central government and state government levels (European Commission 2004c).

However, clearly much remains to be done on both the macro- and the microeconomic fronts. Accession entails going beyond the customs union for manufactures and integrating the markets for agriculture, services, and factors (labor, investment, and capital flows). Until now, liberalization of trade has been restricted to industrial goods. Because agriculture accounts for about 14 percent of Turkey's gross domestic product (GDP) and services 60 percent, the liberalization of trade to date has thus had limited implications for three-quarters of economic activity. Although this statement is an exaggeration because autonomous reforms have been implemented in these sectors of the economy, joining the EU will require Turkey to adopt and implement the whole body of EU legislation—the *acquis communautaire*—in all areas.

The purpose of this volume is to highlight certain aspects of Turkish accession, with an emphasis on the implications of integrating fully into the single market, adopting the *acquis,* and meeting the Maastricht Treaty criteria for fiscal and monetary policy.[4] The contributors to this volume focus primarily on the impact of accession on Turkey—only two chapters consider the possible impacts on the EU. One reason for this emphasis is that in size Turkey is small relative to the EU as a whole. Turkey's GDP in 2004 was €240 billion compared with the combined GDP of the EU25 of €10.2 trillion.[5] Thus Turkey would account for only 2.3 percent of the EU's total output. Most of the adjustment burden and potential benefits therefore pertain to Turkey. One major exception, however, is related to Turkey's large population: the free movement of workers could have a substantial impact on the EU in both economic and political terms, and the large population of Turkey may also have implications for decision making in a larger EU. The outcome of accession talks on the movement of people is very important not only for the EU but also for

Turkey, because the net benefits of accession will depend on the conditions under which Turkey may accede to the EU.

Although the primary interest in this volume is to assess what accession may mean for Turkey and to gauge how far along Turkey is toward meeting the *acquis*, the Turkish case is also relevant for other countries that may seek to use a strategy of "deep integration" with a large, developed country or common market as a focal point and mechanism for undertaking both trade-related and regulatory reforms. Increasingly, developing countries are negotiating deeper forms of regional integration agreements with high-income trading partners. Even though most of these agreements do not come close to the depth of cooperation entailed by accession to the EU—and in some sectors such as agriculture the accession process is unique in that it implies integration into a common policy involving direct subsidies and managed trade—close study of the implications of seeking to emulate the *acquis* should be of interest to other countries contemplating the design of integration efforts.

The volume is divided into four parts:

- the macroeconomic dimensions of EU accession for Turkey
- sectoral analyses of the effects of integration into the EU (adoption of the *acquis*) for the agriculture, manufacturing, services, and network sectors
- the economic challenges of accession for Turkey's labor market, investment framework, and environmental policy
- an assessment of the net impact for the Turkish economy as a whole of the various changes implied by adoption of the *acquis* in the areas covered by the other parts of the volume, complemented by analyses of the likely implications for the EU in three central areas: European decision making and voting after Turkish accession; international transactions, both trade with and inward migration from Turkey; and the EU budget.

This introduction begins by summarizing the themes and key findings emerging from the chapters that follow. It then briefly discusses the likely impacts of Turkey's accession on the EU, and it concludes with a discussion of lessons for other developing countries that can be drawn from Turkey's efforts to date to bring its policies into alignment with the *acquis*.

Macroeconomic Developments and Prospects

From 1990 to 2000, economic crises began to affect the Turkish economy with growing frequency. Periods of rapid economic expansion alternated with periods of equally rapid decline. Inflation during 1990–2000 fluctuated between 55 and 106 percent, for an average rate of 75 percent. Currently, Turkey is in the midst of a determined campaign to turn around decades of weak performance stemming from pervasive structural rigidities and weak public finances. The past few years have witnessed three major attempts at addressing underlying weaknesses. The first, during 2000, was under the three-year stand-by agreement with the International Monetary Fund (IMF), initiated in December 1999 after a significant drop in output mostly caused by external factors, including the 1999 earthquake. Despite some notable achievements, a worsening current account and a weak banking system led to a liquidity crisis in late 2000. This crisis turned into a full-blown banking crisis in February 2001, in which the government responded by abandoning the crawling peg regime and floating the currency. In May 2001, the IMF increased its assistance under a new stand-by arrangement. Just as the revised program was beginning to show results, the terrorist attacks of September 11 in the United States triggered the reemergence of serious financing problems. In February 2002, the IMF approved a new three-year stand-by credit agreement for Turkey to support the government's economic program. With the implementation of the stabilization program, Turkey envisaged a gradual but steady improvement in its economic conditions. In August 2004, Turkey approached the IMF for what it hoped would be a final three-year stand-by agreement that will serve as an exit program from instability and excessive debt.

The economic stabilization programs proved successful at combating inflation, which fell from 54.7 percent during 2000–01 to 10.6 percent in 2004 because of efforts to maintain fiscal and monetary discipline. According to the Turkish State Planning Organization (SPO), the fiscal deficit during 2001 amounted to 16.4 percent of the gross national product (GNP)—and 20.9 percent of GNP, according to the IMF definition. During 2004, the fiscal deficit was brought back down to 6.2 percent and the government ran a primary surplus of 6.9 percent of GNP. After contracting by 9.5 percent in 2001, real GNP expanded by 7.9 percent in 2002, 5.9 percent in 2003, and 9.9 percent in 2004. The growth was driven by strong productivity gains and by robust private consumption, investment, and exports, and it has not been hindered by cuts in government consumption and investment. The unemployment rate fell from 11.5 percent in the first quarter of 2002 to 10.3 percent in 2004, and the average interest rate on government debt declined from 63.8 percent in 2001 to 25.7 percent during 2004. Ratios of debt to GNP are still high, but they have been falling. The net public debt-to-GNP ratio has decreased from 90.5 percent in 2001 to 63.5 percent in 2004. This decline reflects significant income growth during 2002–04, attainment of sizable primary surpluses over the last three years, and appreciation of the real exchange rate (RER).

Although these are positive developments, it is too early to determine to what extent the rebound reflects a transition to sustainable growth. Substantial risks remain. First, during 2002–04 the RER appreciated to what is arguably an unsustainable level. Although the appreciation of the RER helped to reduce the inflation rate and the debt-to-GDP ratio, it led to a widening current account deficit. The annual deficit in 2004 reached US$15.4 billion,[6] and the current account-deficit-to-GDP ratio increased to 5.1 percent. Because foreign direct investment (FDI) inflows remain weak, the deficit is funded by additional foreign debt, raising concerns about the sustainability of the current account. Second, the public sector debt remains far too high for comfort. Assuming trend economic growth of 5 percent and a primary fiscal surplus of 6.5 percent of GDP, the debt ratio will fall over time as long as real interest rates remain below 15 percent. Currently, the real rates on domestic debt are about 11 percent. But shocks to credibility could easily push them higher and lead to concerns about the sustainability of fiscal policy.[7] A primary fiscal surplus of 6.5 percent remains the minimum required for safety. Third, the labor force participation rate declined from about 57 percent at the beginning of the 1990s to 48.7 percent in 2004, mainly because of the discouragement of job seekers. The policy of keeping the primary fiscal surplus at 6.5 percent of GDP over the coming years will constrain the use of fiscal policy to drive down the unemployment rate in the economy. But unless employment growth picks up, continually high unemployment and low participation rates could undermine the social and political support for reforms.

As discussed in greater depth by Sübidey Togan and Hasan Ersel in chapter 1, the macroeconomic challenges for Turkey remain substantial. Besides solving the problems summarized in this introduction, during the preaccession period Turkey needs to reduce its annual inflation rate to about 3 percent, keep the debt-to-GDP ratio below 60 percent, and achieve stable growth in real income over time. Unless Turkey's growth performance does improve, its real per capita GDP will never converge with the EU average and the accession of Turkey might create unmanageable stresses. In addition, the authors note that to avoid the risk of speculative attacks on its currency over the coming years, Turkey should continue to follow policies aimed at establishing a sound fiscal framework, a robust banking sector, and sustained price stability. Turkey also must take measures to increase the national savings rate from its rather low level of 22 percent in 2004 (China's savings rate is 44 percent) and reverse the appreciation of the real exchange rate. To attain sustainability of the current account, the real exchange rate has to depreciate gradually over time to its long-run equilibrium level. After accession, Turkey will be expected to join the Exchange Rate Mechanism (ERM II) for at least two years and to meet the Maastricht conditions for monetary and fiscal convergence before a bid for membership in the European Economic and Monetary Union (EMU) is considered. Once admitted to the EMU, Turkey would replace its domestic currency with the euro at an irrevocably fixed exchange rate, confer the bulk of its reserves to the European Central Bank, and be bound by the Stability and Growth Pact. Togan and Ersel argue that for Turkey the problem is not how to stay out of the EMU but, to the contrary, how to reap the net benefits expected of monetary integration by fulfilling the Maastricht criteria as soon as possible. Finally, the authors note that the benefits of integration can only be derived at some cost, and the costs of fulfilling the Maastricht criteria, including the conditions for sustainability of the current account when estimated by expected output losses, could turn out to be quite substantial.

Sectoral Reform Challenges

Achieving and sustaining macroeconomic stability will depend importantly on structural reforms, especially removal and reduction of subsidies and price controls, and the imposition of hard budget constraints on enterprises owned by the public sector. Agriculture has been a heavily distorted sector of the economy, accounting for a significant share of the public sector deficit. The banking sector was at the heart of the 2001 crisis—better regulation and noninterference in lending decisions are needed to reduce the probability of another crisis requiring bailouts or recapitalization of the system. Privatization of state-owned firms is the most direct means of imposing hard budget constraints. These and many other issues are addressed in the sectoral chapters that explore the effects of integration into the EU on agriculture and on the manufacturing, services, and network industries.

Agricultural Markets and Incomes

In chapter 2, Sübidey Togan, Ahmet Bayener, and John Nash study the impact of EU accession on Turkey's agricultural markets and incomes. In Turkey, agriculture accounts for a large share of total output (14 percent) and employment (33 percent). The corresponding figures for the EU15 are 1.7 percent and 4.3 percent. In absolute numbers, Turkey employs about the same number of people in agriculture as the EU15, or more than 7 million. Trade in agricultural products between the EU and Turkey is a relatively small part of their total trade, because it is not part of the customs union and so is subject to duties, quotas, and price regulations. Turkey applies high specific duties to the commodities supported by the EU's Common Agricultural Policy (CAP): cereals and processed cereals, sugar and sugar products, dairy products, and meat. Olive oil is also highly protected. Turkish exports of vegetables and fruits receive export subsidies. The EU, by contrast, has granted imports from Turkey preferential treatment. Import barriers exist mostly in the form of tariff-quota schemes, in which imports within the quota benefit from preferential treatment. Togan and his colleagues estimate that about 70 percent of imports from Turkey enter the EU duty-free and are not subject to any other import barriers. As a result, most of the adjustment after integration of Turkish agriculture into the CAP will fall on Turkey.

Agricultural support has been important in Turkey, imposing a large burden on taxpayers. In 2003 the total support of agriculture, including the higher prices paid by consumers, was equivalent to 4.4 percent of GDP (OECD 2004a). This figure is much higher than the comparable one for agriculture in the EU—1.3 percent of GDP. These numbers suggest that Turkey's accession to the EU is likely to have important social, distributional, and political effects, unless these transfers are maintained under a common agricultural policy, which is unlikely. Indeed, adoption of CAP-type policies—something Turkey is already in the process of doing—will reduce the overall level of support, even if Turkey becomes eligible for the current CAP levels of financial support.

Since 1993, the CAP has been gradually shifting away from price support to income support, with the result that prices in the EU are now closer (but still above) world market–clearing prices and farmers are compensated by direct income payments. The structure of the CAP is such that it favors the main agricultural products (and farmers) of the original six EU members: Belgium, Germany, France, Italy, Luxembourg, and the Netherlands. Those products are grains, sugar beets, dairy products, and beef. Fruits, vegetables, poultry, and pork—important products of the newer, southern members—receive less or no support. In preparing for the accession of the Central and Eastern European (CEE) countries, the EU decided that farmers from the CEE countries would not be excluded from direct income support payments, but that such payments would be lower: equivalent to 25, 30, and 35 percent of the system prevailing in 2004–06. After 2006, direct payments will be increased gradually in order to achieve parity with the original EU15 in 2013.

Turkish agriculture will confront major reforms in the preaccession period. In Turkey, the most important part of agricultural policy has been price support. State economic enterprises and agricultural sales cooperatives have been commissioned to buy cereals, tobacco, tea, and sugar beet from farmers at prices determined by the government. These prices, which are higher than world market prices, have been protected by import tariffs. The second most important component of Turkey's agricultural policy is the various subsidies, grants, and exemptions lowering the cost of inputs, including capital, fertilizer, seed, pesticides, and water. The output of tobacco, hazelnut, tea, and sugar beet production has been controlled in various ways. Services to farmers, such as research, training, and extension and inspection services, have been provided free or at low cost.

Turkey is implementing significant reforms to move it toward more decoupled and targeted forms of support. Under the government's reform program, output price supports, import tariffs and input subsidies and grants are gradually being replaced by direct payments to farmers based on their holdings of land and animals. Income support has been capped. Privatization of state enterprises in the agricultural sector is also part of the program. The end goal is that Turkey will have an agricultural policy similar to what is now being pursued by the EU in its reforms of the CAP: high intervention prices and protection from the world market will have been replaced by direct income support, lower protection, and prices approaching those on the world market. In chapter 4, Joseph Francois uses a global general equilibrium model to assess the quantitative effects of completion of the customs union by extending its coverage to agriculture. He concludes that despite the importance of the agricultural sector for Turkey, the overall aggregate welfare gain associated with completion of the customs union is limited, although resources will be pulled into agriculture. Commodity-specific impacts are small, with the largest adjustment effects in the more protected sectors, such as grains and meat, and expansion in the sectors that are highly subsidized in the EU, such as sugar.

The Turkish reforms have emerged from the prospect of accession, as well as the need to reduce public expenditure. In the short run they will lead to considerable gains in efficiency. According to Togan and his colleagues, adoption of the CAP will generate substantial changes in the agricultural incomes of producers, the welfare levels of consumers, and the budget revenues of the government. The authors estimate that, in the medium to long term, EU-like policies will lead to a 1.9 percent increase in real household incomes in Turkey. Lower-income households (rural households) will experience an even larger increase in real income. But adoption of the CAP will require substantial adjustments on the part of Turkish farmers. The effect on farmers' incomes will be driven mainly by the amount of CAP-like compensation payments they obtain. Their income will decrease considerably under Agenda 2000 policies without direct payments, but will increase under Agenda 2000 policies with direct payments. The budgetary costs to Turkey of adopting EU-like agricultural policies will depend on whether Turkey receives compensation from the EU budget for introducing these policies. Without compensation, the cost will amount to €3 billion under Agenda 2000 policies with direct payments similar to those applied in the EU and to €1.2 billion if the payments equal only 35 percent of what is granted in the EU member countries.

Manufacturing

In chapter 3, Sübidey Togan, Hüsamettin Nebioğlu, and Saadettin Doğan study the effects of EU integration on the Turkish manufacturing sector. After reviewing developments in the trade in manufactures and in particular the effects of the customs union with the EU, they analyze tariffs and nontariff barriers in trade with the EU and third countries. Because tariffs are now largely a nonissue, they focus more on nontariff barriers, especially technical barriers to trade (product standards). They conclude that challenges lie ahead for both Turkish firms and the government. Both must apply a large number of EU norms. For example, Turkey has adopted all of the 23 new approach directives that require affixing the CE conformity marking, but only 18 of these directives entered into force up to the present time. As a result of these directives, the number of mandatory EU standards decreased from 1,150 in 1999 to less than 500 in 2004 (European Commission 2004c). The Turkish Standards Institute (TSE) is presently concentrating its activities on the transposition of the European and international standards and on achieving full membership in the European Committee for Standardization (CEN) and the European Committee for Electrotechnical Standardization (CENELEC).[8]

Many of the requirements of the *acquis* in this area revolve around accreditation and conformity assessment, in which a large number of government bodies establish criteria as part of regulatory oversight activities and the Turkish Accreditation Agency (TÜRKAK) accredits the inspection service providers. Here a major challenge is for TÜRKAK itself to become accredited and recognized in the EU. Currently, its certifications are not recognized, requiring double accreditation for providers or redundant inspection on entry of goods into the EU. Progress is also needed on the introduction of mutual recognition clauses in national legislation and the acceptance and adoption of simplified procedures for the import of products bearing the CE (Conformité Européene) marking. In 2003 toys, medical devices, and other products bearing the CE marking were entitled to enter the Turkish market freely with no further check on the technical dossiers (European Commission 2004c). Such measures will facilitate trade and reduce costs for traders. Indeed, it has been reported that during the period after the decision was made to accept the CE label, customs authorities sent numerous consignments to the TSE for inspection, arguing that they were not able to assess the risks related to the minimum safety requirements. Numerous studies of the impacts of a customs union have argued that the abolition of such real trade costs is likely to generate significant gains for Turkey. Full implementation of the EU *acquis* on technical barriers to trade, with the accompanying institutional strengthening, will constitute the major change from the status quo in the nonagricultural merchandise trade with the EU.

Market Access and Regulatory Issues

In chapter 4, Joseph Francois complements the analysis of the impacts of extending the customs union to include agriculture by a discussion of the implications of EU accession for regulatory reform in Turkey, focusing in particular on the transportation sector. For this sector, the *acquis* revolves around the EU's common transport policy, which seeks to develop integrated transport systems based on advanced technologies that contribute to environmental and safety objectives; to improve the functioning of the single market in order to promote efficiency and choice; and to improve transport links between the European Union and third countries. The common transport policy places a major emphasis on the strict application of competition rules and state aid disciplines. Challenges range from physical integration to harmonization of infrastructure, vehicle, environmental, and other standards; development of logistics networks; and improvement of border crossings and trade facilitation policies (such as modernization of customs facilities). The EU is concentrating on greater liberalization of rail transport, landing rights/access to airports (allocation of slots), gradual abolition of the queuing system for certain inland waterway markets, and improved application of the rules on work practices in the road haulage sector (European Commission 2004c). An overall goal is a more level playing field through the application of competition principles, including the use of state aid and cross-subsidies.[9]

Railways are a major fiscal burden for the Turkish state. Turkish State Railways (TCDD), manages Turkey's seven largest ports and its railways, locomotive and carriage manufacturers, and repair workshops. During the 1980s and 1990s, rail operation cost the Turkish government more than $10.5 billion in constant 2002 U.S. dollars. As noted by the World Bank's Trade and Transport Facilitation Web page on Turkey,[10] TCDD needs to be restructured, the railway network scaled down, service improved, and prices increased. The *acquis* in this sector requires that TCDD separate out and report on the results of each of its activities (to identify cross-subsidies), and that it end cross-subsidies from ports to rail and from freight to passenger traffic by shifting to a system of direct subsidies for passenger services (motivated by social objectives such as universal service). The much more stringent fiscal discipline associated with implementing the *acquis* will have a beneficial effect on resource allocation and the use of transport services. Existing cross-subsidization of the railways by the ports suggests that port authorities should be subjected to greater scrutiny by regulators and the competition authorities, because in other countries (the threat of) competition by other (new) terminal operators has been shown to be an effective source of market discipline.

Francois explores both the quantitative and qualitative implications of Turkish accession to the EU for the transport sector. He adopts an innovative methodology using data provided by the Organisation for Economic Co-operation and Development (OECD) to determine how far Turkey is from "best practice" as defined by the EU standards for this sector—not just in the regulatory domain but also in terms of "performance." In part, this involves applying numerical estimates of the economy-wide and sector-specific impacts of accession (given the preexistence of the customs union for goods) on the transport sector. This process is complemented by an assessment of the prevailing regulatory regime, using factor analysis (principal components) to identify commonalities across countries and regulations. Francois concludes that there is little support for the claim that accession is exerting significant pressure on Turkey to restructure in view of either general market access conditions or regulatory convergence requirements. Notwithstanding this conclusion, as noted above, Turkey confronts numerous policy changes in adopting the *acquis* in the transport area.

Telecommunications Sector

Chapter 5 by Erkan Akdemir, Erdem Başçı, and Gareth Locksley examines the Turkish telecommunications services from the perspective of EU accession. Turkey is the last OECD country to liberalize its fixed-telephone services. Likewise, its privatization of the public monopoly in fixed lines has been delayed significantly. Yet Turkey, in the medium term, will need to adopt the new set of directives approved and published by the European Parliament and the European Council in 2002. In chapter 5 the authors consider the framework directive, access directive, authorization directive, and universal service directive.

In June 2001, Turkey and the other EU candidate countries signed the eEurope+ Action Plan, by which Turkey committed itself to achieving certain measurable goals in the electronic communications sector. Akdemir and his colleagues provide a detailed comparison of the current Turkish and European statistics and practices in the telecommunications industry. They discuss licensing, price regulation, access regulation, and universal service dimensions. For each dimension, they also describe the main Turkish legislation and its implementation and compare them to those in the EU member and candidate countries. They argue that the main problems facing Turkey are related to the implementation of the new legislation, especially in areas such as access to the network.

Their conclusion was confirmed by the European Commission's 2004 assessment, which found that only limited progress has been achieved in *acquis* alignment to date, despite the fact that the remaining monopoly rights of the state-owned incumbent operator, Türk Telekom, were legally abolished at the end of 2003, including those related to national and international voice telephony and the establishment and operation of telecommunications infrastructure. Thus the market has been open to new entrants since January 2004. However, the authors argue that the (regulatory) measures needed to facilitate market entry are not yet fully in place, including on matters such as numbering, interconnection, conditions of access to the network, and facility sharing, implying that there are still de facto barriers to new entry.

Banking

In chapter 6, Ceyla Pazarbaşıoğlu describes the impact of EU accession on the Turkish banking sector. One of the primary causes of the 2001 currency crisis was the unhealthy structure of the sector, stemming from several factors.[11]

- First, there were problems with state banks. Governments have used these banks for noncommercial objectives such as agricultural support; income redistribution; and industrial, urban, and physical infrastructure development. As a result, the banks faced unrecovered costs from mandates carried out on behalf of the government called "duty losses." The state banks covered their financing needs by borrowing at very high interest rates and at short maturities from the capital markets.
- Second, the banking sector faced problems created by high public sector deficits. As private banks found the financing of public deficits increasingly profitable, government domestic securities as a share of total assets of domestic banks increased considerably, making the banks vulnerable to changes in interest rates. Furthermore, during the 1990s banks began to borrow

funds from abroad and use the funds to buy government bonds.[12] Thus banks also became vulnerable to exchange rate risk.

- Third, in 1994 as part of an effort to prevent an economic collapse following a fear of a bank run, the government introduced full (100 percent) state guarantees for deposits. Before 2001, fear of a renewed banking crisis prevented the authorities from replacing this supposedly temporary measure with a more reasonable deposit insurance scheme.
- Fourth, Turkey lacked competent supervisory authorities, a good regulatory framework, and an effective legal and institutional infrastructure.

Since 1999, Turkey has taken measures to reform the regulatory and institutional framework of its banking sector and restructure the state and private banks. The *acquis* in this area requires, among other things, an independent central bank that, as a primary task, maintains price stability. It also prohibits direct central bank (or public sector bank) financing of the government deficit. Accession entails acceptance of the objectives of the EMU, although compliance with the convergence criteria is not necessarily a precondition. However, because those criteria are indicative of a macroeconomic policy geared to achieving stability, all member states must in due course comply with them on a permanent basis.

In 1999 the Turkish Parliament passed a new banking law, which mandated the creation of an independent Banking Regulation and Supervision Agency (BRSA). The BRSA took over the bank regulatory and supervisory responsibilities previously fulfilled by the Treasury and the Central Bank. For state banks, the Treasury provided floating rate notes to those banks securitizing their "duty losses," and it strengthened their capital base. A law was also introduced prohibiting state banks from running more duty losses—that is, any support provided to the state banks will henceforth have to be budgeted. The state banks were also required to comply fully with all banking regulations. Private banks that had incurred significant losses in the aftermath of the currency crises were either taken over by the Savings Deposit Insurance Fund (SDIF) or asked to strengthen their net worth and balance sheet structure. The capital base of banks under SDIF management was enhanced by the injection of government funds, and measures were taken to facilitate bank mergers and prepare the state banks for privatization.

In addition, the regulation of existing banks was greatly strengthened. Currently, banks are required to maintain an 8 percent capital adequacy standard ratio, on both a consolidated and unconsolidated basis. The maximum open foreign exchange position was reduced from 30 percent to 20 percent. Steps have also been taken to correct flaws such as weak loan loss provisioning and the lenient large exposure and related lending limits. Tighter limits were imposed on both on- and off-balance sheet commitments to related parties, and especially to companies belonging to the same group as a bank. Bank shareholders and managers are now personally liable for the mismanagement and abuse of bank resources. The BRSA requires that banks introduce internationally recognized accounting and auditing standards. All in all, as of 2004 Turkish prudential requirements were in general in conformance with those in the EU for capital adequacy standards, loan classification and provisioning requirements, limits on large exposures, limits on lending to related parties, and requirements for liquidity and market risk management.

The objective of the legislative and regulatory reform has been to bring the regulatory and supervisory regime for the Turkish financial sector up to the level of international practice in line with EU standards. This objective has been achieved to a large extent. Pazarbaşıoğlu argues that Turkey has fulfilled most of the conditions necessary for attaining compliance in the banking sector with the EU integration process. She stresses that the Turkish banking sector will be exposed to certain costs during and after accession in the form of competitive pressures from EU banks that have a strong capital base and risk management skills. However, the Turkish banking system has become more resilient and sounder since the extensive restructuring program and implementation of international standards. This restructuring process came at a large implied fiscal cost estimated to have reached close to one-third of GDP in the initial stages.

A major remaining issue that needs to be solved is the privatization of state banks. In 2003 Turkey decided to privatize the two largest state banks within three years, to withdraw the banking license of another state bank, and to resume the privatization process of another large state bank as soon as market conditions allowed.[13] The data on the Turkish banking sector reveal that in 2004 private domestic banks held about 57.6 percent of the total assets of the banking sector, with the five largest banks accounting for 60 percent of total assets. The share of state banks was 34.6 percent, while that of banks managed by the SDIF was 0.6 percent. Foreign banks' share of total banking assets amounted to 3.5 percent. Thus foreign banks, in terms of their shares of total credits and deposits, remain insignificant in Turkey.

With Turkish accession to the EU, competition in the financial sector will increase as Turkey recognizes the competence of the supervisory authorities of the EU member states and incorporates the principle of home country control in its legislation. According to Claessens, Demirgüç-Kunt, and Huizinga (1998), foreign bank assets as a share of total bank assets over 1988–95 averaged 77 percent in Greece, 31 percent in Spain, 61 percent in Hungary, and 51 percent in the Czech Republic. Thus, with the liberalization of financial markets, the penetration rates of foreign banks in Turkey will increase substantially, causing adjustment costs in the sector. Increased competition will improve the quality and availability of financial services in the domestic market, enable the application of modern banking skills and technology, enhance the country's access to international capital, lower prices for consumers, and lead to a larger variety of financial instruments. Some of the Turkish banks will benefit from larger markets by concentrating on activities in which they have a comparative advantage. Other Turkish banks may be forced to merge with foreign banks or leave the market altogether.

Energy

Chapters 7 and 8 examine Turkey's energy sector. The objectives of the EU's energy policy include improving competitiveness, securing energy supplies, and protecting the environment. The energy *acquis* consists of rules and policies, notably on competition and state aid (including in the coal sector), the internal energy market (for example, opening up of the electricity and gas markets, promotion of renewable energy sources, crisis management, and oil stock security obligations), energy efficiency, and nuclear energy (European Commission 2004c).

In chapter 7, Izak Atiyas and Mark Dutz describe competition and regulatory reform in the Turkish electricity industry. After reviewing the physical peculiarities of the electricity industry and discussing how those characteristics have shaped the evolution of its industrial organization, Atiyas and Dutz present an overview of regulatory reform in the EU, the key directives, and the recent proposals for amendment advanced by the European Commission. They also identify five main challenges associated with adoption of EU norms in this area: market opening, unbundling, third-party access, public service obligations, and regulation.

Historically, the Turkish electricity sector has been dominated by state-owned enterprises that provide distribution, generation, trading, and transmission services. However, privatization has been widespread for some time. Privately owned firms have entered the industry through build-operate-transfer (BOT) or auto-generator schemes. They account for about 21 percent of electricity generation. In addition, firms have been bidding competitively on build-operate-own (BOO) contracts for electricity generation. Transfer of operating rights contracts (TOORs) have been awarded for eight thermal plants and 14 distribution regions. Privatization of generation assets is envisaged to start in 2006 and to be completed in 2011. All assets in the distribution sector will be divested by mid-2006 (European Commission 2004c).

Many of the benefits of privatization come with the transfer of risk. When private companies bear risk, privatization can be expected to lead to efficiency gains. Under the current regulations in Turkey, the private owners in the electricity sector bear construction and operating cost risks. The private operator signs a long-term power purchase agreement with the state-owned generation enterprise in which the latter commits itself to buy the output of the plant for a period of, say, 20 years at a fixed price in foreign currency. In BOT projects, the price has ranged on average from between \$.08 and \$.09 per kilowatt-hour for the first five to 10 years of operation. The BOO projects tend to have lower prices. The BOO contract, guaranteed by the Treasury, assures the investor that the project will be profitable irrespective of the future demand for power. As a result, the government retains the commercial risks. Significant problems have arisen with these arrangements. The high-cost electricity purchase agreements have exposed the state providers to significant losses and contingent liabilities. The financial position of these firms is poor partly because of high-cost BOT contracts that involve purchase costs to the Turkish Electricity and Transmission Company (TEAŞ) in excess of the subsequent sales prices to the Turkish Electricity Distribution Company (TEDAŞ) set by the government. The associated subsidies and cross-subsidies will have to be removed as a result of accession.

A new electricity law passed in 2001 provides for the establishment of an independent Energy Market Regulatory Authority (EMRA) to take over regulatory functions from the Ministry of Natural Resources. Standard regulatory functions include tariff setting, market monitoring, and settlement of disputes concerning access. With this law, the government is introducing a market model along EU lines that will transfer most of the task of supplying and distributing electricity and the associated market risks to the private sector, eliminate the need for additional state-guaranteed power purchase agreements, and minimize costs through competitive pressures on producers and distributors, again along the EU model (see chapter 7). The government, then, will largely withdraw from the electricity generation and distribution businesses. Electricity generation companies will sign contracts for power directly with distribution companies without government guarantees. The government's future role will be largely confined to determining sector policy, owning the transmission system, and ensuring that the rules are respected and that prices are determined competitively. The implication is that, once the law is fully implemented, the regulatory and supervisory regime for the electricity sector will have been brought up to the level of international practice in line with EU standards. Although the various BOT and BOO contracts signed in the past imply that the establishment of a competitive environment may take quite a long time, once the system begins to operate Turkey can expect to derive efficiency gains in the sector resulting in price reductions and improvements in the quality of the service.

In chapter 8, Maria Rita Mazzanti and Alberto Biancardi analyze the institutional endowment and regulatory reform in Turkey's natural gas sector. They focus on Turkey's natural gas market and the measures adopted to liberalize the sector and to comply with EU requirements for accession. As in the electricity industry, the main challenge confronting Turkey is to increase competition in the market while dealing with the legacy of past decisions, in this case the long-term take-or-pay contracts signed by Turkey's Petroleum Pipeline Corporation (BOTAŞ). This government-owned company dominates the natural gas sector in Turkey, controlling the pipeline infrastructure for oil and gas transmission, liquefied natural gas (LNG) terminals, and gas distribution. BOTAŞ has monopoly rights on gas imports and exports and on wholesale trading, transmission, and storage activities.

The 2001 natural gas market law (No. 4646) calls for liberalization of the gas market and the creation of a financially sound, stable, and transparent market (Article 1), including the removal of the import monopoly. As noted in World Bank (2004:1), progress in the three years following adoption of the law was slow: "Industry structure remains monolithic, with no separation of functions other than some distribution. Cost transparency, largely due to the existing industry structure, remains deficient. Competition has not developed in the wholesale sector. International investors remain concerned by the delays." The 2001 law requires BOTAŞ to conduct tenders to transfer to other market players its existing contractual obligations on natural gas purchases and sales until its imports fall to 20 percent of annual consumption (the so-called gas release program). Little progress has been made to date on implementing this requirement, and Mazzanti and Biancardi argue that enforcement of measures to limit the market power of the incumbent will be an important determinant of gains to Turkey from reform as well as a requirement for satisfying the *acquis* in this area. Competition in the natural gas industry is impeded by long-term investments and contracts in the upstream activities (gas contracts and infrastructures). Gas tends to be purchased on the basis of long-term contracts with take-or-pay clauses that require the gas purchaser to pay 70–90 percent of the contracted capacity whether it receives the natural gas or not; the reason is that extractors must invest huge amounts mining and transporting the gas and thus confront very high up-front fixed (sunk) costs and almost zero marginal costs.

Breaking up the upstream and downstream (wholesale) monopoly of BOTAŞ is a precondition for the emergence of competition in the sector. Mazzanti and Biancardi note that the targets set by the law for BOTAŞ shares (no more than 20 percent of imports and the wholesale market) are very ambitious, and much more so than the targets set by EU member states. They also argue that the gas release provisions of the law—which have also been used by EU states in introducing competition—could have a beneficial impact, as long as they are designed appropriately.[14]

The Complementary Implications and Challenges of Reform

Although much has been achieved in sector-specific regulation and reform, much remains to be done in some areas, especially energy and transport. Other economic reform challenges are associated as well with accession and realizing gains from the process. Chapters 9–11 consider three important "horizontal" areas: the labor market, (foreign) investment policy, and EU regulations pertaining to the environment. The first two complement the financial (banking) sector as critical determinants of the effects of accession. Labor market regulations will affect the incentives to invest, the costs to workers of layoffs, as well as the overall cost structure of doing business in Turkey. FDI is an important source of knowledge, employment, and competitive pressure on incumbent firms. Finally, environmental regulation has the potential to enhance social welfare by ensuring that firms and consumers confront the appropriate (social) prices of their economic activities, but it also raises the danger of excessively costly regulation that may not be appropriate to Turkey's circumstances and preferences.

In chapter 9, Erol Taymaz and Şule Özler look at the labor market. They argue that one of the most important issues for Turkey in adopting and implementing the EU *acquis* is related to the labor market regulations and employment policies that prevail in the EU. The *acquis* in this area includes EU legislation covering health and safety at work, labor law and working conditions (working hours, part-time work, collective redundancies, worker protection in case of bankruptcy and closure of plants, child labor—minimum working age), gender equality (equal pay and opportunities), and social inclusion of handicapped people in the workforce. In all of these areas, EU social legislation lays down minimum requirements that must be met by member states.

Adoption of the EU *acquis* will bring radical changes in the functioning of the labor market in Turkey, with vital consequences for firms, workers, and the long-term performance of the economy. The main impact will fall on the informal sector. Taymaz and Özler note that the Turkish labor market is currently quite flexible, because the formal and informal sectors have very different wage-setting mechanisms. The informal sector is largely free from labor regulation and avoids most of the taxes and related charges. Job insecurity is pervasive, and workers receive very few benefits from their employers. By contrast, in the formal sector labor regulations are observed, and taxes and related charges such as social security contributions and payments to various funds are paid. Because the informal sector accounts for some 40 percent of manufacturing jobs, applying EU regulations to this part of the labor market will have major effects.

Taymaz and Özler estimate that when all informal sector firms in the manufacturing sector begin to pay taxes and social security contributions at the same rates applied in the formal sector, the firms affected will lose half of their market shares as their costs rise. As a result, employment in the manufacturing sector will decline by 9 percent, or some 300,000 jobs. As noted by Togan in chapter 12, the effect of this policy change on employment will be even more drastic when one considers its effects on employment in agricultural and services sectors as well. The policy implication is that if a massive increase in unemployment is to be avoided, comprehensive labor market reform will be required that includes both substantial decreases in tax rates on wage income, tax-related charges, and payments to various funds, and reductions in layoff costs. Such measures will also increase the flexibility of the formal market. Such flexibility will benefit the economy overall, because it will remove a disincentive for firms to grow and become part of the formal sector—a step that requires access to the capital markets and banking system, which, in turn, implies becoming subject to taxation. An important corollary not discussed by any of the contributions in this volume is that other policies in the area of taxation and support for the private sector are rendered neutral with respect to the size of firms—in Turkey, as in many other countries, tax and related policies tend to discriminate de facto if not de jure against small firms (Hoekman and Javorcik 2004).

Chapter 10 by Mark Dutz, Melek Us, and Kamil Yılmaz turns to Turkey's FDI challenges. The authors conclude that Turkey would benefit significantly from EU accession, largely because the accession process would help Turkey to overcome its rule-of-law and competition-related constraints to FDI inflows. More rapid and consistent implementation of the rules and regulations that ensure a level playing field for all companies would be assisted by the EU accession process; this process, in turn, would enable Turkey to take full advantage of investment-related benefits.

During the 1980s, Turkey made frequent use of investment and export incentives and also relied heavily on state-owned enterprises. The Turkish public enterprise sector has been and still is very large. The state-owned enterprises have shown, in general, poor economic performance because of the soft-budget constraints they have faced. They are not confronted with the threat of bankruptcy and have benefited from government subsidies in the form of direct transfers, equity injections, and debt consolidation. In recent years, Turkey has eliminated most investment and export incentives, but similar progress could not be achieved for the public enterprises. Although privatization has become a prominent part of the Turkish reforms, it gained momentum only after the 2001 crisis and the associated reforms, because it was recognized that state-owned firms and the related structure of subsidies and soft-budget constraints were a part of the problem underlying the large nonperforming assets of the banks. Turkey recognizes that it will have to stop subsidizing the public enterprises at the prevailing rates, align its state aid policies with those of the EU, apply the same competition policies to all firms whether private or public, and privatize the public enterprises. Greater FDI can play an important role in this transition, as it has in the CEE countries.

In chapter 11, the final major cross-cutting or horizontal issue chapter, Anil Markandya looks at the costs, especially in the public sector, Turkey is likely to incur in meeting the environmental *acquis.* In this area, as in the labor market, the EU *acquis* will probably have major repercussions for Turkey. Joining the EU will require implementing the entire body of EU legislation and standards on environmental protection. This step, in turn, implies substantial investments by the public and private sectors, as well as changes in regulations and supporting institutions. EU policy in this area is based on integration of environmental policy with the sectoral policies of the EU, prevention measures, implementation of the "polluter pays" principle, and measures to address environmental externalities at their source. The *acquis* comprises some 200 legal instruments covering a wide range of areas, including water and air pollution, management of waste and chemical products, biotechnology, radiation protection, and nature conservation.

Markandya breaks down the potential costs of adopting the *acquis* based on three scenarios: a "base case" in which no special reforms are made and the public sector remains much as it is today; a "medium reform" case in which the private sector's share is increased modestly and reforms in pricing proceed to reduce the demand for some of the environmental cleanup services; and a "high reform" case in which the private sector's role is somewhat greater and environmental reforms are implemented with more rigor.

Consider just one representative area subject to environmental regulation in the EU: wastewater collection and treatment. According to the EU urban wastewater directive (91/271/EEC), all urban areas with a total wastewater discharge of 2,000 population equivalent must be connected to the sewer system, and discharges must receive at least secondary treatment except for towns with populations of less than 10,000 and in cases in which such treatment would produce no environmental benefit or would involve excessive cost. Because the majority of the Turkish population lives in municipalities that are not connected to sewer treatment, and because only a very small number of municipalities have wastewater treatment facilities, the implementation costs associated with meeting this EU regulation will be very large indeed. How large will depend in part on negotiations with the EU to determine its interpretation of what is allowed in view of the flexibility provisions embodied in the regulation. But rough estimates of the investment costs of compliance run up to more than $10 billion. Adding the additional operating, maintenance, and replacement costs would further increase this amount.

Wastewater collection and treatment is just one of the relevant directives; others include EU regulations on drinking water, industrial pollution, dangerous chemicals, fuel standards, air quality, and waste management. Markandya estimates that the total investment will run between €28 billion and €49 billion. Although this estimate is very high, he also notes that the costs will be spread over many years—he assumes 17 years. Annual investments would amount to about €2 billion to €3 billion in the high reform (i.e., low-cost) case and €3 billion to €5 billion in the medium reform (i.e., high-cost) case. In the initial years, this investment would amount to 1–1.5 percent of GDP in the low-cost case and 1.5–2.5 percent in the high-cost case. To this one would have to add the extra annual operating costs that will be incurred, which would be in the range of €5 billion to €8 billion. Because Turkey's capital investment spending on environmental areas is about 0.5 percent of GDP, accession will imply an increase of anywhere from a factor of two to four or more. However, many of these investments would probably be made in any event by Turkey, although perhaps not as fast insofar as the EU directives do not correspond to Turkey's priorities at its current stage of development. Important here is the extent to which there is "wiggle room" in the various directives, as well as flexibility on the part of the European Commission in assessing whether achievement of the *acquis* in all of the various areas is a necessary condition for accession.

Also important will be the extent to which funding for some of these investments will be provided by EU member states—although it must be recognized that the money is fungible and that the Turkish government must determine for itself where grants and loans should be allocated for the highest social rate of return. Indeed, determining this allocation and deciding what trade-offs to make will perhaps be one of the greatest challenges confronting successive Turkish governments as the accession process proceeds. In making this determination, the government must compare cost estimates with benefit estimates that evaluate the gains from the implementation of the directives. Undertaking such a cost-benefit analysis is critical. One strong conclusion that emanates from Markandya's chapter, as well as others in this volume, is that such an analysis is needed to determine where the case for investment is strongest and where it would be better to delay making investments (and negotiate extensions or agree on different sequencing with the European Commission).

Toward an Assessment: Net Effects on Turkey

What will be the net impact on Turkey of all the various policy reforms involved in EU accession? In chapter 12, Sübidey Togan attempts to go beyond the merchandise trade liberalization analysis undertaken by Francois in chapter 4 and quantify the impacts on those areas identified by the chapter authors as requiring the implementation of concrete policy changes. Specifically, Togan considers the welfare effects of integration with the EU associated with policy changes in the agriculture, banking, telecommunications, transportation, electricity, and natural gas sectors. He concludes that a conservative estimate of the resulting net increase in the real income of Turkish households is some 3.6 percent of GDP.[15] Integration with the EU will remove numerous distortions in the price system and improve the business climate for private sector development, which, in turn, will increase the allocative efficiency of the Turkish economy. Because these achievements will make Turkey a better place to invest, investment, including foreign direct investment, can be expected to increase, bringing with it associated employment opportunities. The allocative efficiency gains from integration will be boosted by induced capital formation. But these welfare gains will have a price: the adjustment costs associated with attaining macroeconomic stability, adopting EU labor market rules and regulations, and complying with EU environmental directives.

No assessment of costs and benefits should ignore the opportunity costs associated with the accession strategy. Indeed, one can and should ask what the counterfactual is to accession. Any process of regional integration by definition excludes other options—going it alone or relying more intensively on multilateral approaches as the focal points and anchors for reform. Clearly, the political decision has already been made to pursue the accession path, but that decision does not take away the importance of determining whether alternative strategies might not be superior in economic terms.

It is very difficult, however, to address this question. Virtually everything that is being done and will be done by Turkey could be done unilaterally. Many of the benefits from the reforms undertaken to date were gained autonomously—for example, the steps to exert greater macroeconomic discipline, the measures to strengthen the banking system, and the introduction of greater fiscal discipline for agriculture and state-owned firms. How much the templates provided by the EU model have helped is not possible to determine. Clearly, however, the *prospect* of accession played a role in the pursuit of some of these reforms. The key dimensions of accession as an anchor and focal point for reforms are as follows:

- the availability of the EU "model" to follow and implement
- the prospect of eventual free access to the EU for Turkish workers
- the assistance granted to Turkey by the EU.

Does the EU model (the *acquis*) make sense for Turkey? When it comes to disciplines associated with the single market, we would argue the answer is yes. The agenda here revolves around introducing market disciplines, controlling state aids, and encouraging competition in markets for goods and services. Integrating transport and energy markets also makes good economic sense, as do measures aimed at increasing the contestability of these markets and removing competition-distorting cross-subsidies. This is not to say that the EU model in these areas is perfect—EU trade policy, for example, and the CAP most obviously are not very good examples of efficiency-maximizing policies. But the point is that they are better than the status quo ante prevailing in Turkey, and their adoption therefore improves the expected policy stance in these areas.

Other dimensions of the *acquis* leave room for doubt. Although much of what is being pursued through the EU directives in the social and environmental areas is justifiable and will bring benefits, the costs of implementing regulation in these areas can be high. It is not clear that benefits will always outweigh costs, suggesting that these are areas in which greater care and attention are required to sequence implementation appropriately. As emphasized before, however, the accession process will take a long time, allowing for a more gradual convergence in areas where this is likely to be appropriate in view of Turkey's initial conditions.

In part, the cost-benefit ratio will depend on the extent to which additional grants are made available to Turkey that otherwise would not be forthcoming. Accession implies access to the CAP and Structural Funds, and, as a poor country, Turkey will be a net recipient of such transfers. It is not possible at this point to determine how large this net flow will be. The structure of the present system of EU revenue and expenditure is such that rich member states transfer resources to poorer members. Because Turkey is poor relative to the EU25 (even though the difference will be smaller than it was before the accession of the 10 new members), accession will clearly have budgetary effects for the EU if the current criteria are maintained for transfers among EU members. Allocations are determined in part by voting power (in turn, a function of population and size of the economy) as well as relative poverty, and so there is a possibility that the rules of the game will be changed before Turkey accedes in order to manage the fiscal and redistributive repercussions of its accession. In addition, it is projected that by 2020 Turkey's population will be larger than that of any other EU25 member. This projection may raise concerns about the decision-making procedures of the EU, as well as worries about possible immigration effects.

Effects of Turkey's Accession on the EU

The effects of Turkey's accession on the EU will depend importantly on what accession will entail for EU transfers to Turkey, EU governance (decision making), and trade and factor flows, especially migration.[16] Because the trade in goods, services, and capital has already been either covered by the customs union or addressed unilaterally by both parties in terms of bilateral flows, the effects on the EU in these dimensions are likely to be limited in the sense that they will have already occurred at the time of any accession decision. In any event, the aggregate impacts on intra-EU trade will be small. Production and trade in agricultural goods will be affected by accession, but the major effects will be in Turkey, not in the EU, because import barriers are relatively low for Turkish agricultural exports.

Decision Making

In chapter 13, Richard Baldwin and Mika Widgrén evaluate the impact of Turkey's membership on EU voting. They analyze the EU's decision-making efficiency (its capacity to act, as measured by the probability of proposals passing a vote) and the distribution of power in the EU's leading decision-making body, the Council of Ministers. They also compare two alternative Council voting rules: those accepted in the Treaty of Nice and implemented by the accession treaty of the 10 new entrants in 2004 and the rules laid down in the draft Constitutional Treaty (CT). The latter are conditional on the ongoing ratification process.

Baldwin and Widgrén conclude that, in terms of capacity to act, the enlargement will likely have relatively little impact, as long as the CT voting rules come into effect. In particular, Turkey's membership will have only a negligible effect on the EU's capacity to act—in large part because moving from 27 members (the EU25 plus Bulgaria and Romania) to 29 (Turkey and Croatia) does not change much. The answer, however, is quite different if the CT is rejected and the Nice Treaty rules remain in place. Under the Nice Treaty voting rules, the enlargement would substantially lower the EU's ability to act. These findings confirm earlier conclusions by the authors that an enlarged EU cannot function well under the Nice Treaty rules. They also suggest that if the CT is rejected, the Nice Treaty voting rules must be reformed before further enlargement takes place.

As for the distribution of power, they find that Turkish accession will have a big impact. Under both the Nice Treaty and CT rules, Turkey would be the second most powerful member of an EU29. Under the CT rules, Turkey would be substantially more powerful than countries such as Britain and Italy; under the Nice Treaty rules the power differences among the countries with a population of more than 50 million would be small. This situation suggests that the acceptability of the Constitutional Treaty and the probability of Turkey's membership may well be negatively affected.

Migration and the EU Budget

Turkey is likely to have a population larger than Germany's 82 million by 2020, if not earlier. Turkey is poor by European standards—PPP (purchasing power parity)-adjusted per capita income is roughly $7,000—and income disparities within the country are great. The population in the southeast has less than half the average national income, and the large rural population is generally much poorer than the urban population. As discussed by Harry Flam in chapter 14, these facts have implications for both the EU budget and for emigration from Turkey.

If the existing rules for contributions to and receipts from the EU budget remain unchanged—including the Common Agricultural Policy—Flam estimates that Turkey would receive a net transfer of €12 billion from the EU, corresponding to about 14 percent of the present EU budget. The overall net contribution to the 10 new entrants in 2004 and Turkey is projected to correspond to about 60 percent of the present budget. Flam concludes from this that it is unlikely that current rules will remain unchanged in the face of such large increases in net transfers from richer to poorer countries.

As noted earlier, the major trade impacts of Turkish accession on the EU are likely to be in the movement of labor. The decision to emigrate depends on a variety of factors, but real wage differentials are clearly important, as are social networks, culture, language, and geographic distance.[17] It will take decades for Turkey to attain an income level comparable with that of the EU15, implying that income differentials will be a strong incentive for migration from Turkey to the EU. The prospect of large-scale immigration from Turkey (as well as from new members and other candidate countries) is a source of considerable concern among the EU15. This was a major factor in the French decision to subject approval of Turkish accession to a referendum. Fears that immigrants will depress wages, boost unemployment, and cause social friction and political upheavals prevail in many EU member states. Clearly, free migration will not be allowed immediately upon full membership. For the 2004 new EU members, the length of the transition period was seven years, as it was for Greece, Portugal, and Spain. For Turkey, the period may be longer, and it may be subject to longer-term controls. However, because accession is unlikely to occur before 2012, this is an issue that would only come into play in 2020. By that time, Turkey should have converged more toward the average income levels of the EU25, reducing migratory pressures.

As noted by Flam, the strength of the incentive to move and the total number of people who might move are also a function of how rapidly wages rise in Turkey. As workers leave and the supply of workers declines in Turkey, wages will go up. Conversely, immigration will have a depressing effect on wages in the EU—albeit much smaller because the EU labor market is much bigger. The net impact on the Turkish economy will be determined by the extent to which capital owners are affected in Turkey, the impact of the loss of (qualified) workers on Turkish GDP, the extent to which earnings in the EU are remitted, and the magnitude and impact of reverse movements as people of Turkish origin relocate upon retirement and repatriate capital. Much also will depend on the skill levels of the people who move. Unskilled migrants are more likely to be complementary to more skilled nationals in the host economy because they will allow the latter to increase their productivity and thus their real wages.

Whatever the specific impacts, overall welfare will increase as a result of migration, but there will be a redistribution of income. Turkish GDP will decline, and the EU's GDP will rise. EU firms (capital owners) and more highly skilled workers are likely to benefit from the increased supply of less-skilled workers. Turkish migrants will gain from the move, and less-skilled EU workers will lose. The overall welfare increase will stem from a more efficient allocation of labor; Turkish laborers become more efficient when they move to European countries, and the optimal allocation is achieved when the marginal productivity of labor is equalized across EU members.

Flam concludes that the Turkish immigrant population in Germany may rise by some 60 percent by 2030. About 3 million people of Turkish origin are presently in the EU, the overwhelming majority in Germany, which implies a total movement of some 1.8 million Turks.[18] Although this is a highly speculative exercise—as stressed by Flam, much depends on the parameters assumed in the model—these numbers are manageable in view of the current overall EU25 population of 450 million. However, Flam's projections assume no restrictions are placed on migration—a strong assumption.

What such immigration will imply for wages and employment in the receiving countries is even more speculative. While those who have investigated the impacts of immigration suggest that it is likely to be limited, it should be noted that in contrast to the debates between the proponents and opponents of trade integration (where there is significant disagreement about the impact of greater trade on labor market outcomes), there is agreement that immigration will have much greater impacts than expanded trade between poor and rich countries. One reason is that migrants will seek employment in all sectors, not just tradables.[19]

Implications for Other Developing Countries

The requirements for accession to the EU provide a ready-made template, if a constantly evolving and expanding one, for countries seeking to implement far-reaching structural reform programs. What is the relevance of the Turkish experience? What lessons can be drawn for other countries with a starting point similar to that of Turkey that will not be able to accede because they are not part of Europe?

A first lesson is that the prospect of accession is not a panacea. What matters are the autonomous decisions on economic policy made by governments. Although Turkey's accession to the EU was already under discussion in the 1960s, very little progress was made in converging toward EU norms until the early 1990s. A related lesson is that much of what is associated with accession can be pursued by countries that will not be able, or may not desire, to accede. The EU *acquis* is a public good in the sense that any country can avail itself of that body of legislation and regulation. What matters is implementation, which, in turn, requires commitment and the relevant institutions to apply the standards. The regular monitoring and interaction between the European Commission and the partner government, facilitated by the provision of technical and financial assistance, can help to maintain progress. However, accession does not have to be part of the equation for countries to obtain such assistance—a very similar structure is available in the form of the association and economic partnership agreements that many countries have signed with the EU.

Such agreements can have major potential downsides if they involve asymmetric liberalization of trade in favor of the EU, while keeping barriers to imports from the rest of the world at high levels. For this reason, the standard policy advice to governments implementing such discriminatory trade agreements is to pursue a parallel strategy of lowering most-favored-nation protection rates as well (Schiff and Winters 2003). Turkey, because it formed a customs union with the EU, has adopted the common external tariff, which tends to imply a low average level of protection, at least for manufactures.[20] Assuming the problem of trade diversion is addressed through the adoption of low, and ideally uniform, levels of external protection, the EU model of regulatory principles has much to offer countries that are similar to Turkey—that is, emerging markets that have extensive state involvement in the economy, limited competition in service markets, and weak banking systems. A process of "conversion à la carte" is, by definition, not feasible when it comes to accession, but it *is* possible in the context of partnership agreements. Indeed, this option was made explicit by the EU in its 2004 European Neighborhood Policy, which offers partner countries that do not have the prospect of accession the opportunity to adopt parts of the *acquis* and through this harmonization share the benefits associated with the relevant elements of the EU's Internal Market. The challenge for partner countries is to determine where such approximation-cum-harmonization will be beneficial and where not. The Turkish case and its experience offer valuable guidance on what part of the "EU package" would be beneficial to adopt and emulate (with assistance from the EU in the context of such agreements) and which parts are best left on the shelf for the future.

The Turkish experience—as well as those of the CEE countries that acceded to the EU—reveals clearly that trade policy is important, in that the liberalization of trade with the EU led to significant improvements in productivity and trade performance, but that in itself is not sufficient. In an environment characterized by limited, if any, competition in the key network services industries—energy, telecom, transport—a weak financial sector, and limited fiscal discipline (and thus extensive cross-subsidization and transfers), trade liberalization needs to be complemented by measures to harden budget constraints and to enact pro-competitive regulation. The limited stock of inward FDI—a phenomenon that also characterizes neighboring countries in the Middle East and is in striking contrast to the situation in CEE countries—is indicative: foreign investors either perceive the attractiveness of locating in Turkey to be limited or perceive the barriers to FDI to be prohibitive. In practice, the answer is likely to be a mix of these two factors. A long history of macroeconomic instability and high-cost services will lower the interest of an investor, especially in light of the fact that the Central and Eastern European countries offer an alternative location. Administrative barriers to FDI (including red tape) have also been high in the past. Finally, slow progress on privatization helps to explain low FDI.

A similar situation prevails in neighboring countries, although with one major difference: most Arab countries have experienced macroeconomic stability. Administrative barriers to FDI, monopoly provision of services, state-owned enterprises, and slow privatization all reflect political decisions. It is an open question to what extent trade agreements that do *not* involve the prospect of accession could assist countries that want to pursue an investment and services liberalization agenda, although the Turkish experience suggests that even in a context of possible accession, progress on this overall agenda can be slow. However, the deepening of accession efforts in the future will, by necessity, imply that much of the "behind the border" reform agenda must be implemented for accession to become feasible. This may or may not be true for association agreements that include services and investment policies. Much tends to be made of the fact that bilateral and regional trade agreements are increasingly covering these areas, but there is little experience with actual implementation. In principle, again, reforms in this area can and should be implemented unilaterally. Trade agreements may help by allowing gradual commitments to be made in a more credible manner, but much depends on the substance of the reforms. A key requirement (precondition) for the network services industries and the financial sector is appropriate regulation to ensure efficiency, to guard against systemic risks, and to achieve social or equity objectives (e.g., universal service obligations). These are complex areas. Much can be learned from the experience of other countries—such as in the natural gas sector (see chapter 8 by Mazzanti and Biancardi)—but what matters first and foremost is clear objectives. Also important is the establishment of an effective, general competition authority and mechanisms to assess the impacts and effects of reforms.[21] Indeed, an important policy decision is to what extent a country should rely on general competition law to discipline the behavior of enterprises, including dominant firms in the network services industries, as opposed to sector-specific regulatory bodies.

Conclusion

To join the EU, Turkey will have to attain macroeconomic stability, adopt the EU's Common Agricultural Policy, and liberalize its services and network services industries. Integration will be beneficial for Turkey, because it will remove many distortions in the price system, boosting the allocative efficiency in the economy and, in turn, making the country a more attractive place to invest. With accession, Turkey will also be eligible for EU Structural Funds, with the resulting increase in infrastructural investments further contributing to prospects for economic growth. In addition, Turkey will reap benefits from monetary integration, as well as from migration of Turkish labor to the EU. However, the welfare gains derived by Turkey from integration will have a price: the adjustment costs associated with attaining macroeconomic stability, adopting the CAP, liberalizing services and the network industries, and complying with EU environmental directives.

According to the European Commission (2004a), 71 percent of the Turkish population supports EU membership. This high percentage of support can be explained in part by the economic benefits that Turkey expects to derive from membership. Equally important is the recognition in Turkey that the system of governance of a rule-based society, as in the EU with its many institutions, may provide better prospects for meeting the demands of various groups in society.[22] Support for EU membership also stems from the process of Westernization and from geostrategic considerations.[23]

Turkish accession will also affect the welfare of current members of the EU. Welfare will increase because of the further specialization, reflected in trade, capital, and labor flows, as well as the likely growth effects of integration. The empirical research on the economic effects of immigration indicates fairly small and on the whole positive effects.[24] There will also be political gains for the EU. Turkey is a large and fast-expanding market. It is, in fact, the largest market in its neighborhood and has a GDP that amounts to 55 percent of that of Russia. Located at the crossroads of Europe, Eurasia, and the Middle East, Turkey has the potential to act as a major link between these markets. With harmonization of commercial legislation, EU companies will be able to use Turkey as a joint investment and export base for the Middle East and Eurasia. Istanbul is already emerging as a base for transnational corporations operating in the Caucasus and Central Asia. Finally, Turkish membership could help to secure stability and security in the Balkans and Caucasus, thereby increasing EU energy security.

Although the potential net gains for Turkey and the EU members are significant, Turkey faces major challenges in implementing the *acquis*. Major challenges also must be overcome in realizing the potential gains associated with increased labor flows from Turkey—even if they will probably be relatively small compared with the size of the EU labor force. The same is true of decision making and management of the net annual budgetary cost of Turkish membership to the EU. The Baldwin-Widgrén analysis in chapter 13 points to the importance of passage of the EU Constitutional Treaty and the acceptance by existing members of a significant role for Turkey in decision making. Estimates reported by Flam in chapter 14 and in Togan (2004) suggest that budgetary costs will be quite high unless the rules on the CAP and Structural Funds are changed—constituting yet another challenge that will have to be negotiated successfully before accession.

Notes

1. Decision No. 1/95 of the EC-Turkey Association Council of December 22, 1995, on implementing the final phase of the customs union (96/142/EC).

2. "By [their] very nature, [accession negotiations are] an open-ended process whose outcome cannot be guaranteed beforehand" (European Commission 2004b: 10).

3. The Copenhagen criteria for membership were established in preparation for the eastern enlargement and cover political and human rights as well as economic criteria. Membership criteria include "stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities." As noted by many observers, such as Flam (2003), Turkey confronts serious problems in meeting the political and human rights criteria: they imply placing the military under political control and ridding it of its power in the judicial system, and they have direct implications for recognizing individual and collective cultural rights for minorities (i.e., the Kurds). In its recommendation to launch accession negotiations, the Commission argued that in "order to guarantee the sustainability and irreversibility of the political reform process, the EU should continue to monitor progress of the political reforms

closely, on the basis of an Accession Partnership setting out priorities for the reform process. The Commission will, following the analysis in the Regular Report, propose to revise the Accession Partnership in spring 2005. On this basis, a general review of the way in which political reforms are consolidated and broadened will take place on a yearly basis starting from the end of 2005. The pace of the reforms will determine the progress in negotiations. In line with the Treaty on European Union and the Constitution for Europe the Commission will recommend the suspension of negotiations in the case of a serious and persistent breach of the principles of liberty, democracy, respect for human rights and fundamental freedoms and the rule of law on which the Union is founded. The Council should be able to decide on such recommendation by a qualified majority." See European Commission (2004c, 6).

4. The European Commission reports on Turkey provide an extensive list of actions taken by the government (European Commission 2004b, 2004c).

5. In this volume, EU15 refers to the 15 members of the EU prior to the 2004 enlargement in which 10 more countries became members, creating the EU25. The 15 original member countries were Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. Those added during the enlargement were Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, and Slovenia.

6. All dollar amounts are U.S. dollars unless otherwise indicated.

7. The short maturity of debt stock and the large share of foreign currency–linked securities imply particularly high rates of rollover on domestic and international markets, increasing the vulnerability to interest rate and currency rate shocks.

8. The major standards-setting bodies in the EU are CEN, CENELEC, and the European Telecommunication Standards Institute (ETSI).

9. The competition authorities have an important role to play. The Turkish Competition Authority has taken action in the transport sector, such as investigating a price-fixing cartel in Black Sea maritime shipping (see OECD 2004b).

10. See http://inweb18.worldbank.org/ECA/Transport.NSF/Countries/Turkey? Opendocument.

11. The ratio of nonperforming loans to gross loans of the banking system in Turkey reached about 22 percent in 2001. The situation improved during 2002 due to acceleration of out-of-court settlements and voluntary debt restructuring arrangements.

12. The average excess return on Turkish government bonds over the London Interbank Offered Rate, or LIBOR (both measured in U.S. dollars), amounted to only 4 percent over the period 1990–93, but was 22.9 percent over the period 1995–November 2000. In chapter 6, Pazarbaşıoğlu argues that the fiscal cost of the 2001 financial crisis has initially amounted to €50 billion (some 34 percent of GDP). If Turkey had adopted the legislative, regulatory, and institutional framework of the EU banking system at the beginning of the 1990s and had enforced these rules, then the cost of the crisis would have been much smaller.

13. The state banks to be privatized within three years are Ziraat Bank and Halk Bank. The government has withdrawn the banking license of Emlakbank, and it will resume the privatization process of Vakifbank as soon as market conditions allow.

14. See World Bank (2004) for an in-depth discussion of the challenges in and policy options for introducing greater competition into the Turkish natural gas market, including an analysis of the sector's strengths and weaknesses.

15. This is equivalent to about a 2.8 percent increase in real GDP.

16. The 2004 European Commission recommendation states: "The negotiations will be complex and reflect . . . the need for provisions facilitating the harmonious integration of Turkey into the EU. The application in Turkey of the common agricultural policy and the cohesion policy are two examples. The rules regarding the free movement of persons are a third. It is likely that there will be, as in previous enlargement rounds, a need for substantial and specific arrangements and in some areas long transition periods. In the case of free movement of persons permanent safeguards can be considered. . . . The EU will need to prepare itself because . . . the Union's capacity to absorb new members, while maintaining the momentum of European integration, is also an important consideration in the general interest of both the Union and the candidate countries. . . . In any event, the EU will need to define its financial perspective for the period from 2014 before the financial implications of certain negotiating chapters can be tackled" (European Commission 2004b: 7–8).

17. For a survey, see Ghatak, Levine, and Wheatley Price (1996).

18. Flam obtains a number of 1.3 million for Germany, based on an initial Turkish-origin population there of 2.2 million. The number in the text takes into account the additional 800,000 Turks in the rest of the EU as of 2002.

19. Borjas, Freeman, and Katz (1992, 1997) found that unskilled immigrants, particularly from Mexico, increased the ratio of unskilled to skilled workers in the United States by some 20 percent, whereas trade flows were found to have increased the (implicit) ratio by only 4 percent. Freeman (2004) notes that industries that export still hire a sizable number of unskilled workers, while import-competing industries have large numbers of skilled workers. He also observes that the evidence that immigration has a larger impact on the ratio of skilled to unskilled workers does not necessarily mean that large wage impacts are associated with immigration. Even large-scale inflows of workers into specific locations are not found to have big effects on wages (Borjas, Freeman, and Katz, 1996).

20. In principle, any country can choose to adopt the common external tariff of the EU, so that even if a customs union is not on the table any country with a free trade agreement with the EU could emulate the Turkish solution in this dimension. But better than adopting the idiosyncrasies of the EU political economy of protection would be to move toward a system of low and uniform tariffs.

21. The Turkish experience, like that elsewhere in the world, illustrates the need for a competition authority. The Black Sea maritime case of restrictive business practices (see note 10) is a case in point.

22. This may explain the support provided to EU membership by followers of the Islamist political parties as well as by representatives of different minority groups.

23. During the Tanzimat period (1839–77), Westernizing reforms were responsible for the adoption of a series of Western law codes, creation of a judicial organization with secular law courts, introduction of French-style provincial administration (1864), and use of the so-called millet system, which made it possible for the Christian minorities to have their own religious autonomous administration with representative councils. These liberal reforms culminated in the declaration of a constitution and the convocation of a parliament in 1876–77. The process of reforms continued after the national War of Independence of 1919–23. Under Mustafa Kemal Atatürk's leadership, the newly founded Republic of Turkey carried out an extensive and

comprehensive program of modernization and secularization. Atatürk believed that total Westernization of the country was an absolute precondition for Turkey's becoming a member of the Western family of nations. He succeeded in forging a modern nation out of a failing empire and a traditional community, based on the model of the Western countries. Turkey's aspiration to membership in the EU stems from the process of modernization and Westernization, the roots of which may be traced to Atatürk's reforms designed to establish a secular order in a country with a predominantly Muslim population. The Turkish elite consider membership in the EU a natural, desirable, and inevitable step in this process. Furthermore, Turkey realizes that it sits strategically at the edge of three regions of conflict—the Balkans, the Middle East, and the Caucasus. Because of the complexity of its security, Turkey seeks to cultivate stability in order to minimize the potential for conflict. For Turkey, EU membership can help to secure this stability and contain conflict, particularly in the Balkans. Furthermore, the EU and Turkey have a mutual interest in preventing and containing any instability that could arise in the Commonwealth of Independent States (CIS) region.

24. In addition to chapter 14 by Flam, see the studies by Zimmerman (1995), Haisken-De New and Zimmerman (1996), Winter-Ebmer and Zimmerman (1998), and Storesletten (2000).

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