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Economic challenges

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1 Introduction

After pursuing inward-oriented development strategies for 50 years, Turkey switched to outward-oriented policies in 1980. The policy of 'opening up' was pursued with the aim of integration into the European Union (EU). At the current time, all industrial goods circulate freely between Turkey and the EU; that is, no quotas and tariffs are imposed on imports of industrial goods. Turkey is also currently implementing the EU's Common Customs Tariffs on imports of industrial goods from third countries and has adopted most of the preferential trade agreements the EU has concluded over time. On the commercial policy side, the country is implementing measures similar to those of the EU's commercial policy – it has adopted EU competition law, established a Competition Board, adopted EU rules on protection of intellectual and industrial property rights, established a Patent Office, and adopted most of the EU's product standards.

These are considerable achievements. Yet, trade liberalization has been restricted to industrial goods only. In 2000, agriculture still constituted 13.5 per cent and services 58.2 per cent of GDP. Thus, trade liberalization is yet to affect approximately three-fourths of Turkey's GDP. This may change, however, as recently Turkey was officially recognized as a candidate state for EU membership.[1] With accession to the EU, Turkey will liberalize its trade with the EU in agricultural commodities and services, and it will become part of the European single market. Furthermore, EU membership will require Turkey to adopt and implement the whole body of EU legislation and standards – the *Acquis Communautaire* – and also participate in European Monetary Union (EMU).

The purpose of this chapter is to highlight selected aspects of Turkish accession, emphasizing problems related to joining the single market, adopting the *Acquis Communautaire*, and meeting the Maastricht criteria for fiscal and monetary policies. The final section considers issues related to the costs and benefits of Turkish accession.

We argue that Turkey will derive welfare gains from integration with the EU, but will also incur costs associated with the adoption of the Common Agricultural Policy (CAP), liberalization of services, attainment of macroeconomic stability, and complying with EU environmental directives. However, gains from integration are expected to exceed by far the costs of adjustment.

2 Single market effects

In this section, we consider issues relating to technical barriers, liberalization of agriculture and services, and issues relating to state aid.

2.1 Technical barriers

Technical barriers to industry are said to exist as long as the EU and Turkey impose different standards as conditions for entry, sale, and use, and have different legal regulations on health, safety, and environmental protection, as well as different procedures for testing and certification of conformity to existing regulations or standards. Under the EU's new approach to removing technical barriers, essential policy requirements for particular products are set out, while the development of technical standards conforming to the requirements has been entrusted to standardizing bodies. In 1989, the European Community, as it was then, put in place the 'global approach to testing and certification', which is based on mutually acceptable auditing procedures. Goods manufactured pursuant to the requirements of the global approach are permitted to display a generic mark of conformity – the 'CE' mark. All goods displaying that mark are entitled to circulate freely within Europe and are exempted from further conformity assessment by an importing nation.

On the other hand, according to Decision 1/97 of the EC-Turkey Association Council, establishing the Customs Union, Turkey had to harmonize its technical legislation to that of the EU, and according to Decision 2/97 of the Association Council, it was supposed to incorporate into its internal legal order 324 instruments that correspond to various EEC or EC Regulations and Directives on technical legislation before the end of 2000. But the work has not been completed until now. In addition, in order to participate in the free circulation of goods in the enlarged European single market, Turkey has to align its national quality infrastructure, which is a generic term encompassing the operators and operation of standardization, testing, certification, inspection, accreditation, and metrology, to the European one. Products manufactured in Turkey must satisfy the same requirements as those prevailing in the EU, and the demonstration of conformity to these requirements must be done in the same 'harmonized' way and according to the same principles as those in the EU. Recently, Turkey has taken major steps in this direction. But it still has to establish the necessary structures on conformity assessment and market surveillance.

2.2 Agriculture

Joining the EU will require Turkey to extend the customs union to agricultural commodities and also to adopt and implement the CAP. Since currently there are substantial border controls between the EU and Turkey, and external tariffs applied by each to third countries' imports differ significantly, adopting the CAP will imply the abolition of all these border controls in agricultural commodities trade between the two as well as the adoption of the EU's external tariffs with regard to third countries. As a result, the gap between the prices of agricultural products in the EU and Turkey will narrow, with any remaining differences reflecting quality and transportation and/or marketing costs.

Although agricultural price policy will be harmonized between the two parties, different levels of direct support policies and input subsidies in Turkey and EU could, in principle, remain. Current EU support policies continue to be based on market price support provided through administered prices, export subsidies, and tariffs. Price support policies are combined with production quotas and/or land set-asides. Three years ago, a package of measures called Agenda 2000 was agreed by EU Heads of State at the March 1999 European Summit in Berlin.[2] The aim of the agricultural policy reform was to meet the goals of budget reduction and to prepare for enlargement. The reform package can be viewed as continuing the shift that began with the 1992 CAP reform package from support prices to direct payments. Support prices are expected to approach world prices over time.

In Turkey, support was provided in a variety of ways: through guaranteed or minimum prices, via the provision of subsidized loans, and direct agricultural inputs subsidies. Under the price support scheme, the public sector was committed to purchasing products through public marketing agencies and agricultural sales cooperatives at support prices announced by government decrees annually. Moreover, short-term investment credit for agriculture has been subsidized by the government at interest rates well below inflation and commercial rates. Interest rates on loans from the Agricultural Bank have been significantly negative in real terms. Finally, subsidies for fertilizers, pesticides, and irrigation have also been significant in Turkey. According to an OECD estimate (2000), total support to the agricultural sector as a percentage of GDP over the period 1997–9 was just over 8 per cent. The corresponding estimate for the EU in the same period is only 1.53 per cent. Also, between 1997 and 1999, the total support per capita amounted to US$245 in Turkey and US$344 in the EU, while estimates of producer support per hectare of agricultural land amounted to US$295 in Turkey and US$845 in the EU. It follows, therefore, that other OECD countries give even larger transfers per farmer – although compared to Turkey, they have fewer farmers and higher incomes.

Table 12.1 lists the institutional prices for cereals and sugar in Turkey and the EU. It shows that the prices of the commodities under consideration here are

Table 12.1 Selected institutional prices in Turkey and the EU (US$/tonne)

	Turkey			*EU*	
	1998	*1999*		*1998*	*1999*
Wheat			Wheat		
Durum, Anatolian	277	220	Durum	133	127
Durum, other	235	201	Common	133	127
Hard, white	223	192			
Hard, red Anatolian	204	192			
White Barley	150	144	Barley	133	127
Rye	159	136	Rye	133	127
Maize	175	155	Maize	133	127
Sugar beet	68	66	Sugar beet (Italy)	52	50

Source: Various issues of the Official Gazette and European Commission (2000).

higher in Turkey than in the EU. Under a Customs Union between Turkey and the EU, commodity prices in Turkey should move closer to those in the EU. Hence, for those commodities, producer prices in Turkey will have to decline considerably after the formation of a single market in agricultural commodities with the EU. Furthermore, with the implementation of Agenda 2000 in the EU, the prices of these commodities are expected to fall to their world price levels, and as a result Turkish prices will have to fall even further.

Recently, the Turkish authorities decided to phase out agricultural support mechanisms, a condition of the stabilization programme agreed with the IMF and signed on 22 December 1999. The government introduced instead a 'decoupled' direct income payments system as used in the EU. As prices of major agricultural commodities fall towards world price levels in Turkey and the system of subsidized loans and direct subsidization of agricultural inputs is abolished, the country is intending to offset the accompanying reduction in farmers' incomes through an increase in direct aid payments as in the EU. Such a move would help to provide farmers with a fair standard of living.

Recently, the EU declared that farmers from Central and Eastern European (CEE) countries will not be excluded from direct income support payments. It also stated that direct payments would be introduced in CEE countries equivalent to 25 per cent of the present system in 2004, 30 per cent in 2005, and 35 per cent in 2006. After 2006, these payments would increase incrementally in such a way as to ensure the new Member Sates reach in 2013 the support level then applicable. Since by 2013 support could absorb a high percentage of the EU budget, it is likely that the support system will change by then. Since Turkish farmers will face a similar situation, Turkey will have no choice but to finance the direct income support expenditures from its own budget until it is eligible for direct payments from EU. This will place a heavy burden on the Turkish budget and the policy will also have high administrative costs. This can be regarded as one of the costs of joining the EU.

2.3 Services

Services cover a wide range of activities such as financial services, transportation, and telecommunications, and accounted for 58.2 per cent of Turkey's GDP in 2000. Nevertheless, trade liberalization in this sector was not on the agenda in Turkey until the beginning of the Uruguay Round of multilateral trade negotiations. Thereafter, it has been discussed mainly within the Undersecretariat of the Treasury, the organization responsible for carrying out negotiations regarding services.

2.3.1 Financial services

Currently, in the EU, citizens and firms are free to invest their money, open accounts, take out loans, issue securities, and buy insurance and securities wherever they choose to do so within the Union, and banks, insurance companies, and security firms are free to offer their services without restriction in all EU countries.

An essential requirement for the achievement of this liberal regime is freedom for financial agents within the EU to establish branches in all Member States, and to offer their services throughout the EU whether they have established a presence in each country or not, as well as complete capital liberalization. For this purpose, the EU has harmonized basic standards for supervising financial institutions and protecting investors, depositors, and consumers, mutually recognized the Supervisory Authorities' competence and the manner in which they apply those standards, and introduced the principle of 'home country control'. The latter principle means that the EU branches of a financial institution established in one Member State will be subject to prudential supervision by the Authorities in its host country, and likewise the services which it provides throughout the EU will be subject to home country prudential supervision.

In Turkey, the new banking law of June 1999 mandated the creation of a new independent Banking Regulatory and Supervisory Agency (BRSA). The BRSA takes over banking regulation and supervision responsibilities previously fulfilled by various departments. The limits imposed on a single borrower and to related parties were tightened, banks' exposure to non-financial participations were limited, and minimum capital requirements were increased. Furthermore, the new Banks Act introduced higher minimum capital requirements for new banking licenses, and urged implementation of operational policies in line with the Basle Accord. According to this Act, the establishment of a bank, founded as a joint stock company, or opening of the first branch of a bank based in a foreign country, is subject to authorization from the Council of Ministers of a proposal endorsed by BRSA. With the amendment of the Banks Act in December 1999 the BRSA became the sole authority able to grant permission for the establishment of a bank. After receiving the permission to found a bank or open a branch office in Turkey, an additional license from the BRSA is required to accept deposits or engage in other banking operations. Banks are free to open additional branch offices provided they comply with the principles set by the BRSA and they have achieved the standard ratios introduced. If necessary the BRSA may subject the opening of additional branch offices to authorization. Any new bank must have a minimum of $30 million in capital, payable in cash and upfront. Banks established abroad, which are willing to open branch offices in Turkey, must have the same amount of paid-in capital allocated to Turkey. Any amendments to the articles of association of a bank shall require the approval of the BRSA. In addition to the above mentioned regulations, the government has recently taken steps to correct the weak loan loss provisioning rule and the lenient large exposure and connected lending limits. With the December amendments to the Banks Act, tighter limits were imposed on both on- and off-shore balance sheet commitments to related parties and especially to companies belonging to the same group. Furthermore, in June 2000, a plan for the gradual reduction of deposit insurance was put into operation. Finally, on 11 May 2001, Parliament amended the Banking Law. The amendment changes regulations governing the protection of investors, mergers and acquisitions, and competition; accelerates legal proceedings for troubled banks taken over by the Savings Deposit Insurance Fund; and allows the seizure of assets of owners and administrators of failed banks.

With the relaxation of entry barriers to the banking sector during the 1980s, the number of foreign banks in Turkey increased from four in 1980 to 15 in 2002. However, in terms of their shares in total assets, credits, and deposits, foreign banks still remain insignificant. Foreign banks are less active in collecting deposits and extending loans, but play a relatively larger role in offering financial services that are accounted for under off-balance sheet items.

The above considerations indicate that the Turkish financial reform programme was quite successful in transforming the Turkish financial system into a modern one. The objective of the legislative and regulatory reform is to bring the regulatory and supervisory regime for the Turkish financial sector up to the level of international practice and in line with EU standards. The objective has been achieved to a large extent but more still needs to be done. After Turkish accession to the EU, citizens and firms in the EU and Turkey will be free to invest their money, open accounts, take out loans, issue securities, and buy insurances and securities wherever they choose within the EU and Turkey, and banks, insurance companies, and security firms will be free to offer their services without restriction in all EU countries, including Turkey. As a result, competition in the Turkish financial sector will increase, Turkey will recognize the Supervisory Authorities' competence of EU Member States, and introduce its legislature to the principle of home country control. Competition will lead to lower prices for consumers as well as to a larger variety of financial instruments. Some Turkish banks will benefit from larger markets by concentrating on activities in which they have comparative advantage, while other banks may be forced to merge with foreign firms or exit from the market. Adjustment will certainly be costly for both the winners and the losers.[4] This cost can again be regarded as a cost of joining the EU.

2.3.2 Telecommunications

Since its inception in the mid-1980s, the EU's telecommunications policy has focused on two main objectives: economic efficiency and the guarantee of universal service. The achievement of these aims has been pursued through the application of a set of complementary principles: market liberalization and harmonization of conditions for a common regulatory framework. The regulatory framework promoted by the European Commission has now been adopted to achieve these aims. Since 1 January 1998, the EU has had fully competitive telecommunications markets in all Member States but five; Portugal, Spain, Greece, Ireland, and Luxembourg have derogations and have postponed the introduction of full competition until 2002 at the latest.

The EU's experience demonstrates that competition is the best way to ensure efficient operation and sufficient technological innovation to keep up with the pace of global change, that regulation is vital, and that privatization combined with the establishment of conduct regulation has a positive impact on performance.

Turk Telecom dominates the Turkish telecommunications sector, a national monopoly that has exclusive rights to all fixed line voice operations. In January 2000, Parliament approved legislation to reform the telecommunications sector, which initiated the process of deregulating the sector over the medium term. A regulatory

authority has been established and a new regulatory board has been appointed. The reforms have led to the establishment of private mobile telephone companies and of a series of companies providing value added services such as internet access and cable television under revenue sharing agreements. On 12 May 2001, the Turkish Parliament passed the new Telecommunications Act, which aims to end the state monopoly on landline telecom services by privatizing most of Turk Telecom.

When Turkey accedes to the EU, it will have to introduce full competition in telecommunications. In particular, the country will have to adopt and implement the EU's legislative measures, centring on liberalization of all telecommunications services and infrastructure; adoption of open network provision measures to ensure a competitive environment; maintenance and development of minimum supply of services and the definition of common principles for financing the universal service; the establishment of a common framework for the interconnection of networks and services; and the approximation of general authorization and individual licensing regimes to those in the EU.

2.3.3 Electricity and natural gas

An important accession requirement in the electricity sector is compliance with Directive 96/92/EC, which concerns the rules of the internal market in electricity, adopted on 19 December 1996 and effective from February 1997.[4] Most member states have 2 years to bring this into effect. The Directive establishes common rules for generation, transmission, and distribution of electricity, and offers a variety of alternative ways of meeting the criteria. Its fundamental aim is to achieve a competitive market in electricity. Similar considerations apply in the case of natural gas. The 1998 European Gas Directive provides for the gradual opening of the natural gas market to competition over a 10-year period to reach 33 per cent of total gas consumption.

In Turkey, the electricity sector is dominated by state-owned enterprises, although there are privately owned firms accounting for about 21 per cent of electricity generation. Under the current regulations, 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. This contract, guaranteed by the Turkish Treasury, assures the investor that the project will be profitable irrespective of future demand for power. As a result, the government retains the commercial risks.

The Turkish government has recently passed a new Electricity Law,[5] which attempts to introduce a market model similar to the EU's. This 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 along the EU model. The government's future role will be largely confined to determining sector policy, owning the transmission system, and setting up an independent regulatory body to ensure that the rules are respected and that prices are competitively determined.

On the other hand, the current market structure in the Turkish gas sector is based on monopoly provision. BOTAS, the state-owned enterprise, has a monopoly on imports of gas, and is the only transmission company. Local companies – owned either by the municipalities or by BOTAS – provide distribution and supply. Recently, the government passed a new Gas Law (2 May 2001). With this law the government plans to establish a competitive market as in the EU and encourage private sector participation through a phased policy. As in the case of electricity, an independent regulator for the gas industry has been established. This authority determines the transmission and distribution access rules and tariffs and the methodology for the regulation of retail prices.

2.3.4 State aid

During the 1980s, Turkey used three different tools of industrial policy intensively: investment incentives, export incentives, and policies targeted at state-owned enterprises. In each case, the government tried to obtain a preferred allocation of resources through the use of subsidies. Investment incentives, regulated by laws and decrees, have been directed to reducing the cost of investment, reducing the need for external financing, and increasing profitability. On the export side, using various types of incentives during the 1980s, governments have been able to increase profitability.

However, regarding policies for state-owned enterprises, we should note that the Turkish public enterprise sector is still very large. The state-owned enterprises have shown in general poor economic performance due to the soft-budget constraints they faced.[6] They are not subject to market discipline and as such escape bankruptcy laws. Moreover, they receive subsidies from the government through direct transfers, equity injections, and debt consolidation.

Turkey has recently eliminated most of its investment and export incentives. Within this context, GATT-legal subsidies such as those for Research and Development (R&D) and to facilitate the adaptation of plants to new environmental regulations have been introduced. Export subsidies in Turkey are now restricted to subsidies provided for R&D activities, to environmental projects, and to financial assistance for export promotion.

Although considerable progress has been achieved in the fields of investment and export incentives, similar progress has not been made in the case of public enterprises. This means that even though privatization was a prominent part of the Turkish structural adjustment programme since 1983, it did not gain momentum until very recently. Turkey recognizes that it will have to stop subsidizing public enterprises, align its state aid policies to those of EU, apply the same competition policies to all firms whether private or public, and to privatize the public enterprises.[7]

3 Economic challenges

In this section, we consider issues related to macroeconomic stability, labour markets, and compliance with EU environmental directives.

3.1 Macroeconomic stability

The Treaty of Maastricht, signed in December 1991, laid the groundwork for the process leading to the EMU. The Treaty outlined three successive stages. The first stage began with the removal of the remaining capital controls in July 1990 and an enhanced commitment by Member Countries to fixed parities within the European Monetary System (EMS). The second stage began in 1994 with the setting up of the European Monetary Institute in Frankfurt, which prepared the practical steps required to establish an integrated system of European Central Banks, including the partial pooling of foreign exchange reserves and the development of common operating procedures. The third stage started on 1 January 1999 with the irrevocable fixing of exchange rates among the countries admitted to the Monetary Union. It was accompanied by the creation of the European System of Central Banks. At the centre of this system lies the European Central Bank, a new institution that determines monetary policy across the EMU. National banks survive as local subsidiaries, mostly in charge of bank supervision and operational aspects. The common currency, the Euro, began circulating on 1 January 2002, gradually replacing national currencies.

Before entering the Monetary Union, a country has to satisfy the convergence criteria summarized under five headings: (i) member country's inflation may not exceed the average of the three lowest inflation rates in the EMS by more than 1.5 per cent; (ii) its long-term interest rate must not exceed the average of the interest rates in the three countries with the lowest inflation rates by more than 2 per cent; (iii) its exchange rate must have been in the 'normal' band of the Exchange Rate Mechanism (ERM) without devaluation for at least 2 years; (iv) its public debt cannot exceed 60 per cent of its GDP; and (v) the budget deficit must not exceed 3 per cent of its GDP. These criteria are meant to guarantee that the countries that join EMU will be able to sustain a low rate of inflation.

Table 12.2 shows the EMU convergence criteria for Turkey and the CEE countries. It can be seen that the CEE countries are close to satisfying the criteria, but by contrast Turkey is still far away from satisfying the conditions. Indeed, Turkey is in the midst of a determined campaign to turn around decades of weak economic performance, reflected in pervasive structural rigidities and weak public finances. The past few years have witnessed three major attempts at addressing these underlying weaknesses. The first was during 2000 under the 3-year Standby Agreement initiated in December 1999. Despite some notable achievements, a worsening current account and a fragile banking system led in late 2000 to a liquidity crisis, which turned into a full-blown crisis in February 2001. The government decided to abandon the crawling peg regime and floated the currency. In May 2001, IMF increased its assistance under a new stand-by arrangement. Just as the revised programme was beginning to show results, the 11 September events triggered the re-emergence of serious financing problems. In February 2002, IMF approved a new 3-year stand-by credit for Turkey to support the government's economic programme. With the implementation of this stabilization programme Turkey envisages a gradual but steady improvement in its economic conditions.

Table 12.2 EMU convergence criteria

	Inflation rate, %		*Budget deficit, % of GDP*		*Government debt, % of GDP*		*Interest rates, 10 year bonds*	*Exchange rate stability, deviation from parity*		*Currency regime*
	2000	*2001*	*2000*	*2001*	*2000*	*2001*	*Last*	*Last*	*Max (2Y)*	
Bulgaria	10.1	7.9	−1.1	−1.0	83.8	72.5	5.2	0.0	−1.3	Currency Board (EUR)
Czech Republic	3.9	4.7	−4.0	−3.2	29.2	29.0	5.5	14.0	−6.0	Managed Float (EUR reference)
Estonia	4.0	5.8	−0.7	1.1	6.6	6.2	4.7	0.0	0.0	Currency Board (EUR)
Hungary	9.8	9.2	−3.5	−5.0	56.1	51.5	6.7	5.4	−4.5	Crawling peg (EUR)
Latvia	2.7	2.5	−2.8	−1.9	10.0	12.2	10.7	2.6	2.6	Peg (SDR)
Lithuania	1.0	1.3	−2.8	−1.4	28.3	29.0	7.9	8.1	8.1	Currency Board (EUR)
Poland	10.1	5.5	−2.7	−6.3	43.8	38.0	8.3	8.4	−8.7	Float
Romania	45.7	34.5	−4.1	−3.7	29.2	31.2	34.9	−31.4	−31.5	Managed Float (USD reference)
Slovakia	12.0	7.3	−6.8	−7.2	32.9	42.7	7.8	4.0	−2.0	Managed Float (EUR reference)
Slovenia	8.9	8.5	−1.4	−1.3	25.1	25.4	na	−7.1	−7.1	Managed Float (EUR reference)
Turkey	54.9	54.4	−19.6	−17.6	57.4	93.3	56.5	56.9	93.3	Float
Reference value	2.8	3.3	−3.0	−3.0	60.0	60.0	7.3		±15%	

Sources: Deutsche Bank Research (2002), Turkish State Planning Organization, Central Bank of Turkey and Turkish Treasury (2002).

Note
Parity refers to the last 3-year average exchange rates against Euro. In the case of Turkey, the interest rate is annual compound interest rate on government bonds of 8 months' duration obtained in the latest auction of treasury bills.

During the period leading up to adoption of the Euro there are three steps that Turkey must consider. Until entry into the EU is secured, Turkey retains control of its exchange rate policy, implying freedom over its monetary framework and the exchange rate regime. Upon accession, the exchange rate policy of Turkey becomes a common concern for the EU. Turkey will be expected to join the Exchange Rate Mechanism (ERM-II) at some point after accession for a period of at least 2 years. Finally, after fulfilment of the Maastricht criteria, Turkey will have to adopt the Euro.

3.2 Labour markets

According to Togan (2000), the Turkish labour market is extremely flexible. The reason behind the flexibility lies in the fact that it is not homogeneous. It has different wage setting mechanisms in the formal and informal sectors. The informal sector is largely free from most types of labour regulation and is not subject to taxes and related charges. Activities in this sector rely mostly on provision of labour services without formal employment contracts. Job insecurity is pervasive and workers get very few benefits from their employers. Labour regulations are observed by the formal sector and this sector also pays all taxes and related charges such as social security contributions and payments to various funds. According to Togan (2000), the share of informal sector in total employment is about 60 per cent. The reasons for this relatively high share are: (i) the very high tax rates on wage income, high tax related charges, and substantial payments to various funds that have to be paid in the formal sector as a requirement of social security law and the laws regulating the taxation of personal incomes; (ii) the relatively high firing costs imposed by, and the stringency of the various clauses of, the labour law; and (iii) lack or weakness of enforcement mechanisms for respective laws in the economy.

Studies reveal that the Turkish population increases on average by one million persons a year. Thus, Turkey has to create new jobs on a continual basis. In the past, Turkey has successfully solved its unemployment problem through the existence of a large, flexible informal sector where wages are free to equilibrate demand and supply, and via labour migration from Turkey. Table 12.3 shows the number of Turkish citizens and workers abroad. As one can see, 89 per cent of Turkish workers living abroad work in Europe. Moreover, 732,000 workers of the entire 1.2 million working abroad (over 60 per cent) are employed in Germany.

With Turkish accession to the EU, Turkey will have to introduce a comprehensive labour market reform. After the reforms have been passed, the authorities will have to enforce the rule of law uniformly, but this will have to be done without increasing the unemployment rate in the economy. Hence, these labour market reforms will probably entail substantial reductions in tax rates on wage income, tax-related charges, and payments to various funds, as well as reductions in firing costs and making various clauses of the labour law less stringent.

Table 12.3 Labour migration from Turkey (Cumulative, 2001)

	Citizens living abroad		*Workers abroad*	
	Number	*%*	*Number*	*%*
Europe	3,127,691	88.85	1,047,842	88.76
Germany	2,053,600	58.34	732,189	62.02
France	311,356	8.85	76,122	6.45
Netherlands	299,909	8.52	51,000	4.32
Austria	134,229	3.81	57,098	4.84
Belgium	70,701	2.01	25,874	2.19
Other Europe	257,896	7.33	105,559	8.94
Middle East and North Africa	117,180	3.33	100,480	8.51
CIS countries	53,050	1.51	15,895	1.35
Other countries	222,119	6.31	16,333	1.38
Australia	52,620	1.49	13,500	1.14
USA	130,000	3.69	—	—
Canada	35,000	0.99	—	—
Japan	1,729	0.05	1,729	0.15
Other countries	2,770	0.08	1,104	0.09
Total	3,520,040	100	1,180,550	100

Source: State Planning Organization.

3.3 Compliance with EU environmental legislation

Joining the EU will require Turkey to adopt and implement the entire body of EU legislation and standards on environmental protection. This means that Turkey will have to bring its environmental protection system, infrastructure, and standards up to Western European levels, which, in turn, will require substantial investments by both the public and private sectors as well as changes in regulations and supporting institutions.

Consider the EU regulations on wastewater collection and treatment. According to the urban wastewater directive (91/271/EEC), all urban areas with a total wastewater discharge equivalent to 2000 population are required to be connected to a sewer system, and the discharges of collected sewers must receive at least secondary treatment. The directive allows for exceptions for towns with a population of less than 10,000 in cases when sewers would produce no environmental benefit or would involve excessive cost.

According to the 1997 general census of population, the total population of Turkey is approximately 62.87 million. Of this figure, 13.75 million live in areas with populations of 2,000 and less, 49.12 million live in areas with populations of more than 2,000, 22.57 million live in areas with population of 10,000 and less, and 40.3 million live in areas with populations of more than 10,000. In 1997, there were 2,835 municipalities with a total population of 48.2 million. Moreover, 7.3 million lived in rural municipalities. According to the State Planning

Organization, 72 per cent of the population living in municipalities were not connected to sewer treatment. For an additional 23 per cent of the population, sewer systems were under construction. Upon the completion of these systems, the percentage of population connected to sewer systems will rise to 51 per cent of the population living in municipalities. Furthermore, 2 per cent of the municipalities have wastewater treatment facilities, and 14 per cent of the population living in villages have sewer connection with septic tanks.

Assuming that the sewer systems under construction will be completed during the coming years we could conclude that out of the 48.2 million living in municipalities, 24.5 million will be connected to sewer systems in the near future, leaving 23.7 million with no connection to sewer systems. In the villages, a further 11.8 million people have no sewer connection.

The costs for new sewerage systems will depend on three parameters: (i) the proportion of the rural population living in towns that would be classified as agglomerations, with a population of more than 2,000 population equivalent; (ii) the proportion of towns with between 2,000 and 10,000 residents that will be exempted from constructing sewer systems on the grounds of no environmental benefit or excessive costs; and (iii) the proportion of the rural population that must have sewer systems. Once the Commission and Turkey have reached an agreement on these parameters during the entrance negotiations, the cost of compliance with the EU directive can be determined. Rough estimates of investment costs to comply with the directive are in the region of some US$16 billion (Togan 2001). Additional operating, maintenance, and replacement costs would increase this even further.

The above considerations reveal that environmental protection presents challenges for Turkey. These are likely to be even more substantial when one adds to the costs of compliance with regulations on wastewater collection and treatment, the costs of compliance with EU regulations on drinking water, industrial pollution, dangerous chemicals, fuel standards, air quality, and waste management. Again, these costs are best considered as the 'price' of joining the EU. One can also argue that Turkey would have had to bear these investment costs in any case. Only the timing of the investments would be different, as EU directives do not necessarily correspond to Turkey's priorities at this stage of its development.

4 Costs and benefits of Turkish accession: towards an appraisal

Following accession to the EU, Turkey will produce and export those goods and services in which it has comparative advantage. Furthermore, with the increase in market size and elimination of trade barriers, integration will lower prices of different commodities by increasing competition and spurring efficiencies via better exploitation of scale economies. A larger variety of products will be offered in the Turkish market and intra-industry trade with the EU will increase. In cases where larger Turkish firms are operating on a more efficient scale and competing more effectively, liberalization may lead to higher sales and higher employment.

But in other industries restructuring may be accompanied by a sizable re-allocation of employment as firms cut back on redundant workers and close inefficient plants and offices. In those sectors the number of firms will probably be reduced through mergers and bankruptcies. Thus, integration will remove the distortions in the price system, which, in turn, will boost the allocative efficiency of the Turkish economy. As a side-effect, this heightened efficiency will make Turkey a better place to invest, causing investment generally to rise, and with it foreign direct investment. Thus, the allocative efficiency gains from integration will be boosted by induced capital formation. While investment increases above its normal level, the Turkish economy will experience a growth effect. All this means improved welfare for Turkish people in the long term.[8]

Besides the free movement of goods and services, EU membership would involve the free movement of capital and labour with Turkey. Although the 1995 Customs Union decision is silent on the movement of capital, it should be noted that as of 2002 there are no restrictions on capital movements either in the EU or in Turkey.

As for the movement of labour, there is currently a ban on the recruitment of migrant workers from Turkey in EU countries and Turks visiting EU countries face visa restrictions. With accession Turkish workers are expected to migrate to EU countries. Given the current relative wage situation, opening EU labour markets to Turkish workers might increase the wages of Turkish migrants and lower western wages for unskilled workers. The extent of likely Turkish migration is difficult to estimate. Labour mobility between Turkey and the EU will probably be achieved after a relatively long transition period after accession. By that time it is possible that the expected increase in Turkish welfare due to static and dynamic effects of integration may have caused the wage differential between Turkey and the West to decrease. This may, in turn, lead to a reduction in potential migration from Turkey.

Furthermore, with accession Turkey will be eligible for EU structural funds. As a result, infrastructural investments will increase, which, in turn, will contribute to economic growth as emphasized by Canning (2000). Finally, within a few years of EU accession Turkey will abondon its national currency and adopt the Euro. Belonging to the currency union will reduce the costs of international transactions and promote trade and openness. According to Frankel and Rose (2002), joining a currency union can tripple a country's trade with other currency union members. They also argue that there is no evidence of trade diversion, and that each 1 per cent increase in the country's overall trade relative to GDP raises income per capita by at least one-third of a per cent.

Comprehensive and up to date quantitative analyses of the effects of accession on the Turkish economy are not available. Harrison *et al.* (1997) have analysed the economic implications for Turkey of a Customs Union with the EU. The authors show that Turkey would gain between 1 and 1.5 per cent of GDP annually from this type of arrangement depending on the complementary policies it adopts. But the study abstracts from a consideration of the liberalization of trade in services between Turkey and EU, perfect mobility of capital and labour between the two sides, and fails to assess the different costs of adjustment mentioned above.

Welfare gains for Turkey from integration with the EU will have a price, no doubt. That price will be the adjustment costs associated with the adoption of the CAP, liberalization of services, attainment of macroeconomic stability, reform of the labour market, and compliance with EU environmental directives.

From the opposite perspective, gains will accrue to current EU members with Turkish accession. One set of gains would come from standard comparative advantage sources. There are also political gains to be derived from Turkish membership. Turkey is a large and fast expanding market. In terms of GDP, in fact, it is the largest market in the Middle East, Balkans, and Caucasus. As incomes in Turkey and Eurasia increase, the EU will derive potential gains from increased trade. Through increased stability and security in the Balkans and the Caucasus, the EU's energy security can improve and its defence expenditure may decrease, leading to further potential savings.

Since Turkey's integration into the EU will have budgetary implications for the latter, we now turn to a consideration of this effect. In the EU budget, two items dominate the spending side: the CAP and structural spending. On the other hand, two items dominate the revenue side of the EU budget: the fourth resource and VAT. According to the agreed rules, the Union gets a share of each member's national VAT receipts. The fourth resource is based on members' GNPs and is used to balance the accounts.[9]

According to the financial prospects for the EU 15 in the period 2000–6, as determined by the EU Heads of State at the March 1999 European Summit in Berlin, the pre-accession EU financial transfers to the CEE countries cover PHARE,[10] agricultural and structural support. The aim of the PHARE program is to focus resources on the institution building required for the adoption of the *Acquis Communautaire* by the CEE countries, where institution building implies the strengthening of democratic institutions, public administration, and organizations that have a responsibility in implementing and enforcing Union legislation. Approximately 30 per cent of PHARE funds are allocated to institution building and the rest to investment support. On the other hand, support under SAPARD (the Special Accession Program for Agriculture and Rural Development) aims at helping to finance projects in various fields of agriculture and rural development, while support under ISPA (the Instrument for Structural Policies Pre-accession) is designed to help in the fields of environmental protection and infrastructure. Entitlement to EU support from these pre-accession funds calls for co-payment by the recipient country. SAPARD differs from the PHARE scheme in that the selection of projects is the task of the recipient country and the EU participates only in *ex post* control. With ISPA, projects have to be coordinated with the European Commission from the outset. In addition to these pre-accession EU financial transfers to the CEE countries, the after accession transfers of agricultural and structural funds from the EU to the CEE countries offer greater prospects, but their magnitude is not certain yet.

Assuming that the EU will follow a similar budgetary strategy for Turkey, we can estimate that annual PHARE funds to Turkey during the pre-accession period could amount to around Euro 900 million, annual SAPARD funds to Euro 400 million, and annual ISPA funds to Euro 800 million. Thus, during the

pre-accession period, which may start in 2007, Turkey could receive from the EU a total of Euro 2.1 billion annually. After accession, the funds allocated for Turkish agriculture and structural policies could be increased gradually as in the case of CEE countries. Such policies would be feasible as the total amount of appropriations for payment as a proportion of GNP would not exceed the critical value of 1.27. Once a member of the EU, Turkey will also contribute to the EU budget. Turkey's contribution to the EU's budget, forming 1 per cent of its GDP, could amount to about Euro 2 billion annually. As a result, the net budgetary cost of Turkish membership to EU will be reduced accordingly.

The above considerations reveal that the conditions for EU accession can be grouped into two categories. The first involves a number of specific and absolute requirements for membership, where Turkey generally has little or no choice as to the form or type of compliance. The second category covers a range of conditions and guidelines, often in the form of minimum standards, but where Turkey retains some choice about where it positions itself prior to and following accession. Key examples of the former are the requirements regarding the Customs Union, CAP, health of the financial sector, and EMU. Key examples of the latter set of conditions are the requirements regarding the environment and labour markets. It seems that Turkey will have to satisfy, as soon as possible, the former set of conditions and with some time lag the latter set of conditions.

The whole process will be costly to both parties, but it will be beneficial in the end.

Notes

1 See the Presidency Conclusions of the Helsinki European Council held on 10–11 December 1999.
2 See Presidency Conclusions, Berlin European Council, 24–25 March 1999.
3 Claessens *et al.* (1998) define foreign banks as those banks that have at least 50 per cent foreign ownership. According to the authors, the share of foreign bank assets in total bank assets averaged over the period 1988–95 was 77 per cent in Greece, 31 per cent in Spain, 61 per cent in Hungary, 51 per cent in the Czech Republic, and 1 per cent in Turkey. With liberalization in financial markets the penetration rates of foreign banks in Turkey are expected to increase substantially. As some of the Turkish banks merge with foreign banks or exit from the market, employment in the sector will be adversely affected.
4 For a summary of the Directive, see http://www.europa.eu.int/en/comm/dg17/elec/memor.htm
5 Law Number 4628, published in the Official Gazette on 3 March 2001.
6 For a recent analysis of State-owned enterprises in Turkey, see Arslan and Celasun (2000).
7 Turkish Competition Law is silent with regard to public undertakings. It does not contain a clause such as Article 86 (ex Article 90) of the EEC Treaty, which explicitly brings public undertakings within the scope of competition policy. Moreover, it is worth noting that state aid in Turkey has recently taken the form of injections to private banks under the management of Savings Deposit Insurance Fund. These are mainly banks hit by capital losses during the November 2000 and February 2001 crises due to the sharp decline in the market value of government securities holdings and capital losses arising from the sharp depreciation of its exchange rate. According to EU regulations, state aid to the banking sector is subject to the same conditions as any other state aid and as such it should be avoided.

8 The process described above corresponds to the experience of EU membership for Spain, Portugal, and Ireland.

9 The Union's own resources consist of agricultural duties and sugar and isoglucose levies, customs duties, VAT resources, and the fourth resource. The fourth resource is a variable, budget balancing resource for which the call-in rate is calculated during the budgetary procedure in such a way as to cover the amounts not yielded by other budget revenue. The own resources ceiling was raised in 1999 from 1.21 per cent of GNP in 1995 to 1.27 per cent of GNP.

10 PHARE is the European Union initiative that supports the development of a larger democratic family of nations within a prosperous and stable Europe. It was initially developed as an immediate response to challenges facing the countries of central and eastern Europe.

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