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AVRUPA TOPLULUĐU ENSTİTÜSÜ
AVRUPA BİRLİĐİ İKTİSADI ANABİLİM DALI

**AN EVALUATION OF CRITICAL APPROACHES TO THE CUSTOMS UNION
BETWEEN TURKEY AND THE EUROPEAN UNION**

YÜKSEK LİSANS TEZİ

Pınar YÖRÜK KAVAK

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ABSTRACT

The Customs Union was determined by 1963 Ankara Agreement, detailed by 1973 Additional Protocol and became effective in 1996 between Turkey and the EC. Since it is one of major factors which affect Turkish economy, it has been very criticized in Turkey. The aim of the study is to make a categorization and evaluation of these critics. Although, there have been many arguments about this issue in Turkey, most of them have not criticized the direction. The critics are not generally concentrated on the concept of economic integration itself, but of its modelling. In other words, it can be said that there is a general consensus that Turkey's economic integration with the EU is the most rational option. There are four basic categories regarding the essence of critics about the current CU in Turkey. The first one is critics on the source of the CU between Turkey and the EU. The second category is constituted by the critics on the aim of the CU. The third category of the critics on the CU are classified according to possible effects of the CU on an economy. The fourth category of the critics on the CU is about the functioning of it.

ÖZET

1963 Ankara Anlaşması ile kararlaştırılan, 1973 Katma Protokol'le ayrıntıları belirlenen ve 1 Ocak 1996 itibariyle Türkiye ile Avrupa Birliği arasında tam olarak uygulamaya giren Gümrük Birliği, Türkiye ekonomisine şekil veren önemli bir faktördür. Bu nedendir ki özellikle Türk kamuoyunda yoğun olarak tartışılmaktadır. Çalışmanın temel amacı bu eleştirilerin dayandırıldıkları temellere göre kategorizasyonu ve değerlendirilmesidir. Sonuç olarak, Gümrük Birliği'ne yöneltilen eleştirilerin ekonomik entegrasyona değil, ekonomik entegrasyonun modeli üzerine yoğunlaştığı söylenebilir. Başka bir deyişle, AB ile Türkiye arasında gerçekleşecek bir ekonomik birlik, Türkiye ekonomisi için serbest ticaretten sonra en iyi seçenek olarak kabul görmektedir denebilir. Eleştiriler dört ana kategoride toplanmıştır. İlk kategori Gümrük Birliği'nin dayandığı temel üzerine yapılan eleştiriler oluştururken, ikinci kategori Gümrük Birliği'nin amacı üzerine yapılan eleştiriler oluşturur. Üçüncü ve dördüncü kategoriler ise sırasıyla Gümrük Birliği'nin Türkiye ekonomisi üzerine etkileri ile Gümrük Birliği'nin işleyişinden kaynaklı aksaklıklar oluşmaktadır.

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1. INTRODUCTION

As Pelkmans (1997) states, any economic theory of discriminatory trade has to address the question whether the preferential arrangement would be superior to participation in worldwide liberalization. Given a decision to go for regionalism, a further choice is to be made between various methods of regional trade liberalization. According to Panagariya (1996 and 1998) since free world trade is not a realistic possibility, economic integration is seen as a move towards free trade, despite criticism. El-Agraa (1998) defines the term of economic integration as the discriminatory removal of all trade impediments between at least two participating countries and the establishment of certain element of co-ordination and co-operation between them. This definition implies elements of both free trade and protection. One of the major methods of achieving regional trade liberalization is to create a Customs Union (CU). A CU arises when countries join together to abolish all restrictions on trade between themselves while maintaining a common external tariff on imports into the union. The formation of a CU certainly breaches the principle of universal free trade because it practices discrimination against non-members. However, it reduces trade barriers between members of the CU and generally stimulates inter-bloc trade; it may reduce the share of trade with countries which are not in the Union. While such a regional arrangement aid to economic integration of its members, it may be harmful for the liberalization of trade on a global basis.

In 1948 the Netherlands, Belgium, and Luxemburg formed a CU for industrial goods. This method of integration was extended with the foundation of the ECSC which is a CU for coal and steel products including Benelux, France, Germany and Italy. When the EEC was established by the Rome Treaty in 1957, the objective of creating a CU was clearly spelt out besides creating a Common Market. As it was mentioned before, this requires free movement of goods, services, capital and labor to exist among the member states. In order to achieve this outcome, legal barriers restricting free trade between the members of the Community must have been removed. Beside, while legal and governmental systems of the members need to be harmonized to allow free movement of production factors, as well as commercial, competition, environmental and social policies with industrial policies also require modification. Therefore, the establishment of an effective CU and CM require a fairly high degree of economic and political integration.

Until the 1980s when the moves to create the Single European Market (SEM) began to gain importance, the formation of a CU was the main method used by European countries for economic integration. Therefore, the CU has been constituted a central and fundamental position in the economic integration of the Community. The enlargement of the EC has been started firstly by accession of the UK, Ireland and Denmark in 1973, followed by Greece in 1981, and Spain and Portugal in 1986 and the CU of the EC became the largest regional trading bloc in the world.

Turkey has chosen to join a customs union with the European Economic Community (EEC) (the European Community EC). This distinction sourced from new structure of the European Integration introduced by the Maastricht Treaty in 1993.¹ Since the Customs Union of Turkey was decided to make with the European Economic Community by the Ankara Agreement in 1963, when the sides of the CU is considered the EEC or the EC should be used. The association relationship between Turkey and the EEC started and the full membership was set as an ultimate aim by this agreement. The Additional Protocol, signed in November 1970 and put into effect in January 1973 specified the time schedule to abolish customs tariffs gradually between the EC and Turkey.

Turkey started to implement trade liberalization policies in the 1980s, after an extended period of an inward –looking development strategy. During those years, like many other countries, Turkish economy also underwent a series of trade reforms and abandoned the fixed exchange rate regime. With start of the CU process Turkey's tariffs and levies manufactured products imported from the European Union has been eliminated gradually. Trade in agricultural products, with the exception of agro-industrial products, was excluded from the CU regime. By the agreement, Turkey would also apply EU's common external tariff on imports from the third parties. According to certain point of views, the Customs Union (CU) between Turkey and the European Union (EU) is one of the most important developments affecting the Turkish economy as a whole since the liberalization measures launched in 1980. As in same manner, it can be determined as major step for the modernization of the Turkish economy and its integration to the world trading system.

¹ According to new structure , there are three main columns namely, the European Communities (the European Economic Community, the European Coal and Steel Community, the European Atom Energy Community) , Common Security and Foreign policy, Cooperation Process in Justice and Home Affairs. All of these columns are called the European Union.

The last period of the Customs Union between Turkey and the EC started in January 1996, after the 1/95 Decision of the Association Council had been approved by the European Parliament in December 1995. From this day arguments about the impact of economic integration between Turkey and the EU on the Turkish economy has started to gain importance. Questions generally centered on the necessary changes that both sides have to do such as adoption of new rules and regulations to make Turkish legal and economic system more harmonized with the EU economy. They also focused on creating flexibilities around certain regulations on the part of the EU to make transition easier for Turkey. Therefore, there were equally important issues regarding the gains and losses of each side because of the integration of forming a customs union. There were apparent macroeconomic impacts of such reforms in both economies. Any interaction or a movement for further integration would also require convergence in social and political matters as well.

The aim of the study is to categorize critics on the CU between Turkey and the EC, and concerning the issues prominent in the CU. In addition, counter arguments to these critics will be evaluated. Arguments on Turkey's choice between free trade and regional economic integration² will be excluded, since there is no significant critics concerning this issue on Turkey's agenda. It should be noted that, since there is no any significant arguments on whether Turkey should be a member of the EU or not, there is a consensus on Turkey's full membership to the EU. The critics are generally centered on the following topics; the source of the CU, the aim of the CU, the effects of the CU and the functioning of the CU. However the CU can be seen as a different formation from the full membership of Turkey, as it will be discussed later, the full membership of Turkey to the EU should be considered as the ultimate aim while the critics on the CU are evaluated.

2. THE THEORETICAL ASPECTS OF INTEGRATION

² Basically there are two approaches to international trade liberalization: the international approach and the regional approach. The international approach involves international conferences under the aegis of WTO. The purpose of these international conferences is to reduce tariff and nontariff barriers to international trade world-wide. The regional approach involves agreements among small numbers of nations whose purpose is to establish free trade among themselves while maintaining barriers to trade with the rest of the world. The EU is prominent example of such preferential trading arrangements.

2.1. Theory of Economic Integration

Term of economic integration that has attracted increasing attention since the early postwar period, does not have clear-cut meaning. There have been different definitions with different contents. According to Balassa (1961); economic integration can be defined as a process and as a state of affairs. Regarded as a process, it encompasses measures designed to abolish discrimination between economic units belonging to different national states; viewed as a state of affairs, it can be represented by the absence of various forms of discrimination between national economies. Furthermore, to interpret the definition, he has needed to make a distinction between cooperation and integration. The difference is qualitative as well as quantitative. Whereas cooperation includes actions aimed at lessening discrimination, the process of economic integration comprises measures that entail the suppression of some forms of discrimination. According to Pelkmans (1997)³ economic integration is the elimination of economic frontiers between two or more economies. On the other hand, Tinbergen (1965) defines international economic integration as optimization of international cooperation.

The need of becoming together in economic area, also determine the degree of economic integration. However reasons to become economically integrated are mainly economic, there are important arguments that denote the reasons behind some of economic integration models as political rather than economic. According to Viner(1950)⁴, as an economic integration model customs union is naturally a political phenomenon. Since its net effects on welfare can not be estimated previously, the motive behind customs union can not be purely economic. Therefore, Viner concluded that the political motive for a customs union is more influential than the economic one. In addition, Bhagwati(1993) mentioned that countries which found a customs union or a free trade area do not seek only economic interest but also political interests. Despite these arguments, the essence of economic integration is based on both to market integration and economic policy integration. Especially, market integration in and remains the essence of economic integration. It is a behavioral notion indicating that activities of market participants in different regions or member states are geared to supply -and- demand conditions in the entire Union. In a market of perfectly

³ See Osman Küçükahmetoğlu(2000),pp.4-5

⁴ See Osman Küçükahmetoğlu(2000),p.61

homogenous goods or services or one type of financial capital, market integration can be measured by the degree of price convergence. Compared to market integration, policy integration is a less precise concept. Moreover, the degree of binding and commonness may vary, from consultation and cooperation via coordination to common policies or fully-fledged centralization. Therefore, policy integration cannot be measured in any straightforward way. According to Molle(1997) in the case of a customs union which will be explained below, a competition policy at the union level is essential to prevent any action distorting fair competition. In addition, on politico-economic grounds, a large customs union is in a better position to substantiate a trade policy towards the outer world and to improve its terms of trade⁵. Therefore, customs unions are expected to shape their strategic trade policy. Since the internal market is larger, the strategic trade policy at the level of the union is more effective than at the national level. In addition, Küçükahmetoğlu(2000) while interdependency among the members of an economic integration rise in accordance with the level of integration, harmonization and unification of policies on different issues such as fiscal policies are much more required.

2.1.1. Degrees of Economic Integration

There are several possible forms of organization that allow countries to discriminate against a selected group of countries. As stated by Küçükahmetoğlu (2000), in the aim of classifying different applications on different degrees of economic integration, Tinbergen developed negative and positive integration distinction in 1954. As Tinbergen stated that negative integration denotes the removal of discrimination in economic rules and policies under joint surveillance. In this kind of integration instruments which can be seen as trade barriers must be totally removed and new ones should not be set. On the other hand, positive integration refers to foundation of common institutions, or the joint exercise. New institutions and new policies which aim to develop integrated economies and regular markets are built among member states, where old ones must be removed. In practice, negative integration implementation is seen easier than positive integration implementation, however negative and positive integration can be applied together.

According to Heller(1973) the main reason that makes economic integration in the form of different degrees or ways of organizing lies in the degree of interdependence achieved by the member countries This complexity of economic integration, and the radically diverging degrees of

⁵ This subject will be explained later, in customs union theory.

interdependence, has led the analysts to distinguish economic integration process into several stages or to define different models of it. As defined by Balassa (1961) the economic integration can take several forms that each form could be understood different degree of integration. These are; a free trade area, a customs union, a common market, monetary union, an economic union and complete economic integration.

2.1.1.1. Free Trade Area: In a FTA tariffs and quotas abolished for imports among participating countries, but area members retain national tariffs against third countries. According to Chacholiades(1990), when a group of countries forms a free trade area, a policing problem arises namely trade deflection. This side effect arises when imports from the third country enter a high-duty member country through a low-duty member country. To correct the problem of trade deflection, member countries must be able to distinguish effectively between goods originating in the free trade area and goods originating in the rest of the world. Recent FTAs among developed countries go much further in product scope and in approximation of certain forms of economic regulation. Nevertheless, a producer outside the area can export from a low-duty member country to the rest of the free trade area by building just a final assembly plant in the low-duty member country. Also Heller(1973) underlined the necessity of certificates of origin for imported goods from rest of the world to prevent enter of imported these commodities into area via the country with the lowest external tariff.

2.1.1.2. Customs Union: In addition to abolition of all import duties on their mutual trade in all goods, a customs union includes suppressing discrimination for CU members in product market and equalization of tariffs in trade with nonmembers. This means that all member countries agree to eliminate (or lower) their respective tariff rates on imports from each other but not on imports from the rest of the world. Therefore, trade deflection problem do not arise in a customs union. Such reciprocal tariff reductions necessarily discriminate against imports from the rest of the world. Viner(1950) argued that a customs union gives rise to two opposing tendencies. On the one hand, while a customs union tends to increase competition and trade among member countries, it also represents a movement toward freer trade. On the other hand, a customs union tends to provide relatively more protection against trade and competition from the rest of the world, and this represents a movement toward greater protection. According to Chacholiades(1990) because of

this nature of the customs union, the theory of customs union deals with nonoptimal situations, and it is therefore a special case of the theory of the second best.⁶

2.1.1.3. Common Market: It is also a CU abolishes restrictions on factor movements such as labor and capital. Thus, as Chacholiades(1990) stated, the common market countries abolish all trade restrictions on their mutual trade and also establishing a common external tariff as a customs union.⁷ Heller(1973) also defined a common market as economic integration form which includes both free trade area and customs union by allowing the free movement of products and which is more advanced since it provides the free movement of all factors of production. According to Hitiris(1998), since common markets create a single commodity market and a single factor market, tendency towards a single price for each commodity and a single price for each factor will be as strong as in a unitary state. Therefore, in common markets allocation of factors of production improves that leads to rise in welfare.

2.1.1.4. Monetary Union: This kind of economic integration model includes features of the common market besides new features. It can be realized in two methods. The first method requires fixed exchange rates that are determined among the members while the second method requires a common currency of the union. Therefore, monetary policies of the members must be harmonized in the second method. In the case of the EU, at first, the fixed exchange method was applied and then the common currency has been realized⁸.

2.1.1.5. Economic Union: The fourth stage is economic union. As distinct from a common market, it combines the suppression of restrictions on commodity and factor movements with some degree of harmonization of national economic policies, in order to remove discrimination that was due to disparities in these policies.

⁶ The theory of the second best deals with suboptimal situations, that is, situations in which not all Pareto-optimum conditions are satisfied. See Chacholiades(1990),p.227

⁷ Heller (1973) determined free trade areas, customs unions and common markets as the most prominent forms of economic integration among several forms

⁸Also, in the case of the EU, monetary union and economic union function simultaneously.

2.1.1.6. Complete Economic Integration: The last one is total economic integration includes unification of monetary, fiscal, social and counter cyclical policies. Moreover it consists of setting up of a supranational authority where decisions are binding for the member states.⁹

According to Küçükahmetoğlu (2000), forms of economic integration can be determined regarding interdependency level that they aim. For this reason, they can be arranged in order, considering their final interdependency levels, by starting from the simplest one towards the most complicated one. In addition to Balassa's classification, Küçükahmetoğlu defines preferential trade agreement¹⁰ as the first form of economic integration in which participant countries provide and benefit from lower rate of tariffs for each other's imports than tariff rates for imports come from the rest of the world. While the agreement's scope can be limited in terms of variety of commodities, the tariffs for these imported commodities are not totally removed.

2.1.2. Economic Integration between Countries At Different Economic Development Level

From the perspective of economic development, there are three possible kinds of economic integration; between developed-developed countries, developing-developing countries and developed-developing countries. Since the economic integration between Turkey and the EU is an example of asymmetric economic integration between developed- developing countries, it can be useful to examine these kinds of economic integration forms to understand the expectations of both Turkey and the EU in the context of the CU. The aims and results of any form of economic integration can be different according to development level of the participant countries. As El-Agraa(1998), mentioned while the economic integrations between developed countries generally aim to increase in welfare and to accelerate the development, they can lead improvements such as increase in productivity, benefiting from economies of scale, improve in terms of trade and in competitiveness and reducing costs. On the other hand, in economic integrations between developing countries, countries does not aim to benefit from possible static welfare gains of economic integration, they aim to have rapid economic growth by changes in both production and trade. However, as Hitiris(1998) stated that the rationale of integration among developing countries

⁹ Chacholiades(1990) does not consider monetary union as a model of economic integration between common market and economic union in regard of interdependency level. He also determines the economic union as the most complete form of economic integration which have all features of the complete economic integration of classification above. He gives the US as an perfect example of this ultimate model of the economic integration.

¹⁰ Chacholiades(1990), called this economic integration models as "Preferential Trading Club"

is not based on the prospect of static benefits from competition-induced changes in the existing pattern of their production. It is based on the potential dynamic effects, the expectation that integration will foster regional markets which will shape a new developed structure of production capable of generating a greater volume and range of trade. Therefore, the success of a regional economic integration among developing countries must be judged in the longer term. Nevertheless, the prospect of deriving benefits after a long period of economic sacrifice, these kind of economic associations contain, in a sense, elements of self-destruction. In this circumstances, the economic associations between developing countries rarely survive long enough to reap actual economic benefits.

Finally, according to Panagariya(1999) in economic integrations between developed and developing countries, the possible gains for latter one can be prevention of existing and probable protectionist policies of participant developed countries, and it can increase its credibility which is useful for its economic reforms. As it will be explained later, the CU between the EU and Turkey is a type of economic integration which generates between developed and developing countries.

2.2. Theory of Customs Union

The Treaty of Rome in 1957 called for the creation of a customs union and a common market which are clearly outlined in Article 3 of the Treaty. Today, the EU has become more advanced economic integration in which member states have a single currency. In general, the Union has association relationship based on a customs union or free trade agreements with candidate countries. As a candidate country Turkey has been in a customs union with the EU since 1996. Therefore, to understand the critics on the CU between Turkey and the EU, it is crucial to state development of the customs union theory and the basic features of a customs union as an economic integration model.

The scope of the customs union theory can be set, according to Lipsey (1973), as the branch deals with the effects of geographically discriminatory changes in trade barriers. As Balassa (1961) stated, there had been no consistent theoretical analysis of the issues involved by the theory until 1950, when the writings of Maurice Bye, Herbert Giersch and Jacob Viner appeared simultaneously. While Viner investigated the impact of a customs union on trade flows and

distinguished between the trade creating and the trade diverting effects of a union, Maurice Bye¹¹ investigated the trade creation versus trade diversion issue without the Vinerian terminology. In addition, Giersch¹² emphasized the location aspects of a union. In fact, until the work of Viner in 1950, it had been supposed that constitution of a customs union would be certainly in favor of the world trade. The rationale for this was that since free trade maximized world welfare and since customs union formation was a move towards free trade, customs unions increased welfare even though they did not maximize it. Nevertheless, Viner(1950) denoted that the welfare effects from creating a customs union depend on the net impact of trade creation and of trade diversion. After Viner's study the major contributions were made by Meade¹³ in 1955 and Lipsey¹⁴ in 1957. Meade(1955)'s research emphasized the role of prices and international terms of trade for achieving and maintaining equilibrium in international trade and payments under economic integration agreements. He highlighted the effects of substitution in consumption. Meade also indicated that how the formation of a customs union could alter relative prices and as a result change consumption patterns and accordingly leaving the volume of trade among countries to vary. Therefore, this can increase both trade expansion and trade contraction, an increase in welfare will be possible only if there is a net increase in the volume of trade. The level of pre-union tariffs and demand elasticity would determine the net effect on welfare. As a result, while trade creation in a customs union is welfare improving, a trade diverting customs union may not improve welfare depending on the factors mentioned above. Also Lipsey introduced the second best theory into the analysis of customs union in 1957. The theory denotes that reducing tariffs on a discriminatory basis under a regional integration arrangement does not necessarily lead to a welfare gain for individual countries or for the world as a whole as long as the discriminatory barriers in other countries remain unchanged. He supposed that there is a unique second best position in the economy. Although this position is not Pareto optimal, it could be a Pareto improvement. Both Meade and Lipsey concluded that a trade diverting customs union may increase the welfare of the home country. According to Lipsey(1957), Viner had ignored the inter-commodity substitution in consumption. Trade diversion does not necessarily entail a loss in welfare because of the change in the pattern of consumption accompanied by changes in relative prices in the domestic market of member states. Another contribution was made by Kemp and Wan in 1976. According to Kemp and Wan(1976), a customs union would always be welfare improving under specific conditions. Any

¹¹ See, Balassa (1961)

¹² See, Balassa(1961)

¹³ See,Meade(1955)

¹⁴ See Lipsey(1957)

customs union is potentially favorable for all countries considering participation, since even if there is loss, they can be compensated. They also offered a theoretical perspective regarding the common external tariff towards non-members called Kemp-Wan theorem. It denotes that a customs union can always find a common external tariff structure that would make the rest of the world's trade with the union just equal to its trade with home and partner countries combined before the union. Thus, the rest of the world would not be worse off as a result of the customs union. Accordingly, any improvement to the welfare of the member countries as a result of the customs union would add to world welfare.

2.2.1. Definition of Customs Union

According to Balassa(1961) a customs union is one of the basic forms of economic integration which must meet ,according to GATT definition, firstly, the elimination of substantially all tariffs and other forms of trade restrictions among the participating countries and secondly, the establishment of uniform tariffs and other regulations on foreign trade with nonparticipating economies. Also, according to Penketh (1992) CU is an economic integration model in which tariffs reduced to zero on intra-union trade, but on extra- union trade a Common External Tariff (CET) is adopted. It is the CET which distinguishes a CU from a free trade area. With the latter form of regional economics association, nation states are free to adopt their own tariff levels upon goods imported from the rest of the world. As Heller(1973) stated in the same manner with Penketh that the formation of a customs union involves the changing of tariff patterns between the countries forming the union as well as between the union members and the rest of the world. By the definition, a customs union consists of a group of countries that have abolished all tariff barriers among themselves and apply a common external tariff to the imports from the rest of the world. Free movement of all products is assured within the union, and thus the problem of intra-union trade of imported commodities no longer exists. In conclusion, as Mc Donald (1999) defines, a customs union is a regional economic integration which requires policies leading to both negative and positive integration¹⁵. In other words, according to Mc Donald(1999), the establishment of an effective customs union may lead a fairly higher degree of economic integration. (Vertical integration)

¹⁵ According to Tinbergen(1965) negative integration occurs when institutions which impede trade between member countries are abolished and new institutions are not established. On the other hand, positive integration occurs when existing institutions that impede trade between member countries are arranged and the new ones are established to organize new trade conditions between members.

2.2.2. Effects of Customs Union

As Chacholiades(1990) states, the theory of customs union is not concerned with Pareto-optimum conditions, that is, the conditions that lead to maximum welfare. The formation of a customs union necessarily violates Pareto optimality because of the existence of tariffs. The theory of customs union deals with non-optimal situations, and it is therefore a special case of the theory of the second best. In other words, the best way to avoid the negative welfare effects of protection is for all the countries of the world to adopt perfect free trade. However countries, finding progress on that score too slow and try to adopt as a second- best strategy: a geographically limited form of free trade as represented by a customs union. Nevertheless, as Penketh (1992) stated, participation in a CU does not necessarily represents a freer trading regime for all participating countries. There are two reasons for this. Firstly, it is a consequence of averaging tariff levels to calculate the CET that some countries' post-union tariff level (CET) will be higher than pre-union tariff levels. Secondly, as adjustments to the CET are not made following the entry of new members, there may be cases where a CET is significantly above pre-union tariff rates. If there are some possible cases in which a CU could not provide freer trade than it was in pre-customs union situation, reasons of a country for joining a customs should be examined. Any decision in favor of participation a CU depends upon the ultimate objectives of economic policy, namely what countries are attempting to maximize. While these objectives are shaped, possible effects of customs union in question become the most influential factors. Therefore, effects of a customs union have been examined since the theory was introduced. The traditional approach of customs union theory which was developed by Viner, Meade and Lipsey examines the static effects of a customs union. It concerned almost exclusively with the role of countries as importers.

2.2.2.1. Static Effects

Production Effect

Viner(1950) has examined the economic effects of a customs union firstly in the aspect of production by using terms of trade creation and trade diversion. He developed these concepts of trade creation and trade diversion that have been used to analyze whether shifts in trading patterns lead to benefits or costs in terms of gains and losses of consumer and producer surpluses. While he studies the production effect of a customs union, he assumes that two goods are produced, costs are fixed, demand elasticity is zero, and supply elasticity is infinite. As stated by Lipsey (1973) by

introducing these terms, Viner showed that the argument of free trade maximizes world welfare, a customs union reduces tariffs and is therefore a movement towards free trade; customs union will therefore increase world welfare even if it does not lead to world welfare maximum, is incorrect. If formation of a customs union results in a shift in domestic consumption away from relatively high cost domestic production to relatively low cost partner production or rest of the world production or both, then trade creation is said to rise. If there is a change in trade patterns which lead to welfare losses as a result of participating in a CU by switching from a low cost to higher cost source of supply, there is trade diversion. When trade diversion arises, higher cost supplies from the union partner displace lower cost supplies from the rest of the world. This switch in the source of supply arises because although imports from the union partner are more costly than imports from the outside the CU, these imports are not subject to the CET whereas imports from the rest of the world are subject to the CET. When the change in surpluses of the three groups that are consumers, producers and government are collectively considered, there is an overall loss resulting from trade diversion.

Consumption Effect

Since prices would decrease comparatively within the union as a result of the customs union, consumption would increase. In other words, a member country could import from another member cheaper than before and import within the union would increase. As it is seen in the Figure 2.1, while production of member states and the third countries, whose prices remain above the new prices in the union, is decreasing, consumption of members whose pre-union prices remain below the pro-union prices is increasing since consumers' purchasing power increase comparatively. As it is represented in the Figure 2.1, lower market price in A stimulates total domestic demand, which is satisfied by another member. This increase in import constitutes trade expansion.¹⁶

Effects on Government Revenue

As it is obviously seen from Figure 2.1 that abolition of tariffs among members leads to reduce in tax revenue of governments. Besides, if CET is below pre-union tariffs of a member or there is sharp decrease in its exports, there would be decrease in government revenue of that member state.

¹⁶ See, Molle(1997), p. 89

Welfare Effect

As Hitiris(1998) stated, welfare effect of a customs union is explained by consumer and producer surpluses. The previous term refers the difference between the price intended to pay by consumer and the price consumers actually pay. The later term refers the difference between the price intended to sell by producers and the price producers actually sell. Because of customs union, the price of good decreases in A, as it is seen in the Figure 2.1, and therefore consumer surplus increases. On the otherhand , since reduce in price, producer surplus decreases. In other words, this loss of producer surplus is the gain of consumer surplus. In addition, as it is explained above, loss of government revenue because of customs union is also the gain of consumer surplus. Nevertheless, this phenomenon does not mean that there is net welfare gain of A, it only represents that there is redistribution of welfare within the country. As Viner(1950) set that a customs union can lead increase in welfare of members and non members as well as it can lead decrease in welfare of both. The net result regarding the welfare, depends on comparative dominance of trade creation and trade diversion effects. If trade creation is dominant, both of members or one of them can obtain gain in welfare but revunue of rest of the world decreased. If trade diversion is dominant, both of two members or one of them can be subjected to welfare loss, and non-member countries would be effected negatively.

Below, these static effects of a customs unionon a single member country and on two member countries are explained by graphics on the basis of partial equilibrium analysis. There are Country A (Importer country), Country B (Partner country), Country C (Rest of the world) and a single good namely X. Basic assumptions are:

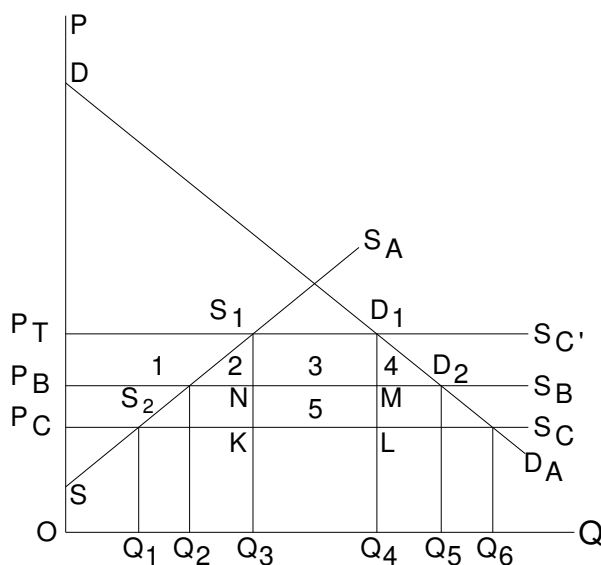
- Pure competition in commodity and factor markets
- Factors of production is fully employed
- Labor, capital and technology are given
- Factors are mobile within countries but not between countries
- Tariffs are the only form of trade restriction
- There are no transportation costs
- Trade is balanced
- Price accurately reflects the opportunity cost of product
- Fiscal and monetary operations are rule out
- There is no externalities

According to model, A and B countries will establish a customs union and apply common external tariff (CET) to imports from Country C. CET is assumed under the tariffs that both A and B

countries applied before the CU that cause emergence of different price level in both A and B Countries.

Figure 2.1 depicts these static effects of a customs union on a single country namely Country A assumed as a small country which is price taker. On the Figure 2.1 S_A represents supply curve and D_A represents demand curve of Country A for X commodity. In free trade situation, S_C represents supply curve of Country C and S_B represents supply curve of Country B for X commodity. S_C^1 represents supply curve of Country C after CU for X. It is assumed that the costs of produce X of the countries are in order as $A > B > C$. In a CU situation, $P_C P_T$ interval represents CET that is equal to the customs tariff of A before the CU. While A applies CET to imports from C, it does not apply any tariff to imports from B. Therefore, while price of C will be increase from OP_C to OP_T , price of B remains at the level of OP_B . Price of A decrease from OP_T to OP_B after the CU. As a result of the CU following changes emerge : Production decrease from OQ_3 to OQ_2 in A, consumption increase from OQ_4 to OQ_5 in A, importation increase from Q_3Q_4 to Q_2Q_5 in A, revenue of customs tariff (represented by 3+5 before the CU) disappear in A, trade creation occurs in the amount of $Q_2Q_3+Q_4Q_5$ in favor of B, welfare gain represented by 2+4 is obtained, trade diversion represented by Q_3Q_4 occurs, welfare lost represented by 5 is obtained, producer surplus decreased from SS_1P_T to SS_2P_B , consumer surplus increase from DD_1P_T to DD_2P_B .

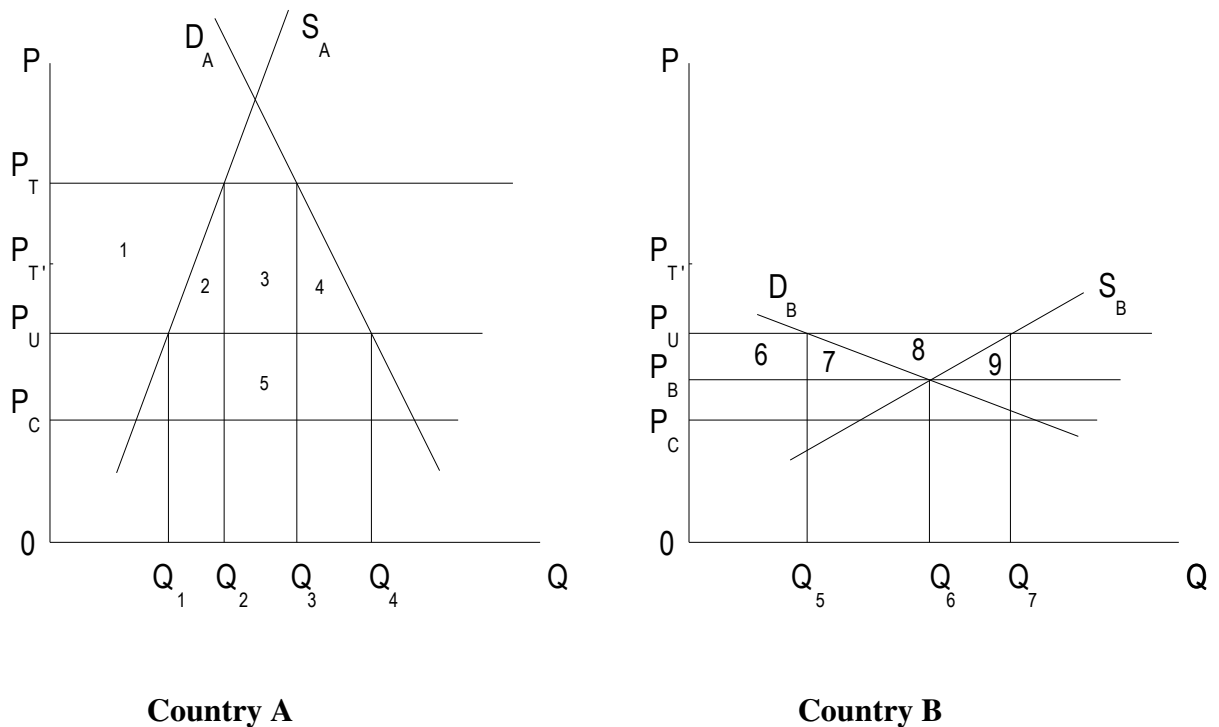
Figure 2.1: Production, Consumption, Welfare Effects of A Customs Union on A Single Country (CountryA)



Source: Küçükahmetoğlu(2000), p.33

Figure 2.2 depicts these static effects of a customs union on two partner countries namely Country A and Country B. Tariff applied by A before the CU is represented by $P_C P_T$ interval to protect its national industry. On the other hand, tariff applied by B to protect its industry from external competition before the CU represented by $P_C P_B$. In addition, before the CU price in A was OP_T , production was OQ_2 , consumption was OQ_3 . Importation in the amount of $Q_2 Q_3$ was provided by C before the CU. Country B was self sufficient and its price was OP_B , production was OQ_6 , consumption was OQ_6 . Since production was equal to consumption in B before the CU, exportation was not made. After the CU, CET which is average of both A and B countries pre-customs union prices, is started to apply. Therefore, price of C including CET is indicated by OP_T^1 . Since OP_B excess OP_T , in the CU situation B has comparative advantage on A. But price of C is more than price of B after the CU. As a result of the CU following changes occur: price in A decrease from OP_T to OP_U , price of B increase from OP_B to OP_U , production of A decrease from OQ_2 to OQ_1 , consumption of increase from OQ_3 to OQ_4 . Difference between production and consumption of A indicated by $Q_1 Q_4$ will be imported from B. Therefore, trade creation occurs and represented by $Q_1 Q_2 + Q_3 Q_4$. welfare increase of A because of trade creation is represented by 2+4. There is also trade diversion represented by $Q_2 Q_3$ which leads welfare lost of A represented by 5. To understand the total effect of the CU on welfare of A, amount of 2+4 and 5 should be compared. In B as a result of the CU, production increases from OQ_6 to OQ_7 , consumption decreases from OQ_6 to OQ_5 , difference between production and consumption is exported to A which is represented by $Q_5 Q_7$. In other words, the gain of B because of the increase in exportation is $Q_5 Q_7$ after the CU. Increase in producer surplus of B is 6+7+8, while decrease in consumer surplus is 6+7 in B. As a result, the welfare gain of B is $(6+7+8)-(6+7)=8$. Nevertheless, production of B increase after the CU, since this increase occurs at high prices in fact efficiency of production decreases in amount of 9. To sum up, Country B is obviously winner of the CU since its revenue from exportation to A is more than the sum of both consumer and producer losses. Country C trade decrease as a result of trade diversion but change in welfare level is excluded from the analysis since its supply curve is accepted fully elastic.

Figure 2.2: Static Effects of A CU On Two Partner Countries (Countries A and B)



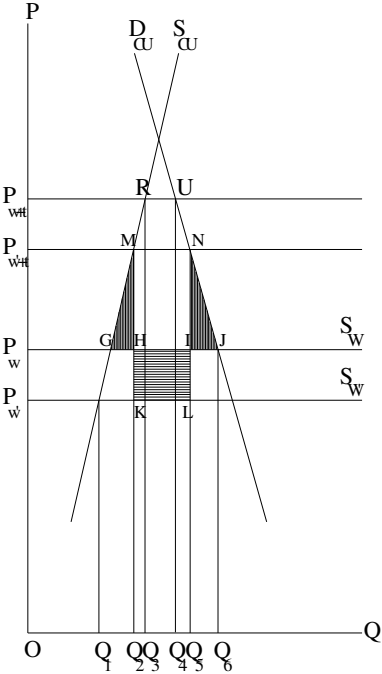
Source: Küçükahmetoğlu (2000) pp.41-42

Terms of Trade Effect

It can be calculated as ratio of export price to import price (P_x/P_m). Increase in terms of trade refers to increase in welfare. As Küçükahmetoğlu(2000) states that the effects of a CU on terms of trade is depend on following factors; domain of the CU, bargaining power of the CU, tariff rates of the third countries apply to the CU members, decrease in costs within the union. In fact, each of these factors effects the price of imported goods to the union from the rest of the world. In other words, Even each members of the CU is small country which mean price taker, if a CU can be regarded as a big country which has big market , it can effect price of good in world market by using CET rate. By a CET level it can also reduce the price of imported good under both domestic price of the union and world price which the members would import good in the case of free trade. Since domestic price remain above the import price, domestic production decrease and domestic consumption increase. Nevertheless, decrease in import price leads rise in tariff revenue that while some part of it payed by the domestic consumers, the rest of it payed by importer which is welfare gain. Another way of emerging terms of trade effects of the CU is based on internal trade of the union. Trade between members can lead welfare gain in exporter country, but can lead decrease in

welfare of importer country as a result of too much decrease in terms of trade of that country than the sum of its welfare gain and trade creation effect. Also as set by Molle(1997), indeed importing countries united in a customs union can enforce lower supply prices on the world market. In this way, they may improve the terms of trade for the customs union. This is illustrated by Figure 2.3, where D_{CU} represents the customs union demand curve and S_{CU} represents its supply curve. P_W represents the price of the rest of the world. The customs union now introduces a tariff t . That takes the price from P_W to P_{W+t} and domestic supply from OQ_1 to OQ_3 . As demanded falls from OQ_6 to OQ_4 , foreign suppliers are confronted with a decrease in their export volume from Q_1Q_6 to Q_3Q_4 . To prevent such a considerable loss of exports, the third country producers will cut their prices to P_W^1 which means they keep an export volume Q_2Q_5 . The customs union can import much more cheaply than before; on the assumption of constant prices for its exports, the customs union lands a net gain; its welfare from improved terms of trade is rectangle $KHIL$, which has to be set against the two triangles GMH and INJ . Therefore, formation of a customs union will for many countries be a rational choice, notably for smaller countries that lack market power.

Figure 2.3: Terms of Trade Effect of A Customs Union



Source: Molle (1997) p. 98

Economies of Scale Effect

Since a CU leads to increase in output by extension of the market, unit cost of production will reduce and efficiency of production will increase. If the reason of decreasing costs is extension of production scale, this is internal economies of scale. If reduction of cost arises from improvement of industry conditions, this is external economies of scale¹⁷. While economies of scale effect of customs union is considered, external economies of scale is excluded. The Figure 2.4 depicts this effect. The approach is static¹⁸ and the analysis is based on partial equilibrium analysis¹⁹. Assumptions are: Countries A and B establish a customs union, Country C represents the rest of the world; Countries produce a homogenous good and A and B have reducing average costs, C has fixed cost; Cost of A and B is higher than cost of C; The domestic price of A and B depends on cost of C and tariff rate applied to imports from C, The customs tariff of A and B is made to measure. In the Figure 2.4, AC_A and D_A represent average cost curve and demand curve of A. OP_A is the price in A before customs union.

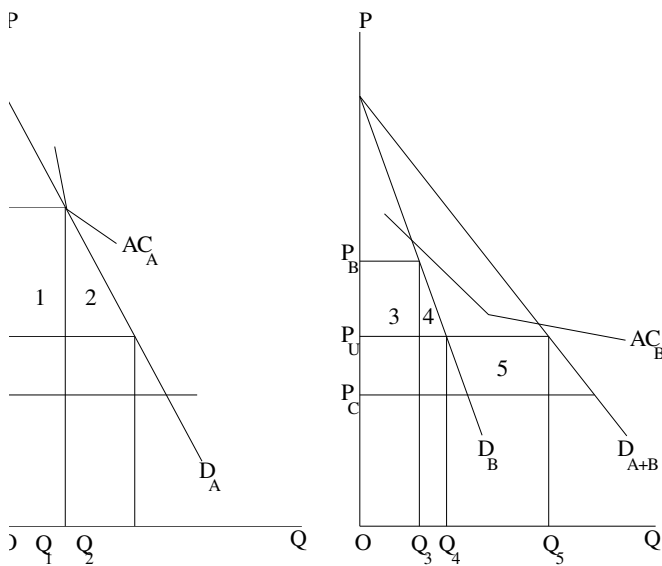
AC_B and D_B represent average cost curve and demand curve of B. D_{A+B} indicates the total demand of A and B. OP_B shows the price of B before the customs union. OP_U represents the price in A and B after the customs union.

¹⁷ See, Corden(1985), p. 58

¹⁸ Some other studies such as Penketh(1992), McDonald(1999), El-Agraa(1990), Hitiris(1998), Healey(1995), economies of scale effect is accepted as a dynamic effect.

¹⁹ See, Corden(1985), p. 58

Figure 2.4: Economies of Scale Effects of A Customs Union



Country A

Country B

Source: Robson (1998),p.43

If both A and B produced before the customs union, as price of A was OP_A and produced and consumed quantity was OQ_1 , price of B was OP_B and produced and consumed quantity was OQ_3 . Tariff applied by A was $P_A P_C$, tariff applied by B was $P_B P_C$. After customs union, common tariff is $P_U P_C$ which is lower than both A and B previous tariffs. Since OP_U is lower than previous price in A, production stops, consumption increase to OQ_2 and importation from B starts. As a result, consumer surplus increases in amount of 1+2 in A. In other words, welfare gain of A is indicated as 1 which sources from production effect of CU, plus 2 which sources from consumption effect of CU. Since cost of production in B is lower than in A, after customs union while production of B increases to OQ_5 which represented by intersection point of AC_B and D_{A+B} , consumption increases to OQ_4 . The increase in production represented by 3+4 leads reduction in production cost. This phenomenon is called as economies of scale effect of a customs union. Reduction in cost is consists by production and consumption effects. Production effect reflects reduction of cost because of increase in production after CU represented by 3 in the Figure 2.4. Consumption effect reflects reduction of cost because of increase in consumption represented by 4 in the Figure 2.4.

Therefore, after CU while B can export to A at OP_U which is higher than OP_C and its production increased in the amount of $Q_4 Q_5$ which means additional gain represented by 5. As a result, while trade creation effect emerges in favor of A, cost reduction effect emerges in favor of B. Both

effects lead to welfare gain. Also Country B can benefit from economies of scale effect of the CU and has an advantage to compete in world market.

If only A produced before the CU, after the CU while it stops the production, B starts to produce which is called trade reversal. Therefore, A imports from B instead of C. Since cost of C is lower than costs of B, in respect of A there is trade creation effect. In respect of B, since it stops to import from C and start to produce at higher cost than C, there is trade suppression effect. Trade suppression which means stopping importation and starting production at higher cost, effects welfare negatively.

If only B produced before the CU, after the CU A starts to import from B instead of C. Therefore, the trade diversion effect occurs. In addition, since production of B increases after the CU, cost reduction effect occurs in favor of it.

Except from the first case, for other three cases, welfare effect of economies of scale which arise from a customs union depends on whether trade creation and cost reduction effects or trade diversion and trade suppression effects are dominant.

If both A and B did not produce before the CU, after the CU, A imports from B instead of C and B starts to produce in stead of import from C. Therefore trade diversion effect emerges in favor of A, trade suppression effect emerges in favor of B after the CU.²⁰

Effects on The Operational Costs

After formation a customs union, there would be changes in operational systems of customs such as decrease in number of staff. These changes can lead more efficient use of sources and to reduce operational costs of customs.

Also according to Lipsey (1973), the theory has been confined mainly to a study of the effects of customs unions on welfare rather than on the level of economic activity or the balance of payments or the rate of inflation. These welfare gains and losses, which are the subject of the theory may rise

²⁰ As Mc Donald(1999) set, the magnitude of the benefits from internal economies of scale is determined by the degree of integration, the significance of transport costs, and technical relationship between cost and output.

from a number of different sources like the specialization of production according to comparative advantage which is the basis of the classical case for the gains from trade; economies of scale; changes in terms of trade; forced changes in efficiency due to increased foreign competition and a change in the rate of economic growth. As he stated that while the fourth source is ruled out of traditional theory by the assumption that production is carried out by process which are technically efficient, the theory of customs union has been almost completely confined to an investigation of the first source which was just evaluated above in the context of static effects of a customs union. Also there is slight attention to the second, the third and the fifth sources. Additionally, as stated by Penketh (1992), however the change in trade patterns induced by the creation of a CU could result in alterations to the competitive environment, and give rise to opportunities to reap economies of scale. These dynamic factors may well have stronger impact on members of a CU than the static effects of trade creation and diversion. In contrary to the static effects, the dynamic effects can be seen in the longer term.

2.2.2.2. Dynamic Effects

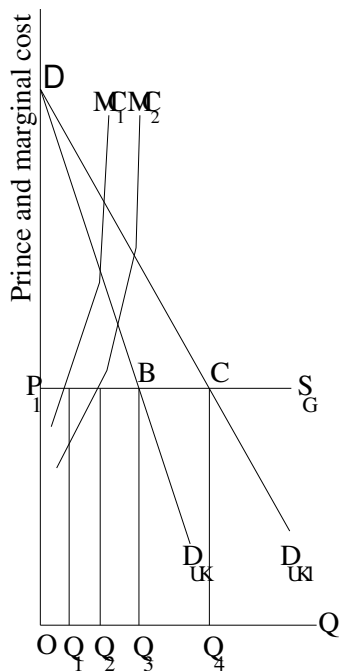
According to Molle(1997) the dynamic effects of a customs union occur in long term, because firms, workers and government react to the new situation and adapt the structure of production and the economy has emerged after a customs union had established. Therefore, in long term, a customs union may entail an important restructuring of the economies of the member states that bring incurring significant adaptation costs. Nevertheless, these long term benefits are considered to outweigh by these short term costs.

Effects on Competition

One of the these dynamic effects is reducing monopoly power within the home country by increasing the possible sources of supply. This can result in higher outputs, lower prices and the reduction of monopoly profits. National firms have to adopt these new conditions to compete. Each member has to specialize on production that has comparative advantage. Therefore, competitive market will emerge and welfare will rise in long term.

As McDonald(1999) stated that increasing the competitive environment may encourage producers to improve non-price competition factors such as the qualities of their product. This may also lead to benefits by increasing the demand for higher quality products.

Figure 2.5: X-efficiency and Customs Union



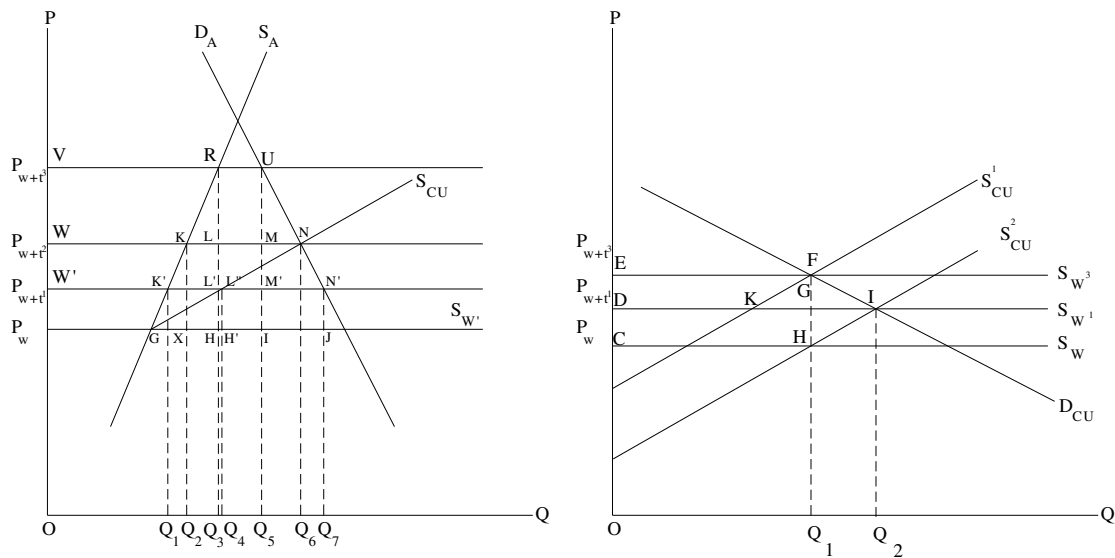
Source: McDonald(1999) p. 50

As it is seen in the Figure 2.5, D_{UK} represents the demand curve of the United Kingdom, where S_G represents the supply curve of Germany. A UK monopolist constrained to the price P_1 because of imports from G. If this increase in competition is also accompanied by innovation to improve the non-price characteristics of this good, the demand curve shifts to D_{UK}^1 . Consumer surplus is increased from P_1AB represents previous improvements in non-price factors, to P_1AC represents after improvements. The increase in UK demand is met by increased imports from G. Therefore, imports rise from Q_1-Q_3 to Q_3Q_4 . If the UK firm responds by the reducing X-inefficiency, this could shift the marginal cost to MC_2 and allow the UK firm to increase its share of the market from Q_1 to Q_2 . If the UK firm reduced X-inefficiency without any increase in the non-price characteristics of the good, the result would be that the UK firm would increase market share and its producer surplus. There would be no benefit in terms of increased consumer surplus. Hence, reduction in X-inefficiency do not necessarily lead to net welfare improvements for consumers. Only if the lowering of production costs results in lower prices will there be any benefits to consumers.

Effects on Technical Development

The second dynamic effect is efficiency gains because of technical efficiency arising from an increase in competition. It has to be highlighted that the technical efficiency gains are by no means automatic as a result of greater competition in integrated markets. According to Molle(1997), the Figures 2.6 demonstrates the relation between competition and technical efficiency. In Figure 2.6 , graph I, S_A and D_A represent supply and demand curves of Country A. While S_W represents the world supply curve, supply of the customs union is represented by S_{CU} . " t_2 " is just sufficient to avoid any imports from the world market. " t_3 " is tariff operated by A before the customs union. After creation of the customs union, the common external tariff will be set at t_2 level, and further lowering of this common outer tariff to t_1 is envisaged. The lowering of the tariff from t_3 to t_2 will lead to satisfaction of total demand of A by supply within the customs union. Since HLMI is equal to $KRL + MUN$, as it was explained in static effects of the customs union, this union would be about welfare-neutral. Reducing the tariff further to t_1 , triggering off an import quantity Q_1Q_4 from partner country and Q_4Q_7 from the world market, would be highly welfare creating, as the combined areas $K'RL'$ and $M'UN'$ clearly outweigh the area $XK'L'H'$. The Figure 2.6, graph II, represents the reaction of producers in A in long term. They accomplish savings on production costs. Therefore, the supply curve of A will move down and the supply of the entire customs union will drop accordingly. It is assumed that it dropped sufficiently to permit the customs union producers to satisfy total home demand in the customs union under a tariff protection of t_1 . The production and consumption effects of this drop in cost are indicated by the shift of equilibrium point from F to I. To see the basic change in welfare effects, consider the change in cost of production of the initial quantity from OE to OD that producers have realised under the pressure of stronger competition. The cost reduction is equal to DEFG. This is a net positive effect and not a redistribution effect of DEFK and a new effect of KFG.

Figure 2.6: Effects of Improved Technical efficiency



I

II

Source: Molle (1997) pp. 101-102

Effects on External Economies

Because of above effects, production efficiency and quality increase in some sectors of the member country. Therefore, other sectors' which take inputs from these sectors, product quality will rise and new external economies can emerge. This leads total improvement in member's economies.²¹

Effects on Investments

As Balassa(1961) stated, the lessening of uncertainty associated with national frontiers will influence investment activity through its impact on investments in export industries and on foreign investments. New foreign investments could take the form of equity or portfolio investments. The possibility of selling on a large market and endeavour to get behind the tariff wall would provide inducement for the establishment of plants by foreign concerns. In other words, a customs union constitutes a big market than any member has. This big market motives both domestic and foreign

²¹ For example, Turkey by means of the agreement that was made between Turkey and the EU on the products of the European Coal and Steel Community, can change its stripe products to flat ones and therefore it can receive technology transfer and foreign direct investment for related sectors. Thus for these sectors, it is expected that external economies will be emerged in long term in Turkey.

investors to make big investments. For foreign investors, direct investments into the union allow to escape from CET.

3. THE CUSTOMS UNION BETWEEN TURKEY AND THE EC

3.1. Historical Development of The Customs Union between Turkey and The EC

From the beginning, the European integration movement has aimed a political integration of member states. To achieve this end, economic integration of the members was seen as reasonable starting point. As the Article 9 of the Rome Treaty states that the Community is based upon a customs union which means that the economic integration was based on a customs union includes free movement of goods, services, capital, labor within the union and a common external tariff for imports from the third countries. Indeed, many of the articles of the Treaty of Rome are concerned with establishing these four freedoms. The first step was taking to create a customs union which creates a tariff union so as to be able to abolish all custom duties on trade between the members. When it was completed in 1968, all customs duties and restrictions among the six founding member states were eliminated and the common external tariff was introduced. However, in the Article 3 of the Treaty of Rome, creation of a common market was set as an objective beside creation of a customs union; the EU had not created a common market by the 1980's even it was often referred to as the common market in 1970s and 1980s. In 1987 the Single European Act was agreed and it committed all member states to the creation of a common market by the end of 1992. In 1993 the Single Market entered into force and really ensured the four basic freedoms. It abolished the role of customs collecting excises/ VAT between the member states and allowed the real customs union underlying the Community to become apparent to all. The single internal market serves as an engine for greater harmonization in a variety of customs and non-customs areas. It also serves as a catalyst in the strategy for economic expansion of the EU. This would not be possible without the existence of the Customs Union and its principle of free circulation of goods.

In this background, the association relationship between Turkey and the EC²² has been established by the Ankara Agreement (Association Agreement ²³) which was signed in September 1963 and

²² Since, the CU between Turkey and the EU was decided before the Maastricht Treaty of 1993 which declared the EU as new structure of the European Integration, the sides of the CU are referred to as, the EC or the EEC and Turkey.

has been put into effect in 1964. The Ankara Agreement envisaged the progressive establishment of a customs union which would bring the parties together in economic and trade matters. By the Additional Protocol which was signed in 1970 and came into force in 1973, time schedule and levels for gradual realization of the CU were determined. In other words, the Additional Protocol set out in a detailed fashion how the Customs Union would be established. The Article 9 of the Protocol provided that on entry into force of this protocol; the Community would abolish customs duties and charges having equivalent effect on Turkish industrial exports to the EC. Accordingly, for Turkey by the Articles 10 and 11 of the Protocol two different lists of goods were set that gradual removal of customs duties would be realized in accordance with them. While for industrial sectors, in which Turkey was more competitive, tariffs were to be eliminated over a period of 12, for other goods the tariff reductions were to be spread over 22 years. By the Article 24, the Additional Protocol also provided that all quantitative restrictions on industrial imports into the Community from Turkey were to be abolished. Briefly, according to the Protocol, the EEC would abolish tariff and quantitative barriers to its imports from Turkey (with some exceptions including fabrics) upon the entry into force of the Protocol, whereas Turkey would do the same in accordance with a timetable. It also called for the harmonization of Turkish legislation with that of the EU in economic matters.²⁴ Nevertheless, in the period of 1973-1980 Turkey had to struggle with both internal and external difficulties such as 1973 oil and 1974 Cyprus crises. In 1978, Ecevit who was the prime minister of Turkish government, decided to freeze Turkey's responsibilities based on the Additional Protocol, for five years. Afterwards, this government has been abolished and new government was established in November 1979. The new government set the membership of Turkey to the EEC as one of the main goals. Also as Manisalı(1995) stated, beginning from January 24, 1980 strict economic measures had been applied to create stable economy in Turkey. This new economic policy was consisted by the aims of restructuring, stable economy and opening of the economy to external forces. These aims would help Turkey for its membership to the EEC. Turkey changed its economic policy and gave up import substitution model. Afterwards, its economy has been opened up to the operation of market forces. Following this development, the relations between Turkey and the Community, which had come to a virtual freeze after the military intervention of 12 September 1980 in Turkey, began returning to normality.

²³ The EU develops association relationship with the third countries according to the Article of 238 of Rome Treaty. This relationship can be based on a customs union or a free trade agreement.

²⁴ Furthermore, it envisaged the free movement of persons between the parties in the next 12 years.

In 1987, on the basis of Article 237 of the Rome Treaty Turkey applied for full membership. In 1990, however Turkey's eligibility for membership was underlined on the Commission's Opinion, deferred the in-depth analysis of its application until the emergence of a more favorable environment.

By the 1/95 decision of the Association Council, Turkey has completed the customs union process with the European Community in accordance with the Association Agreement in 1996. Therefore, the CU has been applied between Turkey and the EC for industrial and processed agricultural products since January of 1996. As it is understood, traditional agricultural products are outside the scope of the CU. Concerning processed agricultural products; the parties have agreed on the establishment of a system in which Turkey would differentiate between agricultural and industrial components of the duties applied on these products, similar to the model applied in the Community. Therefore, with the CU agreement, while Turkey's tariffs and levies on imports of industrial products from the EU were eliminated, Turkey has also begun to apply the EU's common external tariff on imports from the third countries. As mentioned by Bekmez and Genç (2002) by doing this, Turkey has reduced the average protection level from 10, 97% to 5, and 8%. For agricultural goods, trade laws were modified according to GATT regulations. Another criterion for the goods which are included by the CU is the place of origin. However, the place of origin document is not necessary for the goods in free movement within the CU²⁵; there are two conditions for these goods. The first is the goods in question must enter the CU area in accordance with the regulations which are determined by the association law. The second is that all customs duties have to be paid and they would not be getting back in any way.

The customs union decision placed a number of obligations on Turkey, which can be summarized like that the Turkish parliament must adopt new laws on copyright issues; import and export duties must be removed and the tax system should be revised. In other words, because of the economic integration Turkey have to harmonize its national regulations with the EC regulations. According to Özen (2002), the obligations sourced from this harmonization are classified as *dynamic* and *static obligations*.²⁶ The static obligations are obviously determined in the 1/95 decision of the

²⁵ In the customs union theory, since there is a common external tariff, there is no need for place of origin document.

²⁶ The terms of *static* and *dynamic obligations* should not be confused with the *static* and *dynamic effects* in CU theory. These terms are used by the author to explain Turkey's obligations in the context of the CU. Where the static obligations refers to arrangements which Turkey has to adopt in the context of current customs, property rights, competition, state aids and monopolies provisions of the EC, the dynamic obligations refers to arrangements which will be possible to be made by Turkey in extent of the CU.

Association Council. One of the static obligations is arrangements related with the customs provisions. Turkey is responsible to adapt many regulations of the EC in the context of customs provisions. The second kind of static obligations sourced from property rights provisions of the EC. Turkey is responsible to accept all regulations of the EC on this issue and apply them. Other kind of static obligations are based on the competition provisions²⁷ of the EC. However arrangements in the context of this obligation had to be made according to program determined by the Additional Protocol, Turkey have not obeyed this program and these arrangements have been made in the last period of the CU in accordance with 1/95 decision of the Association Council. The last kind of static obligations are concerning the regulations of the EC on state aids and monopolies. During the transitional period, under some conditions, Turkey would continue to give state aids in the purpose of Turkish economy harmonization with the EC economy. Nevertheless, in the last period of the CU, except textile and clothing sector, Turkey was given two years after the 1/95 decision would began to be in forced, as a time to adopt the EC regulations on this issue. For textile and clothing sector Turkey was responsible to adopt the EC regulations just before the accession of Turkey to the CU. In terms of state monopolies, Turkey was obliged to adopt the EC regulations during the period of two years just after the CU would be in forced. In the context of regulations, the second type of obligations of Turkey relates to dynamic obligations. These can be defined as obligations which will make Turkey responsible to adapt some possible regulations of the EC about the issues which can be considered in the future.²⁸ In addition to harmonization of regulations, the CU also requires harmonization of economic policies. The success of the Turkish government in dealing with these mandates will determine the success of the customs union. Without harmonization of policies between Turkey and the EU, the CU cannot be succeeding.

3.2. The Stages and Institutional Base Set By The Ankara Agreement

Since the CU between Turkey and the EC is a part of the association relationship which has been founded by the Ankara Agreement, the terms and the institutions of the Agreement must be examined briefly to understand the institutional base of the CU. By the Ankara Agreement, while the full membership of Turkey to the EEC is put as an ultimate political aim, achievement of the

²⁷ The Article 12 of the CU Decision can be a good example for static obligations of Turkey in the context of competition policy .

²⁸ In the future, since there will be arrangements in trade policy of the EU, Turkey will be responsible to adapt these arrangements in the context of the CU. These kind of arrangements are generally between the Articles of 52 and 62 of the CU Decision. For example, the Art 52 of the CU Decision stated that in the areas directly related with the CU, Turkey has to harmonize its legislation with the EUs legislation such as competition policy, intellectual and property rights. This may be extended in the future regarding improvements in the CU issues. See also Kabaalioglu(1998) p.129

aim is depended on some technical and economic conditions for Turkey. If both sides decide that these conditions are met, than full membership will become real. By leaning on the first Article of the Ankara Agreement, it can be said that the sides of the CU are the EEC and Turkey. In addition, the institutional framework of the association supports this bilateral structure. By the Ankara Agreement, three periods were determined for gradual realization of the CU.

3.2.1. Preparatory Stage

The first is preparation period which was determined to prepare Turkish economy for a customs union with EEC. During this period, Turkey would be given financial aids to strengthen its industry and to be ready for transition period in which Turkey would start to reduce its tariffs on imports from the EEC. Also Turkey needed to establish new industries which have competition power in the EU market. Therefore, financial aid became one of the most important issues of the association relationship. Accordingly, the Financial Protocol which was accepted by the Ankara Agreement, aimed to facilitate integration of Turkish economy to the EU economy. In the Financial Protocol, it was decided that the financial aid²⁹ given to Turkey would be in form of credit not in form of donation. The preparation period was finished by the Additional Protocol which determined the details of the transitional period.

3.2.2. Transitional Stage

The aims of the transitional period were both gradual realization of the CU and getting closer of economic policies of Turkey and the EU. By the Additional Protocol, conditions, methods and terms of the transitional period were designated. As it is mentioned above, reduction of Turkish tariff on imports from the EU was subjected to two lists which offered reduction of tariffs in 12 years and in 22 years for some sensitive sectors. Nevertheless, because of some domestic political reasons Turkey could not apply this program and had been freezing its obligations, sourced from the Additional Protocol, between years of 1978 - 1988. In fact that however Turkey wanted to sign the Additional Protocol insistently, it also realized that its economy was not prepared for transitional period.³⁰ Therefore, Turkey had risen up the customs tariffs 50% just before the Additional Protocol. As a result, in 1988 the scope of list which offered removing of tariffs in 22 years was enlarged and started to be applied. This means that the CU would be completed in 1995

²⁹ The amount of planned financial aid given to Turkey would be 175 million ECU.

³⁰ See Özen(2002), pg12-13

and the final period of the association relationship would start. Before examining the final stage, it has to be underlined that in the Additional Protocol there are also some other provisions which have not been applied yet such as freedom movement, state aids etc. To apply these provisions, as different from the CU provision, the Association Council has to decide on them but it has not give these decisions and therefore these provisions have not been applying yet.

3.2.3. The Final Stage

According to the 5th Article of the Ankara Agreement, the last period is based on the CU and it proposes strengthening of coordination between the economy policies of both sides³¹. On 6 March of 1995 the Association Council decided (1/95) that the CU between Turkey and the EEC would begin to apply completely. Thus, on 1 January of 1996 the CU has began to apply completely and the final period of the association relationship between Turkey and the EU has started. According to Özen (2002), the 1/95 decision of the Association Council is not an agreement. In association law, the Additional Protocol is seen as real customs union agreement. The 1/95 decision is accepted as a document which determines necessary arrangements to apply resolutions of the Additional Protocol. According to the Article 3/3 of the 1/95 decision the CU area is consist of Turkish custom area and the EEC custom area. The CU area between Turkey and the EEC is not limited by the existed member states when the decision would start to be in force. It will be also consist of new member states of the EEC

The Ankara Agreement proposes to establish institutions to manage the Association relationship and to improve it towards the full membership. In this context there are five main organs.

The Association Council

The Association Council is the only decision making and the most authorized institution of the association relationship. There are two sides namely Turkey and the EC in the Council. It is constituted by representatives of Turkish government and the EC. Turkey and the EU have one vote for each and decisions are taken by unanimity. The member states of the EU do not have vote as a unique state, they have to determine a common attitude in the Council. However the institutional structure is based on the bilateral nature of the association relationship, since the Ankara Agreement is mixed agreement which all member states have to sign, the CU can be evaluated as an agreement, which all member states constitute sides

³¹ See Özen(2002)

of it. The Council is powered to decide on issues about the aims determined on the Ankara Agreement and the related protocols. The sides of the Ankara Agreement are obliged to obey decisions of the Association Council. In addition, the Council is authorized to control the applications of its decisions and to advise accordingly. Besides, it can found committees to investigate any issue in the extension of Association Agreement. Disputes between sides on any issue in the extension of the association agreement can be solved in the Association Council.

The Association Committee

Another organ that was established to manage the association relation is the Association Committee which was founded by the Association Council decision. It forms the decisions that will be argued by the Association Council and investigates the issues which are determined by the Association Council. It is composed by the technicians. While Turkish side is constituted by the group with the presidency of permanent delegate assistant, the EU's side is represented by authorized technicians of member countries.

The Mixed Parliament Commission

The Turkey-the EU Mixed Parliament Commission was founded by the 1/65 decision of the Association Council. There are 18 representatives of each side. The main task of the commission is to evaluate annual reports of the Association Council and to advise about issues related with the association relationship. It is the organ which relates Turkish Parliament with the Association.

The Customs Cooperation Committee

The last institution is Committee of Cooperation on Customs. It is technical committee which was founded by the 2/69 decision of the Association Council. It provides technical assistance to the Council on the issues based on the Ankara Agreement's provisions of customs.

The EC- Turkey Customs Union Joint Committee

As it was explained above, the Council of Association is authorized to establish committees especially to ensure the continuing cooperation necessary for the proper functioning of the Agreement. In this regard, on the base of the Art 52 , it established EC- Turkey Customs Union Joint Committee which shall meet at least once a month (Art 53) and it "shall carry out an exchange of views and information, formulate recommendations to the Association Council and deliver opinions with a view to ensuring the proper functioning of the CU"(Art 52). Moreover, wherever

new legislation is drawn up by the EU or Turkey in an area of relevance to the operation of the CU, the CU Decision lays down rules on consultation and decision procedures between the parties.

4. THE 1/95 DECISION OF THE ASSOCIATION COUNCIL

4.1. The Source and The Meaning of The 1/95 Decision

The Decision of the EC-Turkey Association Council which³² is at the basis of the CU, consists in 66 articles, 16 statements and 10 annexes. The Customs Union between the European Community and Turkey came into effect on January 1, 1996. In other words, the third and the final phase of the Association which is based on a customs union has started on this date. As Kabaalioglu(1998) stated, establishment of a customs union between Turkey and the European Union had not been agreed on March 6, 1995. In fact, the commitment to establish a customs union was provided in the Association Agreement, its programme, timetables and rules were established in the Additional Protocol. Actually, it was the 1/95 decision of the Association Council taken on March 6, 1995 and “lays down the rules for implementing the final phase of the customs union” as foreseen in the Ankara Agreement³³. Also there are articles³⁴ of the 1/95 Decision are repetitions of the corresponding ones in the Additional Protocol which are guided by the Treaty of Rome.³⁵

4.2. The Content of The 1/95 Decision

The Article 3 describes the customs territory of the EC and the customs territory of Turkey as two component of the “customs territory” which includes industrial and processed agricultural goods produced in the Community or Turkey and goods coming from third countries and in free circulation in the Community or in Turkey³⁶. Accordingly, the Article 3 of the Council Decision 1/95 puts that “Products from third countries shall be considered to be in free circulation in the Community or in Turkey if the import formalities have been complied with and any customs duties or charges having equivalent effect which are payable have been levied in the Community of in

³² See Neuwahl (1998) p.38

³³ The Association Council Decision 1/95 received the assent of the European Parliament Nevertheless, it was believed that the assent procedure of the European Parliament was not required as this was not a new international agreement but simply an implementation measure of an Association Agreement already in force. See Kabaalioglu(1998),p.117

³⁴ Such as the Article 3 and the Article 4

³⁵ See Kabaalioglu, (1998),p.118

³⁶ See Kabaalioglu(1998), p.118

Turkey, and if they have not benefited from a total or partial reimbursement of such duties or charges.” Therefore, the Customs Union provides the elimination of customs duties, quantitative restrictions and measures having equivalent effect for these type of goods³⁷ between the EC and Turkey.

As well, the kinds of goods covered by the customs union are defined on the Article 2 of the Decision as “products other than agricultural products”. In other words, only industrial goods may benefit from the customs union, however the Article 24 affirms that “ the Parties’ common objective to move towards the free movement of agricultural products”. Thus, as Kabaalioglu(1998) set, Turkey and the Community shall progressively improve the preferential arrangements which they grant each other for their trade in agricultural products. It has to be noted that, processed agricultural products are defined as products contain “agricultural component” that can be obtained by, according to Art 19, “adding together the quantities of basic agricultural products considered to have been used for the manufacture of goods in question”. The Community shall apply to Turkey the same specific duties that represent the “agricultural component” applicable to third countries. Turkey, too, shall apply the “agricultural component” to imports from the Community.

Furthermore, according to Neuwahl(1999), not only does 1/95 Decision establishing the customs union go beyond what is normally understood by a customs union, but it is also supplemented by further measures such as declaration on the resumption of financial cooperation. In addition, establishing a customs union also necessitates harmonizing the commercial policy of Turkey with the ECs commercial policy besides adopting its Common Custom Tariff and all the relevant customs legislation.³⁸ According to Kabaalioglu(1998), this also requires adopting the autonomous regimes and preferential agreements with third countries. Harmonization of the Turkish commercial policy with the ECs commercial policy would be realized by negotiations which are made on a “mutually advantageous basis” with concerned countries. Accordingly, Article 16 of the 1/95 Decision determines that Turkey would align itself “progressively with the preferential customs regime of the Community” within five years as from January 1, 1996. According to

³⁷ As Balasubramanyam and Togan(2001) state, since all industrial goods apart from European Coal and Steel Community(ECSC) products are covered by the CU, in the case of these products, Turkey signed a free trade agreement with the EU in 1996.

³⁸ As Kabaalioglu(1998) underlined, Turkey has applied substantially the same commercial policy as the Community in the textile sector.

Balasubramanyam and Togan(2001), since Turkey had to apply the CET and accepted all the EU preferential agreements by 2001, it would be faced with different sets of tariff rates for different groups of countries such as countries with which the EU has FTAs. As Balasubramanyam and Togan(2001) stated, all group of countries have benefited from the reduction in nominal protection rates in Turkey as a result of the CU.

In addition to harmonization of commercial policies, Turkey had to adopt customs legislation with the Community Customs Code. As Article 28 of 1/95 Decision determines fields that Turkey had to adopt its legislation are,

- Origin of goods
- Customs value for goods
- Introduction of goods into the territory of the customs union
- Customs declaration
- Release for free circulation
- Suspensive arrangements and customs procedures with economic impact
- Movement of goods
- Customs debt and the right of appeal.

According to Art.52 of the 1/95 the CU Decision in addition to these areas, Turkey is responsible to adopt the EUs legislations on competition, intellectual rights and properties, and also trade barriers for industrial goods³⁹. As it is well known, in customs union theory fair competition conditions are essential to avoid one or both of two parties from possible market share loss. The competition rules of the customs union between Turkey and the EC are provided by the Articles between 32-38 of the Decision. According to Kabaalioğlu(1998) Turkey is imposed a lot of requirements fall outside the basic customs union structure by the Decision 1/95. Requiring Turkey to have a national competition law (Art 39) is one of them. As stated by Laird and Halter(1999), Turkish Competition Law based on the competition articles of the Treaty of Rome, passed in 1994 and the Competition Board which was established to be responsible for the implementation and the enforcement of the prohibitions set out in the law, has started running three years after. Additionally, according to Laird and Halter(1999), the key provisions of Turkey's competition law are based on the EU competition law: agreements, decision, and concerted practices in restraint of

³⁹ See Emlak Bankası(1996),p.18

competition; abuse of dominant position; and mergers and acquisitions⁴⁰. Therefore, arrangements between Turkish and foreign enterprises or between foreign enterprises, even outside Turkey, may be covered by the law. However, the Art 34 of the CU Decision states that any aid which distorts or threatens competition by favouring certain undertakings of the production of certain goods shall, in so far as it affects trade between the EU and Turkey, be incompatible with the proper functioning of the CU. Aid to promote the economic development of Turkey's less developed regions will be allowed until 1 January 2001. Actually, it can not be denied that this kind of arrangements in competition conditions will be useful for both national and common markets. A law and a body administers this law, provide fair competition and so well working market. In long term, together with other factors also this will help to attract foreign capital.

In terms of intellectual, industrial and commercial property rights the Article 31 of the Decision 1/95 is allocated. According to Kabaalioglu(1998), the CU could function properly only if "equivalent levels of effective protection of intellectual property rights" were provided in both constituent parts of the CU. The Parties undertook to meet the obligations set out Annex 8⁴¹ of the Decision. In fact, it was Turkey that was going to implement all these provisions as the Community and Member States had already adopted these texts. According to Laird and Hartler(1999), Turkey started to make considerable reforms in its intellectual property rights regime in 1995 by enacting laws on patents, trade marks, industrial designs, geographical indications and copyright. All these laws were enacted as a part of harmonization of Turkish intellectual property regime with the EU legislation on intellectual property rights and the WTO Agreement on TRIPS. In addition, Turkey accepted a number of international conventions governing this area such as Locarno Treaty(1968)⁴² and Nice Agreement (1957)⁴³. As a result, Turkey have been given an extensive legal framework for protection of intellectual property rights by these reforms.

⁴⁰ See Laird and Halter(1999), p.152

⁴¹ Annex 8 "On Protection of Intellectual, Industrial and Commercial Policy" which Turkey had to join, consist of four full pages, nine articles but also listing many international conventions and agreements (all of which contain extensive provisions), in addition to extensive national laws to be adopted, shows the dimension of the undertaking that Turkey has entered into. See Kabaalioglu(1998), p.126

⁴² It was signed by Turkey in 1998

⁴³ Nice Agreement which was signed by Turkey in 1996, concerns the international classification of goods and services for the purpose of the registration of marks.

4.3. Consultation and Decision Making Procedures Established By The Decision

As Neuwahl(1999) stated, while the consultation and decision making procedures of the CU Decision are investigated, it has to be reminded that one of the characteristics of the customs union which it shares with the Ankara Agreement, is that of the “institutional void”. The term denotes not so much to a lack of institutional structure for the implementation of the agreements, but rather its diplomatic or intergovernmental character which translates in practice into a lack of parliamentary control and an absence of recourse to judicial dispute settlement.

In the Decision, the consultation and decision making procedures are between the 52-62 Articles. As it was mentioned in chapter three, the Articles 52 and 53 establishes *the Joint Committee* and determines its working rules. The Article 54 arranges the harmonization process of Turkish legislation with the EU legislation. In this regard, it stated that “in areas of direct relevance to the operations of the Customs Union, and without prejudice to the other obligations deriving from Chapters I to IV Turkish legislation shall be harmonized as far as possible with Community legislation.” and “areas of direct relevance to the operation of the Customs Union shall be commercial policy and agreements with third countries comprising a commercial dimension for industrial products, legislation on the abolition of technical barriers to trade in industrial products, competition and industrial and intellectual property law and customs legislation. The Association Council may decide to extend the list of areas where harmonization is to be achieved in the light of the Association's progress.

As the Art 55 states, wherever new legislation is drafted by the European Commission in any of these areas, the Commission shall “informally consult Turkish experts”, together with experts from the member states. After this informal consultation the Commission will transmit its proposal to the Council of Ministers (of the European Community). Since Turkey is not a member, the Commission shall send copies thereof to Turkey, for information purposes. According to Art 55, Turkey and the Community may consult each other upon mutual request, within the CU Joint Committee before the actual decision of the Council of Ministers. The Article 56 set that regarding these areas, “Turkey will be immediately informed within the CU Joint Committee”, “ to allow Turkey to adopt corresponding legislation which will ensure the proper functioning of the CU”. In addition, this article set that where there may be problems for Turkey in adopting the corresponding legislation, the CU Joint Committee shall make every effort to find a mutually acceptable solution in order to maintain a properly functioning customs union.

The Article 57 determines the rules for amending legislation by Turkey in an area of direct relevance to the functioning of the CU. According to Kabaalioglu(1998), while Turkey has a right to amend legislation concerning the CU, such a right to differ from the Community legislation depends on the approval of the CU Joint Committee. As the Art 57 stated that “the principle of harmonization defined in Article 54 shall not affect Turkey's right, without prejudice to its obligations deriving from Chapters I to IV to amend legislation in areas of direct relevance to the functioning of the Customs Union provided the Customs Union Joint Committee has concluded that the amended legislation does not affect the proper functioning of the Customs Union or that the procedures referred to in the paragraphs 2 to 4 of this Article have been accomplished.” It also states that “where Turkey is contemplating new legislation in an area of direct relevance to the functioning of the Customs Union, it shall informally seek the views of the Commission of the European Community on the proposed legislation in question so that the Turkish legislator may take his decision in full knowledge of the consequences for the functioning of the Customs Union.” and “the Parties shall cooperate in good faith with a view to facilitating, at the end of the process, the decision most appropriate for the proper functioning of the Customs Union. Once the proposed legislation has reached a sufficiently advanced stage of drafting, consultations shall be held within the Customs Union Joint Committee.” The Article 57 added that “If Turkey's adoption of such legislation is likely to disrupt the proper functioning of the Customs Union, the Customs Union Joint Committee shall endeavour to find a mutually acceptable solution.”

As it was determined in the Article 58, the parties of the CU have the right to refer to the CU Joint Committee under some conditions; “if, at the end of the consultations undertaken under the procedure provided for in Article 56 (2) or Article 57 (4), a mutually acceptable solution cannot be found by the Customs Union Joint Committee and if either Party considers that discrepancies in the legislation in question may affect the free movement of goods, deflect trade or create economic problems on its territory, it may refer the matter to the Customs Union Joint Committee which, if necessary, shall recommend appropriate ways of avoiding any injury which may result. The same procedure will be followed if differences in the implementation of legislations in an area of direct relevance to the functioning of the Customs Union, cause or threaten to cause impairment of the free movement of goods, deflections of trade or economic problems. If discrepancies between Community and Turkish legislation or differences in their implementation in an area of direct relevance to the functioning of the Customs Union, cause or threaten to cause impairment of the free movement of goods or deflections of trade and the affected Party considers that immediate action is required, it may itself take the necessary protection measures and notify the Customs

Union Joint Committee thereof; the latter may decide whether to amend or abolish these measures. Priority should be given to measures which least disturb the functioning of the Customs Union.”

Both of the Articles 59 and 60 arranged the procedure which involves preparation of draft measures in areas of direct relevance to the proper functioning of the CU and consultation process. According to Article 59; “in areas of direct relevance to the proper functioning of the Customs Union, the Commission of the European Communities shall ensure Turkish experts are involved as far as possible in the preparation of draft measures to be submitted subsequently to the committees which assist the Commission of the European Communities in the exercise of its executive powers. In this regard, when drafting proposals, the Commission of the European Communities shall consult experts from Turkey on the same basis as it consults experts from the Member States of the Community. Where the matter referred to the Council of the European Union is in accordance with the procedure applying to the type of committee concerned, the Commission of the European Communities shall transmit to the Council of the European Union the views of the Turkish experts.” In addition, the Article 60 set that “Turkish experts shall be involved in the work of a number of technical committees which assist the Commission of the European Communities in the exercise of its executive powers in areas of direct relevance to the functioning of the Customs Union where this is required to ensure the proper functioning of the Customs Union. The procedure for such participation shall be decided by the Association Council before the entry into force of this Decision. The list of Committees is contained in Annex 9. If it appears to the Parties that such an involvement should be extended to other Committees, the Customs Union Joint Committee may address the necessary recommendations to the Association Council for decisions.” As it is understood; although Turkey cannot be directly involved by the decision making procedure, it can join the process by the consultation process and committees.

In terms of disputes, although the Articles 61 and 62 of the CU Decision set the rules, there is no provision in the Association Agreement whereby the Court would have automatic jurisdiction. According to Article 61 “without prejudice to paragraphs 1 to 3 of Article 25 of the Ankara Agreement, if the Association Council fails to settle a dispute relating to the scope or duration of protection measures taken in accordance with Article 58 (2), safeguard measures taken in accordance with Article 63 or rebalancing measures taken in accordance with Article 64, within six months of the date on which this procedure was initiated, either Party may refer the dispute to arbitration under the procedures laid down in Article 62. The arbitration award shall be binding on the Parties to the dispute.” Also the Article 62 set the rules when a dispute is referred to arbitration

t; “If a dispute has been referred to arbitration there shall be three arbitrators. The two parties to the dispute shall each appoint one arbitrator within 30 days. The two arbitrators so designated shall nominate by common agreement one umpire who shall not be a national of either Party. If they cannot agree within two months of their appointment, the umpire shall be chosen by them from seven persons on a list established by the Association Council. The Association Council shall establish and review this list in accordance with its rules of procedure. The arbitration tribunal shall sit in Brussels. Unless the Parties decide otherwise, it shall adopt its rules of procedure. It shall take its decisions by majority.” Table 4.1 summarizes the conditions and results of measures which are mentioned in Articles 58(2), 63 and 64 of the Decision.

Nevertheless, as Neuwahl(1999) stated, since Turkey is under an obligation to bring its law into line with Community legislation, there is a little room for both parliamentary control and for protection of the individual. Neither the Association Agreement nor the customs union benefits from a court system with compulsory jurisdiction of the type of the European Court of Justice. The Article 66 states that “The provisions of this Decision, in so far as they are identical in substance to the corresponding provisions of the Treaty establishing the European Community shall be interpreted for the purposes of their implementation and application to products covered by the Customs Union, in conformity with the relevant decisions of the Court of Justice of the European Communities.”The Council may resolve the dispute by a decision which shall be binding on the part of the Parties concerned since each party is required to take the measures necessary to comply with such decisions. In cases, where the Association Council can not resolve the dispute, the Council may decide to submit the dispute to the Court of Justice of the EU. The decision to submit a case to the European Court can only be taken unanimously. In other words, although there is no clear expression in the Article 66, it can be explained that the related decisions of the Court of Justice of the EU with the regarding dispute can be seen as a guide, if a dispute can not be solved by the Association Council.

Table 4.1 Summary of Protection, Safeguard and Rebalancing Measures

Protection Measures

Article 58(2)

Conditions: If there is serious damage in;

- a sector
- a region
- balance of payments

Measure:

-It must be the least harmful for the CU

-It must only deal with the specific problem

Result: Within 6 months The Association Council;

- A) makes a decision ,
 - the problem is solved

OR

 - the problem is consigned to the Court of Justice

OR

 - the problem is consigned to another judgement authority

- B) does not make a decision,
 - the problem consigned to arbitration and decision will be binding for both sides

Safeguard Measures

Article 63

Conditions: If differences between legislations or in applications of legislations which are in areas of direct relevance to the proper functioning of the CU

- obstruct the free circulation of goods
- OR
- lead trade divergence
- AND
- the effected side needs to get measure urgently

Measure: It must be the least harmful for the CU

Result: The Joint Committee;

- A) makes a decision
- B) does not make a decision and the problem is consigned to the Associaiton Council. Within 6 months it;
 - a) makes a decision ,
 - the problem is solved

OR

 - the problem is consigned to the Court of Justice

OR

 - the problem is consigned to another judgement authority
 - b) does not make a decision
 - the problem consigned to arbitration and decision will be binding for both sides

Rebalancing Measures

Article 64

Conditions: If one of the sides;

- takes protection measures according to the Article 58(2)

OR

-takes safeguard measures according to the Article 63

AND

If balance between rights and obligations sourced from 1/95 is damaged because of these measures

Measure: It must be the least harmful for the CU

Result: Within 6 months The Association Council;

- A) makes a decision ,
 - the problem is solved

OR

 - the problem is consigned to the Court of Justice

OR

 - the problem is consigned to another judgement authority
- B) does not make a decision
 - the problem consigned to arbitration and decision will be binding for both sides

5. CRITICS ON THE CU BETWEEN TURKEY AND THE EU

In period just before and after the CU between Turkey and the EU came into effect on 1 January of 1996, arguments on it has become multiplied. In this section, these arguments are classified regarding their sources. Although some of these arguments are not scientific, they can be seen in many papers edited by NGOs and public institutions. In this context, the study includes some references which consists these kind of arguments, not because of their uncertain contributions to the customs union research but because of their impact on the public opinion.

5.1. Arguments Regarding Source of the 1/95 CU Decision

The arguments about the source of the CU between Turkey and the EU based on whether it is a decision of the Association Council sourced from the Association Agreement or a separate agreement. As stated by Manisalı (1995) claims that the CU is not natural conclusion of the Ankara Agreement. The aim of both the Ankara Agreement and the Additional Protocol was to join to the Community under same conditions with other countries. Nevertheless, by 1991 Maastricht Treaty, generating common foreign and security policies have been added to the EU agenda as new aims. In other words, the community has been turned into another kind of economic integration model in which a member would gradually transfer its power on both economic and political issues to a supranational authority. Henceforth, it was not the same community that Turkey had wanted to be involved in by 1963 Ankara Agreement and 1970 Additional protocol. After Maastricht Treaty, however the Community members needed to get approval of their national parliaments on new extended structure of the Community, Turkish government did not need to get such an approval and signed the CU agreement on 6 of March in 1995. Since the EU is not same of the EC regarding both its economic and political aspects, the CU which is supposedly accepted as prelude for the full membership to the EU has to be approved by the Turkish Parliament as an independent agreement.

Also Tezel (1996) stated that the CU in question is different agreement from the one which was determined by Ankara Agreement. In fact, because of its form which resembles an agreement more than a decision because of going into details, it can not be perceived as a decision, it should be evaluated as different agreement from the Association Agreement.

On the other hand, there are arguments, will be explained below, claims that since the CU is a step forward to the full membership to the EU, and the full membership was set as main aim by Ankara Agreement, the CU is a natural source of the Ankara Agreement. The common basis of these arguments is that, the fact of European Integration has not been stable, it always consists of dynamic elements. That is why it has been established by series of agreements which provide flexibility and set only the frame to achieve the aim. Also the Association relationship between Turkey and the European integration should have been convenient for this nature of the European integration. Therefore, while the Association relationship has proceed and conditions for both parties has changed, the Ankara Agreement which in nature resembles the establishing agreements of the European integration, espacially the Treaty of Rome, has needed to be supplemented by other law instruments like protocols.

Kabaalioğlu (1999) approaches to the CU as a part of whole accession procees of Turkey to the European integration. His argument is based on the nature of European integration established by the Treaty of Rome which declares that “the Community shall be based upon a customs union which shall cover all trade in goods” (Art.9). The CU between Turkey and the EC was completed in 1996 and constituted a final phase of Turkish association before accession to the Community in accordance with the Ankara agreement which provides “the final stage shall be based on customs union” (Art.5) as the Treaty of Rome does.⁴⁴ And the Association Council Decision 1/95 “lays down the rules for implementing the final phase of the customs union” which was foreseen in the Ankara Agreement. In other words, the drafters of the Association Agreement between Turkey and the EC, just like the founding fathers of the EC, based an important aspect of relations on a customs union. To sum up, according to Kabaalioğlu(1998), the commitment to establish a customs union was provided in the Association Agreement and its program and adoption were established in the Additional Protocol. Thus it was agreed in 1963 and detailed in 1970, not in 1995.

As Özen (2002) mentions, the 1/95 decision of the Association Council is not an agreement. In association law, the Additional Protocol is seen as real customs union agreement. The 1/95 decision is accepted as a document which determines necessary arrangements to apply resolutions of the Additional Protocol. In fact, while the transitional period of the CU was realized by a protocol, the last period was realized by a decision. This means that while to start transitional

⁴⁴ See Haluk Kabaalioğlu (1999),pg. 114-115

period of the CU approvals of both Turkey and the EU member states were required, to start the last period approval of both Turkey and the EU member states were not required. By elimination of this approval process, possibility of the Greek Parliament' veto was removed. In other words, it was preference of Turkey to realize the last period of the CU by a decision not by an agreement. Nevertheless, although, there was no legal obligation, the EU put the 1/95 decision of the Association Council to the vote in the European Parliament.⁴⁵

In addition to these counter arguments, it can be said that, since the Ankara Agreement was approved by Turkish Parliament, there is no need to get Parliamentary approval for 1/95 Decision.

5.2. Arguments Regarding Aim of the CU

The aim of the CU between Turkey and the EU is another subject for the critiques. The main argument is that, if the CU between Turkey and the EU is not a step for the aim of full membership, it can be harmful for Turkish economy regarding its impacts. At this point, the question gains importance which is it a step for the full membership or not? For some critics such as Kinzer (1997), there is differentiated perception of the CU between Turkey and the EU. While Turkey sees the CU as an important step to full membership, the EU sees it as a different process from full membership.

As Uğur (1997) states that, the Association Agreement has two main aims namely the CU and Turkey's full membership to the EU. The first aim was realized on time. Nevertheless, it does not mean that the full membership is closer than ever. The main assertion is perception of full membership by the EU as political rather than economic phenomenon. Although importance of economic aspects of the membership can not be denied, it depends heavily on political factors. Since the CU can not contribute to solution of Turkey's the political problems such as democratization, it can not guarantee the full membership of Turkey to the EU.

In accordance with Tezel (1996) the EU has not guaranteed for the full membership in return the CU. Moreover, as it is understood from results of the Lisbon Summit 1992 and Copenhagen Summit 1993, the EU evaluates the CU apart from the full membership of Turkey. In this respect,

⁴⁵ In opposition to Manisalı's argument, Alkaya (1999) claimed that the CU is a natural result of the Ankara Agreement.

the CU between Turkey and the EU has to be reevaluating by Turkey. It is not reasonable to be included in an economic integration model in which Turkey can not join the decision making procedure but has to adopt its decisions. Therefore, for Turkey, if the CU is not a prelude for the full membership to the EU, other alternative economic integration models such as free trade agreement should be discussed. As in theory, since a FTA does not include common external tariff to the third countries and common trade and competition policies, for a country being involved by it does not prevent to implement own national trade policy.⁴⁶ Another alternative to the CU that Oktay (1996) discuss is liberalization of country's trade by preferential trade agreements on single country basis as the US does. By doing so, economic privileges can be reciprocal and synchronized between Turkey and a partner country which Turkey finds beneficial to be in preferential trade relation. Nevertheless, if Turkey makes such agreements with developed western countries, political pressures that are claimed to be existed in the CU context, would be still exist. Otherwise, if Turkey makes such agreements with developing countries which have similar unstable economic and political conditions with Turkey, the gain from this trade will be so controversial. Hence, to a make rational choice among economic integration models, the question of the purpose of the CU is whether integration with the EU or to get only economic gains by the means of trade off, has to be considered.

As Michael Lake (the EU envoy in Ankara) mentioned in Kinzer's (1997) article "the CU created misconceptions on both sides. The EU side felt that Turkey would be preoccupied with making it work and not press for full membership for some time. Turkey had the misperception that the customs union was stepping stone toward full membership in the next year or two. This led to a drifting apart, which both sides are now determined to reverse.

The aim of Ankara Agreement is participation of Turkey as a member to the EU and the CU is a part of this full membership process. However, the main aim of the CU is joining of Turkey to the EU; there is no direct relationship between the full membership and the CU. As in same the same manner with Uğur, Savaş(2002) state that since full membership necessitates realization of political criterions beside the economic ones, just complement of the CU is not enough for Turkey which is candidate country for full membership, although it improves Turkey's economic conditions in

⁴⁶ As in same manner with Tezel, Oktay (1996) argued, if the CU was not based on Turkey' full membership intend, it was not necessary to be involved by it because of negative effects brought about it. At that time, since it does not lead diversion from trade liberalization goal, FTA can be evaluated instead of the CU.

comparison with the EU's. Also it is important to motivate Turkey during the process of achieving the full membership aim by giving approximate date for it. By doing this the EU prevent evaluation of other alternatives to the CU by Turkey.

According to Özen (2002), while Ankara Agreement which sets the full membership as an ultimate political aim defines some economic provisions for achieving this aim, and also determine a CU between community members and Turkey to realize these economic provisions. Turkey is the only state which has a customs union with the EEC without being full member of the EU. In fact, except form the bilateral nature of the Association Agreement when the decision making process of the association relationship is examined, it can be said that there is one sided integration of Turkey to the European single market. For Turkey, if it is not a part of full membership process, the CU can not be seen as reasonable economic integration model. In other words, the CU is useful for Turkey only as a phase of full membership.

The CU is the most extensive trade association of Turkey in the aims of both outward oriented growth and the full membership to the EU. By its provisions, it can be seen as an economic integration which is more advanced than a CU. In addition, by completion of the CU, Turkey fulfilled its obligations on a large scale as a WTO member. Especially, after Turkey's candidacy for full membership was confirmed in 1999, the relationship between Turkey and the EU went beyond the CU.

Confirmation of Turkey candidacy in 1999 Helsinki Summit was depended on completion of the CU between Turkey and the EU⁴⁷. By means of realized provisions of the CU which ensure advanced association and integration than a classic CU does, Turkey became more close to the full membership. In fact, the need of an economic association between Turkey and the EU which is more advanced than a classic customs union is sourced from full membership aim. Due to the association relationship has the intention of full membership of Turkey; the CU between Turkey and the Union is founded as an advanced economic integration than a classical customs union does regarding its extension. Hence, it is claimed that the reason of why Turkey and the EU set up such an advanced CU is the intention of full membership of Turkey to the EU.

⁴⁷ See <http://www.deik.org.tr/yayinlar.asp?publications>

As Neuwahl (1999) states that, the significance of the CU clearly goes beyond the economic realm, just as Turkey has never seen the CU as an end itself. Not only does Association Council Decision 1/95 establishing the CU but it is also supplemented by further cooperation and a declaration on the resumption of financial cooperation. Politically, these instruments form a coherent whole, fitting into a strategy intended to bring Turkey closer to the EU. At this time of great political and economic transformation on the Europe scene, Decision 1/95 reaffirms the significance of the objectives of the Ankara Agreement and of its Article 28, which provides for the accession of Turkey to the European Community as soon as the operation of the Agreement has advanced far enough to justify full acceptance by Turkey of the obligations arising from the membership.

According to Kabaalioglu (1998), both Turkey and the Community looked for similar benefits from the establishment of a customs union between themselves. In fact, if the final was to be Turkey's accession, then it was natural that the foundation of this link was going to be the acceptance of all the basic freedoms of movement. The Additional Protocol also contained a number of detailed provisions for the implementation of the free movement of workers, services and capital in accordance with the Association Agreement.

As it is mentioned by Bayar (2000), the CU between Turkey and the EU is not a static integration model which includes only economic intentions. It has also deeper meaning and purpose as full integration of Turkey to the EU. Therefore, there can be no alternative economic integration model which is inferior to it in terms of extension. Accordingly, as an alternative to the CU, FTA would lead recession in relationship and cause a diversion from the aim of full membership.

The CU is the most important undertaking on the purpose of integration with both the EU and world economies. There is no doubt that by the CU, Turkey fulfills the most of its obligations in extension of the WTO.

5.3. Arguments Regarding Effects of the CU

As it is explained before, in theory, there are two types of possible effects of a CU on an economy. The first is static effects, the second is dynamic effects. It can be useful to explain critics on effects of the CU between Turkey and the EU according to this classification.

5.3.1. Arguments for Static Effects of the CU

5.3.1.1 Production Effect

As it is mentioned in chapter 2, according to traditional theory of customs union the production effect of a customs union is explained by terms of trade diversion and trade creation which were developed by Viner. Evaluation of Turkish foreign trade with the EU by using these terms can be useful to understand the general situation.

Since Turkey started to apply reduction in customs tariffs and adoption of common external tariff in the extension of the CU's completing process in 1993, when the effects of the CU on Turkish foreign trade are observed, indicators should be evaluated since 1993. According to Table 5.1 there is stable increase in Turkish exports between 1993 and 2004. Also its imports increase in similar pattern. While in 1993 exports to the EU was 7, 599 billion\$, in 2004 it was 34,417 billion \$. On the other hand, while in 1993 import from the EU was 13,875 billion \$, it was 45,434 billion \$ in 2004. The average proportion of exports to imports between 1993 and 2000 is 66, 39 %. The first important amount of trade deficit between Turkey and the EU was seen in 1996. The arithmetical average of deficit between 1996 and 2004 is 8, 7 billion \$. During the period of 1993 and 1995, Turkey's trade deficit with the third countries was 11, 05 billion \$ on the average⁴⁸. The share of the EU in this deficit was 43, 25%. Also between 1996 and 2000 while average trade deficit was 19,784 billion \$, the EU's share in it was 44, 4 %. Therefore it can be said that the EU has considerable share in Turkey's foreign trade deficit.

⁴⁸ See <http://dtm.gov.tr/ab/rakamlar/ditcaret.htm>

Table 5.1: Trade between Turkey and the EU (billion \$)

YEARS	EXP	IMP	BALANCE	EXP/IMP (%)
1993	7.599	13.875	-6,2	54,8
1994	8.635	10.915	-2,28	79,1
1995	11.078	16.861	-5,78	65,7
1996	11.549	23.138	-11,589	49,9
1997	12.248	24.870	-12,622	49,2
1998	13.498	24.075	-10,577	56,1
1999	14.348	21.401	-7,053	67,0
2000	14.510	26.610	-12,1	54,5
2001	16.118	18.280	-2,162	88,2
2002	18.459	23.321	-4,862	79,2
2003	24.484	31.695	-7,211	77,2
2004*	34.417	45.434	-11,017	75,8

* EU-25 Since 1 May 2004

Source:DTM, DIE⁴⁹

Table 5.2 indicates that increase in both value and share of exported investment goods from Turkey to the EU is remarkable after the CU. On the other hand, while share of intermediate and consumer goods in Turkish export decreased, value of these commodities increased.

⁴⁹ See <http://dtm.gov.tr/ab/rakamlar/ditcaret.htm>

Table 5.2: Turkey-EU Trade (Exports of Commodity Groups) million\$

EXPORTS							
YEARS	Investment Goods		Intermediate Goods		Consumer Goods		TOTAL
	Value	Share (%)	Value	Share (%)	Value	Share (%)	
1994	252	2,9	2.805	32,5	5.577	64,6	8.635
1995	318	2,9	3.528	31,8	7.232	65,3	11.078
1996	396	3,4	3.727	32,3	7.425	64,3	11.549
1997	423	3,5	4.105	33,5	7.721	63,0	12.248
1998	489	3,6	4.612	34,2	8.397	62,2	13.498
1999	631	4,4	4.981	34,7	8.737	60,9	14.348
2000	666	4,6	5.203	35,9	8.631	59,5	14.510
2001	960	6,0	5.751	35,7	9.359	58,1	16.118
2002	1.274	6,9	5.834	31,6	11.330	61,4	18.459
2003	2.077	8,5	7.431	30,4	14.929	61,0	24.484
2004*	3.776	11	10.772	31,3	19.759	57,4	34.417

* EU-25 Since 1May 2004

Source: DTM⁵⁰

In addition, Table 5.3 indicates that while value of imported investment goods increased, share of imported investment goods from the EU to Turkey decreased. Similarly, while value of imported intermediate goods increased, share of them in total import decreased. On the other hand, there is significant increase in both value and share of consumer goods importation from the EU to Turkey.

⁵⁰ See <http://dtm.gov.tr/ab/rakamlar/istatistik%20seti%20ing.xls>

Table 5.3: Turkey-EU Trade (Imports of Commodity Groups (million\$))

IMPORTS							
YEARS	Investment Goods		Intermediate Goods		Consumer Goods		TOTAL
	Value	Share (%)	Value	Share (%)	Value	Share (%)	
1994	3.209	29,4	6.912	63,3	795	7,3	10.915
1995	4.831	28,7	10.539	62,5	1.491	8,8	16.861
1996	7.388	31,9	12.880	55,7	2.870	12,4	23.138
1997	7.327	29,5	14.009	56,3	3.535	14,2	24.870
1998	7.182	29,8	13.270	55,1	3.622	15,0	24.075
1999	6.069	28,4	11.823	55,2	3.525	16,5	21.401
2000	7.254	27,3	14.116	53,0	5.114	19,2	26.610
2001	4.317	23,6	11.168	61,1	2.595	14,2	18.280
2002	5.361	23,0	14.417	61,8	3.196	13,7	23.321
2003	6.999	22,1	19.233	60,7	5.147	16,2	31.695
2004*	10.672	23,5	26.819	59,0	7.613	16,8	45.434

* EU-25 since 1May 2004

Source: DTM⁵¹

As Bayar (2000) determined , there may be no trade diversion regarding the first four years of the CU. Also there is no significant change in pattern of trade between Turkey and the EU which was the most important trade partner of Turkey both before and after the CU. In addition there is no significant change in trade between Turkey and the third countries too. As Laird (1999) stated, trade creation effect of the CU between Turkey and the EU is the most important features of it.⁵² Although, effects of the CU on Turkish economy are significant in short term, it does not mean that Turkey will not be affected by the CU.

When the CU effects on Turkish trade are evaluated, all factors have to be taken into consideration and the CU should be accepted as a phase of full membership.⁵³ One of the critics on the CU describes it as only reason for Turkish foreign trade deficit. Another critic claims that it was not well negotiated and since it includes single-sided obligations, it can prevent entering of Turkish firms to alternative markets. Both of the critics also exclude some factors such as conditions of the

⁵¹ See <http://dtm.gov.tr/ab/rakamlar/istatistik%20seti%20ing.xls>

⁵² See Bayar(2000),p.37

⁵³ See Soğuk(2002),p.3

global economy and starting date of the EU's tariff reductions to Turkish exports. First of all, while the CU effects on Turkish trade are evaluating, it has to be put that in 1971 within the Association Agreement's extension, the EU removed most tariffs to Turkish industrial products. Also by the 1973 Additional Protocol, regarding to sector sensitivity Turkey was given 12 years and 22 years terms for gradual tariff reduction to strengthen competitiveness within these periods. Until 1996 Turkey had been benefiting from the zero tariffs in the EU's market. In 1996 according to the additional protocol the CU was completed and obligations became two sided. The improvement of trade between Turkey and the EU in favor of the EU can depend on this. Secondly, after the CU there is no significant change in Turkish trade with the third countries. Therefore, it can be generally claimed that no significant trade diversion effect occurred for Turkey in most sectors for the reasons that the EU, in pre-customs union period, was the major trading partner. Besides, devaluation of Turkish lira on 5 April of 1994 and global economic crisis in 1997 have to be considered as external factors which could influence Turkish foreign trade.

Also it should be noted that there is an improvement in both exports and imports between Turkey and the EU between 1995-1999.⁵⁴ Trade creation effect had become visible for the EU between those years. At the beginning, it is normal that imports to Turkey from the EU has risen more fast than its exports to the Union since low competitiveness of Turkish economy in compare with the EU economy. But in long term, because of technology transfer and flow of information, Turkish competitiveness will improve. Additionally, trade creation effect will be visible for Turkey.

Furthermore, according to research made by Neyapti, Taşkın and Üngör (2003), the CU agreement has positively effected on Turkey's exports to and imports from the EU. The paper can be differentiated from forgoing works by taking the factual evidences since the implementation of the CU as the basis of the analysis of its impacts on Turkish trade. While they are modeling imports and exports for the Turkish economy as suggested in the literature, they also add investigation of their differences with regards to both the volume and behavioral aspects, separately for the EU group of countries as well as for the CU period. They conclude that after controlling for the effects of real exchange rate and income, both exports and imports of Turkey have been positively affected by the CU. They also observed that political stability and good governance have been factors that contribute to trade.

⁵⁴ See Uyar(2001),p.165

In addition, as it is mentioned on DPT report of 2000, if we look at the EU's share in Turkish foreign trade after the CU, it can be said that the volume of the EU's trade is increasing. While in 1995, the EU's trade share was 48, 7%, in 1999 it increased to 53, 1%. Nevertheless, in 1996 while increase in Turkish imports from the EU was 37, 2%, increase in Turkish exports to the EU was 4, 2%. In 1997 this increase in the EU exports, caused by the CU, was slowed down and continuing in a softer pattern. Increase in imports from the EU was 7, 5% and exports to the EU were 6, 2% in 1997. The reason of why the increase in imports from the EU was slowing down is reduction of tariffs for the third countries exports together with the EU's exports in the extension of the common external tariff. Therefore importing from countries other than the EU became attractive. In 1998 while total exports of Turkey increased 2, 4%, the exports to the EU increased 9, 7%. Also in the same period, while total imports of Turkey decreased 5, 4%, imports from the EU decreased 3, 1%. In 1999 despite total export of Turkey decreased 1, 4%, exports to the EU increased 6, 2%. Also, while total imports of Turkey decreased 11, 4%, imports from the EU decreased 11%. As a result, regarding that share of the EU from Turkey's exports is about 50% and Turkey's exports to the EU is in increasing pattern, it can be said that despite the third countries competition and economic stagnation, the EU constitutes a stable market for Turkey's exports. Especially after the CU, this situation becomes more definite. Due to global economic crisis while export of Turkey to the third countries is decreasing, exports to the EU is increasing. On the basis of sectors, share of industrial productions in Turkey's imports from the EU is 96% and in its exports to the EU is 86%. After the CU, share of textile and agricultural products in Turkey's export decreased. As a result in DPT report (2000), the CU leads to more powerful and integrated economic relation between Turkey and the EU. Therefore, Turkey was given a chance for entering a stable and big market by privileged trade relationship with the EU.

It should be added that regarding the CU effects on Turkey's foreign trade, the effects of free trade agreements between Turkey and Central and Eastern Europe countries which made in the context of adaptation of both the common trade policy and preferential or autonomous trade regimes of the EU have to be considered.⁵⁵ In fact these agreements are also beneficial in the context of Turkey's export oriented growth strategy. Moreover, FTA countries become important markets for Turkey with upward trend of their economic development. Ratio of total import to total GNP of these countries was 42,5% in 2001 which was more than two times of the world average. Among these

⁵⁵ Savaş(2002),p.12

countries Poland (50 billion Dollar), Czech Republic, Israel and Hungary (30-35 billion Dollar) are main importer countries.⁵⁶ The Table 5.4. represents that between 1996-2004 Turkey's annual average of exports to these main FTA countries. Turkey's share in total imports of FTA countries is 1-2%⁵⁷. However this amount of share is not enough, it could be state that Turkey preserves its market share in these countries by doing FTAs. Otherwise, Turkey might not compete with the EU countries in the import market of these 13 countries.

Table 5.4: Annual Average of Turkey's Trade between 1996-2004 in extension of FTA (Million \$)

COUNTRY	EXP	IMP	BALANCE	EXP/IMP %
Bulgaria	358,710	494,546	-135,836	68
Czech Rep.	118,328	231,448	-113,121	66
EFTA	412,664	1,883,321	-1,470,657	25,6
Estonia	13,889	14,249	-360	356
Israel	713,866	417,829	296,037	169
Letonia	15,999	2,672	13,327	2961
Litvania	49,876	86,689	-36,813	59
Hungary	176,185	254,666	-78,480	84
Macedonia	98,271	766,219	-667,948	13
Poland	328,652	257,701	70,950	199
Romania	533,596	672,618	-139,022	82
Slovakia	36,624	84,934	-48,309	57
Slovenia	67,420	65,361	2,059	109

Source:DTM

At present, Turkey is continuing to negotiate FTAs with Mediterranean countries in the extension of Europe-Mediterranean Free Trade Area project. If it will be completed in 2010 with the result of a new market which includes 40 countries emerges for Turkey. Also, on DPT report (2000), it is mentioned that the free trade agreements which we have to sign in the extension of the EU common commercial policy, lead extension of market for Turkish exports. Moreover, Harrison et al.(1996), suggest that improved access to third country markets would be the biggest gain from

⁵⁶ <http://www.dtm.gov.tr/ab/sta.htm>

⁵⁷ <http://www.dtm.gov.tr/ab/sta.htm>

the CU. Using a comparative static computable general equilibrium model for Turkey, they estimate that Turkey stands to gain between 1 and 1,5 per cent of GDP annually from the CU.

5.3.1.2. Consumption Effect

The most important outcome of consumption effect of a customs union is decrease in price of inputs and capital goods for industry beside decrease in price of consumption goods. If there is decrease in price of inputs, industry of country in question can improve more easily.

However, the average tariff rates reduction is 5% after the CU, expected decrease in prices has not emerged.⁵⁸ Import of consumption goods, inputs and capital goods has increased especially during the first two years of the CU and has been continuing to rise which indicates that the consumption effect of the CU has emerged.⁵⁹ Unproductiveness of public sector and big amount of public debt can be put as reasons for this manner of prices in Turkey as they were before the CU. Also, according to DEIK web site (2004), for Turkish consumers, the CU will lead to increase in variety of products and to decrease in prices.

In addition, the composition of imported goods is another important factor in considering the CU's effects. Between 1995-2000 investments goods share in Turkish imports is 29, 3%, while input's share is 55% and consumer goods' share is 14, 3%.⁶⁰ After the CU rise in consumer goods importation which negatively influenced the Turkish economy, depending on several factors. First of all, Turkey had removed the tariffs on imported inputs in 1980's, whereas tariffs on consumer goods were removed in 1996. Secondly, consumer loans with lower interests in last years have motivating effect on consumption of imported goods. Thirdly, revaluation of Turkish Lira in 2000 can be responsible for the biggest increase in consumer goods importation

5.3.1.3. Terms of Trade Effect

There is no specific research available on this issue. In other words, terms of trade effect has not been studied for Turkey.

⁵⁸ See Oktay(1996),p.10

⁵⁹ See Uyar(2001),pp.165-166

⁶⁰ See Soğuk(2002),pp.6-8

5.3.1.4. Effects on Government Revenue

Before the CU two types of taxes had been taken for imports in Turkey. By the CU these taxes were abolished and the common external tariff of the EU has begun to apply.⁶¹ Because of this arrangement, not only the government revenue would be decline but also the government spending would rise in short term. Nevertheless, these possible effects have not emerged and due to increase in production, government income which came from the new tax system has risen in Turkey. Annual loss of tariff on imports is expected as 2.454 billion \$⁶².

5.3.1.5. Operational Costs Effect

Because of arrangements which have been required by the CU, it would be expected to decline in operational costs in customs. But in fact, this did not emerge. According to Uyar (2001) operational costs in Turkish customs has increased after the CU. Nevertheless, despite new arrangement were made in accordance with new customs code, technological infrastructure has not been completed yet. When all technological requirements are met, it is assumed that operational costs of Turkish customs will decrease.

5.3.2. Arguments for Dynamic Effects of the CU

5.3.2.1. Competition Effect

To constitute a successful customs union, equal and fair competition conditions is one of the most crucial factors. Because of this reason, the CU necessitates harmonization of Turkish competition policy with the EUs competition policy. If the extension of the EUs competition policy is considered, it is not hard to estimate that Turkey has been making a lot of arrangements and will continue to make during this harmonization process.

As a result of these arrangements, Turkish economy is improving and it is expected become an economy which provides fair competition conditions and stability for both domestic and foreign investments.

According to DPT report (2000) the textile and clothing industry is one of the most important sectors for exportation of Turkey. In 1998 the sector's share in total export of Turkey was 39% and

⁶¹ See Uyar(2001),pp.174-177

⁶² See Bayar (2000)

its share in total employment was 21%. Total share of the EU in textile and clothing sector's exportation is 60%. After the CU, expected increase in sector exports to the EU does not emerge because of economic stagnation which has sourced from adaptation to the Maastricht criteria's. In extension of the CU, removing of direct subventions for the sector and in sufficiency of new subventions cause difficulties for competition power of it. Also by the extension of free trade agreements with third countries in the context of the CU, Turkey obtains privileged trade regime which provides equal competition conditions for its firms. Nevertheless, increase in imports to Turkey can lead losing domestic market share of domestic firms in short term

As in same manner with DPT, another critic on the CU is that loosing of domestic market share by domestic firms due to their low competitiveness in compare with the EU's firms.⁶³ Also it is not proper to consider the CU effects on Turkish economy without evaluation of its effects on production process, quality infrastructure and competition power. There are some sectors which were negatively affected by the CU since they do not have competition capacity with the EU firms in terms of quality and technology. Also this could lead an amount of unemployment in those sectors in short term but in long term, some of these firms will adapt new competition conditions and by technological transfer they will increase their productiveness and efficiency. At the same time, there will be other firms which are negatively affected by new competition conditions and can not compensate their deficiencies. Therefore, they will have to turn towards other sectors which have comparative advantage or withdraw from the market. Certainly, there is increasing unemployment in Turkey because of some reasons. The CU can be one of them or can accelerate it but in long term, since advantages of the CU such as big market, technology transfer and FDI, Turkish industry will grow and unemployment in Turkey will decrease. Furthermore, the existing labor will become more qualified.

Also as it is mentioned on DEIK web site (2004) one of the benefits of Turkey brought about the CU is that domestic firms are pushed to increase their products quality and productivity to compete with the EU's firms. In consequence, domestic firms become more equipped and competitive in long term.

⁶³ See Soğuk(2002),pp.7-9

5.3.2.2. Effects on Investments

Flow of foreign capital has not come as expected after the CU. Especially, the EU's share of FDI to Turkey have not increased. As Table 5.5 indicates that there is no so much difference between the number of FDI before and after the CU which was completed in 1 January 1996. This phenomenon can depend on special conditions of Turkey such as instable economical and political environment, high inflation rate. In the same direction, Bayar(2000) state in his empirical study which is conducted as general equilibrium model based on imperfect competition that economic and political unstability can effect flow of FDI negatively. It can also depend on the EUs fund system. Since Turkey is not a full member of the EU, it can not benefit from some important structural funds of the EU such as European Social Fund. Therefore, Turkey can not make structural reforms as quickly as other European countries did. As a result, foreign capital becomes abstainer to invest in such a country which has not completed the reforms that are to be eligible for the EU.

On the other hand , as Bayar (2000) stated that in long term, because of the arrangements in extension of the CU, Turkey's credibility in international financial markets will rise. Therefore, Turkey will become more attractive for foreign capital. This will also lead to increase in employment. Moreover, by the CU with reforms and adaptations it brought, Turkey and the EU relationship and association is advanced. In generally speaking, the CU by providing more powerful and stable economy to Turkey will increase Turkey's competitiveness within the global economy.

As it is mentioned before, dynamic effects of a customs union which are more important than static effects can be seen in long term. However, Turkey has utilized its advantages since the Additional Protocol of 1973; it is still early to evaluate the dynamic effects of the CU between Turkey and the EU because of some structural problems of Turkey.

Table 5.5: FDI Permits in Turkey(Million Dollar)

YEARS	AMOUNT OF CAPITAL	NUMBER OF PERMITS
1993	2,125	1120
1994	1,484	1089
1995	2,938	1225
1996	3,837	1178
1997	1,678	1340
1998	1,646	1224
1999	1,700	1019
2000	3,474	1082
2001	2,726	1233
2002	2,243	1355
2003	1,208	659

Source: DPT⁶⁴

5.4. Arguments Regarding Functioning of the CU

As mentioned in DPT report (2000) the reforms in trade policy, competition policy, intellectual property rights and technical issues which are necessitated by 1/95 Association Council decision brings a new understanding and discipline to the Turkish market. By means of these new arrangements cooperation between bureaucracy and private sector increases in Turkey.

According to Manisalı (2002), the EU has not fulfilled some of its obligations in extension of the CU. One of them is based on the Art 36 of the Additional Protocol which is providing free movement of labor between Turkey and the EU during the period of 1976-1986. However, it has removed the provision of free movement of labor. The EU has not run the fourth financial protocol between Turkey and the EU, and has continuing to apply quotas on imports from Turkish textile products. In addition, the EU has applied some anti-dumping closures in last years to Turkey. The EU has provided tariff reductions which Turkey was given in the context of the CU to other countries without a customs union agreement. Manisalı also states that despite the association relationship, in the extent of the fourth Financial Protocol agreed in 1981 Turkey have not received the aid in amount of 600 million ECU yet. Hence, Turkey is only candidate country which

⁶⁴ See <http://www.ekutup.dpt.gov.tr/yabancis.htm>

completes the CU without any financial aid. In addition, since Turkey is not full member of the EU, it can not benefit from regional and sector funds. Therefore, the aids in the context of the financial protocols become more important for Turkey. As in the same manner with Tezel, Manisalı (1995) underlines possible damages of being involved by the CU while being outside of the decision making process for Turkey. According to Manisalı the Customs Union has two main bases. The first, abolition of customs and generate single market among members. The second is, creating common customs and trade policies. In broader sense, the last one can lead to move together in foreign policy and security issues.

Under these conditions, for Turkey involving by the CU without full membership to the EU means to become dependent on the EU and lose the economic sovereignty. According to him, the main factor which make Turkey dependent to the EU is that since Turkey is not a full member of the EU, it is not included by the European Union institutions such as the Parliament, the Council and the Commission, but it is obliged to apply policies of the CU and foreign trade which are made by these institutions. According to Manisalı (2002), especially the preferential trade agreements of the EU with the third countries are in favor of Turkey because Turkey has become an open market for these countries. He pointed out one example that Turkey has not been directly benefited from the preferential trade agreements of the EU with the North Africa countries especially with Tunisia which will give advantages to Turkey in the market. Therefore, CU and full membership must be realized at the same time or CU should be completed after full membership as in Greece example. In fact, it is more proper to realize both the CU and the full membership at the same time as other candidate countries did. Nevertheless, it is not the case for Turkey. Turkey is unique candidate country which completed the CU before the full membership; even there is no any expression that determines the CU as a factor of full membership on the CU agreement. Also there are benefits of the EU to keep Turkey outside the Union. One of them is that since Turkey is not a member, it can not receive financial aids as much as a member, to harmonize its economy with the EU. Another benefit is without full membership Turkey can not use the right of free movement of labor⁶⁵. And the last benefit is that since Turkey has one of the most crowded populations among the EU members, it would be one of the major members in the European Union Commission. Another problem mentioned by Manisalı (1995) is about the Article 66 of 1/95 the CU Decision. According to him, this article can cause troubles for Turkey under some conditions, since Turkey's problems

⁶⁵ Even Turkey has been given benefiting from the free movement of labor by the Additional Protocol, it can not use this without a decision of the Association Council.

on its commercial policy can be discussed and solved by the Court of Justice of the EU in which Turkey is not directly represented.

According to Özen (2002) there are provisions of both Ankara agreement and the Additional Protocol that the EU has to dedicate financial sources to Turkey in extent of them. Financial aids to Turkey are one of them. The EU has had the aim of supporting Turkey during integration period by financial aids. Nevertheless, he underlines like Manisalı, an adequate aid could not be realized since the Ankara Agreement. The EU has provided 750 million ECU in extent of three financial protocols but the amount of 600 million ECU in the extent of the fourth financial protocol has not been released yet because of Greece's veto. Also, after the CU promised aid in amount of 2, 5 billion ECU has not come. Total amount of financial aid that Turkey has benefited since 1964 is 2 billion ECU. It is not enough in comparison with Turkey's economic capacity. The CU gives opportunity to the EU to make use of all means of Turkish domestic market at present. But in full membership situation the EU has to spend much more money than it has gained from Turkish market because of possible aids to Turkey in extent of structural funds. Furthermore, as stated by Tezel (1996) the CU creates both winning and losing sectors in short and long terms. Nevertheless, there is no mechanism to aid these sectors that loose.

There is a critic that in any case, promised aid in extent of the Fourth Financial Protocol is not enough.⁶⁶ Besides, if Greece veto would be removed, there would be another obstacle. The EU is accused to be dishonest. The aid in question has not been released since 1981. On Oktay's study, it is also mentioned that Turkey's obligation to adopt free trade agreements between the EU and the third countries can be harmful for Turkey. These agreements are made regarding existing interest of both sides but not Turkey's interests. In the same manner İlhan states that, obligation of adaptation to all free trade agreements of the EU makes Turkey unconditionally dependent to the EU. It is also consider that provisions of these agreements have not to be against Turkey's interests. Another critic is made on one of Turkey's obligation that trade agreements which are between Turkey and a third country must not effect the CU provisions.

Another issue for the critics is mentioned by Mercenier and Yeldan(1997). According to them, in a general equilibrium exercise, characterize the net impact of the CU as undesirable for Turkey. In addition, Bekmez and Genç (2002) stated that there would be some difficulties during transition

⁶⁶ See Oktay(1996)pp.25

period and after Turkey's full membership to the EU. One of them is that in countries which are experiencing insufficient domestic savings pool, foreign capital must fund the investments. Nevertheless, it is difficult to be attractive for foreign capital if there is current account balance deficit. To solve this problem, these countries like Turkey can offer higher interest rates or tax breaks or a combination thereof. However, while EU is progressing towards a common monetary policy for its members, it is also expecting from candidate countries to be compatible with the current member's economic standings. By doing this, EU is taking away one policy instrument from candidate countries to correct economic problems. Other difficulty sourced from economic harmonization. Regarding welfare effect of the CU, there can be two different results depending on the interpretation of harmonization. In Turkey's understanding of harmonization, tariffs are reduced to zero but certain import surcharges are still allowed on EU products. On the other hand, according to the EU interpretation of harmonization, both tariffs and import surcharges are reduced to zero. If Turkey's interpretation is followed, harmonization of tariffs is welfare enhancing but if EU's interpretation is followed, it is welfare reducing. When Turkey will become a member of the EU that is the final aim and the CU is a part of this process, another impact can be sourced from emergence of single price in both EU and Turkey for same products. For authors, the exclusive role of determining the welfare effects of harmonization will be vested in the price system. Also it may be a concern to policy makers in situations where price system fails to distribute works the benefits of the integration perfectly across all participants of the market activity in both Turkey and the EU.

Furthermore, authors study counterfactual equilibrium analyses for a range of policy scenarios which are Customs Union with the EU, full membership to the EU, full membership plus replacement tax and free trade. It can be useful to examine the final aim of Turkey which existed CU is a phase of it, in comparison with current situation and alternatives. In the first scenario, it is assumed that obligations of both Turkey and the EU are full filled. Import tariff rates on EU manufactured goods are reduced completely and no change is made on agricultural and service sector. Import tariffs on non-EU goods are reduced by 25% in the agricultural sector and 40% in both manufacturing and service sectors. As it is seen in Table 5.3 and Table 5.4 the Turkish economy experiences a 2% decrease in GDP under CU scenario. In addition, 99% of tariff revenues and 63% of fund revenue from EU are lost. Also 25% of tariff revenues from the ROW (Rest of the world) and 61% of the fund revenues from ROW are lost. While private consumption increases 1, 6%, private savings increase 0, 5%. Regarding trade volume between Turkey and the EU under the CU scenario, Turkish exports to the EU increase by 11%, however Turkish imports from the EU increase by 5, 9%. Since CET requires to decrease import taxes on the third countries

for Turkey, exports and imports from the ROW increased by 2, 2%. Unfortunately, 12% of interest payments of government will occur under this scenario. The full membership scenario considers Turkey's full accession into EU. This scenario requires complete elimination of tariffs on EU goods for all sectors. However, only 50% of tariffs will be reduced on non-EU goods. The EU will compensate the Turkish government for a portion of losses because of reduction in tariffs rates of EU imports. Under this scenario GDP decrease 2, 7%. Public consumption also decreases 26, 4% while private consumption increase 1, and 9%. Furthermore, public savings decrease 2, 7% while private savings increase 0, and 5% as in the first scenario.

Table 5.6: Economic Indicators of the Turkish Economy under Policy Scenarios

	BaseYear Values(Billion TL)	Policy Scenarios (% change)			
		CU	Full Membership	Full membership+Tax	Free Trade
GDP	390,796,6	-2,1	-2,7	-2,8	-3,4
Public Consumption	43,127,6	-20,7	-26,4	-16,5	-33,5
Private Consumption	262,140,5	1,6	1,9	-1,2	2,5
Public Savings	13,692,7	-2,1	-2,7	-2,8	-3,4
Private Savings	76,141,1	0,5	0,5	-9,2	0,7
Public Investment	34,228,8	0	0	0	0
Private Investment	68,458,6	2,3	2,7	1	3,6
Exports to the EU	24,706,6	11	13,7	3,6	15,2
Export to the ROW	27,457,4	2,2	3,5	-4,2	5,6
Imports from EU	34,392,8	5,9	14,6	1,8	9,4
Import form ROW	48,095,3	2,2	-1,5	-4,1	4
Exchange rate(TL/\$)	2630	11,6	14,4	13	18,7

Source: Bekmez and Genç (2002)

In terms of trade, this gives the second best results after Free Trade that is 13,7% increase in exports to the EU and 3,5% increase in exports to ROW.

It has to be point out that while exports to ROW is increasing, import from ROW is decreasing by 1, 5% because of trade diversion. Regarding imports from the EU, this scenario gives the best result by 14, 6% increase. Government revenue also decreases under this scenario as in other scenarios due to the elimination of tariffs and tariff related taxes on imports

Full membership plus replacement tax scenario analyses the impacts of full membership with the assumption of an increase in the domestic indirect tax rate. Government losses due to tariffs reduction are compensated with an indirect tax rate. As different from other scenarios, under this private consumption decrease 1, 2% while public consumption decrease 16, 5%. Furthermore, private savings increase under all scenarios except this one. In terms of trade exports to the EU increase only 3, 6% and exports to ROW decrease 4, 2%. Turkish imports from the EU increase by 1, 8%. For imports from ROW there is 4, 1% decrease in this scenario since trade diversion. Indirect taxes also increase 22, 8% as different from other scenarios: This means that indirect taxes should be increased by 22, 8% to compensate for the losses due to tariff reduction. So it can be called a “compensation tax rate”.

Under free trade scenario, it is assumed that Turkey will remove all tariffs. The biggest amount of GDP decrease will be experienced under this scenario by 3, 4%. Also the most dramatic decrease in public consumption will emerge by 33, 5%. Private consumption increase 2, 5%. As it is expected, the most dramatic increases will be experienced under this scenario regarding imports and exports except imports from the EU. Increase in this is the second best by 9, 4%.

As it is seen on Table 5.7 government revenue also decreased under all scenarios because of the elimination of tariffs and tariff related taxes on imports. Also government savings decrease under all scenarios.

The comparison of revenue, consumption savings and investment changes in government and private sectors indicates that the economic crisis in the Turkish economy is the result of the unbalanced structure of the government sector. Therefore, cutting public expenditures is a good policy to eliminate the negative impact of the public sector on the economy.

As a result, it can be said that, Turkey's accession into the EU will have a trade creating impact between EU and Turkey under all scenarios. Despite a slight increase in the wage rate elimination of tariff and tariff related taxes will decrease the domestic price level. The lower price level and changes in the exchange rate in favor of EU cause on increase in exports between the EU and Turkey. According to Bekmez and Genç full membership appears to be the most beneficial scenario for the Turkish economy.

Table 5.7: Government Income and Expense Balance under Different Policy Scenarios

	Base Year Values (Billion TL)	Policy Scenarios (% change)			
		CU	Full Membership	Full Membership+Tax	Free Trade
Incomes:					
Indirect Taxes	20,525,805	-0,85	-1,03	22,8	-1,44
Corporate Taxes	5,093,022	0,55	0,57	-1,14	0,8
Income Taxes	26,486,100	0,5	0,54	-0,82	0,71
Tariff Income:					
From EU	582,002	-99,11	-	-	
From ROW	515,501	-24,97	-40,08	-40,53	
Factor Incomes	13,462,894	-2,04	-2,69	-2,76	-3,4
Expenses:					
Consumption	43,127,656	-20,64	-26,46	-14,37	-33,55
Transfers	16,980,748	0	0	0	0
Interest Payments	9,023,531	11,99	13,91	13,59	19,04
Savings	13,692,731	-2,04	-2,68	-2,75	-3,39
Investment	34,228,780	0	0	0	0

Source: Bekmez and Genç (2002)

V. CONCLUSION

Rapid increase in the number of regional economic integrations and undeniable success of the European Integration has augmented the arguments on the aims and the effects of the regional economic integrations especially in last two decades. In this context, it is intensively argued that regional economic integrations are obstacle for free trade or they constitute a phase of process towards free trade. While these theoretical disputes continue, there is a fact that joining into a regional integration becomes more preferred way among countries. Despite the political reasons behind this phenomenon differ according to regions and the countries in question; there is a common economic reason that is increase in welfare.

Under these conditions, Turkey has also designated its direction towards the European Integration since 1960's. Although, there have been many arguments about this issue in Turkey, most of them have not criticize the direction. The critics are generally on the way and the degree of economic integration. In other words, it can be said that there is a general consensus that, Turkey's economic integration with the EU is the most rational choice. Since, Turkey has founded an association relationship with the EU on the basis of a customs union; critics are especially intense on it. The aim of this study is to categorize and evaluate these critics. There are four basic categories regarding the essence of critics.

The subject of the first category is the *source* of the CU between Turkey and the EU. As a main argument about the legal base of the CU, it is argued that the CU can not be grounded on the Association Agreement (Ankara Agreement). Two different reasons can be demonstrated to support this. The first reason is that since the scope of European Integration had been widened and accordingly its structure had changed in the period of between 1963 Ankara Agreement and 1995 the CU decision, the CU which was decided to found by the Association Agreement was not natural result of it. Another reason is based on the *content* of 1/95 CU decision. Because of its comprehensive content as a decision, the 1/95 CU decision of the Association Council must be regarded as a separate agreement from the Ankara Agreement. Accordingly, it can be claimed that since the decision consists important obligations which can affect both economic and political independence of Turkey, and the CU decision must have been re-evaluated as a separate agreement and it must have been put to the vote in the Turkish Parliament. Although, these two reasons are

based on true grounds regarding the historical process of the association relationship, it will be incorrect to come to such a result. The founding agreements of the EU such as the Rome Treaty in 1957, do not state certain rules but determine a frame for the achievement of the aim. Accordingly, the Ankara Agreement which establishes the association relationship on the base of the customs union, also determines a frame to achieve its aim. Like founding agreements of the EU, it does not set details and certain rules so that it provides flexible political and economic environment in accordance with the dynamic nature of the whole European Integration process. It must be very well known that from the beginning, the European integration has both enlarged and deepened. While it has deepened, a supranational authority has begun to emerge and the members have transferred some part of their sovereignty to this high authority. These important developments in the Community can only arise in a flexible environment provided by these founding agreements of the EU. As a candidate for full membership, Turkey had to accept this dynamic nature of the European Integration and to fulfill its commitments sourced from both the Ankara Agreement and the Additional Protocol as a part of full membership process. Otherwise it would be described as an unreliable side of the association relationship and this would be harmful for full membership process that started in 1963. Rejection of the 1/95 decision of the Association Council sourced from the Ankara Agreement would be understood as rejection of the main principles and the soul of European integration. By the decision of 1/95 of the Association Council, the CU had to be completed. In addition, although the 1/95 Customs Union decision of the Association Council resembles an agreement by its contents, it is a decision by its legal forms. Since the frame of Turkey's obligations regarding the CU, have been decided in the Ankara Agreement which was approved by the Turkish Parliament and the Additional Protocol, there is no legal base for put the CU decision to the vote in Turkish Parliament. Therefore it must be perceived as a decision of the Association Council which is one of the major institutions of the association relationship. Today, the CU between Turkey and the EU has been completed. Therefore, there is no functional meaning to argue above issues. However, it can be useful to examine these arguments to understand the source and the reason of critics on the CU, which is in force.

The second category of critics on the CU, is constituted by the critics on the *aim* of the CU. According to the basic argument the critics in this category are based on, realization of the CU does not guarantee the full membership of Turkey to the EU. Therefore, it is argued that the ultimate aim of the CU was not the full membership of Turkey to the EU. As it is stated in reasoning of this argument that the CU is an economic integration model but the full membership to the EU has both political and the economic aspects. The Ankara Agreement has two main

objects namely; realization of a customs union between Turkey and the EU and the full membership of Turkey to the EU. The full membership was foreseen through gradual realization of the CU and further economic integration based on the formers. Although, the full membership includes the CU in theory, realization of the CU can not directly lead to full membership since the CU has economic aspects rather than political aspects of the association relationship. In this respect, the object of full membership stipulates some political provisions but realization of the CU meets only economic provisions. Additionally, the attitude of the EU especially in 1992 Lisbon Summit and 1993 Copenhagen Summit has also supported this irrelevancy of the CU with the full membership. Also establishment of the CU by other candidates to the EU after realization of full membership can be seen as another reason that supports the argument. Indeed, Turkey is unique candidate which had completed the CU before the full membership. Therefore, Turkey's way in comparison with other candidates, can be evaluated as a different way. Besides these reasons, absence of open expression that determines the realization of the CU is a step to membership in 1/95 Decision of the Association Council, leads to the argument that the aim of the CU is not the realization of the full membership. It is also argued that, the CU does not aim full membership in terms of political integration, but it brings some obligations for Turkey which are political. In particular, including Turkey in scope of economic decisions made by the EU decision making organs but excluding it from the decision making process of the EU make Turkey unconditionally dependent to the EU in both political and economic issues. Therefore both economic and political interests of Turkey can be damaged. Because of this reason, supporters of this argument claims that Turkey should look for another economic integration model with the EU. The most favored alternative to the CU is free trade area (FTA). The second favored alternative is a preferential trade agreement (PTA). In both methods of the economic integration, while Turkey is not dependent in economic and especially political aspects, it can also benefit from the gains of special trade conditions provided by these economic integration models with the EU. As a result, according to the argument, for Turkey the direction of economic integration is right but the way is wrong. At this point, it should be highlighted that while the Ankara Agreement sets the full membership as an ultimate aim, it also sets some economic provisions for full membership and determines a customs union between sides to realize these economic provisions. In other words, the CU is the way for the realization of economic provisions required by the full membership. Nevertheless, despite the CU is a phase of the full membership, realization of it can not directly lead to the membership. However this does not mean that there is no any relation between the membership and the CU. It is the major component of full membership to the EU. Also there is positive affect of 1/95 CU Decision in confirmation of Turkey's candidacy to the EU in 1999 Helsinki Summit. Moreover, the

need of such a widened customs union in terms of its content and reforms required, is based on the aim of further integration than economic integration. By means of realized provisions of the CU which ensure advanced association and integration than a classic CU modelling does, Turkey became more close to the full membership in terms of both economic and political aspects. The 1/95 decision of the Association Council declares not only the last phase of the CU but also the resumption of financial cooperation. In this way, the decision establishes not only the CU but also provides a platform for advanced cooperation between two sides in the future. It also reaffirms the significance of objectives of the Ankara Agreement beside the Article 28 of the agreement which provides for the accession of Turkey to the EC as soon as the operation of the Agreement has advanced far enough to justify full membership. Because of all these reasons, Turkey should continue on the way of CU which also provides fulfillment of its obligations originating from the WTO membership. While Turkey evaluates the alternative regional economic integration models, it should be taken in to account that a FTA can lead recession in relations with the EU and may cause a diversion from the aim of full membership which can be seen as the best choice for Turkey under these global economic and political conditions. Also while benefits of PTAs option are evaluated, the position of countries which these agreements are made should be considered. If such an agreement is made with a developed country, almost same pressures like in the CU situation will be experienced by Turkey. If a PTA is made with a developing country, the gains from this trade will be so controversial. However, this study excludes the subjects of full membership of Turkey to the EU, while the CU is explained, it must be considered in the scope of full membership. It could not be regarded as a different goal from the main goal which is the full membership of Turkey to the EU.

The third category of the critics on the CU are classified according to possible *effects* of the CU on an economy. In customs union theory, there are two basic kinds of effects called the static effects and the dynamic effects. In terms of static effects of the CU between Turkey and the EU, two main critics on production effects of the CU should be evaluated. As it is claimed that the EU has a big share in Turkey's foreign trade deficit in between 1993 -2000. Moreover, since the CU was not well negotiated, it includes provisions that cause single-sided obligations for Turkey. Because of these provisions such as exclusion of Turkey from the decision making process in international trade issues like Free Trade Agreements that EU negotiates with the third countries but including it in the scope of these decisions, the CU can prevent entering of Turkish firms to alternative markets. At this point, it must be noted that the EU had removed its tariffs on Turkish industrial products exports in 1971, there was no significant trade creation effect in favor of Turkey after

1996. But on the other hand, since Turkey has abolished its tariffs on the EU industrial exports in 1996, trade creation effect of the CU has been significant in favor of the EU just after 1995. And also the economic crisis in 1997 has to be taken into consideration while the foreign trade of Turkey is evaluated as an external factor. Moreover, when lower competition power of domestic firms compare to the EU' firms is considered, it is also normal that trade creation effect has emerged in favor of the EU. In long term, because of technology transfer and flow of information, Turkish competitiveness will improve. While the competition power of the domestic firms will increase, it can be argued that Turkish firms share in the EU market will increase. In fact, the EU has always been the major trade partner of Turkey even before the CU. Regarding the CU effects on Turkey's foreign trade with the third countries, the effects of free trade agreements between Turkey and Central and Eastern Europe countries which were concluded in the context of adaptation of both the common trade policy and preferential or autonomous trade regimes of the EU have to be considered in scope of free trade. These agreements are beneficial in the context of Turkey's export oriented growth strategy. FTA countries will become important markets for Turkey with upward trend of their economic development. Moreover, since the common external tariff (CET) which is applied to the third countries is below the prior tariffs of Turkey, importation from the third countries also becomes more attractive than ever and as a result the sharp increase in the EU imports to Turkey has been slowing down in some degree. This factor also causes reduction of trade diversion effect. It should be noted that while there is an increasing pattern of the EU imports to Turkey, there is also increasing pattern of Turkish exports to the EU because of entering big and stable market.

Another *static effect* of the CU is consumption effect. There are two significant arguments. Despite the reduction of average tariff rate was 5% in Turkey, expected decrease in prices has not emerged. However the prices have not reduced after the CU, import of consumer goods from the EU has risen. It must be highlighted that import of inputs and capital goods have increased after the CU which means that by providing proper conditions for the importation of investment goods, the CU encourage the domestic investments. Also increase in imports of consumer goods just after 1996 can be explained by removing of tariffs on this type of goods has been made in 1996 while tariffs on investment goods had been removed in 1980s. In addition, unproductiveness of public sector and big amount of public dept can be seen as a reason as to why prices which has not decreased after the CU. It must be pointed out that the CU will lead to decrease in prices and increase in variety of goods in long term, since it provides proper conditions for production of good quality with less costs. Moreover, increase in importation of consumer goods can be caused

by two factors which are consumer loans given in lower interest rates and the revaluation of TL in 2000.

Regarding of terms of trade effect, there is no specific research available and critics on this issue. In other words, terms of trade effect has not been studied extensively for Turkey.

In terms of the *dynamic effects* of the CU, the first possible effect is competition effect. Regarding the competition effect it can be stated that there are sectors which have been negatively affected by the CU such as textile and clothing industry, which is one of the leading sector of Turkish exportation. For this sector, especially removing of direct subsidies in the extension of reforms required by the CU, cause difficulties in terms of competitive power. As it is claimed that a general increase in import from the EU after the CU can lead to losing market share of domestic firms. As a result there has been unemployment in the short term. On the other hand, as a result of these arrangements which have been made in extension of Turkish competition policy harmonization with the EU competition policy, Turkish market will improve and it will provide fair competition conditions and stability for both foreign and domestic investors. As it is mentioned before, also by the extension of PTAs in the context of the EU trade policy, Turkey will obtain privileged trade regime which provides equal competition conditions for its firms in foreign markets. By means of transfer of technology and flow of information from the EU, Turkish firms will raise their competition power and increase their productions in the long term. Therefore unemployment which would emerge in short term will decrease. Regarding the effects of the CU on the foreign investments, there is one argument that foreign direct investments have not come in the amounts as expected. Despite, this statement is correct in the short term, it does not mean that the CU failed. There are significant reasons for this phenomenon which are based on the structural problems of Turkish political and economic environment such as high inflation and instable political environment. Additionally, since Turkey is not a full member, it could not benefit from structural funds of the EU to recover and to harmonize its economy, therefore the required structural reforms could not be made on time. By the reforms and arrangements in the context of the CU, Turkey will become attractive for foreign capital in long term.

The dynamic effects of the CU will emerge in the long term, while the static effects of it can be seen in the short term. Therefore it is early to get consequences of dynamic effects of the CU especially before the completion of structural reforms in Turkish economy. It should be considered that Turkish economy suffered for a long time due to macroeconomic instability.

Although, the static effects of the CU have not emerged generally in favor of Turkey, there are valid reasons for this which can not be attributed solely to the CU. In addition, as it is explained in the second chapter, developing countries rationale to establish an economic integration with other developing countries is to obtain a new developed structure of production capable of generating a greater volume and range of trade. But unfortunately, this type of economic associations generally does not survive long enough to reap actual economic benefits because after a long period of economic sacrifice, they contain elements of self-destruction. Turkey is obviously a developing country and beside the additional reasons, its rationale to enter the CU with developed countries do not differ much more than a developing country which in an economic integration with developing countries. Therefore, if Turkey does not want to get frustrating results that some developing countries get at past, it has to wait for the positive outcomes resulting from painful structural reforms. In other words, although Turkey has not seen static effects of the CU in favor of it in the short term, there are reasons waiting for much more important dynamic effects.

The fourth category of the critics on the CU is about the *functioning* of it. As it is stated that the Fourth Financial Protocol has not been operational yet because of the Greek veto. The promised aid for realization of the CU in amount of 2, 5 billion ECU have not been received by Turkey yet. This issue is widely criticized in both side of the dispute on the CU. But it must be noted that the reasons behind this phenomenon is political rather than economic. As it is well known, some disagreements between Turkey and Greece in international politics issues have significant effects on the Greek veto of the Fourth Financial Protocol. Despite the fact that insufficient financial support cause difficulties for Turkey in the process of structural reforms which have been made in extension of the CU, as a candidate Turkey will receive significant amount of financial aid in the extent of structural funds.. In other words, in full membership situation the EU has to spend much more money than it has gained from Turkish market at present because of possible aids to Turkey in extent of structural funds. Another argument states that free movement of labor which has been determined by the Additional Protocol, has not applied yet and will not be applied in determined time. As discussed in the case of Greek veto on the Fourth Financial Protocol, this issue is criticized widely in Turkish public. In addition, reduction in Turkish exportations of textile and clothing industry to the EU has continued after the CU. Moreover, some tariff reductions which have been granted to Turkey, are provided by the EU to the third countries which are not included in the CU. Besides, the need of mechanism to aid sectors which are the loser of the CU is increasing. These three phenomenons constitute the main factors which supports to other options of Turkey as economic integration models such as FTA and PTA. As it was mentioned before,

adoption of existing PTAs between the third countries and the EU can be harmful for Turkish economic interest, since these agreements have not been made by taking account Turkey's interest. Beside this, Turkey has also guaranteed that its possible trade agreements with a third country will not be in contradiction to the CU provisions. In other words, according to the argument, Turkey has delivered some part of economic sovereignty to the decision making system of the EU where she is not represented.

At this point, however, it must be considered that provisions of these agreements have not been formulated against Turkey's interests. Also, these agreements give advantages for Turkey which adopts export oriented growth model. Furthermore, Turkey is not completely excluded from the decision making process. While the EU's organs make a decision in scope of the CU, they consult to the committee of Turkish experts in related issues. As Bekmez and Genç(2002) stated, the EU is taking away one policy instrument from candidate countries to correct economic problems by taking away possibility of offering higher interest rates or tax breaks or a combination thereof to attract the foreign capital. However, by the reforms in trade policy, competition policy, intellectual property rights and technical issues which are necessitated by 1/95 Association Council Decision brings a new understanding and discipline to the Turkish market. By means of these new arrangements cooperation between bureaucracy and private sector increased in Turkey. In conclusion, it can be argued that most of the critics which may be justifiable for both sides of the dispute on the CU, are intense on the functioning of the CU. This phenomenon originates from the special position of Turkey which is outside the EU but inside the CU. As it was mentioned in the fourth chapter, the full membership is the best option for Turkey. When it will realized, most of these critics will drop.

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APPENDICES

APPENDIX A

**RELATED ARTICLES OF AGREEMENT ESTABLISHING AN ASSOCIATION
BETWEEN THE EUROPEAN ECONOMIC COMMUNITY AND TURKEY**

(Signed at Ankara, September 1, 1963)

RELATED ARTICLES OF THE AGREEMENT ESTABLISHING AN ASSOCIATION BETWEEN THE EUROPEAN ECONOMIC COMMUNITY AND TURKEY

(Signed at Ankara, September 1, 1963)

TITLE I

PRINCIPLES

Article 1

By this Agreement an Association is established between the European Economic Community and Turkey.

Article 2

The aim of this Agreement is to promote the continuous and balanced strengthening of trade and economic relations between the Parties, while taking full account of the need to ensure an accelerated development of the Turkish economy and to improve the level of employment and living conditions of the Turkish people.

In order to attain the objectives set out in paragraph 1, a customs union shall be progressively established in accordance with Article 3, 4 and 5

Association shall comprise:

- a preparatory stage;
- a transitional stage;
- a final stage.

Article 3

During the preparatory stage Turkey shall, with aid from the Community, strengthen its economy so as to enable it to fulfil the obligations which will devolve upon it during the transitional and

final stages.

The detailed rules for this preparatory stage in particular those for aid from the Community, are set out in the Provisional Protocol and in the Financial Protocol to this Agreement.

The preparatory stage shall last five years, unless it should be extended in accordance with the conditions laid down in the Provisional Protocol.

The change-over to the transitional stage shall be effected in accordance with Article 1 of the Provisional Protocol.

Article 4

During the transitional stage the Contracting Parties shall, on the basis of mutual and balanced obligations:

- establish progressively a customs union between Turkey and the Community;
- align the economic policies of Turkey and the Community more closely in order to ensure the proper functioning of the Association and the progress of the joint measures which this requires.

This stage shall last not more than twelve years, subject to such exceptions as many be made by mutual agreement. The exceptions must not impede the final establishment of the customs union within a reasonable period.

Article 5

The final stage shall be based on the customs union and shall entail closer coordination of the economic policies of the Contracting Parties.

.....

Article 28

As soon as the operation of this Agreement has advanced far enough to justify envisaging full acceptance by Turkey of the obligations arising out of the Treaty establishing the Community, the Contracting Parties shall examine the possibility of the accession of Turkey to the Community.

APPENDIX B

RELATED ARTICLES OF THE ADDITIONAL PROTOCOL

RELATED ARTICLES OF THE ADDITIONAL PROTOCOL

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Article 9

On the entry into force of this Protocol, the Community shall abolish customs duties and charges having equivalent effect on imports from Turkey.

Article 10

For each product, the basic duty on which Turkey is to apply the successive reductions shall be the duty actually applied in respect of the Community at the date of signature of this Protocol.

The timetable for the reductions to be effected by Turkey shall be as follows: the first reduction shall be made on the entry into force of this Protocol. The second and third shall be applied three years and five years later. The fourth and subsequent reductions shall be made each year in such a way that the final reduction is made at the end of the transitional stage.

Each reduction shall be made by lowering the basic duty on each product by 10 %.

Article 11

Notwithstanding Article 10 (2) and (3), Turkey shall progressively abolish, over a period of twenty-two years, in accordance with the following timetable, the basic duties in respect of the Community on the products listed in Annex 3: a reduction of 5 % on each duty shall be made on the entry into force of this Protocol. Three further reductions, each of 5 %, shall be made three, six and ten years later.

Eight further reductions, each of 10 %, shall be made twelve, thirteen, fifteen, seventeen, eighteen, twenty, twenty-one and twenty-two years respectively after the entry into force of this Protocol.

.....

Article 24

The Community shall, on the entry into force of this Protocol, abolish all quantitative restrictions on imports from Turkey. This liberalization shall be consolidated in respect of Turkey

APPENDIX C

**RELATED ARTICLE OF DECISION No 1/95 OF THE EC-TURKEY ASSOCIATION
COUNCIL of 22**

RELATED ARTICLE OF DECISION No 1/95 OF THE EC-TURKEY ASSOCIATION

COUNCIL of 22 December 1995 on implementing the final phase of the Customs Union (96/142/EC)

.....

Article 2

This Chapter shall apply to products other than agricultural products as defined in Article 11 of the Association Agreement. The special provisions relating to agricultural products are set out in Chapter II of this Decision.

Article 3

This Chapter shall apply to goods:

-produced in the Community or Turkey, including those wholly or partially obtained or produced from products coming from third countries which are in free circulation in the Community or in Turkey,

-coming from third countries and in free circulation in the Community or in Turkey.

Products from third countries shall be considered to be in free circulation in the Community or in Turkey if the import formalities have been complied with and any customs duties or charges having equivalent effect which are payable have been levied in the Community or in Turkey, and if they have not benefited from a total or partial reimbursement of such duties or charges.

The customs territory of the Customs Union shall comprise:

-the customs territory of the Community as defined in Article 3 of Council Regulation (EEC) No 2913/92 of 12 October 1992 establishing the Community Customs Code (1),

-the customs territory of Turkey.

This Chapter shall also apply to goods obtained or produced in the Community or in Turkey, in the manufacture of which products coming from third countries and not in free circulation either in the Community or in Turkey were used.

These provisions shall, however, apply to those goods only if the import formalities have been complied with and any customs duties or charges having equivalent effect payable on third-country products used in their manufacture have been levied in the exporting State.

If the exporting State does not apply the provisions of the second subparagraph of paragraph 4, the goods referred to in the first subparagraph of paragraph 4 shall not be considered to be in free circulation and the importing State shall therefore apply the customs legislation applying to goods from third countries.

The Customs Cooperation Committee set up by Decision No 2/69 of the Association Council shall determine the methods of administrative cooperation to be used in implementing paragraphs 1, 2 and 4.

Article 4

Import or export customs duties and charges having equivalent effect shall be wholly abolished between the Community and Turkey on the date of entry into force of this Decision. The Community and Turkey shall refrain from introducing any new customs duties on imports or exports or any charges having equivalent effect from that date. These provisions shall also apply to customs duties of a fiscal nature.

.....

Article 12

From the date of entry into force of this Decision, Turkey shall, in relation to countries which are not members of the Community, apply provisions and implementing measures which are substantially similar to those of the Community's commercial policy set out in the following Regulations:

-Council Regulation (EC) No 3285/94 (3) common rules for imports),

-Council Regulation (EC) No 519/94 (4) (common rules for imports from certain third countries),

- Council Regulation (EC) No 520/94 (5) (Community procedure for administering quantitative quotas (implementing provisions: Commission Regulation (EC) No 738/94 (6),
- Council Regulations (EC) No 3283/94 (7) and (EC) No 3284/94 (8) (protection against dumped and subsidized imports),
- Council Regulation (EC) No 3286/94 (9) (Community procedures in the field of the common commercial policy),
- Council Regulation (EEC) No 2603/69 (10) (establishing common rules for exports),
- Council Decision 93/112/EEC (11) (officially supported export credits),
- Council Regulation (EC) No 3036/94 (12) (outward processing arrangements for textiles and clothing),
- Council Regulation (EC) No 3030/93 (13) (textile imports under common rules),
- Council Regulation (EC) No 517/94 (14) (textile imports under autonomous arrangements),
- Council Regulation (EC) No 3951/92 (15) (textile imports from Taiwan).

In conformity with the requirements of Article XXIV of the GATT Turkey will apply as from the entry into force of this Decision, substantially the same commercial policy as the Community in the textile sector including the agreements or arrangements on trade in textile and clothing. The Community will make available to Turkey the cooperation necessary for this objective to be reached.

Until Turkey has concluded these arrangements, the present system of certificates of origin for the exports of textile and clothing from Turkey into the Community will remain in force and such products not originating from Turkey will remain subject to the application of the Communities commercial policy in relation to the third countries in question.

The provisions of this Decision shall not constitute a hindrance to the implementation by the Community and Japan of their Arrangement relating to trade in motor vehicles, mentioned in the Annex to the Agreement on safeguards attached to the Agreement setting up the World Trade Organization.

Before the entry into force of this Decision, Turkey and the Community will define the modalities of cooperation in order to prevent the circumvention of the said Arrangement.

In the absence of such modalities, the Community reserves the right to take, in respect of imports into its territory, any measure rendered necessary by the application of the said Arrangement.

.....

Article 16

With a view to harmonizing its commercial policy with that of the Community, Turkey shall align itself progressively with the preferential customs regime of the Community within five years as from the date of entry into force of this Decision. This alignment will concern both the autonomous regimes and preferential agreements with third countries. To this end, Turkey will take the necessary measures and negotiate agreements on mutually advantageous basis with the countries concerned. The Association Council shall periodically review the progress made.

In each of the cases referred to in paragraph 1 the granting of these tariff preferences shall be conditional on compliance with provisions relating to the origin of products identical to those governing the granting of such preferences by the Community.

Where, during the period referred to in paragraph 1, Turkey maintains a tariff policy different from that of the Community, goods imported from third countries into the Community and released for free circulation with preferential treatment by reason of their country of origin or of exportation shall be subject to the payment of a compensatory levy if they are imported into Turkey, in the following circumstances:

- they have been imported from countries to which the same preferential tariff treatment is not granted by Turkey, and
- they can be identified as imported from these countries, and
- the duty to be paid in Turkey is at least five percentage points higher than that applicable in the Community, and
- an important distortion of traffic related to these goods has been observed.

-The Customs Union Joint Committee shall establish the list of the goods to which the compensatory levy applies, as well as the amount of this levy.

.....

Article 19

The agricultural component applicable to goods imported into Turkey shall be obtained by adding together the quantities of basic agricultural products considered to have been used for the manufacture of the goods in question multiplied by the basic amount corresponding to each of these basic agricultural products as defined in paragraph 3.

The basic agricultural products to be taken into account are listed in Annex 2.

The quantities of basic agricultural products to be taken into account are set out in Annex 3.

In the case of goods classified under the nomenclature codes for which reference is made in Annex 3 to Annex 4, the amounts of the agricultural component to be taken into account are set out in Annex 4.

The basic amount corresponding to each basic agricultural product is the amount of the charge applicable on import into Turkey of the agricultural product originating in a non-preferential third country during the reference period applicable to agricultural products. The basic amounts are set out in Annex 5.

.....

Article 24

The Association Council hereby reaffirms the Parties' common objective to move towards the free movement of agricultural products between themselves as provided for in Articles 32 to 35 of the Additional Protocol.

The Association Council notes that an additional period is required to put in place the conditions necessary to achieve free movement of these products

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Article 28

On the date of entry into force of this Decision, Turkey shall adopt provisions in the following fields, based on Council Regulation (EEC) No 2913/92 of 12 October 1992 establishing the Community Customs Code and Commission Regulation (EEC) No 2454/93 of 2 July 1993 (16) laying down the implementing provisions thereof:

-origin of goods;

-customs value of goods;

-introduction of goods into the territory of the Customs Union;

-customs declaration;

-release for free circulation;

-suspensive arrangements and customs procedures with economic impact;

-movement of goods;

-customs debt;

-right of appeal.

Turkey shall take the measures necessary to implement, on the date of entry into force of this Decision, provisions based on:

-Council Regulation (EEC) No 3842/86 of 1 December 1986 laying down measures to prohibit the release for free circulation of counterfeit goods (17) and Commission Regulation (EEC) No 3077/87 of 14 October 1987 laying down the implementing measures thereof (18);

-Council Regulation (EEC) No 918/83 of 28 March 1983 setting up a Community system of reliefs from customs duties (19) and Commission Regulations (EEC) No 2287/83, (EEC) No 2288/83, (EEC) No 2289/83 and (EEC) No 2290/83 of 29 July 1983 laying down the implementing measures thereof (20);

-Council Regulation (EEC) No 616/78 on proof of origin for certain textile products falling within Chapter 51 or Chapters 53 to 62 of the Common Customs Tariff and imported into the Community, and on conditions for the acceptance of such proof (21).

The Customs Cooperation Committee shall lay down the appropriate measures to implement paragraphs 1 and 2.

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Article 31

The Parties confirm the importance they attach to ensuring adequate and effective protection and enforcement of intellectual, industrial and commercial property rights.

The Parties recognize that the Customs Union can function properly only if equivalent levels of effective protection of intellectual property rights are provided in both constituent parts of the Customs Union. Accordingly, they undertake to meet the obligations set out in Annex 8.

SECTION II

Competition

A. Competition rules of the Customs Union

Article 32

The following shall be prohibited as incompatible with the proper functioning of the Customs Union, in so far as they may affect trade between the Community and Turkey: all agreements between undertakings, decisions by associations of undertakings and concerted practices which have as their object or effect the prevention, restriction or distortion of competition, and in particular those which:

-directly or indirectly fix purchase or selling prices or any other trading conditions;

-limit or control production, markets, technical development or investment;

-share markets or sources of supply;

-apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

-make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

-Any agreements or decisions prohibited pursuant to this Article shall automatically be void.

The provisions of paragraph 1 may, however, be declared inapplicable in the case of:

-any agreement or category of agreements between undertakings,

-any decision or category of decisions by associations of undertakings,

-any concerted practice or category of concerted practices which contributes to improving the production or distribution of goods or to promoting technical or economic progress, which allowing consumers a fair share of the resulting benefit, and which does not:

-impose on the undertakings concerned restrictions which are not indispensable to the attainment to these objectives;

-afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

Article 33

Any abuse by one or more undertakings of a dominant position in the territories of the Community and/or of Turkey as a whole or in a substantial part thereof shall be prohibited as incompatible with the proper functioning of the Customs Union, in so far as it may affect trade between the Community and Turkey.

Such abuse may, in particular, consist in:

-directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

-limiting production, markets or technical development to the prejudice of consumers;

-applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

-making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

Article 34

Any aid granted by Member States of the Community or by Turkey through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between the Community and Turkey, be incompatible with the proper functioning of the Customs Union.

The following shall be compatible with the functioning of the Customs Union:

-aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;

-aid to make good the damage caused by natural disasters or exceptional occurrences;

-aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division;

-for a period of five years from the entry into force of this Decision, aid to promote economic development of Turkey's less developed regions, provided that such aid does not adversely affect trading conditions between the Community and Turkey to an extent contrary to the common interest.

The following may be considered to be compatible with the functioning of the Customs Union:

-in conformity with Article 43 (2) of the Additional Protocol, aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;

-aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State of the Community or of Turkey;

-for a period of five years after the entry into force of this Decision, in conformity with Article 43 (2) of the Additional Protocol, aids aiming at accomplishing structural adjustment necessitated by the establishment of the Customs Union. The Association Council shall review the application of that clause after the aforesaid period.

-aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions between the Community and Turkey to an extent contrary to the common interest;

-aid to promote culture and heritage conservation where such aid does not adversely affect trading conditions between the Community and Turkey to an extent contrary to the common interest;

-such other categories of aid as may be specified by the Association Council.

Article 35

Any practices contrary to Articles 32, 33 and 34 shall be assessed on the basis of criteria arising from the application of the rules of Articles 85, 86 and 92 of the Treaty establishing the European Community and its secondary legislation.

Article 36

The Parties shall exchange information, taking into account the limitations imposed by the requirements of professional and business secrecy.

Article 37

The Association Council shall, within two years following the entry into force of the Customs Union, adopt by Decision the necessary rules for the implementation of Articles 32, 33 and 34 and related parts of Article 35. These rules shall be based upon those already existing in the Community and shall inter alia specify the role of each competition authority.

Until these rules are adopted,

-the authorities of the Community or Turkey shall rule on the admissibility of agreements, decisions and concerted practices and on abuse of a dominant position in accordance with Articles 32 and 33;

-the provisions of the GATT Subsidies Code shall be applied as the rules for the implementation of Article 34.

Article 38

If the Community or Turkey considers that a particular practice is incompatible with the terms of Articles 32, 33 or 34, and

-is not adequately dealt with under the implementing rules referred to in Article 37, or

-in the absence of such rules, and if such practice causes or threatens to cause serious prejudice to the interest of the other Party or material injury to its domestic industry, it may take appropriate measures after consultation within the Joint Customs Union Committee or after 45 working days following referral for such consultation. Priority shall be given to such measures that will least disturb the functioning of the Customs Union.

In the case of practices incompatible with Article 34, such appropriate measures may, where the General Agreement on Tariffs and Trade applies thereto, only be adopted in conformity with the procedures and under the conditions laid down by the General Agreement on Tariffs and Trade and any other relevant instrument negotiated under its auspices which are applicable between the Parties.

Approximation of legislation

Article 39

With a view to achieving the economic integration sought by the Customs Union, Turkey shall ensure that its legislation in the field of competition rules is made compatible with that of the European Community, and is applied effectively.

To comply with the obligations of paragraph 1, Turkey shall

-before the entry into force of the Customs Union, adopt a law which shall prohibit behaviours of undertakings under the conditions laid down in Articles 85 and 86 of the EC Treaty. It shall also ensure that, within one year after the entry into force of the Customs Union, the principles contained in block exemption Regulations in force in the Community, as well as in the case-law developed by EC authorities, shall be applied in Turkey. The Community shall inform Turkey as

soon as possible of any procedure related to the adoption, abolition, or modification of block exemption Regulations by the EC after the entry into force of the Customs Union. After such information has been given, Turkey shall have one year to adapt its legislation, if necessary;

-before the entry into force of the Customs Union, establish a competition authority which shall apply these rules and principles effectively;

-before the entry into force of this Decision, adapt all its aids granted to the textile and clothing sector to the rules laid down in the relevant Community frameworks and guidelines under Articles 92 and 93 of the EC Treaty. Turkey shall inform the Community of all its aid schemes to this sector as adapted in accordance with these frameworks and guidelines. The Community shall inform Turkey as soon as possible of any procedure related to the adoption, abolition or modification of such frameworks and guidelines by the Community after the entry into force of the Customs Union. After such information as been given, Turkey shall have one year to adopt its legislation;

-within two years after the entry into force of this Decision, adapt all aid schemes other than those granted to the textile and clothing sector to the rules laid down in Community frameworks and guidelines under Articles 92 and 93 of the EC Treaty. The Community shall inform Turkey as soon as possible of any procedure related to the adoption, abolition or modification of such frameworks and guidelines by the Community. After such information has been given, Turkey shall have one year to adapt its legislation;

-within two years after the entry into force of the Customs Union, inform the Community of all aid schemes in force in Turkey as adapted in accordance with point (d). If a new scheme is to be adopted, Turkey shall inform the Community as soon as possible of the content of such scheme;

-notify the Community in advance of any individual aid to be granted to an enterprise or a group of enterprises that would be notifiable under Community frameworks or guidelines had it been granted by a Member State, or of individual aid awards outside of Community frameworks or guidelines above an amount of ECU 12 million and which would have been notified under EC law had it been granted by a Member State.

Regarding individual aids granted by Member States and subject to the analysis by the Commission, on the basis of Article 93 of the EC Treaty, Turkey will be informed on the same basis as the Member States.

The Community and Turkey shall communicate to each other all amendments to their laws concerning restrictive practices by undertakings. They shall also inform each other of the cases when these laws have been applied.

In relation to information supplied under paragraph 2, points (c), (e) and (f), the Community shall have the right to raise objections against an aid granted by Turkey which it would have deemed unlawful under EC law had it been granted by a Member State. If Turkey does not agree with the Community's opinion, and if the case is not resolved within 30 days, the Community and Turkey shall each have the right to refer the case to arbitration.

Turkey shall have the right to raise objections and seize the Association Council against an aid granted by a Member State which it deems to be unlawful under EC law. If the case is not resolved by the Association Council within three months, the Association Council may decide to refer the case to the Court of Justice of the European Communities.

Article 40

The Community shall inform Turkey as soon as possible of the adoption of any Decision under Articles 85, 86 and 92 of the EC Treaty which might affect Turkey's interests.

Turkey shall be entitled to ask information about any specific case decided by the Community under Articles 85, 86 and 92 of the EC Treaty.

CHAPTER V

INSTITUTIONAL PROVISIONS

SECTION I

The EC-Turkey Customs Union Joint Committee

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Article 52

In accordance with Article 24 of the Association Agreement, an EC-Turkey Customs Union Joint Committee is hereby established. The Committee shall carry out exchange of views and information, formulate recommendations to the Association Council and deliver opinions with a view to ensuring the proper functioning of the Customs Union.

The Parties shall consult within the Committee on any point relating to the implementation of this Decision which gives rise to a difficulty for either of them.

The Customs Union Joint Committee shall adopt its rules of procedure.

Article 53

The Customs Union Joint Committee shall consist of representatives of the Parties.

The office of Chairman of the Customs Union Joint Committee shall be held alternately, for a period of six months, by the representative of the Community, i.e. the European Commission, and the representative of Turkey.

In order to carry out its duties, the Customs Union Joint Committee shall meet, as a general rule, at least once a month. It shall also meet on the initiative of its Chairman or at the request of one of the Parties in accordance with its rules of procedure.

The Customs Union Joint Committee may decide to establish any subcommittee or working party to assist it in carrying out its duties. The Customs Union Joint Committee shall lay down the composition and rules of operation of such subcommittees or working parties in its rules of procedure. Their duties shall be determined by the Customs Union Joint Committee in each individual case.

SECTION II

Consultation and decision procedures

Article 54

In areas of direct relevance to the operations of the Customs Union, and without prejudice to the other obligations deriving from Chapters I to IV Turkish legislation shall be harmonized as far as possible with Community legislation.

Areas of direct relevance to the operation of the Customs Union shall be commercial policy and agreements with third countries comprising a commercial dimension for industrial products, legislation on the abolition of technical barriers to trade in industrial products, competition and industrial and intellectual property law and customs legislation.

The Association Council may decide to extend the list of areas where harmonization is to be achieved in the light of the Association's progress.

The procedural rules provided for the Articles 55 to 60 shall apply for the purposes of this Article.

Article 55

Wherever new legislation is drawn up by the Commission of the European Communities in an area of direct relevance to the operation of the Customs Union and the Commission of the European Communities consults experts from Member States of the Community, it shall also informally consult Turkish experts.

When transmitting its proposal to the Council of the European Union, the Commission of the European Communities shall send copies thereof to Turkey.

During the phase preceding the decision of the Council of the European Union, the Parties shall, at the request of either of them, consult each other again within the Customs Union Joint Committee.

The Parties shall cooperate in good faith during the information and consultation phase with a view to facilitating, at the end of the process, the decision most appropriate for the proper functioning of the Customs Union.

Article 56

Where it adopts legislation in an area of direct relevance to the functioning of the Customs Union as defined in Article 54 (2), the Community shall immediately inform Turkey thereof within the Customs Union Joint Committee to allow Turkey to adopt corresponding legislation which will ensure the proper functioning of the Customs Union.

Where there is a problem for Turkey in adopting the corresponding legislation, the Customs Union Joint Committee shall make every effort to find a mutually acceptable solution maintaining the proper functioning of the Customs Union.

Article 57

The principle of harmonization defined in Article 54 shall not affect Turkey's right, without prejudice to its obligations deriving from Chapters I to IV to amend legislation in areas of direct relevance to the functioning of the Customs Union provided the Customs Union Joint Committee has concluded that the amended legislation does not affect the proper functioning of the Customs Union or that the procedures referred to in the paragraphs 2 to 4 of this Article have been accomplished.

Where Turkey is contemplating new legislation in an area of direct relevance to the functioning of the Customs Union, it shall informally seek the views of the Commission of the European Communities on the proposed legislation in question so that the Turkish legislator may take his decision in full knowledge of the consequences for the functioning of the Customs Union.

The Parties shall cooperate in good faith with a view to facilitating, at the end of the process, the decision most appropriate for the proper functioning of the Customs Union.

Once the proposed legislation has reached a sufficiently advanced stage of drafting, consultations shall be held within the Customs Union Joint Committee.

Where Turkey adopts legislation in an area of direct relevance to the functioning of the Customs Union, it shall forthwith inform the Community within the Customs Union Joint Committee.

If Turkey's adoption of such legislation is likely to disrupt the proper functioning of the Customs Union, the Customs Union Joint Committee shall endeavour to find a mutually acceptable solution.

Article 58

If, at the end of the consultations undertaken under the procedure provided for in Article 56 (2) or Article 57 (4), a mutually acceptable solution cannot be found by the Customs Union Joint Committee and if either Party considers that discrepancies in the legislation in question may affect the free movement of goods, deflect trade or create economic problems on its territory, it may refer the matter to the Customs Union Joint Committee which, if necessary, shall recommend appropriate ways of avoiding any injury which may result.

The same procedure will be followed if differences in the implementation of legislations in an area of direct relevance to the functioning of the Customs Union, cause or threaten to cause impairment of the free movement of goods, deflections of trade or economic problems.

If discrepancies between Community and Turkish legislation or differences in their implementation in an area of direct relevance to the functioning of the Customs Union, cause or threaten to cause impairment of the free movement of goods or deflections of trade and the affected Party considers that immediate action is required, it may itself take the necessary protection measures and notify the Customs Union Joint Committee thereof; the latter may decide whether to amend or abolish these measures. Priority should be given to measures which least disturb the functioning of the Customs Union.

Article 59

In areas of direct relevance to the proper functioning of the Customs Union, the Commission of the European Communities shall ensure Turkish experts are involved as far as possible in the preparation of draft measures to be submitted subsequently to the committees which assist the Commission of the European Communities in the exercise of its executive powers. In this regard, when drafting proposals, the Commission of the European Communities shall consult experts from Turkey on the same basis as it consults experts from the Member States of the Community. Where the matter referred to the Council of the European Union is in accordance with the procedure

applying to the type of committee concerned, the Commission of the European Communities shall transmit to the Council of the European Union the views of the Turkish experts.

Article 60

Turkish experts shall be involved in the work of a number of technical committees which assist the Commission of the European Communities in the exercise of its executive powers in areas of direct relevance to the functioning of the Customs Union where this is required to ensure the proper functioning of the Customs Union. The procedure for such participation shall be decided by the Association Council before the entry into force of this Decision. The list of Committees is contained in Annex 9. If it appears to the Parties that such an involvement should be extended to other Committees, the Customs Union Joint Committee may address the necessary recommendations to the Association Council for decisions.

SECTION III

Settlement of disputes

Article 61

Without prejudice to paragraphs 1 to 3 of Article 25 of the Ankara Agreement, if the Association Council fails to settle a dispute relating to the scope or duration of protection measures taken in accordance with Article 58 (2), safeguard measures taken in accordance with Article 63 or rebalancing measures taken in accordance with Article 64, within six months of the date on which this procedure was initiated, either Party may refer the dispute to arbitration under the procedures laid down in Article 62. The arbitration award shall be binding on the Parties to the dispute.

Article 62

If a dispute has been referred to arbitration there shall be three arbitrators.

The two parties to the dispute shall each appoint one arbitrator within 30 days.

The two arbitrators so designated shall nominate by common agreement one umpire who shall not be a national of either Party. If they cannot agree within two months of their appointment, the umpire shall be chosen by them from seven persons on a list established by the Association Council. The Association Council shall establish and review this list in accordance with its rules of procedure.

The arbitration tribunal shall sit in Brussels. Unless the Parties decide otherwise, it shall adopt its rules of procedure. It shall take its decisions by majority.

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Article 64

If a safeguard or protection measure taken by a Party creates an imbalance between the rights and obligations under this Decision, the other Party may take rebalancing measures in respect of that Party. Priority shall be given to such measures as will least disturb the functioning of the Customs Union.

The procedures provided for in Article 63 shall apply.

CHAPTER VI

GENERAL AND FINAL PROVISIONS

Entry into force

Article 65

This Decision shall enter into force on 31 December 1995.

During the year 1995, progress in the implementation of this Decision shall be examined regularly within the Association Committee, which will report to the Association Council.

Before the end of October 1995 the two Parties shall consider within the Association Council whether the provisions of this Decision for the proper functioning of the Customs Union are fulfilled.

On the basis of the report(s) of the Association Committee, if Turkey on one side or the Community and its Member States on the other side considers that the provisions referred to in paragraph 3 have not been met, this Party can notify to the Association Council its decision to ask for a postponement of the date referred to in paragraph 1. In such a case this date is deferred to 1 July 1996.

In this case paragraphs 2 to 4 shall apply *mutatis mutandis*.

The Association Council may take other appropriate decisions.

Interpretation

Article 66

The provisions of this Decision, in so far as they are identical in substance to the corresponding provisions of the Treaty establishing the European Community shall be interpreted for the purposes of their implementation and application to products covered by the Customs Union, in conformity with the relevant decisions of the Court of Justice of the European Communities.