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WITH TAX PERSPECTIVE,  
THE RELATIONS BETWEEN EUROPEAN UNION  
AND TURKEY AND THE CUSTOMS UNION

MASTER THESIS

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## ABSTRACT

This study deals with the relations between Turkey and the European Union in the respect of the Customs Union with tax perspective.

After a brief introduction part, the Thesis is divided into two main parts. In first part, the process passed from the foundation phases of the European Union and Turkey's position in these periods, the Customs Union application of the European Union and Turkey's part in that relevant Customs Union formation are examined in turns and with a historical perspective. In second part, again within the concept of the Customs Union, the tax policies of the European Union are initially expressed. Afterwards, in same part of the thesis, The Turkish Tax System is put forward with its main points and these two tax system is examined with a comparative perspective. After a conclusion part, where the statistical information mentioned, my thesis is finished with a general conclusion part where I express my own ideas about the relevant subject.

Due to its special type, the relevant relations between Turkey and the European Union initially examined with historical perspective. By giving some examples from the decisions of the European Court of Justice and with some figures and numbers, the content of the thesis is tried to be supported

The result of this study shows us that the Customs Union application of Turkey and the Turkish Tax System take the European Union and her applications as a model and so there are not so big differences between the two sides' policies. Furthermore, the differences in question are not the dissolvable impediments to reach the full membership and can be solved in a certain time period.

## ÖZET

Bu çalışma Türkiye-Avrupa Birliđi ilişkilerini vergi boyutu ile Gümrük Birliđi çerçevesinde ele almaktadır.

Tez temelde kısa bir giriş kısmının ardından 2 ana bölüme ayrılmaktadır. Birinci bölümde, Avrupa Birliđinin kuruluşundan bugüne kadar geçen süreç ve Türkiye'nin ilgili süreçteki yeri, Avrupa Birliđi Gümrük Birliđi uygulaması ve Türkiye'nin Gümrük Birliđi yapılanması içindeki yeri sırası ile ve tarihi bir bakış açısı ile incelenmektedir. İkinci bölümde ise yine Gümrük Birliđi çerçevesinde Avrupa Birliđinin vergi politikaları öncelikli olarak ele alınmaktadır. Ardından yine aynı bölümde Türk vergi sistemi ana hatları ile ortaya konmakta olup, her iki vergi sistemi karşılaştırmalı bir bakış açısı çerçevesinde irdelenmiştir. Tezim rakamsal verilerin ortaya konduğu sonuç bölümünden sonra kişisel görüşlerimi belirtmiş olduğum genel bir sonuç bölümü ile sona ermektedir.

Kendine has özellikleri nedeni ile Türkiye-Avrupa Birliđi ilişkileri öncelikli olarak tarihi çerçevede ele alınmıştır. Adalet Divanı kararları ve belli başlı rakamsal veriler ve tablolar vasıtası ile de tezin içeriđi desteklenmeye çalışılmıştır.

Sonuç bize göstermektedir ki, Türkiye'nin Gümrük Birliđi uygulaması ve Türk Vergi Sistemi kendisine Avrupa Birliđi'ni model almaktadır ve bu nedenle de iki tarafın aralarında bu bağlamda üyeliđi engelleyici bazda farklar bulunmadığı, mevcut farkların da belirli bir zaman içerisinde çözülebileceđi düşünülmektedir.

## ÖNSÖZ

Türkiye'nin son dönemde dış politikasının ana gündem maddelerinden birisini Avrupa Birliğine üyelik teşkil etmektedir.

Yarım asra yakın bir süredir sürmekte olan bu serüven 10-11 Aralık 1999 tarihli Helsinki Zirvesi ve son olarak da 17 Aralık 2004, Brüksel kararları ile nihai şeklini almış olup, içinde bulunduğumuz dönemde tam üyelik müzakerelerine doğru hızla ilerlemektedir.

İnsan hakları, demokratik yapı, serbest pazar ekonomisi gibi Kopenhag Kriterlerinin yanında ülkemizin üyeliğini etkileyecek olan bir diğer unsurda mevzuat uyumudur ve Gümrük Birliği çerçevesinde incelenmiş olan Türk Vergi Sistemi de bu mevzuatın içerisinde yer almakta olup, kanımca büyük önem taşımaktadır.

Tezimde tarihi bir bakış açısı ile ilişkilerin temelini ve bugününü irdelemeyi ve bu noktadan hareketle Gümrük Birliği bağlamında Türkiye ve Avrupa Birliğinin vergi sistemlerini inceleyip, fark ve/veya ortak noktaları ortaya koyarak ilişkilerin vergi boyutunun önemi ve Gümrük Birliğinin tam üyelik yolunda Türkiye Cumhuriyeti için ne ifade ettiği incelenmiştir.

## LIST of TABLES

CAP:	Common Agricultural Policy
CCT:	Common Custom Tariff
CU:	Customs Union
EC:	European Community
ECJ:	European Court of Justice
ECSC:	European Coal and Steel Community
EEA:	European Economic Area
EEC:	European Economic Community
ECOFIN:	Economic and Financial (meeting)
EFTA:	European Free Trade Association
EMU:	European Monetary Union
EU:	European Union
GSP:	Generalized System of Preference
NAFTA:	North American Free Trade Association
NPAA:	National Program for Adoption of Acquis
SAD:	Single Administrative Document
SEA:	Single European Act
VAT:	Value Added Tax
WTO:	World Trade Office
UN:	United Nations



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## INTRODUCTION

During the Helsinki Summit held in 10-11 December, 1999, the candidacy of Turkey was approved.

In December 2004, after the affirmative recommendation of the European Union Commission, it was decided that Turkey has fulfilled the “Copenhagen Political Criteria” and the negotiations for participation was decided to be started after the relevant certain steps.

However, the evaluations the membership process of Turkey and the formation of the Customs Union alone, I mean without the effects of the different sources, can cause different opinions in people’s minds. Therefore, to have a broader perspective about the EU and her policies, a historical approach must initially put forward and the effects of the relevant formation should be considered in the parallel of the global economic and social conditions and of course Turkey’s local realities. If the importance of “time” concept can be understood to evaluate such policies in negative or positive way, most of the misleading approaches can be put forward.

In this respect, in this thesis, the historical bases and the following steps of the relations shall be explained in turns from a broader and global perspective and during these times, the Turkey’s economic, social and commercial situation shall also be expressed.

The thesis is divided into two parts. In first part the foundation of the European Union, the relations between Turkey and the EU and with philosophical basis the Customs Union is explained. In second part, within the concept of the Customs Union, taxation policy of the EU and Turkish taxation policy is explained.

To have a comprehensive beginning, the historical formation of the EU will be initially explained.

## PART 1. THE EUROPEAN UNION AND THE CUSTOMS UNION

### 1. HISTORY Of The EUROPEAN UNION

As a result of a complex and historical process, with Maastricht Treaty, signed in 1992 in Maastricht and came into force in 1993, the unification of the European Countries was realized under the name of “European Union”.

However, it should be known that, the ideological bases of the unification of the European countries’ go deeper. The idea of the “ European Integration” is sometimes based on the work of Piere Dubois (a French Juris ), “De recuperatione Terre Sancte “, published in 1306, but sometimes based on the works of Rousseau and Kant. Meanwhile, when we consider the other ideas, which mainly discuss the unification ways of Europe, the relevant list can be enlarged by containing the names of Sully, Saint Simon, Penn, Leibniz, Saint Pierre and Bluntschli <sup>1</sup> However, what I think is; the sentences of Victor Hugo, famous French author, should be expressed here due to the his realistic and different approach. He stated that:

“How USA honored a new world; when the day comes, The United States of Europe will adorn the old world, too. No matter to be accepted or not, but the dream of unity of this old continent, suffered from conflicts, will remain so.”<sup>2</sup>

Furthermore, Winston Churchill, former Prime Minister of England, also offered the foundation of United States of Europe during a speech he made in Zurich. According to his opinions, the unity will base on the solidarity between France and Germany, but England and Common Wealth countries will form another unity and these two bodies will keep the peace of the continent.

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<sup>1</sup> Tekinalp, Gülören-Tekinalp, Ünal **Avrupa Birliđi Hukuku**, İstanbul, Beta Yayın Evi, 2000, p. 3

<sup>2</sup> Karluk, Rıdvan **Avrupa Birliđi ve Türkiye**, İstanbul, Beta Yayınevi, 2003, p.1.

In the respect of such unity ideas, some other names and foundations can be easily added to this list. However, when we look for the real steps to realize such a unity, the incidents bring us to 1950's.

Mr. Robert Schuman, former Foreign Affairs Minister of France, stated that, in order to supply a strong peaceful environment in Europe, the solidarity between France and Germany must be seen as an obligatory condition. For centuries, Europe was the scene of frequent and bloody wars. As an example, from 1870 to 1945, with terrible losses of lives, France and Germany had wars for three times.<sup>3</sup> The Schuman Plan, based on the scheme of Jean Monnet, mentioned that the only way to prevent the hostility between France and Germany is (under the management of a high authority) to form a common production system of coal and steel for the relevant two countries and to have the achievement, it was also thought that, this system must let the participation of other European countries. Depending on the views of Mr. Schuman, a supranational foundation, which obtains some rights of its member states in the field of the production and delivery of steel and coal, should be created and this can be an initial step for a larger European Unity.<sup>4</sup> Being known as Schuman plan, this plan was initially accepted by Germany and then Italy, Belgium, The Netherlands, Luxembourg and France shared Germany's positive answer. In the parallel of Schuman plan, as a result of the movements aimed political integration in Europe, with the positive approaches of other countries; negotiations for creating a common market began at 1950, 20 June. As a result, in 1951, the European Coal and Steel Community (ECSC) was set up with six members: Belgium, West Germany, Luxembourg, France, Italy and the Netherlands. The power to take decisions about the coal and steel industry in these countries was placed in the hands of an independent, supranational body called as the "High Authority". Jean Monnet was its first President.<sup>5</sup>

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<sup>3</sup> [http://europa.eu.int/abc/history/index\\_en.htm](http://europa.eu.int/abc/history/index_en.htm), 2005.

<sup>4</sup> Tekinalp, op.cit, p. 6.

<sup>5</sup> [http://europa.eu.int/abc/history/index\\_en.htm](http://europa.eu.int/abc/history/index_en.htm), 2005.

However, it should be initially considered that, at the beginning phases of this movement; there were two main ideological approaches. According to the federalist approach local, regional, national and European authorities should cooperate and complement each other. On the other hand, the functionalist approach favors a gradual transfer of sovereignty from national to Community level. Today, the two approaches have merged in a conviction that national and regional authorities need to be matched by independent, democratic European institutions with responsibility for those areas in which joint action is more effective than action by individual States. In this regard, the single market, monetary policy, economic and social cohesion, foreign and security policy, employment policy, environmental protection, foreign and defense policy, the creation of an area of freedom and justice can be mentioned as significant points.<sup>6</sup>

To be able to mention the recent structure of the EU, the bases of the Union, and the Communities of the Union will be explained briefly.

## 1.1. FOUNDATION of the EUROPEAN COMMUNITIES

### 1.1.1 European Coal And Steel Community (ECSC)

As I mentioned above, in 1951, with Paris Treaty, the ECSC was set up with the membership of Germany, Belgium, The Netherlands, Luxembourg, Italy and France and so first European Community was realized. In 1973 England, in 1981 Greece, in 1986 Portugal and Spain, in 1995 Finland, Sweden and Austria became the member of ECSC.

The Treaty of ECSC is not an international treaty, but is first supranational association Treaty, which means that the sides transfer some of their rights to a supranational foundation (here, it is ECSC)<sup>7</sup>

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<sup>6</sup> Karluk, op.cit, p.2.

<sup>7</sup> Tekinalp, op.cit. p.7.

This community has 4 organs. These are;

- Ministers Committee
- High Authority
- General Committee
- Court

ECSC had the aim of improving the economic situation and life standards of the Member States, creating working areas and rational distribution of coal and steel.

The validity of the Paris Treaty, founded the ECSC, was 50 years and so ended in 2002, 23 July. With this improvement, the subjects dealing with the coal and steel were transferred to the scope of EU and its commission.

After this relatively good work of unification, some aims in order to form a defense community and a political community were unsuccessful due to the negative attitude of France Parliament. This showed that a probable unification of Europe will be more sufficient and realistic, if it initially considers a unification, which mainly depends on the economic grounds, and this thought led the formation of another European Community.

#### 1.1.2. European Economic Community (EEC)

It was founded with the Rome Treaty signed in 1957; 25 March (came into force in 1958, 1 January). The Rome Treaty, a quite extensive Treaty, has not only contained the rules for economic integration, but also carried the aims for monetary integration and political collaboration under its constitution.<sup>8</sup>

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<sup>8</sup> Tekimalp, op.cit, p.7.

European Economic Community made the free movement of goods, capital and labor possible among the Member States and demanded the foundation of the Customs Union and the Common Market.

In the Rome Treaty, the main 4 organs are defined as authorized (Commission, Council of Ministers, General Committee and Court ), but later by containing the relevant communities these organs were named as Council, Commission, European Parliament and European Court of Justice .

The Treaty of Rome does not have any maturity date for European Economic Community like European Coal and Steel Community.<sup>9</sup>

### 1.1.3. Euratom

EURATOM was also formed by the Treaty of Rome. The aim of this Community is to make the usage of energy of atom and its derivatives for humanist and peaceful grounds. This community also has Commission, Council of Ministers, General Committee and Court which were named later as Council, Commission, European Parliament and European Court of Justice.

Through the successful works of the Communities, stated above, a new broadening process, which contains the membership of new countries, has experienced. The success of the Sixes led Denmark, Ireland and the United Kingdom to apply for Community membership. They were finally admitted in 1972 following difficult negotiations with UK, during which France, under General de Gaulle, used its veto twice, once in 1961 and again in 1967. This first enlargement, which increased the number of member from six to nine in 1973, was matched by a deepening of the Community's tasks; it was given responsibility for social, regional and environmental matters.<sup>10</sup>

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<sup>9</sup> Karluk, op.cit, p 15.

<sup>10</sup>[http:// abgs.gov.tr/ab](http://abgs.gov.tr/ab), 2005.



## 1.2. THE RELATIONS BETWEEN TURKEY AND THE EUROPEAN UNION

Turkey became a member of most of the European foundations founded after the Second World War. After 1947, Turkey was added to Marshall Plan list and at the beginning of 1950's, Turkey became a member of NATO. Furthermore, Turkey was a member of European Council. All these mean that, after the II. World War, Turkey made his choice and showed his willingness to become a part of new Europe<sup>11</sup>

19 months later after the Rome Treaty, Turkey applied to the European Economic Community to be the “ associate member “ in the respect of article 238 (The Community may conclude with one or more States or international organizations agreements establishing an association involving reciprocal rights and obligations, common action and special procedures <sup>12</sup> ) of Rome Treaty in 1959 , 31 July. This application occurred just after the application of Greece and so, we may say that, this incident had an important effect on the application of Turkey. At the Minister Council of European Economic Community's summit, held in 1959, 11 September, the application of Turkey was considered in a positive way and the commission was charged for executing the conditions of partnership with Turkey. With the consultation meetings held at 28-30 September of 1959, the relations between Turkey and Community were officially started.

This period, which will be ended by the membership of Turkey, can be divided into three parts. These parts shall be also explained, briefly in the Customs Union part, but hereby in order to keep the structure of the thesis, the brief history of these periods shall be mentioned.

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<sup>11</sup> Manisalı Erol, **Türkiye-Avrupa İlişkilerinde Sessiz Darbe**, İstanbul, Derin Yayınları, 2003, p.74

<sup>12</sup> [http:// abgs.gov.tr/ab-Traety of Rome](http://abgs.gov.tr/ab-Traety of Rome), 2005.

### 1.2.1. PREPARATION PERIOD

Begins from 1 December 1964 (the date Ankara Treaty came into force) and goes till 1973, 1 January. In this period of time, in order to reduce the differences at the economies of Turkey and the Community, The Community gave some advantages to Turkey. At the beginning, the relevant period was planned as 5 years, but later it finished in 9 years.

The ensuing negotiations resulted in the signature of the Agreement Creating an Association between the Republic of Turkey and the European Economic Community (the "Ankara Agreement") on 12 September 1963. This agreement, which entered into force on 1 December 1964, aimed at securing Turkey's full membership in the EEC through the establishment in three phases of a customs union which would serve as an instrument to bring about integration between the EEC and Turkey.<sup>13</sup>

Ankara Agreement contains 33 article (main agreement), a temporary protocol (11 Article), Fiscal Protocol (9 Article), Single Act and the letters bilaterally declared about the labors.<sup>14</sup>

As I stated above, Ankara Treaty mainly depends on the 238<sup>th</sup> Article of Treaty of Rome and determines the partnership principles between Turkey and the Community and so can be called as a "Frame Treaty". The details were defined by the further Treaties. With this Ankara Treaty, Turkey became "associate member" of the Community.

Therefore, it can be thought that Ankara Agreement is quite important for the relations between Turkey and Greece. When we look at the relevant Treaty with

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<sup>13</sup> [http:// abgs.gov.tr/ab](http://abgs.gov.tr/ab), 2005.

<sup>14</sup> Manisalı, op.cit, p.75.

details, we recognized that, there are some main principles at the Ankara Agreement and these principles can be explained as follow:

- 1) In order to reach the aims stated in the Treaty, to form a Customs Union between the Community and Turkey,
- 2) To realize a stronger relations between the publics of Turkey and the publics of the Member States,
- 3) To abolish the existing economic differences between Turkish economy and EEC's Member States' economies,
- 4) To make some economic supports to Turkey to improve her economy,
- 5) To make the full membership of Turkey to the Community in future easier,
- 6) To share the idea stated in Rome Treaty, and to guaranty the peace and freedom.<sup>15</sup>

Although the Ankara Agreement envisaged the free circulation not only of goods, but also of natural persons, services and capital between the Parties, it excluded Turkey from the EEC decision-making mechanisms and precluded Turkey from recourse to the ECJ for dispute settlement.

As it shall be noticed at the further parts of the thesis, the Customs Union, that was to be established between the Parties, went much further than the abolition of tariff and quantitative barriers to trade between the Parties and the application of a Common External Tariff to imports from third countries, and envisaged harmonization with EEC policies in virtually every field.

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<sup>15</sup> Karluk, op.cit, p.548.

The Ankara Agreement still constitutes the legal basis of the Association between Turkey and the EU.<sup>16</sup>

During this preparation period, the numbers at import had exceeded the export and it showed to the Community that “Turkey is a good market” for them<sup>17</sup> However, in this period, there were no changes on the rights of free movements of workers and services.

From the date of the entrance into force of Association Treaty, Community decided to give some commercial and fiscal incentives to Turkey. In commercial area, for the four basic export products, that were exported by Turkey to the Community (tobacco, raisin, dried fig and hazelnut), Community applied reductions at custom duties (sometimes in some certain quotas sometimes without any quotas.) In fiscal area, Community, for supporting the investments which will strengthen the bilateral relations, through the European Investment Bank, decided to open a fund (175 millions ECU) to prepare Turkish economy to the Customs Union.<sup>18</sup>

Turkey did not have any obligation towards the Community in this period<sup>19</sup>

As mentioned above, Ankara Agreement enables the full membership of Turkey, but has no time limit. In another word, there are no time expressions about the validity of the relevant Treaty. Therefore, Ankara Treaty shall be in valid till one side behaves in a negative way.<sup>20</sup>

Furthermore, in order to apply the partnership mechanism and to improve the relations between two sides, Ankara Agreement founded some organs such as Turkey - EU Joint Parliamentary Commission, Turkey - EC Association Council,

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<sup>16</sup> [http:// abgs.gov.tr/ab](http://abgs.gov.tr/ab), 2005.

<sup>17</sup> Karluk, op.cit, p.551.

<sup>18</sup> Manisalı,Erol, **İç Yüzü ve Perde Arkasıyla Avrupa Çıkmazı,Türkiye-Avrupa Birliği İlişkileri**, İstanbul, Otopsi Yayınları, 2003, p.93.

<sup>19</sup> Bozkurt Veysel, **Avrupa Birliği ve Türkiye**, İstanbul, Alfa Kitapevi, 1997, p.277.

<sup>20</sup> Manisalı, op.cit, p.75.

Turkey - EU Association Committee, Customs Cooperation Committee and Turkey - EU Joint Consultative Committee<sup>21</sup>

### 1.2.2. TRANSITION PERIOD

Additional Protocol came into force in 1973, 1 January and with this step the transition period started. Additional Protocol is a very important Treaty which foresees the free movement of goods, services, labors and capital within certain time periods.<sup>22</sup>

Additional Protocol is a quite comprehensive agreement and based on full membership and full integration. With its 64 Articles and with the methods, turns and time statements, it shows the concept of free movement of goods, labors, services and capital, transportation, taxation and harmonization of dispositions, economy and commercial policies.<sup>23</sup>

The main difference of this period from the preparation period is, at this time Turkey also had some commitments towards the Community. The Sides aimed to realize a “Customs Union“ by getting the conditions of Turkish economy closer to the Community’s ones”. By this meaning, the relevant Customs Union shall contain the industrial products. On the other hand, for the agricultural products another common agriculture policy was decided to be followed.

In the respect of products, transition period for realizing the Customs Union was divided into two parts. For some products, the transition period was planned as 12 years, and for some other products it was planned as 22 years. Furthermore, in these years, Turkey had undertaken that she would accept and try to apply common customs tariffs policy of the Community.

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<sup>21</sup> Manisali, op.cit, p.76.

<sup>22</sup> Manisali, Ibid, p.93.

<sup>23</sup> Manisali, Ibid, p. 94.

When we look at the process from the perspective of the Community's obligations stated in Additional Protocol, we see that, Community immediately removed all the custom taxes and restrictions on Turkish industrial products (except cotton thread, knitted products with cotton, the carpets made from wool and thin animal hair and for purified petroleum products a quota emerged for 200.000 tone) and for some agricultural products, it gave some easiness for Turkish exports under certain quotas. Furthermore, in the respect of the Additional Protocol, it was foreseen that in 1986, the free movement of Turkish labors shall be realized.<sup>24</sup>

As it can be easily understood, the Additional Protocol shortly means that in 1995, the complete Customs Union shall be materialized and in 1.1.1995, it can be observed that for the products which were contained by 12 years list cumulatively %95 of the products, for the products which were contained by 22 years list %90 of the products, the custom duties reductions were realized. At the harmonization of Common Custom Tariff policy, in 12 years list %90, in 22 years list %85 harmonization was realized. The missed parts of the obligations were foreseen to be completed (i.e. %5 for 12 years products) till the end of 1995.<sup>25</sup> For the agricultural products, Turkey undermined that she shall approximate its agricultural policy to Common Agricultural Policy of the Union.

At that time, it was also decided that, Turkey shall also accept the relevant Customs Union dispositions of the European Community. However, as we stated before, the preference trade regime of the Union was not also practiced for Turkey in the respect of Additional Protocol, because Turkey was considered as a developed country<sup>26</sup>

The Additional Protocol brought significant advantages for Turkey's agricultural exports to the EEC. 92% of our agricultural exports in 1971 benefited

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<sup>24</sup> Soğuk, Handan- Uyanusta, Esra, **Gümrük Birliğinin'nin Türkiye Ekonomisine Etkileri**, İstanbul, İKV Yayınları, 2004, p.9.

<sup>25</sup> Manisalı, op.cit, p. 96.

<sup>26</sup> Manisalı, Ibid, p. 97.

from this regime. Despite other agricultural producers such as Greece, Portugal and Spain which latterly became as the Member States of the Union, and the EEC's conclusion of preferential trade agreements with certain Mediterranean countries, Turkey preserves its position even today.

Had the Additional Protocol been implemented in full, the free circulation of goods and services and the harmonization of Turkish legislation with that of the EEC in a multitude of areas would have been achieved at the end of the 22 year timetable.

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### 1.2.3. FINAL PERIOD

As stated in Ankara Treaty, after the conclusion of Transition Period, the final period would be started. In this period, the Customs Union was planned to be completed. After that, the policies for harmonization to be a member of the Union were foreseen to be realized.

On 24 January 1980, Turkey shifted its economic policy from an autarchic import-substitution model and opened its economy to the operation of market forces. Following this development in the economic area and the multiparty elections in 1983, the relations between Turkey and the Community, which had come to a virtual freeze following the military intervention of 12 September 1980 in Turkey, began to return to normality. In the light of these positive developments, Turkey applied for full membership in 1987, on the basis of the EEC Treaty's 237<sup>th</sup> Article, which gave any European country the right to do so. Turkey's request for accession, filed not under the relevant provisions of the Ankara Agreement, but those of the Treaty of Rome, underwent the normal procedures. The Council forwarded Turkey's application to the Commission for the preparation of an Opinion. The Commission's Opinion was completed on 18 December 1989 and endorsed by the Council on 5 February 1990. It basically underlined Turkey's eligibility for membership, yet deferred the in-depth analysis of Turkey's application until the emergence of a more

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<sup>27</sup> [http:// mfa.gov.tr/ab](http://mfa.gov.tr/ab), 2005.

favorable environment.<sup>28</sup> It also mentioned that Turkey's accession was prevented equally by the EC's own situation on the eve of the Single Market's completion which prevented the consideration of further enlargement. It went on to underpin the need for a comprehensive cooperation program aiming at facilitating the integration of the two sides and added that the Customs Union should be completed in 1995 as envisaged.<sup>29</sup>

However, in Luxembourg Summit, Turkey was not considered as a part of expansion policy of the EU. In Luxembourg Summit, it was accepted that the full membership negotiations with 10 Central and East European countries, Southern Cyprus and Malta would begin and the proceeding of these process were determined. After this approach of EU, Turkey decided to stop her political dialogue with the Union. However, in Cardiff Summit, Turkey was added to the candidate countries for which a Progress Report would be prepared. In Vienna Summit, nothing more than the ones for Turkey in Cardiff Summit emerged.<sup>30</sup>

In Helsinki, European Council held on 10-11 December 1999 and Turkey was officially recognized without any precondition as a candidate state on an equal footing with the other candidate states. Thus, Turkey, like the other candidates, became eligible to reap the benefits from a pre-accession strategy to stimulate and support its reforms.

However, in Nice Summit held in 7-9 December, 2000, Turkey was not added to enlargement perspective of the EU for the next 10 years.

The Council approved the Accession Partnership on 8 March 2001 and the Framework Regulation concerning EU's financial assistance to Turkey on 26 February 2001. The Accession Partnership document, the so-called road map for Turkey's accession, basically sets priority areas where Turkey is expected to further

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<sup>28</sup> [http:// dtm.gov.tr/ab](http://dtm.gov.tr/ab), 2005.

<sup>29</sup> Karluk, op.cit, p.550.

<sup>30</sup> Karluk Rıdvan-Tonus Özgür, **Avrupa Birliğinin Genişleme Perspektifinde Türkiye'nin Yeri**, 2004 İktisat Kongresi, p. 6.



its alignment to EU acquis and determines EU' s financial schemes that will support Turkey within the accession process. After the approval of the Commission's Accession Partnership for Turkey, the Turkish government announced its own National Program for the Adoption of the Acquis (NPAA) on 19 March 2001. With this document, Turkey heralds a new beginning in its efforts in various fields such as democratization, human rights and liberal economic policies, as well as common market policies.

Another important benchmark as regards Turkey's accession process has become the decisions taken at the Copenhagen European Council. Presidency Conclusions reads "if the European Council in December 2004, on the basis of a report and a recommendation from the Commission, decides that Turkey fulfils the Copenhagen Political Criteria, the European Union will open accession negotiations with Turkey without delay". Accordingly, Copenhagen Summit has initiated a new era during which both Turkey and the EU will need to take comprehensive measures as regards Turkey's accession to the EU.

The Union acknowledged the determination of the new Turkish government to take further steps on the path of reform and urges in particular the government to address swiftly all remaining shortcomings in the field of the political criteria, not only with regard to legislation but also in particular with regard to implementation. In the Presidency Conclusions, it is stated that the EC-Turkey Customs Union should be extended and deepened and the Union will significantly increase its pre-accession financial assistance for Turkey.

Although there haven't been expressed a certain time period for the opening up the accession negotiations with Turkey in the Presidency Conclusions, EU Head of States declared their willingness to initiate the negotiations in December 2004 provided Turkey fulfils the Copenhagen Criteria.

Following the conclusions of the Copenhagen European Council in December 2002, the Commission presented in March 2003 a report on

"Strengthening the Accession Strategy for Turkey". In this report, the Commission proposed a substantial increase in financial assistance for the period 2004-2006. Pre-accession financial assistance should reach € 250 million in 2004, € 300 million in 2005 and € 500 million in 2006. In line with the approach followed for all candidate countries, financial assistance will be linked to the priorities set out in the Accession Partnership. The communication also proposed enhanced co-operation in other areas, such as the political dialogue, the economic dialogue, justice and home affairs, maritime safety, the process of legislative scrutiny, extending the scope of the customs union, and deepening trade relations.

A revised Accession Partnership was adopted by the Council on 19 May 2003. A revised National Program for the Adoption of the Acquis was adopted on 24 July 2003. This document sets out how Turkey envisages dealing with the Accession Partnership, the timetable for implementing the Partnership's priorities, and implications in terms of human and financial resources. Both the Accession Partnership and the National Program for the Adoption of the Acquis are revised on a regular basis to take account of progress made and to allow for new priorities to be set.

In view of deepening the Customs Union, Turkey and the Commission are working on an action plan in order to achieve the complete free circulation of goods. As regards the extension of the Customs Union, work on the liberalization of services and public procurements has continued with a view to the resumption of negotiations.

On 5th November 2003, the Commission released its sixth Regular Report on Turkey's Progress towards Accession, together with its Strategy Paper that contains recommendations for the future.

In its 2003 Regular Report and Strategy Paper, the Commission has concluded that the majority of its expectations specified in the revised Accession Partnership have been fulfilled and that Turkey has shown great determination in this

direction. On the other hand, the Commission pinpoints to the shortcomings in the efficient and uniform implementation of the reforms.

In the conclusions of the Brussels European Council on 12 December 2003, the considerable and determined efforts of the Turkey to accelerate the pace of reforms (many of which are significant in political and legal terms) were welcomed. It is stated that the legislative packages adopted and the first important steps taken to ensure effective implementation have brought Turkey closer to the Union. The European Council underlines the importance of Turkey's expression of political will to settle the Cyprus problem.

When we look at the recent occasions, it can be seen that the hardest points for Turkey in the respect of full membership are political criteria. With 7 harmonization package, Turkey, according to her national program, realized most of her responsibilities.<sup>31</sup>

The European Council encourages Turkey to build on the substantial progress achieved so far in its preparations for launching accession negotiations and underlines its commitment to workings towards full implementation of the pre-accession strategy with Turkey, including the revised Accession Partnership, in view of the decision to be taken by the European Council in December 2004 on the basis of the report and recommendations of the Commission.

The Presidency of the EU would be held by Ireland from 1 January to 30 June 2004. Ireland will be followed by The Netherlands, who will hold the Presidency from 1 July to 31 December 2004. In the Program of the Irish Presidency, it is stated that they will support Turkey's efforts to fulfill the necessary criteria with

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<sup>31</sup> Karluk-Tonus, op.cit, p.13.

a view to the decision to be taken at the European Council in December 2004 on the opening of accession negotiations.<sup>32</sup>

As a result of the summit held in 17 December 2004 in Brussels, 3<sup>rd</sup> of October 2005 was determined as the beginning that of the negotiations. With that last improvement, the EU with 25 countries after the last expansionist movements decided that Turkey is ready to begin the negotiations for membership.<sup>33</sup>

In January 2005, Luxembourg takes over the Presidency of the Council of the European Union and recently UK got the Presidency of the Council of the Union.

After the brief explanation of the history of EU and EU-Turkey relations, the ground is ready to focus on main theme of the thesis, the Customs Union. Therefore, in the following part, the Customs Union concept, EU' s customs union application and Turkey' s position shall be examined.

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<sup>32</sup> [http// dtm.gov.tr/ab](http://dtm.gov.tr/ab), 2005.

<sup>33</sup> [http://www.cnnturk.com.tr/OZEL\\_DOSYALAR](http://www.cnnturk.com.tr/OZEL_DOSYALAR), 2005.

### 1.3. FINAL WAY TO THE UNION

As we know, from the very beginning of unification practices, to create “the European Union” has been the final target. By being mentioned in some reports (such as Davignon Report, Tindemanns Report, Gencher–Colombo Report), one of the most important point of the history of the EU is the direct election of the members of the European Parliament in 1976. With the preparation of White Paper in 1985 (aimed the foundation of internal market till 1992 ) and Schengen Treaty (which has made the free movement of citizens of member states and wanted relevant countries to apply an unique proceedings toward the citizens of third countries relevant countries), the European Union dream began to be a realistic thought.

However , the main differentiation made at the Treaties of ECSC, EEC and EURATOM were materialized by The European Single Act. The European Single Act is a very important judicial document which was emerged after the meeting of the Council of European Community in December 1985<sup>34</sup>. Meanwhile, by Single Act, in order to realize the free and efficient “common market” ( this concept has begun to be used first in Single Act ), the decision making system was changed and in stead of unanimity, in some fields a type of qualified majority system was formed and the completion of the common market till 1992 was accepted. The single market and SEA marked a turning point in European integration, the roots of which, however, stretch back well before 1985.<sup>35</sup> Furthermore, the collaboration at foreign affairs, economic and monetary issues, protection of nature and measurements for health, security, protection of consumers and harmonization of VAT were also mentioned in it. The role of the European Parliament was also expanded with the Single European Act.

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<sup>34</sup> Karluk, op.cit, p. 60.

<sup>35</sup> Wallece Helen- Wallece William, **Policy Making in the European Union**, The New European Series,Oxford, 1998, p.85.

In this period of time, “The European Political Collaboration”, which designed the mutual consultation between the Member States as an obligation and announced in London Declaration in 1981, was also became a different foundation with European Single Act with a presidency, politic committee and other organs .

The Community expanded southwards with the accession of Greece in 1981 and Spain and Portugal in 1986. These enlargements made it even more imperative to implement structural programs designed to reduce the disparities between the Twelve’s in terms of economic development. During this period, the Community began to play a more important role internationally, signing new agreements with the countries in the southern Mediterranean and countries in Africa, the Caribbean and the Pacific, which were linked to the Community by four successive Lomé Conventions (1975, 1979, 1984 and 1989).<sup>36</sup>

As a result of all these process, which were summarized above with their main points, relevant occasions prepared the suitable ground for Maastricht Treaty. In 1992, 7 February, Maastricht Treaty (Treaty of European Union) was signed and came into force in November of 1993. At this summit, the Union made some decisions which have accelerated the European Union process. In the respect of these decisions, the Union purposed to realize the single market till the end of 1992 by making some changes in the Treaty of Rome.

Then Maastricht Treaty established the European Union (EU)<sup>37</sup>. From the beginning of the unification of Europeans, the Communities have been the basis of the European Union, but with Maastricht Treaty, the structures of the Community was redesigned. The theory, called as “three columns theory” and determined in Maastricht Treaty, defines these new structures as: Communities, Common Foreign Policy and Security and Collaboration at Justice and Internal Affairs. Meanwhile, the

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<sup>36</sup> [http// abgs.gov.tr/ab](http://abgs.gov.tr/ab), 2005.

<sup>37</sup> Tekinalp, op.cit, p.15.

process of the monetary unification was openly stated in Maastricht Treaty. The Monetary Union was aimed to be realized till 1999 and it was done.<sup>38</sup>

On 1 January 1995, three further countries joined the European Union. Austria, Finland and Sweden expanded the Union with their specific characters and opened up further dimensions at the heart of central and northern Europe.<sup>39</sup>

However, it is thought that, the EU, founded by Maastricht Treaty, had an unsatisfactory formation in the respect of columns and framework. That's why, at the second article of Maastricht Treaty, a command asking the continuity of intergovernmental summits was actually stated. In any case, the expansion process of the Union which has been containing the membership of the countries from Central, South and east Europe has made this action something obligatory. On the other hand, enlarging immigration matter and problematic type of Schengen system has required some mandatory changes at the relevant column and needed extra regulations about visa and refugees at EU Treaty. The Treaty of Amsterdam, which realized these above expressed changes, was signed in 1997, 2 October<sup>40</sup> and at 1999, 2 October, the Treaty came into force

In the composition of Amsterdam Treaty, main two points at European Unification from the Treaty of Rome take attention. First, the conditions of the membership of the EU are mentioned clearly as a written expression (to match the conditions stated at European Human Rights Convention has become a condition to be a member). The second change is that, if the behavior of a member state continuously contrasts the principles of the Union, the voting rights of the relevant state at European Council can be propped up.

Nevertheless, in spite of all expressions above, Amsterdam Treaty did not make a lot changes on the previous Treaties, but only added some extra mechanisms

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<sup>38</sup> Dehousse, Renaud, **Europe After Maastricht ;An Ever Closer Union ?**, Law Books in Europe, 2000, p.22.

<sup>39</sup> [http:// abgs.gov.tr/ab](http://abgs.gov.tr/ab), 2005.

<sup>40</sup> Tekinalp, op.cit. p.25.

such as a “more strong collaboration”. The relevant measurements, which will make the Monetary Unification easier, and the consultation of foreign affairs were the main movements of Amsterdam Treaty. Rules of Rome and Maastricht Treaties were put at Amsterdam Treaty with a new code system and some new rules were added. Furthermore, the criteria which were accepted in Copenhagen Summit and so called as Copenhagen criteria, which were seen as mandatory conditions for the candidates and members, were became something like a law by Amsterdam Treaty. The role of European Parliament was also strengthened by this Treaty and the scope of the authority of European Court of Justice was enlarged.

After the approval of Amsterdam Treaty, European Commission declared Agenda 2000 report, which contains some perspectives of the Union in the respect of improvement in 21<sup>st</sup> century. The main four points can be explained as:

1. Expansionism ( this part of the report has some opinions about the countries such as The Czech Republic, Hungary, Poland, Slovenia ,Estonia ,Leetonia ,Lithuania, Romania, Bulgaria and Slovakia . Due to the report declared in 1993, Cyprus did not have any part at this report and Turkey was evaluated in a different perspective. Furthermore, an Accession Partnership for candidate countries was also stated by Commission. At this report, Turkey was not introduced as a candidate country during this expansionist period and it was stated that the relations between Turkey and EU should be developed in the respect of Customs Union.)
2. The reform at Common Agriculture Policy of EU ( This part mainly says that the first reform step at common agriculture policy made in 1992 should be improved and direct payment method must be applied to the farmers instead of price support method )
3. The changes at structural funds



#### 4. The financing of EU

As stated in Amsterdam Treaty, summits have begun to have a more important role in the formation of EU. Hereby, some important Summits should be mentioned. As an example, In Luxembourg summit, held at 12-13 December of 1997, the expansionism process of EU and economic and monetary issues were evaluated. After the report of Agenda 2000, it became much more clearer that the expansionism of EU will take a long time and so European Commission suggested that a meeting under the name of European Conference, at which the relevant countries shall be represented by their presidents or prime ministers, should be held. (In 1999 European Conference was realized in Brussels. Turkey rejected to join this conference, but was represented at the conference held in Nice in 2000, 23 November)

In February, 2001 the Nice Treaty, which amended the Treaty on European Union and the Treaties establishing the European Communities, was signed. In Nice summit the required ground for the enlargement policy of the EU for the relevant 12 candidate countries was put forward, but Turkey was not mentioned. Furthermore, in the decision making system of the EU, qualified majority system became more popular after the Nice Treaty (except the industry policy and the issues dealing with the taxation policy). The voting system, the number of parliaments and the vote allocation in the Council was also taken up again (the new qualified majority rate became %74.78 (258 votes))

In Helsinki Summit, held in 10-11 December ,2004, important decisions, in the respect of enlargement policy, was declared and the membership plans of 13 candidate countries was illustrated.

In 2004, recently, the Netherlands took over the Presidency of the Council of EU. In May, 2004 the Accession Treaty entered into force and the European Union's

biggest enlargement step was realized. In this respect 10 new countries – Cyprus ( Southern Cyprus ), the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia joined the European Union . The number of the Member States became 25.

In October, 29, 2004, the leaders of EU Countries signed the first constitutional law of the Union.

In December, 8, 2004 the negotiations for Membership with Romania was completed.

Recently, the agenda of the Union is the approval of the Constitutional Law of the Union. Depending on the elections held for approving the Constitutional Law of the Union, for example German public gave a positive answer. However, French and Dutch public's approaches have showed us that, hard days can be expected for the European Union.

The Members of the Union are Austria, Belgium, (Southern) Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, The Netherlands and United Kingdom.

On the other hand, the candidate countries can be expressed as Bulgaria, Croatia, Romania and Turkey.

## 2. EUROPEAN UNION AND THE CUSTOMS UNION

Custom Union is one of the essential elements of the European Union's single market. In the application of the Customs Union, the Member States abolish all the obstacles which impede the trade between each other and apply common tariffs and quotas towards to third countries.<sup>41</sup>

The economic developments, both in Turkey and in World, are so fast to observe. With the expansion of trade volume of the world and with the increase of competition, even the companies have tried to find new markets for themselves. Therefore, it is so clear that, the only way to have the success in this area with its circumstances is "to be successful at international fronts". During this international globalization process, it is clear that regional integration practices have been realizing at which the quantitative restrictions and other impediments against free trade are removed. In this regard, what we see as an economic integration formation among the European Countries is Customs Union and in general meaning European Union<sup>42</sup>

As, it shall be stated rapidly, the main objective of the European Community is to establish a Common Market which is built on a Customs Union and so Customs Union is one of the most important part of "Acquis Communautaire" which is divided into 35 parts and.<sup>43</sup>

It shall be expressed with details in next parts, but as a summary, the basic features of EU's Customs Union can be mentioned as follow:

- 1) The first main concept of the Customs Union in concern is the free movement of goods produced in Member States. Goods produced in one Member States should be able to move freely in all Member States without any payment of custom duties.

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<sup>41</sup> Kılıç Ramazan, **Türkiye-AB İlişkileri**, Ankara, Siyasal Kitapevi, 2002, p. 13.

<sup>42</sup> Uyar, Süleyman. "Ekonomik Bütünleşmeler ve Gümrük Birliği Teorisi", İstanbul, **İKV**, 2000 1-12.

<sup>43</sup> Dotto, Stefano, **Avrupa Birliği'nin Gümrük Birliği, Malların Serbest Dolaşımı, Ortak Dış Ticaret Politikaları ve Türkiye'nin Uyumunu**, İstanbul, İKV Yayınları, 2002, p. 9.

- 2) The second is the common customs duties. If goods produced in third countries are imported into any Member States, they are subject to the payment of the common customs duties.
- 3) The third is the free movement of goods from a third country. Once goods are imported into a Member State, they must be allowed to move freely in all other Member States without the payment of any further customs duties.<sup>44</sup>

However, before telling about the complex structure of the Customs Union in concern, it can be useful to explain “the Customs Union concept” in a large perspective and so in next part, the meaning of the Customs Union shall be examined.

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<sup>44</sup> Pitiyasak, Saravuth, **Legal Research Free Movement of Goods within EU**, Chulalongkorn University European Studies Program (CUESP), 2005, p.1.

## 2.1. THE CUSTOMS UNION CONCEPT

In the respect of the effects of globalization process, some countries have formed deeper integration types for themselves. Initially, these countries have become the members of international organizations aiming the liberalization of world trade like GATT and WTO. However depending on the articles, which permit the economic integrations of defined countries among themselves, the formations of local integrations have been emerged.

On the other hand, when we look at the meaning of integration, we see that; “Integration” means unification and so economic integration can be defined as; “the works to reduce the separation levels among the national economies.” Rıdvan Karluk defines the economic integrations as “by giving the liberty to the movements of goods and services and removing the restrictions which damage the free trade, to create a common market”.<sup>45</sup>

In this regards, it can be observed that, the economic integration movements among countries had begun in 1960s’ and have continued during 1970s’, 1980s’ and 1990s’. The examples for such integration movements, the members of which are the main developed countries, are as European Union (EU), The European Free Trade Association (EFTA), The North American Free Trade Area (NAFTA); and the examples of developing countries can also be stated as The Latin American Integration Association (LAIA), The Association of South-East Asian Nations (ASSEAN), The Black Sea Economic Cooperation (BSEC), The Asia Pacific Economic Cooperation (APEC).<sup>46</sup>

Therefore, it can be easily noticed that in different parts of West Europe, Africa, South America and Southeast Asia, different kinds of local economic integrations have emerged. The most common feature of the local economic integrations is that; these foundations generally contain the economic proceedings between at least two countries. In this respect these integration types are generally

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<sup>45</sup> Uyar, op.cit, p.1.

<sup>46</sup> Kılıç, op.cit. p. 6.

classified as free trade area, customs union and economic unity.<sup>47</sup> This classification will be explained with details at the next parts of thesis

However, in order to understand the philosophy of the free trade concept, it must be known that, principally, in international trade, it is generally accepted that, there are two main ways for the economic liberalization. These are “International Approach “and “Regional Approach “.

When we have a look at the basis of these two approaches, we recognized that “international approach” contains the formation of GATT (and its rounds such as Kennedy, Tokyo and Uruguay) and WTO. As it is known, the main aim of these international conferences is, by eliminating the tariffs, quotas and other measures having equivalent effect against trade, to extend the sufficiency of international trade. On the other hand, at regional (local) approach, the main aim is, by the economic unification of the certain numbers of countries, to liberalize the trade among themselves, but to continue the relevant commercial restrictions towards other countries. The European Economic Community and its Customs Union formation is a good example for such kind of foundation.<sup>48</sup>

Therefore, it should be considered that the subject of this thesis is placed on regional approach and in this approach when the Member States constitute an economic integration among themselves; they remove many kinds of commercial impediments.

Meanwhile, this integration can also be emerged in different ways. I mean, the relevant economic integration theory emphasizes the four different type of integration and these are:

- Free Trade Area

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<sup>47</sup> Kar, Muhsin-Günay, Enver, **Küreselleşme ve Bölgesel Ekonomik Bütünleşmeler**, In: Kar, Muhsin-Arıkan, Harun, Avrupa Birliği Ortak Politikaları ve Türkiye, (3-22), İstanbul, Beta Yayınevi, 2003.

<sup>48</sup> Kılıç, op.cit, p. 3.

- Customs Union
- Single Market
- Economic Union

To illustrate the basis of the Customs Union, below all of these kinds of economic integration models shall be explained briefly.

#### 2.1.1 FREE TRADE AREA

“Free Trade Area concept” is used when countries wish to bring their economies together, but not to integrate them or turn this integration into a single economy. In other words, the Member States eliminate all kinds of commercial impediments among themselves, but determine their commercial policy towards the non-member countries independently. (i.e. European Free Trade Association EFTA, European Economic Area EEA, North America Free Trade Agreement NAFTA ) The features of the Free Trade Area can be numerated as below:

1. Eliminate custom duties and restrictions to trade between the members,
2. Each member state of the free trade area protects its own custom tariffs and commercial policy in force towards third countries,
3. Rules are needed to determine which goods inside the area can move freely from one member state to another,
4. Custom procedures have to be kept for consignment crossing the internal borders to see if the rules are met.

Therefore, it can be shortly said that, if two or more countries found a Free Trade Area, the member states remove all the impediments against international trade, but there are no any obligations for a common tariff policy against third countries. Furthermore, the free movements of production factors are not in concern in the defined region.

In Free Trade Area, the effects such as trade diversion and trade creation, which will be latterly explained, can also be seen as the economic effects.

### 2.1.2. THE CUSTOMS UNION

The first example of the Customs Union is the Custom Union founded under the name of “Zollverein” in Germany in 19<sup>th</sup> century and also the Custom Union founded by Belgium, The Netherlands and Luxemburg in 1948 can be the other example.<sup>49</sup>

When we compare the Customs Union to Free Trade Area, we see that, the cooperation under the Customs Union goes deeper and aimed at economic integration with no internal border restriction. All members of a Custom Union apply a common customs tariff and commercial policy towards third countries’ goods, so no rules are needed to determine which goods inside the union move freely and no origin rules are needed and consequently no internal frontiers are needed for customs of external trade purposes

J.VINER, who is known as the founder of the Customs Union theory and studied on this issue in 1950s’, put some conditions forward for the creation of customs union in his article (The Customs Union Issue) with its all sides and continued his ideas with another article the name of which was the Theory of Customs Union. Before J.Viner, Adam Smith, Samuelson and D.Ricardo also stated

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<sup>49</sup> Kılıç, op.cit, p.15.



the importance of free trade. However, normally the process of the improvement of the Customs Union theory is usually started with J.Viner. In this respect, to be informed about his ideas about the relevant issue can be useful.

J.Viner expressed briefly these conditions for the formation of the Customs Union:

- i. The tariffs among the member states are removed,
- ii. At the import proceedings from the non-member countries, a common custom tariff policy is applied,
- iii. The revenues, earned from the custom proceedings, are shared in the respect of certain conditions which are formerly determined.<sup>50</sup>

J.Viner prepared a good beginning for the Customs Union idea and his opinions are mainly depended on production analyzes.

Meade, with his theory depended on consumption, Vanek and Kemp with their theory depended on the effects of Customs Union on the trade levels and Chacholiades with his opinions about the relevant area, theoretical process of the Customs Union has been completed.<sup>51</sup>

As a result of these philosophical sources, when we have a look at the effects of Customs Union from the theoretical perspective, which may make the understanding the EU-Turkey relation easier, it is noticed that, the relevant effects of Customs Union are divided into two parts. Mainly, “the dynamic” and the “static” effects of the Customs Union shall be evaluated separately. In this parallel, it can be useful to mention these divisions briefly:

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<sup>50</sup> Kılıç, op.cit, p.13.

<sup>51</sup> Kılıç, Ibid, p.14.

### 2.1.2.1. STATIC EFFECTS OF THE CUSTOMS UNION

When the countries form an economic integration under the name of customs union, it shall change the nominal prices and so these changes shall effect the consumption, production and the structure and the trend of the trade. After the unification, under the assumption of the stability of technology and structure of the economy, the effects which are emerged due to the re-distribution of the production factors are named as static effects. In other words, under the assumption of stability of factors' structure, level of technology and type of demand, the effects of customs union which are caused by the re-distribution of the sources is defined as static effects.<sup>52</sup>

The static effects of the Customs Union is classified as “The production effects of the Customs Union”, “the consumption effects of the Customs Union” and “the effects of Customs Union to trade levels”

#### 2.1.2.1.1. Production Effects of the Customs Union

It is theoretically assumed that, the emergence of the Customs Union affects the production types of the counties in concern

However, the production effects of the Customs Union are also divided into two parts. These are Trade Creation Effects (Positive Production Effect) and Trade Diversion Effect (Negative production Effect). However, to examine these divisions, some simple hypothesis must be known. These are;

- a) The existence of the rules of fair competition,
- b) The production is realized with fixed costs,

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<sup>52</sup> Uyar, op.cit, p.5.

- c) The existence of unique commodity,
- d) No cost for transportation cost,
- e) The custom taxes must be “ad valorem<sup>53</sup>”.

In this regard, the details of the effects of the Customs Union can be mentioned as follow:

i. Positive Production Effects (Trade Creation)

Under this assumption, it is accepted that, production is carried from a non-member country, where the production costs are higher, to a member country, where the production costs are lower. This effect is realized, because member states removed the custom barriers against each other and so the countries where the costs are lower export the relevant commodities to the other countries. With this method of trade not only the production costs reduce, but also the new trade possibilities are created.

ii. Negative Production Effects (Trade Diversion)

A country, which becomes the member of the union, can formerly import a certain type of product from a third country which is not the member of the relevant union and where the cost of the relevant product is lower, however, after joining the union, in the respect of the rules of that union, this trade for the certain type of product turns to the member state country where the cost of that is higher from the non-member country and it causes the trade diversion.

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<sup>53</sup> AD VALOREM TAX : A tax on goods or property expressed as a percentage of the sales price or assessed value.

As a result, the difference between the trade creation effects and the trade diversion effects shows us the net prosperity effects of Customs Union. Therefore, we can say that, if the trade creation effects of a Customs Union are relatively bigger than the trade diversion effects of the Custom Union; the production effects of this union is positive and this customs union increases the production power of the union and also it effects the prosperity of the world in positive way <sup>54</sup>

#### 2.1.2.1.2. Consumption Effects of the Customs Union

Just like Production Effects of the Customs Union, it is again theoretically assumed that, the emergence of the Customs Union affects the consumption types of the counties in concern

The effects of the Consumption Effects of the Customs Union are also classified like Production Effects of the Customs Union.

##### i. Positive Consumption Effects

This mainly depends on the creation of a new trade. If a country is producing a certain product by herself before joining the union, but after becoming the member of the union due to the removal of the custom barriers, if she imports the same product from the other member state of the union because of the lower price level, the consumption effect is positive. Since with all these incidents, as a result, the price of the relevant product reduces and so the consumption of it increases

##### ii. Negative Consumption Effects:

This emerges, if the trade diversion occurs in the relevant customs union. If a country is importing a certain product from a non-member state where the costs and so the prices are lower, but after becoming the member of the union due to the

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<sup>54</sup> Kılıç, op.cit, p. 30.

certain trade rules, if she imports it from a member state where the costs and so the prices are higher, the unit price and the consumption of the relevant product reduces.

#### 2.1.2.1.3. The Effects to Trade Levels

The formation and extension of the Customs Union also affect the trend and the volume of the traders. The levels of the trade shall create important effects on the union's (in complete meaning), member states' ( one by one ) and non-member states' by regulating the distribution of income. The effects of the Customs Union can be classified as follow:

- It increases the productivity in the Union,
- It increases the bargaining power of the Member States,
- It increases the volume of the economy,
- It changes the commercial trends to Union from the non-Member States.<sup>55</sup>

#### 2.1.2.2. DYNAMIC EFFECTS OF THE CUSTOMS UNION

There are also some dynamic effects of the Customs Union which plays an important role to illustrate the effects of the Customs Union clearly.

The economic union movements cause deep changes on the production capacity and the source productivity of the Member States. These are the dynamics effects which have formed time by time and arise from the subjects like the supply of sources, the organization of the production and technology. After the foundation of the Unions, all these effects cause deeper results and cause increases at the level of

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<sup>55</sup> Uyar, op.cit, p.7.

prosperity of non-member states, unions and world economy. These effects are named as the dynamic effects of the Customs Union.<sup>56</sup>

It is mainly accepted that customs union has advantages and disadvantages under the assumption of dynamic effects of the customs union. It increases the companies' structure by effecting the competition, infrastructure, foreign trade and integration and avoids the monopolistic formations. However, the disadvantages of the customs union are also real that; it effects the efficient distribution of sources; it can cause the oligopolistic formations, can cause bureaucratic impediments and can increase the administrative costs.<sup>57</sup>

Now, after this classification of the effects of the CU the aim of which is to explain the Customs Union concept better, the explanation of other types of economic unions can be continued. In this regard, the Single Market takes the first turn.

### 2.1.3. SINGLE MARKET

The Single Market is just like customs union, but additionally under this concept the capital, labor and enterprises move freely in the determined region.

When two or more countries found a single market, as an addition to customs union, free movement of production factors such as labor, capital and enterprise are also realized. Therefore, all trade barriers are removed and also common custom tariffs are applied towards non-member states. In other words, single market contains the Free Trade Area and Customs Union, but as I stated above, with free movements of production factors and application of common custom tariffs, it differs from them.

The example of Single Market is emerged at European Union by the application of Single European Act in 1987.

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<sup>56</sup> Uyar, op.cit, p. 8.

<sup>57</sup> Kılıç, op.cit, p. 35.

#### 2.1.4. ECONOMIC UNION

The Economic Union contains all features of the Single Market, but by a common Central Bank, single money and special tax system and also by a common foreign trade policy, the relevant countries create a unity. In such a unification model, goods and production factors move freely and so common social and economic policies are emerged.<sup>58</sup>

When two or more countries found an economic union, as I stated above, as an addition to single market, common economic, fiscal and monetary policies emerge. It is the final and the most complete type of economic unification.<sup>59</sup>

The example of such an economic union is being experienced, nowadays, in the European Union, but also the type of USA is also the other example for Economic Union.

After this brief introduction of the liberalization of trade in the world and commercial unification steps, from its beginning, the Customs Union formation in EU can be evaluated.

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<sup>58</sup> Kılıç, op.cit, p.5.

<sup>59</sup> Kılıç, Ibid, p.15.

## 2.2. A BRIEF HISTORY OF THE CUSTOMS UNION IN THE EUROPEAN UNION

As we know in 1958, when the first six Member States created a Community, which will be later named as European Union, one of the targets was to create a tariff union so as to be able to abolish all custom duties on trade between Member States.

Depending on the Treaty of Rome, it was foreseen that the free movement of goods will be supplied in 1.1.1970, at the end of transition period. However, the Customs Union between the Member States was realized one and half years ago than the planned date.

In 1968, the two required points for forming the Customs Union were realized. In such a way that, depending on the decision in 26.07.1966, except the agricultural products, among the Member States, all the taxes in export and import proceedings were abolished and with the Council regulations in 1968, which was renewed afterwards, they accepted to apply common custom tariffs.<sup>60</sup> Therefore, all custom duties and restrictions among the six founding Member States of the Community were eliminated and common customs tariff application (an abolition of internal and external tariffs) became a chance to the economies of the Member States.

At that time, the goods moving freely were, as it experienced later, the Community originated goods and the third country originated goods which are cleared through the customs of the Member States. What we understood from this structure was that, the free movement was supplied by the abolishment of the custom duties and quantitative restrictions.

However, the experience of the first twenty–seven years of the EEC had not been very encouraging. In spite of the efforts made by the Commission and ECJ, the

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<sup>60</sup> Tekinalp, op.cit, p. 312.



role of the Community had been effectively limited to slow, due to the rearguard actions against the spreading of different technical regulations and standards in individual member states. Their proliferation reflected growing public concern for the protection of consumers and the environment; but they were also an instrument of external protection in times of recession and growing unemployment. On the other hand, the process of harmonization at the EC level had proved to be both in efficient and ineffective. Its snail's pace compared unfavorably with the speed with which national authorities introduced new laws and regulations.<sup>61</sup>

However, the basic principles of the Customs Union were applied regularly. In this regard, Custom legislation, beyond that essential to a tariff union, was progressively created in order to ensure that wherever goods were imported into the Community, they were not only subject to the same tariff rules but also to the same custom provisions to ensure that the tariff was applied in the same way everywhere. Common origin rules, warehousing procedures and all the other instruments were hammered out. One of the most important movements was the Single Administrative Document (SAD). In 1988 a major step was taken for the simplification of custom procedures. The SAD was established as a declaration from which replaced 150 separate documents previously used by the customs administrations in the Member States.

Through the single market, entered into force in 1993, the four freedoms have become more significant (free movement of goods, persons, services and capital in a frontier free internal market). This single market 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.

In 1994, the custom code consolidated all of the Community custom legislation into a single text and set up a framework for the Community's import and export procedures. The underlying principle was that the procedures should avoid the

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<sup>61</sup> Tsoukalis Loukas, **The New European Economy Revisited**, Oxford Publishing, 1999, p.65.

interruption of trade flows by establishing the right balance between the freedom of trade and the responsibility of traders on the one side and the necessity of control on the other side.<sup>62</sup>

As it is easily seen by the above mentioned historical process of the Customs Union, from the beginning point of its formation, the main aim was to liberalize the trade between the Member States.

On the other hand, when we look at the official foundations of the Union in this regard, we see different approaches. For example, European Court of Justice located in La Haye defines the Customs Union as follow:

“Customs Union is a type of economic integration where one tariff’s application at all member states and done customs barrier’s application towards all non-member states, removing all custom taxes applied on the trade realized in the Union by the Member States, the sharing the revenues obtained from the goods purchased from non-member states among the members”<sup>63</sup>

Furthermore, Treaty of Rome, which has been seen as the basic Treaty of the Union, mentions the Customs Union apparently. The 9<sup>th</sup> article of Treaty of Rome says that:

“The Community shall be based upon a Customs Union which shall cover all trade in goods and which shall involve the prohibition between Member States of custom duties on imports and exports and of all charges having equivalent effect, and the adoption of a common custom tariff in their relations with third countries.”

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<sup>62</sup> Tekinalp, op.cit, p.314.

<sup>63</sup> Uyar, op.cit, p. 6.

It can be easily noticed that, in the article 9 of the Treaty of Rome, the Customs Union of the EU, containing all the commercial commodities, bases mainly three main points:

1. The abolition of custom duties, charges having equivalent effect and any kinds of payment during the trade between the Member States,
2. The acceptance of a common custom tariff application towards third countries,
3. In the respect of Article 95, the member states mustn't put real taxes between each other.<sup>64</sup>

What we understand from the above mentioned numbers can be also explained in the respect of the Articles of Treaty of Rome.

Generally, in the Treaty of Rome, abolishment of the custom duties and charges having equivalent effects are mentioned between the articles 12-17 and now 12<sup>th</sup> Article is still in valid. 12<sup>th</sup> Article prohibits the new custom duties and charges having equivalent effect on the export and import activities. According to these articles, all the custom duties and charges having equivalent effect would be abolished step by step in 12 years period. Meanwhile, in this period of time, the Member States would not create new custom taxes and would not increase the existing taxes. After the transition period, all the authority for putting new custom taxes transferred to EU authority, but this time countries began to apply charges having equivalent effect and quantitative restrictions (The placement common custom tariffs are placed between 18-29, the abolishment of the quantitative restriction is stated between 30-37.<sup>65</sup>)

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<sup>64</sup> Bozkurt, Enver, **Avrupa Birliđi Hukuku** ,İstanbul, Nobel Yayınevi, 2000, p. 144.

<sup>65</sup> Kılıç Ramazan, op.cit p. 249.

As we can comprehend from the above stated points, Customs Union is an important part of the common commercial policy of the Union. In this regard, through some kinds of special instruments, there are some rules regulating the trade under the practice of the Customs Union. These rules are classified as the rules for imports and the rules for exports and also one of the other significant points of the Customs Union is the practice of Common Custom Tariffs. (I mean, for example, one of the relevant instruments, which have been created by the Commission and Council, is Common Custom Tariff application of the Union. The other instruments can be expressed as generalized system of preference and other practices. All of these instruments form the Integrated Tariff of the European Communities<sup>66</sup>)

When we look at these concepts in turns, significant points are emerged for the understanding of the Customs Union. In this regard, the relevant terms can be explained as follow:

#### 1) Common Custom Tariff Policy

Custom tariff, which has some rules that must be applied during the trade with third countries, is a quite important point for the Customs Union and the trade between the Member States. It can be also defined as “the unique tariff applied for the products imported from the third countries”. It became in force in 1.07.1968 with 950/68 numbered Directive. However, the 18-29<sup>th</sup> Articles of the Treaty of Rome are about CCT and also 113. Article of the relevant Treaty gives a right to the organs of the Union for making required differences on the levels of the tariffs. The significant feature of CCT is that; it is applied to third countries commonly by the Member States. EU applies this instruments differently to the different countries (i.e. to the Members of WTO, most favored nation rule is being applied)

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<sup>66</sup> Taş Seyhan, **Avrupa Birliği Ortak Ticaret Politikası**.In Kar Muhsin, Arıkan Harun,.Avrupa Birliği Ortak Politikaları ve Türkiye, İstanbul, Beta Yayınevi, 2003, p.141.

In *Diamantarbeider* decision<sup>67</sup> ECJ stated that, if the Member States individually apply custom duties or charges having equivalent effect to the goods imported from third countries, the single implementation of the CCT would be damaged and so in order to avoid such problems, for the imports from third countries, CCT was decided to be applied and the Member States transferred their rights on this issue to the organs of EU. However there is one exemption on this issue that depending on the 115<sup>th</sup> Article of the EC Treaty, if any Members feel the economic difficulty, by Commission approval, this country can hinder the entrance of the goods imported from third countries to the relevant Member State<sup>68</sup>

In CCT policy of the Union, the customs taxes are divided into two parts as autonomous and conventional taxes. Autonomous taxes show the official levels of the taxes, but the conventional taxes shows the taxes with compromise which have been determined under the rules of GATT. These kinds of taxes (conventional ones) are unchangeable and so changes on the relevant taxes made through autonomous taxes.

In the respect of the tax levels, it has been seen that, the levels of CCT are quite lower than the ones applied in the World. For example, in 1988 the arithmetic average of the relevant taxes was %7.3, but from 1.07.1995, it increased to %9.6, but for industrial products, it reduced to the levels of %6. However for the sectors such as textile, shoe and paper products, for some motorized vehicles, televisions and radios, it was still %10 etc.<sup>69</sup>

On the other hand, in the application of CCT, exceptions have played a quite important role. For example, if a third country, without any exception, increases the custom taxes; the Union has the right of increasing the tariff levels as a protective measurement.

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<sup>67</sup> Case Number:37/38/73

<sup>68</sup> Bozkurt Enver , op.cit, p.149.

<sup>69</sup> Taş, op.cit, p.142.

When we look at the 113<sup>th</sup> Article of the relevant Treaty, we may easily recognize the above mentioned points under the Treaty of Rome interpretation. The relevant Article is as follow:

Article 113:

1. The common commercial policy shall be based on uniform principles, particularly in regard to changes in tariff rates, the conclusion of tariff and trade agreements and the achievement of uniformity in measures of liberalization, export policy and measures to protect trade such as those to be taken in case of dumping or subsidies.
2. The Commission shall submit proposals to the Council for implementing the common commercial policy.
3. Where agreements with one or more States or international organizations need to be negotiated, the Commission shall make recommendations to the Council, which shall authorize the Commission to open the necessary negotiations.

The Commission shall conduct these negotiations in consultation with a special committee appointed by the Council to assist the Commission in this task and within the framework of such directives as the Council may issue to it.

The relevant provisions of Article 228 shall apply.

4. In exercising the powers conferred upon it by this Article, the Council shall act by a qualified majority.

Another point which gives the right of applying exceptions to Union is the tariff subventions. These exceptions are applied for the sake of member states for the required raw materials and so on.

## 2) Preferential Trade Regimes

GSP, which was created by UNCTAD, is a tool that enables the developing countries' entrance to developed countries' market. This practice is autonomous and applied unilaterally.

The beginning point for calculating the relevant compromise is "most favored nation" principle. By beginning from this point, the reductions at the custom taxes for the selected products are calculated. By considering the EU's market conditions, the products are divided into four parts which begins from the most sensitive product. This principle is also known as "Preference Modulation".

In this system, for specific countries, in order to support the production process and economic developments, special measurements are taken. For the least developed countries, all custom taxes and quotas are removed for all products except the arms. This application is also defined as "everything but arms" principle.

However, if the producer in the Union faces to a serious problem due to GSP application, protection principle is brought into application and the relevant compromises are propped up. The system is executed by a special committee under the name of GSP Committee.<sup>70</sup>

This system is practiced by GSP Committee which is formed by EU Commission under her structure<sup>71</sup>

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<sup>70</sup> Dotto, op.cit, p. 34.

<sup>71</sup> Dotto, Ibid, p. 35.

### 3) The Regulations for Imports

The regulations for imports are also seen as important tools of the Customs Union. The relevant regulations are also divided into parts as follow:

i. Observation and Protection Measurements: These types of measurements are observed mainly in the different plants of textile sectors. European Union, at the beginning phase of its unification steps, initially tried to finish some measurements which were applied by the Member States to the sensitive sectors and after finishing this process, it got the right of applying these restrictions to them. These kinds of restrictions were continued till 1994

ii. The Common Rules for the Contribution of Quotas: The 520/94 numbered Directive of the European Council determines the principles of the contribution of probable restrictions applicable to imports and exports. In this regard, if it is required, the demanded restriction on the imports and exports initially defined in the Union and will be contributed to the exporters and importers of the Union in the respect of certain principles.

iii. Anti-Dumping Measurements: In the parallel of the WTO decisions, the type of the anti-dumping measurements was renewed in 1994. The aim of this renovation was to avoid the probable practice of the anti-dumping measurements as an impediment to trade as a measures having equivalent effect. The essence of this practice is to define the measurements against a product from a third country which can damage the markets of the Union due to its export with dumping price.

iv. Anti-Subventions Measurements: Treaty of Rome principally forbids the unfair aids and supports and expresses the exceptions in 92<sup>nd</sup> Article. When we look at the relevant article, we see the following points:

Article 92.



1) Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

2) The following shall be compatible with the common market:

(a) 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;

(b) aid to make good the damage caused by natural disasters or other exceptional occurrences;

(c) 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.

3) The following may be considered to be compatible with the common market:

(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;

(b) 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;

(c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect

trading conditions to an extent contrary to the common interest. However, the aids granted to shipbuilding as of 1 January 1957 shall, in so far as they serve only to compensate for the absence of customs protection, be progressively reduced under the same conditions as apply to the elimination of customs duties, subject to the provisions of this Treaty concerning common commercial policy towards third countries;

- (d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;
- (e) such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.

2026/97/EC Directive also says that for specific kinds of subventions, the Union has the right of taking offsetting measurements.

v. The Measurements for Protecting the Commercial Rights of the Union against Unfair Commercial Practices: With 2641/84 numbered Directive of the Council, it was decided that against unfair commercial practices of the third countries, in order to compensate probable losses, the Union has the right of create counter applications for protecting the Community's rights. However, after Uruguay Round of WTO, this Directive was changed by 3286/94 numbered directive and determined the relevant measurements as ; to take back the commercial privileges, to increase the existing tariff levels, to take other measurements which can effect and/ or change the quantitative restrictions and the imports and export conditions.

vi. Other measurements can be expressed as the measurements that were taken against Libya and Iraq

#### 4) The Regulations for Exports

According to the export policy of the European Union in the parallel of Customs Union, we initially see that, direct state aids and support are forbidden. (It means, a state can not support the export by direct monetary aids, but this type of help can only be realized by export credits or such kinds of aids.) Furthermore, if the scarcity of a product is observed in the Union, the export of the relevant item can be restricted and also in order to protect the cultural heritage or the human and common health and as a result for the petroleum products and raw petrol certain impediments for restricting the export can be created.

The export incentives are still organized by the national rules by the states, but for the official export support credits a common rule in the respect of OECD application is accepted. In this regard, it is decided that the credits, which can damage the fair competition shall be prevented and also the credits shall be keep at a certain degree and information flows and collaboration among the Member States should be materialized.

A common export control system for exports for military aims was also formed and became in force in 1995.

As a result of above mentioned items, it should be considered that to set up, develop and run a single common market, where goods freely circulate everywhere, Customs Union where common rules exist at its external borders is the unique way. A Customs Union is a secure basis for highly developed integration. Without the Community's Custom Union, the European Union's common commercial and

development policy, its common agricultural market and an effective coordination of economic and monetary policies would not be possible<sup>72</sup>

After this brief introduction of the type of the Customs Union in EU, the relations between Turkey and EU in the respect of the Customs Union can be examined, now. The other details of the Customs Union of EU shall be also seen under the Turkish application.

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<sup>72</sup> <http://europa.eu.int/the custom policy of EU, 2005>.

### 3. THE EUROPEAN UNION AND TURKISH CUSTOMS UNION

The Turkey –EU association relations, that guided Turkey’s foreign economic and commercial relations, were culminated with the establishment of the Customs Union. The Completion of the Customs Union is the most important development effecting Turkish economy since the adoption of liberalization <sup>73</sup>

Turkish –EU Customs Union relation constitutes an advanced form of integration with its far-reaching perspective and comprehensive context covering a wide range of policies. The Customs Union with the EU is the most comprehensive element that contributes to strengthening Turkey’s expanding role as a business partner <sup>74</sup>

As far as the implementation procedures are concerned, the CU decision supplements the partnership’s existing “legal framework”. In addition to classical components of a custom union, i.e. tariff reductions and harmonization with the Common Custom Tariff, the Decision also contains other principles and arrangements, which aim at developing the partnership beyond the envisaged fields, parallel to the broad and dynamic evolution of the EU itself. <sup>75</sup>

When we look at the relevant issue from a larger perspective, we see that, the EU Member States and Turkey are also the members of the WTO the target of which is to liberalize the world trade and this reality has also guided Turkey’s approach. In this regard, the Customs Union is also containing some responsibilities for both sides. These responsibilities are classified as the ones for bilateral relations and the ones for the other parts of the world. It means that for bilateral commercial relations, the impediments damaging the free trade shall be removed, and also some policies

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<sup>73</sup> <http://europa.eu.int/> Turkey-EU Customs Union, 2005.

<sup>74</sup> <http://europa.eu.int/> Turkey-EU Customs Union, 2005.

<sup>75</sup> Bayar, Ali, **The Effects of the Customs Union on Turkish Economy, An Econometric Analysis of the Four Years'**, İstanbul, İKV, 2000, p.1.

shall be harmonized. However, for the other parts of the world, both sides must apply a common policy. Especially for imports, same regime must be applied, or, trade diversions can be seen.<sup>76</sup>

After this small introduction of the Customs Union, we can have a better look at the historical sources of the Customs Union in the respect of Turkey's experience.

As mentioned before, an agreement establishing an Association between the European Economic Community and Turkey was signed in Ankara on September 12, 1963. The establishment of a customs union between Turkey and EC was agreed in 1963 and constituted the third phase of the Association Agreement.

Association agreement has been characterized as “an association prior to accession “as well as” an association for purposes of development”. According to the Ankara Agreement association shall comprise three stages. These stages were mentioned at previous parts of the thesis, but this time these stages will be examined with the Customs Union perspective:

- Preparatory Stage: As stated before, with the entry into force of the Association Agreement in December 1964, after being ratified by the parliaments of all of the Member States and that of Turkey, the preparatory stage commenced. During this period, the Community introduced some trade advantages for Turkish exports to the European Community together with a Financial Protocol “desiring to promote the accelerated development of the Turkish economy in furtherance of the objectives of the arrangement of Association”.

During the preparatory stage, Turkey did not assume any obligations towards the EC. It was a phase during which Turkey was to strengthen his economy with the assistance of the Community, to carry out the obligations that he would assume in the following stages.

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<sup>76</sup> Dotto, op.cit, p.12.

- Transitional Stage: The operation of the Ankara Agreement during the first four years of the preparatory stages was considered successful and it was also felt that the passage to the transitional stage would provide the Turkish economy with a new framework which stimulates economic activity during this period. On November 23, 1970 the additional protocol was signed and annexed to the Agreement Establishing an Association between the European Community and Turkey.

As it will be seen below, the Additional protocol was intended to regulate the conditions, detailed rules and timetables for implementing the transitional stage.

- Final Stage: On January 1, 1966, the Customs Union between the European Community and Turkey came into effect and final stage which was planned to be ended by full membership.

As we know, on 1.1. 1996 the Customs Union between European Community and Turkey came into effect. The relations in the respect of the Customs Union are generally determined by Ankara Agreement and additional protocol, but mainly defined by 1/95 numbered decision. Being so different from Free Trade Models, Turkish-EU Customs Union mainly depends on the free movement of goods and so foresees the harmonization of rules and practices on the special areas which can affect the trade.<sup>77</sup>

This paper (1/95 numbered decision) gave unilateral responsibilities to Turkey. Despite Turkey was not the member of EU, it has undertaken some obligations unilaterally<sup>78</sup>

As it will be explained below, the Customs Union implies fundamental changes in the Turkish trade and competition legislation and policies, and creates

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<sup>77</sup> Dotto, op.cit, p. 58.

<sup>78</sup> Manisali, op.cit, p.32.

new opportunities and challenges for the Turkish economy. The decision of Turkey-EU Association Council to establish a Customs Union between Turkey and the EU was the most important development affecting the Turkish economy as a whole, since the liberalization measures in the 1980s.<sup>79</sup>

With the completion of the Customs Union, Turkey also accepted the required adaptation to the relevant parts of acquire communautaire. These parts can be expresses as follow:

- 1) The parts about the free movement of goods
- 2) The parts about the competition
- 3) The parts about Intellectual Property Right

In setting the objective of a customs union, both Turkey and the Community were much influenced by the success of the Custom Union then being realized between the six members of the Community. Both Turkey and the Community looked for similar benefits from the establishment of a customs union between themselves. If the final aim 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. Free movement of goods was established by the Customs Union. The Additional Protocol contained a number of detailed provisions for the implementation of the free movement of workers, service and capital in accordance with the Association Agreement.<sup>80</sup>

The relevant Customs Union between Turkey and EU contains the industrial products and processed agricultural products and removes custom duties at imports

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<sup>79</sup> Bayar, op.cit, p. 2.

<sup>80</sup> Kabaalioglu ,Haluk , The Customs Union: A Final Step Before Turkey's Accession to the European Union , **Marmara Journal of European Studies**, 1998, p.115.



and exports, measures having equivalent effect and quantitative restrictions and forbids the new designs of above mentioned trade impediments.

However, it can be seen that, the Customs Union between EU and Turkey is a little bit different, because both sides are applying the same Common Custom Tariffs, but they are not sharing the revenue. The commercial protection policy is common. (As we know European Commission is responsible for the anti-dumping practices and also it observes the competition policies of the Member States and so there is no supra-national authority for controlling this kinds of issues especially for Turkey). Furthermore, the commercial protection instruments can be applied between the two sides. As we see, Turkey has already undertaken the Common Commercial Policy under these meanings, however there is no common commercial representation in the respect of Customs Union. The Members of the Union have a common commercial policy and are moving together during the meetings with third countries. In Turkey-EU Customs Union, Turkey is making use of commercial liberalization which has been created by EU and tariff reductions which are given by third countries. Furthermore, Turkey is also participating the negotiations the Treaties for EU's commercial policies and bilateral agreements with third countries, European Commission is supporting Turkey in those areas.<sup>81</sup>

On the other hand, 1/95 numbered Council Decision states that, to remove the non-tariff barriers, Turkey must undertake the Community's technique regulations in 5 years period and so avoids the destruction of the trade by technique impediments. I mean, with the entry into force of CU, Turkey has eliminated all custom duties and charges having equivalent effect, as well as quantitative restrictions applied on imports of industrial products from the Community. For products imported into Turkey from third countries, Turkey started to apply the rates of protection specified in the common external tariff, except for those products classified as sensitive. Custom duties on sensitive products will be gradually eliminated over a period of 5 years.<sup>82</sup>

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<sup>81</sup> Dotto, op.cit, p.13.

<sup>82</sup> Bayar, op.cit, p.2.

To create a full integration between the Turkish and Community's markets, it has been seen that not only at commercial policy area, but also at other fields of common policies, the integration works must be created. In this regard, 1/95 numbered Customs Union decision expresses that the Competition Policy (including state aids and state monopolies) and the intellectual property rights have also big importance for the integration.

The Association Agreement (Ankara Agreement) outlined that "in order to attain the objectives set out a customs union shall be progressively established".

The 2<sup>nd</sup> Article of the relevant agreement states that "the aim of the agreement is to promote the continues 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 people ."

In this regard, it is expressed that:

- Turkey eliminated all custom duties and charges having equivalent effect applied to imports of industrial products from the EU,
- Turkey started to apply the Community's Custom Tariffs for imports from third countries,
- Turkey and the EU established a system for processed agricultural products, in which parties differentiate between the agricultural and industrial components of the duties applicable to those products and abolished the duties for the industrial components.

Whilst the commitment to establish a customs union was provided in Association Agreement, it was the Additional Protocol of 1970 which specifies the program for bringing into being. The 1970 program contains timetables for removing barriers on trade between the partners and the timetables whereby Turkey would adopt the EC's Common Custom Tariff on its trade with third countries.

It can be said that the responsibilities of sides in the respect of Customs Union were defined by Additional Protocol and EU, except some exceptions, realized her responsibilities in 1971 (2 years before the additional protocol). However, for Turkish responsibilities, as transition periods, 12 and 22 years periods were suggested for different kinds of products.

Article 9 of the Additional Protocol provided that, from the beginning date of this protocol, the Community would abolish custom duties and charges having equivalent effect on Turkish industrial exports to EC<sup>83</sup>

Furthermore by 24<sup>th</sup> Article, all the quantitative restrictions were abolished for the industrial imports into the Community from Turkey

With the Interim Agreement, entered into force in 1971, 1 September, the abolition all tariff restrictions on Turkish industrial exports to Community took effect immediately and through this activity, the Community did its responsibility to achieving a customs union for industrial products in one step at the beginning of the transition period.

By the means of the Customs Union, Turkey and the EC had to abolish the tariffs and quantitative restrictions at their bilateral trade and begin to apply the common tariff on imports from third countries. With Additional Protocol Turkey and the EC accepted that no more obstacles such as tariffs, quotas, quantitative restrictions will be implemented.

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<sup>83</sup> Kabaalioglu Haluk, op.cit, p.115.

Additional protocol is a kind of time table for Turkey to abolish the existing Turkish tariff on industrial imports from the EC. Articles 10 and 11 established two different lists of goods. For industrial sectors in which Turkey was more competitive, tariffs were to be eliminated over a period of twelve years. For other goods, the tariff reductions were to be spread over twenty two years. Furthermore, charges having equivalent effect to custom duties also to be reduced according to same time tables. Within twenty-two years, Turkey was to abolish progressively all quantitative restrictions and measures having equivalent effect on imports from Community (Article 25)<sup>84</sup>.

On the other hand, the initial target of the Additional Protocol also has contained the agricultural products, like industrial products (Article 11). In this parallel, in Additional Protocol, Turkey also accepted to regulate its own agricultural system to Common Agricultural Policy of the Union during the transitional period to make the free movement of agricultural products possible.

In 1.1.1996, the final step of the relations, which based on the Association Agreement and the Additional Protocol, was realized with the acceptance of the Council Decision 1/95 of March 6, 1995 which lays down the rules for implementing the final phase of the Customs Union.

As a result, it can be stated that, the responsibilities of Turkey are not due to the Customs Union decision, but due to the Ankara Agreement and Additional protocol. In the respect of policies which has been followed for the last 30 years, with 1/95 numbered Council Decision, the responsibilities emerged due to Additional Protocol were deepened and reinforced.<sup>85</sup>

In this regard, with 1/95 numbered decision, in order to have a new vision, Turkey has undertaken some responsibilities for certain methods and times.

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<sup>84</sup> Kabaalioglu Haluk, op.cit, p.116.

<sup>85</sup> Dotto, op.cit, p. 59.

### 3.1. The Content Of Decision 1/95 Establishing The European Economic Community-Turkey Customs Union

As stated earlier, the Customs Union between Turkey and EU contains the industrial and processed agricultural products. In other words, Decision 1 /95 is being practiced for the goods freely moved in the Union and Turkey except the agricultural products. Free movement concept is used for the goods having the origin of the Union or Turkish or the goods produced in third countries, but finished the required custom and taxation proceedings. It means that; after the completion of the required steps, the trade of such kinds of products can be done in Turkey and in the Union.

On the other hand, with the decision of 1/95, both sides were accepted that, the existing conditions were not suitable for the free movement of agricultural goods, but it was also emphasized that the relevant free movement supply shall be also possible for them.

For the recent periods of the bilateral relations, the trade of service has become more and more important and both sides have been agreed that the content of the Customs Union should be expanded to contain the trade of service<sup>86</sup>

Meanwhile, as a result of the Customs Union process, some organs also have been emerged to continue the relevant process. Ankara Treaty, which founded a partnership between Turkey and EU, formed Partnership Council and Partnership Committee as partnership organs and with 1/95 numbered decision, as mentioned before which constituted the Customs Union, also founded the Customs Union's Common Committee. Customs Union Common Committee is formed by the Turkish and European Commission's members and has been aiming the regular functioning

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<sup>86</sup> Dotto, op.cit, p. 14.

of the Customs Union. In 2000, as a result of the accession preparations, 8 sub-committees under Partnership Committee were founded to supply a better functioning of the customs union.

For the commercial kinds of conflicts, 1/95 numbered decision also contains some points, but if it is not possible, 1/95 says that the relevant conflicts must be solved by Partnership Committee. If also this way is not possible, Partnership Committee can also form an arbitrators committee<sup>87</sup>

However, when we again look at the content of the 1/95 numbered decision, it must be initially known that; an important feature of the Turkey-EU Customs Union is that; Turkey is the first and only country to enter into such an advanced form of economic integration without being a full member. As it is a unique case for EU, there are also several issues other than tariff reductions where Turkey and the EU agree to cooperate<sup>88</sup>

As we shall see below, with 1/95 numbered Council decision, some important changes in Turkish administration system has been made (i.e. competition law, the standardization of state aids, intellectual property rights, etc). Therefore, we can say that, in spite of its economic integration structure, the Customs Union means more than removing fiscal barriers or quantitative restrictions. For example, with 1/95 numbered decision, for the regular functioning of the Customs Union and for the harmonization of common trade policy, the regulations at common rules at import and export, management of quotas, the protection against imports with dumping and subvention, the autonomous dispositions at the import of textile products were become harmonious to EU's system.<sup>89</sup>

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<sup>87</sup> Dotto, op.cit, p. 15.

<sup>88</sup> <http://europa.eu.int/> Turkey-EU Customs Union.

<sup>89</sup> Dotto, Ibid, p.61.

After this small introduction, the details of the Customs Union will be illustrated by mentioning the certain points of it. In this regard, main parts of the Customs Union shall be explained under the EU and Turkish relation basis.

With this perspective, Free Movement of Goods takes the first turn.

### 3.1.1. Free Movement Of Goods

Free movement of good part is one of the most important parts of the *acquis communautaire* of the Union and all of the Member States must accept it. Turkey accepted to undertake this obligation in a transition process continued till 31.12.2000.

As mentioned earlier, the main objective of the European Community is to establish a Common Market which is built on a Customs Union. The first basic concept of the Customs Union is the free movement of goods produced in the Member States. Goods produced in one Member States should be able to move freely in all Member States without payment of custom duties. The second one is the common custom duties. If goods produced in third countries are imported into any Member State, they are subject to the payment of the common customs duties. Third is the free movement of goods from a third country. Once goods are imported into a Member State, they must be allowed to move freely in all other Member States without the payment of any further custom duties.

For example, accordingly to Article 24 (formerly 10), goods from a third country shall be freely moved within the Member State if three conditions are met. First, goods have been passed the import formalities. Secondly, goods have been paid in import Member State by any custom duties or charges having equivalent effect. Finally, the goods must have benefited from total or partial drawbacks of such duties or charges.<sup>90</sup>

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<sup>90</sup> Pitiyasak Saravuth, op.cit, p.4.

Article 25 (formerly 12) aims to abolish custom duties and charges having equivalent effect. Article 25 provides that the Member States shall refrain from introducing between themselves any new custom duties and charges having equivalent effect, and from increasing those which they already apply in their trade with each other. This prohibition applies both to imports and exports.

Thus, the free movement of goods notion is based very much on the concept of a Customs Union. It is not the end in itself, but it is rather the means to reach the end, so called a Common Market<sup>91</sup>

The free movement of goods is the cornerstone of European Community and appears at the heart of EC Treaty. It is the important pillar of the internal market and in Article 14 (formerly 7A) of the EC Treaty it is mentioned as:

“The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provision of this Treaty”

The technical features of the free movement of goods can be expressed with details. However, to be able to do that, initially the definition of “Good” must be understood in meaning of EU application.

“Good” concept has also been evaluated many times especially by ECJ on its different decisions. For example in Commission v. Italy case<sup>92</sup> the good is defined as “everything that has monetary value and can be the subject of the commercial transactions. Furthermore, in Commission v. Italy case, the frame of the “good” concept is described as the things produced both in the Member States and in third

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<sup>91</sup> Pitisayak, op.cit, p. 2.

<sup>92</sup> Case Number: 7/68.



countries but become the subject of the free movement after the payment of all custom duties and fees <sup>93</sup>

In Region of Wallonia Case<sup>94</sup>, Commission v. Belgium, the facts were that Belgium prohibited the importation of waste and contended that waste did not constitute “goods”, if it could not be recycled or reused because they have no commercial value. The ECJ rejected this submission and held that all waste was to be regarded as goods

In Almelo v. Energiebedrijf Ijsselmij Case<sup>95</sup>, the ECJ made it clear that electricity constituted “goods”. However, the ECJ did not come up with conclusion that all intangibles constituted “goods”.<sup>96</sup>

Meanwhile, in the respect of Casis de Dijon Case <sup>97</sup>, a product recognized and approved in one EC country should also be allowed to be imported and sold in other EC countries without the need for any additional testing and approval<sup>98</sup>

In this regard, it is clear that, the free movement of goods provisions within the EC Treaty should apply to all types of movements of goods. As a result of the Treaties and the decisions of ECJ, some basic points for “goods” concept and its free movement side have been emerged.

First and basically, they are applied to movement of goods from one Member State to be sold in another Member State.

Secondly, they are applied to movement of goods in transit through one Member State to be sold in another Member State or outside the European Community.

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<sup>93</sup> Bozkurt, op.cit. p. 146.

<sup>94</sup> Case Number: C-221/03

<sup>95</sup> Case Number: C-393/92

<sup>96</sup> Pitiyasak,op.cit, p. 4.

<sup>97</sup> Case Number: 120/78

<sup>98</sup> <http://secretariat.efta.int/Web/Pblications/FactSheets/ Freemovementofgoods/goods.pdf>.

Thirdly, they are applied to re-importation of goods which are imported from one Member State to another, where they were produced or put on the market.

Fourthly, they are applied to parallel imports.

Fifthly, they are applied to movement of goods by individuals.

Finally, they are applied to movement of goods involving no commercial transaction. (It was confirmed by the ECJ in the waste disposal case, *Commission v. Belgium* which is written above)

Furthermore, in *Van Gend en Loos* case<sup>99</sup>, (*Van Gend en Loos v. Nederlandse Administratie der Belastingen*) the ECJ held that Article 12 (now 25) had direct effect (the principle that Community legislation must be applied by national courts as the law of the land) and created individual rights which national courts must protect. Therefore, individuals could invoke Article 12 (now 25) before national courts.

In *Re Statistical Levy* case<sup>100</sup>, *Commission v. Italy*, even though there was no definition of charges having an equivalent effect in the EC Treaty, the ECJ defined this term as “ any pecuniary charge, however small and whatever its designation and mode of application, which is imposed unilaterally on domestic and foreign goods by reason of the fact that they cross a frontier, and which is not a custom duty in the strict sense, constitutes a charge having equivalent effect even if it is not imposed for the benefit of the state, is not discriminatory or protective in effect and if the product on which the charge is imposed is not in competition with any domestic product.

However, in *Storage Charges* case<sup>101</sup>, *Commission v. Belgium*, the facts were the Belgian authorities imposed charges on the goods undergone customs clearance

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<sup>99</sup> Case Number: 26/62

<sup>100</sup> Case Number: 24/68

<sup>101</sup> Case Number: C-428/02.

in a warehouse. The ECJ held that charges for custom clearance constitute charges having equivalent effect, if they are imposed solely in connection with the competition of custom formalities.

According to these kinds of ECJ judgments, charges made for services authorized by the Community legislation may not constitute charges having an equivalent effect to custom duties if they have met following conditions:

- The charges do not exceed the actual cost of the services,
- The services are required by Community legislation,
- The services promote the free movement of goods.<sup>102</sup>

Furthermore, as it shall be evaluated with details below, under the application of Customs Union and according to Article 90 (formerly 95), no Member States shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. It also constitutes an important pillar of the Customs Union.

Quantitative restrictions have also same meaning under the CU application. The ECJ has decided the meaning of quantitative restriction in some cases. As an example, in Import of Lamb case<sup>103</sup>, Commission v. France and Import of Potatoes case<sup>104</sup>, Commission v. UK, the ECJ held that the most obvious example of quantitative restrictions on imports and exports are complete bans or quotas restricting the import or export of a given product by amount or by value. In this regard quantitative restrictions have been seen as an impediment to free movement of goods and removal of these kinds of restriction were planned to be realized.

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<sup>102</sup> Pitiyasak, op.cit, p. 5.

<sup>103</sup> Case Number: 302/86

<sup>104</sup> Case Number:118/78

As a result of these, Customs Union was established as the primary step towards the “free movement of goods” among the EU member states. However, it was soon realized that the measures adopted under the classical definition of the Customs Union fell short of securing free movement of goods at a desired level. Hence the Member States decided to follow a more liberal approach and sought to abolish the barriers in front of the free movement of goods as well. In this respect, the technical barriers were the main targets to be eliminated.

However, for the products in the Customs Union, in order to realize the harmonization and liberalization, mainly two main methods are followed. One of them is the transfer of the rules of the EU to national system and the other one is mutual recognition of the rules. This approach can be seen in 94<sup>th</sup> and 95<sup>th</sup> of the European Union Treaty. In order to facilitate this process, there are mainly two ways: Classic and New Approach <sup>105</sup>

- Classic Approach

For the harmonization trials of the technical dispositions, till 1985, the classic approach, which depends on the “product”, was applied. Under the practice of this type of application, the management of the Union not only prepares some certain definitions for the product which will be presented to market, but also prepares a common type, which must be accepted by the member states, for the relevant product. This classic approach mainly contains these products:

- 1) Motorized Vehicles

- 2) Medical Products

- 3) Cosmetics

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<sup>105</sup> Dotto, op.cit, p.17.

#### 4) Chemical Products

#### 5) Legal Metrology and Ready-made Packing

- New Approach

The classic approach continued until 1985 and the main change came in 1985, when the EC developed a “new approach” to technical harmonization and standards. The “new approach” means that the European Institutions in Brussels decide only on the essential health and safety requirements that products need to meet; detailed guidance on how to meet these requirements is then provided by specialist working through the European standards organizations such as CEN ( the European Committee for Standardizations), CENELEC (the European Committee for Electro technical Standardizations) and ETSI ( the European Telecommunications Standard Institute)<sup>106</sup>

Under the application of this New Approach, the basic liabilities are determined and the details of these products which can cover these liabilities are defined by the required harmonized standards. Only the products which can cover the relevant basic obligations can be sold in the market. In this new approach, there is an assumption that if a product covers the harmonized standards, it is thought that this product is also harmonious with the basic obligations in relevant regulation. Furthermore, before selling the relevant product in the market, the seller must apply an accordance evaluation procedure on her product (i.e. CE sign). In the respect of new approach, the appropriateness of the product in concern to relevant directive is confirmed by CE sign. (93 / 465 / EEC numbered Council Decision). If there is no opposite certain proof which, a product with, a product with CE sign has the free movement right in EU and Turkey. The responsibility of putting a CE sign on the relevant product belongs to the manufacturer or her representative at the Union.<sup>107</sup>

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<sup>106</sup> <http://secretariat.efta.int/Web/Pblications/FactSheets/Freemovementofgoods/goods.pdf>.

<sup>107</sup> <http://turkpatent.gov.tr>.

After telling the basic points of the free movement concept in the Union, the 1/95 numbered decision can be evaluated in that respect. As a result, we see that, this decision embodies two essential elements:

- Firstly, it is agreed that Turkey would adopt the Community mechanisms, more specifically the *acquis communautaire*, related to standardization, measuring, calibration, quality, accreditation, testing and certification within five years from the Decision's entry into force. The list of the legislation that has to be adopted was specified by the Association Council Decision No:2/95.
- Secondly, during this process, if Turkey fulfills the required harmonization measures with the respect to a certain good or group of goods, the technical barriers to that particular good(s) have to be abolished without having to wait for the end of this transition period<sup>108</sup>

With respect to harmonization movements with the EU legislation, the Decision on Standardization regime in External Trade published in the Official Gazette no: 22222 of 9.3.1996, entered into force on 8.5.1996. In line with the existing international standards, the new regime envisages quality controls to be carried out only on grounds of personal security, environmental protection, national security requirements and consumer protection. Other aspects of quality are to be determined by market conditions. The aim is to meet WTO TBT Agreement commitments and to fill the gap that may arise from the five-year transition period and to prevent technical legislation and standards applied in foreign trade from constituting an obstacle to international trade. In 1993, Turkish Standard Institute started to adopt and harmonize its standards with those of EU. The aim is to harmonize Turkey's legislation on a wide range of technical regulations under 32 main topics with those of EU. Furthermore, to bring standardization procedures in

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<sup>108</sup> Bayar,op.cit, p.3.

conformity with the EU norms and to prevent Turkish imports from possible technical barriers, the Law no. 4457 on Establishment of Turkish Accreditation Council has been adopted on 27 October 1999. To acquire the maximum benefit for Turkey's imports, it is of utmost importance to eliminate disputes among institutions and start to bring the new system into action as soon as possible. If the system is not changed, problems in imports will be inevitable.

In the field of abolition technical barriers, apart from these limited initiatives, no progress was achieved and that can be considered crucial for Turkish companies and this can also make the process difficult for the Turkish companies

With the completion of Customs Union, the custom duties between the both sides were removed and Turkey began to apply Common Custom Tariff to third countries. The only exception to this practice was that from 1996 to 2000, for the certain products which were named as "sensitive products", such as cars, shoes, leather products and furniture, the Common Custom Tariff levels were a little bit highly determined. However, in 2001, with the application of import regime, the transition period for the relevant products was ended and Harmonization to Common Custom Tariffs was realized.<sup>109</sup>

As a consequence of the CU, Turkey's weighted rates of protection for imports of industrial products originating from EU and EFTA member states have fallen from %5.9 to %0 and from %10.8 to %6 for similar goods originating from third countries. With the implementation of the Uruguay Round reductions, Turkey's average rates for third countries will be lowered to % 3.5<sup>110</sup>

As stated above, free movement of good, which facilitates the free trade, removes all custom duties, charges having equivalent effects and quantitative restrictions for both sides in import and export activities. A general exception to this

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<sup>109</sup> Dotto, op.cit, p. 60.

<sup>110</sup> Bayar, op.cit, p..2.

freedom is current, if the damage public health, public morality and public security are in concern.

This concept should be taken into consideration just like the 9<sup>th</sup> Article of the Treaty of Rome which is mainly about the Customs Union and accordingly the Customs Union, the relevant formation shall be applied generally as follows in Turkish example:

- Goods, wholly or partially obtained or produced from the products coming from third countries which are in free circulation in the Community or in Turkey, manufactured in the Community and / or Turkey.
- Goods coming from third countries and in free circulation in Turkey or in the Community ( of course, if the import formalities of the relevant products coming from third countries have been complied with and any custom 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<sup>111</sup>).

With this decision, in the custom territory which contains the custom territory of the EC and Turkey, the custom duties' elimination and charges having equivalent effect abolishment was also formed.

When we look at the harmonization movements of Turkey in the respect of Free Movement of Goods under the 1/95 numbered Decision, we recognize some significant points. According to the 8<sup>th</sup> Article of 1/95 numbered Decision, as mentioned earlier, Turkey accepted to transfer the Community's instruments, which are about the removal of the commercial impediments, to her national law in 5 years

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<sup>111</sup> Kabaalioglu, op.cit, p. 118.



period from the date when it came into force and also it was stated that the relevant instruments and details of Turkey's practices shall be determined by the Partnership Council in 1 year from the date when the relevant decision came into force and both sides decided to help each other for metrology, calibration, accreditation, test and documentation areas.

In the parallel of the 8<sup>th</sup> Article of 1/95 Decision, it was foreseen that, In 5 years period which begins from the date when the 1/95 decision came into force, Turkey will transfer the Community's tools which are dealing with the removal of the technical barriers of the trade and about these tools and the details of their applications by Turkey were decided to be determined with Partnership Council decision in 1 year period which begins from the date when the relevant decision came into force ( this decision was taken mainly in 1997) and both sides are convinced to collaborate on the standardization, metrology, calibration, accreditation and the relevant test areas.

The 10<sup>th</sup> Article also says, Turkey accepted that the goods from Union has the free movement right in Turkey, if the appropriateness of the relevant goods are confirmed by the Community's directives,<sup>112</sup>

In the respect of these articles, Turkey has the obligation of realizing the relevant obligations and technical regulations of the Community and also Turkey has to harmonize the mutual recognition principle which makes the acceptance of a product marketed in other member country in Turkey possible.

7<sup>th</sup> Article of the 1/95 Decision, gives Turkey the right of restrict the free movement of goods in the respect of public health, morality, security.

Actually, in the relevant fields generally mentioned above, the required harmonization most realized, but it must be mentioned that in some certain areas the

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<sup>112</sup> Dotto, op.cit, p. 23.

harmonization movements are more efficient. Especially, for the products evaluated under the classic approach Turkey has been quite successful. Turkey also approved an Environment Law which facilitates the harmonization movements under the new approach. The relevant law which is generally about the conditions of throwing to the market, the responsibilities of producer and distributors, the appropriateness evaluation foundations, the observation and auditing of the market came into force in 1.1.2002. To support this law 5 regulations were prepared (3 of them were accepted)

Furthermore, as mentioned earlier, the measures having equivalent effect also removed in 1.1.1996. With this respect, the quotas of the Community against Turkish textile products and also the 740.025 tone quota against Turkish refined products were ended.<sup>113</sup>

The exceptions to these commercial liberties are the products mentioned in 2/95 numbered list. These products, such as motorized land vehicles, ceramics and leather materials, are seen as sensitive products and special kinds of protection measurements are applied. In this regard, from 1.1.1997, each year %10, %10, %15, %15 and % 50 reductions of the protection levels were planned to be realized and it has been done<sup>114</sup>

However, it must be accepted that, there have been some fields that have not been harmonized sufficiently. Turkish companies have had difficulties during their trades with European market due to the insufficient documentation system of Turkey. For example, there is no company in Turkey which supplies CE signature to the internal companies (nowadays, Turkish Accreditation Foundation making some movements in the relevant field) and also an efficient framework for the commercial activities have been expected to be realized. 7<sup>th</sup> Article of the 1/95 numbered decision which was written above must not be used against free trade<sup>115</sup>

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<sup>113</sup> **Avrupa Birliđi'ne Uyum Sürecinde Gümrük Birliđi'nin Dış Ticaretimize Etkileri**, İstanbul, Tüsiad Yayınları, 2003, p.29.

<sup>114</sup> Tüsiad, op.cit, p. 29.

<sup>115</sup> Dotto, op.cit, p.26.

### 3.1.2. Common Commercial Policy and Common Custom Tariff

Common Commercial Policy is defined at 113<sup>th</sup> (new number of the Article is 133) Article of The Treaty of Rome and is the first phase of the integration. <sup>116</sup>

Common Custom Tariff policy is placed on the principles of liberalization measurements at the trade with third countries, export policy and commercial defense policy. <sup>117</sup>

After certain phases, Common Commercial Policy became a common policy of the Union and also with Nice Treaty Service Trade and Intellectual and Industrial Property Rights were also placed under the authority of the Union.

As it is known, after the completion of Customs Union, the Member States began to apply common custom policy and wanted Turkey to apply the same policy. Therefore, in practice, with 1/95 Decision Turkey accepted the Common Custom Tariffs' of the Union.

It means that, as they will be explained with details in further parts of my work, upon the entry into force of the 1/95 numbered Decision, Turkey has agreed to apply:

- Measures those are compatible with the import, export and textiles legislation of EU.
- The Common Customs Tariff (CCT)
- Turkey has also agreed to adopt the preferential trade regime applicable to third countries within a period of 5 years from the

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<sup>116</sup> Dotto, Ibid, p. 30.

<sup>117</sup> Dotto, op.cit, p.30.

entry into force of the Decision ( Turkey has declared the countries that will be given priority in this field)<sup>118</sup>

Furthermore, in accordance with 16<sup>th</sup> Article of the Association Council decision No 1/95, Turkey introduced its GSP scheme by taking account of the recent EU GSP Regime as of January 1<sup>st</sup> 2002 within the framework of 2002 import regime, as regards 2456 products. The product coverage of GSP has been increased to 2884 units of products by the Import Regime of 2003. <sup>119</sup>

In the field of import and export legislation and CCT, the legislative harmonization has been achieved to a large extent<sup>120</sup>

In the respect of Decision 1/95, Turkey adjusted his custom tariff with the Community Custom Tariff in relation to third countries (Article 13). Furthermore, the commercial policy of Turkey was also planned to be harmonized with the common commercial policy of the Community in a determined term. In order to materialize this structure, Turkey accepted to negotiate agreements on “ a mutually advantageous basis “ with the countries concerned and due to the realistic approach of the sides in concern, in order to apply the points mentioned above, 5 years as from 1.1.1996 was given to Turkey to align itself. (Since, from January 1, 1996 Turkey has applied same commercial policy as the Community has had in the textile sector and also same commercial policies as mentioned at world trade organization agreements).

Furthermore, to avoid the trade diversion in the respect of the Customs Union, Turkey has been working on the harmonization to preferential and autonomous regimes of EU which were signed with third countries. Till now, except the Free Trade Agreement signed with EFTA countries in 1991, Turkey has signed

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<sup>118</sup> Bayar, op.cit, p. 5.

<sup>119</sup> <http://europa.eu.int/> Turkey- EU Customs Union, 2005.

<sup>120</sup> Bayar, op.cit, p.5.

some free trade agreements with the East European countries and Israel. (these countries will be mentioned one by one at the last part of the thesis)

Common Commercial policy of the Union has resulted with the increase of the easy trade opportunities of the third countries and this really has affected the trade liberalization of the World. However, this policy has also affected the countries, such as Turkey and other trade partners, which have had different entrance conditions to the relevant market.

### 3.1.3. Custom Provisions

Customs Union also contains the alignment of the Turkish Customs Tariff to the Common Custom Tariff of the Community. In order to realize this, Turkey had to adopt legislation in line with the Community Custom Codes in the respect of Article 28. The areas mainly mentioned in Article 28 can be mentioned as:

“Origin of goods, customs value of goods, introduction of goods into territory of the customs union, customs declaration, release for free circulation, substantive arrangements and customs procedures with economic impact, movement of goods, customs debt and right of appeal.”

Turkey has also adopted a series of text to implement the Community legislation and whenever the Common Customs Tariff is changed, Turkey shall adjust its custom tariff to these changes.

### 3.1.4. Agricultural and Processed Agricultural Products

As it is mentioned in Article 2, the Customs Union covers initially the industrial and processed agricultural products and so traditional agricultural products are excluded from the Customs Union.

The Association Agreement provided that “the Association shall likewise extend to agriculture and trade in agricultural products, in accordance with special rules which shall take into account the Common Agricultural Policy of the Community “.

Decision 1/95 stated that; “The Parties’ common objective to move towards the free movement of agricultural products “but noted that” an additional period is required “to establish the conditions necessary to achieve this free movement (Article 24). Thus, Turkey and the Community shall progressively improve the preferential arrangements which they grant each other for their trade in agricultural products.<sup>121</sup> It means that CU decision stipulates that the EU and Turkey shall progressively improve, on a mutually advantageous basis, the preferential arrangements in agricultural products, but as already mentioned the industrial components of the processed agricultural products are already covered by the CU. Elimination of tariffs on the industrial components of processed agricultural products was carried out gradually between 1.1.1996-1.1.1999<sup>122</sup>

With 1/95 numbered decision, the share of agriculture and industrial parts of the products contained by processed agricultural products and to remove the taxes for the industrial products’ and the relevant parts of custom duties was decided to be practiced. However, to minimize the negative effects as a result of this application, for certain time period, by adding some share belongs to industrial products to agricultural products share, an additional protection to real agricultural share was realized. This system was applied for EU and EFTA, but the share of the third countries’ originated agricultural products was kept at the same level that was applied to EU and EFTA at first stages and the adjustments made for EU and EFTA countries were not realized<sup>123</sup>

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<sup>121</sup> Kabaalioglu, op.cit, p.121.

<sup>122</sup> Bayar, op.cit, p.6.

<sup>123</sup> Tüsiad, op.cit, p.31.

However, in the period between signing of the Ankara Agreement and adoption of Customs Union Decision, the EU granted certain concession to Turkey. As a result, a large extent of Turkey's agricultural exports to the EU benefits from tariff exemptions or tariff reductions (i.e. prior to the Protocol dated 25.5.1997, %71 of the agricultural exports benefited from the exemptions and %5 benefited from the reductions. Hence in total, %76 of Turkey's exports benefited from the concessions)<sup>124</sup>

On the other hand, for processed agricultural products, Turkey and the EC may apply agricultural components (basic agricultural products considered to have been used for the manufacture of the goods in question) established in accordance with the Decision 1 /95. In this regard, the Community shall apply to Turkey the same specific duties that represent the agricultural components to third countries and Turkey shall apply the same instruments, too.

The negotiations on agricultural concessions that had been initiated in 1993 were concluded in 1997. The protocol and annexes embodying the bilateral concessions on agricultural goods were initialed on 20.5.1997 in 38<sup>th</sup> EU-Turkey Association Council meeting.

As a result of these new bilateral concessions, the volume of Turkish exports benefiting from concessions increased from %70 to %93, whereas for the EU it resulted in an increase from %7 to %33<sup>125</sup>

However, in agriculture, Turkey gave its first real concessions to EU by the Decision No: 1/98. Nevertheless, this Agreement did not function properly due to Turkey's ban on beef imports. As a response to this ban, the EU suspended some of its concessions on Turkey's exports.

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<sup>124</sup> Bayar, op.cit, p.6.

<sup>125</sup> Bayar, Ibid, p.6.

Furthermore, the Agriculture Technique Committee dialogues, which aimed to facilitate the commerce of agricultural products between Turkey and the Community, began in 1993 and finished in 1997 by the signature of 1/97 numbered Association Council Decision. In this regard, the quota for tomatoes sauce for 30000 tone became in valid in 1.1.1997. The applications for the other agricultural products which have been the subject of preference regime began in 1.1.1998.<sup>126</sup>

Another important impediment to Turkey's agricultural exports stems from hygiene concerns. In this field, legislative and procedural harmonization will not only facilitate Turkey's export, but also may be used as a means of control on imports.<sup>127</sup>

### 3.1.5. Competition Law

Depending on the 15<sup>th</sup> Article of the Association Agreement signed in 1963, the Treaty of Rome's provisions on competition, taxation and approximation of laws must be made applicable in their relations with the Association. With the Additional Protocol, the competition provisions of the Treaty of Rome (85, 86, 90, 92) were decided to be applied.

In the field of adaptation of Turkish legislation to the competition policy of the EC, a great degree of progress has been achieved with the entry into force of laws on protection of competition and protection of consumers as well as decree laws on patents, copyrights, trademarks and industrial designs, prevention of unfair competition in importation.<sup>128</sup>

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<sup>126</sup> Tüsiad, op.cit, p.31.

<sup>127</sup> Bayar, op.cit, p.7 .

<sup>128</sup> Bayar, Ibid, p.2.



Turkey passed a law on Competition in December 1994 which also based on the competition articles of the Treaty of Rome. The Competition Board, which will be administering this law, has been formed <sup>129</sup>

A Decree on state aid compatible with the system in force in the EU and relevant provisions of the WTO Agreement subsidies and countervailing duties has entered into force. This decree limits the scope of state aids to research and development, protection of environment, market research and promotion activities abroad. <sup>130</sup>

Furthermore, in accordance with the obligations laid down in Article 42 of the Association Council Decision No 1/95, Turkey is entitled to adjust state monopolies of commercial character, so as to ensure that no discrimination exist between the nationals of the Member States and of Turkey regarding the conditions which goods are produced and marketed. Turkey's harmonization in this field is achieved with the entry into force of "law on the monopoly of alcohol and alcoholic drinks "amending the Law No.4250 on 20.1.2001<sup>131</sup>

On the other hand tobacco law was published on 9.1.2002 in the Official Gazette No: 24635. The new tobacco law introduces a new arrangement for the alcoholic beverages and basically transfers TEKEL's regulatory rights such as licensing, by separating them from the commercial activities of production and distribution, to an independent Body namely ,"Tobacco products and Alcoholic Beverages Regulatory Board." The Board, established on 20.07.2002, will draft the implementing rules in conformity with the obligations set out in the Decision 1/95.<sup>132</sup>

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<sup>129</sup> Kabaalioglu, op.cit, p.123.

<sup>130</sup> <http://europa.eu.int/> Turkey-EU Customs Union,2005.

<sup>131</sup> <http://europa.eu.int/> Turkey-EU Customs Union,2005.

<sup>132</sup> <http://europa.eu.int/> Turkey-EU Customs Union,2005.

### 3.1.6. Anti-dumping and Other Trade Defense Instruments

In a customs union, allegations of dumping are inconceivable. It was expected that with the completion of the Customs Union, the Community allegations for dumping would be eliminated.

The application of trade defense instruments will be subject to a review by the Association Council. When the Council determines that Turkey has implemented competition provisions, controls on state aids and other parts of the *acquis communautaire*, which are related to the internal market and ensured their effective enforcement, the Council Association may decide to suspend the application of these instruments (Article 44). The aim is to provide a guarantee against unfair competition comparable to that existing inside the Internal Market <sup>133</sup>

The 47<sup>th</sup> Article of the Additional Protocol gives a very important role for the Council Association in dumping cases. Any allegations of dumping must be made to the Association Council by one of the contracting parties. In other words, in the process of Turkey's adoption of the *acquis communautaires*, based on Article 47 of the additional protocol, an early warning system of anti dumping investigations shall be established. In concluding these investigations, priority shall be given to price commitments.<sup>134</sup> If the Council finds a dumping case, it will address recommendations to the parties involved. However, in spite of the recommendation, if the relevant dumping continues, after informing the Council, it may introduce "interim measures of protection "such as anti-dumping provisions. These measurements can continue up to three months. The Council may, at any time, decide that such protective measures shall be suspended pending the issue of the Council recommendations.

Decision 1/95, in this regard, stipulates that the modalities of implementation of anti-dumping measures remain in force when the Customs Union is achieved.

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<sup>133</sup> Kabaalioglu, *op.cit*, p.124.

<sup>134</sup> Bayar, *op.cit*, p. 9.

Through a series of laws, regulations and decrees for adapting the Turkish legal system to the European Community, Turkey has already aligned her rules on state aids, incentives, competition and the like and therefore, in principle, it should be expected that the Council take a decision for the suspension of provisions on trade defense instruments. However, safeguard clauses will remain in force <sup>135</sup>

In this regard, Draft Law on the Prevention of Unfair Competition that was prepared in compliance with the Uruguay Round decisions, has just been adopted by the Parliament ( October 1999 )<sup>136</sup>

### 3.1 7. State Aids

Principally, the state aids which damage the proper functioning of the Customs Union, are evaluated as incompatible.

In line with the EC Treaties, any measures, which can be identified as state aid, including measures such as grants, soft loans and tax concessions or any other kinds which may distort trade, are prohibited. This prohibition is qualified by the possibility of taking certain political, economic and social considerations into account<sup>137</sup>

Due to the special situation of Turkey, it was decided that for a five years period from the entry into force of the Decision, aids to promote development of Turkey's undeveloped regions and aids aiming at accomplishing structural adjustment necessitated by the establishment of the Customs Union shall be compatible with the Customs Union. Furthermore, in accordance with the Decision, in the textile and clothing sector, Turkey planned to align her state aids to those of the EU before the entry into force of the Decision. On the other hand, harmonization

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<sup>135</sup> Kabaalioglu, Ibid, p. 125.

<sup>136</sup> Bayar, op.cit, p. 9.

<sup>137</sup> Pitiyasak, op.cit, p.8.

of the state aids in other sectors decided to be completed within two years from the Decision's entry into force<sup>138</sup>

In this regard, in 1995 Turkey declared that there are no specific state aids in Turkey and the existing incentives are compatible with the provisions of Customs Union Decision and WTO Agreement on Subsidies and Rebalancing Measures and this declaration was accepted by EU.

Furthermore, in 1996, Turkey has aligned its state aids system with that of the EU on textile and clothing sectors.

It may be briefly stated that, due to the structure of the Customs Union, the state aids of Turkey has changed to general exemptions from direct payment. A decree law has introduced new rules that are compatible with the system in force in the EU and relevant provisions of WTO agreement on subsidies and countervailing duties. Subsidies through resources in any form whatsoever which distort or threaten to distort competition are banned.<sup>139</sup> In this regard, Turkey has adopted the OECD's consensus rules on officially supported export credits with a repayment period of two or more years.<sup>140</sup>

In the parallel of the state aids, state monopolies have also created some kinds of problems under the application of CU. For example, as I mentioned in Competition Law part, trade in alcoholic beverages is hampered by the requirement to have products priced and distributed by the State Monopoly TEKEL, and the requirement on the market access, thresholds, labeling, sampling and certification. The Customs Union decision foresaw that the TEKEL Monopoly should have been abolished by the beginning of 1999. However, till today, this has not taken place.

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<sup>138</sup> Bayar, Ibid, p. 8.

<sup>139</sup> Atak Ercan, **Harmonization of Turkish Legislation and Practice with that of the European Union**, Erişim: 05 Mayıs 2005. ( [www.document](http://www.document)) URL. [http:// www.tbmm.gov.tr](http://www.tbmm.gov.tr).

<sup>140</sup> Bayar, op.cit, p. 8.

In this regard, first concrete step towards a solution could have been the Law on Monopolies, which was adopted by the Turkish Parliament in January 2001. However, the law foresees a transitional period and keeps the monopolistic powers of TEKEL for another six years.<sup>141</sup>

### 3.1. 8. Intellectual, Industrial and Industrial Property Rights

Intellectual and industrial property right is a kind of right which gives a monopolistic right on economic basis to the owner of the relevant right owner for a certain time period<sup>142</sup>

As mentioned before, Customs Union will not function properly unless intellectual property is protected at an equal level by sides.

31<sup>st</sup> Article of the Association Council Decision 1/95 is about Intellectual, Industrial and Commercial Property Rights. The proper functioning of the Customs Union mainly depended on the equivalent levels of effective protection of intellectual property rights.

Legislation on copyright and related rights, patents, trademarks, counterfeit goods, protection of geographical indications and industrial designs should be implemented without any prejudice to Turkey's status as a developing country in the WTO. On the other hand, obligations arising from the TRIP's agreement shall be binding within three years of the Decision's entry into force. Turkey is also obliged to align with the Budapest Agreement, the Geneva Agreement, as well as the Protocol annexed to the Madrid Agreement, no later than three years from the Decision's entry into force.

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<sup>141</sup> [http://europa.eu.int/abc/history/index\\_en.htm](http://europa.eu.int/abc/history/index_en.htm), EU Turkey Customs Union, Outstanding Trade Matters, 2005, p.1.

<sup>142</sup> <http://dtm.gov.tr>, AB-Türkiye Gümrük Birliği, Refah İçinde Birlikte Çalışma, p.7.

In this respect, in 1995 Turkey introduced significant changes to its intellectual property regime. Those sections of the harmonization of intellectual property rights that had to be completed before the CU's entry into force were fulfilled in 1995 by the coordinated efforts of the Turkish Patent Institute. Hence Turkey became a party to the related international conventions and adopted legislative amendments for trademarks, patent rights and protection of industrial designs and geographical indications. Moreover, Turkey became a signatory to a number of important conventions governing property rights and these reforms have given Turkey an extensive legal framework for the protection of intellectual property rights. However, since the decision's entry into force, there has been no progress concerning obligations that were to be fulfilled in accordance with a time table. Moreover, implementation of several of the harmonized legislation has been officially suspended. Furthermore, the legislative amendments on pharmaceutical products have not been realized so far and Turkey is included on the US "priority watch list" of countries as a result of its applications in IP rights<sup>143</sup>

It was of course mainly Turkish side's responsibility and Turkey should realize the relevant steps at his legal system in this area in order to complete the process of the Customs Union.

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<sup>143</sup> Bayar, op.cit, p.7.

PART 2. WITH IN THE CONCEPT OF THE CUSTOMS UNION, TAXATION  
POLICY OF THE EUROPEAN UNION

4. TAXATION IN THE EUROPEAN UNION

Taxation is central to national sovereignty, because without revenue governments can not conduct policy. It is an instrument of economic regulation which can be used to influence consumption, encourage saving or shape the way in which companies are organized. Tax policy is essential to all Member States, and a country's actions can have an impact not only at home but also in neighboring countries.<sup>144</sup>

Fiscal policy is comprises a whole corpus of “public finance” issues: the relative size of the public sector, taxation and expenditure; and the allocation of public sector, responsibilities between the different tiers of the government. Hence fiscal policy is concerned with a far wider area than that commonly, but arguably, associated with it, namely, the aggregate management of the economy in terms of controlling inflation and employment-unemployment levels.<sup>145</sup>

One of the key challenges for governments is to design an efficient, fair and simple tax that is conducive to industrial growth. Taxes are raised to finance the public goods and services that are needed to support economic development and provide economic opportunities to everyone. However, the burden of taxes can

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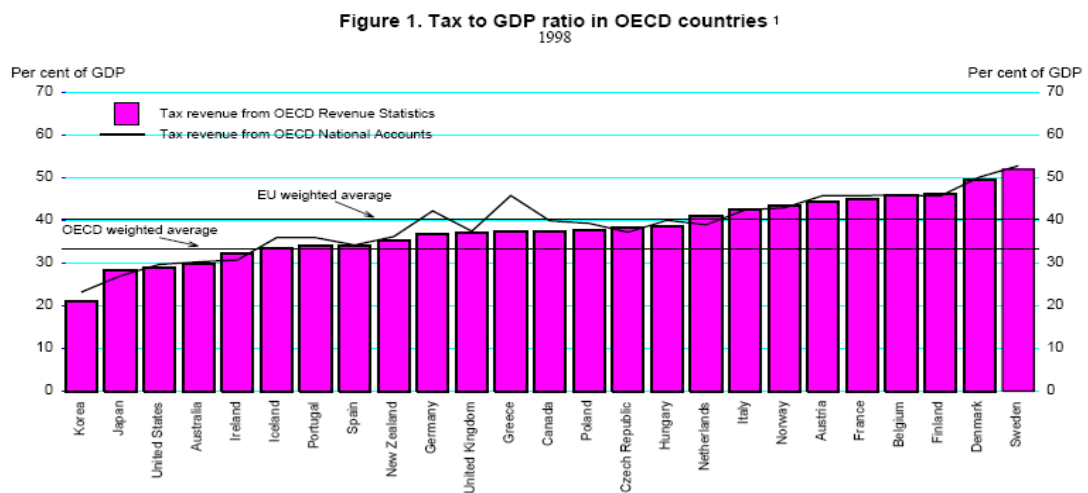
<sup>144</sup><http://europa.eu.int/> / the tax policy in EU –pdf, 2005.

<sup>145</sup> El-Agraa , Tax Harmonization ,Oxford Publishing, 1997, p.319.

adversely affect the economic growth by discouraging the new investment, work effort, acquisition of skills and entrepreneurial incentives<sup>146</sup>

When we look at the taxation trends in World, we see that, there has been a continuing upward trend in the average OECD tax burden on individuals and enterprises of all sizes since 1965, driven by increases in public spending. No OECD country currently has a lower tax to GDP ratio than its respective in 1965. The figure below shows it clearly.

Figure 4.1 Taxation in the EU



1. Tax revenues from OECD National Accounts are not fully comparable to the information found in OECD Revenue Statistics. The divergences are due to a variety of general and country specific factors. The most important are the following: i) differences in accounting periods and methods; ii) voluntary social security contributions, which are fairly large for some countries (including Germany), are included as tax revenues in the National Accounts but not in the Revenue Statistics; so are the employer social security contributions for government employees; iii) imputed government contributions are not included in the Revenue Statistics; iv) inheritance and gift taxes are not considered as taxes in the National Accounts while they are included in the Revenue Statistics; v) for EU countries, VAT and customs revenues are shown net of the amounts transferred to the European Commission in the National Accounts while the Revenue Statistics show gross data. Source: OECD National Accounts; OECD Revenue Statistics, 1965-1999.

Source: OECD , European Taxation

However, there is a general application that, virtually all OECD countries, to varying degrees, provides corporate tax relieves which generally reduce the effective income rate. These measures include tax allowances and tax credits associated with specific investments such as research and development or those targeted to key industrial sectors or certain geographic areas<sup>147</sup>

<sup>146</sup>,Technology and Industry, Entrepreneurship and Growth: Tax Issues, OECD Directorate for Science, 2005, p. 4.

<sup>147</sup> OECD, op.cit, p. 5.



The main objects of the relevant fiscal issues can be numbered differently. The area of taxation and expenditure criteria have resulted in general agreement about the basic criteria of allocation, equity, stabilization and administration.

In this respect, it can be observed that, there are also some real forces which shape the EU taxation policy and these forces can be mentioned as follow:

1) Growths in public spending and fiscal consolidation have implemented rising tax burdens:

A sustained expansion of public sector commitments of welfare provision and the rise in unemployment acted as persistent underlying pressures to increase taxes in most EU countries between 1970 and the early 1990s. Reflecting the important role played by wage-based taxes in financing the welfare system in most EU countries (social security contributions and/ or personal income tax), this was largely reflected in a pronounced rise in the tax wedge on labor. Since the increase in public expenditure was also financed by an “inflation tax” until the late 1970s, the disinflation policies pursued during 1980s implied a surge in real interest rates and a debt “snowball effect” reflected in a steep increase in interest payments on public debts.<sup>148</sup>

High levels of spending in Europe emerged in the early postwar period as an element of social consensus between employers and unions. Indeed, generous unemployment insurance and health schemes have been administered jointly by the “social partners” in several EU countries. While this high level of redistribution has no doubt had a favorable impact on social cohesion and has smoothed labor relations, the associated rigidity has increasingly been seen to have costs. High social

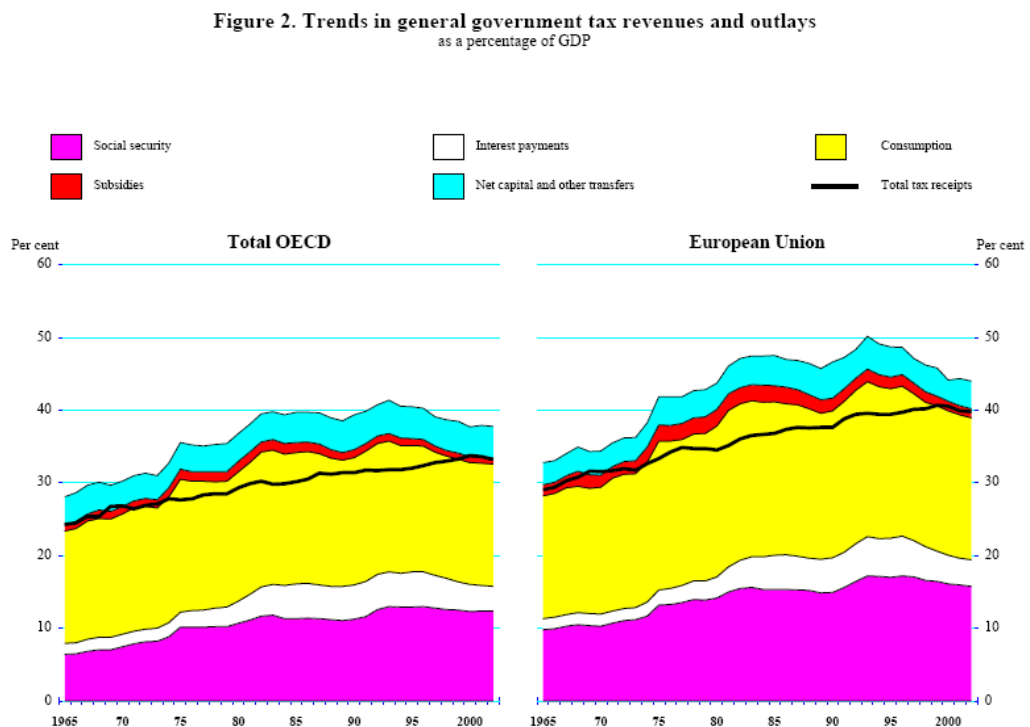
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<sup>148</sup> Joumard, Isabella, Tax Systems in European Union Countries, Erişim: 2005, (WWW document) URL. <http://www.oecd.org/eco/eco>, p.5.

contributions by employers and generous unemployment benefits have discouraged employment, and the rise in unemployment further increased the extent of redistribution, creating a vicious circle. Health care costs have risen rapidly as public insurance has permitted excessive use of some services. As a result of the aging of the population, generous pay-as-you-go pension plans increasingly have had to face the choice of raising contributions or reducing benefits, especially since public plans in several countries permitted early retirement in sectors hit by high unemployment as the result of loss of competitiveness or adverse demand shifts.<sup>149</sup>

The figure below shows it in a certain way

Figure: 4.2 Trends in General Government Tax Revenues and Outlays



Source : OECD, European Taxation

<sup>149</sup> Mason Paul, Fiscal Policy and Growth in the Context of European Integration , Eriřim: 2005, ( WWW. Document) URL. [http:// www.oecd.org/eco/eco](http://www.oecd.org/eco/eco), p.4.

## 2) A Brighter economic outlook has recently allowed some tax reductions:

Since the late 1990's, most EU countries have taken advantage of buoyant revenues to reduce tax rates. Through some of these tax measures have involved cutting indirect taxes with little overall impact on supply-side conditions, many have been designed to have a structural impact: increase employment incentives and opportunities and boost productivity. Main candidates for cuts have been social security contributions and the personal income tax.<sup>150</sup>

## 3) Upward Pressures on Public Spending Will Likely Increase

Population ageing will raise spending on pensions and health care. This mainly reflects rapidly rising elderly dependency ratios in conjunction with extensive public old-age-pension and health- and long-term care system in place in many EU countries. Prospect for enlargement of the EU by admitting 13 new member countries may also imply additional spendings.

## 4) Policies of the European Union

Free capital movements, the elimination of custom controls, the advent of the single currency and the development of information and communication technologies all contribute to increase the mobility of the tax bases. On one hand, enhanced mobility within the EU area may create welfare gains by enabling individuals and companies to choose as a jurisdiction of residence that country or region that provides fiscal package. The greater exposure to international competition also provides strong incentives for governments to raise public sector efficiency and may yield a double dividend; lower taxation and better public service. On the other hand, free movements of products and factors, in conjunction with differences in EU countries' tax systems and barriers to effective information changes, extend the scope for tax avoidance and evasion. This could require lowering the tax burden on

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<sup>150</sup> Jounard, op.cit, p.7.

highly mobile production factors and resulted in a higher tax pressure on less mobile ones.<sup>151</sup>

However, from the view of the EU Member States, the taxation policies create different results, because each behavior of these causes an important effect on the other Member States. Therefore, some of the regulations about taxation and taxation policy were foreseen in the Treaty of Rome<sup>152</sup>

Any consideration of EU fiscal policies must acknowledge that the starting point is one in which the European countries stand out as having an extraordinarily high level of government services and taxation, relative to other industrial countries and even more so, relative to poorer countries

In this regard, there are two opposing aspects to taxation in the EU: the power to tax and the power to prevent taxation. It was fundamental to the initial success of common market that it could stop its members taxing each other. Therefore what can be said in this regard is EC law prohibiting taxes<sup>153</sup> Due to its formation, the economic aspect of the Union can be stated as to facilitate the free and unimpeded flow of goods, services and factors. Since the tariffs are not the only distortion factor, the proper establishment of intra-EU free trade necessitates the removal of all non-tariff distortions that have an equivalent effect. Hence the removal of tariffs may give the impression of establishing free trade inside the EU, but this is by no means automatically guaranteed, since the existence of sales taxes, excise duties, corporation taxes, income taxes etc. may impede this freedom.<sup>154</sup>

As a result, when we consider the successes on the economic and the monetary unification works, one of the most important issue dealing this above mentioned areas can be mentioned as the polices on “Tax”. In this regard, the works

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<sup>151</sup> Jounard, Ibid, p.8.

<sup>152</sup> Fantorini Stefano- Üzeltürk Hakan, **Avrupa Birliğinin Vergilendirme Politikası ve Türkiye'nin Uyumunu**, İstanbul, İKV, 2001, p.8.

<sup>153</sup> Williams, op.cit, p.2.

<sup>154</sup> El-Agraa A.M, op.cit, p. 320.

on tax harmonization shall affect how the sustainability of these successes will occur and can be improved<sup>155</sup>

Important fiscal obstacles to a common market are fiscal burdens on the cross border movement of goods, services, income or capital, differential tax treatment of domestic and imported goods and services, substantial differences among national tax laws, double taxation of foreign source income and differential tax treatment of residents and non-residents. Therefore, from the points mentioned above, we see that, a certain degree of tax harmonization or at least coordination between the Member States is indispensable for the establishment and the proper functioning of common market.<sup>156</sup>

However, it should be noticed that, the tax policy in EU is a secondary politic when we consider the economical unification as main target. As a matter of fact, the articles of the Treaty of Rome dealing with the tax matters (Articles 95 to 99, Article 100 and 220) are not among the basic elements, but are put at the third part under the name of Community Politics after the articles of Competition Law.<sup>157</sup>

The EC Treaty has several basic principles which are to be respected in tax matters as well, one of which is prohibition of discrimination against goods, services, workers, as well undertakings and capital from other Member States, and of any other discrimination based on nationality within the scope of EC Treaty. This and other fundamental principles such as Community loyalty and neutrality of State aid to undertakings have significant consequences for national tax sovereignty.<sup>158</sup>

In recent years, the contribution of tax policy to Community objectives has increasingly been linked to the development of the Internal Market, to EMU and to closer economic integration. In the context of the introduction of the Internal Market,

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<sup>155</sup> Tuncer Mehmet , **Avrupa Birliği Vergi Uyumlaştırması Politikası**, Kar Muhsin , Arıkan Harun, İstanbul, Beta, 2003, p.281.

<sup>156</sup> Terra Ben-Wattel Peter, **European Tax Law** ,Second Edition, Kluwer Law International, 1997, p. 1.

<sup>157</sup> Karluk, op.cit, p.465.

<sup>158</sup> Terra- Peter, Ibid, p.2.

the Community adopted a significant body of legislation on VAT and excise duties in early 1990's. This, however, only highlighted the absence of a coherent policy on direct taxation. At the same time, it became clear that, too often, tax proposals were discussed in isolation rather than in the context of wider policy <sup>159</sup>

One of the Member State's possibilities of being tax heaven can cause the flow of the capital and investment to this country and this can damage the structure of other Member States. Furthermore, as we know, in order to supply sustainable development of the defined sectors, EU created many common policies. The probable different in the respect of this common policies, due to the different tax application of the Member States can cause distortions. Therefore, the tax policies of the Member States must contribute to these common policies. In this parallel, the tax policies of the Member States shouldn't create any kinds of obstacles to the enterprises of Member States which wants to join and benefit these common policies<sup>160</sup>

The Maastricht Treaty and the Decision of Copenhagen Summit show us that the Member States and the Candidate States must cover some economic condition which can be determined as the rules of Market Economy and should be abstain from any kinds of regulations which have any possibility of breaking down this type of economic formation. In this regard the custom applications, which may have harmful effects to the market economy, tax policy and the budget disciplinary, have become more important in the Community.

At the informal ECIFIN meeting at Verona in April 1996, the Commission, contrasting the need for progress in tax coordination in the EU with the number of decisions adopted in this area and therefore proposed a new and comprehensive view of taxation policy .Three main, interlinked and mutually reinforcing challenges for the EU were identified and these are;

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<sup>159</sup> **Communication from the Commission to the Council**,The European Parliament and the Economic and Social Committee, Commission of the European Communities, 2005 p.4.

<sup>160</sup> Karluk Ridvan, op.cit, p. 465.

- The stabilization of Member States' tax revenues,
- The smooth functioning of Internal market,
- Promoting employment.<sup>161</sup>

After this brief introduction of EU's tax policy, before illustrating the taxation system of the EU, I want to explain the history of taxation in the Union. However, in order to do it in a right way, I think, initially the classification of the taxes should be known.

As we know, mainly, there are mainly two types of taxation.

- Indirect Taxes: The taxes which are basically levied on consumption and have very important role in determining the quotation of the goods.
- Direct Taxes: The taxes, like corporation and income taxes, emerge as a result of the personal and industrial activities. These taxes are levied on wages and salaries when activities have been practiced and payment has been met (income taxes ), or on the profits of industrial or professional business at the end of annual activity(corporation taxes).<sup>162</sup>

In the respect of the EU, the other harmonizing factors, applied by the organs of the Community, which can also affect the taxation, can be mentioned as the

- articles prohibiting the discrimination against goods, services, workers, capital and services ,

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<sup>161</sup> Commission of the European Communities, op.cit, p. 4.

<sup>162</sup> El-Agraa A.M, op.cit, p. 321.

- Tax competition between Member States (tax competition leads a more or less spontaneous harmonization since neighboring States with a comparable level of economic opportunity, infrastructure, social security and public services, cannot afford to diverge significantly in tax burdens, especially other obstacles to individual or corporate emigration and to cross border economic activities are gradually removed, and as the economic and monetary union approaches. If Member States do diverge significantly in tax burdens without offering corresponding public service or economic opportunity, economic activity will move to the more tax-efficient Member States

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In this regard, when we look at the tax issue at the Community with the historical perspective, we see that in the history of the EC, principally four type of sales (turnover) taxes existed.

- The Cumulative Multistage Cascade System: This type was operated in West Germany until the end of 1967, in Luxembourg until the end of 1969 and in the Netherlands until the end of 1968. In this model, the tax was levied on the gross value of the commodity in question at each stage of production without any rebate on taxes paid earlier stages.
- Value Added Tax (VAT): It has been operated in France since 1954 and will be explained with details at further parts of this work.
- The Mixed System: It was operated in Belgium and Italy and was cumulative multistage system which was applied down to the wholesale stage, but incorporated taxes which were applied at a single point for certain products.

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<sup>163</sup> Terra-Peter, op.cit, p.2.



- Purchase Tax: It was operated in United Kingdom and was single stage tax which was normally charged at the wholesale stage by registered manufacturers or wholesalers and this type of taxation gave the chance of making trade without any payment to the traders.

A diversity of taxation can also be seen in the form of excise duties .The number of goods subjected to this tax type can be classified as classic type (normal 5 products; tobacco products, hydrocarbon oils, beer , wine and spirit ) and extensive type which also contains coffee ,sugar ,salt ,matches etc.( like in Italy ) .

In the respect of corporation tax, three basic schemes were practiced and still exist in a slightly disguised form, but not in any single country at all times. First type is separate system used in UK (the system needed a complete separation of corporation tax from personal income tax and has usually referred to as the classical system). The second type is two rate system practiced in Germany and was recommended as an alternative system for the UK in the Green paper in 1971 .The third is credit system (imputation system<sup>164</sup> ) which gives shareholders credit for tax paid by company, and this credit may be used for offsetting their income tax liability on dividends, part of the company's tax liability is imputed to the shareholders and regarded as a prepayment of their income tax on dividends ( this was a French system )

Briefly, corporation tax varied from being totally indistinguishable from other systems (Italy) to being quite separate from personal income tax with a single or a split rate which varied between “distributed” and “undistributed” profits to being partially integrated with the personal income tax systems.

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<sup>164</sup> IMPUTATION SYSTEM System under which at least part of the tax paid by a company on its profits is credited against the tax liability of shareholders in receipt of distributions paid by the company out of those profits.

The personal income tax system itself was differentiated in very many aspects among the original six, not just in the respect of rates and allowances, but also administration procedures, compliance and enforcement <sup>165</sup>

Furthermore, when we look at the VAT system with the same perspective illustrated above; two different principles for taxation emerges: “destination principle” and “origin principle “. Under the application of destination principle goods going to same destination must bear the same tax load without regarding their origin. However, under the application of the origin principles the goods from same origin must pay exactly the same tax, without regarding their destination.

As a result, we see that, the harmonization issue of EU can be divided into two parts: The developments before Single European Act and the developments after Single European Act.

#### i. The Period before the Single European Act

As we know, this period of time shows the incidents occurred during the foundation of the Community. The most important works during this period was the works about the harmonization of indirect taxes such as turnover taxes and excise duties which mainly depended on Article 99 of the Treaty of Rome. Here the harmonization was seen as something vital because the removal of tariffs would have left taxes as the main source of intra-EU trade distortion. <sup>166</sup>

In this respect, the works on VAT can be illustrated as something significant. Between 1967 and 1977, six directives were put forward for balancing the existing differences among the member states. These related to three major aims:

- The inclusion of the retail stage in coverage of VAT,

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<sup>165</sup> El-Agraa, op.cit, p.322.

<sup>166</sup> El-Agraa, Ibid, p.325.

- The use of VAT levies for the EU general budget,
- The achievement of greater uniformity in VAT structure.

With the respect of corporation tax, some different kinds of system to apply this type of tax successfully (In Neumark report recommended a split rate system, the Van den Tempel Report preferred the adoption of the separate or classical system and the draft directive of 1975 offered imputation system). On the other hand, the method of tax harmonization which was accepted was not the ideal one of a single EU corporation tax and a single pattern, but rather a unified EU corporation tax and accompanied by freedom of tax patterns. Hence all systems were entertained at some time or another and all that can be categorically stated is that by 1986, the EU limited its choice to separate and imputation system.<sup>167</sup>

For excise duties, due to the different rates applied by the Member States, the improvements were slower when, for example, the works on VAT is considered. The greatest improvement put forward on this issue was about tobacco, and a new harmonized system was adopted in January 1978. The main points under this system were the abolition of any duties on raw tobacco leaf and the adoption of a new sale tax at the manufacturing level, combined with a specific tax per cigarette and VAT.

Furthermore, the changes on stamp duties (the draft directive in 1976 recommended a compromise between the system in the Member States and this recommendation was accepted) can be seen as a success, but for the area of personal income taxation no improvements can be seen and the only changes for social security payment was the draft directive of 1979 which dealt with balance of taxation of migrant workers .

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<sup>167</sup> El-Agraa, op.cit, p.327

### i.i. The Period Beginning with the Single European Act

The Single European Act (SEA) was declared to realize the single market instead of European Community by the end of 1992, which means that the new area with the Member States without frontiers (without any custom controls). Custom controls protect the indirect taxes of one EU member country from relative tax bargains which are obtainable elsewhere within the EU. Moreover, custom controls guarantee that government can collect the VAT that belongs to them. A frontier-free EU would undermine these factors unless the rates of indirect taxation within the EU were brought much closer to each other.<sup>168</sup>

With White Paper, some measurements must be adopted with regard to VAT and excise duties. For VAT, the measurements are as follows:

- The replacement of the system of refunding tax on exportation and collecting it on importation by a system of tax collection by the country of origin,
- The introduction of an EU clearing system to ensure that revenues would continue to accrue to the EU Member Nations where consumption took place so that the destination principle would remain intact,
- The narrowing of the differentials in national VAT rates so as to lessen the risks of fraud, tax evasion and distortion in competition.

For excise duties;

- An interlinkage of bonded warehouse system (created to defer the payment of duty since, as long as the goods remain in these

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<sup>168</sup> El-Agraa, op.cit, p.331.

warehouses, duties on them do not have to be paid; recall that excise duties are levied only once on manufactures or importation),

- Upholding the destination principle,
- An approximation of the national excise duty rates and regimes<sup>169</sup>

The Lisbon European Council established an ambitious strategic goal for the EU namely “... to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion “Attaining that goal was a focus of the recent European Council in Stockholm. The tax systems of the Member States must be conducive to the necessary market reform; of itself, this requires the Community to place tax policy in a new perspective.<sup>170</sup>

In October 2001, the Council decision authorizing the Commission to negotiate savings agreements with 6 third countries, in June 2003 the package to combat harmful tax competition (code of conduct for business taxation, directive on the taxation of Savings, Directive on the taxation of the Interest and Royalty payments between associated companies), in December 2003 Amendment to broaden scope of parent –Subsidiary Directive were adopted by Council in the field of Direct taxation.

In October 2000, Directive simplifying rules on tax representation, in January 2001 Directive setting minimum standard VAT rate, in May 2002 Directive and Regulation adopting rules for applying VAT to electronically delivered services, in December 2002 Directive extending the reduced VAT rate for labor intensive services to 31/12/003, in January 2004 Directive concerning VAT implementing powers and derogation procedures, in February 2004 Directive continuing reduced

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<sup>169</sup> El-Agraa A.M, op.cit, p. 331.

<sup>170</sup> Commission of the European Parliament, op.cit, p .5.

VAT rate for labor intensive services until 31.12.2005 were adopted by Council in the field of VAT.

In March 2001, Council decision on reduced rates of excise duty and exemptions on certain mineral oils used for specific purposes, in July 2001 Commission decisions establishing common fiscal marker for gas oil and kerosene, in February 2002 council Directive revising EU rules on tobacco taxation, in June 2003 Decision of Council and European Parliament on computerization of movement of excisable products, in October 2003 Energy Tax Directive were adopted by Council in the field of excise duties.

In June 2001 Directive on Mutual Assistance in Recovery of tax debts, in October 2002 Council and Parliament Decision adopting the Fiscalis program to improve operation of tax systems in Internal Market, in October 2003 Regulation improving administrative co-operation in the field of VAT were adopted by council in the field of administrative co-operation against fraud.<sup>171</sup>

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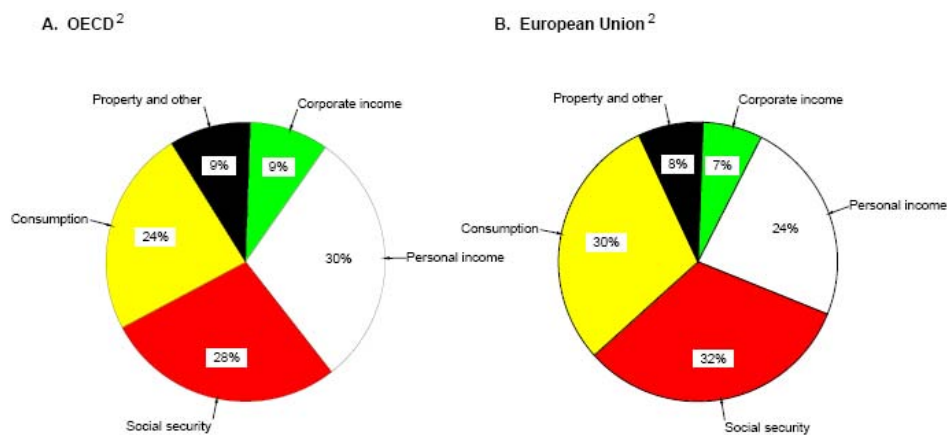
<sup>171</sup> [http://eu.int/taxation\\_pdf](http://eu.int/taxation_pdf), 2005.

#### 4.1. MAIN FEATURES OF THE TAXATION POLICY OF THE EUROPEAN UNION

What we can, initially, say is that the tax burden in the EU area, as I mentioned before, is much higher than in most other OECD countries. Defined as the tax-to-GDP ratio, it stood %40 in 1998. The tax mix is also different. Most EU countries rely on social security contributions, consumption and environmentally-related taxes. On the other hand, corporate income and property taxes account for a much lower share of total tax revenues than in Japan and the USA (the UK and France being the main exceptions to this EU type). Overall, while income redistribution is often conceived as a key objective of EU countries' tax systems, progressivity embodied in statutory tax rates on personal income is weakened by a large set of tax system is the relatively low taxation of property and capital income and the fact that social security contributions are basically proportional and sometimes regressive.

Figure: 4.1.1 European Union's Taxation

Figure 3. Tax mix by source<sup>1</sup>  
Per cent share of total tax revenue, 1998



Source: OECD, European Taxation

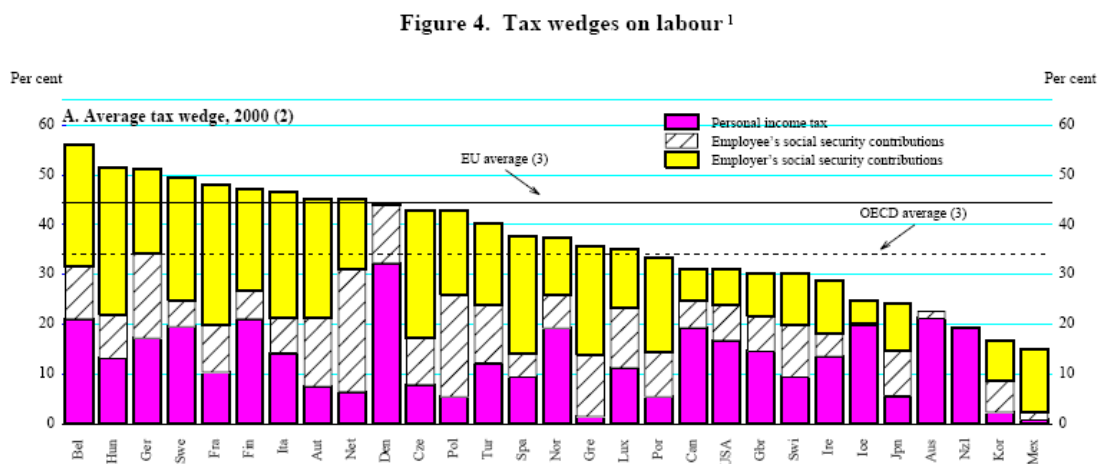
In this regard, we recognize that, there are some common points in the taxation policy of EU:

a) There is a high tax wedges on labor:

The average effective tax rate on labor in the EU area is about %15 percent higher than the USA and Japan.

The figure below can give us a good example to understand the existing situation which is coming from quite short history.

Figure 4.1.2 Tax Wedges on Labour



Source : OECD, European Taxation

b) Consumption taxes play an important role in the system

Effective tax rates on consumption in the EU area are higher than in most other OECD countries. This not only reflects a higher tax to GDP ratio, but also a tax mix relying heavily on consumption taxes. In fact, consumption-based taxes accounted for %30 of total tax revenues in the EU



area in 1998 with VAT playing a dominant role, accounting for about %60 of total tax revenues on goods and services in the EU area

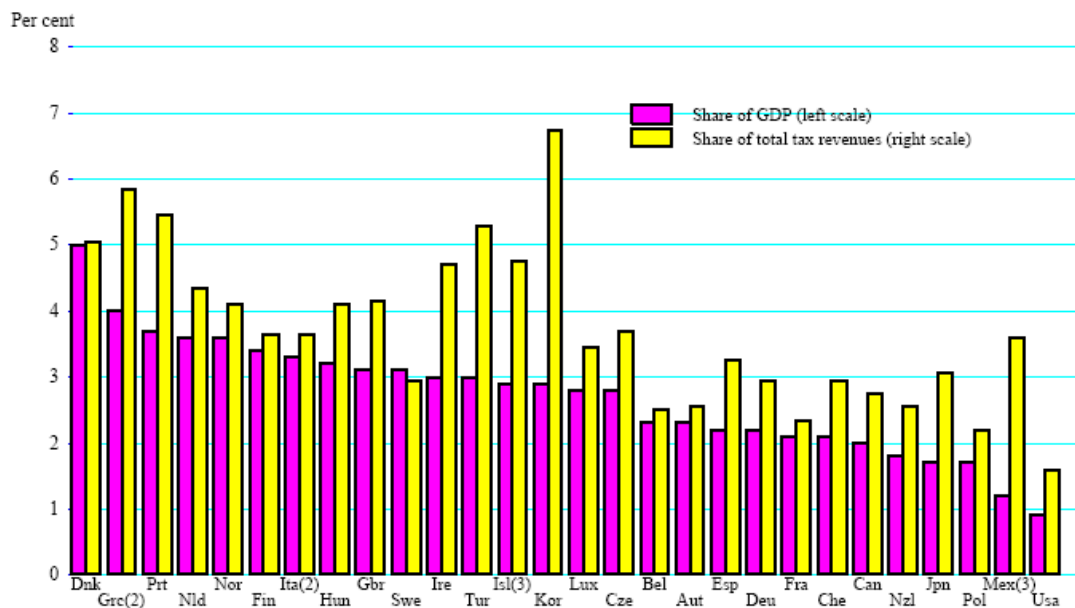
c) Environment related taxes raise substantial revenues

Environment related taxes represent a much higher share of GDP in EU countries than in most other OECD countries. Motor fuel and vehicle taxes, which have initially been introduced for fiscal rather than environmental reasons, account for bulk of these revenues.

The figure below may show it in a better way.

Figure 4.1.3. Revenues from Environmentally-related taxes

**Figure 6. Revenues from environmentally-related taxes (1)**  
1998, in per cent of GDP and total tax revenue



1. These data do not reflect environment-related provisions in other taxes, including personal and corporate income-taxes, such as accelerated provisions or tax credits for energy-saving and pollution-reducing equipment.  
 2. 1997 instead of 1998.  
 3. 1995 instead of 1998.  
 4. Weighted average.  
 Source: Environmentally-related tax database, OECD.

Source : OECD, European Taxation

d) Taxation of capital is relatively low but some distortions remain

These realities of the EU have some parts as follow:

- Tax rates on saving vehicles are relatively low and converging:

Progress towards greater tax neutrality on capital income accruing from different types of asset has been hallmark of recent reforms in most EU countries. Under such a system, a unique flat rate tax applies to net capital income (interest income, dividends and capital gains) while labor income is subject to an additional and progressive tax. The move towards a lower and flat tax on capital income has often reflected the need to remain competitive on the international capital market, in particular in the context of free capital movements and the advent of single currency, and/or the difficulty of securing a proper tax assessment.

- But the taxation of saving still favors housing investment and retirement schemes:

Most EU countries grant tax-favored treatment to specific saving instruments. Typically, retirement schemes and housing investment benefit from the most generous tax breaks. In both cases, these breaks are motivated in part by social or economic objectives: alleviating future pressures on public pension and schemes and facilitating population access to proper housing. Many EU countries have recently increased (e.g. Italy and Spain) or envisage increasing (Germany), tax incentives to retirement saving, though from very different starting points.

- ... often grants a favored regime to non-residents

EU countries still apply different tax provisions on capital income, and often grant preferential tax treatments to non-residents

e) Arrangements to undo double taxation exist but are still imperfect

f) Corporate Income tax bases remain narrow, and special regimes are widespread

Corporate income tax revenues in most EU countries are low by international standards, as a share of GDP, despite the statutory rates on corporate profits broadly in line with other OECD countries.

g) Income redistribution plays an important role in the system

Income redistribution is considered to be an important objective of EU countries' tax system. It is mainly reflected in a highly progressive tax schedule of the personal income tax. However, several factors act to weaken the statutory progressivity of EU tax system. First, the personal income tax base is very narrow in many countries (e.g. France). Second, capital income is mainly taxed at a flat rate in EU countries. The taxation of property/wealth is also low in most EU countries with the OECD average. Third, the personal income tax in most countries embody extensive tax advantages whose value tends to increase with income, such as tax breaks for health, childcare and education expenses. Overall, the tax systems contributes more to income redistributions in EU countries than most other OECD countries, but this largely reflects higher overall tax shares while the relative efficiency of EU countries' tax system in redistributing income appears to be lower than that of many other OECD countries, but this largely reflects higher overall tax shares while the relative efficiency EU countries' tax system in redistributing income appears to be lower than that of many other OECD countries.<sup>172</sup>

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<sup>172</sup> Jounard, op.cit, p.36.

After having a small look at the common points of the EU Tax system, the taxes applied in the EU can be examined in a better way.

## 4.2. TAXES IN THE EUROPEAN UNION

Each modern national tax systems has developed over a period of many decades, according to economic, social, climatological circumstances and above all as a result of tradition and physiological attitudes based on history and religion. The results are all sorts of different taxes and different emphasis on direct and indirect taxes. These differences may result in differences in macro and micro-economic tax burdens affecting the patterns of domestic and international trade and competition<sup>173</sup>

In the constitution of all states, there must be a provision allocating the power to tax. The provision will often also impose limits on that power. There is no such power in the constitution of the EU. The need to raise taxes is implicit in the statement of the purposes of the EU set out in Article 2 of the EC Treaty, but tax is nowhere mentioned. Nor is there any assertion of a common policy for taxation in the statement of activities in Article 3. This only set outs the things that the EU will not tax, customs duties are to be eliminated and obstacles to free movement removed.<sup>174</sup>

Article 269 of the EC Treaty requires the Community budget to be wholly financed from own resources. These depend on the Member States' capacities to contribute. At present, these own resource consist of agricultural levies, custom duties, a percentage of VAT revenue calculated on harmonized basis and GNP-based resources. The EU has no power to create or levy taxes<sup>175</sup> When the first six Member States set up the ECSC in 1951, as mentioned before, they gave the High Authority the power to raise the funds, that it needed, from levies on the forms of production under its control. They also allowed it to borrow on the market. The levy was, in effect, a (sales) tax of up to %1 (higher if the Council agreed ) of the stocks of coal and steel products within the ECSC's jurisdiction. Taken with the borrowing powers that the Treaty also gave to the High Authority, this gave the ECSC fiscal

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<sup>173</sup> Van Hoorn J, **The General Implication of a Common VAT System in the Enlarged Common Market**, A.Halsted Press Book, 1997, p.4.

<sup>174</sup> William, op.cit, p.5.

<sup>175</sup> <http://eu.int/> / European Union Taxation policy, p.6.

autonomy. However, the Member States did not give fiscal autonomy to the EEC and EURATOM when they set them up in 1957. The finance of the EC and EU is determined by reference to the proposed expenditure and the resources are then found to meet this expenditure. In the early days of the EEC, this approach arose in part because much of the expenditure of EEC was compulsory. It was a direct result of legal instruments establishing the common agricultural policy, and no institution or state had any discretion in it. Reforms of the CAP have reduced the compulsory element of the budget to half of the total, and have opened the budget to greater political debate and force the EU to balance its budget. The Council decision 70/243 gave the EEC its own financial resources .

These were divided into three kinds:

- The agricultural levies collected by the EEC,
- The custom duties collected under the Common Custom Tariff,
- A percentage of the VAT collected by the Member States under the first and second VAT Directives.

The structure of the 1970 Decision has remained as the core of the approach for providing the EU's budgetary resources to date<sup>176</sup>

By the time, the requirement for another resource emerged and the fourth source became the income tax. It is "the application of a rate .... to the sum of all Member States' GNP established in accordance with Community rules. The level of this resource is kept in check by the overall reduction planned in the EU budget over the medium term future, with a ceiling planned of %1.335 of GNP<sup>177</sup>

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<sup>176</sup> William, op.cit, p. 45.

<sup>177</sup> William, Ibid, p.50.

Article 2 of the Rome Treaty (The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing the common policies or activities referred to in Articles 3 and 3a, to promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States. ) mainly defines the aims of the Union by mentioning the duties of the Community. It means that in order to reach the aims stated above the economic policies of the Member States must be approximated and the common market must be established. In the Single market, it is important to see that Member States' tax measures do not hamper the free movement of goods, services and capital or distort competition. Progress on the harmonization and coordination of taxation has been fairly slow, but this due to the complexity of the issues involved and the fact that the relevant articles of the EC Treaty require unanimity for any change <sup>178</sup>

Court of Justice draws a basic ways to establish the common market with these words:

“ the elimination of all obstacles to intra-Community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market “<sup>179</sup>

The European Union plays only a subsidiary role on taxes and social security contributions. Her aim is not to standardize the national systems of compulsory taxes and contributions but simply to ensure that they are compatible not only with each other, but also with the aims of the Treaty establishing the European Community<sup>180</sup>

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<sup>178</sup> <http://eu.int> / European Union Taxation policy, p. 6.

<sup>179</sup> Terra-Peter, op.cit, p.10.

<sup>180</sup> <http://eu.int> / European Union Taxation policy, p.5.

Custom duties and discriminative domestic taxation of foreign products are the most obvious and direct fiscal impediments to the functioning of a common market. They are incompatible with the free movement of goods. Therefore, elimination of fiscal trade barriers within the Community began with harmonization of indirect taxes.<sup>181</sup> Hence, the initial concentration of the efforts of harmonization of indirect taxes shows us the importance of “free trade area “for EC

Here, before telling the details of taxes applied at EU, I want to mention the articles of the Treaty of Rome dealing with the taxation policy of to Community to have initial information about the taxes in EU.

Articles 95-99 of the Treaty of Rome deal with indirect taxes.

- Article 95(new 90<sup>th</sup> Article): No Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. Furthermore, no Member State shall impose on the products of other Member States any internal taxation of such a nature as to afford indirect protection to other products. Member States shall, not later than at the beginning of the second stage, repeal or amend any provisions existing when this Treaty enters into force which conflict with the preceding rules.

Shortly Article 95 prohibits direct and indirect discrimination against foreign products and direct and indirect fiscal protection of domestic production. Although prohibiting discriminatory and protective product taxation, Article 95 does not in itself affect national tax sovereignty. As long as there is no Community harmonization, the Member States remain free to organize their tax systems in the way they considered expedient, and to fix the rates they think necessary.<sup>182</sup> However,

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<sup>181</sup> Terra- Peter, op.cit, p. 3.

<sup>182</sup> Terra- Peter, Ibid, p. 7.



all the discriminatory application through the affects of indirect taxes such as turnover taxes and excise duties are forbidden as a general principle.

This principle is one of the basic points of the Single Market. As it can be understood, here the different tax applications between the same products were not allowed, but if the difference is because of the qualification of the relevant products, the right of application is acceptable. The Member States, by considering the place and the producer of a product, can not apply different taxes on same products which cause discrimination.<sup>183</sup>

In order to see the application of Article 95, Humbolt Case can be put forward. The French citizen, Mr.Humbolt, purchases a powerful German car and in France the road taxes applied on cars are progressive and basically depended on the power rating of the car. However, the limit to apply this article progressively is only up to 16 CV and the use of a car powered over 16 CV was taxed at a flat rate of 5.000 FF. The highest progressive rate for a car under 16 CV was only 1.100 FF Per annum. In the respect of all these realities, Mr. Humbolt claimed that the existing application is incompatible with Article 95, because all the French made cars fell within the power rating band up to 16 CV and only the imported cars (such as his car) can be subjected such an application. In this regard, Court stated that Member States were free to subject products like cars to a system of road tax which increases progressively depending on an objective criterion. However, French tax system showed discrimination against foreign products and entails protective features. Moreover, the difference between the highest progressive rate and the flat rate (FF 3.900 or%450) was excessive as compared to the difference between steps in the progressive rate. Therefore Consumers could be discouraged financially from buying any imported cars. After all these points, the Court held that the French road tax system was incompatible with Article 95. Therefore, we see that, the applications in Member State should be proportionate. As it ca be predicted Article 95 has direct

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<sup>183</sup> Fantorini-Üzeltürk, op.cit, p. 8.

effect and can be applied on by individuals before the national courts in concern to challenge the validity of national tax law incompatible with it.

- Article 99 (new 93<sup>rd</sup> Article): “ The Council shall , acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market within the time-limit laid down in Article 7a “

As we see, Article 99 is at the basis of advanced integration of turnover taxes within the EC. Turnover taxes have been harmonized to a large extent because it is clear that taxes on goods and services could be used by the Member States to substitute for import duties and export subsidies previously levied or extended but now prohibited. The system of VAT was introduced, excluding any other form of turnover tax and the destination country principle (VAT is to be paid in the state of final sale, exports are therefore, zero-rated and imports are taxed) was chosen because together they make it possible to determine the exact amount of tax on a product every stage of production, and to refund exactly that amount upon exportation. This system therefore eliminates the possibility for the Member States of hiding export subsidies in arbitrary refunds upon exportation.<sup>184</sup>

Numerous Directives on VAT have been adopted and implemented, ever further limiting or eliminating national sovereignty entirely as regards the system and the base of turnover taxation and as regards exemption. As it shall be explained latterly, the internal market brought about further integration of VAT through limitation of the number of different rates and through the introduction of minimum

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<sup>184</sup> Terra-Peter, op.cit, p. 7.

rates: a reduced rate not lower than %5 and a standard rate not lower than % 15. Furthermore, the necessity of border checks was lifted as of 1 January 1993 through the introduction of internal “intra-Community transactions “as a taxable event replacing imports as a taxable event which was later changed.

Article 99 is also important for the harmonization of excise duties which is deal with alcohol, mineral oils and tobacco.

The importance of the principle mentioned in 99<sup>th</sup> Article is so obvious. The taxes mainly mentioned in 99<sup>th</sup> Article is so important for the function of the Single Market. The taxes are obtained from good and service and the free movement of these goods and items form the base of the Single Market. Therefore, any suggestion to Commission were realized to make the approve of regulations of such taxes by Council possible<sup>185</sup>

Other articles dealing with taxation will also be explained below. However, initially, it should be known that, the authority and the responsibility about the national taxation policy belongs to the Member States.<sup>186</sup>

As a result, the liberty of the taxation policy of the Member States is restricted directly and indirectly. The direct restrictions can be expressed as:

- Main restrictions by Treaties and the interpretation of the ECJ,
- Main restrictions by directives and regulations.

The restrictions by indirect ways are also applied in EU. Especially, after the application of Single Money, a better and stronger collaboration among the Member States on the tax issues are required, because in these situation fiscal problems, differentiations and disharmony can not be balanced with the regulations of money

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<sup>185</sup> Fantorini-Üzeltürk, op.cit, p.9.

<sup>186</sup> Fantorini-Üzeltürk, Ibid, p. 9.

value. Practically, the local tax policies, which are not in harmony with the Member States' tax policies, show difficulties in this area. In this regard, the coordination among the Member States' tax policies is required due to the budgetary discipline.<sup>187</sup>

The other provisions in EC Treaty dealing with taxes ,except articles 12 ,95 and 99 , are Article 73d,130f(2),130r(2) and Article 220

- Article 12: “Member States shall refrain from introducing between themselves any new custom duties on imports or exports or any charges having equivalent effect, and from increasing those which they already apply in their trade with each other”
- Article 73d: Article 73d. 1. The provisions of Article 73b shall be without prejudice to the right of Member States:

(a) To apply the relevant provisions of their tax law which distinguish between tax-payers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;

(b) To take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.

2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.

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<sup>187</sup> Fantorini-Üzeltürk, op.cit, p.11.

3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 73b.

- Article 130f: “The Community shall have the objective of strengthening the scientific and technological basis of European industry and encouraging it to become more competitive at international level, while promoting all the research activities deemed necessary by virtue of other Chapters of this Treaty.

2. For this purpose the Community shall, throughout the Community encourage undertakings, including small and medium-sized undertakings, research centers and universities in their research and technological development activities of high quality; it shall support their efforts to co-operate with one another, aiming notably at enabling undertakings to exploit the internal market potential to the full, in particular through the opening up of national public contracts, the definition of common standards and the removal of legal and fiscal obstacles to that co-operation.

3. All Community activities under this Treaty in the area of research and technological development, including demonstration projects, shall be decided on and implemented in accordance with the provisions of this “

This article is a part of research and technological development. Its second paragraph provides that the Community shall support efforts of undertakings to co-operate with one another ,in particular through , the removal of legal and fiscal barriers to that co-operation in order to achieve the Community’s aim of strengthening the scientific and technological basis of the European industry .This statement of purpose does not add anything fiscally specific .<sup>188</sup>

On the other hand Article 130 providing that Community policy on the environment shall be based on the principle that the polluter should pay and that the

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<sup>188</sup> Terra-Peter, op.cit, p.9.

Council shall take action by unanimous acts. These provisions may become the basis for “green taxes”.<sup>189</sup>

- Article 220 : “ Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals:
  - The protection of persons and the enjoyment and protection of rights under the same conditions as those accorded by each State to its own nationals;
  - The abolition of double taxation within the Community;
  - The mutual recognition of companies or firms within the meaning of the second paragraph of Art. 58, the retention of legal personality in the event of transfer of their seat from one country to another, and the possibility of mergers between companies or firms governed by the laws of different countries;
  - The simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts or tribunals and of arbitration awards.”

This article provides that that Member States shall enter into negotiations with each other with a view to securing, for the benefit of their nationals, the abolition of double taxation within the Community

The articles mentioned above are mainly entails points for indirect taxes. However, direct taxes are not explicitly mentioned in anywhere<sup>190</sup> Article 100 (The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue

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<sup>189</sup> Terra- Peter , op.cit, p.10.

<sup>190</sup> Terra- Peter, Ibid, p. 10.

directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market) is the unique legal base for the harmonization of direct taxes. Furthermore Article 235 (if action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, take the appropriate measures ) can be showed as a complementary provision in the respect of direct taxes. In the field of direct taxation, as I shall explain with details in the following pages, due to the sovereignty issue and voting system, Article 100 is hard to apply on the direct taxes, so in principle the only binding legal instrument for EC harmonization of Direct Taxation is the Directive (recommendations can also be used, but as we know they are not directly binding). Merger Directive and Parent-Subsidiary Directive are the example of this application. The Commission put several recommendations forward on direct tax matters, one of the most important of which is the Recommendation on the tax treatment of frontier workers.

Furthermore, the probable differences between the laws and practices in the Member States can damage the structure of the Union. In this regard, Article 101 (Where the Commission finds that difference between the provisions laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the common market and that the resultant distortion needs to be eliminated, it of the Treaty offers eliminating such points . If Commission considers a distortion serious enough to require elimination, it must consult the Member State concerned. If such consultation does not result in an agreement eliminating the distortion in question, the Council shall, on a proposal from the Commission, acting unanimously during the five stages and by qualified majority thereafter, issue the necessary directives. The Commission and the Council may take any other appropriate measures provided for in this Treaty) is a safety valve that enables the Community to handle crises without being paralyzed by the unanimity rule of Article 100. Member States are required to consult the Commission where they want to

proceed with unilateral measures or actions that may cause such distortions to competition conditions. The commission must make recommendations for appropriate measures, to be taken by the States concerned, to avoid the distortion. (Art.102)<sup>191</sup>

On the other hand the articles , for four freedom ( Free movement of goods, services, persons and capital articles 9-37 and 48-73H of the Treaty : i.e The free movement of persons – workers and undertakings, stated in Articles 48 and 52/58 of the EC Treaty has an important affect on native tax systems of countries because fiscal discriminative applications between residents and non-residents ((in the respect of income and corporate tax)) have an important place in the cases of ECJ ), for competition and State aids (Articles 92-94) ,the general prohibition on discrimination based on nationality within the scope of application of this Treaty ( Article 6 ) and the Article 5 which entails some points for Member States to collaborate to facilitate the achievement of the Community duties, also affect the national tax rules and applications under the aims of the Community .<sup>192</sup>

One of the main principles of international tax law is the different application of the principle of taxation based on residence and principle of taxation based on source. Depending on the taxation basing on the residence principle, worldwide taxation is applied to residents is basing on an idea that all persons living or established in a State are having the usage of the social, political, economic sources of that State and earning most of their incomes from that State and so they should pay the relevant taxes of their worldwide income under the conditions of the State in concern. However, source taxation is applied to non-residents with another idea that the country where the income is derived should have a clear share of the relevant income without considering the residence of the person in concern. The most common one of the above expressed ways of taxation of EC Member States is stated in the Article of 24 of the Treaty (Member States shall remain free to charge their duties more rapidly than is provided in Article 23 in order to bring them into line

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<sup>191</sup> Terra - Peter, op.cit, p.11.

<sup>192</sup> Terra - Peter, Ibid, p.12.



with the common custom tariff ) and from this way of statement, we see that although containing a clause prohibiting tax discrimination based on nationality of the tax payer, it is so clear that it does not regard residents and non-residents as being in the same position for tax purposes. Because depending on the many decisions of the ECJ distinctions may be made between residents and non-residents because, they are not in the same position in certain points Distinctions are possible only if there is an objective difference between residents and non residents which justifies the difference in tax treatment.

As a result of these articles, before telling the details of the taxation policy of the EU, the application of the EU in the respect of “free movement” concept should be evaluated

For free movement of goods, as it is known, one of the basic principle is the right of cross border circulation and a prohibition of discrimination on the grounds of nationality and / or origin and other criteria except these such as residence etc. which causes disadvantaging foreigners and/or foreign products are also prohibited. Article 95 stated above is a main point for this issue. It is applied to VAT and all specific taxes on products provided that they are internal taxes. It also covers any other compulsory charges. The reference to taxes imposed “directly or indirectly “on domestic products includes taxes of any kind applied on the raw materials or earlier stages of production of a product. As the article is restricted to products, it is not applied to taxes on services or financial transport.<sup>193</sup> Discrimination may operate in several ways. First the local tax system can impose heavier or different taxes on foreign products than on those that originate within the state. Second, subsidies can provided from within the tax system for local product, but not their foreign equivalent. Third, formalities or charges can impose administrative barriers. Fourth, if the requirements of the local tax system of the state, to which the products are sent, do not fit with the requirements of the system of the state from which the products are sent, a barrier may be created. Finally, there can be double taxation of products

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<sup>193</sup> Williams, op.cit, p.74.

moving between States. This can happen if the state of production and the state of consumption both impose local taxes on the same product, even if each tax individually does not discriminate.<sup>194</sup> In order to explain the effects of free movement of goods on the national tax measures “The Tax advantages for newspaper publishers case” can be put forward. In this case practice of a French tax measure which gives the right of tax-free applications for example for building necessary buildings or any other equipment for the publication for the publication of the newspaper which mainly contains political news. However, this article in French law did not give the same right for publishing houses of such establishments which were founded abroad and so Court considered that the French measure caused French publishing house to have their printing done in France and this tax-free provision of the law was regarded as a prohibited measure having an equivalent effect as quantitative import restriction. Furthermore, in EC Commission v. Belgium case (Case 153/89), The Belgians had taken the view that there was a lower wastage on brewing Belgian beer than on foreign beer, and therefore applied an excise duty that worked out higher on imported beer. The Court found this to be a breach of article 95.<sup>195</sup>

Paragraph 2 of article 95 poses a much broader test: are the products to be compared in competition with each other, so that the domestic producers may be the beneficiaries of protection. In Humbolt Case <sup>196</sup>Mercedes car was subjected to a special tax because it had a very large engine capacity. The French tax system imposed a tax on cars proportionate to engine size, but with a surcharge on the large engines which were found only in imported cars .This the Court found discriminatory.

For free movement of workers (depending on the equality principle workers from other member states have a right to equal treatment as regards social security benefits and taxation ) and for the free movement of establishment which entails the

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<sup>194</sup> Williams, op.cit, p.70.

<sup>195</sup> William, Ibid, p.76.

<sup>196</sup> Case Number: 112/84

right to take up and carry on activities as a self employed person and set up and manage undertakings and the right to equal treatment in member states involved , taxation principles are also playing an important role for the design of national tax law<sup>197</sup> Schumacker Case<sup>198</sup> is a really good example to understand how “the distinction “ concept is defined under the Community law and how it is applied in the respect of free movement of workers. The Schumacker case concerned the German tax legislation granting personal tax allowances and refunds of overpaid payroll tax only residents. With this case, for the direct tax purposes, Court accepted that residents and non-residents are not equal and difference in tax treatment must be proportionate to real difference in situation<sup>199</sup> Mr. Schumacker, who is a Belgian and living in Belgium, earned his whole employment income in Germany. Due to his Belgian residency, he was entitled to the Belgian personal allowances, but he had too little Belgian taxable income to benefit from them, as his employment income was allocated by international tax law to the Source State, Germany ,but at the same time he was denied the German personal allowances such as a high basic allowances and splitting of income between spouses ,because he was not a resident taxpayer in Germany. The Court saw no relevant difference between Mr. Schumacker and labors resident in Germany. Although not resident in Germany, He earned his entire income in Germany and was, therefore, from an individual income tax point of view, in a similar position as resident employees.<sup>200</sup> The result is that income related tax benefits must be accorded to non-residents on the same basis as to residents and non-residents. Person related tax benefits, generally, need to be granted to non-residents because they are not an equal position in that they already enjoy such tax benefits in their State of residence.

On the other hand, for the free movement of capital and payments and establishment “avoir fiscal case<sup>201</sup> “ which is about the difference in taxation of permanent establishment (branch of non-resident company) and domestic companies,

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<sup>197</sup> Terra-Peter, op.cit, p.15.

<sup>198</sup> Case Number: C-279/93

<sup>199</sup> Terra-Peter, Ibid, p.17.

<sup>200</sup> Terra-Peter, Ibid, p.18.

<sup>201</sup> Case Number: C-250/95

can be a good illustration which shows total prohibition of discrimination on the basis of residence or source. Shortly, this case can be summarized as this: French applies an imputation system of taxation of distributed company profits. A shareholder obtaining a dividend is granted an imputation credit (avoir fiscal) to be credited against the income tax levied from the company distributing the dividend is wholly or partly credited against the corporate or individual income tax of the shareholder. However, French, like other countries applying imputation system grants the imputation credit only resident taxpayers and under bilateral tax treaties also to certain foreign shareholders. Many non-French based insurance companies making portfolio investments in French quoted companies through their French branches considered themselves discriminated against since they were not granted the tax credit in the respect of the French dividends they received, whereas under same circumstances French-based insurance companies were granted credit. This provision prohibits the discrimination which bases national tax provision in the respect resident and non-resident investors and between domestic and foreign source capital income. Article 73d and article 67, Court held that the right of establishment is unconditional and Member States therefore can not make application of it conditional on the results of bilateral tax treaty negotiations with other Member States<sup>202</sup>

From the above mentioned points the approach of the Treaty for the four freedoms in concern can be summarized with three points as follows:

- Measures overtly making a distinction on the basis of nationality or origin. They are prohibited, unless they can be justified by the public interest requirements listed in the EC Treaty itself,
- Measures indirectly putting products, capital or economic operators of other Member States at a disadvantage, such as a distinction between resident and non-resident taxpayers on the basis of a

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<sup>202</sup> Terra- Peter, op.cit, p.22.

criterion which irrelevant for the taxation purpose pursued and affects mainly nationals of other Member States. They are also prohibited unless they maybe justified under the rule of reason,

- Measures without distinction, but which restricts intra-Community trade or capital movement. They are also prohibited, unless they may be justified under the rule of reason. Such measures without distinction seem to be permitted, however, in matters of freedom of movement of persons, provided national treatment is granted to workers and undertakings of other Member States which are in a comparable position as nationals.<sup>203</sup>

Except the above mentioned effects of taxation policy, it should be know n that the relevant policy of the EU has some more effects on other policies:

- 1) Employment: The Community's guidelines on employment urge Member States to make their tax system more job-friendly. On October 1999 the ECOFIN Council approved a Directive 1999/85/EC allowing a reduced rate of VAT to be applied on an experimental basis to labor-intensive services. However, tax systems in general need to be overhauled if proactive employment policies are to be successful. Such long term structural changes are already having an impact on unemployment in some Member Sates
- 2) Economic and Monetary Union (EMU): If EMU is to be successful Member States have not only to comply with budget disciplines but also to deepen and strengthen economic policy coordination, particularly in the area of taxation. The Council's annual broad economic policy guidelines contain recommendations on the

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<sup>203</sup> Terra- Peter, op.cit, p.16.

volume and structure of national taxes and social security contributions taxes and the increasing need for coordination between Member States. Tax systems have to be structured in a way which will promote economic growth, competitiveness and employment while at the same time bringing in sufficient revenue to finance social welfare spending.

- 3) Environment: The use of tax to achieve environmental goals (by means of green taxes, vehicle or road infrastructure taxes, tax incentives) has been at the center of discussions since early 1990s.
- 4) Health: VAT and excise duties account for a large proportion of the retail price of tobacco and alcohol, and health and consumer protection policies are taken into consideration when setting tax rates in order to discourage the abuse of such products.
- 5) International Competitiveness: Some charges, such as VAT, can be deducted on export; others are levied on the cost of production and therefore affect competitiveness. So the way taxes and social security contributions are structured can influence the competitive position of European Economies. In times of public or private austerity a number of Member States have been able to maintain investment in research and development capacity by means of favorable tax measures.
- 6) Tax Competition: Decisions about the location of investment, business activities, jobs and earnings are sensitive to differences in national tax regimes and social welfare systems. Without increasing mobility and differentials in tax bases, business can identify the components on which they are taxed and shop around to find the country where tax is lowest. Such competition between Member States puts downward pressure on the level of tax and

contributions which may be damaging if it is not regulated, as it undermines the fairness and overall efficiency of tax systems<sup>204</sup>

#### 7.1. The European Unions's International Tax Commitments:

The EU's fiscal policies (and its Members States) are constrained by the EU's membership of WTO (World Trade Organization) and of the GATT. Those constraints are fundamental to constitution of the EU. As a regional trading organization, it takes its context internationally from being a special grouping within the GATT and running under rules that must comply with the GATT. The restraints placed on the EU and its members by the GATT are therefore fundamental. Less fundamental, but also important, are the subsidiary agreements on custom duties and related issues formulated within or under the authority of the WTO and GATT. Together, these provide most of the shape for the Community Custom Code<sup>205</sup>. Nevertheless bilateral agreements such as double tax conventions, double social security agreements can be also mentioned in this parallel.

On the other hand, under the international aspect of the tax policy of EU OECD plays a quite important role. The OECD has established a pivotal role in interstate fiscal relationships through the work of the Committee on Fiscal Affairs and its Fiscal Affairs Department. There are three areas in which it is currently active. The first is the production and maintenance of the OECD Model of Tax Convention and on income and capital and other model conventions on aspects of taxation. The second is intergovernmental work on tax policy and practice that take place through the Committee on Fiscal Affairs and its subcommittee. Behind these reports are regular ongoing discussions and exchanges of information on a wide range of issues covering all the main direct taxes. Out reach is the third relevant area of activity .One policy of the OECD is to contribute to sound economic expansion in members as well as nonmember countries in the process of economic developments.

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<sup>204</sup> <http://eu.int> / European Union Taxation Policy, p. 6.

<sup>205</sup> <http://eu.int> / European Union Taxation Policy, p. 8.

It has made major efforts to help the emerging economies of central and eastern Europe and rest of the world.<sup>206</sup>

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<sup>206</sup> Williams, op.cit, p.20.



### 4.3.TAXATION POLICY OF THE EUROPEAN UNION

As I did at the beginning of my thesis, I will again divide taxes into two parts, as indirect and direct taxes, to explain the EU Taxes.

#### 4.3.1. INDIRECT TAXES

Indirect Taxes are levied on the production and consumption and are not borne by the “taxable persons ( traders or industry ) who pay them, collecting that tax on behalf of the government and passing it on in the price to the final consumer on whom the burden falls ( examples include VAT and excise duties )<sup>207</sup>

In 1997, indirect taxes accounted for around EUR 1 000 billion ( %13.8 of EU GDP ).They tend to remain more or less at the same level over time ,although there are national variations around European average .<sup>208</sup>

As we mentioned at previous part, Article 99 of the Treaty is mainly regulates the form of indirect taxation. One of the first tax harmonization measures introduced at Community level concerned indirect taxes on the raising of capital (Directive 69/335/EEC, last amended by Directive 85 /303/EEC ). The aim was to harmonize the indirect tax (capital duty) levied by Member States on the raising of capital for companies. Transactions covered by Community legislation include the formation of capital companies, increases in capital, shares issues and generally any such transaction which increases a company’s capital.<sup>209</sup>

From the very beginning history of EU, Commission has had an important duty to harmonize the taxation, especially the indirect taxation due to its structure. I mean, because of its direct effect on the movements of goods and capital, the

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<sup>207</sup> <sup>207</sup> <http://eu.int> / European Union Taxation Policy, p.5.

<sup>208</sup> <sup>208</sup> <http://eu.int> / European Union Taxation Policy, p.11.

<sup>209</sup> <sup>209</sup> <http://eu.int> / European Union Taxation Policy, p.11.

formation of indirect taxes have had the priority <sup>210</sup> and as it was expressed at previous section this type of taxes are regulated in 99<sup>th</sup> Article of the Treaty .

Following the introduction of above mentioned model of indirect taxes, Community efforts at harmonization have focused on two important taxes .VAT and Excise Duties

#### 4.3.1.1. VALUE ADDED TAX

Value Added Tax is a general consumption tax which is directly proportional to the price of goods and services. It is collected fractionally, i.e .on each transaction in the economic chain and is neutral. The general features of VAT can be expressed as follow:

- It is a general tax applying in principle to all commercial activities involving the production and distribution of goods and provision of services,
- It is a consumption tax because it is borne ultimately by the final consumer. It is not a charge on companies,
- It is charged as a percentage of price, which means the actual tax burden is visible at each stage in the production and distribution chain,
- It is collected fractionally, via a system of deductions whereby taxable persons (i.e. VAT-registered business) can deduct from their VAT liability the amount of tax they have paid to other taxable persons on purchases for their business activities. This

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<sup>210</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, Ankara, DPT, 1995, (www.document) URL: <http://ekutup.dpt.gov.tr/ab/uyum/>, p.5.

mechanism ensures the tax is neutral regardless of how many transactions are involved<sup>211</sup>

During the last 50 years, huge changes have taken place in the way that states tax goods and services. In the EU, this is in part because the Member States now derive nothing from internal frontier duties. Instead, with few exceptions, States have adopted a general form of taxation known as VAT. The adoption of VAT in over 100 countries in all parts of the world derives in large part from decisions first taken by the six original member states of the EEC<sup>212</sup>

When the EEC was established, each of six states had a different way of imposing taxation on products and transactions. Many of them have multilevel taxes (imposing taxes on items as they were manufactured, mined or grown, and then each stage until they were sold. This led to multiple taxation and multi-level taxes then cause cascading, the process of tax-on-tax as the tax on each level of production came to form part of the tax base for the next level of tax. Furthermore, if some of the stages of production and distribution took place in one Member State, and the rest in another state, both states would be adding their own taxes to price of goods and this creates a barrier to free trade<sup>213</sup>).

In order to establish the internal market, the system of consumption taxes had to be as neutral as possible. Where tax rebates on exports of goods from one Member State to another were higher than the amounts actually paid they acted as export subsidies. For that reason, they adopted the VAT, although at the time it was introduced the Member States were allowed to set their own rates.

There was not at first sight thought to be the same need for coordination on direct taxes. However, people may sometimes choose to live and work in a particular

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<sup>211</sup> <http://eu.int> / European Union Taxation Policy, p. 13.

<sup>212</sup> William, *op.cit.*, p. 79.

<sup>213</sup> William, *Ibid.*, p. 80.

country in order to pay less tax, or companies may attempt to reduce their tax burden, all of which can lead to tax competition between the Member States<sup>214</sup>

Even in 1960's, Commission searched for a "one phase taxation", which can be realized during the production or selling phase, instead of the existing one. As a result of these searches, it was understood that, the existing taxation system can damage the functioning the Single Market and a very close results were also seen in Neumark Report. Both the Commission and Fiscal and Finance Committee suggested a Value Added Tax system.<sup>215</sup>

In 1960, Commission formed three working group and the first group constituted a sub committee under the names of A, B and C. Furthermore, in 1960, the Commission appointed the fiscal and financial committee ( chaired by Firtz Neumark and so generally called as Neumark report ) and these both groups declared reports and at the conclusion of these reports both recommended that the Member States must abolish the cascade tax ( the production and consumption taxes which had hitherto been applied by Member States ) which create a barrier to trade particularly imports and exports between Member States, as it was difficult to calculate the exact amount of tax incorporated in the price of goods and services and adopt the value added tax which has advantage of making the tax content of a product visible at each stage in the production or distribution chain. It was chosen as a method of indirect taxation because it avoided the cumulative effect of cascade taxes and ensured tax neutrality both nationally and in trade between Member States and with non-Community countries<sup>216</sup>. At that time, the VAT tax was existed in France under the name of "taxe sur la valeour ajoutée ". The French government had reformed the multi-level system in 1954 by introducing the tax. This had solved the cascade problem in France, although it did not solve the international problems

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<sup>214</sup> <http://eu.int> / European Union Taxation Policy, p. 3.

<sup>215</sup> Fantorini-Üzeltürk, op.cit, p.11.

<sup>216</sup> <http://eu.int> / European Union Taxation Policy, p.12.

caused by different systems. The other states had not made any similar reform. They gave themselves the task of doing so in Article 99<sup>217</sup>

The EEC Commission agreed with the findings of the ABC and Neumark Report and proposed, in a draft directive, that the harmonization should be realized in three stages.

- In first stage– ending four years after the implementation of the directive– the Member States should leave their multi-stage cumulative system turnover taxes and should begin to apply non-cumulative system by their choice.
- In second stage– planned to be ended on 31 December 1969– the non-cumulative system must be replaced by a common VAT system.
- In third stage, in which no time limit was mentioned, all the obstacles as tax frontiers to intra-Community trade must be abolished.

The proposal was submitted to parliament. As a result of the searches on this proposal, Deringer report was declared and in this report it was suggested that, the three stages must be reduced to two because this proved too hesitant an approach and this was accepted by the Commission and resulted in the submission of the two revised directives to the Council of Ministers with a new approach that, interpretation of Article 99 should cover not only the turnover taxes, but also should cover the harmonization of excise duties and other indirect taxes .

As a summary, two Directives about VAT based on the reports declared at the end of 1960's were prepared and the works on the indirect taxes began with the First

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<sup>217</sup> <http://eu.int> / European Union Taxation Policy, p. 8.

Directive which was declared in 1967. The First Directive is fundamental to the EC VAT system.<sup>218</sup>

Simply, I think, the most important part of the Directive is Article 1. It requires the Member States to replace their current turnover taxes with the common form of VAT. Article 2 defines this common form by reference to the principle of a tax, applying to goods and services “on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged. With this Directive VAT was accepted as the common expense tax and till 1 January 1970, it was decided that the different types of taxes shall be left and all the Countries in concern shall accept this new VAT system. The detail of the common VAT was left to the Second Directive. The introduction part of the First Directive is quite important to understand the aim of EEC about its general approach to tax policy. It is as follow:

“The main objective of the Treaty is to establish, within the framework of an economic union, a common market within which there is healthy competition and whose characteristics are similar to those of a domestic market. The attainment of this objective presupposes the prior application in Member States of legislation concerning turnover taxes such as will not distort conditions of competition or hinder the free movement of goods and services within the common market “

In same part of the directive, it is also expressed that the harmonization of relevant taxes must result in the abolition of cumulative multi-stage taxes and the adoption by all Member States of a common system of Value Added Tax. Such a system of VAT can have the highest degree of simplicity and neutrality when the tax levied in as general a manner as possible and when its scope covers all stages of production and distribution and the provision of services. Therefore, it is in the

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<sup>218</sup> William, op.cit, p. 81.

interest of the common market and of the Member States to adopt a common system which shall also apply to retail trade. However, the application of that tax to retail trade might in some Member States meet with practical and political difficulties. Member States are therefore permitted to apply a common system only up to and including the wholesale trade stage and apply as appropriate, a separate complementary tax, at retail level. Even if the rates and exemptions are not harmonized this should result in neutrality in competition in that similar goods will bear the tax burden within each country, whatever the length of the production or distribution chain, and since in international trade the amount of tax burden borne by goods is known so that an exact equalization of that amount may be ensured.<sup>219</sup>

Depending on the above mentioned points, what we see about the VAT is that, during the first stage Member States are free to decide on the rates to be applied and the certain exemptions. The first Directive gave the 1 January 1970 as a deadline for the Member States in concern to replace their existing system by the common VAT system that based on the principle that a general tax on consumption is applied to goods and services. However, this deadline was extended by Third, Fourth and Fifth Directives.

The scope of VAT system was explained in Second Directive. In this regard, the value added tax should apply to :

- The supply of goods and the provision of services within the territory of the country by a taxable person against payment,
- The importation of goods,

The tax should be calculated on the basis of the consideration or price for the supply of goods or provision of services, or in the case of importation, on the custom value of the goods. The Member States were free to establish their own standard rate

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<sup>219</sup> Terra - Peter, op.cit, p.35.

of tax and to subject certain goods and services to increased and reduced rates, but the application of zero rates were strictly limited. It also allowed the Member States to retain significant derogations from the common form of VAT in a number of sensitive areas. Moreover, imported goods should be taxed at the same rate as that applied internally to the supply of goods. Furthermore, by consulting, the Member States were free to determine their own exemptions. A taxable person was required to keep sufficiently-detailed accounts and to issue invoices in respect of goods and services supplied by him to another taxable person. She was authorized to deduct from the tax for which she is liable the value added tax invoiced to him in respect his purchases and imports where these goods and services were used for the purposes of his business<sup>220</sup>

Within this framework, Member States were free to adopt special measures to simplify the procedures or prevent fraud or to apply a special system to small business whose subjection to normal system of VAT would meet with difficulties; or to apply a special system, best suited to national requirements and possibilities, to agricultural sector, until further proposals for directives or common procedures had been accepted. The two directives were adopted unanimously by the Council of Ministers<sup>221</sup>

As I stated above the VAT system was in valid only in France. Germany was also successful to implement the requirements that were declared in Directives that entered into force in 1968. The Netherlands got the new system in 1969 and Luxembourg accepted it in 1970. However, Belgium and Italy had some difficulties to implement the new system. Therefore Third Directive was declared and extended the deadline until 1972 for the application of the points mentioned in First and Second Directive. On the other hand, due to the remaining difficulties for Italy, The Fourth and Fifth Directive were declared and the deadline again extended until 1973.

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<sup>220</sup> Terra-Peter, op.cit, p.38.

<sup>221</sup> Terra-Peter, Ibid, p.39.



When we look at the same issue for other countries, which became the member of the Union later, we see that, Denmark had the relevant system before its membership, in 1967. Ireland had it in 1972, UK in 1973, Spain and Portugal in 1986. Greece had adopted the relevant system in 1987 ( after the declaration of two new directives ,15<sup>th</sup> and 21<sup>st</sup> Directives ) and Austria, Finland and Sweden had adopt their existing VAT system just after their membership in 1995 .

As I expressed before, especially the first and second directives were the basic and the first step for the formation and harmonization of VAT and indirect tax implementation in the Union. However, there are some unclear parts left by these Directives. For example, after the Second Directive, it was still a right for Member States to decide which goods and services were within the charge to tax and which were exempted from it. Furthermore, who should be subjected to VAT, how VAT was applied to both imported goods and cross-border supplied of services. In other words, the VAT adopted in each member state might have common principles, but it was far short of being a common tax.<sup>222</sup>

In the parallel of all these, on 17 May 1977 Sixth Directive, the aim of which was to harmonize the exiting national laws, was adopted. The Sixth Directive ensured that the tax was applied to the same transactions in all Member States, so that they formed a common basis for funding the Community, and introduced a common assessment.<sup>223</sup> It was scheduled to come into force in 1978. It occurred so in some States, but only came fully into effect in 1987, when Greece adopted the required legislation.

The main reason of this directive was the Council of Ministers' decision of 21 April 1970, which was quite important for the Union in the respect of "own source" concept. This approach showed that, from the beginning of 1975, the budget of Community had to have some extra incomes (it has some from the custom duties and agricultural levies) from VAT application by applying a rate which is not more

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<sup>222</sup> William, op.cit, p.82.

<sup>223</sup> <http://eu.int> / European Union Taxation Policy, p. 12.

than %1, but afterward this rate increased till %1.4. During Edinburg Council in 1992, Community's high dependency on the VAT was criticized and as a result of this opinion VAT restricted as the bases of % 55 of GNP and the relevant rate was decided to be reduced gradually from %1.4 to %1.

There was also a deadline in Sixth Directive to implement the points of it and this date was 1 January 1978, but with Ninth Directive this deadline were extended until 1 January 1979 (but there were exceptions such as Greece, this country had deadline till 1987 due to its membership process)<sup>224</sup>. Furthermore, in 1983, 1992 and 1.1.1993 some changes on the VAT application were also made.

Shortly, Sixth Directive, by harmonizing the VAT assessments, creates a new source for EU. On the other hand, with this Directive, to abolish the fiscal frontiers, an advanced harmonization of VAT was realized. However, in some specific areas, such as the taxation of the small-scaled companies, the taxation of travel agencies, no mandatory implementation was regulated and so the Member States had the right to move with such freedoms. Furthermore Member States will apply their own rules on antique objects and collection belongings etc. till the formation of common regime for taxation.<sup>225</sup>

As mentioned in 11<sup>th</sup> Article, VAT is determined by multiplying the defined percentage with tax assessment. With the relevant Directive a common percentage of VAT could not be determined and so instead of that, a minimum limit was expressed as %15. It means that Member States are free to determine their own VAT rates, but it can not be less than %15.

When the Standard Rate is defined, a maximum limit, which no VAT rate can be more, is also created. Practically, the Member States can not apply "super"

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<sup>224</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p.5.

<sup>225</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p.6.

VAT rates which are more than standard rates. The countries, which have such high rates (for example for luxury goods), had to reduce these to level of standard rate.<sup>226</sup>

However, what should be considered is today the VAT rates are changing among %15 - %25 in the Member States of EU.

On the other hand 12<sup>th</sup> Article gives the opportunity to the Member States to apply one or two reduction rates which mustn't be less than %5 and which are expressed as "special products" in Annex- H. The products which are not mentioned in that list can not make use of the relevant reduction right. The products listed in Annex-H are the ones which are quite different from each other, but the common point of them is that the aim of applying reduced rates to these products is to minimize VAT's effects on the low income owner families. The most important product groups in Annex-H are food stuff, drugs and medical equipments and services, water sources, human transport, accommodation, participating the sport matches and the usage the sports foundations, books, newspapers and magazines, entrance to shows, theaters, waste processing etc. The reduced rates can be applied to some special kinds of repair of buildings and constructions<sup>227</sup>

On the other hand, if the existing competition is not damaged, the same reduction possibilities can also be applied to natural gas, living vegetables and woods for heating.

Reduced rates differ from %5 (in UK) to %17 (in Finland). Some countries may apply two different reduction rates in the respect of their rights stated in Article 12.<sup>228</sup>

The countries are free to apply the reduction rates in the respect of above mentioned details. However, the application of this right mustn't be discriminative.

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<sup>226</sup> Fantorini-Üzeltürk, op.cit, p.22.

<sup>227</sup> Fantorini-Üzeltürk, Ibid, p 23.

<sup>228</sup> Fantorini-Üzeltürk, Ibid, p.25.

Furthermore, it must be known that, zero rates are not suitable in the VAT application due to the fair competition rules being practiced in the Union.

However, the 6<sup>th</sup> Directive formed some proceedings which are exempted from the VAT. These exemptions are only the ones which were mentioned clearly between 13<sup>th</sup> and 19<sup>th</sup> Articles. The main type of such exemptions is the “imports”. The aim of this application is to protect the companies in EU against their international rivals. The company located in EU, which exports to a third country, must make the payment of VAT at the State where the goods arrived. However, the country, where this company is settled, also applies VAT on the relevant product and this loads double tax on the relevant product and damages its competitiveness in the respect of the price advantage. As a result of such an exemption, which enables the reduction rights, the companies exporting to third countries are free from such a disadvantage.

Furthermore, in 13<sup>th</sup> Article, as mentioned above, some exemptions, without reduction right, are mentioned which are in favor of public use. Some of these can be expressed as posting services, the medical services supplied by public foundations, education services supplied by the foundations, which are permitted to do such activities by public authorities, some cultural activities and the sport activities held by public authorities without any profit aim.

The insurance services, some bank proceedings, stamps, lotteries, allocation of buildings and building plat etc. are also free from VAT despite they are not seen as public services.

There are also VAT exceptions for the import proceedings mentioned in 6<sup>th</sup> Directive. These are:

- The goods exempted from the customs taxes. ( i.e. some goods mentioned in 83/181/AET Directive)

- Under some certain limits, the goods carried by travelers.
- Re-imported goods
- The goods belong to diplomatic regime, international foundations, and NATO forces.

The Article 14 (1) also states that the goods supplied in the Member States and under the exemption application, will also be exempted from the last importation. Furthermore, as an addition to these exemptions some exemptions, due to the custom proceedings (i.e. transit, contemporary importation) or Common Custom Tariffs are also mentioned (i.e. posting orders). The small goods, sent as small deliveries and not considered as commercial goods, are also used these exemptions in the respect of 78/1035/AET directive.

Meanwhile, on 29 June 1985 White Paper, a kind of program giving details about the achievement of Single Market, was published. In White Paper the measures which were seen as mandatory to receive the target as these:

- Removal of technical barriers
- Removal of physical barriers
- Removal of tax barriers

Being the main point of my thesis, I want to focus on fiscal barriers. In White Paper, it is stated that harmonization of indirect taxes has always been something vital for achieving the internal market. Because, it is quite logical that, only abolishing the frontier control, the aim of the internal market can not be realized, since the different tax applications, especially the indirect tax

implementations such as VAT and excise duties, can damage the formation of the market. One of the main points of White Paper is the Fourteenth Directive which and the suggested system under it. The Commission suggested building a “clearing house” system to ensure that VAT collected in the exporting Member States and deducted in the importing Member State is reimbursed to the latter, just like a registration system. Commission thought that the main problem of the existing situation is the different rates and coverage of VAT, but this cause systematic fraud and evasions. Due to the different rates, the trade trended to the countries where the low rates of VAT applied and with this different tax rates the frontier controls did not mean many thing in the respect of common market.

The situation of USA was a good example at that time and I think today it is remaining so. As we know, in US there are no tax frontiers and differences of up to %5 in tax rates are acceptable even between neighboring States. In white paper same example was put forward by Commission and depending on the US example, it is discussed that if a target rate suggested by the Community, the margin of this rate should be +/- %2.5.

As a result of approximation of VAT focuses on three areas:

1. The Common base
2. The number of rates
3. The level of rates

On the other hand in White Paper, it was also stated that the approximation of indirect taxation will give rise to considerable problems for some Member States and that as a consequence it maybe necessary to provide for derogations, although these should be kept to a minimum.

White Paper demonstrated that, in order to abolish fiscal frontiers there must be a considerable measure approximation of indirect taxes. In its global communication, the Commission proposes four major changes in the system of indirect taxation within the Community.

1. The Commission proposes an approximation of the VAT and the main excise duties. The Commission criticized the existing complicate system at that time and put two choices forward. One is the three rate system ( reduced, standard and increased ) and the other one is two rate system ( reduced and standard ) and for the standard rate Commission proposed a rate between %14 and %20 and for reduced rate between %4 and %9.
2. The Commission proposes the elimination of the distinction made between supplies within a Member State and supplies to another Member State. For intra-community trade the system of relieving goods from tax at export and of imposing tax at import should be abolished.
3. A revised VAT clearing mechanism is proposed. It was designed to operate on the basis of bilateral flows between the Member States and it can operate simply on the basis of money owed to or from a central account.
4. For VAT purposes the Commission proposes to change the place of taxable transactions regarding services. From the outset of VAT in the Community, the taxation of supply is, according to the Sixth Directive, generally the place where the supplier of a services are linked to the customer's country within the Community provided he is an entrepreneur <sup>229</sup>

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<sup>229</sup> Terra-Peter, op.cit, p.53.

These proposals of the Community were considered to radical. Inability either to agree on a clearing system or to align rates, however, ruled out any rapid move in this direction and in May 1989, the Commission prepared a new proposal. In this new proposals the idea of;

- Approximation of the rates of VAT and excise duties,
- The requirement of abolishing the tax frontiers to achieve the single market.

However, this time only a minimum was suggested for the standard rate, not lower than i.e. %15, and for the reduced rate Commission considered that the proposed band (%4-%9) best meets the need of situation. As a result, for zero rate products, it is suggested that Member States who wishes can maintain applying zero-rating for very limited products. However, the revised proposals of the Commission was not very popular, because the creation of a system of taxation in the country of origin, as supposed by Commission, presupposes the fulfillment of conditions that could not be met before 1 January 1993 and also to achieve the effective elimination of borders by this date for companies and individuals while respecting the economic neutrality of the common system of VAT, the Council found it necessary to continue, for a limited period of time, to collect the VAT in the State of consumption .

By 1990, the common form of VAT was becoming reality. As it can be seen above, besides the framework directives, several others had been adopted. As I stated above, one of the main points for common market and for all types of taxes is the abolition of fiscal frontiers and on 16 December 1991, ECOFIN Council agreed on the text of Directive 91/680/EEC, the Directive on the abolition of fiscal frontiers. However, this directive also changed the VAT system. Depending on this Directive



the transitional period shall be applied till the end of 1996, but from the beginning of 1997, it will be replaced by certain tax regime.<sup>230</sup>

The starting point of the Directive amending and supplementing the 6<sup>th</sup> Directive with a view to the abolition of fiscal frontiers is that purchases by private individuals will, as a general rule, be taxed exclusively in the country of purchase except the two exceptions (Purchases of new cars and other means of transport, Distance sale). The adoption of the Directive 91/680 /EEC created a framework for a VAT system without fiscal frontiers. This Directive completed 6<sup>th</sup> Directive especially about the common VAT system and as I stated above the frontier tax controls were abolished. The regime accepted by the Directive the date of which is 16 December 1991 was realized to be in valid between 1 January 1993 and 31 December 1996.<sup>231</sup> The suggestion about the certain tax regime will be prepared by Commission and presented to the Council till the end of 1994.

The period stated in this Directive, which was planned to be in valid till 1996, was seen as transition period and the features of this period can be summarized as this:

1. In this system, tax is realized on the additional values during the production and delivery of goods or services. It means that, additional value is the difference between the selling price and the purchasing price .For example ,if a textile company purchases some required goods by paying 1.000.000 TL and sells the goods she produced with 1.500 .000 TL / unit, 500.000 TL is the additional value which is created by this company.
2. One of the basic point which forms the VAT system is the “prior tax reduction. “This avoids the formation of tax pyramid. With this application, the VAT paid during the purchase is deducted from

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<sup>230</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p. 9.

<sup>231</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p.7.

the VAT collected during the sale and the difference emerged by this proceeding is paid by declaration which is given to the relevant tax department.

3. By letting the reduction of VAT paid up to %100 for the investment goods, the consumption type of VAT was adopted<sup>232</sup>.

With this Directive, 16 December 1991 dated, from 1 January 1993, some easiness on the application of the taxation at the arrival country was brought. The implementation which was in valid till the beginning of 1993, the exported goods were subjected to the frontier controls. At the frontier, some accounts for the exporter country and some accounts for importer country were summed and all these proceedings caused time and money loss for the relevant countries. Furthermore, all the points had to be repeated each time that the export realized.

On the other hand, with the new application, which became in valid from the beginning of 1993, customs were abolished and all the proceedings which can be named as “bureaucracy“became useless. With this implementation, the trucks were passed the customs without waiting and nothing like tax payment was in question for these trucks. However, the tax (VAT), through giving the relevant documents for VAT to the tax department in the relevant area by the receiver, was realized. Meanwhile, the products in concern were exported with “0“ VAT application. Furthermore, the exporter companies were committed to declare the selling information and the VAT numbers (which was given to each enterprise founded in EU) of their customers by giving a declaration in each three months.

For the imports from the third countries, the system of the payment of VAT, which was paid at the time of importing by giving a declaration, was continued<sup>233</sup>.

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<sup>232</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p. 5.

<sup>233</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p.10.

On 19 October 1992, the Council finally adopted Directive 92/77/EEC on the approximation of VAT rates .The main provisions as follow:

- Each Member State will apply a single standard VAT rate of at least %15,
- The high VAT rates will be abolished effective 1 January 1993,
- Each Member State will allowed to apply one or two reduced rates at least equal to %5 on cultural or social products or services,
- As transitional measure, the countries applying zero rates or rates less then %5 will be able to maintain them.

The main intention of the Commission by preparing the Directive 91/680/EEC and of the Council by accepting it was to form a transitional system which will be ended on 31 December 1996. According to the relevant Directive, The Commission must report to the Council on the operation of the transitional system and submit proposals for a definitive system before 31 December 1994. When the Council considers that condition exist for satisfactory transition to the definitive system, it must decide on the necessary arrangements for the entry into force of the definitive system before 31 December 1995. It means that the transitional arrangements are automatically continued as long as the Council has not decided on the definitive system.<sup>234</sup> As a result of this process in 1996 the final step for a common system was begun to be focused on.

On July 1996 the Commission declared the final system of VAT system under the name of “A Common System of VAT- A Program for the Single Market.” In this

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<sup>234</sup> Terra- Peter, op.cit, p.47.

paper, authorities waited for a structure of VAT which was quite similar to the approach expressed in proposal in 1987. However, it shall be seen that the Commission's approach differed a lot (i.e. there is nothing about the clearing mechanism in this new text), because in the preamble of this Paper, two main points mentioned stressfully. These are:

- Neutrality of taxation,
- The target of establishing an internal market characterized by the abolition of obstacles to the free movement of goods, services, capital and persons.

Anyway, as I stated above the new system with the name of certain tax regime was planned to be in valid from the beginning of 1997. With this step, the principle of taxation at arrival state was abandoned and the principle of the taxation at the country where the product in question is produced was emerged.

Therefore, this new system would have these points:

- An easing of the administrative obligations incumbent on enterprises and administrations and a significant simplification of taxation,
- No reduction of Member States' tax revenues,
- No increase in the risk of tax evasion<sup>235</sup>.

It is thought that with the existing system (before the renovation in concern made on VAT issue) there had been some drawbacks, because this system depended

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<sup>235</sup> Terra- Peter, op.cit, p.47 .

on a range of diverse factors (such as different rates, definitions etc.) which affects the intra-Community trade and competition in EU. Commission concluded that the below mentioned criteria must be covered by the new system:

1. It must abandon the segmentation of the single market into 15 tax areas( member states ),
2. It must be simple and modern so as to rise to the challenges of the 21<sup>st</sup> century,
3. It must guarantee equal treatment of all transactions carried out in the Community<sup>236</sup>.

Under these circumstances, the new system was introduced by the Commission as the logic of domestic market. The distinction between domestic and intra-Community transactions must be eliminated enabling operators to reduce to only to the number of tax systems currently applicable: transactions involving a third country and transactions carried out within the Community.

Furthermore, to guarantee both the simplicity and the effectiveness of the system, it is necessary that the principle be generally applied of taxing all transactions carried out within the Community.

The logical requirement for covering this above mentioned points (treating transaction within the single market in the same way as transactions carried out within one Member State) is to introduce a single place of taxation. The place of taxation is no longer a tool to determine the territorial scope of the VAT, but rather the Community scope.

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<sup>236</sup> Terra- Peter, op.cit, p.48.

With this new system as it was stated in the 2<sup>nd</sup> Directive, an obligation to prepare an invoice which shows the delivery of goods and /or performing a service and with this action the auditing activities became easier.

It should be also explained that the relevant 12 Member Countries were formed a network system in order to supply a information flow of the commercial commodities. These controls became something mandatory for the firmness of the new system. Through this system, which has been in force since 1992, the volume of the enterprises, VAT numbers etc. can be examined.<sup>237</sup>

#### 4.3.1.1.1. THE VAT SYSTEM IN THE EUROPEAN UNION

As I mentioned above the 1<sup>st</sup> and 2<sup>nd</sup> Articles of the First VAT Directive expresses the principles of the new VAT system<sup>238</sup>. The main features of the common VAT system of the EU can be summarized as:

- **Generality:** As a rule, the VAT system of the EU is applied to whole goods and products. Only the goods and services, which were mentioned in legal regulations specifically regulates VAT, can have some exemptions.
- **Proportionality:** VAT is defined as a proportion of the price of a product. I mean, VAT is determined depending on the percent of the price of a product. Therefore, during the production or the allocation phase of the goods and services, VAT can be easily seen and it is called as “transparent tax”.
- **To Be Taken from the Consumption:** VAT is a consumption tax and reflected to the final consumer.

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<sup>237</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p. 9

<sup>238</sup> Fantorini-Uzeltürk, op.cit, p.16.

- Reflection: Through the reflection principle, the company is exempted from the burden of VAT, and as mentioned above final consumer has the VAT burden.
- Reduction Right: Through this right, the tax burden is taken by final consumer not by the companies. The entities and people, subjected to taxation, can get the VAT, paid by them for their works, back. A company, which has a part during the production or the delivery time of the relevant product, reflects the VAT to the consumers only pays the difference between the VAT paid during the first and final stages<sup>239</sup>.

As I will explain below, the EU VAT system depends on the arrival country principle, i.e. a product becomes the subject to VAT, not in the country where the selling activity occurs, but where the consumption realizes.

After the approval of 1<sup>st</sup> and 2<sup>nd</sup> Directives, the Community decided to create a VAT system in which taxes on imports and to remove the tax returns on exports, but this has never been realized. The opinion under this decision was to create a VAT system which is applied in a country where no controls at borders happen. However, such a “exit country” principle was seen as a system which can create some problems in the parallel of fair competition and so “arrival country principle” was chosen.<sup>240</sup>

In 1993, when the Single Market was founded and when the fiscal boundaries were removed, a transition regime was materialized. Therefore, on one hand the controls at borders will be hindered and on the other hand taxation in the arrival place will be realized. However, a consensus on this approach could not be seen and the system was continued as before.

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<sup>239</sup> Türk Vergi Sisteminin Avrupa Birliği Vergi Sistemine Uyumu, İstanbul, 2002, İktisadi kalkınma Vakfı Yayınları p.17.

<sup>240</sup> Fantorini- Uzeltürk, op.cit, p.18.

The rules of VAT were explained to people living in the Member States of EU with the 8<sup>th</sup> Directive (6 December 1979). Afterwards, about the same issue, 13<sup>th</sup> Directive was declared and the harmonization of the different applications in the Member States and avoidance of tax fraud was intended.

#### 4.3.1.1.2. The Exemptions Of The VAT Implementation In The European Union

The simplest VAT system is one which all goods and services would be taxed at only one rate. However, certain transactions, particularly as regards services, are exempt from tax <sup>241</sup>

The exemptions of VAT were divided into two parts as reduced and non-reduced.

The reduced exemptions were named as zero rated exemptions and in this exemption application, the goods and service in concern is not subjected to tax and the VAT of these goods is returned.

However, at non-reduced exemptions, the tax is not implemented only at the phase at which the relevant exemption is applied, but the tax issued on the relevant good and/or service before the exemption is not returned.

The required points can be found between 13<sup>rd</sup> and 17<sup>th</sup> Articles of 6<sup>th</sup> Directive. In this respect, these exemptions can be briefly classified as:

- Without reduction right (such as medical services, governmental education etc.),

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<sup>241</sup> Van Hoorn J, op.cit, p.10.



- Import exemptions (the goods of the travelers, the re-imported goods, the goods belongs to diplomatic regime, NATO and international organizations).
- With reduction right (the goods especially subjected to export proceedings which can be defined as international transportation and export proceedings).<sup>242</sup>

Under this assumption, as mentioned at the previous parts of the thesis, the general exemptions are classified as “the useful activities for public“ such as medical treatments at hospitals, the activities of the religious and philosophical foundations, public transport, telecommunication services etc. The exemptions applied to the imports are the VAT exemptions applied to the temporary imports (i.e. under this implementation , a good is imported, but without changing ,it is exported again), the goods which are subjected to the transit-transport, the imported goods which are considered as exemptions in the country in question, the gold imported by Central Banks etc<sup>243</sup>.

On the other hand, for the export activities, the exported goods, the gold exported to the Central Banks of Member States, the transit transported goods etc. are also subjected to the exemptions regulated by 6<sup>th</sup> Directive .

Temporary Exemptions Regime: The 28<sup>th</sup> Article of 6<sup>th</sup> Directive stated that some products subjected to the non-reduced exemption practice can be subjected to the VAT application by some Member States if they choose, but if these exemptions are being applied in that time, this application could be defended in the transition period.

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<sup>242</sup> Türk Vergi Sisteminin Avrupa Briliği Vergi Sistemine Uyumu ,op.cit, p. 29.

<sup>243</sup> Türk Vergi Sisteminin Avrupa Briliği Vergi Sistemine Uyumu ,op.cit, p.19.

#### 4.3.1.1.3 THE VAT ASSESSMENT IN THE EUROPEAN UNION

As I stated above, with the 2<sup>nd</sup> Directive declared in 1967, it was decided that VAT will be taken from the determined value of the goods and services and also all the expenses emerge during the delivery of the goods and services, dues, fees which forms the cost of the commodity will be included in the tax assessment.

Under this assumption, in order to avoid unfair competition, tax harmonization became something mandatory <sup>244</sup> However, as it can be guessed, it was not something very easy because it may cause some budgetary loss for the country which decreases the rate of VAT, may cause social reactions in the country that increases the rate of VAT.

In this respect, there is one Directive prepared by the suggestion of the Commission in 1987 and another Directive accepted by Council in 1992.

The one prepared in 1987, the two sided harmonization system was advised. For the goods included in first group, the rate changing between %4 and %9 was planned to apply to the goods such as medical services and foodstuff (reduced rate). However, for the goods and services except the mentioned above ones, the rate changing between %14 and %20 was suggested to be applied (standard rate).

However, the Directive accepted by Council in 1992 means a lot for the existing system. The rules accepted by this Directive was planned to apply between 1.1.1993 and 31.12.1996. This is a kind of transition regime. The certain rates were planned to be determined by the Directive of Council.

As suggested in 1987, at this two rated regime was accepted. The explanation can be categorized as follow:

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<sup>244</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p.17.

1) Reduced Rate: This rate will be at least %5 and the Member States can have one or two reduced rates. The products and services subjected to reduced rates were listed in 1992 with Annex- H of the Directive as these.

- Foodstuff ( except the alcoholic drinks )
- Water distribution
- Pharmacological products
- The medical and subsidiary products for handicapped people
- Public transport
- Book , magazine and newspaper supply
- Cultural activities
- The royalties and services of authors ,compositors and interpreters
- The house construction for the social politic aims.
- The supply of the goods and services for the improvement of agricultural production
- The services of Hotels and the similar enterprises
- The entrance to the sportive activities
- The payment for benefiting from the sport foundations
- The supply of the foundations dealing with the funeral jobs.
- Medical and dental treatment services
- The rubbish collection and destruction service for the way opened to the public use
- The supply of the goods and services of the public foundations working for the social security and help<sup>245</sup>

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<sup>245</sup> Türk Vergi Sisteminin Avrupa Birliği Vergi Sistemine Uyumu, op.cit, p.24.

- 2) Standard Rate: The standard rate will be at least %15 (%15 and more). This rate shall be in use for the products which are not expressed in the above mentioned list.

The Directive abolished the increased rate. In this respect, the increased rates applied on the automobile, hi-fi video, perfume etc. were removed. The Directive also mentioned that in order to avoid structural problems, the application of the %0 and less than %5 rates in certain areas were permitted to apply during the transition period (such as house heating, clothes and shoes for kids and some certain agricultural products).

Since 1993, private individuals going to other Member States have been able to buy goods or services for their personal use and be taxed in the same way as its nationals. They can then return home with their purchases without being taxed again. There are couples of exemptions:

- The purchase of new vehicles (less than six months old or with less than 6000 km on the clock) in another Member State. This transaction is taxed in the Member State of destination at its rates and in accordance with its rules. The vehicle has to be registered and taxed in the country where the buyer is normally resident.
- Mail order sales by a company located in another Member State. Where the seller takes responsibility for transporting the goods ordered, VAT will be charged either at the rate applying in the country where the buyer is resident or at the rate in the seller's country, depending on the seller's annual sales volume in the country of destination<sup>246</sup>

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<sup>246</sup> <http://eu.int> / European Union Taxation Policy, p. 14.

While origin-based taxation remains as the basic principle of the common VAT system for private individuals, the transitional system kept various parallel destination based methods for companies, the aim being to ensure that the VAT levied in each Member State reflected the volume of consumption there and due to this problem two more Directives were adopted in 1992 and 1995 to streamline the system and remove the most serious distortions. However, it was impossible to achieve any radical simplification because the parallel origin and destination based taxation regimes continued to apply uniformly and rates remained too far apart. As a result, the existing VAT system is cumbersome for traders and the single market is, to some extent, still fragmented.<sup>247</sup>

Figure: 4.3.1.1.2 The VAT Rates of the Member States<sup>248</sup>

Member States	Reduced Super Rate	Reduced Rates	Normal Rate	Parking rate <sup>249</sup>
Belgium	1	6	21	1
Denmark	-	-	25	-
Germany	-	7	16	-
Greece	4	8	18	-
Spain	4	7	16	-
France	2.1	5.5	20.6	-
Ireland	4	12.5	21	12.5
Italy	4	10	20	-
Luxembourg	3	6	15	12
The Netherlands	-	6	17.5	-
Austria	-	10/12	20	-
Portugal	-	5/12	17	-
Finland	-	8/17	22	-
Sweden	-	6/12	25	-
UK	-	5	17.5	-

Source: <http://eu.int>

<sup>247</sup> <http://eu.int> / European Union Taxation policy , p. 815.

<sup>248</sup> At May 1999 ( source taxation and custom Union ).

<sup>249</sup> In the Member States which initially applied a reduced rate to non-eligible goods.

In July 1996, depending on the performance of transitional period, Commission proposed a package to improve the system. In this respect the new system must;

- Put an end to the segmentation of the market into national tax areas,
- Be simple and modern,
- Ensure equal treatment for all transactions within the Community,
- Guarantee effective taxation and controls to maintain the level of VAT revenue.

The program focuses on three areas of Community action:

- Uniform application,
- Modernization of VAT,
- A change to origin-based taxation<sup>250</sup>.

The gradual approach of proposed in 1996 has proved extremely difficult to implement. The Member States have showed little enthusiasm for the proposals in Council meetings and, as was the case with the transitional system, have been reluctant to accept the greater modernization of VAT rates and tax structure which is a prerequisite for the definitive system.

The Commission itself has not given up the long-term goal of the origin based taxation but plans to follow a strategy based on simplification, modernization

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<sup>250</sup> <http://.eu.int> / European Union Taxation Policy, p.15.

and more uniform application of the present VAT system coupled with a fresh approach to administrative cooperation between official <sup>251</sup>.

On the other hand, as I stated before, on 1 May 2004, ten new states became the members of the EU and the EU tax rules will become applicable in the new Member States.

As a consequence of the accession, EU acquis <sup>252</sup> in the tax area will apply in the new member states. Some new member states have negotiated special exemptions or transitory provisions such as initially lower VAT and/or temporary VAT exemptions. Negotiations regarding some directives have not yet been finalized which means that further derogations are still possible. However, the basic rule is that, the new member states must adopt new domestic tax legislation, or amend their existing laws to bring them into line with EU tax law <sup>253</sup>

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<sup>251</sup> <http://eu.int> / European Union Taxation Policy, p.18.

<sup>252</sup> The EU acquis : The body of common rules and standards, policies, directives, and the European Court of Justice jurisprudence.

<sup>253</sup> The Commission of the European Communities, op.cit, p. 1.

#### 4.3.1.2. EXCISE DUTIES

Excise Duties are special taxes levied on particular consumer products: manufactured tobacco, alcoholic drinks, mineral oils, etc. Their rates are usually expressed in an amount per unit of product, although sometimes a percentage of the value is used instead.

The choice of excisable products is partly dictated by public health, environmental and energy saving considerations. The rates of excise duties vary from one Member State to another but they are important source of revenue.<sup>254</sup>

In the respect of the formation of Single Market, the structural harmonization of the Excise Duties were completed through some directives approved in 1992<sup>255</sup>

As it mentioned above, being different from the turnover taxes, excise duties do not contain all goods and services, but are levied on certain kinds of product and/or group of products.<sup>256</sup>

In the respect of the formation of Single Market, the structural harmonization of the Excise Duties was completed through some directives approved in 1992<sup>257</sup>. A common system of excise duties was introduced on 1.1.1993 when the single market came into being. It applies to three main categories of product:

- Manufactured tobacco ,
- Alcoholic drinks,
- Mineral oils.

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<sup>254</sup> <http://eu.int> / European Union Taxation Policy, p. 19.

<sup>255</sup> Fantorini-Üzeltürk, op.cit, p.39.

<sup>256</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p.21

<sup>257</sup> Fantorini-Üzeltürk, Ibid, p.39.



The Member States can, however, continue to levy other (disharmonized) taxes on these products (green taxes) and others, such as vehicle registration or road taxes, fees etc. if they do not constitute either a turnover tax or a barrier to trade.

A harmonization for the structure, application methods and application fields of the excise duties were realized in EU, but there has been no harmonization on the levels of it, yet. Here, the accepted approach is that, under the assumption of the difference of the custom levels in EU, by determining some minimum levels for certain types of products, in stead of harmonizing the levels, to make the numbers of the relevant levels closer seemed more logical.<sup>258</sup>

The taxable event is usually the production of goods or importation of them into the Community. However, payment is generally suspended until the goods are declared for release for consumption, usually at a later stage in the commercial chain. This rule ensures that excise duty is always paid in and to the Member States where the goods are consumed. In other words, excise duty is not usually paid on goods leaving manufacturers or wholesaler until after the storage and forwarding stage. Goods imported from outside the EU can move within the EU under the suspension arrangements until they are officially released for free circulation<sup>259</sup>

Under the EU taxation example, necessity of the harmonization of excise duties is as important as the harmonization of VAT, because the goods subjected to excise duties such as the alcoholic beverages, mineral oils, sugar are on one hand is an important for individual consumption. On the other hand, they are important for industrial production. When the consumption area of these goods becomes industrial area, the tax levied on these kinds of products becomes production tax. The different rates of the excise duties cause different price quotation and so damage the fair competition. On the contrary to the VAT, the unequal situation can not be solved by return of the tax during the export of the goods, because excise duties are kinds of collective expenditure taxes that emerge during the production period before the

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<sup>258</sup> Fantorini-Üzeltürk, op.cit, p.39.

<sup>259</sup> [http:// eu.int](http://eu.int) / European Union Taxation Policy, p.18.

final selling and so the weight of such taxes on the raw material can not be defined definitely.

Furthermore, as it is known, the excise duties are added to the tax assessment of VAT and the differences of the rates of excise duties cause the difference of VAT on the products and so indirectly it affects the price differentiation. This formation also damages the competition between the Member States' products. Furthermore, as much as the Member States prevent their freedoms on the excise duties' application, the common policies of the Union can not function sufficiently.

Finally, in the respect of the Customs Union, the harmonization of the excise duties has played a very important role otherwise the gap emerged due to the abolishment of the custom duties may be filled by excise duties <sup>260</sup>

The 92/12/AET numbered European Council directive is the main document for the content of the excise duties in EU.

The 3<sup>rd</sup> Article of the relevant document, the excise duties are applied on petroleum products, alcohol and alcoholic beverages and tobacco products.

As it is mentioned in 6<sup>th</sup> Article, excise duties shall be applied when the relevant product will be subjected to consumption in the Community.<sup>261</sup>

The Community rules covering the excise duties can be classified as:

- 1) Harmonized tax structure (definition of products, units of measurement, exemptions),

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<sup>260</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p. 22.

<sup>261</sup> Fantorini-Üzeltürk, op.cit, p.39.

- 2) Tax rates: In 1992 the Council adopted common minimum rates for the Member States, giving them a degree of discretion to set their own rates of excise duty, while taking due account of international environment,
- 3) Movement of excisable product between the Member States.

However, to organize the excise duties under the practice of the Union has not been something very easy. When we compare it to the VAT concept, due to its great capacity of supplying revenue, the rate difference between excise duties are bigger. Meanwhile, there have been no common approaches of the Member States for the goods under the scope of excise duties. For example, whether the beer and wine is luxury goods or not, or cigarette is something harmful for the public health and so must be the subject of high taxes etc. are remaining as unclear points between Member States.

In spite of all these difficulties, the works for the harmonization of excise duties began at the early stages of the unification. It was decided that tobacco, alcohol, beer, wine and mineral oils shall be harmonized. It was a quite important step, because it was known that the %95 of the revenue obtained from the excise duties were from the above mentioned products. However, due to the reluctant treatment of the Member States, except the tobacco, there was no great success at the other materials. The first movement about the excise duties was the harmonization of the taxes obtained from manufactured tobacco and cigarette. With 72 /464 numbered Directive which was declared in 31.12.1972, the main principles for manufactured tobacco and the commands applied for cigarette were put forward and with the 79/32 numbered Directive the main definitions and classifications for the above mentioned products were made. In the respect of Common Market reality, planned to be realized in the 1.1.1993, with 92/79 and 92/80 numbered Directives, the excise duties on the cigarettes and manufactured tobacco were approximated.

At the end in 19.10.1992, Council decided that, the issues except the tobacco and cigarette had to be harmonized in the respect of tax bases, rates and assessments. Depending on the 92/79 numbered Directive, the Member States shall apply minimum excise duties on the cigarettes from the beginning of 1.1.1993. This tax shall be formed by specific tax (calculated for each material unit), ad valorem tax (calculated for maximum retail selling price ) and VAT tax ( which is proportional with retail selling price) and as a result, in the respect of 2<sup>nd</sup> Article of the same directive, general minimum excise duty (specific tax + ad valorem tax) This minimum excise duty tax, each year from the 1<sup>st</sup> of January, is indexed to %57 of the retail price of the mostly consumed product and this must contain all the taxes .<sup>262</sup>

For the manufactured tobacco the important Directive is 92/80 numbered Directive. Depending on this Directive, for the materials contained by this Directive (such as cigar), there are two choices to issue the relevant tax. One is the ad valorem tax which is freely calculated depending on the maximum retail selling price or the other one is this tax will be subjected to specific tax or another mixture of these two taxes.

Diplomatic relations and deliveries under the relations of consulates, for international organizations and for NATO forces not placed where the tax shall be paid, exceptions from the excise duties are regulated.

Except from these above mentioned obligatory exceptions, the processed tobacco not suitable for smoking and used for industrial and agricultural aspects, under the observation of administration, destroyed tobaccos, the processed tobacco used for scientific or quality control aspects, the tobacco re-processed by the producer are also seen as exceptions.<sup>263</sup>

For mineral oils, 92/81 and 92/82 numbered Directives are the declared. The first one was harmonized the structure of the excise duties on the mineral oils, the

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<sup>262</sup> Türk Vergi Sisteminin Avrupa Briliği Vergi Sistemine Uyumu ,İktisadi op.cit, p.43.

<sup>263</sup> Fantorini-Üzeltürk, op.cit, p.45.

other one brought the regulations of the harmonization of rates. Depending on the 92/82 numbered Directive, from 1.1.1993 the excise duty of normal petrol was 337 Ecu for Per 1000 liter, 287 Ecu for special kind of petrol, 18 Ecu for kerosene, but if it is used for heating it is 0, for heavy fuel oil 13 ECU for 1000 kg, 100 Ecu when it is used as liquid petrol gas, and 0 when it is using for heating and for diesel oil 248 Euro for 1000 liter.

There are also exemptions for mineral oils. In the respect of 8<sup>th</sup> Article of 92/81/ AET Directive;

- Mineral oils except the motor and central heating fuel,
- The mineral oils used at air-ways, except the private flights,
- Except the sea-vehicles belong to the human beings, the mineral oils used at transports in sea in EU boundaries,
- The mineral oils used as an addition to coke for chemical reductions,

are seen as exemptions in the respect of excise duties.

Furthermore, the 8<sup>th</sup> Article also enables exemptions for mineral oils from the excise duties totally or partially;

- If it is used in heat and energy foundation and electricity production,
- If it is used at the travels in internal waters except the ships belong to human beings,

- If it is used in environmental projects,
- If it is used at railway transportation for goods and passengers,
- If it is used at the projects for testing, improving and producing of ships and planes,
- If it is used at agricultural, gardening and forestry activities and fishery at internal waters,
- If it is used at research activities at ports and water ways<sup>264</sup>.

For alcohol and alcoholic beverages, 92/83 and 92/84 numbered Directives were declared. The first one was harmonized the structure of the excise duties on the mineral oils, the other one brought the regulations of the harmonization of rates. In the respect of 92/83 numbered Directive beer, wine, ethyl alcohol and the other alcoholic beverages were defined and it was stated that the tax shall be calculated;

- For per hectoliter/degree Plato values of the product or,
- The hectoliter/ degree value of the alcohol rate of the finished product,
- In the respect of 92/84/ AET Directive, the minimum excise duty applied on the beer shall be 0.748 Euro / HL/ degree or 1.87 Euro HL/ alcohol.

As it mentioned in 92/83/AET Directive's 9<sup>th</sup> Article, the excise duty on the wine shall be determine for hector liter value of the finished product. 92/84/AET

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<sup>264</sup> Fantorini-Üzeltürk, op.cit, p.52.

Directive did not define a minimum level for wine as an excise duty, but the Member States has the right of determining the maximum level of excise duties for wine.

According to 92/83/AET Directive, the excise duty levels for fermented beverages shall be determined in the respect of finished products' hector liter values

The minimum level of the excise duties is defined as 550 Euro/ hectoliter in 92/84/ AET. It is also same for ethyl alcohol.

The Member States also have some reduction rights for excise duties (i.e. for beer or other relevant products, produced by small enterprises, which have the production capacity not more than 200.000 hectoliter)

There are also general exemptions in alcoholic beverages such as diplomatic regimes and other parts as mentioned before. Furthermore, under the demands of the Member States, if they delivered when they become undrinkable, when they used for the production of the products which are not for individual consumption, when they used at the production of vinegar and other nutriment's aromas and at the chocolate's production under certain levels.

Furthermore, there are also some other exemptions for alcoholic beverages, when they used for analyzes production tests and scientific aspects and searches, for medical aspects in hospitals and drugstores, in the production process the result of which will not be an alcoholic beverage, the production process of the compositions which are not the subjects of the excise duties. If the persons are produced alcoholic beverages for themselves, the relevant goods will also not seen under the application of excise duties.<sup>265</sup>

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<sup>265</sup> Fantorini-Üzeltürk, op.cit, p.50.

More flexible rules apply to occasional purchaser. Private individuals going to another Member State can buy an unlimited quantity of excise-paid products for their personal use; if they are buying for commercial purposes ( or by mail order ), on the other hand, the excise duty has to be paid in the country of destination<sup>266</sup>.

However, there are some other excise duties except this scope. These taxes are named very differently in different countries. For example, in Turkey vehicle purchase tax is under this scope, some other countries motorcycle purchase tax is also under this scope. The tax such as these special taxes, the Member States are free to regulate. However, in Treaty of Rome there are some restrictions that when the countries regulate special excise duties for the area which does not contain the special economic and social aims. These are:

- No more charges having equivalent effect shall be in question,
- These taxes must be applied as internal taxes,
- This internal taxes must be harmonious with the non-discriminative and non –protective rules of the Treaty of Rome<sup>267</sup>.

Another subject under the tax harmonization is the energy products. The June 1992 UN Conference on the Development in Rio called for a global strategy to reduce greenhouse gases, including the use of economic instruments was an important point for that. At the time, the Commission was proposing a new harmonized carbon and energy tax aimed at stabilizing CO2 emissions in the Community in the medium term. Even after amendment, however, the proposal met consistent opposition and Ecofin Council asked the Commission to table another proposal based on the current system of excise duty for mineral oils.

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<sup>266</sup> <http://.eu.int> / European Union Taxation Policy, p. 21.

<sup>267</sup> Türkiye - At Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları, op.cit, p.25.



The new proposal ( COM(97 ) 30 ) reflects environmental concerns but is essentially shaped by the need to ensure that the internal market operates correctly .The main idea is to extend the Community system of excise duty on mineral oils to cover natural gas, coal and electricity, raising the minimum rates for the others. At the same time taxes on labor would be reduced ensure the overall tax burden does not rise.

The proposal is part of coordinated plan aimed at meeting the targets set by the 1997 UN conference on Climate Change in Kyoto where the Community undertook to reduce greenhouse gases by %8 from 1990 levels between 2008-2012

<sup>268</sup> .

The need for a limited rationalization of internal taxes, rather than full harmonization, was accepted in the revised version of Article 99 in the Maastricht Treaty. The article now imposes an obligation to harmonize “to the extent that such harmonization is necessary to ensure the establishment and the operation of single market “. In other words, it is now accepted that there is no need for a single set of EU wide indirect taxes.

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<sup>268</sup> <http://.eu.int> / European Union Taxation Policy, p.22.

#### 4.3.2. DIRECT TAXES

Direct taxes are also important impediment to free trade by affecting the investment, production and employment decisions. The arrangement of the Direct taxation are mentioned in article 220 of the EC Treaty, in the respect of double taxation, but as we will see in further parts of my thesis, there have been no regulations and/or agreement made by the Community till now and this gap has been tried to be filled by the international and bilateral agreements<sup>269</sup>

Direct taxes totaled one billion Euros (%13.7 of European GDP) in 1997, reflecting the general rise in tax and social security contribution<sup>270</sup>

In a report, which was sent by the Commission to the Council, the harmonization of Direct taxes was defined as this:

“Harmonization of the systems of corporation tax means introducing: a common scope of application; a common tax system; similar rates of tax; a common base of assessment. It also means a common solution to the problem of taxing profits earned abroad through permanent establishments and subsidiaries”<sup>271</sup>

The works on the harmonization of the direct taxes have focused on the income tax and the corporation tax, but when the functions of the Single Market are considered, the importance of the corporation tax becomes much more sufficient<sup>272</sup>

Basic differences in the effective tax burdens on labor and on investment returns, and especially excess tax burdens (double taxation) as a result of the border crossing of economic activities, definitely frustrate free competition and the free

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<sup>269</sup> Karluk, Rıdvan, op.cit, p.465.

<sup>270</sup> <http://eu.int> / European Union Taxation Policy, p.24.

<sup>271</sup> Terra- Pete, op.cit, p.66.

<sup>272</sup> Fantorini-Üzeltürk, op.cit, p.83.

movement of labor and capital within the Community. They cause fragmentation of the capital and labor markets by impeding optimum allocation of production factors. Preferential tax treatment of domestic investment over investment abroad obviously infringes capital export neutrality. Furthermore, a significant difference in overall tax burden between undertakings from different Member States operating within the same national jurisdiction infringes capital import neutrality. Meanwhile, European industry has to operate in the quite large markets instead of large domestic market. Having to cope and comply with so many different tax systems and authorities' makes business planning and cause tax avoidance and tax evasion. Finally, significant differences in effective enterprise tax burdens influence the location of production plants, which may lead to sub-optimal allocation of production factors. As technical, administrative and other barriers to cross border economic activities are gradually removed within the EC; mobile undertakings will more easily set themselves up in Member States offering the lowest tax cost. This will lead to tax competition in that Member States will try to attract economic activities from other Member States by granting tax holidays base or rate reductions or other tax incentives<sup>273</sup>

However, due to the its structure, the harmonization and the other features of the direct taxes do not have a clear part in EC Treaty like indirect taxes. As I stated earlier, there are mainly a few reasons for this result.

- a) Sovereignty problem,
- b) The decision making system of EU,
- c) From the beginning of EU, the main impediments for the free movement of goods are seen as indirect taxes, not direct taxes,
- d) There is no direct reference to direct taxes like indirect taxes in the Treaty of Rome<sup>274</sup>.

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<sup>273</sup> Terra- Peter, op.cit. p.54.

<sup>274</sup> Tuncer Mehmet, op.cit, p.288.

According to the functioning of the Common Market, Article 100 of the EC Treaty, as I stated before, puts a legal basis forward for direct tax measures at the Community level. It means that harmonization of the Direct taxes i.e. personal income taxes seen as something not individually very important, because such harmonization is not coming as the first condition for the proper functioning of the Common market. From the beginning of the works of completing internal market, i.e. national income taxation is not considered necessary for the completion of internal market. Harmonization of personal income taxes will, therefore, not, in foreseeable future, be initiated by the Commission.

The legal acquisition in the field of direct taxes is;

- The Directive about the direct taxes on the capital increases,
- The Directive about the common system of taxation of parent-subsidiary companies in different Member States,
- The Directive about common system of the companies' mergers, the exchange of the shares etc.<sup>275</sup>

These directives will be latterly explained with details and so the significant points may be understood bitterly.

As a result, there has been no more harmonization or coordination of direct taxes in the Community. Such progress as there has been is no more than a partial response to the specific situations of double taxation and cross border economic activity.<sup>276</sup>

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<sup>275</sup> Fantorini-Üzeltürk, op.cit, p.55.

<sup>276</sup> <http://.eu.int> / European Union Taxation Policy, p. 24.

However, the stamp duty is the first type of direct tax which tried to be harmonized. In this field, in 1973 Council determined the stamp duty as % 1 from 1976 for the foundation of the capital based companies and investment capital<sup>277</sup>.

In general terms, current EC Direct tax harmonization policy is aimed at:

- Curbing alarming tendency in national tax policies of shifting the tax burden from the more mobile capital factor to less mobile labor factor, leading to over-taxation labor,
- Alignment of corporation taxes, both in respect of rates and in respect of assessment bases,
- Co-ordination of the tax treatment of distributed company profits,
- Elimination of obstacles, such as withholding taxes, to the cross border flow of dividends, interest and royalties,
- Facilitating the cross-border grouping together of companies,
- Non-discriminatory tax treatment of non-residents taxpayers, especially frontier workers,
- Creating a favorable tax environment for small and medium sized business,
- Harmonization of the taxation of savings, while at the same time avoiding a possible flight of savings from the Union to third States<sup>278</sup>.

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<sup>277</sup> Tuncer Mehmet, op.cit, p.289.

<sup>278</sup> Terra-Peter, op.cit, p.264.

However, not so much successful steps has been taken it the Direct taxation. Just two main Directives on specific issues of the international grouping of companies, one multilateral Convention on transfer pricing arbitration, and a couple of non-binding recommendations, can bee seen in this respect. There are of course some reasons for this situation and one of them can be stated as the unanimity decision making system and I think the most important one is the reality that the Member States want to protect their tax sovereignty.

There are some main problems when we examine the Member States approach and applications in Direct Taxation. These are the ways of eliminating double taxation on foreign source income and the way of eliminating national double taxation on distributed domestic company profits. Finally the taxation of companies in Member States has also created problems.

Hereby, in order to finish this part of the thesis, I want to express the existing rates of the corporation and the income taxes in the Community of some of the Member States of the EU:

Figure: 4.3.2.1

The Corporation Tax Rates in the Community's Member States

Countries	The Tax Rates(%)	Countries	The Tax Rates(%)
Germany	45	Ireland	32
Austria	34	Spain	35
Belgium	40	Sweden	28
Denmark	34	Italy	37
Finland	28	Luxembourg	30
France	40	Portugal	34
The Netherlands	35	Greece	35-40
UK	30		

Source: Fantorini,Uzeltürk, op.cit, p. 101

Figure: 4.3.2.2 The Income Tax Rates in the Community's Member States

Countries	The Minimum Rates (%)	The Maximum Rates(%)
Germany	29	53
Austria	10	50
Belgium	25	55
Denmark	40	58
Finland	5.5	56
France	10.5	59
The Netherlands	7	60
UK	20	40
Ireland	24	46
Spain	20	56
Sweden	31	56
Italy	19	46
Luxembourg	5.2	47
Portugal	15	40
Greece	15	45
Other kinds of income	20	45

Source : Fantorini,Uzeltürk, op.cit, p. 94

#### 4.3.2.1. The History Of Direct Taxation In The European Union

From the very beginning of the history of the Community, there have been some attempts for the harmonization of Direct Taxes. For example, in Neumark Report split –rate system's adoption by six Member States were suggested and in 1967 Commission presented a program for the harmonization of direct taxes. In 1969, two of these policy issues were realized as a proposal for a Merger Drective and Parent-Subsidiary Directive and submitted to Council on 15.01.1969 .The relevant Directives adopted in 1990.

However, the EU has a common system for the taxation of the below mentioned specific field from 1969.

- The investment capital for companies,
- Mergers ,the exchange of shares ,
- The relations Parent-Subsidiary type companies

Furthermore, to avoid the double taxation of the partner companies' benefits, the double taxation issue has been a significant part of the works on taxation<sup>279</sup>

In 1970, in order to supply international neutrality the classical system of taxation of distributed company profits were suggested in the Van den Tempel report.

Unfortunately, due to its structure and the Member States' approaches no more improvements have emerged. In 1975, Commission submitted a proposal to the Council about the harmonization of the system of company taxation and of withholding taxes on dividends. In this proposal Commission proposed a partial imputation system. In this respect, the national corporation taxes should be between %45 and %55 and any Community shareholder should receive the same imputation credit as a domestic shareholder. Member States would be free to fix the amount of the imputation credit, to be given to both domestic and foreign shareholders, between %45 and %55 of the corporation tax on the profits out of which the dividend was paid. It was also advised in that report that, with the harmonization of the high rates, the tax bases must also be regulated<sup>280</sup>. However, when we look at the result of this proposal, the willingness of the Member States to even discuss a more or less total

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<sup>279</sup> Türk Vergi Sisteminin Avrupa Briliği Vergi Sistemine Uyumu, op.cit, p. 15.

<sup>280</sup> Terra-Peter, op.cit, p.66.



base harmonization was not enough and the relevant proposal never submitted to Council.

On the other hand, in 1976, a Mutual Assistance Directive, which is mainly concerns the exchange of tax information between the relevant authorities of the Member States, in the field of direct taxation was adopted. As a result of this Directive, in same year, the Commission proposed a directive on “ the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises“, but it has never become a directive. In 1990, by some modifications, it became a multilateral convention between Member States.

In 1980 and in 1984, some proposals about the different parts of direct taxation were sent by the Commission to Council, but they also did not become a real Directive. In White Paper published in 1985, direct taxes also had a very small part.

In 1989, the Commission proposed a directive on a common system of withholding tax on interest income (%15 percent of the withholding tax on interest payment in all EC area) and this Directive was followed by capital movement Directive declared in 1988. However, the countries, such as Germany, steps reduced the importance of this proposal, too.

In the field on personal income taxation nothing has happened. Only one proposal for a Directive in this field has ever been submitted to the Council in 1979, which was about the harmonization of income taxation provisions with the respect to the freedom of movement for frontier workers, but it was withdrawn by the Commission in 1993.

In 1 December, 1997, a tax package was accepted by ECOFIN Council. This agreement contains a directive draft which targets to tax income emerges as a result of saving rights and the interest amounts between partner companies .<sup>281</sup> As a

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<sup>281</sup> Türk Vergi Sisteminin Avrupa Birliği Vergi Sistemine Uyumu, op.cit, p. 15.

result of hard negotiations the report was approved and the content of it was accepted. In this regard the harmful rules decided to be abolished till the end of 2002. The works on the taxation of saving rights has been continuing.

Briefly, what can be understood from the above mentioned history is that, a common system of taxation of distributed company profits is politically unattainable in the short term, because it involves approximation of tax rates, which in its turn implies harmonization of tax assessment bases. The Member States, however, do not want to conform their tax base to a common system, since this virtually entails the sacrifice of not only fiscal sovereignty but also sovereignty in matters of national economic and social policy. So, by the beginning of 1990, there was no concrete harmonization of direct taxes in the EC whatsoever, except in so far as resulting spontaneous harmonization due to the tax competition between the Member States. The second half of the 1980s saw substantial cuts in tax rates, both corporate and personal, accompanied by a broadening of the assessment bases of income taxes.<sup>282</sup>

In 1990, the Commission prepared its guidelines on company. In this regard, the adoption of the Merger Directive, the Parent-Subsidiary Directive and the Transfer Price Arbitration Directive was proposed. About the foreign losses, the abolition of withholding taxes on interest and royalty payments within the group companies, a systematic examination of Member States' rules on transfer pricing with a view to making them uniform to prevent double taxation, the transparency of company taxation (especially it was stated that the incentives such as state aid must be clearer), the Commission announced a proposal for Directive.

As a result of this new approach, the Council adopted Merger Directive and Parent subsidiary Directive and Arbitration Directive. However, the proposals of the Commission about the foreign losses, intra-group interests and royalties, have not been adopted.

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<sup>282</sup> Terra- Peter, op.cit, p.67.

National corporate taxes within the EU vary significantly in their rules for defining profits, the rates of tax applied to those profits, and the systems within which those profits are taxed. This has long been recognized within the EC, and various measures were proposed to remove the various differences. These started with the Neumark report and the Van Tempel study. Both assumed that there should be at least a common corporate tax system. Specific proposals dealing with individual problems were first tabled in 1969. A proposed directive aimed at a common system was tabled in 1975, but made no progress. However, with the improvements of the formation of single market decisions were declared by Guidelines on Company taxation published in 1990. This paper put forward the adoption of Merger Directive, Parent –Subsidiary Directive and the Arbitration Procedure Directive. On the tax front the main problem for companies wishing to take advantage of the single market is probably the difficulty of cross border cooperation between companies established in the Community, therefore these directives have been very important.

Now, some brief information about these Directives can be stated.

#### 4.3.2.2. The Parent-Subsidiary Directive

The main of the Directive is to eliminate the disadvantaging suffered by companies in different Member States within a parent-subsidiary relationship because of inconsistencies in treatment by national tax systems. In doing so, it supersedes relevant provisions in bilateral double tax conventions. However, the scope of the Directive is limited in several ways. First, it applies only where the parent has a %25 interest in the subsidiary. Second, it is subject to national safeguards to prevent fraud. Third, it applies only companies of a form listed in the Directive. Fourth, each company must be resident for both national law purposes and double tax convention purposes within a member state. Where a dividend is paid from a subsidiary to a parent, the Directive places limits on the taxing powers of both states involved. The state from which the dividend is sent must exempt the dividend from withholding tax if %25 link exists. In other words, the dividend must be

received gross in the state of the parent company. That state must also observe restrictions. It may not itself impose a withholding on the dividend. More important, it must either exempt the dividends from taxation or allow relief for the underlying tax against any tax it levies. The effect is that the state where the subsidiary is resident is free to tax that company's profit. The dividend of those profits to the parent company may not be taxed as such by the state of the subsidiary. The state of the parent company may tax dividends, but must recognize that this is derived from taxed profits. It must also allow relief for the tax already paid on the profits funding the dividend.

#### 4.3.2.3. The Merger Directive

The purpose of this Directive is to remove tax barriers against cross-border linkages companies. Under national tax laws, such transactions normally incur heavy tax costs if the transaction involves assets or value leaving the jurisdiction. At the time the directive was adopted these could occasionally take as taxes half the value transferred and in others none at all. Such provisions clearly rendered some transfers uneconomic, and the regime as a whole distortion. The main solution offered by the Directive is to remove the distortion by removing the tax charge. This is done by exempting the companies involved from capital gains tax on the values realized, if there is a locking-in or reinvestment of those values. The Directive also protects against a tax charge on the cancellation of any shares involved or on the allotment of the new shares. Application to cases where the company receiving the shares obtains less than %25 of the capital of the transferring company is not mandatory.

#### 4.3.2.4. Arbitration Directive

One of the main problems of the national governments is the transfer pricing. For example, a parent company in one state supplies its subsidiary in another state with partly finished goods. It also supplies the know-how to train staff to finish the goods ,an with the necessary intellectual property licenses to sell the goods. It will probably impose a price, charge or royalty on the subsidiary to pay for those assets

and rights. The sums paid will count as a deduction against the profits of the subsidiary and as part of the profits of the parent. The amount chosen as the price is therefore of direct concern to both tax authorities of the subsidiary state might suspect tax avoidance to be a reason behind the precise prices used. What may happen is that the tax authorities of subsidiary may refuse to accept prices used by the MNE, and may insist that a lower price be used for assets supplied. They will disallow the claim for a deduction above that amount. However, the tax authority of the parent may not agree, and may insist on calculating the profits on the assumption that the price was fully received. If this happens, MNE is being taxed excessively; because the parent is being taxed that subsidiary is not allowed fully to treat as an expense. With this Directive, an arbitration procedure is introduced to prevent double taxation in connection with the adjustment of profits between associated enterprises from different member states.<sup>283</sup>

Differences in taxation between Member States can influence companies' investment decisions and create distortions of competition. In 1990 the Commission asked a committee of independent experts and so on 25 October 1990, Ruding Committee chaired by Onno Ruding, former Finance Minister of the Netherlands, was chaired and announced a new report to see whether differences in corporation tax caused distortions in the single market, particularly as regards investment decisions and competition, and to suggest ways of overcoming this problem. Depending on this report, Committee's findings can be summarized as follows:

As main matters in the direct taxation are listed as the elimination of double taxation of cross border income flows, approximation of corporation taxes, removal of discriminatory features of imputation system, the setting of minimum level for the statutory corporation tax rate, common rules for a minimum tax base, so as to limit excessive tax competition and encouraging the maximum transparency of national tax incentives. To apply the required measurements to the problems mentioned above, the implementation phases are divided into three parts

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<sup>283</sup> William, op.cit, p.150.

-phase 1: by the end of 1994

-phase 2: during the second phase of the economic and monetary union

-phase 3: concurrently with full economic and monetary union

Shortly, it was expressed that Source countries should abolish withholding taxes on dividends paid by subsidiaries to parent companies, home state of parent companies should prevent double taxation of the profits transferred home by subsidiaries in other Member States, abolition of withholding taxes on intra-group payments of royalties and interest should be adopted speedily and be extended to cover all such payments between undertakings of different Member States etc.

Despite a measure of convergence between tax systems, individual action by Member States was unlikely to prove effective in elimination major tax distortions. The committee made specific recommendations designed to eliminate double taxation of cross border income flows and harmonize the components of corporation tax; rates, assessment basis and the administrative collection system. Essentially, it suggested that the key components of member States' corporation tax systems be harmonized. Its proposals to eliminate double taxation dealt with abolition of charges, regulation of transfer pricing, treatment of losses abroad and completion of the network of bilateral tax agreements. The need to eliminate double taxation, ensure effective taxation and prevent tax evasion is recognized by Council

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Consequently, The impact of corporation tax on competitiveness was first studied in 1962, when working parties were set up to discuss tax bases and instances of favorable tax treatment. Attempts to harmonize corporation tax (1975), the rules governing carry-over of losses (1984-1985) and the tax bases for companies (1980)

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<sup>284</sup> <http://eu.int> / European Union Taxation Policy, p. 28.

failed. EU Member States do, nevertheless, realize that economic integration will require greater cooperation on tax collection and Council Directive 77/799/EEC provides for mutual assistance between national tax authorities.

There are two reasons for the recent tax policy of EU which does not have a general policy on taxation. One reason is that; there is a definite relation between the tax issues and the sovereignty of the countries, therefore the regulations in tax issues have been mainly made by Directives ( Directives are more convenient for such kind of issues than regulations, because the policies of taxation is under the authority of the national parliament in the Member States and with Directives the countries have some flexibility during the legalization of them) and the other reason is that, during the preparation of the foundation treaty of the Union, the countries mainly focused on the Customs Union which ensures the free movement of goods. Therefore, instead of a common tax policy, works for reducing the differences emerged by the existing tax application of Member States has been in valid.

Neumark Report which is seen as the fundamental concept for determining the tax policy of the Union, it was put forward that, a common and unique tax policy for all of the Member States and so for the Union is impossible and so, in principle, it was expressed that the differences in the tax policies of the relevant countries which do not damage the targets of the Union are seen acceptable and so instead of working on a common tax policy, harmonization way has been chosen to reach a satisfactory tax policy in the EU.<sup>285</sup>

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<sup>285</sup> Terra-Peter, op.cit, p.150.

## 5. TURKISH TAX SYSTEM

When we look at the Turkish Tax Systems, we see the below mentioned points initially.

- The tax system in Turkey is progressive. In other words, the higher your income, the higher the rate at which you will pay tax.
- The 2005 individual tax rates vary from 15% - 40%.
- in 2005 the standard rate of Turkey corporate tax is 30%.
- Note: from 1.1.2004 the surtax of 10% was abolished in Turkey<sup>286</sup>

Now, the details of these common points can be explained in turns as follow.

### 5.1. The General Structure Of Turkish Tax System

Hereby, in order to make a comparison with the EU and to have a conclusion, I want to explain the type of Turkish Tax System, briefly.

The complete taxes, which are applied in a country in a certain time period, are named as “tax system”.<sup>287</sup>

In that regard, the general out-line of the Turkish Law in the respect of taxation should be explained.

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<sup>286</sup> <http://worldwide-tax.com/Turkish> Tax System, 2005.

<sup>287</sup> Öncel, Mualla-Kumrulu, Ahmet-Çağan, Nami, **Vergi Hukuku**, İstanbul, Turhan Yayınevi, 2005, p.225.



The Article 73 of the 1982 Constitution, entitled tax duty lays down the following principles of taxation:

- All individuals and legal persons, citizens or aliens are liable to be taxed,
- Taxes are intended to cover public expenditure,
- Taxes should be determined by law with regard to individual ability to pay,
- An equitable and well balanced distribution of tax burden constitutes the social objectives of fiscal policies,
- Taxes and fiscal burdens likewise may only be imposed amended or abolished by Acts of Parliament,
- Parliament may delegate to the Council of Ministers the authority to make rules and to provide for immunities and exemptions of particular taxes and similar burdens or to amend the maximum and minimum limits laid down by the Acts of Parliament.

Article 91 of the Constitution does not allow Decrees having the force of Acts to regulate tax matters, except under martial law and in extraordinary conditions

On the other hand article 167-2 of the Constitution allows the Council of Ministers to be mandated by laws, to impose or to abolish subsidiary fiscal burdens on import, export and any other external trade transaction, in addition to taxes and similar fiscal burdens<sup>288</sup>.

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<sup>288</sup> Avrupa Araştırmaları Dergisi, 1992, p.214.

As a result, in my division, shortly, I want to examine the Turkish tax system under the three parts:

1) Income Taxes

- Corporate Income Taxes
- Individual Income Taxes

2) Taxes on Expenditure

- Value Added Tax and Excise Duties
- Banking and Insurance Transaction Taxes
- Stamp Duty

3) Taxes on Wealth

- Inheritance and Gift Taxes
- Property Taxes

In the respect of these divisions, the initial details of the Turkish Tax System shall be explained as follow:

1) Income Taxes

The most important taxes of Turkish tax system are the taxes obtained from the incomes.<sup>289</sup>

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<sup>289</sup> Öncel- Kumrulu-Çağan, op.cit, p. 235.

The income tax, which is taken from the income, was accepted in 1949 and became in force from the 1950. Latterly, in 1960, the relevant system has changed and has had the recent form.<sup>290</sup>

In Turkish tax system, there are two types of taxation for the taxation of income. These are Individual Income Taxes and Corporation Taxes.

- Corporate Income Tax :

This tax is accepted as a result of the reforms made in 1949 and included in the direct taxes.<sup>291</sup>

For tax purposes, all type of funds are considered as “corporation” and therefore subject to taxation<sup>292</sup>

The subject of this type of taxation is the earnings of corporations. As Individual Income Tax, this tax is emerged when the earning is realized by the corporation.<sup>293</sup>

In Turkey there are 2 popular forms of incorporation as a company, "a joint stock company: and a "limited liability company".

- **Joint Stock Company (with the suffix of A.S. in Turkey)**
  - A minimum of 5 shareholders is required to found the company.
  - The shareholders may be individuals or a limited company.
  - The liability of the owners of the company is limited to the sum of capital invested.

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<sup>290</sup> Fantorini-Üzeltürk, op.cit, p.84.

<sup>291</sup> Fantorini-Üzeltürk, Ibid, p.95.

<sup>292</sup> <http://.kpmg.ie/taxation/turkey>.

<sup>293</sup> Öncel- Kumrulu-Çağan, op.cit, p. 332.

- The total capital must be at least YTL 50,000.
- The shares may be registered in the name of their owners or negotiable shares (bearer shares).
- The company nominates a 'board of directors'.
- The manager of the company may be a shareholder or any other citizen.
- An annual general meeting of the shareholders must be held.
- Companies that are traded on the stock exchange operate in this form.
- Companies in Turkey that are owned by foreign investors are usually A.S. companies.

- **Limited Liability Companies (with the suffix STI.LTD. in Turkey)**

- The minimum of number of shareholders is -2. The maximum number of shareholder - 50.
- Shareholders may be individuals or companies.
- The minimum capital for a company - YTL 5,000.
- Shares are not negotiable. A share may be sold only with the consent of at least 75% of the shareholders.
- A limited liability company may not engage in banking or insurance.

- There is no obligation to hold an annual general meeting of the shareholders.<sup>294</sup>

The Turkish corporate tax system is a two-tier system. First, corporate profits are subject corporate profits are subject to corporate income tax. Second, if the company distributes its profits to individual or corporate shareholders, the dividends are subject to a withholding tax at the corporate level. A surcharge (fund contribution) is levied on both taxes. The taxable base for the withholding tax is calculated differently from that for corporate income tax. Therefore, income not subject to corporate income tax may be subject to withholding tax. Dividends received by corporate shareholders are exempt from further taxation<sup>295</sup>.

Whether a company is subject to full or limited tax liability depends on its status of residence. If a company is statutory domicile or place or management are established in Turkey (resident company), she will have full tax liability, a joint in this case worldwide income is taxable. If a non-resident company conducts business through a branch or a joint venture, it will have a limited tax liability, i.e. fully subject to corporate tax on profits earned in Turkey on an annual basis .If there is no presence in Turkey, withholding tax will generally be charged on income earned, i.e. for services provided in Turkey. However, if there is an avoidance of double taxation treaty, reduced rates of withholding tax may apply.

As I stated before, corporate income tax is an objective tax and due to this reality, there is one simple taxation rate<sup>296</sup> The basic corporate tax rate is %30 ( in the respect of the 32. Article of the temporary law, this rate is determined as %33 for the earnings realized in 2004), with additional levies amounting to %10 of the tax, and the total tax rate becomes % 33. Additional levies will be abolished effective from 1.1.2004, thus the effective tax rate for corporation will be %30. For resident

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<sup>294</sup> <http://worldwide-tax.com/Turkish> Tax System, 2005.

<sup>295</sup> Kesti, Juhani, **European Tax Handbook /Turkey**, International Bureau of Fiscal Documentation,2001, p. 617.

<sup>296</sup> Öncel- Kumrulu- Çağan, op.cit, p.351.

corporations, tax is levied on worldwide income, but credit is given for foreign tax payable in the respect of income from foreign source (up to the amount of Turkish corporate income tax, i.e.%30 )

Figure: 5.1 Corporate Taxation in Turkey

	Liability on income generated in 2004 (10% WHT)*	Liability on income generated in 2005 and onwards (10% WHT)*
<b>Taxable corporate income</b>	<b>100.0</b>	<b>100.0</b>
Corporate income tax	33.0	30.0
* Dividend withholding tax base	67.0	70.0
Dividend withholding tax	6.7	7.0
<b>Effective corporate tax</b>	<b>39.7</b>	<b>37.0</b>

\* Based on the assumption that 100% of the profit after corporation tax will be distributed to individual or foreign corporate shareholders.

Source : Pricewaterhousecooper/ [www.pwc.com/Turkey](http://www.pwc.com/Turkey)

In general, all income is subject to corporate income tax .the most important exemption is for dividends received from resident companies (participation exemption)<sup>297</sup>

8<sup>th</sup> Article of Turkish Corporate Income Tax Law provides a special regime for the funds under which all portfolio management income of the funds are exempt from corporate taxation. The tax exemption does not apply to investment funds/ corporations whose portfolio includes investment in foreign currencies<sup>298</sup>

Corporate entities having their statutory domicile and place of management outside Turkey, but established in Turkey in the form o branch are subject to tax on an annual return based on income received from the permanent establishment in Turkey.

<sup>297</sup> Kesti Juhani, op.cit, p.618.

<sup>298</sup> [http://kpmg.i.e./Turkey\\_pdf](http://kpmg.i.e./Turkey_pdf) .

From the non-resident's point of view, many payments abroad including those for professional services and technical assistance, royalties and rentals are subject to withholding tax at rates varying between %10 to %25 .In this regard ,countries having avoidance of double taxation treaties with Turkey have considerable advantages. Turkey has signed such treaties with 49 countries and the investors of these countries can benefit from a reduction in withholding taxes. (.i.e. South Korea , Jordan ,Belgium, Japan ,UK , Finland , Germany , France ,Albania, China ,India etc )

- Individual Income Tax

According to the 1<sup>st</sup> Article of the Law of Income Tax, the incomes of the human beings are subjected to income tax. Income is a total of all kinds of earnings and goods which is earned by a human being in one calendar year that constitutes the source of the savings and consumptions<sup>299</sup>

To have any kinds of income is the reason to create the relevant tax and so the person, who has the relevant income, becomes the subject of the individual income tax. Therefore, the difference between the corporate tax and individual income tax is the person who is the subject of the taxation.

“Income” concept is defined in the Income Taxation Law as:

In this parallel, the main points of the income can be mentioned as follow:

- a) Income is something individual
- b) Income is defined on the annual basis

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<sup>299</sup> Fantorini-Üzeltürk, op.cit, p.84.

- c) Income is a kind of unique concept
- d) Income is something real.
- e) Income is something global<sup>300</sup>

Income taxes in Turkey are levied upon the income, both domestic and foreign, of individuals and corporations resident in Turkey. Non Residents earning income in Turkey through employment, ownership of property carrying on a business or other activities giving rise to income are also subject to taxation but only on their income derived in Turkey<sup>301</sup>.

Resident individuals are subject to unlimited tax liability, i.e. they are subject to taxation on their worldwide income. Non-resident individuals are subject to limited tax liability, i.e. they are subject to taxation on their Turkish source income only

The rates in Turkey for this tax is %15 (minimum rate) and %40 (maximum rate).

The following individuals are deemed to be residents of Turkey:

- those whose legal domicile is in Turkey as defined in the Civil Code
- those who continuously stay in Turkey for more than 6 months within a calendar year .Certain foreign nationals retain their limited tax liability even if their stay in Turkey is longer

The taxable income in this taxation type can be classified as :

-business income

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<sup>300</sup> Öncel-Kumrulu-Çağan, op.cit, p.245.

<sup>301</sup> <http://.deik.org.tr/bultenler/taxsystem.pdf>.



-agricultural income

-employment income

-professional income

-income from immovable property

-income from movable property

-other incomes such as capital gains and occasional income

The limited tax liability covers trade or business income for permanent establishment, salaries for work done in Turkey (regardless of where paid or whether or not remitted o Turkey), rental income from real property in Turkey, Turkish derived interest , and income from sale of patents ,copyrights and similar intangible assets .

The personal income tax rate varies from up to %40. Due to its structure, it has a different application with a tariff. There is a increase level which is %5 till 78.000 TL and after 78.000 TL, the relevant level fixed on %40. The relevant application can be explain as follow:

- For first 6.600 TL	-	%20
-For the next 8.400 TL	-	%25
-For the next 15.000 TL	-	%30
-For the next 48.000 TL	-	%35

- For the earnings more than 78.000 TL- %40

For the taxation of wage income, the levels mentioned above are applied by decreasing 5 point.<sup>302</sup>

## 2) Taxes on Expenditure

As it was stated in the previous parts of the thesis, taxes on expenditure are valid for the products and services which are produced, sold and consumed and they are indirect taxes<sup>303</sup>

The types of this kind of taxes are as follow:

- VAT and Excise Duties

VAT was introduced into Turkish tax system effectively from January 1985 by Value Added Tax Act. No. 3065 and the model was the 6<sup>th</sup> Directive of EU<sup>304</sup>

In Turkey, consumption type VAT is in valid after the changes realized in 1998.

The subject of VAT in Turkey is all kinds of delivery of goods, service supply and imports of all kinds of goods and service, in the respect of commercial, industrial, agricultural and professional activities.<sup>305</sup>

The rate of VAT for all kinds of proceedings subject to taxation is mentioned as %10 in the relevant laws 28<sup>th</sup> Article. However, the authority, to increase the relevant rate till %40 and to reduce the relevant rate till %1 and to determine different VAT rates for some goods and services, was given to the government.

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<sup>302</sup> Öncel-Kumrulu-Çağan, op.cit, p.325.

<sup>303</sup> Öncel- Kumrulu- Çağan, Ibid, p.399.

<sup>304</sup> Tuncer, op.cit, p.296.

<sup>305</sup> Öncel-Kumrulu-Çağan, Ibid, p.402.

Recently, in 27.10.1993, with 93/4932 numbered decision, the standard rate is determined as %15, with 99%13648 numbered decision the relevant rate is increased to %17 and with 2001/2344 numbered decision, the relevant rate is increased to %18. Furthermore for some agricultural products' deliveries and for financial rent proceedings, the relevant rate was determined as %1 and for some products and basic nutriment products and for some other products, it is determined as %8.<sup>306</sup>

VAT payable on local purchases and on imports is regarded as "input VAT" and VAT calculated and collected on sales is considered as "output VAT". Input VAT is offset against output VAT in the VAT return filed at related tax office by the 25<sup>th</sup> of the following month (However, after 1.1.2004, the date will be 23<sup>rd</sup> of the following month). If output VAT is excess of output VAT, the excess amount is paid to the related tax office. On the other hand, if input VAT exceeds output VAT, the balance is carried forward to the following months to be offset against future output VAT. There is no cash refund to recover excess input VAT, except for exportation.

In Turkey, one standard rate, two reduced rates and two raised rates are being practiced and from 1.1.1998, as Commission advised, Turkey removed the "0" rate in VAT.<sup>307</sup>

No distinction between resident and non resident tax payers or private and government entities performing the relevant taxable transactions except in cases of exemptions stipulated in the VAT Act.

Exemptions in VAT may be grouped as follows:

- Export of goods,
- Services rendered to clients located outside Turkey,

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<sup>306</sup> Öncel-Kumrulu-Çağan, op.cit, p.409.

<sup>307</sup> Fantorini-Üzeltürk, op.cit, p.72.

- Processing of goods for export,
- Supplies of sea, air or rail transportation vehicles,
- Petroleum exploration activities,
- Diplomatic exemptions,
- The social and military aimed exemptions,
- Transit transport<sup>308</sup>

The taxation term at VAT is the each three months period of the year when the relevant activities are emerged. However, the Ministry of Finance has the right of designing this three months period on the monthly basis.

VAT is levied in the respect of written declaration of the tax payers, if there are no opposite rules.

For the payment of VAT, if three months term is accepted, till the 25<sup>th</sup> day's evening of the 3<sup>rd</sup> month, the relevant tax amount must be paid. If it is paid on monthly basis, each month's 25<sup>th</sup> day's evening is the last day to make the tax payment. In these periods the tax payers must make the relevant payments.

There is also a so-called reverse charge VAT mechanism and under this mechanism, VAT is calculated and paid to the related tax office by the Turkish company on behalf of the foreign company. The local company treats this VAT as input VAT and offset it in the same month.

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<sup>308</sup> Avrupa Arařtırmaları Dergisi, op.cit, p.212.

When we evaluate the existing VAT system of Turkey in the respect of EU, we see that, the experiences gained from 1985 have given some advantages to Turkey. However, there are also some differences between the two systems. As an example, in EU the activity which create the taxation mainly focused on the expenses for consumption, but in Turkey before the 4369 numbered law, income was also seen as a source for taxation. By the change made in 1.1.1999, consumption type of VAT was begun to be applied. Furthermore, in EU the lotteries and such activities were free from the taxation, but in Turkey these are seen as the taxation bases. For the financial proceedings, the content of which is clearly explained, are sometimes free from the taxation in EU, but such an exemption is not in valid in Turkey. There is also another difference in the parallel of the return of VAT. In EU, the taxpayers from out of EU, have the right of having such returns, but it is not possible in Turkey. The services, emerges as a result of importation, is free from taxation in EU, but in Turkey, they are also subjects of taxation. The value of the lost products' can be reduced, if it can be proved, in EU, but such a reduction ca happen in Turkey only in earthquakes and floods. In the Community for works of art, second hand goods and their sellings, some special tax regulations are in valid. However, in Turkey for these subjects, the general rules are applied. The deliveries of the postage stamp with the value, which is written on them are seen as tax exemptions in EU, but in Turkey, these are also seen as tax subjects. In the Community, the tax, which can not be reduced at the end of certain time period, is returned or turned over if the taxpayer demands, but such a return is not possible in Turkey. In Turkey, the tax of transactions Bank and Insurance and Vehicle Purchasing tax are subject to VAT in the Union, but it is not so in Turkey. There are also some differences from the perspective of exemptions. As we see, the exemptions in Turkey are mainly due to the economic and military reasons, but in EU the exemptions are mostly on education and health issue. There are also some differences for the rules applied to Small and Middle Scaled Enterprises. The cash payment system in not valid in Turkey and some different criterias are applied in that respect. Furthermore, the

existing raised rates and % 40 levels can create problem for Turkey in the respect of EU.<sup>309</sup>

On the other hand, when we look at the excise duties, it is seen that, in Turkish taxation system, all the taxes are named under the VAT. Today, due to the funds and the other additional taxes, the scope of the excise duties has been enlarged. However, due to its technique structure, petroleum consumption tax and vehicle purchasing tax are seen under excise duties. Tobacco products, alcoholic beverages, ispiertos, roentgen films are seen as excise duties. However, the law declared 1.08.2202, is an important step for the excise duties in Turkey. With this law, the complex structure of the excise duties is a little bit simplified and 14 different types which were collected with different names as funds, taxes etc. In this law, the products subjected to Excise duties are listed under 4 groups and products in these lists are quite similar to ones in EU. However, it must be stated that the content of the excise duties applied in Turkey is larger and higher than EU in the respect of numbers and rates and also in Turkish law, the tax amounts are determined in the respect of values, but in EU it is determined as a result of amount principle.<sup>310</sup>

- Banking and Insurance Transaction Tax

Banking and Insurance company transaction remains exempt from VAT, but are subject to a Banking and Insurance transaction tax. This tax applies to all kinds of incomes earned by the banks (i.e. on loan interest.) and insurance companies (however, the bank proceedings for Financial Rent Proceedings are exempted from this Law). The rate of this tax is officially determined as %3, but as a result of the authority of the government from 1989, it changed as %5. Afterwards, in 1991, it became %1 and delayed till 01.01.2001.<sup>311</sup>

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<sup>309</sup> Fantorini-Üzeltürk, op.cit, p. 80.

<sup>310</sup> Özdeşer Hüseyin-Şafaklı Okan, **Avrupa Birliğinde Yeni Vergi Politikaları**, Erişim: 2 Şubat 2005, ( WWW document) URL. [www.Maliye.gov.tr/vergipolitka.pdf](http://www.Maliye.gov.tr/vergipolitka.pdf), p.12.

<sup>311</sup> Öncel- Kumrulu- Çağan, op.cit, p.420.

- Stamp Duty and Valuable Papers

These kinds of formations are applied to a wide range of documents such as contracts, agreements, financial statements, payrolls etc. Stamp duty is levied as a percentage of the value of the document at rates varying between %0.15 to %0.75 ( When we look at the issue from the monetary perspective, we see that the relevant stamp duty changes between 200.000 TL and 20.000.000 TL)

On the other hand, the valuable papers are evaluated under this type of taxation. In this regard passports (66.000.000 TL), identification cards ( 2.200.000 TL), driving licenses ( 27.000.000 TL) etc. can be stated as examples of this type of taxation.<sup>312</sup>

Furthermore, the taxes applied on the communication ( varies between %15 and %25) and the taxes on the Lotteries ( determined as %10 depending on the type of the Lottery) .

### 3. TAXES ON WEALTH

- Inheritance and gift taxes

Items seen as gifts or through inheritance are subject to taxes between %1 and % 30 of the item's appraised value. Tax paid in a foreign country on inherited property is deducted from the taxable value of asset. Inheritance tax is payable over the period of three years and in two installments per year

- Property taxes

The authority for applying this type of taxation belongs to the municipalities. It is a special wealth tax and the properties form the subject of this kind of taxes.

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<sup>312</sup> Öncel-Kumrulu- Çağan, op.cit, p.436.

These taxes are paid each year on the tax values of land and buildings at different rates. <sup>313</sup>For buildings, it changes between %0.1 and %0.2. For lands it changes between %0.1 and %0.3. Buildings and lands owned in Turkey are subject to real estate tax at following rates;

- Residence %0.1
- Other buildings %0.2
- Vacant land ( allocated for construction purposes) %0.3
- Land %0.1<sup>314</sup>

In the case of the sale of property, a %1.5 levy is paid on the sales value by both the buyer and the seller. The rate is also applied as %1.5 if the property is contributed as capital-in-kind.<sup>315</sup>.

- REPORTING DATES and PAYMENTS

The tax year in Turkey is the year ending on December 31. Advance payments of income tax are made as specified below:

- An Individual - An individual whose income is only from a wage is not obligated to file an annual return. The employer deducts tax from the employee and transfers it to the Tax Authority every month.

- A self-employed individual must make 4 advance payments, one every quarter. A temporary tax of 15% of the net profit must be paid on

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<sup>313</sup> Öncel- Kumrulu- Çağan, op.cit, p.364.

<sup>314</sup> [http://pwc.com/tr/general\\_taxguide\\_for\\_foreign\\_investors.pdf](http://pwc.com/tr/general_taxguide_for_foreign_investors.pdf), p.12.

<sup>315</sup> <http://kpmg.ie/Turkey-pdf>.



making each advance payment.

- A self-employed individual must file a tax return by the end of the month of March in the year following the end of the tax year.

- A Limited Company - A Limited Company - It is compulsory to submit the financial statements by April 30.

The advance payments are at the rate of 25% of the net profit for the quarter.

- A delay in submitting the annual return beyond the date prescribed is liable to a fine.<sup>316</sup>

- DEDUCTION of TAX at SOURCE

- Taxation of Employee

The employer is obligated to deduct tax at source from an employee and to make additional contributions to social security.

- Social Security

- The employer's contribution is 19.5%.% of the salary (to the limit specified in law). The employee's contribution is 14% of the salary.

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<sup>316</sup> <http://worldwide-tax.com/Turkish> Tax System, 2005.

- Turkey has signed a Double Taxation Prevention Agreement for social security with a number of countries.
- Note: There are additional payments to unemployment fund.

- Other deductions

Tax, in Turkey, must be deducted at source from the following payments according to the following table:

- Dividend - 10%.
- Interest - 0%.
- Royalties - 25%
- Use of intangibles - 22% <sup>317</sup>

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<sup>317</sup> <http://worldwide-tax.com/Turkish> Tax System, 2005.

## 5.2. A Comparison Between Turkish And The European Union's Tax Systems

In recent years, the contribution of tax policy to Community objectives has increasingly been linked to the development of the Internal Market, to EMU and to closer economic integration. In coming years the EU will be welcoming a number of new member states, like Turkey, and each with their own unique systems. It is vital that the body of Community tax law is consolidated and stabilized to the large extent possible before enlargement. Equally, post-enlargement, it will be vital to ensure that taxation does not prevent both existing and new Member States from being able to compete on a level playing field or from extracting the full benefits of the Internal Market.<sup>318</sup>

At the same time, globalization and vastly expanded trade and capital flows require Community policies which enhance, not put at risk, the EU's global competitiveness. Technological innovation and, in particular, the development of e-commerce, enhance the mobility of certain forms of economic activity, particularly the service sector, and the mobility of capital. Business in the EU increasingly operates in more than one Member State and there are more international mergers and acquisitions more than ever before. In this changing environment, tax barriers to free movement of capital and tax measures that distort competition must be eliminated. At the same time, EU tax systems must be sufficiently flexible and responsive in order to keep pace with these developments, whilst remaining as simple as possible in order to minimize costs. Moreover, tax systems must be more transparent in order to ensure the right tax is paid at the right time in the right place, and that opportunities for fraud and evasion are minimized. There is a growing international consensus that this can only be achieved through cross-border co-operation and in particular through the exchange of information.<sup>319</sup>

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<sup>318</sup> Commission of European Communities, *op.cit*, p.7.

<sup>319</sup> Commission of European Communities, *op.cit*, p.8.

However, we also must know that, as I mentioned at before parts of my thesis, the harmonization of taxation policies of the EU is not an aim to reach, but a tool to realize the targets which was formed on the basis of principles stated in Treaty of Rome.

By the way, in spite of the all works, there are some problems on the taxation policy of EU such as tax competition among the Member States, the different tax rates among the Member States, the necessity of tax revenues, the complexity of tax systems of the Member States, bureaucracy, tax fraud.

Initially, the decision making mechanism for determining the taxation policy of the Union must be changed and instead of unanimity, at least the qualified majority system must become valid.

As we know, on condition that the Member States respect the Community rules, they are free to choose the tax systems that they consider most useful for them. However, tax harmonization is quite necessary when we consider the widely differing characteristics of the Member States' tax systems and different national preferences. In this regard, in my opinion, a higher degree of harmonization is needed in the indirect tax field, because, as I mentioned before, indirect taxes may create big obstacles to the functioning of Internal Market. In spite of all works realized till now, there are still some problems such as certain type of VAT and Excise duties (there are so many different application of excise duties over the minimum rates determined by the Community and this is damaging the trade among the Member States by causing fraud)

Due to the structure of them, I think, the harmonization of direct taxes shall be hard and shall create problems to the targets of the Union. We see the policy of the Union that especially for the individual income taxes do not have any big danger to the functioning of the Internal Market and we can say that all Member States have different kinds of application in this type of taxation, but this shall create problems if there is no harmonization works for it. The same sentences can be expressed for

corporation taxation of the Community, so, what should be realized is that, a solution which leaves the choice of application of Direct Taxes to the Member States is a temporary solution. When a higher level of integration than at present becomes a reality, one of the basic points which impede this aim shall be direct taxation policy of the Union and this will be the one of the first problems which must be solved initially.

In the respect of Turkey, from the fiscal point of view, the existing relations between Turkey and EU can be seen in two phases:

- The existing commitments of parties each other,
- Turkey's fiscal outlook as a prospective member state.

Till now, Turkey realized some of his commitments such as the abolishment of custom duties, avoid fiscal levies and charges having equivalent effect and application common custom tariff rates towards third countries by 1.1.1996 .<sup>320</sup>

Furthermore, double taxation policy of Turkey, flexibility with VAT rates, abolishment taxing dividends can also be seen the positive steps of Turkey.

In Special Consumption Tax, with the 4760 numbered law, the increased rate system of the excise duties, which was contrary to EU system, was abolished

However, for the reduced rates there are still some problems in system.

For example, for VAT application, it must be initially considered that, the rates of VAT is still determined by the national authorities in Turkey and to make the relevant rates closer to the ones in EU can create problem. Especially, the

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<sup>320</sup> Avrupa Araştırmaları Dergisi, op.cit, p.213.

exemptions in the VAT application in Turkey can be different in some ways and Turkey must solve this issue to not face serious with serious problem. As I stated before, in EU can apply maximum two rates and both must be more than %5 ,but in Turkish system , there are still two rates as %1 and % 8 and this %1 is contrary to EU practice. Furthermore, the content of list declared by EU to show the products which can be the subject of the reduced rate is not the same as the one in Turkey; some products are in contradiction with the relevant list<sup>321</sup>. The controlling system and the modernization of the local administration can be seen the other problems.

For excise duties, the basic problems are a little bit different. The taxation bases are quite close to the each other (in EU and Turkey). However, the problem shall be emerged during the works to make the rates and exemptions of Turkey harmonious to the EU's ones. For example, the excise duty of mineral oils can be determined to support in the parallel of supporting the agriculture sector, but such kinds of policies can create problems in quite new future. Furthermore, Turkey must be careful during the determination of national and imported products' excise duties rates.<sup>322</sup>

In the field of direct taxation, by the double taxation treaties, Turkey has made some reforms to move in a good way. For the 434, 435 and 436 numbered Directives of the Union, Turkey formed 4684 numbered law and eliminates the main differences. As its existing type, it can be stated that the model of the Turkish corporation tax is harmonious with the EU<sup>323</sup>. However, it should be also considered that there are also some problematic areas. For example, the personality principle in the Tax Law is one of these problems. (In Turkey for special kinds of companies and partnerships, the taxation principle is determined in the respect of personality principle, but in EU, this issue is subjected to corporation taxation and there has been no common application, yet). The cash taxation, the calculation of income tax, reductions' systems are also the other problems. However, it must be known that the

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<sup>321</sup> Tuncer, op.cit, p.296.

<sup>322</sup> Fantorini-Üzeltürk, op.cit, p.53.

<sup>323</sup> Tuncer, Ibid, p.297.

rates of Turkey are in the middle when we consider the rates applied in EU countries and this is a positive point.

Institutionally, the Turkish tax law system fits the Community Member States' tax systems. Disregarding the fiscal necessities particular distortions in tax matters can always be eradicated to achieve an ideal harmonization.

Nevertheless, generally, the below mentioned points can be seen as problems for the Turkey's tax integration with the Union. These are

- Initially, the evaluation of the taxation and the taxes in Turkey should be differentiated. It must be known the taxes are not the unique source to have income, but they also affect the economy in general meaning. Therefore, during the works on the relevant taxes, a more sensitive approach should be created and probable effects must be evaluated<sup>324</sup>
- To have a legal approach during the works on taxation shall minimize the weakness of the system.
- A more sensitive control system must be created and the sufficient and effective punishment system as a result of the judicial decisions should be formed.
- Turkey must do more things about the harmful tax applications and during the double taxation treaties, the types of these harmful effects of the tax policies must be determined and in that regard the relevant treaties should be prepared.<sup>325</sup>

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<sup>324</sup> Fantorini-Üzeltürk, op.cit, p.102.

<sup>325</sup> Fantorini-Üzeltürk, Ibid, p.104.

- Fund contributions having equivalent effect: The surcharge on income tax and corporation tax is considered as a component of those taxes. This contribution has to be considered during the application of double taxation treaties and fund contributions can have equivalent effect to custom duties.
- Protective incentives: If such incentives give special tax advantages, it can damage the fair competition of the companies even at different countries.
- Constitutional structure: The authority of taxation mainly belongs to the Parliament. However, in the respect of existing laws, the Council of Ministers has the authority to fix the rates of VAT, income tax corporation tax etc. Regarding the VAT, again, Council of Ministers and even the Ministry of Finance and Customs are authorized to regulate its main application. Therefore, the Constitutional position and considerations should be revised in case of Turkey's membership.

The Constitution allows the Council of Ministers to impose additional levies on external trade which form part of fund contributions. In this case, the main power and authority is not the Parliament, but the government which can easily manipulate the system. Still the object is to achieve an equal effect of fiscal burdens on external trade where it does not comply with the EC standards<sup>326</sup>

I think, all these points which can be mentioned as problems, can be solved step by step on the way to full membership. I mean, these are not the main obstacles for being the member of the Union. As we have seen, Turkish Tax System takes the tax system of EU as model and the existing problems of the Union are also valid for

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<sup>326</sup> Avrupa Arařtırmaları Dergisi, op.cit, p.214.



Turkey. What I believe is, these problems shall be solved harmoniously with EU before or after the membership process.

## 6. CONCLUSION

Customs Union concept is something more than an economic formation for Republic of Turkey. The obligations caused by the membership of Customs Union forced Turkey to undertake the most of the regulations of the EU and her policies. As a result of this, Turkey has realized great improvements at the harmonization of standardization and technical points, competition, intellectual property rights, common commercial policy and custom regime. It is planned that, with the liberalization of service trade and public purchasing areas, this relevant collaboration will strengthen.

In this regard, to give a brief account of the work achieved so far with regard to harmonizing Turkish legislation and institutional framework with that of EU, such a classification can be made:

- Elimination of all customs duties and equivalent charges as to industrial imports from the EU, as well as quantitative restrictions,
- Adoption of the Community's common external tariff in trade with third countries,
- Adoption of measures that are substantially similar to those of the common commercial policy of EU, which include,

-Common rules on imports and exports,

-Management of quotas,

-Protection against dumped or subsidized imports,

-New commercial policy instrument,

- Officially supported exports credits
- Autonome arrangements on textile imports,
- Technical barriers to trade and standardization of foreign trade,
- Preferential trade regimes of the Community,
- Inward and outward processing regimes.

However, it should be noticed that in spite of the above mentioned conclusions of the relevant policy of the Union, there are some different ideas about the Customs Union and so in order to have a logical result, these approaches must be evaluated.

According to this reality, when we look at the negative approach's perspective, which thinks that the formation of the Customs Union has damaged the Turkey's advantages, we recognized some common points. These main points are as follow:

- Turkey market was entirely opened to EU,
- The foreign policy of Turkey will be depended on the policies and applications of Europe.

It is also expressed that in 1995, for Europe, the relations between Europe and Turkey was finished. Afterwards, the important point for Brussels is "to keep Turkey in this unilateral relation system." and to create such a relation with Europe has been a historical mistake of Turkey.<sup>327</sup>

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<sup>327</sup> Manisalı, op.cit, p.33.

Furthermore, in spite of the quite comprehensive harmonization of Turkey to Union's products and Common Customs policy, the Union has not realized many of her obligations (i.e. she has not made the fiscal protocol functioned, in 1986 the free movement of labor was not realized, for certain time periods EU continued the quota system for Turkish textile products and also applied anti-dumping practices against products exported by Turkey.) Meanwhile, EU has supplied reductions at customs duties to many countries which mean that Turkey has not been the only country which has had these kinds of incentives, but many other countries have the same advantages and furthermore other countries are not the members of Customs Union and did not give any compromises to EU like Turkey. The common tariff policy's acceptance by Turkey has not considered as something normal, because Turkey has not become a member of the EU.

Through the process ended by 1/95 numbered decision, Turkey accepted to apply EU's foreign trade policy, which contains the Treaties signed and will be signed by EU with third countries, the trade embargoes which shall be applied by EU against third countries, all the practices and policies to realize export incentives. The important point here is all these policies have been determined by the Member States according to their own advantages, but have been applied by Turkey which is not a member state and has not had any part at the important decision making mechanisms.

Especially, 16<sup>th</sup> Article of the relevant 1/95 numbered decision, which states that Turkey is accepting to conform all the autonomous regimes and privileged commercial treaties in 5 years, and 52<sup>nd</sup> Article, which states that the changes in Turkish internal legislation must cause any negative effects on Customs Union of EU, has limited the Turkish commercial liberty. Since, some of these Treaties or Treaties shall be latterly signed can be against Turkish profits and also if Turkey does not behave in the parallel of the EU's policies, EU has the right of taking measurements (i.e. special sanctions). Meanwhile, Turkey can not sign preference trade agreements with any third countries, if it does not agree with the Customs Union. (Article 56)

According to 54<sup>th</sup> Article, when EU brings a new rule about the Customs Union, it has just the obligation of informing Turkey to supply relevant harmonization, but Turkey has the obligation of applying this renovation. However, while Turkey is not the member of EU, it can not take any role during these changes. In the respect of, 57<sup>th</sup> and 58<sup>th</sup> Articles, EU Commission shall also consult Turkish experts, but this is just a consultation, because the decisions shall be created by EU organs.

According to Article 64, Turkey also accepted the obligation of applying and the accepting the decisions of European Court of Justice about Customs Union and due to the EU's structure; these decisions are over the Turkish Parliament's will. However, Turkey is not a member of EU and has not any part at making law<sup>328</sup>

Furthermore, as it is known, the fiscal relations between Turkey and the EU began with the fiscal protocol which was a part of Ankara Agreement. In the respect of relevant Association Agreement, in order to improve the Turkish economy quickly, Community accepted to form fiscal aids for Turkey. The conditions and the amount of the relevant fiscal aid was determined by the Fiscal Protocol and principally through European Investment Bank, allocated to the certain projects which can help developing the Turkish economy. Despite the existing association relations, the potential use of the fiscal aids has not been represented regularly by EU. As an example, 600 million ECU fiscal aid which was initialed in 1981 was not approved till 1995.<sup>329</sup>

As expressed above, the imports from EU have exceeded the exports to EU. The foreign investment has not been able to placed as it was expected and CU caused a trade diversion in Turkish foreign trade ( i.e. in medicine sector )

Whilst, with its approximately 66 million people and attractive consumption structure, Turkish market is so important for Europe that Japanese and Americans

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<sup>328</sup> Manisalı, op.cit, p.116.

<sup>329</sup> Manisalı, Ibid, p 85.

has to be kept out from Turkey. Therefore, Turkey should be along with Europe and EU will not accept Turkey as a member and the only way to be with Turkey is “Customs Union”. What is trying to be mentioned is that; Turkey will not be in European Parliament, European Council and European Commission, but she is in Customs Union and must behave in the respect of these three foundations without being a part of political system and this is an ideal solution for EU.<sup>330</sup>

Furthermore, there is no sufficient progress not only on bilateral matters, but also on issues that require merely unilateral efforts such as Customs Code, standardization and dumping laws.

The foreign investments have not increased enough after the acceptance and application of 1/95 numbered decision.

As a result of all these mentioned above, it can be easily understood that, the CU between Turkey and the EU, which has been operational since the beginning of 1996, presents a unique example in the sense that Turkey is the first and only country that enters into such integration without being a member of the Union.

On the other hand, when we look at the same issue from the perspective of positive approach, which thinks that the existing formation of the Customs Union has helped the Turkey to make some improvements, we notice some different points.

What is mainly accepted is that when the scope and the mechanisms are concerned, the Customs Union Decision and Resolution on Broadening the Association has created the necessary steps for Turkey in order to reach full membership target. When we consider the economic points of Customs Union, it is seen that the free movement of industrial goods have been fulfilled to a large extent. However, a completely liberal trade regime and real integration has not been achieved in the preparation and application of common external trade policy (i.e.

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<sup>330</sup> Manisalı, op.cit, p.43.

sensitive products, preferential trade policies and dumping and institutional provisions)<sup>331</sup>

Another striking feature of the CU is that, it has gone well beyond the classical definition of a custom union, as a step by the prevailing integration theory. To be specific, the Customs Union between Turkey and the EU not only involves the abolition of all customs duties and charges, prohibition of all quantitative restrictions between the parties and implementation of a common customs tariff to the outside world: it also requires Turkey to harmonize its commercial and competition policies, including intellectual property laws, with those of Union, and extends most of the EU's trade and competition rules to the Turkish economy<sup>332</sup>

The Customs Union has also meant the culmination of Turkey's liberalization efforts to catch up the world economy, a process that started in early 1980s, since EU rules have great parallelisms with those of the WTO and other international regimes. Furthermore, the formation of CU and the experiences that Turkey gained during this process have been so important to form a contemporary foreign trade structure for Turkey in a global perspective<sup>333</sup>

In this wider context of the Customs Union, Turkey has already adopted a considerable amount of relevant Community legislation, established necessary institutions, and taken strides to implement them properly.

The great impetus gained during this process has also paved the way for further involvement in the *acquis*, which made it possible for Turkish authorities and, indeed, compelled them to study and classify Community instruments in other fields of integration. This surely facilitated the work undertaken after the Helsinki Summit

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<sup>331</sup> Bayar *op.cit*, p.21.

<sup>332</sup> Atak, *op.cit*, p. 1.

<sup>333</sup> Tüsiad, *op.cit*, p.73.

in the context of the requirement of complete adoption and implementation of the *acquis*<sup>334</sup>

Meanwhile, the trade numbers from the early times of Republic of Turkey can also help us to see the effect of the Customs Union. For example, figure below which shows us the Changes at the Trade Volume of Turkey shows us the realities of the Turkish Trade:

Figure: 6.1 Foreign Trade Numbers of Turkey

	Turkey Total	EU	Turkey Total	EU	Turkey Total	EU
Years	Export Increase (%)	Export Increase (%)	Import Increase (%)	Import Increase (%)	Trade Increase (%)	Trade Increase (%)
1968						
1971	36.3	45.6	53.3	48.1	46.6	47.2
1972	30.9	30.1	33.5	46.2	32.5	40.4
1974	73.1	77.8	141.7	105.4	116.9	96.2
1980	89.9	70.8	109.3	35.0	103.7	45.9
1985	173.5	146.5	43.4	65.0	78.4	94.0
1993	92.9	127.5	159.4	181.1	132.0	156.9
1994	18.0	13.4	-20.9	-6.1	-7.6	1.7
1995	19.5	34.0	53.4	63.1	38.6	50.6
1996	7.3	4.2	22.2	38.1	16.6	24.2
1997	13.1	6.1	11.3	7.4	11.9	7.0
1998	2.7	10.2	-5.4	-3.1	-2.6	1.2
1999	-1.4	6.2	-11.4	-11.0	-7.7	-4.8
2000	3.4	0.1	33.1	23.2	21.3	14.0
2001	14.0	12.0	-23.5	-31.6	-10.9	-15.6
2002	14.1	12.0	23.7	26.5	19.6	19.7

Kaynak DİE- annual reports 1968-2002

<sup>334</sup> Atak, op.cit, p.2.



As we see, till 1980, due to the Turkey's foreign trade policy, whole foreign trade numbers are at very low levels. After 1974 Oil Crise, the total share of EU at our foreign trade volume reduced, because the import from EU reduced %30 from %50, but as we see our exports were quite stabile and protected her level at %45 and the trade gap realized around %21. Briefly, from 1970 to 1980's the trade volume of Turkey-EU increased around %15 level.

During 1980-1995, I mean before the 1/95 numbered decision, the exports of Turkey to EU increased around %16 and our imports of Turkey from EU increase around %15. In 1980, there was a great trade deficit in Turkish foreign trade balance (%46) and this gap reduced to %17.5 levels till 1985 and it increased again to %25 levels just before the 1/95 numbered decision. During same time period, the trade deficit between Turkey-EU reduced %9.7 levels from % 29 levels and then before CU decision, it again increased to % 20 levels.

After 1/95 decision, the import level from EU was around %53 and it reduced to %44 level in 2001 and the trade deficit at same time period was around %33.4 but latterly it reduced to %5.8 in 2002.

As a result, EU has had always very important part at Turkish foreign trade and before CU it was %48 and after 1/95 numbered decision it became %50. Therefore, more than the effects of CU, the currency policy, interest rates and international economic improvements have had more importance in Turkey's trade.<sup>335</sup>

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<sup>335</sup> Tüsiad, op.cit, p.83.

However, when we look at the Turkish Foreign trade and the share of EU, we see such a figure:

Figure : 6.2 The Share of the EU in Turkish Foreign Trade

	General Million			European Union Million			Deficit	The Share of EU (%)		
	Export	Import	Volume	Export	Import	Volume		Export	Import	Volume
1968	496	764	1.260	226	393	619	167	45.4	51.4	49.1
1971	676	1.171	1.847	329	582	911	253	48.7	49.7	49.3
1972	885	1.563	2.448	428	851	1.279	423	48.4	54.5	52.2
1974	1.532	3.778	5.310	761	1.748	2.509	987	49.7	46.3	47.2
1980	2.910	7.909	10.819	1.300	2.360	3.660	1.060	44.7	29.8	33.8
1985	7.958	11.343	19.301	3.204	3.895	7.099	691	40.3	34.3	36.7
1993	15.348	29.429	44.777	7.289	10.950	18.239	3.661	47.5	37.2	40.7
1994	18.105	23.270	41.375	8.269	10.279	18.548	2.010	45.6	44.2	44.8
1995	21.636	35.707	57.343	11.078	16.760	27.938	5.782	51.2	47.2	48.7
1996	23.224	43.626	66.850	11.548	23.138	34.686	11.590	49.7	53.0	51.9
1997	26.261	48.559	74.820	12.248	24.870	37.118	12.622	46.6	51.2	49.6
1998	26.974	45.921	72.895	13.498	24.075	37.573	10.577	50	52.4	51.5
1999	26.588	40.692	67.280	14.333	21.419	35.752	7.086	53.9	52.6	53.1
2000	27.485	54.149	81.634	14.352	26.388	40.740	12.036	52.2	48.7	49.9
2001	31.342	41.399	72.741	16.118	18.280	34.398	2.162	51.4	44.2	47.3
2002	35.761	51.270	87.031	18.330	23.288	41.618	4.958	51.3	45.4	47.8
2003	42.385	60.679	103.064	22.068	27.440	49.508	5.372	52.1	45.2	48.0
2004	63.016	97.340	160.356	34.399	45.427	79.826	11.028	54.6	46.7	49.8

Source :DTM<sup>336</sup>

<sup>336</sup> <http://dtm.gov.tr/ab/rakamlar/genel.xls>.

Figure: 6.3

Turkish Trade With EU in the respect of Product Group  
Million \$  
Export

Year	Investment			Semi-Product			Consumption			Total
	Value	Share (%)	Value (%)	Value	Share (%)	Value (%)	Value	Share (%)	Value (%)	
1996	412	3,4	---	3.872	32,0	---	7.803	64,5	---	12.091
1997	463	3,6	12,4	4.281	33,2	10,6	8.154	63,2	4,5	12.900
1998	511	3,6	10,4	4.814	34,1	12,5	8.799	62,3	7,9	14.126
1999	684	4,6	33,9	5.201	34,9	8,0	9.032	60,5	2,6	14.919
2000	759	5,0	11,0	5.442	36,1	4,6	8.874	58,8	-1,7	15.085
2001	1.092	6,5	43,9	6.044	35,9	11,1	9.668	57,4	8,9	16.853
2002	1.414	7,3	29,5	6.206	31,9	2,7	11.826	60,7	22,3	19.468
2003	2.333	9	65,0	7.923	30,6	27,7	15.588	60,2	31,8	25.898
2003*	2.213	9,4	-	7.178	30,6	-	14.018	59,8	-	23.457
2004*	3.270	10,7	47,8	9.483	30,9	32,1	17.816	58,1	27,1	30.648

Year	Investment			Semi-Product			Consumption			Total
	Value	Share (%)	Value (%)	Değer	Pay (%)	Değ. (%)	Değer	Pay (%)	Değ. (%)	
1996	7.444	31,7	---	13.169	56,0	---	2.898	12,3	---	23.517
1997	7.423	29,3	-0,3	14.317	56,6	8,7	3.565	14,1	23,0	25.316
1998	7.271	29,6	-2,0	13.628	55,5	-4,8	3.669	14,9	2,9	24.570
1999	6.131	28,1	-15,7	11.597	53,1	-14,9	3.580	16,4	-2,4	21.833
2000	7.460	27,2	21,7	14.552	53,1	25,5	5.247	19,2	46,6	27.387
2001	4.466	23,6	-40,1	11.593	61,2	-20,3	2.681	14,1	-48,9	18.948
2002	5.603	22,9	25,5	15.280	62,3	31,8	3.287	13,4	22,6	24.518
2003	7.388	22,1	31,9	20.446	61,0	33,8	5.342	15,9	62,5	33.494
2003*	6.124	21,0	-	18.363	62,9	-	4.443	15,2	-	29.181
2004*	9.360	22,9	52,8	24.126	59,1	31,4	7.026	17,2	58,1	40.830

Source: DİE<sup>337</sup>

<sup>337</sup> <http://dtm.gov.tr/ab/rakamlar/genel.xls>.

What we noticed from this above expressed figure is that there has been a trade deficit (in favor of EU ) at the trade between Turkey and EU from 1970's. On the other hand, it can be also realized that the foreign trade share of EU was around %46 between 1993-1995, but increased to %50.1 between 1996-2002, but this increase is in favor of EU ( I mean, import numbers of Turkey from EU is more than export numbers). The experiences of the countries and the CU theories show that the trade deficit after the CU is a normal result.<sup>338</sup>

However, the crisis in Turkey and in world during this process, and the products, which Turkey has exported (i.e. cheap textile products), has played important role at this structure. The figure above can illustrate this better:

Figure.6.4. Foreign Trade and Products' Share

	Agriculture		Textile		Iron&Steel		84,85 and 87. Codes*		Industrial Products		Total	
	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.
1994	1.647	185	4.150	501	293	1679	782	4.375	1.762	3.865	8.634	10.279
1995	1.965	790	5.353	828	505	1353	1239	6617	2017	6773	11078	16860
1996	1854	675	5660	1379	421	1852	1505	10155	2109	8848	11548	23138
1997	2037	512	5930	1611	622	2081	1550	11751	2109	9123	12248	24870
1998	1941	477	6464	1425	703	1873	2083	11696	2307	9011	13498	24075
1999	1900	489	6363	1318	818	1466	2705	10428	2562	8238	14348	21416
2000	1483	474	6433	1400	888	943	2803	13612	2745	9599	14352	26388
2001	1674	304	6699	1280	997	1004	3754	7736	2993	7957	16118	18280
2002	1602	432	7594	1636	922	1465	4897	9908	3315	9847	18330	23288
2003	986	343	6336	1210	956	1610	4205	7769	2795	8174	15278	19106

\*\*Numbers are million Dollar

Source : DTM<sup>339</sup>

<sup>338</sup> <http://ikv.com.tr/pdf>, Gümrük Birliğinin Türkiye'ye Etkileri, p. 13.

<sup>339</sup> <http://dtm.gov.tr/ab/rakamlar/genel.xls>.

- 84. Codes: Nuclear Reactors, Boilers, Machinery Tools, Tools, Components, 85.Codes: Electronic Machines and tools and their components, 87.Code: Motorized Land Vehicles, tractor, Bicycle, Motorcycle etc.

It is also a reality that the trade volume between Turkey and EU has doubled since 1995. The import amount of Turkey has been more than the export amount. (Turkey has mainly imported investment goods, and also the textile sector of Turkey has played an important role at the export of Turkey. The other sectors such as electronic equipments, aluminum products and automotive products must also be noted as the successful areas during this partnership)

As we see above, on one hand the percentage of textile sector has been diminishing, but on the other hand the percentage of automotive, electronic and machine industries have been increasing. As a result, the types of the exports of Turkey has been changing and industrial and semi-industrial products' share has been increasing and this formation can also be evaluated as the positive effect of the Customs Union

When we compare the same membership process of Turkey to other candidate countries, it should be accepted that, as a result of Customs Union, Turkey has had some more advantages and this has been expressed by the EU officers.

On the other hand the works to modernize custom administration has also facilitated to control the existing customs proceedings which have been enlarged due to the increasing foreign trade of Turkey and also has helped to inspect illegal movements.<sup>340</sup>

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<sup>340</sup> Tüsiad, op.cit, p 74.

However, it must be accepted that the Customs Union is a successful integration type and both sides, after the Helsinki Summit, are trying to deepen this integration. With the improvements at public purchasing policy, public aids and free movement of services both sides will get more advantage from the relevant formation. Furthermore, as it is stated from the beginning, free movement at agricultural products should be also realized for the realization of the potential use of CU.<sup>341</sup>

As a result of all these, the protection level which was around %16 before Customs Union, reduced %0 towards EFTA and EU countries and %4.6 towards third countries<sup>342</sup>

For avoiding trade diversion due to the Customs Union, the works for conforming the autonomous and preferential commercial treaties has been going on.

According to the harmonization works on rules which are regulating the imports from third countries, since 1.1.1996, against 43 countries towards which EU has been applying quantitative restrictions and supervision measurements on textile products, Turkey has also been applying similar measurements, too<sup>343</sup>

In order to remove technical impediments for testing and documentation, National Accreditation Center has been working and for accelerating the harmonization movements and remove the measures having equivalent effects “Frame Law” was accepted by the Turkish Parliament.

Furthermore, the effects of CU on the foreign investment are also important for understanding the Turkey-EU relation in the parallel of CU. The figure below shows us the reality of the Turkey about the foreign investment.

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<sup>341</sup> Dotto, op.cit, p.50.

<sup>342</sup> Dotto, Ibid, p.61.

<sup>343</sup> Dotto, Ibid, p.61.

Figure: 6.5. Foreign Investment Numbers in Turkey

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
EU Total	1145	961	1843	3272	934	1075	1069	1950	1805	1426
Total	2063	1477	2938	3836	1678	1646	1700	3477	2738	2243
EU/General %	55.5	65.1	62.7	85.3	55.7	65.3	62.9	56.1	65.9	63.6
General Effective Entrance	746	636	934	914	852	953	813	1707	3288	1042

\*\*Numbers are million Dollar

Source : DTM<sup>344</sup>

It is so certain that, due to the ground of the Customs Union, the placement of the foreign investment plays a very important role and such investments must be settled as a result of the Customs Union. However, the numbers above show us that, the situation of Turkey is not something satisfactory and there are so many critics on that issue. Nevertheless, to look at only the numbers without evaluating the conditions can be wrong. I mean, with the conclusion of the Customs Union, Turkey integrated to the European Single Market. Turkish export numbers has increased statically, but has not been as successful as expected, because due to the fiscal and economic conditions ( high interest rates, unhealthy type of Turkish Banks, large public share in the market, etc.) and insufficient industrial framework and services given to the industry Turkey's imports has increased more from EU during this period of time, from 1995 Turkey can not create a firm macro economic environment, Turkey has not be able to placed foreign investment in its boundaries.

As a result, as we see, CU has effected the fair comptetion's placement and the partnership with CU has also helped the Turkey's harmonization works to the rules at WTO. However, as mentioned above it has not made great effects to the foreign investment in Turkey.

<sup>344</sup> <http://dtm.gov.tr/ab/rakamlar/genel.xls>.

It should also be accepted that, the process, which has been experienced during the relevant Customs Union, has also affected the protection of the consumer. After the rules of Customs Union and its competition affect, increased the product quality and products diversity and when the norms of EU applied more, the protection of consumer will enlarge.<sup>345</sup>

At the beginning of the discussions made about the Customs Union, there was a fear that, after the application of CU, Turkey will lose most of its custom revenues due to the removal of customs duties and custom taxes. However, depending on the researches of Foreign Trade Undersecretary, the customs revenues were %2.3 of GNP of Turkey in 1994 and it became %2.61 in 1997, after the 1/95 numbered decision. This relevant revenue increased %134 in 2000 and all these show us that the CU has increased the public revenues. This increase has occurred, because due to her responsibilities toward the EU, Turkey has modernized her custom administration. As an example, with the start of the project of the modernization of Turkish Custom Administrations, till February 2003, 61 Custom Head Offices and 16 Custom Main Head Offices modernized which means that the bureaucratic proceedings, staff and customization expenses have reduced.<sup>346</sup>

Due to the undertakings of Turkey coming from CU, she has applied the common commercial policy of EU and so accepted and signed many of free trade agreements in this respect.<sup>347</sup>

Turkey signed free trade agreements with the countries mentioned below:

EFTA Countries

Israel

Romania

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<sup>345</sup> Tüsiad, op.cit, p.86.

<sup>346</sup> Tüsiad, Ibid, p.89.

<sup>347</sup> IKV, op.cit, p.23.



Hungary  
Estonia  
The Czech Republic  
Slovakia  
Bulgaria  
Latonia  
Macedonia  
Croatia  
Bosnia-Herzegovina  
Poland  
Lithuania

Furthermore, with the countries mentioned below, the negotiations for signing free trade agreements have been going on:

Egypt  
Morocco  
Faeroe Islands  
Tunisia  
Palestinian  
Lebanon  
Albania  
Jordon  
Mexico  
South Africa  
Algeria  
Serbia- Montenegro  
Syria

As it can be easily understood, all of these free trade agreements and the negotiations are the results of Customs Union and the foreign trade volume of Turkey increased 6.2 billion dollar from 4.8 billion dollar from 1997 to 2001. In

other words, the proportion of these countries at Turkish foreign trade increased %8.54 from %6.50.<sup>348</sup>

All these obviously mean that, after these free trade agreements and their trade effects has affected Turkey's structure in the respect of CU as mentioned above.

As a result of all these, it can be expressed that CU has increased the volume of Turkish Foreign Trade. The public revenues have not decreased and the foreign trade deficit has not enlarged. There have been not ouch trade diversion against third countries and with the free trade agreements mentioned above, the trade volume with these countries has been affected positively. Turkey's competition law, consumer protection policy, the harmonization of world commercial and other norms and intellectual property rights have been formed by the effects of CU.

The existence of the membership of CU has accelerated the full membership process of Turkey to EU.

As mentioned before, most of the problems faced by exporters and importers of both Turkish and the EU origin concern technical regulations and testing requirements. The Customs Union decision foresaw that Turkey should have adopted into its legal order the Community instruments relating to removal of technical barriers to trade.<sup>349</sup>

There is now effective co-operation between Turkey and the EU in the fields of standardization, calibration, quality, accreditation, testing and certification. New rules parallel to EU's industrial standards and conformity assessments have been

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<sup>348</sup> Tüsiad, op.cit, p.94.

<sup>349</sup>EU Turkey Customs Union, Outstanding Trade Matters, Erişim: 8 Haziran 2005, (WWW document). URL. <http://deltur.cec.eu.int/english/CUtradeproblems-revised1.rtf>, p. 1.

enacted, and an accreditation institute has already been set up in 2000 to oversee the implementation.<sup>350</sup>

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<sup>350</sup> Atak, *op.cit*, p.2.

## GENERAL CONCLUSION

After having the both approaches, negative and positive ones, by expressing my own opinion about the Customs Union and its effects on the Turkey's policies, I want to finish my thesis.

In this regard, it must be initially accepted that, the Customs Union policy of Republic of Turkey has been a choice made by the Turkish authorities. Depending on the evaluation perspective, this choice can be criticized or the authorities, who have had the responsibility, can be congratulated. Therefore, by only evaluating the different opinions on the ideological basis and for short time periods, the objective results can not be put forward.

As stated above, the policies, like the Customs Union policy, are the policies which are the results of a long historical process and due to their formations, the effects of such policies can be seen for long times. Therefore, what I mainly think is, after the 1/95 numbered decision which concluded the Additional Protocol and materialized the Customs Union, approximately ten years passed and such a short time period is not enough to make an objective evaluation.

On the other hand, when we look at the effects of the CU to Turkey, I think that, first of all the economic effects should be examined, because as mentioned above, the CU was started unilaterally and the barriers ( except some specific goods) were removed for Turkey at the beginning phases of the relevant relations. However, Turkey gave the same easiness to EU during 22 years period. The other point which must be considered also during the evaluation of CU is that, the relation between Turkish economy and CU has also affected by the global economic developments. The devaluation in 5.4.1995 in Turkey, the Asian and global crises in 1997, serious recession in Turkish economy in 1998, the general election and Gulf earthquake, the economic crises in Turkey in November 2000 and in February 2001 etc. has also had great effects to Turkish economy in the parallel of Customs Union. Furthermore, as it

is known, to get more benefits from CU, the harmonization of Turkish legislation must be completed.

It is so certain that, to evaluate the existing formation of the Customs Union in the respect of Turkey, as I mentioned above, in 1970, the function of Customs Union began asymmetrically and at that time the foreign trade volume of Turkey was 300 million dollar. Therefore it means that, the Turkish Customs Union did not begin with 1/95 numbered decision, but with that decision the process which was begun by additional protocol was planned to be resulted. This decision also means that the rights equalized the compromises that Turkey received for her industrial products in 1971. Therefore, the evaluations, which were started from 1996 when Turkey has had more responsibilities, shall be wrong. I mean, if the advantages that Turkey has received by free taxation for the relevant industrial products to EU countries since 1970 are ignored, the wrong conclusions can be emerged.

As I expressed above, it mustn't be forgotten that, the Customs Union is also quite important for Turkey in the respect of the Turkey's harmonization with the global markets. It should be considered that, by accepting the Customs Union, Turkey became a member of an important part of the EU, one of the biggest markets in world. This helps the modernization of Turkish commercial activities and also to have a good trade share with the EU, such a strong and stabilized market, has also protected Turkey's economy during the global crisis and Turkey has had minimum damages from the relevant crises (i.e. Asia and Russian Economic crises).

Meanwhile, when we look at the modernization steps of the Turkish society, we always see the effects of the foreign sources in positive and negative ways. What I mean is, nearly none of the sources of the revolutions, especially the economic ones, has based mainly on the Turkish society. When we follow this opinion in the respect of the EU, we see that, the foreign effects and the existing conjuncture have played determining roles again. For example, during the beginning process of the Turkey- EEC relations, the effects of the movements of Greece can not be ignored.

The political environment emerged after the II. World War also played important roles on Turkey's relevant policies.

Furthermore, the globalization process which has formed especially after the 1990s' affected the middle scaled economies and their native sources a lot. The collapse of Communist regimes and the unsuccessfulness of the protective economic policies ( due to the existing conditions) has lead many countries to follow liberal economies and many countries has tried to join economic organizations both in local and/or international basis. Especially after the Uruguay Rounds of WTO and the differentiation at the quantitative restrictions and the custom taxes of the countries, it should be accepted that, the commerce and the policies of the countries have changed a lot and all of these results are again the results of a long process.

It is a reality that, due to the existing conditions during the negotiations in 1995 and before, Turkey has had some disadvantages in the respect of Customs Union. Especially, to be affected by the decisions of the EU about foreign trade policy without having any share at the decision making mechanism is a big fault and disadvantage for Turkey. However, due to the insufficient economic conditions of Turkey, in order to liberalize the economy and improve the economic situation, Turkey had to be faced with such realities. What I think is that, if Turkey had not been a part of Customs Union policy of the EU and if Turkey had not worked with Europe, such a firm economic partner, the effects of the economic crises occurred in Turkey at the beginning of 2000s' and the results of the globalization process and the decisions of WTO would have damaged the Turkish political and economic situation more badly. It must be accepted that, with the Customs Union realities, Turkey has learned the contemporary commerce and modernized her economy, law system and management activities.

Consequently, in the respect of the Customs Union and its effects on Turkey, it must be realized that, such policies and decision are the results of a long and historical processes and they have had very important roles at the histories of countries. However, in my opinion, from a broader perspective, till now, in the

respect of globalization perspective, the positive effects are more than the negative effects, but as I mentioned before to see the certain results, some more time must pass. Furthermore, when we look at the Turkey- the European Union relation and Turkey's full membership target, the positive contributions of the Customs Union mustn't be ignored and during the full membership process, existing problems must be considered objectively and should be solved as soon as possible with the experiences of Turkey which she have had during the application of CU process.

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