# INTERNATIONAL TAXATION AND THE ROLE OF CUSTOMS UNION BETWEEN TURKEY AND EU

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**Abstract**
A Customs Union is a union of states, which share a common customs area. However, there is not a standard type of custom union. A customs union may be built according to different forms and for different legal reasons. Turkey signed a Customs Union agreement with the European Union in 1995. The customs union with Turkey is a good example of a country not yet a member of the EU, but with which the EU has a customs union. The customs union between Turkey and the EU concerns industrial and processed agricultural products. It is of great importance for Turkey to dismantle customs duties and similar fees. Turkey has put the common external tariff of the EU standard into practice against third countries. However, on the Turkish side in particular, there were economic concerns and criticism. On the other side there are also proponents of the customs union in Turkey. In this paper we examine the meaning and background of the customs union and the taxation in international trade.
**Key Words:** Customs Union, Turkey, EU, FDI, Export-Import, International Trade

## ULUSLARARASI VERGİLENDİRME VE GÜMRÜK BİRLİĞİ'NIN TÜRKİYE İLE AB ARASINDAKİ ROLÜ

**Özet**
Gümrük Birliği birden fazla devlet arasında gerçekleşen ve ortak gümrük alanı meydana getirme temeline dayanan bir ekonomik işbirliği anlaşmasıdır. Ancak, gümrük birliğinin standart bir şekli yoktur. Bir gümrük birliği farklı biçimlerde ve farklı ekonomik önceliklere göre inşa edilebilir. Türkiye ile Avrupa Birliği arasından 1995 yılında imzalanmış olan Gümrük Birliği AB üyesi olmayan bir ülke ile yapılan Gümrük Birliğine örnek teşkil etme özelliği taşıdığından dolayı çeşitli tartışmalara konu olmaktadır. Şöyle ki, Türkiye ile AB arasındaki Gümrük Birliği sadece sanayi ve işlenmiş tarım ürünlerini kapsamaktadır. Bundan dolayı Türkiye ile AB ülkeleri arasındaki mal ve hizmetlerin serbest dolaşımına bazı kısıtlamalar getirilmiş ve bu özel durum özellikle Türkiye tarafında eleştirilere konu olmaktadır. Diğer taraftan Gümrük Birliğinin Türkiye'nin AB üyelik sürecine katkı sağlayacağını ve Türkiye'nin AB ekonomik entegrasyonuna dâhil edeceğini savunanlar bu kısıtlamalara rağmen Gümrük Birliği'ni destekleyen tezler ileri sürmektedirler. Bu çalışmada bu tartışmalar uluslararası ticarette vergilendirme ilkeleri çerçevesinden mercek altına alınmıştır.
**Anahtar Kelimeler**: Gümrük Birliği, Türkiye, AB, DYY, ihracat-ithalat, Uluslararası Ticaret

## Prologue

The taxes operate a significant role in the national and international economic activities. Investments decision as well as export and import of goods are significantly affected by the tax rates and tax system of the countries. Through this paper we try to construct a correlation between the effects of international taxation and the role of customs union in this system. Accordingly, it is an attempt to examine the relationship between the EU and Turkey from the taxation system in more detail. In other words, it focuses on the Customs Union between the EU and Turkey, with special emphasis on three main issues: export, import and FDIs.

The Customs Union is a concrete step towards Turkey's entrance into the EU. The Customs Union accelerates the convergence between both sides, not only economically but also politically.

The objectives of the EU are to increase the essential welfare level of the population on the whole continent and to enlarge the EU integration area in order to create and safeguard the Union through economic opportunities and political instruments. In addition, international

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competitive pressure from globalization forces the individual countries and regional blocs to make more long term regional agreements and international cooperation treaties.

The above mentioned compelling global pressure is bringing the EU and Turkey closer together. For the purpose of cooperation, the two sides have been undertaking a gradual convergence process since 1963. The result of this process was the agreement on the formation of a Customs Union in December 1995. This can be viewed as an important economic step for this convergence process. Because of the importance of this process, the customs union with Turkey have been analyzed in detail. In conclusion, the Customs Union with Turkey represents a positive step for both sides in mutually maximizing their economic and political relations.

## 1. The Importance of Intensive Trade Relations between Turkey and the EU

The economic and political relations between EU and Turkey are based on such a strategy, which aims to profit from the advantages of international collaboration. The establishing of a customs union between Turkey and EU is a part of such strategy. Such cooperation has following essential additional benefits:

- More alternatives for investors and traders
- Expanding the volume of trade in an economy (more FDI, Export and Import between partner countries)
- More alternatives for employees as well as employers
- More alternatives for consumers
- Enabling the free movement goods and services

In fact, nowadays countries are trying to strengthen their cooperation with one another and act together at the international level in order to make progress and to utilize essential advantages of globalization and to maximize their economic and political interests.

Aside from the above mentioned actual developments, there also many other impacts on developments in Turkey. These are national and global economic and political crises and priorities: Economic and political crises around Turkey force the country to cooperate with EU and other national and supranational governments. Extending the economic and political relations between Turkey and the EU brings more advantages for the EU as well as for Turkey.

However, the EU as a supranational organization has the more advantageous position in almost every international handling with single countries like Turkey. In fact, in comparison to the rest of the world, the total trade volumes as well as FDI inflows/outflows of Turkey to/from EU countries are not as decisively important for the EU´s economy as for the economy of Turkey itself. EU trade with Turkey is crucially important for the economic growth and stability in Turkey. Moreover, access to the hinterlands of Turkey has a critical priority for EU international relationships. Arab countries and Iran are mentioned as hinterland countries of Turkey. Turkey has common historical, economic, political and cultural experiences with these countries.

Turkey’s strategic geographic location plays a role as a meeting point for business partners between Asia and Europe. Turkey represents large potential markets for FDI seekers, where labor and tax costs are low. Furthermore, the customs union with EU and ongoing EU negotiations between Turkey and EU gives new and wider perspectives for strengthening the position of Turkey and for attracting further investments. As a matter of fact, through exports and FDIs, the capital inflows to Turkey are significantly higher than capital outflows. All these facts show that Turkey as a business partner provides several fundamental location advantages for foreign investments. Consequently, Turkish relationships with the EU strengthen its regional position between Asia and Europe, so that Turkey can use these advantages more decisively as a crossroad country. Hence, developing the economic and political relationship with the EU is critically important.

Every single element of this relationship is like a ring in a chain. Each can be classified as economic parameters (FDI in/outflows, exports, imports, trade agreements) and political (integration policy of EU towards Turkey. Finally, considering the issue from a global point of view, these relationships are necessary for all sides to take full advantage of global developments. The hinterlands of Turkey and EU are floating in economic and political instability. Consequently, they are a gateway for unregulated immigration into EU territory.

As a result of diverse economic and political interests of the EU with these countries, the EU Commission follows different strategies towards Turkey and Mediterranean countries. The reasons for implementing different policies is that these countries represent significant differences in economic, political as well as social structures.

According to UNCTAD calculations, about 80% of foreign direct investments take place among the developed countries and the remaining 20% go to developing countries. That means, most goods are produced by companies from industrialized countries. To put these products on the market, they need consumers in developing countries.

In other words, products of developed countries need to be exported to developing countries. There is also serious competition between developing countries, in order to receive a part of these FDIs. In this sense, Turkey is in a position in which it has borders with developed as well as with developing countries and Turkey shows some characteristics of developed as well as of developing countries. As long as the free movement of people is restricted, it would be unrealistic to speak of a long term and full integration or cooperation between EU and Turkey. Without the free movement of people neither the free movement of goods nor the free movement of capital is completely possible. In this context, the EU and Turkey are trying to protect as well as to improve their global economic and political interests through cooperation with each other.

## 2. The EU's Economic Policies and the Concept of the Customs Union

A Customs Union is a union of states, which share a common customs area. However, the word "Union" is an ambiguous term. Customs union partners cannot be defined as integrated countries (Liebich, 1951).

There is not a standard type of custom union. A customs union may be built according to different forms and for different legal reasons.

According to Viner, a full (perfect) customs union has the following distinctive features (Viner, 1950):

- Elimination of internal tariffs between member countries
- Common external tariffs against third countries
- Distribution of income from external tariffs among member countries

The customs union theory was developed in the 1950s by Viner (1950), Meade (1955), and Lipsey (1957) and is the most developed part of the neoclassical theory of integration. According to Viner’s theory, a customs union is based on the elimination of internal tariffs and other trade restrictions, but in contrast to a pure free trade zone, the member states execute a common tariff towards third countries. Thus product movements between member countries are no longer subject to duty.

A customs union has two main specifics: trade creation and trade diversion effects. Trade stimulation (the effects of the decreasing of costs of goods in a custom union area that increase the efficiency of economic integration between partners) arises from the fact that products from within the customs union become cheaper, stimulating trade, due to the elimination of internal customs tariffs. Trade diversion arises from the fact that countries outside the customs union are discriminated through customs duties in effect towards countries outside the union. Trade creation and trade diversion effects are fundamental phenomena, which economists try to make more understandable, transparent and measurable through various models and theories (Vanek, 1965).

Viner partly agrees with Adam Smith that "good fences make good neighbors". A mere neighborhood alone is not enough for a favorable international relationship. A strong cooperation can achieve a more advantageous level for the neighborhood (Viner, 1950).

Looking at an overview of the European customs union history, it is obvious that the idea of a customs union has experienced various forms in European countries in the course of time, and a continuing development can be seen, reaching up to the present state.

Today's EU Customs Union is based on the principles of the Benelux customs union (A Customs Union between Netherlands-Belgium-Luxembourg "Benelux" established since 1948). However, the Customs Union between EU member states still has several complications, despite the creation of the single market. The more the EU countries become integrated, the more they also become integrated in the customs union area. For a successful customs union and profitable economic cooperation, a successful integration is necessary in every area.

Real economy and monetary circulation play an important role in the practice of the customs union. The countries that have adopted the Euro as their currency have a stronger relationship with one another than with any of the other members. Former customs unions between the different European countries have encountered various problems. For example, the Austrian-Hungarian Customs Union (1867-1917) was at times unable to fulfill its function due to wars, economic crises, currency instability and other conflicts (König, 1953:17).

The works of Viner, Meade and Lipsey further developed the customs union theory. Lipsey, inspired by Viner and Meade, focused on the second-best criterion (Lipsey, 1970:25).

Second best means next to the best, in the case of quality next below the first (Webster's New World Dictionary, 1960: 1316). The Second-best criterion assumes that compliance with the largest possible number of efficiency conditions is not appropriate if an unchanging distortion exists. Instead, the welfare loss can be minimized by the state through distorting other conditions of effectiveness. According to the "first best option", the full liberalization of international trade is the best policy. Therefore, only trade liberalization provides the optimum. If the "first best" in the form of the Pareto optimum is not attainable, then the second best will be relevant. In the case of second best option, trade limitations and tax against third countries are expected to lead to a positive impact in terms of the welfare of a member of a customs union.

Economies of scale describe the fact that growing operations and firm size also increase the possibilities of reducing costs in purchasing, manufacturing, sales, organization, research and development. This aim can be achieved by the formation of a customs union. Tariff reductions by an enlarged single market lead to greater market opportunities. Insofar as mass and serial production processes are made possible, lower unit costs can be achieved through economies of scale. This allows an increase in productivity (Eren, 1998:125).

There are still areas in this theory, especially in the realm of trade creation, which could be further developed to increase productivity and trade between partner countries. The effects of the customs union and its functions, especially in the case of the EU and its external economic relations (such as those with the Mediterranean and other neighborhood countries) outside the customs union, must be considered here.

## 3.The Customs Union between the EU and Turkey

Turkey signed a Customs Union agreement with the European Union in 1995, and Turkey was officially recognized as a candidate for full membership on 12 December 1999.

Negotiations were started on 3 October 2005. All these steps are based on the Copenhagen Criteria. These criteria are as follows (Eren, 1998:191):

- Political criteria: Stable institutions, guaranteed democracy, rule of law, the protection of human rights and respect for and protection of minorities
- Economic criterion: A functioning market economy and capacity to cope with competitive pressure and market forces within the Union
- Acquis criterion: The ability to assume the obligations of membership including adherence to the aims of political, economic and monetary union endorsement.

The customs union with Turkey is a good example of a country not yet a member of the EU, but with which the EU has a customs union. On the European side, the EU has some reservations about Turkey entering the EU because of its economic and political instability and its democratic deficits. The customs union agreement has also been planned as an economic instrument to build a close relation with Turkey. Hence this close economic partnership with Turkey has following priorities: expansion of the territory of EU integration, preservation of peace and freedom, and a continuous balanced strengthening of trade and economic relations with Turkey. To achieve these goals the gradual establishment of a customs union was planned.

According to the regulations of the Additional Protocol, (The Additional Protocol was signed in 1971 and came into effect on 1 January 1973.) the EU reset customs on industrial products originating in Turkey. Turkish products received a transition period for resetting customs tariffs, which for some products is based on a 12 year and for other products on a 22 year period. Turkey removes the customs on the EU industrial products gradually until the end of a 12 or 22 year period respectively.

## 4.Proponents of the Customs Union in Turkey and their Opponents

On the Turkish side in particular, there were economic concerns and criticism. On the other side the proponents of the customs union in Turkey, especially among representatives of the textile sector expected an export increase through the elimination of import quotas.

The same positive prospectives were expected for the tourism sector and for the banks, which expected an increase in financial transactions. From the view of pro EU politicians, the customs union was therefore seen as an important step for the integration of the Turkish economy into the European economic area. According to Togan, the EU is a major source of technology and investment for Turkey, hence the customs union is a good option for both sides to optimize their economic interests (Togan, 1997:21).

 

Furthermore the proponents of the customs union with EU favorize it as a significant contribution to the membership process of Turkey into the EU. Opponents of the customs union in Turkey were to be found in the automotive industry and the so-called white (refrigerators, washing machines) and brown (electronic consumer goods such as televisions) industries. They were especially concerned about low-cost imports from the EU and common tariff and quotas against third countries causing permanent economic disadvantages.

## 5.Existing Problems in Practice

In practice, existing technical and legal adjustment problems decelerate the flow of products between EU and Turkey. One of these problems concerns the monopolistic markets for tobacco and for the alcohol industry, which has not yet been resolved in Turkey despite some legislative changes. Another problem lies in the interpretation of terms that appear in agreements and are not entirely clear, such as "Second Hand Products." It was decided that high-tech products from EU countries imported into Turkey must have a manufacturing age of less than 6 months, because Turkey wants to prevent the import of old technology. Ambiguities in the “Copyright” and “Know-how” areas are considered to need modern economic and legal adjustment and regulation. Such problems appear especially in the area of medical and pharmaceutical products (TUIK, 2008).

In a customs union area, the movement of some goods may be differently regulated and strictly controlled due to health or security reasons. Another challenge is taxation on goods. Goods traffic is always controlled. Therefore, the free movement of goods cannot flow as freely as that of citizens. Especially on the Turkish side, exports to the EU countries follow different rules internally.

For example, in order to better the reputation of Turkish products, it is necessary to improve the quality of goods to European standard. There is a need to export products that meet the minimum standards of CE, ISO 900 or TSE (Turkish Standard Institute) etc.

## 6.The Effects of the Customs Union between Turkey and the EU on FDI and Export-Import

The effects of the customs union can be measured or determined by statistical data and the volume of investment in comparison to previous years. According to different model calculations and statistical representations, both sides (EU and Turkey) have profited from the Customs Union. However the customs union is not a full economic and political unification, but only a kind of economic cooperation. In addition, the customs union raises the volume of trade between the involved countries. For more accurate results, there are several macroeconomic model calculations. E.g. macroeconomic models by De Santis, and Mercenier Yeldan Harrison can be implemented.

According to calculations in the model of De Santis (1998), the effects of the customs union on the Turkish economy show an entirely positive output. The ratios of the increase are between 0.7% and 1.7%. The growing sectors are the food industry, the beverages and tobacco, textile and clothing industries, leather industry and fur products, footwear, chemical and mineral industries. These sectors are mostly based on labor-intense production; hence they represent a comparative advantage for Turkish economy (Eren, 1998).

After establishing a customs union between EU and Turkey, there is a rising trend in the volume of Turkish foreign trade. This tendency has become more stable since the implementation of the customs union. Total Turkish textile and clothing exports to the EU in 1995 were 4.3 billion Euros and in 2000 around 7.7 billion Euros. i.e. an increase of 72% (Neyapti, 2005).

Moreover, 90% of the Turkish imports are products such as industrial equipment-machinery and raw materials and 10 percent are consumer goods (food, etc.). 75% of Turkish imports from the EU are investment-products such as machinery, high-technology components and other accessories and raw materials, approximately 25% are consumer goods. On the other hand, 75% of Turkish exports to the EU are consumer goods and 25% raw materials and industrial products (Jones, 2004).

The Turkey's trade balance shows a negative trend. Turkey imported more goods than it exported. According to mercantilism such a negative balance would be a disadvantage for Turkey. In older times, the mercantilists believed that a country should export more than it imports. In that way a country could profit from international trade. However this perspective is no longer relevant for international trade. The reasons have been defined by the comparative advantages theory of Ricardo, Samuelsson and Heckscher-Ohlin as well as by neo-classic economists. Furthermore Turkish imports are mostly based on the investment goods, which improve the productivity of the country’s economy.

The export/import ratio (X/M) is one of the fundamental indicators to express the external trade deficit in the economy of a country. It measures the external trade balance of a country. Changes in the export/import ratio also affect the country´s current account balance as well as its foreign exchange reserves. Parallel to growth in the Turkish economy, its export/import ratio has shown an increase since the 1980.

The annual compound rate of changes gives information about the performance of business over a given time period. The Turkish economy was very volatile and overshadowed by political crises in the period between 1970 and 1979. Hence, national production and exports were significantly low. Furthermore the volume of international trade was also significantly low. Therefore, Turkish imports were high.

Low economic activity and political turbulences and can also be observed from Figure 2. However, after 1980 Turgut Özal's government put a special program in power, by which export oriented companies were encouraged and subventioned to increase the volume of their trade. The effects of this export oriented economic policy of Turkey can be observed in the period of 1996-2001 as well as in following periods.

According to a study by Izmen and Yilmaz, the customs union agreement with the EU did not have much impact on Turkish exports in the first five years. However, the exports and imports to with EU show positive progress. Furthermore the Turkish economy shows a competitive and integrative performance in the customs union area.

Turkish trade relations with Europe have always had considerable importance. Between 1999 and 2003, trade with the EU-25 accounted for 53 percent of Turkey’s exports and 51 percent of imports. If one includes countries, which became members in 2004, and Bulgaria and Romania, which joined in 2007, Europe’s share in Turkish exports and imports in 2004 was 59 percent and 53 percent respectively. With 49 percent share in imports at the end of 2005, EU continued to be the most important trade partner for Turkey, despite the rapid increase in imports from China in the 2000s. The Chinese share in imports rose to 7.8% in 2007 from 2.2% in 2001 (Izmen, 2009).

Mainly, revenue in China rises through the low cost of labor-based production and manufacturing. Turkish economy has been most affected by the national economic and political development from 1950 to 1980. Since 1980, global economic and political developments gradually played a significant role on the developments of the Turkish economy. From 1960 to 1980 Turkish economy has been overshadowed by a series of military coups in Turkey: after a military coup on 27 May 1960 Prime Minister Adnan Menderes was sentenced to death, and after a military coup on 22 March 1970 and 1971 all political parties were banned and finally after the military coup of 12 September 1980 Turkey was ruled by a military committee. Then the military handed power over to Turgut Özal's party ANAP (Motherland Party). The ANAP implemented pro EU and pro liberal economic policies. All these political and military incidents had enormous effects on the volume of the Turkish foreign trade.

After 1980, with the transition to a liberal market economy, foreign direct investment into Turkey reached a respectable level. Although regulation article No. 6624 on the promotion of foreign capital was in force from 1954 until 1980, there were no significant improvements in the FDI into Turkey. The critical reasons were infrastructure deficits, lack of capital accumulation, political crisis, the lack of recognition and promotion of investments. 61% of direct investment in Turkey originated from EU-15 countries, 31% came from other OECD countries, 4% from Islamic countries and 4% from other countries. The EU is the main FDI partner of Turkey and the role of Islamic countries by direct investment in the Turkey is considerably low.

The biggest investors in Turkey come, as always, from the countries of the European Union. Germany, with 995 realized direct investment projects in Turkey is the leading country, followed by the Netherlands with 403 companies and the UK with 350 companies. Direct investment from the EU countries in 1989 to 1994 was 65% and this figure increased by 2.3% to 67.3% between 1996 and 2002 as a result of the customs union. (http://www.invest.gov.tr) The amount of FDIs in Turkey by 2005 is over 10 billion US dollars. While from 2006 to 2008 FDIs to Turkey boomed, from 2009 and 2010 there was a significant decrease due to the worldwide financial crisis and lastly in 2011 FDI flows into Turkey made new progress and reached 16 billion USD. The quantity of FDI inflows to Turkey from 2005 increased rapidly. This increasing trend continued until the end of 2008. This period represents a record FDI inflow into Turkey.

The effects of the global financial crisis that began in 2007 in the USA as a real estate sector showed its economic consequences until late 2010. Consequently, between 2009 and 2010, due to effects of the global financial crisis, there is declining period for FDI inflows to Turkey. In 2011 a new upswing began. The FDI flows into Turkey have been negatively affected by the global economic crisis in 2009 which began to show itself in the last quarter of 2008 and its aftershocks have been felt until end of 2010 (TUIK, 2012).

## Conclusion

To sum up, the Customs Union and its effects on the economic and political integration of Turkey are worthwhile. The customs union with Turkey has not fully satisfied all the wishes, but it has provided an important step. Economic cooperation and international relations are dependent on such specific agreements.

The European Countries and Turkey have had significant relations throughout their history. They increased and strengthened these relations and helped make the customs union possible and encourage further political and economic steps to integrate the Turkey into EU.

Apart from the EU countries, other international blocs, such as Islamic countries, the British Commonwealth, the Black Sea Countries Economic co-operation, etc. have built up relations with and signed treaties with Turkey. In comparison to the relations between Turkey and EU, they have, however, not played a very important role in the Turkish economy.

  

After the customs union with the EU, trade volumes and FDI movements between EU and Turkey show an increasing trend. On the other hand, with the acceleration of globalization, there is a global increase in international trade as well as FDI movements. This increasing trend has become significantly higher with the intensification of relations between EU and Turkey. Finally, it is suggested that if the EU's relations with other Mediterranean countries like Turkey can be improved with the customs union and similar agreements, it will be profitable for all sides.

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