ECONOMIC ASPECTS OF TURKEY'S ACCESSION TO THE EU - HOW TURKEY'S MEMBERSHIP IS CHALLENGING THE EU

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Introduction

On the 17th of December 2004, the European Council decided that accession talks with Turkey would open in October 2005, following the positive recommendation of the Commission. This means that Turkey is formally on the way to joining the European Union (EU) by 2015-2020. By virtue of its size, its potential, and its economic weaknesses, Turkey's membership is likely to pose a major challenge to the community's structure. With its population of 70 million, this poor and agricultural country is, on its own, expected to provoke a shock comparable to the advent of the 10 new members.

Turkey has expressed the will to take part in the European integration since the very beginning of the process. In 1963, European Communities (EC) and Turkey signed an Association agreement that brought stronger economic and commercial cooperation. In 1987, it submitted its first application for membership. This effort amounted to the creation of a customs union with the EU in December 1995. Until recent times, and despite a written democratic constitution, the military and religion have strongly influenced Turkish politics. The economy was also characterised by *dirigisme*. In the 1990s, Turkey was set on the path of liberal reforms in political, economic, and social arenas. It finally obtained the official status of candidate in 1999.

Although accession talks are already scheduled, the prospect of Turkish membership is inspiring large controversies across Europe. None of the previous enlargements were questioned to such an extent about their cost and desirability. In many European countries, people are sceptical about an extension of the EU to a country that is assumed to belong to the Asian continent, and seen as stemming from a different cultural heritage. Others simply fear that European prosperity and integration would be compromised by a new costly enlargement with uncertain outcomes.

From an economic stance, the matter is usually presented as: "Will it be a shock for the EU?", implying that only Turkey will truly benefit from accession. Yet, we have to be careful not to fall into a purely accounting analysis made up of fixed cost-benefit calculations. The issue calls for a much longer-term study of the dynamic gains of Turkey's integration, on which it is difficult to put a figure.

The purpose of this essay is to give an overview of the main economic challenges arising from the prospect of Turkey's accession to the EU. This analysis will begin with an estimation of the consequences on the EU budget and policies. We will then discuss the nature and scope of integration's expected gains.

The Initial Outlay for Turkish Membership

"On a process as complex as enlargement, one cannot put a price tag" (European Commission 2005). Yet, while negotiating, actors continue to bear in mind the possible cost of membership. Budgetary aspects form a crucial part of the accession negotiations. It is these visible expenditures on enlargement that we will discuss first.

The sources and amounts Turkey will benefit from depend on a number of fluctuating factors, such as the EU policies and the potential specific arrangements agreed as part of accession negotiations. Hence, projections of the cost of Turkish membership for incumbent members are by their nature, highly speculative. The following section modestly attempts to give an idea of the maximum budgetary transfers that Turkey is entitled to receive under current policies.

Three of Turkey's characteristics imply potentially large demands on the EU budget: low income levels, a large population, and the importance of agriculture. Yet, while adding significantly to expenditure, Turkey will pay only a small contribution given the modest size of its GDP.

As things stand at present, the EU budget is dominated by two items: Structural Operations (35%) and the Common Agricultural Policy (42%). The gross receipts of any member country are to a large extent determined by these funds. Evaluating the Turkish inflow in these two areas may allow us to get a good picture of what the Turkish membership represents in terms of budgetary burden.

A major challenge for Cohesion Policy

Turkey's integration will drastically increase economic disparities in the EU. As a matter of fact, its economy today is 2% of EU-25 GDP. Assuming average annual growth of 5%, it would be only 3% of GDP on accession in 2015, whereas its population will already account for more than 14% of the EU-28.

Table 1: Gross Domestic Product -Turkey and the EU

	GDP at Current prices € Million	GDP per head as % of EU25 GDP	GDP per head (PPS)	% of average EU (PPS)
Turkey	191 711.3	1.99	5920	26.9
Romania	48 372.8	0.50	6350	28.8
Poland	202497.1	2.10	10020	45.5
Greece	141334.0	1.47	17030	77.4
Germany	2110400.0	21.91	23940	108.8
New EU 10	444419.5	4.61	--	--
EU25	9622124.8	100	21990	100

Source: Eurostat, 2005.

Turkey's accession would have the effect of diminishing Community GDP per head, which fell by 12% at the time of the 2004 enlargement, by a further 9%. Besides that, it has to be borne in mind that the different regions within Turkey deviate a lot from one another in terms of per capita income[1]. This means that the EU is going to integrate many very poor regions. As one can imagine, the accession of Turkey would then represent a major challenge for cohesion policy. Indeed, on the basis of present rules, the whole Turkish territory would qualify for significant support from the Cohesion and Structural funds for a long period of time. [2]

Yet subsidies are to be limited as a result of regulations confining the amount that a recipient country can draw from structural funds, to a maximum of 4% of its own GDP. This allows a quick assessment of the ceiling of Structural Funds Turkey could receive. It is assumed that, given its lower level of development and its current growth rates, Turkey will grow more quickly than the EU average over the next decade. So, following Dervis, Gros, Oztrak and Isik, we can suppose that the Turkish GDP would increase to 4% of the EU-28 GDP by 2015 (in comparison with today's 2% share) (2004). This implies that extending current Structural Funds to Turkey would cost at most 0.16% of EU-28 GDP

[1] The poorest regions (in eastern Anatolia) report income per head around one-fifth that of the richest regions (in the Marmara – Istanbul region).

[2] Even in the case of new rules, the critical income gap with the EU average implies that Turkey is likely to broadly benefit from European Structural Funds.

(0.04*0.04). The European Commission reached the striking estimation of €22.4bn per year (2004 prices).

Structural Funds are intended for poor regions, defined as having a per capita GDP lower than 75% of the Community average. This means that enlargement will amount to a deterioration of the current member states' budgetary positions. Greece and Spain may not qualify for aid anymore, and the UK rebate is being questioned. In fact, the accession of Turkey, together with that of the Balkan countries, may require reform of the entire funding system. More than ever, the EU will have to strike a difficult balance between solidarity and budgetary constraints.

A decisive impact on the Common Agricultural Policy

Turkey is essentially an agricultural country which is considerably less developed economically in comparison to the EU. This basically means that (i) Turkey will have to catch-up and secure full transition and (ii) the EU will have to provide income support mechanisms.

A competitive gap and a less protected market[3] will mean a substantial income loss for Turkish farmers. Continuous rural development efforts and an upgrading of administrative capacity would be required from Turkey to create as favourable conditions as possible to participate in the Common Agricultural Policy (CAP). With this in mind, support for structural changes in Turkish agriculture and food industries is to be given before accession, so that when it joins it can cope with competitive pressures[4].

Concerning the likely funds that Turkey may receive as part of agricultural policy, estimation is more complicated and uncertain.[5] Dervis, Gros, Oztrak, and Isik suggest that we start from the rate of support to farmers of the former EU-15, which is globally around 20% of their value-added (2004). So, assuming as before, that the Turkish economy accounts for 4% of EU-28 GDP and that agriculture contributes 10% to this,[6] the cost of providing an equivalent rate of support for Turkish agriculture would be 0.08% of EU-15 GDP (0.2*0.04*0.1).

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[3] The customs union has existed since 1995 but barriers remain on agricultural products.

[4] This assistance is given through the EU's Programme for the Support of Agriculture and Rural Development (SAPARD)

[5] One has to assess the output structure of Turkish agriculture in about a decade, and then calculate to what extent this would change if Turkey participates in the CAP. This leads to an excessively complex operation, because we have to take account of the entire input/output matrix.

[6] Agriculture produces at present around 12% of GDP in Turkey, but taking into account that its share has been declining continuously over the last decade, a reasonable assumption might be that in about a decade, agriculture will account for about 10% of Turkish GDP at maximum.

The number calculated above is an upper limit. In fact, the CAP is likely to change over time, inter alia, because of the commitments made in the context of the WTO to abolish exports subsidies. In addition, it has already been agreed within the EU that the cost of the CAP should rise by less than 80% of the increase in nominal GDP. This implies that the cost of the CAP as a percentage of EU GDP has to fall over the next decade. Depending on the overall growth rate of the EU, the cost of the CAP is thus likely to be less than 0.4% of the GDP. Moreover, since any single country is not likely to get more than one quarter of this sum, it is clear that the cost of extending tomorrow's CAP to Turkey cannot be more than 0.05-0.1% of the EU's GDP. This amount of CAP subsidies that Turkey would receive has been estimated by the Commission at €8.2bn per year.

In summary, the accession of Turkey means that considerable expenditures will have to be made in agriculture and that the income of the founding countries' farmers will be further reduced. It is expected that Turkey's accession, together with the 2004 enlargement, will add to internal pressures for a reform of the CAP.

A trigger to budget reform?

According to Dervis, Gros, Ostrak and Isik, the gross cost of Turkey's membership might altogether amount to 0.26% of EU-28 GDP (2004). We have now to look at Turkey's contribution to the EU budget.

A country's contribution comprises a share of VAT revenues, customs duties and GNP. At present all member states contribute to the EU budget at the same percentage of GNP and overall contributions are more or less proportional to countries' GNP. Assuming that the EU budget will continue to be limited to around 1-1.2% of GDP, and under the assumption made so far that the Turkish GDP represents about 4% of that of the EU-15, Turkey's contribution to the budget will amount to around 0.048% of EU-15 GDP, that is around €6bn according to the Commission. Then, under current policies, the *ceiling* for the net cost should be around 0.20% of EU GDP, equivalent to about €20bn given today's EU GDP of around €10,000bn We should also add to this assessment the costs brought by special internal policies in Turkey, additional administrative costs (e.g. new translation services) and the pre-accession financial aid, which may reach €2.6bn according to the Commission.[7]

The Turks insist on the high level of uncertainty and methodological difficulties associated with these forecasts. It is not only Turkey, but also the EU

[7] Now the schedule for the start of negotiations is set (next autumn), Turkey will benefit from different pre-accession instruments such as SAPARD (support to structural change in agriculture), ISPA (concerning infrastructure), and substantial amounts of funding for democracy-building as was the case for central and eastern European countries with the PHARE programme.

that is evolving and changing constantly. It is obviously impossible to predict with any accuracy what the budgetary rules will be in ten years' time. Available studies give varying estimates of the net budgetary cost of Turkey's accession. The European Commission estimated the overall cost at €25-28bn per year for the first ten years of integration, assuming Turkey is to be integrated in 2015.

We can conclude from this analysis that Turkey's membership implies a substantial or even unbearable budgetary cost for the EU under current policies. Also, the rules for both Structural Funds and CAP are likely to become more restrictive. Many commentators argue that the EU should take advantage of this second enlargement (that should include Turkey and Balkan countries) to review the whole system. As a matter of fact, the biggest contributors are seeking to limit their contribution to 1% of the EU GDP. There is hardly room left for more generous policies, at least for the financial perspective 2007-2013. If Turkey is to be integrated, the EU budget design will need to be vastly overhauled.

The prospects for immigration flows

The demographic size and the relative poverty of Turkey are factors giving rise to concerns about likely immigration flows and 'social-welfare tourism.' In fact, the entrance into the EU means the removal of all barriers to free movement of labour. The European labour market may be flooded with millions of unskilled Turkish workers. If substantial and uncontrolled, these immigration flows could lead to important disturbances in the EU labour market.

As theories of migration argue, a major incentive to move is a real income differential. However, it has to be noted that it may not merely be that the same job will be better paid in the EU; it may be that the person moving will be able to get a better job with higher pay. The direction of migration flows will also be impacted on by the location of existing Turkish communities in Germany, France, Netherlands and Austria.

The effect of migration on GDP will obviously differ with the skill level of migrants. If migrants are mainly unskilled, unskilled workers currently residing in the EU may lose out, while both the Turks who stayed and the Turks who moved will benefit from an increase of wages. On the other hand, the migration of highly skilled workers cannot be regarded as an unwanted phenomenon for Europe, while Turkey could face a significant loss of human capital. A number of researchers have come up with estimates of potential migration. Studies on the implications of enlargement for migration vary considerably and are based on very different methodologies. Depending on which method is followed, anywhere between 500,000 and 4.4 million migrants are to be expected by 2030. At this stage it is very difficult to forecast the level and the structure of these flows.

Current rural-urban migration in Turkey may contribute to a trend of unskilled rural Turks migrating to EU labour markets. Yet if economic expansion advances sufficiently rapidly and is accompanied by adequate employment policies and job creation, developing growth areas such as Istanbul and Koecali could absorb a large part of these rural migrant flows. Other counter-arguments can be put forward. Commentators emphasise the relative stability of overall migratory pressures independent of accession. Additionally, the Spanish, Portuguese, and Irish cases where people were actually seen to have returned once their home economies prospered must be recalled. Opinion polls have been taken on this issue and confirm speculation[8]. In any case, the issue of migration is subject to negotiations. Despite the Rome Treaty's free movement of labour provision, the Commission and the Council agreed that a very long transitional period and even a permanent safeguard may be required.[9]

The accession of Turkey to the EU means an important commitment by Europeans to substantial expenditure, even after a necessary reform of the EU budget and policies. The costs for Turkey, on the other hand, are smaller. However, positive effects can also be expected for both.

Important short-term gains for Turkey; Positive long-term perspectives for both parties

It is easier to identify the immediate costs of enlargement, rather than long-term gains. And, in the case of costs it must be emphasised that the numbers put forward are only estimations. Since models utilise many variable factors, there is scope for both very pessimistic and optimistic viewpoints. Let us begin by presenting the gains Turkey could expect. We will then overview potential benefits to the EU, bearing in mind the risks of such estimations.

EU membership is economically positive for Turkey as it will bring EU funds, new market opportunities, and increased competitiveness

Since 1990 Turkey has made sweeping liberal reforms, both in political and economic arenas, but there is still a long way to go to reach European standards. The prospect of membership could boost and consolidate Turkey's transformation.

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[8] See for example the Europe Monitor-CEPS Turkey poll made in May 2004, according to which 60% of Euro-Turks would like to return to Turkey once it becomes an EU member.
[9] It is the first time that the option of permanent conditions is foreseen.

The EU and Turkey signed a treaty of enhanced cooperation and customs union in 1995, which commits the EU to limited financial support. Further on, EU membership would mean a considerable increase in funds for Turkey, even allowing for EU budgetary and policy reviews.

For Turkish firms, membership means fuller access to the vast European market. The establishment of the 1995 customs union led to only a small increase in trade between Turkey and the EU. In particular, intra-branch trade has been disappointing. The advent of membership, with the prospect of a full removal of administrative and non-tariff barriers, would provide new opportunities to trade creation, though agricultural markets will remain regulated. In addition, the expected diffusion of technology following market integration will benefit Turkish industry and increase competitiveness. As Viner and Meade's theory (cited in El-Agraa 2004) shows, regional economic integration allows greater gains when economies are competitive and diversified.

Pre-accession reforms can reaffirm Turkey's international credibility, help restore its economic health, and attract FDI

Now seems the right moment to support Turkey as it recovers strongly from the 2001 crisis. Turkey is succeeding in stabilising its macroeconomic indicators after a long period of irregular performances and crises. Inflation has decreased to one-digit numbers for the first time ever since 1972. GDP continues increasing by rates above 10%, with a peak of 13.6 % in the second quarter of the last year. At the same time, unemployment has fallen to 10%. Turkey also reached a new agreement last year with the IMF on a three-year $10bn economic programme that will, according to the IMF's managing director Rodrigo Rato, "help Turkey... reduce inflation towards European levels, and enhance the economy's resilience" (Rato 2004). It also offers indirect proof of Turkey's credibility and an approval of its reforms by international institutions. The EU itself has taken partial responsibility for supervising the financial sector in order to enhance the economy's resilience. Enhanced financial sector credibility will reduce risk premia and attract greater investment. Indeed, previous irregularity along with red tape and corruption have been the main reasons for the country's dismal failure to attract much needed Foreign Direct Investment (FDI) flows, which last year reached scarcely $1bn. With recent changes, this tendency should be corrected. The efforts required from Turkey to join the EU in terms of meeting the 'Copenhagen criteria'[10] and fully implementing the *acquis communautaire*[11]

[10] The Copenhagen criteria are: democratic institutions and rule of law; competitive market economy; and ability to take on the obligations of membership

are the same efforts that most attract FDI. In addition, the prospect of EU membership also provides Turkey with enhanced credibility on an international level. Moreover the prospect of EU membership enhances Turkey's strategic position; as investors perceive the combined benefit of low labour costs, relatively well-educated workers, and access to the European market. In these circumstances, the benefits of FDI flows may spill over into the EU by accelerating economic convergence.

For Turkey, the benefits from EU membership are quite clear and this explains their strong willingness to join as soon as possible. However, for existing EU members, the gains seem more opaque and conditional.

Both EU and Turkey will gain in the long-term from enlargement

Turkey is often presented as a large, poor country which will swallow up the better part of the EU budget. The total cost of the 2004 enlargement, incorporating ten central and eastern European countries was little more than €40bn and involved significant trade gains and economic opportunities in return. With hindsight, we may even see it as self-financing because of net welfare gains on both parts. If truth be told, Turkey has more in common with an emerging economy than a transitional one. Central and Eastern European Countries (CEEC) have been faster and more conclusive in their economic reforms. The gap between social classes was not so great. Populations were generally better educated and economies relatively more industrialized. Recent Turkish stabilisation has not lasted long enough to prove that the new economic growth will allow it to catch up with current EU members. Still, Turkey's major economic indicators can be compared to those of Balkan countries in relation to whom membership is almost unquestioned; and is similar to the CEEC economies fifteen years before the 2004 enlargement.

[11] This increases the well-being of the economy, thanks to more fiscal rigor, less corruption and more transparency.

Table 2: Comparison of indicators in the year preceding the opening of accession negotiations (Turkey in 2003, Bulgaria and Romania in 1999, Poland & Slovenia in 1997)

	GDP per capita (€)	Budget balance (% GDP)	Debt (% GDP)	Inflation (%)
Turkey	6256	-8,8	87,4	18,4
Bulgaria	5120	-0,9	79,3	7,0
Romania	4980	-1,9	24,0	54,8
Poland	7410	-2,6	44,0	13,2
Slovenia	12600	-1,2	21,6	8,8

Source: Independent Commission on Turkey (2004)

The EU should then profit from similar gains as those from the last enlargement, although Turkey's accession has specific advantages and dangers also. For example, the fact that trade between Turkey and the EU would further increase substantially can be questioned. As the EU and Turkey form a customs union, they are more commercially integrated than the EU was with the CEEC in the early 1990s after the fall of the Iron curtain. Since then, commerce has grown rapidly between EU and CEEC, whereas it still remains relatively low between EU and Turkey. In 2001, EU products represented 49% of Turkish imports while the EU represented a share of 53% of Turkey's exports. Turning to the CEEC, 60% of their exports are destined for the EU. But in terms of GDP, trade with the EU represents 48% of the GDP for the CEEC against just 20% of Turkey's GDP. Turkish products are certainly generally less competitive than those from the CEEC, so it is more difficult for them to make their way into European markets. Still, trade is growing, if not rapidly, at least steadily, and according to the European Commission's reports, there is no reason why this tendency should reverse. Moreover, with more investment, closer ties, and the removal of remaining barriers, exchanges can only be expected to increase. Acknowledging that Turkey is a market of 70 million consumers and is still growing, with strong economic growth, it represents an enormous market and a significant long-term opportunity for European firms.

If Turkey accedes to the EU and gains greater international credibility, it will surely use EU funding, FDI, and other investment flows to improve infrastructure and modernise industry. This also represents an enormous opportunity for European construction and engineering firms. Turkey has enormous mineral and raw material reserves and has a strategic position in the crude oil transit network. These factors would be valuable additions to the European strategic resource position. Its cultural links and geographic position opens doors for Europeans into new markets in the Middle Eastern world for example, European firms based in Turkey supplying the wider Middle East area. Turkey's adhesion is therefore clearly in the interests of the European export, construction and engineering sectors. Moreover, integration may bring economies of scale resulting from increased production due to the extension of the market. As well as the initial benefit to capital owners profits and equity valuation, we might presume that households would also realise downstream benefits from the capital accumulation after some time.

In the short term, the growth benefits of Turkey's integration are small for the EU. Nonetheless, if Turkey develops rapidly, accession could prove advantageous. Turkey's probable high economic growth in the following years will contribute strongly to overall EU growth. Moreover, Turkey has a significant demographic advantage over the existing EU members. Its large, young and growing population will be a positive asset for a European economy burdened by the increasing weight of its ageing population. Migration could contribute to stemming declining growth potential and rejuvenate the European labour force.[12]

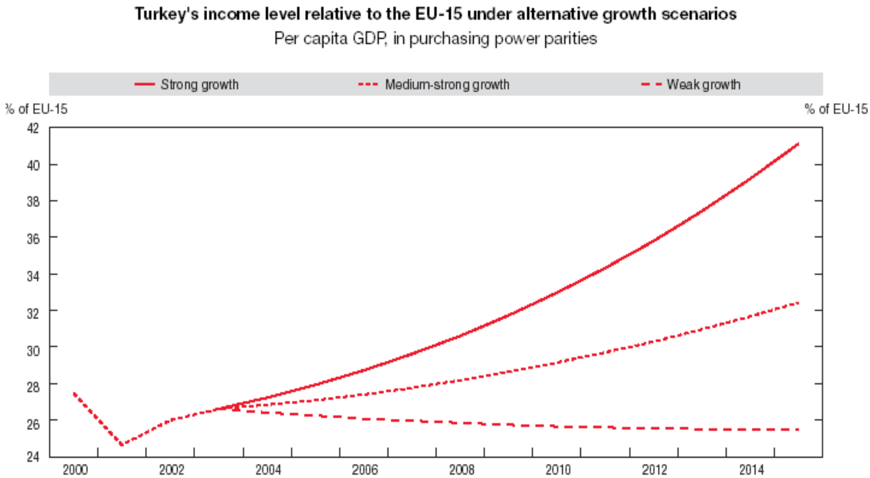
EU support for Turkish reforms: a condition for mutual gains

The gains outlined above are dependant on many factors, and it is clear that the EU would gain most by limiting itself to administrative, political and economic engagements. Turkey's circumstances remain volatile. Even if economic growth remains strong and inflation controlled, fiscal and budgetary rigor still does not yet meet EU standards and represents a source of risk. The outcome of enlargement and the mutual gains from convergence rely to a large extent on the continued implementation of reforms, especially those increasing the growth of mutual trade, investment and productivity. A strategy of utilising economic incentives and rigorous enforcement is needed if the size of the informal sector is to be reduced.[13] This must be accompanied by less onerous regulations in product and labour, markets, a simplification of administrative procedures, a shift away from the tax burden on labour and decrease of social security charges. Privatisation should be further supported so as to increase economic efficiency. Increased investment in human capital (i.e. increased education and training) is also desirable in order to increase competitiveness and would help in attracting FDI inflows. Turkey has started to implement the *acquis communautaire* since the negotiation of the customs union. The country has successfully pursued liberal reforms and the financial sector is stabilizing. Executive power and the judicial system also work more transparently and effectively now, according to the

[12] In this respect, the EU has a strong interest in that reforms and investments should be made in Turkey for education and training over the next decade.
[13] The informal sector is huge in Turkey and could cover up to the half of the national economy according to the European Commission's report.

Independent Commission on Turkey (2004). But these positive steps need firm support to be converted into sustainable growth and macroeconomic stability.

Figure 1:



Source: OECD 2004

Conclusion

This analysis has shown that the fears of large negative economic repercussions following Turkey's accession are exaggerated. It is true that this enlargement entails substantial budgetary costs for the EU, yet Europeans could also take advantage of new market opportunities and the benefits of Turkey's demographic profile in the long run. Turkey remains the greater beneficiary of integration. It should expect high growth and gradual convergence to European living standards following its entry into the common market.

If enlargement is well handled, it could result in reasonable benefits for both parties. However, Turkey's accession is not an exchange of goods and services with finite, established terms. One can see it as an investment with an initial outlay, variable gains, and an acceptable risk factor. In addition, Turkey's accession represents an opportunity to accelerate the reform of EU structures and policies.

Finally, when addressing the question of membership, we must remember that other pertinent issues are at stake. One can cite concerns about the Cyprus dispute, the treatment of the Kurdish minority, recognition of the Armenian genocide, and basic human rights such as freedom from torture and freedom of expression. In addition, we should never forget that the EU is also a political project, and that joining it means much more than complying with economic criteria.

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