

# CRS Report for Congress

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## Turkey: Qualifying Industrial Zones (QIZs)-- Issues and Economic Implications

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### Summary

Before Turkey's parliament blocked a measure allowing U.S. troops access to Turkey's military bases, Congress had been considering trade and aid proposals for Turkey. One trade proposal, which was passed by the House in the 107<sup>th</sup> Congress, would have brought Turkey under the Qualifying Industrial Zone (QIZ)<sup>1</sup> tariff reduction "program," which was linked to the U.S.-Israel Free Trade Agreement (USIFTA). The Turkey-QIZ program, while offering some new tariff benefits to Turkey, would have excluded from tariff and quota benefits textile and apparel products, Turkey's largest exports to the United States. The issues may be addressed again in the 108<sup>th</sup> Congress. In addition to the above proposal, other options include: (1) exploring other possible textile and apparel tariff treatment, (2) a free trade agreement, and (3) a short-term package of textile and apparel benefits for Turkey. This report will be updated as events warrant.

Turkey is arguably a pivotal country at a pivotal time in history. Geographically, it is both a land bridge between Europe and the Middle East, and Iraq's northern neighbor. (See map, figure 1.) It is a country connected culturally and religiously to the Middle East, and politically and economically (as a Muslim secular democracy) to Europe and the West. And it is a country the United States wants to engage to help anchor Western-style economic stability in the Middle East.

Turkey is also a country beset with domestic challenges. Its coalition government represents three different parties. It has a market economy with a large state-controlled

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<sup>1</sup> H.R. 5385, the *Miscellaneous Trade and Technical Corrections Act of 2002* incorporated the language of bipartisan bills S. 2663 (Breaux, Grassley, McCain et al), and H.R. 5002 (Crane Wexler, Arney, Lantos, Sessions, et al). The Senate did not act on H.R. 5385 by the end of the 107<sup>th</sup> Congress. Similar legislation (no number yet) was marked up by the Senate Finance Committee on February 26, 2003, with the Turkey-QIZ proposal omitted. These zones are sometimes also referred to as qualified industrial zones.

economic sector struggling to stabilize, and is heavily dependent on trade. Combined exports (\$35 billion) and imports (\$45 billion) equal roughly half of Turkey's 2001 GNP of about \$150 billion (State Department figures). Turkey's economy has suffered shocks in recent years from the effects of the Persian-Gulf War of 1991, huge foreign debt, high inflation, low foreign direct investment, depreciation of its currency, and severe earthquakes.<sup>2</sup>

## The Turkey-QIZ Legislation

### Aims of the Legislation

Legislation to include Turkey in the QIZ tariff-reduction program (see footnote 1 for details on the legislation, and text box 1 for QIZ definition) was passed by the House in the 107<sup>th</sup> Congress. The Turkey-QIZ legislation had the strong support of the Administration, which numbered among its objectives: (1) rewarding Turkey for its support in the Afghanistan war (Turkey commanded the International Security Assistance Force in Afghanistan) and any potential war with Iraq; (2) enhancing trade between Turkey and Israel; and (3) bolstering the economy of Turkey by enabling it to attract more foreign investment and diversify its exports so it can contribute to greater regional stability.<sup>3</sup> At the same time, under continuing pressure from the U.S. domestic textile, apparel, and leather production industries, the Administration excluded Turkey from QIZ benefits in the industries where Turkey could likely benefit most in the short run.

**Figure 1. Map of Turkey, Israel, Jordan, and Iraq**



Source: Map Resources. Adapted by CRS. (M.Chin 02/03)

### QIZ Proposals

The QIZ legislation would have done two things. First, it would have added Turkey to the list of countries (Jordan and Egypt) eligible to establish QIZs with Israel. The QIZ concept was a 1996 extension of the U.S.- Israel Free Trade Agreement (USIFTA) and was designed to promote Middle-East peace, political stability, and economic

<sup>2</sup> Turkey's economy is still based largely on agriculture (40% of all workers), textiles, and apparel (its two greatest exports). Its labor force is mostly literate (85%). Turkey's population has a standard of living about one-sixth that of the United States. Source: *CIA: The World Factbook 2002*, *DRI-WEFA Country Outlook, 2001*, and *OECD Economic Outlook 2001*. For background on Turkey, see *Turkey: Issues for U.S. Policy*, by Carol Migdalovitz, RL31429.

<sup>3</sup> Remarks by Senator Breaux for himself, Sen. Grassley, and Sen. McCain introducing S. 2663, in the *Congressional Record*, June 20, 2002, p. 5860 and 5861.

development through economic partnership with Israel. Specifically, the 1996 amendment which created the QIZ program authorized the President to exempt from customs duty those articles imported into the United States that are made in the West Bank, Gaza Strip, or a QIZ, meeting specific “rules of origin” requirements (enumerated in text box 1 below). The amendment further defined QIZ as any area that: (1) encompasses portions of Israel and Jordan or Israel and Egypt, and (2) has been so designated by both the local (i.e., country) authority and the U.S. Trade Representative.<sup>4</sup>

### Text Box 1. What is a QIZ?

QIZs are a specific type of free trade zone. Other examples are maquiladoras in Mexico, and special economic zones in China. Free trade zones, of which there are about 800 world-wide, employing more than 24 million workers, are typically industrial parks housing manufacturing operations built with foreign direct investment – typically by multinational corporations. Trade zones simplify cooperative production between countries because they are fiscally outside the customs territory of a country. This means that for raw materials flowing into and goods moving out of zones, customs procedures are streamlined and tariffs do not apply until the goods formally enter a country as imports for consumption.

QIZs are distinguished from other trade zones as follows: Trade zones in general: (a) are stand-alone entities (not directly connected to *other* countries); (b) produce for export to *any* country; and (c) operate solely under the authority of and conditions determined by the host government. QIZs, however: (a) are like a three-legged stool, with each leg representing a producing country: Israel, the United States, and another Middle East country, linked together by the “seat” which is the United States; (b) produce goods solely for export to the United States; and (c) operate under both the authority of the host countries and the oversight authority of the United States, which determines conditions for and authorizes tariff relief.

The mechanism of QIZ establishment, production, and export is as follows:

**Establishment.** Managers of publicly or privately owned industrial parks in an authorized country apply to the U.S. Trade Representative (USTR) for QIZ status. The QIZ (tariff benefit) designation (plus tax and other benefits typically offered by the host country) attracts manufacturers.

**Production.** These manufacturers must submit for approval, detailed production information to a Committee composed of government officials from Israel and other QIZ partner governments. This information is to demonstrate that the costs of materials and labor of goods produced meet U.S. “rules of origin” requirements which are as follows: (1) The manufactured product must contain both Israeli and Turkish content; (2) must be imported directly from Israel, the West Bank, the Gaza Strip, or a QIZ, and (3) the appraised value (cost content plus direct cost of processing operations) must include 35% “local value content” from Israel and Turkey; of this 35%, 15 percentage points (slightly less than one-half) may be in U.S. imports.

**Export.** Once the product is completed, the shipper and/or importer may put an “N” before the product Harmonized Tariff System (HTS) number on the customs invoice. This tells the U.S. Customs Service that the imported goods come from a QIZ and are eligible for tariff-free and quota-free status.

Second, the QIZ bill would have added restrictions to participation by Turkey that do not apply to participation by any other members. Specifically, the QIZ legislation would have prohibited tariff reductions (and consequently quota removals from linkage to USIFTA) on eight item groups made in Turkey-Israel QIZs: textiles, apparel, footwear, handbags, luggage, flat goods (e.g., wallets), work gloves, leather wearing apparel, and

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<sup>4</sup> The QIZ concept was first authorized in a 1996 amendment (Sec. 9 of P.L. 104-234) to the U.S.-Israel Free Trade Area Implementation Act of 1985 (USIFTA, P.L. 99-47). Rules of origin are defined in P.L. 104-234 (19 U.S.C. 2112 note).

any other articles the President determines to be “import sensitive.” For these categories, Turkey would have retained its existing duty rates (normal or preferential) under the Generalized System of Preferences (GSP) and its quota limits under the Agreement on Textiles and Clothing, explained below. In addition, the President could have excluded from tariff reductions any items he determined to be “import sensitive.”

## Implications

### Turkey’s Reaction to the Proposal

The QIZ proposal was not as favorable as Turkey had hoped. Turkey has reportedly pressed for more market access for textiles, (reduction of tariffs and elimination or expansion of quotas) and movement toward a free trade agreement. Commenting on the QIZ proposal, a Turkish economic source indicated that benefits to Turkey from the zone program would be “not very much.”<sup>5</sup> This may have played a role in Turkey’s subsequent request for additional aid in return for allowing the United States to station more military troops in Turkish bases, in order to open a northern front against Iraq.<sup>6</sup>

### How Useful Would the QIZ Legislation Have Been for Turkey?

The short-term usefulness of any QIZ legislation for Turkey would have depended largely on the treatment of textiles and apparel. Framers of the QIZ legislation argued that the program would have helped Turkey in the long run, by promoting development of its high tech industry and wean itself from its traditional (textile and apparel) exports. Supporters of the Turkey QIZ legislation also pointed to Jordan’s success in expanding its exports under the QIZ program. Jordan’s QIZ exports to the United States began only in late 1999 (at \$159,000) and three years later, totaled \$369.5 million. Jordan’s QIZ exports are concentrated in two out of the 10 categories of apparel, and accounted for 90% of its total exports to the United States of \$412 million in 2002.

To benefit in the short run from expanded investment and exports, Turkey would have had to overcome three key obstacles. First, it would have had to overcome the fact that 49% of its exports, (with tariffs averaging 13.7%) are ineligible for tariff reduction and quota removal (see table 1).<sup>7</sup> Second, Turkey would have had to expand the remaining 51% of its eligible exports, (with tariffs averaging 3.5%). “High tech” products for which the United States seeks to encourage expansion are included in this group. If “high tech” is defined as “electronics,” it accounted for only 1.3% of Turkey’s exports in 2002 (with tariffs averaging 3%). Third, potential investors in eligible industries in

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<sup>5</sup> Administration Backs Bill to Create Free Trade Zones for Turkey, *Inside U.S. Trade*, July 5, 2002.

<sup>6</sup> The State Department Congressional Budget Justifications for Foreign Operations for FY 2003 estimates \$20.9 million in aid to Turkey. The Administration has also reportedly offered Turkey a “generous” package of economic and military aid, totaling several billion dollars, in return for its cooperation against Iraq.

<sup>7</sup> Calculation: duties on all goods imported from Turkey for which QIZ tariff reductions would apply were divided by the total dutiable value. In 2002, U.S. exports to Turkey were \$3.1 billion (unchanged from 2001); imports from Turkey were \$3.5 billion (up 15%).

Turkey could be discouraged by both economic interruptions of a war with Iraq and its aftermath, and the challenges of transporting components between the non-contiguous QIZ partner states (Israel and Turkey) in order to adhere to QIZ rules of origin requirements.<sup>8</sup>

**Table 1. U.S. Average Tariff Rates on Key Eligible and Non-Eligible (for Tariff Relief) Imports from Turkey, 2002**

HTSUS Number	Item	Import Value \$(millions)	Share of Total U.S. Imports from Turkey %	Effective Tariff Rate %
<b>Ineligible Imports</b>				
61	Apparel -knitted/crocheted	684	19	15.7
62	Apparel - not knitted	505	14	15.9
63	Textile articles	278	8	9.2
52	Cotton yarns	73	2	7.6
54	Manmade yarns	58	2	13.3
	Other	128	4	
	<b>Sub-Total /Average</b>	<b>1,726</b>	<b>49</b>	<b>13.7</b>
<b>Eligible Imports</b>				
72	Iron/steel	281	8	2.4
71	Pearls/ semi- and precious stones	199	6	5.5
27	Mineral fuels	185	5	1.1
24	Tobacco goods	157	4	10.9
84	Nuclear reactor parts	147	4	3.3
	Other	825	23	
	<b>Sub-Total/Average</b>	<b>1,794</b>	<b>51</b>	<b>3.5</b>
	<b>Grand Total</b>	<b>3,520</b>	<b>100*</b>	<b>10.5</b>
Data Source: CRS Calculations on U.S. International Trade Administration data. *Numbers may not total 100% due to rounding.				

## Status of the U.S. Textile and Apparel Industry

As noted above, the QIZ legislation would not apply to textiles, apparel and leather, or other goods the President determines to be “import sensitive.” Thus, those industries in the United States are not likely to be adversely impacted in the short run. The impact on other U.S. industries, however, is unclear.<sup>9</sup>

What would have been the impact on the U.S. economy if Turkey’s textile, apparel and leather industries were given greater access to it? In these three industries combined, U.S. employment has suffered large declines of about 38%, or 680,000 jobs (declining from about 1.8 million to 1.1 million jobs) between 1993 and 2001. Much of this job loss (23 of the 38 percentage points, or roughly 157,000 jobs)<sup>10</sup> can be attributed to increased imports from or plant relocations to Mexico or Canada since the North American Free Trade Agreement (NAFTA) went into effect. The probable impact of lowering tariffs and

<sup>8</sup> The stock of U.S. foreign direct investment in Turkey was \$1.2 billion in 2001, compared with \$4.1 billion for Israel and only \$14 million in Jordan.

<sup>9</sup> Also, the U.S. Customs collected less than \$28 million in revenues from Turkey on goods that were *eligible*, as compared with \$234 million on goods that were *ineligible* for tariff reduction.

<sup>10</sup> These figures update p. 8 of *NAFTA: Estimates of Job Effects and Industry Trade Trends After 5 ½ Years*, by Mary Jane Bolle, CRS Report 98-783.

quotas for Turkey even on these ineligible items could be significant, but still small relative to other U.S. imports. This is because Turkey, with a 2001 U.S. textile, apparel, and leather export total of \$1.5 billion, ranked as the U.S.'s 17<sup>th</sup> supplier of these goods, compared to China, the first supplier with \$19 billion and Mexico, the second supplier with \$10 billion. Any trade increase from Turkey in these industries could represent a trade diversion from other countries.

A potentially greater impact on U.S. textile and apparel industries than relaxing QIZ requirements on Turkey is expected to come in January 1, 2005. This is when the Agreement on Textiles and Clothing (the 1995 agreement negotiated through the WTO as a successor to the 1974 Multifiber Arrangement) which regulates quotas, is scheduled to expire. At that point, a flood of new textile, apparel, and leather imports from WTO countries could enter the United States quota-free from nations throughout the world.

## Other Alternatives

At least two other trade proposals have been mentioned as alternatives or supplements to the QIZ program for Turkey. First, is a possible free trade agreement (FTA) with Turkey, (referred to earlier) which was broached by envoys from Turkey seeking to upgrade their economic relationship, enhance trade and investment ties, and gain support for Turkey's economic reform program (see footnote 5). At least three considerations would affect the "if" and "when" of such negotiations: the political and economic merits of such a proposal, the already full schedule of U.S. Trade Representative (USTR) Zoellick, and concerns of U.S. states.

Second, in February, 2003 the USTR reportedly floated an additional congressional "package" of textile and apparel trade benefits, separate from the QIZ proposal, to reward Turkey for stationing U.S. military personnel during a likely war with Iraq.<sup>11</sup> This package would, among other things: (1) offer Turkey duty-free and quota-free access to the United States for apparel made with U.S. fabric and yarn; and (2) allow the U.S. military to purchase certain textile products from Turkey for a year, during which the Berry Amendment would be waived and Turkey would be exempt from the "Buy American" Act (providing preference for American goods in government purchases).<sup>12</sup> This proposal might have been more attractive for Turkey and shown U.S. concern for the domestic textile and apparel industry; however, it might also have encroached on the Administration's commitment to minimize trade effects on the U.S. textile industry.<sup>13</sup>

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<sup>11</sup> USTR Approaches Congress for Support on Turkey Textile Benefits. *Inside U.S. Trade*, February 21, 2003. This proposal is not currently available on the USTR website.

<sup>12</sup> 41 U.S.C. Sec. 10a-10d. See *The Buy American Act: Requiring Government Procurements to Come from Domestic Sources*, by John Luckey, CRS Report 97-765.

<sup>13</sup> "Fast-track" refers to renewed presidential authority granted in P.L. 107-210, Aug. 6, 2002, to negotiate trade agreements on a "fast-track" basis – without amendment and with limited debate.