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FOREIGN ECONOMIC RELATIONS BOARD

THE BUSINESS CASE FOR A TURKEY - EU CUSTOMS UNION 2.0

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The Business Case for a Turkey - EU Customs Union 2.0
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Table of contents

Foreword

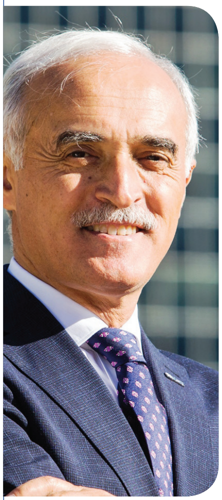
It is with my great pleasure, to present DEİK's recent report titled "The Business Case for a Turkey-EU Customs Union 2.0" that aims to provide a fresh perspective into the discussion on the modernization of Turkey-EU Customs Union.

Turkey's relationship with the EU is a time-honored and continuous one, despite obstacles that have been or still need to be tackled along the way. Leaving behind more than a decade on official accession negotiations, the integration between Turkey and the EU has been on the agenda of both sides for a long time, unlike any other candidate. Notwithstanding the setbacks the relation has faced from time to time, both parties remained committed to the process.

As of today, Turkey-EU relations remain at a pivotal moment where the relationship and integration have to be taken to a new level, responding to the needs of the current political and economic atmosphere. The last few years have made it abundantly clear that the current arrangement of Turkey-EU Customs Union falls short of serving its intended purpose and an urgent need to be 'updated.' A revised and evolved Customs Union is therefore imperative for economic and trade relations between parties to continue as effectively as possible. Furthermore, the official start of negotiations on a modernized Customs Union will serve as an appropriate and timely response to the current trade climate characterized by aggressive and zero-sum approaches that endanger harmony in the global economic system.

Working in close cooperation with the Turkish Ministry of Trade, Foreign Economic Relations Board of Turkey – DEİK, upon its establishment in 1986 is assigned to organize and strategically manage the foreign economic relations of the Turkish private sector, analyze investment opportunities at home and abroad as well as coordinate Turkish private sector's business activities. 145 Business Councils and 6 Regional Councils constituting the backbone of the organization are tasked with improving foreign economic and trade relations of Turkey with respective countries, as well as to promote economic diplomacy in order to forge and foster new economic alliances whilst ensuring the preservation of our current ones. While Europe has always been an important economic and trading partner for Turkey, it's our utmost responsibility to respond to the developments that are closely linked to the region.

In that perspective, the Customs Union ranks high on our agenda and has always served as an anchor in Turkey-EU relations diplomatically as well as economically. As the representatives of the Turkish business community, we look forward to the modernization focused on trade, which we believe will have a positive mutual impact and therefore have commissioned this report to provide an accurate and objective overview of the evolutions. I would like to take this opportunity to thank Zeynep Bodur Okyay, the Coordinating Chairperson at DEİK's European Business Councils and Sinan Ülgen, Managing Partner at Istanbul Economics for their immense contribution in the making of this report.



Nail Olpak
President
DEİK

Turkey-EU Customs Union has been one of the most important achievements of the decades-long relationship between Turkey and the EU. Since its implementation, the Customs Union has supported the growth of trade relations between Turkey and Europe, paved the way for modernization of Turkey's economy, increased its competitiveness and productivity as well as improved Turkey's alignment with the EU *acquis*.

Initiated with the motivation of Turkey's accession to the EU in the foreseeable future, the delay in the accession process has created an impediment in effective implementation of the Customs Union in the years to follow. Doubled with the effects of changing global economy, modernization of the existing Customs Union has become inevitable as both parties agreed in 2015. As studies argue, the depth and scope of the Customs Union should be addressed to meet the requirements of the global economy.

Given the current stalemate of the accession negotiations between Turkey and the EU, upgrading the existing Customs Union provides a potential for a better and stronger Turkey-EU partnership in every aspect as it was the case two decades ago. There is no doubt that such achievement will create a 'win-win' situation for both sides in economic terms and will increase Turkey's ability to better harmonize its trade and economic policies with the EU, in a time of intensifying, global cutthroat competition, with financial volatility and turbulent waters globally. In addition to economic advantages, it will act as an anchor for a refreshed atmosphere in Turkey's alignment with the EU specifically paving the way to advance on relevant negotiation chapters. Such a positive momentum in Turkey-EU relations has the potential to function as a tool for overcoming the current stalemate at the accession negotiations.

The representatives of the Turkish business community believe that the modernization of the Customs Union as the backbone and anchor of the relations between Turkey and the EU will be mutually beneficial. Aiming towards practical steps and solutions, we sincerely hope that this report will provide a better understanding of the business community's perspective on the issue and offer policy recommendations to decision-makers on both sides to increase bilateral efforts towards a modernized Customs Union.

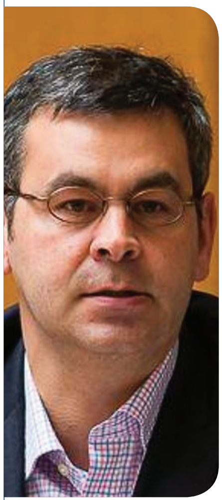
Zeynep
Bodur Okyay
Coordinating Chairperson
DEİK European Business Councils

For long, Turkey's relationship with the EU was underpinned by the objective of membership. Yet despite being initiated in 2005, Turkey's accession negotiations have stalled. In the meantime, Turkey and the EU have continued to cooperate outside the framework of accession as illustrated by the refugee deal or the ongoing collaboration on counter-terrorism. But these chapters of cooperation essentially reflect a transactional approach to the relationship. They don't represent a momentum towards a more advanced degree of political or economic integration. The Customs Union remains the only realistic framework which in the absence of imminent progress on the accession track can still provide a more advanced institutional and rules-based framework for the future of the Turkey-EU relationship.

At the same time, it is also clear that the existing framework for the Customs Union which had entered into force at the end of 1995 and therefore more than two decades ago needs to be overhauled. The revision will need to address a set of mutual problems related to the functioning of this trade regime. But even more importantly, the new framework will need to reflect the developments over the past two decades on international trade policy.

The European Commission as well as the World Bank have already prepared and published their analysis on the overhaul of the Customs Union. The conclusions are similar and point to mutual economic benefits. Yet despite these credible findings, the EU Council has so far failed to approve a negotiations mandate for the European Commission for the start of the talks with Turkey for a revision of the current Customs Union. Political considerations have led EU governments to delay this decision.

This analysis carried out jointly by Istanbul Economics and DEIK aims to demonstrate that the overhaul of the Customs Union should not solely be analyzed from the perspective of mutual economic gains. Even more important are likely to be the institutional, regulatory and governance related reforms. These much needed reforms that should accompany the recently announced new economic program of the government can lead to significant improvements to Turkey's business and investment climate. They could therefore provide dynamic benefits to both Turkish and European economies at a time when their economic interdependence are due to be reinforced as an insurance against rising global protectionism.



Sinan Ülgen
Managing Partner
Istanbul Economics

Executive Summary

The modernization of the Customs Union has been on the agenda of the Turkey-EU relationship throughout the past few years, but progress has been slow mainly due to political considerations. There is indeed an acknowledged need to upgrade the existing trade agreement, negotiated back in 1995, between Turkey and the EU. So far, the Council has refrained from giving the green light to the European Commission to start these negotiations with Turkey, essentially on the grounds of political considerations. However, the recent improvement of the political ties between Ankara and Brussels as well as a number of key European capitals should create a more amenable environment for the lifting of the political barriers to start the Customs Union modernization negotiations.

This study aims to demonstrate, by the existing economic literature and the available evidence, the mutually beneficial impact of an overhauled Turkey-EU Customs Union. Such an overhaul would involve the extension of the scope of the Customs Union's sectoral coverage by including service industries, agriculture, and public procurement but also the modernization of its overall governance framework by designing a new dispute settlement mechanism and addressing deficiencies in trade policy convergence.

The risk of non-action, specifically a failure to move forward with the modernization of the Customs Union, is too severe. The accumulation of trade irritants and mutual grievances related to the functioning of the Customs Union must be addressed with an overhaul of this trade arrangement. Failing to do so raises the prospect of an already perceptible gradual erosion of each sides' commitment to the full implementation and the enforcement of existing rules.

From the EU's perspective, the modernization of the Customs Union would also allow it to regain its role as an anchor in Turkish policy reform. As set out in the different sections of this study, the Customs Union overhaul would imply a higher degree of legal and regulatory harmonization and convergence for the existing areas covered by the Customs Union as a result of the modernization of the dispute settlement regime. At the same time, it would extend the scope of convergence to the new areas and disciplines to be incorporated in the updated trade deal. For instance, Turkey would also start to comply with EU rules on state aids and public procurement as well as services. Turkey's business and investment environment would continue to be transformed in line with the goal of market integration with the EU. Regulatory differences and non-tariff barriers would be eliminated, providing EU companies with enhanced market access.

However, from a political economy perspective, the modernization of the Customs Union is of more critical importance to Turkish policy makers. Turkey indeed stands at a turning point on its road towards sustained growth and development. The policy framework launched after the 2001 crisis has paved the way for the country to sustain an impressive growth performance under a generally benign international financial environment. Turkish policy makers now need to introduce a new and upgraded vision for the future of the Turkish economy. The overhauled Customs Union has the potential to become a pillar of Turkey's much needed new economic reform program.

Introduction

The modernization of the Customs Union has been on the agenda of the Turkey-EU relationship for the past few years, but progress has been slow mainly due to political considerations. There is indeed an acknowledged need to upgrade the existing trade agreement, which was negotiated back in 1995, between Turkey and the EU. The EU-Turkey Customs Union, which was unique in its ambition and depth, has been gradually overtaken by other and much broader trade agreements. It is this recognition that led the European Commission, after an agreement on principle with Turkey, to submit a negotiations mandate to the European Council in December 2016. So far, the Council has held back from giving the European Commission the green light to start these negotiations with Turkey, essentially on the grounds of political considerations. The recent political rapprochement between Ankara and Brussels, as well as some key European capitals, should create an environment more amenable for the lifting of the political barriers to start the Customs Union negotiations.

This paper will focus on the political economy dimension of the modernization of the Customs Union with a view to exploring the scope and nature of its expected benefits. The first section summarizes the current literature on the economic benefits of the existing Customs Union as well the estimated economic benefits of the modernized Customs Union. The second section underlines the importance of an overhauled Customs Union for the economic competitiveness of the trade partners, especially in an era beset by increased risks of global protectionism. The following sections examine the impact of policy convergence in services, public procurement and state aids from the standpoint of the evolution of Turkey's business and investment environment. The penultimate chapter focuses on the impact of the modernization of the dispute settlement regime, which will be critical for the proper functioning of the upgraded trade regime. The final section underlines the importance of the modernization of the Customs Union for the future path of economic reforms in Turkey.

The Fundamentals

At present, Turkey is the only non-member country which is in a Customs Union arrangement with the EU[1]. This unique situation is the consequence of Turkey's early interest in the then newly established European Economic Community. Indeed, Turkey was the second country, just after Greece, to have concluded a formal association agreement with the EEC. The Ankara Association Agreement of 1963, a year after the Athens Agreement was signed between the EEC and Greece in 1962, envisaged Turkey's economic and political integration with the European Community in three stages. The final stage was to be a fully-fledged Customs Union. This agenda was primarily shaped by the Treaty of Rome itself, which had set out a similar roadmap for the members of the EEC. The Customs Union was the model of economic integration chosen by the founding fathers of the European Communities. It was simply extended later on to Greece and Turkey as their model of economic integration with the EEC. This approach changed almost three decades later when the EU decided to negotiate new agreements with the newly independent Central and Eastern European Countries. The "Europe Agreements" were to be based on a free trade agreement instead of a Customs Union. As a result, Turkey currently remains as the only country with the responsibility of having to manage a common commercial regime with the EU without actually being a member of the EU.

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1. With the exception of Andorra and Monaco. It obviously remains to be seen whether the UK will opt for this option after Brexit.

The final transition period set out in the Ankara Agreement, which ultimately was to lead to Turkey's EU accession, commenced at the end of 1995 when the Turkey-EU Customs Union was completed. The parties negotiated the details of this unique regime which was implemented through Turkey-EU Association Council Decision Number 1/95 on 31 December 1995.

It has therefore been more than two decades since the launch of the existing Turkey-EU Customs Union. Since then, trade agreements have evolved and have come to incorporate more ambitious provisions and new disciplines. There is, therefore, a need to revise the Customs Union between Turkey and EU in order to reflect these developments in international trade. Secondly, these past two decades of practical experience with the Customs Union regime have brought a number of structural issues and deficiencies to the fore. On the Turkish side, the main issue is the trade asymmetry caused by a lack of full alignment with the EU's preferential trade policy. With each new free trade agreement, the EU has gradually extended the number of its preferential trade partners.

Nevertheless, Turkey has had difficulty in following this path due to a lack of incentive on the part of the EU's new trading partners to also negotiate a free trade agreement with Turkey. This asymmetry has led to trade losses for Turkey, both in export markets and its domestic market as a result of trade diversion.

From the EU's perspective, the main issue has been Turkey's weakness in enforcing the commitments of the Customs Union. The dispute settlement clauses envisaged in the Association Council Decision 1/95 and ultimately by the Ankara Association Agreement of 1963 proved too deficient to function as a reliable enforcement mechanism. As a result, disagreements over the functioning of the existing Customs Union and alleged violations of the parties' commitments under this regime could not be properly addressed or redressed, leading to an accumulation of unresolved disputes.

Finally, the coverage of the existing Customs Union is limited to manufactured goods and processed agricultural products. The new round of negotiations aims to extend this scope by including services and possibly agriculture. This would naturally increase its economic impact considering that the current trade regime, due to its limitations on sectoral coverage, only covers about 20% of the national economies of the trading partners.

Summary Economic Impact

The general assessment in economic literature is that the existing Customs Union has been beneficial to the Turkish economy. However, its relative impact on the EU economy is more limited, so studies have mostly focused on Turkey. Harrison[2] assessed a positive contribution for Turkey in the order of 1-1.5% of GDP, driven mainly by improved market access to third countries. Adam and Moutos[3] have used a gravity model approach for the foreign trade between the EU-15 countries and Turkey covering the 1988-2004 period. The findings point to an 11% decrease in intra-EU trade, compensated by a 31% increase of Turkey's exports to the EU-15 and a 65% increase in EU-15 exports to Turkey. Similarly, Yilmaz[4] also reported a positive impact of the Customs Union on the Turkish economy.

2. Harrison, G. W.; Rutherford, T. F.; Tarr, D. G., "Economic Implications for Turkey of a Customs Union with the European Union", European Economic Review, 41, 861-870, April 1997.
3. Adam, A.; Moutos, T., "The Trade Effects of the EU–Turkey Customs Union", World Economy 31 (5), 685-700, May 2008.
4. Yılmaz, K., "The EU–Turkey Customs Union Fifteen Years Later: Better, Yet not the Best Alternative", South European Society and Politics, 16 (2), 235-249, June 21, 2011.

In particular, the Customs Union has helped enhance productivity in the manufacturing sector and therefore improved Turkey's international competitiveness. According to a more recent World Bank[5] study (2014), the Customs Union has led to a four-fold increase in the value of bilateral trade since 1996. The World Bank study also states that "*the rise in FDI flows from the EU to Turkey has been similarly significant, as has the deeper integration between Turkish and European firms along production networks.*" It also adds that "*the Customs Union has supported these developments and directly contributed to Turkey's productivity gains over the period through the reduction in its import tariffs on most industrial products.*"

Finally, the European Commission also assessed the economic impact of the existing Customs Union in a study it commissioned in 2016 in order also to evaluate the impact of deepening the Customs Union[6]. The study indicated that the existing Customs Union provided a 0.7% contribution to GDP for Turkey and 0.008% for the EU[7].

Table 1. Estimated impact of a modernized Customs Union

	EU	Turkey
Real GDP (%)	0.008	0.722
Household income (EUR billions at 2016 prices)	1.6	7.5
Bilateral exports (EUR billions at 2016 prices)	8.7	6.0
Real growth in total exports (%)	0.029	1.28
Real growth in total imports (%)	0.029	2.60

Source: *European Commission, "Study of the EU-Turkey Bilateral Preferential Trade Framework, Including the Customs Union, and an Assessment of Its Possible Enhancement", Final Report, 26 October 2016.*

Two of the studies above - conducted by the World Bank (2014) and the European Commission (2016) - also carried out an analysis of the economic implications of a modernized Customs Union. In the World Bank study, the authors simulated the impact of liberalization in agricultural and services trade between Turkey and the EU. Their findings suggest a reform of Turkey's border policies regarding services and utilities would lead to an increase of US$1.2 billion[8] in economic welfare in Turkey or 0.19% of GDP. More significantly, a dynamic simulation of the expected impact of a modernized Customs Union with free trade in agricultural products and services demonstrated that Turkey's real GDP in 2018 would have been 23% higher than its real GDP in 2013[9].

Studies conducted by the World Bank and the European Commission found significant positive impacts on the key economic parameters including but not limited to GDP.

The European Commission report includes a more detailed economic assessment of the Customs Union modernization which is expected to generate economic gains for both parties. The findings indicate that the gains for the EU are relatively smaller but still substantial, with welfare expected to increase by €5.4 billion. EU exports to Turkey would particularly benefit (increasing by an estimated €27.1 billion). For Turkey, the gain in real GDP is significant at 1.46% above the baseline, with commensurately large gains in economic welfare (€12.5 billion) despite the fact that only a relatively small gain in direct exports to the EU (€5.0 billion).

5. World Bank, "Evaluation of the EU-Turkey Customs Union", Report No. 85830-TR, March 28, 2014. See: http://www.worldbank.org/content/dam/Worldbank/document/eca/turkey/tr-eu-customs-union-eng.pdf
6. European Commission, "Study of the EU-Turkey Bilateral Preferential Trade Framework, Including the Customs Union, and an Assessment of Its Possible Enhancement", Final Report, October 26, 2016. See: http://trade.ec.europa.eu/doclib/docs/2017/january/tradoc_155240.pdf
7. The share for the EU is much lower given the relative size of the EU economy.
8. In 2007 constant prices.
9. The scenario assumes that the upgraded Customs Union entered into force in 2013.

The Customs Union as a Trade Partnership for Enhanced Competitiveness

In an age where the liberal economic order is under threat from rising protectionism, the upgrading of the Customs Union is expected to improve the negotiating positions of both Turkey and the EU in prospective trade negotiations and in countering the protectionism of third countries. The overhaul of the Customs Union will need to incorporate a clause that would allow Turkey and the EU to harmonize their trade defence measures in addition to their external trade policy, as is the case nowadays. Indeed, under the existing Customs Union arrangements, there is no requirement for Ankara and Brussels to adopt a common position on the application of trade defence measures with respect to third countries. It is also likely that under WTO rules, this convergence cannot be posited as an ex-ante rule. Each trading partner would need to assess the situation on their own and by taking into account the impact on their domestic markets.

Considering the rise of protectionism on the global scale, upgrading of the Customs Union is expected to improve the negotiating positions of both Turkey and the EU.

Nevertheless, EU and Turkish policy makers may, by all means, engage in much closer consultation before they decide to apply these measures. Also, Turkey and the EU could enjoin their economic weight and diplomatic influence in their effort to combat rising global protectionism. This is particularly important when they need to negotiate with large economies such as the US and China for enhanced market access or de-escalation of protectionist measures.

For instance, in 2017, the EU was the largest export market for the US, with US$283 billion US exports destined for the EU. Turkey was the 16th largest, with US$11.7 billion[10] US exports going to the EU, representing 4.2% of the amount the US exported to EU markets. Turkey ranked ahead of 20 EU countries, just after Spain and ahead of Poland, regarding its importance for US export industries.

Table 2. Trade with the US

Rank	Country	US Exports in 1000 USD
1	European Union	283,500,031
2	Canada	214,996,013
3	Mexico	189,353,294
4	China	153,691,661
5	Japan	72,306,203
6	Germany	68,650,928
7	United Kingdom	58,132,622
8	Korea, Rep.	50,907,097
9	France	39,566,547
10	Netherlands	34,369,865
11	Singapore	34,167,578
12	Hong Kong, China	30,835,264
13	Belgium	28,516,347
14	Brazil	25,103,852
15	India	23,816,908
16	Australia	23,611,555
17	Switzerland	21,403,816
18	Ireland	18,222,912
19	Italy	16,795,778
20	Malaysia	15,959,880
21	Spain	15,543,105
22	Russian Federation	12,587,902
23	Colombia	12,086,405
24	Chile	11,738,874
25	Turkey	11,694,394

Source: *World Integrated Trade Solution (WITS).*

10. With EU listed as a single trading partner.

A similar analysis could be applied to China. In 2017, the US was the first export market for China, with US$519 billion Chinese exports to the US. Turkey ranked 15th with a value of US$23.3 billion[11]. Chinese exports to Turkey thus represented 4.5% of Chinese exports to EU markets with Turkey ranking ahead of 21 EU countries, just after Poland and ahead of the Czech Republic in terms of its importance for Chinese export industries.

Table 3. Trade with China

Rank	Country	Exports in 1000 USD
1	United States	518,909,197
2	European Union	420,716,056
3	Hong Kong, China	262,373,040
4	Japan	162,665,284
5	Germany	113,586,212
6	Korea, Rep.	97,855,084
7	India	71,173,473
8	Mexico	70,785,904
9	United Kingdom	59,615,589
10	France	55,376,786
11	Canada	54,453,000
12	Australia	49,970,585
13	Russian Federation	48,372,270
14	Singapore	45,197,654
15	Netherlands	40,593,853
16	Malaysia	37,788,024
17	Indonesia	34,520,247
18	Italy	31,818,350
19	Spain	28,941,619
20	Brazil	27,320,253
21	Poland	26,473,952
22	Turkey	23,359,136
23	Czech Republic	20,473,232
24	Philippines	18,477,818
25	Belgium	16,836,169

Source: *World Integrated Trade Solution (WITS).*

Another important argument is that by eradicating the barriers to free trade and advancing economic integration, the Customs Union is contributing to the competitiveness of EU industries. The modernization of the Customs Union that will eliminate non-tariff barriers would further consolidate this trend. This statement can be substantiated by newly available international trade data compiled by UNCTAD. The UNCTAD-Eora Global Value Chain Database explores trends and patterns in international production through the analysis of global value chains (GVCs). The following table provides a more specific illustration of Turkey's contribution to the EU's competitiveness, listing the total value added in each country's exports that originate from Turkey. As such, it represents a reflection of the global value chains in modern-day manufacturing and production. For instance, in 2017, Turkish value added amounted to US$7.5 billion for Germany's total exports. Germany is followed by the Netherlands and Italy regarding Turkey's contribution to their export performance. Interestingly, out of the top 10 countries, nine are EU members, the one exception being the US, while 13 of the top 20 countries are EU members.

By eradicating the barriers to free trade, the Customs Union is contributing to the competitiveness of EU industries. The overhaul of the current arrangement would further consolidate this trend.

Another perspective obtained from this database on global value chains is Turkey's contribution to the export competitiveness of individual EU countries and the importance for the supply chains of local industries. For instance, Turkey ranks 24th globally in terms of its contribution to value added in Germany's exports. However, this ranking is higher than 13 EU members, including Slovakia, Romania, and Portugal.

11. Idem.

Table 4. Turkey's contribution to EU exports

Rank	Country	Contribution in 1000 USD
1	Germany	7,450,503
2	Netherlands	2,727,195
3	Italy	2,660,806
4	Belgium	2,004,834
5	France	1,650,894
6	UK	1,193,935
7	Spain	876,559
8	USA	644,883
9	Austria	621,067
10	Romania	607,220
11	Israel	521,864
12	China	505,438
13	Hungary	380,554
14	Switzerland	360,261
15	Denmark	359,562
16	Canada	355,962
17	Sweden	354,232
18	Russia	353,056
19	Poland	320,401
20	Singapore	296,616

Source: *UN Conference on Trade & Development (UNCTAD) - Eora Global Value Chain Database.*

Turkey's contribution to the EU's export competitiveness can also be analysed from a more disaggregated perspective. The following table lists the EU country/industry pairs that benefit most from value-added originating in Turkey. In the top 20, there are six countries which are EU members (Germany, Italy, France, Spain, Netherlands and Belgium) and 8 different industry groups (chemical products, business services, textiles, basic ferrous and non-ferrous metals, wholesale trade, metal products, passenger cars and parts, machinery and equipment).

Table 5. Turkey's contribution to EU export industries

Country	Industry	Contribution in 1000 USD
Germany	Chemical products	479,623
Germany	Business services	456,873
Italy	Manufacture of chemicals and chemical products	300,967
Italy	Manufacture of textiles	271,996
France	Manufacture of chemicals and chemical products	267,720
Germany	Basic ferrous metals	265,649
Germany	Wholesale trade	264,218
Netherlands	Manufacture of chemicals and chemical products	243,345
Italy	Manufacture of basic metals	214,811
France	Other business activities	205,904
France	Manufacture of basic metals	205,845
Spain	Manufacture of chemicals and chemical products	192,984
Germany	Passenger cars and parts	191,895
Italy	Wholesale trade and commission trade, except of motor vehicles and motorcycles	190,102
Italy	Other business activities	177,075
Germany	Machines	171,377
Belgium	Manufacture of chemicals and chemical products	167,758
Italy	Manufacture of fabricated metal products, except machinery and equipment	159,079
Germany	Ownership of land and dwellings, property services	131,370
Germany	Fabricated metal products	124,143

Source: *UN Conference on Trade & Development (UNCTAD) - Eora Global Value Chain Database.*

These figures demonstrate the level of economic interdependence reached between the economies of Turkey and the EU and underscores Turkey's contribution to the EU's international competitiveness.

The Customs Union & Services Trade Liberalization

The service component is set to be the most impactful component of the modernized Customs Union. Services account for around 70% of both the Turkish and the EU economy. Once completed, the overhauled Customs Union would, therefore, open up a much larger share of economic activity to free trade and competition.

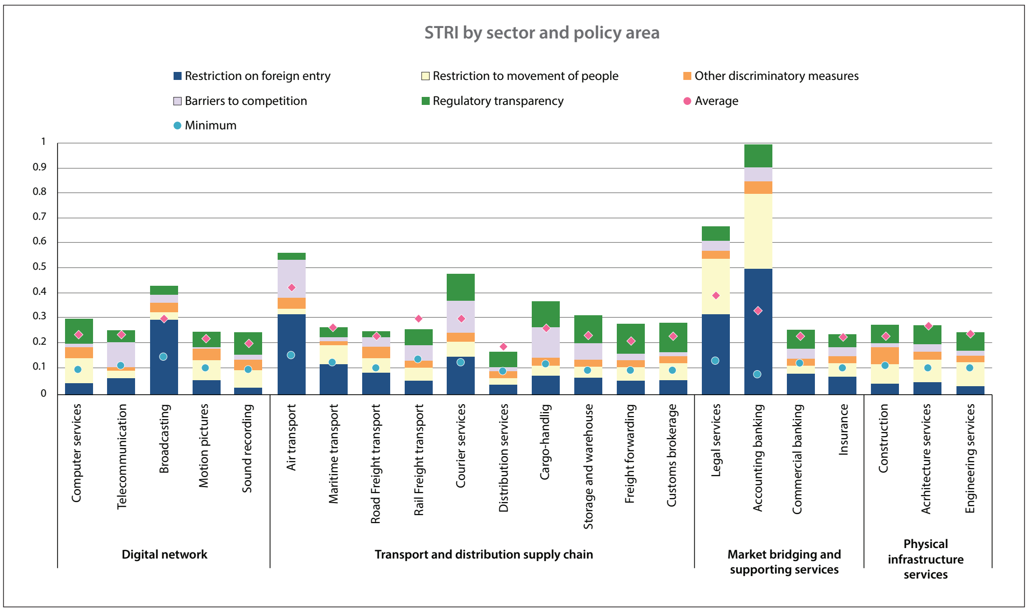
The service component, which accounts for around 70% of both the Turkish and the EU economy, is set to be the most impactful component of the modernized Customs Union.

When it comes to the liberalization of trade in services, the EU and Turkey have three different options. The first option is to aim for market integration and adopt the European Economic Area model, which stipulates full *acquis* compliance. In other words, under the EEA model of services trade liberalization, Turkey will commit itself to fully harmonize its policy framework on service industries with the EU *acquis* and also undertake the obligation of maintaining this full convergence over time. The second option is the WTO General Agreement on Trade in Services - GATS model - where the parties do not opt for regulatory harmonization and instead focus on mutual market access commitments. The third option is a "hybrid model" where the EEA model is adopted in some service sectors with full *acquis* adoption, with the GATS model being favoured in other sectors.

The common thread in all of these options is the mutual removal of barriers to market access for service providers. The OECD has compiled a database entitled the "Services Trade Restrictiveness Index" on existing barriers to services trade[12]. Accordingly, Turkey has a higher than average level of restrictiveness on services trade. Trade barriers are particularly high for business services such as legal and accounting work, air transportation, courier, cargo and broadcast services. Turkey only has a lower than average level of trade restrictiveness in distribution services and rail freight transport. A move towards the liberalization of trade in services with the EU will require Turkey to eliminate existing barriers to the trade in services. In many service industries, Turkey will move to below OECD average figures for trade

In many service industries, Turkey will move to below OECD average figures for trade restrictiveness. As a result, market entry for EU companies will become significantly easier.

Figure 1. Barriers to services trade - Turkey



***Note:** The STRI indices take values between zero and one, one being the most restrictive. They are calculated on the basis of the STRI regulatory database which contains information on regulation for the 35 OECD Members, Brazil, China, Colombia, Costa Rica, India, Indonesia, Lithuania, Russia and South Africa. The STRI database records measures on a Most Favoured Nations basis. Preferential trade agreements are not taken into account. Air transport and road freight cover only commercial establishment (with accompanying movement of people.)*

***Source:** OECD Services Trade Restrictiveness Index", OECD Trade Policy, March 2018.*

12. "OECD Services Trade Restrictiveness Index", OECD Trade Policy, March 2018. See: http://www.oecd.org/tad/services-trade/services-trade-restrictiveness-index.htm

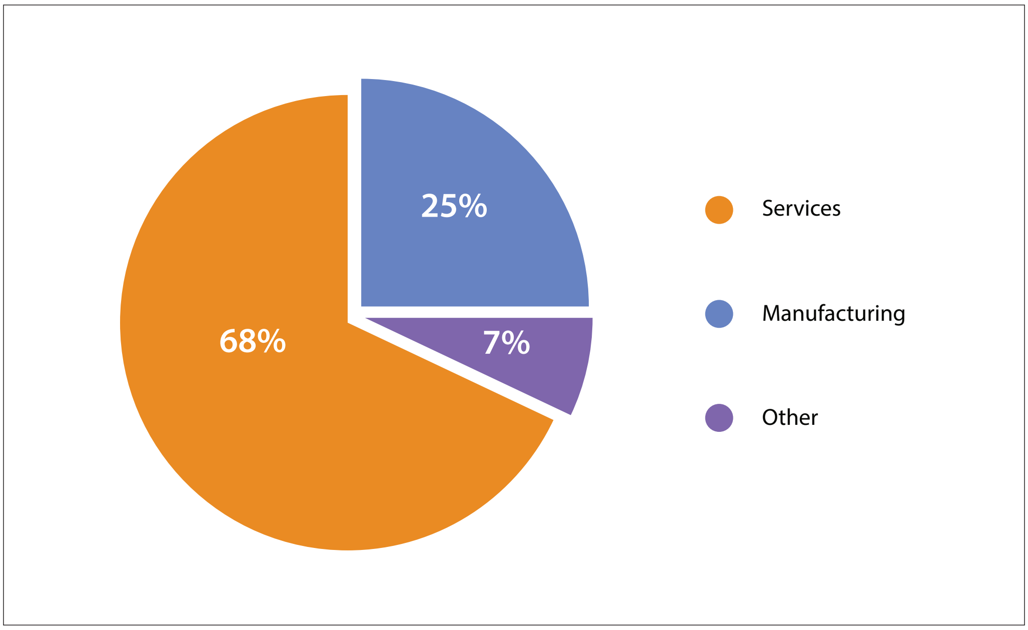
restrictiveness. As a result, market entry for EU companies will become significantly easier for a market size of around US$450 billion, corresponding to the share of services in the national economy.

The OECD database also allows service industry-based policy simulations to illustrate this point better. For instance, a comparison of trade restrictiveness for commercial banking services between Turkey and Germany (taken as a proxy for the EU) can be carried out. In commercial banking, Turkey ranks near the OECD average with a score of 0.257 while Germany's score is substantially lower at 0.152, indicating that under a scenario of services trade liberalization Turkey will need to lower its barriers to trade in commercial banking, particularly concerning the restrictions on foreign entry and regulatory transparency.

Economic theory suggests that the elimination of residual barriers to market entry for service industries will increase competition, productivity, consumer choice and surplus and, according to the impact assessment carried out by the European Commission, total value added in the services sector. These dynamics will also improve the investment environment for services, which has been the primary beneficiary for foreign direct investment to Turkey over the past decade. Of the US$121 billion in total FDI inflows over the decade between 2007 and 2016, US$82 billion was invested in service industries.

Economic theory suggests that the elimination of residual barriers to market entry for service industries will improve the investment environment for services in Turkey.

Figure 2. Sectoral share of FDI inflows 2007 - 2016



Source: *Ministry of Economy, "Foreign Direct Investments in Turkey 2016", September 2017.*

Indeed, the EEA option would mean that Turkey would have the same policy framework for service industries as EU member states. This option would, therefore, eliminate the behind-the-border barriers to services trade between Turkey and the EU, supporting Turkey's integration in the EU's single market for services. The end result would be higher policy predictability and regulatory transparency, key components in promoting both domestic and foreign investment.

However, as a country with an ever-elusive prospect of accession, Turkey may find it difficult to accept the ensuing level of policy dependence on the EU. The EEA model indeed portends a policy framework where the EU, in line with its own decision-making rules and procedures, adopts policy frameworks and expects EEA partner countries to comply with them. The apparent democratic deficit that this model represents has proven to be challenging to manage, even for EEA countries. This challenge will be even more severe for a large country such as a Turkey that has a long history and even an imperial heritage. Therefore, politics may not be amenable to the full transposition of the EEA model for Turkey. The GATS model is another option but is restricted in terms of its ambition. It would not lead to services market integration between Turkey and the EU, given that its scope would be limited to mutual concessions on market access. It would therefore not fully address the critical issue of regulatory convergence.

The Brexit talks may, however, provide an opening. The trade liberalization model foreseen between the UK and the EU in a post-Brexit era could provide an interesting and possibly transposable blueprint for Turkey as well. However, in the absence of a concrete Brexit blueprint, Turkey and the EU may still opt for a "hybrid model" where in some service industries full EU *acquis* compliance would be the rule and in others, a GATS based mutual market access commitments would provide the conditions for the freer trade in services. Selecting the exact model for the liberalization of trade in services between Turkey and the EU is therefore set to be one of the most critical aspects in the modernization of the Customs Union. This choice will have a long-term impact on the pace and scope of convergence of Turkey's policy framework with the EU *acquis.*

The trade liberalization model foreseen between the UK and the EU in a post-Brexit era could provide an interesting and possibly transposable blueprint for Turkey as well.

The Customs Union & Internal Markets: The Case of Public Procurement

Turkey has a relatively substantial public procurement market, which reached US$61 billion in 2017 (equal to 7% of GDP) according to figures published by the Public Procurement Agency[13]. The current Customs Union does not cover public procurement. As a result, EU companies may not take part in such bidding on a level playing field with Turkish companies. This practice may indeed help domestic companies carve out a significant market share in public purchasing, but also risks eroding the government surplus and by extension the taxpayer surplus on account of a less competitive framework.

Turkey presents significant opportunities to EU companies with its growing public procurement portfolio.

The modernization of the Customs Union is set to introduce a mutual opening of the public procurement markets in addressing this deficiency and advancing Turkey's integration with the European Single Market.

As a result of the respective opening of public procurement markets, Turkish contractors would then be able to fully participate in all EU tenders without discrimination. Turkey is renowned for its variety of globally competitive companies, most notably in the construction and transportation industries, which would easily take advantage of improved access to procurement markets in the EU, as well as new investment opportunities.

The same would be true for EU companies aspiring to bid for Turkish government contracts. Improved preferential access to Turkish procurement markets would indeed overcome current discriminatory and protectionist practices, which limit the ability of EU companies to compete on equal terms with their Turkish counterparts for public contracts. A few figures may demonstrate the overall protectionist impact of Turkey's public procurement framework.

Firstly, Turkish legislation allows for an ever-increasing set of exemptions from the application of the Public Procurement Law. In 2017, the value terms exemptions accounted for 8.2% of total public procurement spending. In other words, exemptions would appear to reduce the potential size of the market open to EU competition by around 0.65% of GDP.

13. All data related to public procurement used in this section of the report was obtained from the 2017 report of the Turkish Public Procurement Agency. See: http://dosyalar.kik.gov.tr/genel/Raporlar/2017_kamu_alımları_izleme_raporu_rev3.pdf

Secondly, the public procurement threshold in Turkey is higher than in the EU. The thresholds in force until January 2018 stood at TL39 million for work contracts and between TL1 – 1.8 million for goods and services. Contracts that fall below the threshold may legally remain closed to participation for foreign companies. In 2017, tenders below the threshold constituted 88% of all public tenders, amounting to 27% of the overall value of public contracts.

For contracts which are above the threshold, foreign and EU companies are hindered by the prevalence of domestic price preferences for up to 15% of the contract value. A domestic price preference was imposed in 6,309 of the 16,843 tenders open to foreign participation during 2017 (37.46% of the total). In terms of value, in a market size of US$42 billion open to international participation, US$18.5 billion worth of contracts were conditioned to domestic price preferences.

The exclusionary economic impact of the public procurement rules is severe, as illustrated in the following table.

Table 6. Public purchasing – Turkey

Nationality	Number of	Contract		
Contractor	Companies	%	Value (1000 TL)	%
Turkey	49,241	99.20%	226,097,126	98.47%
EU	245	0.49%	524,456	0.23%
US	32	0.06%	41,691	0.02%
Other	118	0.24%	2,940,780	1.28%
Total	49,636		229,604,053	

Source: *Turkish Public Procurement Agency, 2017. See: http://dosyalar.kik.gov.tr/genel/Raporlar/2017_kamu_alımları_izleme_raporu_rev3.pdf*

Accordingly, in a public procurement market of TL229 billion (US$61 billion[14]), the economic share of EU companies stands at around 0.23%. The modernization of the Customs Union is therefore set to level out the playing field and open up a market worth more than US$60 billion for EU-based companies interested in public procurement contracts in Turkey. In return, Turkish companies will benefit from being able to participate, on equal terms, in government tenders in the EU worth €1.9 trillion or 14% of EU GDP[15].

The Customs Union & Policy Harmonization: State Aids

The modernization of the Customs Union will also entail reform of Turkey's state aids legislation. Turkey's harmonization with EU rules on state aids had already been envisaged under the current Customs Union as part of the chapter on competition. Although Turkey adopted a competition law in alignment with EU norms and has established a track record in the enforcement of rules designed to restrict the anti-competitive behaviour of companies, there has been very little progress on compliance with state aids rules. Furthermore, although the Turkish government enacted legislation for the monitoring of state aids and established an administrative structure for its implementation back in 2012, the enforcement of state aids rules has been delayed and remains ineffective. This lack of harmonization is closely linked to the loss of credibility of the accession objective.

The overhaul of the Customs Union will enhance Turkey's reform appetite for the revision and harmonization of its state aids legislation and practices.

The history of state aids rules compliance within the EU amply demonstrates the sensitivity of this legislation. Governments consider state aids as a core component of their economic sovereignty. In the EU, any remaining scope for a national industrial policy relies on the availability of non-competition distorting instruments of states aids.

14. Taking into account the average $/TL exchange rate of 2017.
15. European Commission, "European Semester Thematic Factsheet Public Procurement", November 22, 2017. See: https://ec.europa.eu/info/sites/info/files/file_import/european-semester_thematic-factsheet_public-procurement_fr.pdf

This may explain why, for a country like Turkey with an ever-elusive prospect of accession, compliance with state aids rules has not been high on the political agenda.

Turkey's non-compliance with EU state aids rules, despite its existing commitment under the Customs Union regime, has, on the other hand, led to a weakening of the overall legislative and regulatory framework designed to ensure a fair environment for competition. Currently, government decisions, actions, and practices that may indeed skew the competitive environment cannot be challenged. The Turkish Competition Board is not legally competent to address these states led breaches of competition. As a result, the government and state-linked entities, including companies with state ownership, have found it easy to support selective industries or companies or more generally engage in discriminatory practices.

There is undoubtedly a separate debate to be had, despite a lack of a clear accession objective, on whether Turkey should still comply with the EU's rules on state aids. Indeed, it may be difficult to find sound political arguments to substantiate this argument, given the stalled accession dynamics. Instead, the argument is mostly an economic one, and when it comes to the objective of the overhauled Customs Union accelerating Turkey's integration with the EU Single Market, the harmonization of state aids rules becomes more critical. Secondly, with the enlarged scope of the Customs Union, rules on state aids will also acquire significance for service industries. In particular, network industries like telecommunications, air transportation, and energy as well as digital platforms display tendencies for a concentration of economic power, where a sound implementation of state aids rules is even more important in ensuring market and consumer-friendly outcomes.

The implementation of state aids rules in alignment with EU practices will provide a pivotal contribution to Turkey's efforts to enhance its business and investment environment.

As a result, the establishment in Turkey of a proper framework for the monitoring and implementation of state aids rules in alignment with EU practices will provide a pivotal contribution to Turkey's efforts to enhance its business and investment environment. These rules will also significantly limit the political or economically motivated intervention of the government and state agencies in the functioning of the market. They will thus finally complete the existing competition rules and create a more robust legal and regulatory framework at the national level that can consolidate and maintain free and fair market competition.

The Customs Union & Modernization of Dispute Settlement

Dispute settlement has been a dysfunctional component of the current Customs Union with negative ramifications for its proper functioning. The prevailing mechanism of dispute settlement remains the pertinent clause of the Ankara Association Agreement of 1963 which essentially tasks the Turkey-EU Association Council with the adjudication of disputes.

Since the entry into force of the Customs Union at the end of 1995, the number of unsettled disputes has continued to grow. Even in the most salient disputes, parties have been unable to reach a settlement.

However, the Association Council is a political organ where decisions are taken by unanimity, and both Turkey and the EU each have a single vote. Therefore, in the matter of dispute resolution, the Association Council is prone to fail and has indeed, in its role of an impartial arbiter, since either Turkey or the EU can block an adverse decision. This has been the leading structural shortcoming of the prevailing Customs Union.

The dispute settlement clause of the Association Council Decision 1/95 has not addressed this shortcoming. It is very limited in its scope and pertains only to disputes related to the duration of trade defence measures. For all other disputes, the dispute settlement clause of the Association Agreement remains in force.

Since the entry into force of the Customs Union at the end of 1995, the number of unsettled disputes has continued to grow. Even in the most salient disputes, parties have been unable to reach a settlement. One example of this is the EU's unwillingness to constructively address the issue of road quotas for Turkish companies and Turkey's refusal to extend its Customs Union obligation to the Greek Cypriots.

Faced with an alleged violation, the aggrieved party includes the dispute in the agenda of the Joint Customs Union Committee, the next level being the Association Committee. Finally, the dispute reaches the Association Council and is included in the talking points of the aggrieved party. Nevertheless, the settlement remains conditional on the political willingness of the aggrieved party to take the necessary measures to solve the problem. When this willingness is lacking, the set of contractual obligations between Turkey and the EU on a dispute settlement is not sufficient to overcome this bottleneck. As a result, problems remain unresolved.

The ability of either side to block the path of a dispute settlement at the political level has led to an erosion in the state of enforcement of mutual commitments for the Turkey-EU relationship.

The ability of either side to block the path of a dispute settlement at the political level has led to an erosion in the state of enforcement of mutual commitments for the Turkey-EU relationship. The accumulation of trade irritants and mutual grievances have also raised questions over the sustainability of this trade relationship and gradually undermined the willingness of the parties to resolve them. This systemic failure has, in essence, created a vicious circle of dissolving resolve and mounting irritants.

Policy predictability would be a key benefit of the Customs Union region for both Turkish and European businesses.

This environment has at the same time weakened policy predictability, which would be a key benefit of the Customs Union region for Turkish and European businesses. Indeed, the harmonization of trade, customs, competition, and intellectual rights policies is an essential feature of the Customs Union. It was argued that the resulting policy predictability would be a key consideration for improving Turkey's business and investment environment. The ensuing policy convergence would underpin the rules-based economic environment and pre-empt moves towards discretionary policy making. However, the dysfunctionality of the dispute settlement system has damaged this objective and reduced the benefits of policy predictability.

In the absence of a sound dispute settlement mechanism, non-compliance with contractual obligations cannot be redressed. Therefore, policy-induced barriers to market entry or impediments to trade that are in principle violations of the Customs Union rules cannot be resolved in a reasonable timeframe that would limit the costs to aggrieved businesses. As a result, departures from the goal of policy convergence cannot be contained, undermining the objective of policy predictability, which is a crucial feature of a sound investment environment.

This situation is even more pronounced for European businesses as a result of legal asymmetry. European law has enshrined the principle of direct effect. The jurisprudence of the European Court of Justice has confirmed that Association Council Decisions are also within the scope of the doctrine of direct effect. As a result, EU or Turkish entities can go to courts in EU countries to avail themselves of their rights under the Customs Union and to contest decisions or actions by EU governments that allegedly infringe their rights. However, there is no similar recourse in Turkey. Turkish or EU entities cannot go to court in Turkey to redress their grievances. In the Turkish legal order, there is no recognition of the direct effect doctrine. A legal challenge to government action is possible only if an obligation set out under the Turkish domestic legislation is supposedly being violated.

Interestingly, the Association Council Decision 1/95 has never been submitted to the Turkish Parliament. As a result, it does not have the force of law, and therefore aggrieved entities cannot base their legal challenge directly on the provisions of Association Council Decision unless the relevant clauses have already been directly transposed into Turkish law. This asymmetric situation, therefore, creates a skewed level playing field for EU entities as opposed to their Turkish counterparts who can rely on the provisions of the Association Council Decision 1/95 that have direct effect to protect their rights before national courts in EU countries.

Incidentally, football provided an interesting case demonstrating this asymmetry. In 2002, Rüştü Reçber the goalkeeper for the Fenerbahçe Football Club, transferred to Barcelona. He was initially treated as a non-EU player there and his playing time was impeded by the quota for non-EU players. He went to court in Spain successfully arguing that this practice constituted a violation of his rights on the basis of the Turkey-EU Association Council Decision 1/80 which enshrined the principle of non-discrimination of Turkish workers in EU job markets provided that they are legally employed. On the other hand, no EU football player has been able to do the same in Turkey, and such players have been considered under the quota for foreign players while playing for Turkish teams.

By these considerations, the modernization of the dispute settlement regime is set to be a key component of the EU mandate for the negotiations. The upgrading of the dispute settlement provisions would nonetheless provide many mutual benefits. It would significantly enhance the ability of the contracting parties to enforce their mutual obligations under the Customs Union. Alleged violations can be resolved, rather than being added to an ever-growing list of trade irritants. Policy harmonization would also be strengthened, improving policy predictability and ultimately helping Turkey achieve a more transparent and market-friendly business and investment environment.

The modernization of the dispute settlement regime would significantly enhance the ability of the contracting parties to enforce their mutual obligations under the trade regime.

The way forward would need to be an essential overhaul of the current regime of dispute settlement. The major amendment would be a transition to a mandatory dispute settlement, akin to existing clauses in many new generation trade agreements. Mandatory dispute settlement would introduce a time limit for a political level settlement at the Association Council. If the parties were unable to come to an agreement by the expiry of this period, the dispute would need to be adjudicated by another acknowledged arbiter. The European Court of Justice or another internationally recognized venue of arbitration could be identified for this purpose. Unlike current rules, the parties would no longer have the ability to block this procedure. This overhaul would not only accelerate dispute resolution but would also significantly improve the functioning of the Customs Union.

The Customs Union as the Pillar of Turkey's Economic Reform Program

Beyond its mutual economic benefits as examined in this study, the modernization of the Customs Union is set to provide important advantages in political economy terms. The Turkey-EU relationship was long framed by a narrative of accession. Envisaged by the Article 28 of the Ankara Association Agreement, the goal of Turkey's EU membership was gradually advanced, and the accession negotiation was formally initiated in October 2005, incidentally at the same time as it was for Croatia. Since then, however, several developments both in Turkey and in Europe have impeded Turkey's progress towards accession. As a result, even though it firmly remains to be the objective of the Turkish government, the ultimate objective of accession has become ever more elusive and uncertain. The momentum for EU reforms was also lost. Turkey's convergence with EU rules, norms, and regulation or in short, the EU *acquis*, has been negatively affected. In effect, the EU lost its anchoring role regarding the new policy framework in Turkey.

Beyond its mutual economic benefits as examined in this study, the modernization of the Customs Union is set to provide important advantages in political economy terms.

The consequence of this loss of credibility on the accession narrative has been a gradual shift towards a transactional relationship between Turkey and the EU. There are indeed spheres of cooperation and collaboration between Ankara and Brussels, as illustrated very clearly by the refugee deal. However, essentially all of these areas fall within a framework for intergovernmental cooperation which is separate and different from the aspired goal of political and economic integration.

Given that the accession talks have stalled with no real short-term prospect of revitalization, the Customs Union is the only rule-based framework that continues to underpin the relationship between Turkey and the EU. As such, it is vitally important to ensure the sustainability of this contractual arrangement for an advanced trade integration.

The risk of non-action, specifically a failure to move forward with the modernization of the Customs Union, is too severe. The accumulation of trade irritants and mutual grievances related to the functioning of the Customs Union must be addressed with an overhaul of

The accumulation of trade irritants and mutual grievances related to the current Customs Union must be addressed with an overhaul under the current arrangement.

this trade arrangement. The alternative raises the prospect of what has been an already perceptible gradual erosion of erosion of each sides' commitment to the full implementation and enforcement of existing rules.

From an EU perspective, the modernization of the Customs Union would also allow it to regain its anchoring role for Turkish policy reform. As set out in the different sections of this study, by achieving the modernization of the dispute settlement regime, an overhaul of the Customs Union would pave the way for a higher degree of legal and regulatory harmonization and convergence in the existing areas covered by the Customs Union. At the same time, it would extend the scope of convergence to the new areas and disciplines to be incorporated in the updated trade deal. As such, Turkey would also start to comply with EU rules on state aids and public procurement as well as services. Turkey's business and investment environment would continue to be transformed in line with the goal of market integration with the EU. Regulatory differences and non-tariff barriers would be eliminated, enhancing market access for EU companies.

From an EU perspective, the modernization of the Customs Union would allow it to regain its anchoring role for Turkish policy reform.

From a political economy perspective, the modernization of the Customs Union is of more critical importance to Turkish policy makers. The overhauled Customs Union has the potential to become a pillar of Turkey's new economic reform program, which was announced in mid-September[16].

The overhauled Customs Union has the potential to become a pillar of Turkey's new economic reform program, which was announced in mid-September.

Turkey is indeed at a turning point on its path towards sustained growth and development. The policy framework launched after the 2001 crisis allowed the country to sustain an impressive growth performance under a benign international financial environment.

Turkish policy makers now need to introduce a new and upgraded vision for the future of the Turkish economy. It is clear that the international environment has changed with the gradual end of fiscal stimulus and the low-interest rate policy in the West. The tightening of monetary policy in the US is starting to have a negative impact on the emerging markets universe. Turkey's significant international financing needs, amounting to US$250 billion/year[17], leave it more exposed to a growing sentiment of global risk aversion[18].

This vulnerability is at the core of the recent financial distress that has led to the recent depreciation of the Turkish Lira. Turkey, therefore, needs to adjust its growth model away from one which is over-reliant on capital deepening financed by foreign savings to a model based on high values productivity growth. This will require a new and ambitious economic reform program underpinned by structural reforms.

The EU had in the past functioned as an effective anchor for Turkey's political, economic and institutional reforms. This argument was recently articulated eloquently by Turkish economists Daron Acemoglu and Murat Ucer in their National Bureau of Economic Research paper[19]. In their analysis, the authors state that "*The EU accession process has had at least two types of impacts on Turkish institutions. Politically, the EU shouldered a role similar to the one played by the IMF and the World Bank on the economic side in the aftermath of the 2001 financial crisis, with a combination of both pressure for reform and a template for best-practice legislation…*". "*Second, as already noted, the prospect of EU accession acted as both an anchor and a carrot for the ruling party — there were major economic gains to be had from closer ties with Europe; as Turks were increasingly keen on becoming part of Europe, the cards were stacked against any moves that would alienate Turkey's European partners.*" To underscore the vital contribution of the EU dynamic to Turkey's successful economic modernization, Acemoglu and Ucer proposed that "*The most important lesson, which applies both to Turkey and other emerging economies in our view, is that even starting with weak institutions and political imbalances, rapid and high-quality*

The EU had in the past functioned as an effective anchor for Turkey's political, economic and institutional reforms.

16. Turkish Ministry of Treasury and Finance, "New Economy Program. Balance – Discipline – Transformation 2019 – 2021", September 20, 2018. See : http://www.bumko.gov.tr/Eklenti/11245,ovpsunumv11ingilizcepdf.pdf?0
17. That is the approximate figure reflecting the sum of the country's foreign debt rollover and its current account deficit.
18. Idem.
19. Acemoglu, D.; Ucer, M., "The Ups and Downs of Turkish Growth, 2002-2015: Political Dynamics, the European Union and Institutional Slide", National Bureau of Economic Research Working Paper 21608, October 2015. See: http://www.nber.org/papers/w21608.pdf.

growth appears feasible if the political opening for deep structural reforms and improvements in economic institutions can be found."

As the authors mention, "*the EU's anchor for Turkish institutional reforms and leverage over Turkish politicians came to an abrupt end in around 2010, when the accession process virtually completely stalled.*" The situation is no different in 2018.

Therefore, with little palpable prospect of a revitalization of the accession talks, the Customs Union is the only viable option for re-engineering the virtuous cycle of EU-led reforms in Turkey.

The Customs Union is the only viable option for the near future for re-engineering the virtuous cycle of EU-led reforms in Turkey.

The Way Forward

The aim of this paper was to demonstrate, on the basis of the existing economic literature and the available evidence, the mutually beneficial impact of an overhauled Turkey-EU Customs Union. Such an overhaul would involve extending the scope of the Customs Union's sectoral coverage by including service industries, agriculture, and public procurement, as well as modernizing its overall governance framework by developing a new dispute settlement mechanism and addressing the deficiencies in trade policy convergence.

Turkey and the EU have already undertaken an extensive set of discussions concerning the feasibility of this joint endeavour. The Turkish government and the European Commission had even reached an understanding regarding the scope of the renewal, and reaffirmed their willingness to start these negotiations formally. As a result, the European Commission prepared and forwarded a mandate for draft negotiations to the European Council in December 2016. Since then, however, progress has stalled, influenced by the deterioration in the relationship between Turkey and the EU. The overall political climate between Turkey and the EU is now improving. For example, the Ministerial level Reform Action Group recently met in Ankara for the first time after a hiatus of 3 years. A concrete step to encourage this rapprochement would be for the European Council to finally give its consent for the formal initiation of the negotiations for the modernization of the Customs Union.

A second and related element in the current debate on the overhaul of this trade agreement is the nature and scope of the political conditionality that will be set out. EU governments will indeed have to reach a consensus on whether the start of this new round of trade talks should be linked to political conditions like concrete improvements in human rights or press freedoms or the rule of law. Such a linkage and front loaded conditionality would imperil this process with the risk of rejection by Ankara. Additionally, it could also be claimed that the renewed Customs Union would provide a strong foundation for strengthening the rule of law, at least in the policy areas to be covered by the new agreement.

As opposed to the accession track, where the enhancement of democratic norms and the rule of law is an explicit objective, the modernization of the Customs Union can have the upgrading of the rule of law as an implicit objective. In other words, the proper implementation of Turkey's commitments under the modernized Customs Union may indeed lead to improvements in the rule of law. At the same time, the EU may be reluctant to disassociate its moral values from its economic goals. A partition of responsibilities between the different EU institutions may, therefore, be contemplated with the Council and the Commission taking the initiative for the economic and governance-related aspects and the European Parliament, with its powers under the ratification of trade agreements, shouldering the responsibility for the political conditionality. A timely conclusion to this internal EU debate on how to move forward with Turkey, and the Customs Union, in particular, is nonetheless necessary if the EU wishes to retain a realistic prospect of being a collaborative and influential partner for Turkey going forward.

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