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A Modernized EU-Turkey Customs Union

Expert Interviews and Analysis

Samuel Doveri Vesterbye, Managing Director at the European Neighbourhood Council (ENC)

Dr. M. Sait Akman, G20 Director at the Economic Policy Research Foundation of Turkey (TEPAV)



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Rue Washington 40
1050 Ixelles
Brussels, Belgium

+32(0) 26 465 139
media@encouncil.org
www.encouncil.org

Authors:

Samuel Doveri Vesterbye
Dr. M. Sait Akman

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Nail Olpak

“ To become strong and sustainable, these relations need to be based on mutual respect, trust and empathy ”

Turkey-European Union (EU) relations date back to the 1963 Ankara Agreement, which envisaged an association regime. This agreement envisaged preparatory, transitional and final stages for Turkey’s integration into the EU.

The Customs Union entered into force on 1 January 1996. It provided a high level of integration between the parties. Analyzing the impact of 20 years of implementation, we observe that Turkey has become the EU’s 5th main trading partner globally with the value of bilateral trade in goods currently amounting to €140 billion. Comparing to 1996 figures we see a fourfold increase. Similarly, the EU is the most important trading partner for Turkey, representing 41% of Turkey’s global trade. Moreover, around three quarters of Foreign Direct Investment (FDI) in Turkey currently originate from the EU.

This relationship did not only increase the volume of Turkish industrial production but also increased its quality and competitiveness.

However, the fundamentals of this relationship require adaptation to today’s challenges. It has to be equipped better to satisfy both sides’ expectations on one hand and face the reality of a changing economic and business environment on the other. The upgrade shall satisfy Turkey’s concerns about EU commercial policy with third countries while concluding Free Trade Agreements (FTA). It should also improve the functioning of the current Customs Union agreement. Strengthened economic and trade relations between the EU and Turkey will create a win-win situation that will contribute to increasing living standards of all. This is why, we believe, as MÜSIAD, that the negotiations to modernize the Customs Union must avoid any politicization as seen in the accession negotiations and preserve its technical nature.

The strategic importance of Turkey-EU relations increases for both sides in parallel with rapid changes in the nature of international relations and our region. To become strong and sustainable, these relations need to be based on mutual respect, trust and empathy for each other. Both sides have a lot of benefits to gain if cooperation strengthens in different areas, such as foreign policy, economic and trade relations, energy supply, security to border management, employment, culture, education and migration policies.

The business community is aware that the Turkey-EU relationship is based on a strong and deep economic integration. The massive mutual economic interest and benefits should be better reported and acknowledged.

Therefore, I hope this report will provide a better understanding on the importance and the necessity to reform and modernize the Customs Union agreement between Turkey and the EU.

Nail Olpak, President of Independent Industrialists and Businessmen’s Association (MÜSIAD)
Istanbul, March 2017



Amb. Christian Berger

“ Now 20 years on we need to look at it afresh ”

At the time of writing these lines political tensions between Turkey and the European Union (EU) and several of its Member States are running high, have been running high for months. At the same time however technical cooperation, trade exchanges, investment in infrastructure but also the support efforts to the refugees are going strong. Daily bilateral consultations cover broad areas of cooperation and shared interests.

One of the rays of hope for a better and stronger EU-Turkey partnership is the economic potential that comes with a modernized Customs Union: building on our longstanding strategic economic and trade relations; Turkey's status as a candidate country for accession to the EU; and through Turkey's membership and cooperation with the EU in the World Trade Organization (WTO); the Organization for Economic Co-operation and Development (OECD); and the Group of Twenty (G20).

The EU has always been the main trading partner of Turkey. Current figures stand at about €140 billion of exchanges representing about 42% of Turkey's global trade while Turkey is the EU's 5th trade partner with a share of 4,2%. The EU received nearly 48% of Turkey's exports in 2016. Thanks to the EU-Turkey Customs Union, the EU, being the largest integrated market in the world, remains a secure and open market for Turkish exporters.

For the last two decades, the EU-Turkey Customs Union has been the backbone of the bilateral trade framework. The Customs Union and the accession process have substantially contributed to the removal of several major trade barriers and to significant legislative compliance. The Customs Union has been instrumental in integrating Turkey into EU and global markets but also for the overall modernization of the country. The EU and Turkey are de facto economically integrated: with three quarters of overall Foreign Direct Investment (FDI) stocks coming from the EU (66,3% on average between 2008 and 2016), Turkey has become an investment base for European business with increasing integration into the EU's supply and production chains, often in middle to high-value added segments and financial services.

Back in 1995, the Customs Union was a unique agreement in its ambition and depth and quickly became a success story. Now 20 years on we need to look at it afresh. Its depth and coverage must keep up with new requirements and meet the wider ambitions of deep and comprehensive trade deals that the EU is pursuing on the global stage right now. It is now essential to steer the Customs Union towards a new dimension apace with the realities of the global economy. As such, the current trade framework is less well equipped to frame and foster a modern and ambitious preferential trade relationship between the EU and Turkey. Therefore, the enhancement of the trade relations to cover services, public procurement, further liberalization in agricultural products and the modernization of the Customs Union should bring additional welfare gains both to Turkey and the EU.

In times like these it is clearly needed and a win-win for both sides.

H.E. Christian Berger, Ambassador and Head of Delegation of the European Union to Turkey
Ankara, March 2017

I Introduction and Background I



Samuel Doveri Vesterbye

Samuel Doveri Vesterbye

Director of the European Neighbourhood Council (ENC)

Dr. M. Sait Akman

G20 Director at the Economic Policy Research Foundation of Turkey (TEPAV)



Dr. M. Sait Akman

“ Sometimes the incentive of cross-societal entrepreneurship goes further than hollow promises of reform and engagement ”

Responsible co-anchoring.

Relations between the European Union (EU) and Turkey were given a front-row seat in the mid-1990s, when EU-Turkey economic relations were upgraded and the 1995 Customs Union agreement came into effect.

The move was strategic, both in political and economic terms. The results were lasting and – arguably – the most anchoring part of EU-Turkey relations in recent history. And despite recent political setbacks, the original Customs Union paved the way as a guiding economic incentive during the late 90s and 2000s.

The 1995 Customs Union agreement was fundamental, because it encapsulated not only political classes inside the EU and Turkey, but equally co-integrated entire business communities and middle class consumers on both sides.

It is popularly mentioned that the value of bilateral trade in goods increased more than fourfold after 1996. Today it amounts to €140 billion, representing 41% of Turkey’s global trade and over 70% of Foreign Direct Investment (FDI).

But less commonly do we speak about the positive growth effects of the Customs Union on welfare and its impact on various working sectors like increased productivity, creating jobs, improved technology and new industries in Turkey and across the EU.

And finally, we seldom remember how the Customs Union lay the ground for Turkey’s rapid growth of pluralism during the mid-2000s; paving the way for pluralist societies¹, gender equality² and a rapid increase in Gross Domestic Product (GDP) per capita.

But for that trajectory to continue – and to avoid stalling during these difficult times – further efforts are needed.

As with the fragility of the EU’s own project; socio-cultural identity and good intentions cannot always account for integration or political-economic alliances. And sometimes the incentive of cross-societal entrepreneurship goes further than hollow promises of reform and engagement.

Structural initiatives and economic agreements are needed to anchor societies, and transform future generations, as well as to build institutions to increase trust and cooperation. Economies, governments, peoples and ideas necessitate cementing in order to form united blocks that foster inter-dependence, spill over and shared objectives like trade, technology, and welfare, through regional alliances.

1 According to Necdet Saglam from the Anna Lindh Foundation Turkish Network, the Turkish civil society and ‘third sector’ has experienced a large expansion since the mid-1990s. Data from 2014 show that 99.029 associations and 4734 foundations exist in Turkey (<http://www.annalindhfoundation.org/report/turkey-growth-and-expansion-third-sector>)

2 http://ec.europa.eu/justice/gender-equality/files/epo_campaign/131128_country-profile_turkey.pdf

“ It defends our long-held notions of innovation and free trade, while opting for welfare and growth under the regulated protection of an updated and modernized Customs Union.”

“ This is by far the more favourable option in terms of welfare benefits, especially when compared to a basic FTA, whereas a Deep and Comprehensive Free Trade Agreement (DCFTA) is considered a sort of middle way option with regards to welfare.”

And at a time when calls for openness and growth are high on everyone’s agenda, a modernized Customs Union with Turkey offers a real long-term compromise.

It defends our long-held notions of innovation and free trade, while opting for welfare and growth under the regulated protection of an updated and modernized Customs Union.

And meanwhile, it proves useful to remember that it takes two responsible parties to co-anchor a lasting partnership.

Chronology and background figures.

The dialogue between the EU and Turkey concerning a possible upgrading of the Customs Union started in early 2014.

By May 2015, the EU Trade Commissioner and Turkey’s Minister of Economy agreed to enhance bilateral economic relations and launch the preparations for a future negotiation to modernize and extend the existing EU-Turkey Customs Union based on a Memorandum of Understanding.

As of 2016, domestic public consultations and preparatory steps were taken by the EU and Turkey, including impact assessments.

The Turkish Ministry of Economy and the European Commission (EC) have since then launched the process to apply for a mandate to start negotiations. The positive mandate response is likely to be granted by mid- to late 2017. For this to happen, each respective government authority must approve it, including expected unanimity voting by the Council of the European Union (Council). Despite some apprehension from a select few EU member countries, it is widely hoped that the overwhelming majority of large EU member countries, as well as their business groups and Small and Medium-Sized Enterprises (SME), will support the mandate. As far as the other EU member countries are concerned, their willingness and support is likely to depend on private sector encouragement and expert advice, both politically and economically, in order to facilitate the process in the Council during 2017.

On the EU side, the EC completed its working document in December 2016, (to recommend for the Council Decision) to authorize the opening of negotiations with Turkey. In its assessment, the EC largely benefits from both the World Bank’s (WB) study³ evaluating the Customs Union, and an in-depth analysis of an independent study titled Study of the EU-Turkey Bilateral Preferential Trade Framework, including the Customs Union, and an Assessment of Its Possible Enhancement⁴.

Both studies reveal, albeit with some methodological differences, the positive impact of a possible enhancement of the Customs Union to new areas, as well as mitigating asymmetries, in terms of GDP, welfare increase and boosting export. In both studies, it is argued that the Customs Union should proceed with the necessary upgrading to cover issues beyond existing industrial products. It would need to include trade in services, agricultural products and public procurement, while not reverting back to a Free Trade Agreement (FTA) instead of a deepened Customs Union. The WB study notes that the current Customs Union has brought greater benefits than a FTA because it has provided an anchor for Turkey’s tariffs and negated the need for rules of origin. The study also describes the Customs Union under negotiation as an imperfect structure in which benefit maximization is difficult due to asymmetries.

3 Evaluation of the EU-Turkey Customs Union, by World Bank, Report No.85830-TR, 28 March 2014.

4 http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2016/turkey_anx6_en.pdf

“ This is by far the more favorable option in terms of welfare benefits, especially when compared to a basic FTA, whereas a DCFTA is considered a sort of middle way option with regards to welfare. ”

In turn, the modernization of the Customs Union and the extension of the scope of the framework surrounding bilateral trade relations have been identified as the necessary steps to be taken. According to the EC’s study, an enhanced commercial framework can raise welfare in the EU and Turkey by €5 billion and €12 billion respectively. Turkey’s impact assessment also indicates that the best scenario to follow remains a full liberalization in agriculture, services and bilateral opening of public procurement markets in conjunction with FTA’s concluded between Turkey and trade partners of the EU. This is by far the more favorable option in terms of welfare benefits, especially when compared to a basic FTA, whereas a Deep and Comprehensive Free Trade Agreement (DCFTA) is considered a sort of middle way option with regards to welfare.

Once the EU and Turkey conclude the negotiations, the European Parliament (EP) needs to approve the decision at the International Trade Committee (INTA) and at the plenary level. The 2017 INTA committee report concerning the modernization of the Customs Union with Turkey and the 2017 Foreign Affairs Committee (AFET) report on Turkey are both likely to give a better understanding of how the EP feels about the process. Also, as a result of recent institutional changes in the EP – the INTA and AFET committees will have to cooperate more on a variety of topics.

Fortunately, these cross-committee amendments, as well as improved inter-institutional relations between EU bodies, is likely to give parliamentarians a broader oversight in regional relations and pressing foreign policy priorities like Turkey and trade.

Once the Council decides on the mandate, the EC and the Turkish Ministry of Economy, aided by the Turkish EU Affairs Ministry, will start the negotiation phase, which is estimated to last until 2020. In parallel, it will prove important for business councils, think tanks and associations to inform policy makers and parliamentarians about their concerns and expectations to guarantee a free flow of information, maintain momentum and coordinate policy. Most importantly, all sides agree on the need for reform and the necessity to install a fair and transparent agreement to bring the Customs Union up to date with global economic and commercial developments and to increase growth.

The pressing necessity for reform can be traced back to changing local-domestic and global structural circumstances, which increasingly affect trade, regulation, rules and fairness.

The following factors are generally agreed upon by experts and the three major impact assessments mentioned above.

In a nutshell, they say that:

1. The 1995 Customs Union agreement was an interim process, and not an end in itself. For it to run smoothly and effectively, most experts agree that more guidelines and ‘improved rules’ between the EU and Turkey are needed.
2. Based on the official WB assessment report, the Customs Union is technically ill-equipped to deal with modern day trade shifts and challenges in the new global economy. This is particularly the case as production networks have naturally developed in unforeseen directions since 1995.
3. The EU alone has signed several new FTA’s that can deeply affect Turkish trade volumes and patterns. The major concern for Turkey is the erosion of its preferences in EU markets and trade asymmetry with third countries that have new generation trade agreements. This doesn’t allow Turkey any decision-making,

despite it fundamentally affecting its economy by opening its market for products of the third country trading partners. And at the same time, Turkey receives no reciprocal access, thereby leaving competitive advantages to EU firms unless Turkey manages to conclude a similar deal with the third country.

4. The narrow coverage of the 1995 Customs Union agreement is full of untapped growth potential. Because the original Customs Union left out agriculture, services and public procurement, the EU and Turkey face a favorable situation of untapped growth potential in economic and employment terms. Widening the scope of the Customs Union is therefore expected to be the largest area to yield economic gains for employment and growth across the EU and Turkey.

5. Lacking judicial dispute settlement is an increasing problem, especially for certain sectors, since it slows down the process of trade and creates ill-defined rules. This – contrary to popular belief – is disliked by the private sectors on both sides as it fosters uncertainty and long periods of waiting. An improved understanding for dispute settlement will also enhance transparency, accountability and rule of law.

6. The asymmetric structure of the Customs Union makes it more difficult for Turkey to take part in the decision-making process. It also means that Turkey adapts more slowly to EU laws and often operates at sub-optimal levels because it is not properly consulted. It goes without saying that areas of accountability and legislation would also be greatly improved through a reformed Customs Union – which, in turn, will impact Turkish society and institutions more positively.

7. The Customs Union remains an uneven playing field for some sectors, which pushes Turkey to seek compensation and financial assistance, safeguard measures, and forms of adjustment assistance to minimize the negative impacts of certain economic areas and the welfare of people. It remains to be seen how this compensation will work, but it is likely to form an integral part of the agreement to secure transitional economic stability. At the same time, both Turkey and certain EU member countries continue to uphold protective measures when it comes to public procurement as well as other sectors.

Scope of the report.

This report aims to collect different perspectives from policy makers, experts and business associations through interviews and analysis on the subject of EU-Turkey Customs Union reform.

It serves as an important preliminary analysis and general overview to map out the multi-layered interests, challenges and feedback from the private, public and non-governmental sectors. The report is meant to help the various stakeholders involved in shaping the re-configuration and reform of the EU-Turkey Customs Union. Through this kind of mapping and an exchange of policy views, the stakeholders should get a clearer overview of the negotiation and economic perspectives with the intention of fostering more information symmetry and potential for better policy coordination. It should also help understand the economic and political motivations and expectations from the EU and Turkish sides, including ones from non-governmental organizations, business associations and academics.

Methodology.

The report consists of four core sections, including an introduction, analysis, interviews and policy recommendations for the modernization of the Customs Union. The interview section contains nine structured interviews, with three specifically tailored questions to each interviewee that are related to their given sectors, ranging from concrete business practices and government policy to economic academic advice and non-governmental feedback.

The interviews include high-level policy makers and business representatives from the EU and Turkey, as well as academics and economic specialists. The analysis section is co-authored by the reports' editors: Samuel Doveri Vesterbye, Director of the European Neighbourhood Council (ENC) and Dr. M. Sait Akman, G20 Director at the Economic Policy Research Foundation of Turkey (TEPAV).

The ten structured interviews with key decision makers and opinion shapers will help the reader to better understand the expectations, concerns and opinions of technical and political government decision makers, as well as economists and business representatives who will be directly affected by a reformed Customs Union.

All interview questions are developed and conducted by researchers from ENC, in consultation with both publication partners and co-editors. Approximately one third of the interviews are pooled from governmental policy makers, whereas the remaining two thirds are divided between key economic experts, university academics and business representatives. All recommendations are solely based on the interview responses and analysis by the report's co-editors.





Amb. Angelina Eichhorst

I Government - Expert Interview I

Amb. Angelina Eichhorst

Deputy Managing Director for Western Europe, Western Balkans and Turkey
European External Action Service (EEAS)

Walk us through the Customs Union reform – how does the timeline look and what is expected from European Union (EU) countries to guarantee a smooth process?

The timeline, as it currently stands, is aiming for the European Council to provide the Commission with the official mandate to start negotiations with Turkey on Customs Union reform by end-June. This tentative deadline has been set by the Maltese Presidency in order to agree on the mandate within its term, one of the Maltese Presidency priorities. The plan is for negotiations to start soon after the adoption of the mandate.

To secure a smooth negotiations process, EU Member States are expected to keep focus on the concrete proposal. Groups in Member State constituencies are likely to address specific aspects of the Customs Union. We have to see how this process will be taken forward.

What are the major barriers and misperceptions when it comes to reform, both in Turkey and the EU?

Expectations will have to be managed and we cannot predict what the main questions will be. The negotiations will strike a balance and find mutually agreeable solutions.

Can we expect the reform to impact Turkey positively in terms of increased accountability, rule of law and good governance through the strengthening of independent economic regulatory institutions?

The existing Customs Union has helped Turkey significantly raise the quality of its production and international competitiveness of its private sector. Today, Turkey's regulatory institutions have gained a stronger voice, but there is room to further increasing the independence of these institutions in Turkey.

A reform of the Customs Union is likely to help further diversify sources of influence in Turkey. The largest positive governance impact on Turkey would likely stem from the widened scope of the reformed Customs Union, i.e. in the area of public procurement enhanced rules would introduce more legal predictability, fairness, transparency and judicial review. Therefore, it is our hope that the role of stakeholders would be strengthened through increased involvement, information flow, and early consultations.

Overall, a Customs Union reform would positively influence trade between the EU and Turkey to the benefit of the private sector and Turkish citizens.

I Government - Expert Interview I



Murat Yapıcı

Murat Yapıcı
Director General for EU Affairs
Turkish Ministry of Economy

Is Customs Union reform a top priority for Turkey and what are the most challenging issues and sectors to modernize in Turkey?

The European Union (EU) is Turkey's most important trade and investment partner and our trade relations mainly rest on the Customs Union. With the update of the Customs Union, Turkey aims to fix its asymmetric structure and expand the scope of the preferential trade relations in line with the recent trends in international trade. In fact, while both the EU and Turkey negotiate and conclude Deep and Comprehensive Free Trade Agreements (DCFTA's) with third countries, a shallow Customs Union which excludes trade in services, e-commerce, public procurement and agricultural products does not reflect the ideal integration level among the parties.

Therefore, this process is an important opportunity for deepening and expanding the framework of economic and trade relations with the EU and for contributing to Turkey's integration to the world economy.

Turkey has achieved significant level of competitiveness in industrial products thanks to the Customs Union. Nonetheless, enhancement of preferential trade relations to new areas, through expansion of current trade concessions in agriculture, and through market opening in services and public procurement will be a challenge for Turkey. Turkey aims to initiate a comprehensive reform process in the agricultural sector to boost efficiency and the standards of production and to compensate for the losses that might occur as a result of liberalization. Furthermore, an alignment process to the EU legislation in services and public procurement will be required. Turkey is willing to take on that challenge, since it is an important leverage to trigger the reform process in these sectors and to increase Turkey's competitiveness in a wider scope of areas.

Despite the already envisaged challenges, there is a high level of political commitment in Turkey. The Turkish private sector also supports the process. We are happy to see the same level of willingness on the EU side. Currently, the update process is an important priority for us in order to further improve trade and economic relations with the EU.

What does Turkey expect from a reformed Customs Union with the EU? (i.e. improved decision-making powers, economic adjustments or institutions to accommodate dispute settlements etc.)

First and foremost, we expect a solution of existing structural problems. Turkey aims to eliminate the democratic deficit within the Customs Union by taking effective part in the decision-making and consultation process of the EU for the areas directly related to the functioning of the Customs Union. Furthermore, in the absence of a systematic mechanism, Turkey has been facing troubles in aligning with the EU's Free Trade Agreements (FTA). Being Customs Union partners, Turkey aims to attain the same advantageous access to third country markets while preventing possibility of trade diversion. Therefore, another important objective is the resolution of the FTA problem with a legally binding provision to ensure that Turkey

benefits simultaneously from the EU's FTA's with third countries. Turkey also aims at abolishing road quotas, which are acting as non-tariff barriers impeding the free movement of goods and increasing the cost and delivery times of the goods.

Moreover, we expect to achieve full trade potential between Turkey and the EU by enhancement of preferential trade relations in agriculture, services, e-commerce and public procurement. We envisage that Turkey will attain significant level of competitiveness in these new areas and it will have the opportunity to follow the recent trade trends and integrate more to the world economy.

Also, we aim to modernize the Customs Union through improving its functioning. In that respect, a functioning dispute settlement mechanism will be established and both sides expect to improve our already advanced relations in areas like technical barriers to trade and customs cooperation.

What should the EU do to guarantee a stable and constructive reform process in Turkey within the context of an upgraded Customs Union?

The best way for the EU to guarantee a stable and constructive reform process in Turkey is the facilitation of our accession negotiations to the EU.

Turkey has strong trade and economy relations with the EU thanks to the Customs Union, and upgrading it with the elimination of structural problems and enlarging the scope of preferential trade relations would bring important economic benefits to both sides.

In that respect, this mutually beneficial process should not be tangled with political motives. Negative political messages from the EU side within the context of the update of the Customs Union will lessen Turkey's enthusiasm for reforms in challenging sectors/areas, which is indispensable for the successful conclusion of the process. The EU's constructive approach in this regard will be an important leverage for the successful conclusion of the update of the Customs Union.

It should also be remembered that the Customs Union is a deep model of trade integration where parties apply common policies in many areas directly related with the free movement of goods. In that respect, sustainability and stability of such a deep trade relationship should be the responsibility of both sides. Turkey believes that development of a partnership approach would be critical in handling the challenges that the update process will bring.



Michele Villani

I Government - Expert Interview I

Michele Villani

Principal Administrator on Turkey and Trade

Directorate-General for European Neighbourhood and Enlargement Negotiations (DG NEAR)

How is a reformed Customs Union likely to impact Turkey's economic and political relations with the European Union (EU)?

The current Customs Union has been a cornerstone for economic and trade integration between the EU and Turkey for nearly 22 years.

It helped create a fourfold increase in EU-Turkish bilateral trade, while Turkey continues to be the EU's fifth largest trading partner. The EU is still Turkey's first trading partner globally and relies on the EU for 41% of its trade.

Through the alignment of technical and product legislation and of economic legislation, the Customs Union has enabled Turkey to be plugged into the EU internal market, including 500 million consumers.

This has largely been thanks to low-cost inputs like for example capital goods coming from the EU to Turkey. These have enabled more competitive products in Turkey for both domestic and export markets. In turn, this increased the levels of investments to Turkey, like Foreign Direct Investments (FDI), as well as portfolio, short-term, long-term, and green field investments from the EU, which now accounts for nearly two thirds of all incoming FDI's to Turkey.

A reformed Customs Union can only improve economic integration and a modernized and extended Customs Union cannot but improve the economic benefits on both sides. In our impact assessment study, we have calculated that the Gross Domestic Product (GDP) of Turkey will increase by 1,44% under a modernized Customs Union. The EU's GDP will increase much less – but in relative terms, it's still a very important figure of around 0,01%. And this calculation does not take into account the impact of services and public procurement liberalization, because of technical modeling limitations.

However, when we add those impacts we might have even larger figures. Again, leading to stronger trade increases. We calculated that EU exports to Turkey are likely to increase by €27 billions. Turkish export to the EU will similarly increase by €5 billions. Economic welfare will increase more for Turkey in relative terms at around €12,5 billions, whereas the EU is estimated at €5,4 billions.

If other strands of the EU-Turkey relationship (like the accession process or the visa liberalization process) advance at a slower pace, it becomes all the more important to look at the Customs Union reform to maintain healthy bilateral relations. This will increase both economic benefits and the political standing of bilateral relations as a whole.

Can you explain the importance of Turkey becoming an active, equal and included 'decision shaper' in terms of EU Customs Union economic policy making?

Turkey should be included into the decision shaping process, implementation, management, and functioning of the Customs Union. In this respect, I should say

that what we are faced with today is an asymmetric Customs Union, where Turkey is obliged to follow EU decisions. Turkey has the obligation on the basis of the Customs Union decision No. 1/95 to align itself, without having a say in neither the decision-making nor the 'decision shaping' of the current Customs Union.

One of the key objectives of this negotiation will therefore be to redress this asymmetry. The structure of the Customs Union has to take into account Turkey by associating and including Turkey into the 'decision shaping'. An example would be committees or procedures that allow them a better say. More stringent and tighter mechanisms on the Free Trade Agreement (FTA) negotiations, especially when it comes to third countries.

How can the EU find the right balance between economics and political issues like democracy? Could a win-win approach be found in concepts of economic transparency and accountability, which are beneficial areas for the Turkish business communities too?

It will certainly improve the business environment and the link between political-democratic issues, as economic or trade agreements help a business climate in becoming more predictable.

Rules will be aligned and a number of economic legislations will have to be complied with, which will improve the business and investment climate and clearly improve on aspects like rule of law, freedoms and the independence of the judiciary. These all fall squarely into the political criteria.

Both business communities would benefit for this because a wider and deeper agreement can spillover into areas like the rule of law and freedoms, as well as the judiciary, which is clearly a mutual advantage for the sake of a better economic governance, including independent regulatory bodies.

I Business Representative - Expert Interview I



Dr. Özer Balkız

Dr. Özer Balkız
Deputy Secretary General
The Independent Industrialists' and Businessmen's Association (MÜSİAD)

What are the perceptions of companies and Small and Medium-Sized Enterprises (SME's) in Anatolian cities, outside bigger provinces, concerning the debate of the modernization of the Customs Union?

The SME's and the companies throughout Anatolian cities strictly believe that if necessary adjustments about agriculture and services that have been offered by Turkey are fully accepted in the modernized Customs Union all sides will win or benefit collectively. On the other hand, having an easy way for access to finance is crucial for the SME's in Anatolian cities. They are aware of the fact that in developing countries, including Turkey, the share of SME's in total credit volume is less than credit volume in the developed countries in Europe and Japan. If the required adjustments about this problem enter into force, difficulties on financing will gradually disappear for the SME's. Thus, the products of the SME's in Anatolia will come into a competitive environment. From another perspective, SME's play an important role in the functioning of both local and international production networks thanks to globalization and regional integration. If the reform of the Customs Union covers necessary adjustments in favor of Turkey, it facilitates the entry of the SME's into export markets and accelerates their competitiveness. Eventually, the modernization of the Customs Union provides the SME's in Anatolia with great opportunity in terms of diffusion of products across Europe.

Are SME's willing to modernize the Customs Union and revitalize relations with the European Union (EU) from a bottom-up perspective, or do they have an interaction with policy-makers upon the latter's political orientation?

The current Customs Union agreement covers only industrial products despite the gains it has made for our national economy. There is no regulation about agriculture and service sector. It also contains many structural problems. Therefore, the current agreement is insufficient to meet the expectation of our country in its present case. The most systemic problems we face can be divided into three: the lack of Turkish decision-making in the EU, difficulties in undertaking the EU's Free Trade Agreements (FTA's) and road quotas. Taking them all into consideration, SME's represent the part that wishes to revitalize and develop relations with the EU. They are also in close relationship with policy makers in order to make up for deficiencies in the current agreement. For the sake of achieving this, they have prepared various reports concerning the content of the modernized Customs Union. When it comes to the perspective of European countries about the Customs Union reform, they – especially companies trading in Turkey – support the idea that the current Customs Union agreement should be extended to new fields. The current agreement does not include some vital business opportunities such as public procurement, law of company, right of establishment, food safety, and taxation advantages. If the expressed recommendations about the Customs Union reform are re-arranged from a bottom-up perspective it will generate powerful business activities and strengthen the economic ties between Europe and Turkey.

Sectors like agriculture and services remain uncovered by the 1995 Customs Union Agreement. Does an eventual modernization of the Customs Union into these sectors help increase growth and employment in Turkey?

Because of the shifts in economic and commercial relations in the world over the last 20 years, it has been stated that the modernization of the Customs Union is beneficial and necessary – leading to mutually positive economic effects for both Turkey and the EU. Depending on this, it can be clearly said that the current Customs Union agreement does not satisfy Turkey’s economic expectation. In present case, agriculture, services, and public procurement are excluded from the current Customs Union agreement, while only applying to industrial products. A modernized Customs Union updated with the addition of missing areas will provide significant contributions to the exports of goods and services from one side of the country. In tandem, competitiveness will increase among our firms, which will lead to an increase in production volume and variety. Eventually, growth and employment will converge to Turkey’s potential level. In addition to this, companies that give importance to research and development, designing, branding and innovation will be winners of this recreation and transformation. Furthermore, this will help expand the quality and scope of the products in the Customs Union to cover the areas of the agriculture, services, and industry. This, in turn, will help economic and financial integration among the parties, thereby enhancing and widening the scope for collaboration between SME’s in the global market.

I Business Representative - Expert Interview I



Melih Özsöz

Melih Özsöz

Corporate Communication and Resource Development Director
Foreign Economic Relations Board of Turkey (DEİK)

What are the main concerns for Turkey, in terms of foreign economic relations, when it comes to Customs Union reform?

In May 2015, Turkey and the European Union (EU) announced for the first time their decision to revise the framework and to expand the scope of the Customs Union, which is considered to be the cornerstone of Turkey's European integration. Established back in 1996, the Customs Union between Turkey and Europe was promoted to be the roadmap for Turkey's EU membership and served as a definite tool for Turkish industry, trade, and business to open up to Europe and the rest of the world.

The Customs Union was clearly perceived as a vehicle to integrate Turkey in Europe, with a view of accession one day. Since then, in parallel to the changes of the rules in international trade, the 21-year old Customs Union between Turkey and the EU started facing heavy critique from Turkey due to the unbalanced trade situation it created. Criticism has focused on three main areas: First and foremost, Turkey has been largely absent in the EU negotiation processes of trade agreements with third countries, while such treaties have the potential to severely affect the Turkish economy. Secondly, quotas applied to Turkish trucks on exports and imports disregarding and breaching rules of fair competition. Lastly, the visa requirements toward Turkish citizens, mainly to business people which jeopardize the free competition principle of any trade agreement.

With these criticisms on the table, the Customs Union framework between Turkey and the EU has become old-fashioned and in urgent need of revision.

As a representative council of Turkish business abroad, can you explain the priority given to the modernization of the Customs Union in Turkey?

The priorities of the current revision are two-fold. Number one is to revise the Customs Union between Turkey and the EU in light of the new global tendencies of world trade. Number two is to update the Customs Union in light of shortcomings arising from Turkey's absence in the decision-making process and the barriers encountered in the free movement of goods and persons, in such a way that the potential update will produce permanent solutions to some chronic problems on the Turkey-EU agenda.

Despite the negative atmosphere surrounding Turkey's EU accession negotiations, the revision of the Customs Union seems untouched from the daily Turkey-EU routine. Parties on both sides remain dedicated towards revision and progressively work towards the economic negotiations.

However, several challenges remain on the surface and seem to be negotiated in the process. One of them is Turkey's integration into Europe's decision-making process. The revision should enable Turkey to build a solid ground for participating into the policy-making process in the area of European trade policy in order to minimize the detrimental effects of EU Free Trade Agreements (FTA's) with third countries on Turkish economic development. However – as the EU and the third

countries usually are not willing to have Turkey at the negotiating table – this issue is best solved with the modernization of the Customs Union.

A second challenge is that of visa requirements for Turkish citizens, which is especially important for the business sector. The establishment of the free movement of goods through the Customs Union was meant to be one of the many stages on the road to membership for Turkey. Other freedoms that include the free movement of persons would be gradually achieved. Nonetheless, as free movement of goods has been maintained to a certain degree, the free movement of persons has not faced a parallel development. Therefore our Turkish business communities really expect to find a permanent solution to this age-old problem. However, the prospect for a solution to the visa issue got very blurred once both parties linked a basic human rights issue to the migration deal between Turkey and Europe. The current framework for reform seems to be blind to that. Furthermore, as a requisite to free movement of goods, the free movement of business actors also needs to be included into the framework.

Last but not least, road transport quotas are of prime importance for the Turkish business community and are required to be solved within the framework of the reform. One of the features in the establishment of the Customs Union is the removal of quantitative barriers, or so called quotas. While the abolishment of these quotas is accomplished in the area of free movement of goods, the same cannot be said of the transport sector. That's a priority for us.

Do you think that the reform process can help cement EU-Turkey relations and build new trust through shared institutions and economic growth?

Despite its challenges, the process of reform carries an important opportunity for the future of Turkey-EU relations: the advantages that will arise for Turkey's EU membership target.

While the revision of the Customs Union will create a 'win-win' situation on both sides in economic terms, the path to be followed by Turkey will increase Turkey's ability to better harmonize its trade and economic policies with the EU. This will create a positive political atmosphere as Turkey will fulfill requirements of the EU *acquis communautaire*, paving the way to advance on relevant *acquis* chapters. This in return may function as a useful tool that solves the urgent need towards rebuilding trust while also injecting some new momentum into relations that will put the negotiations back on track.

I Business Representative - Expert Interview I



Stefan Moritz

Stefan Moritz
Managing Director
European Entrepreneurs for CEA-PME

How is the Customs Union reform likely to benefit growth for Small and Medium-Sized Enterprises (SME's) across Europe?

From the European SME perspective, which takes into account all SME's associated in our confederations member association, we believe that a Customs Union reform with Turkey would be an intelligent step forward.

Instead of solely focusing all the energy on a full membership for Turkey, we think that the economic relationship between the European Union (EU) and Turkey must include more progress, especially for the SME's. This doesn't mean that we exclude Turkish EU membership, but we do believe that SME progress and development is important. And if currently and politically, this is the best way to do it, then we fully approve and support those reforms.

Customs Union reform would make things more clear. It would help set rules and clarity on trade relations in different sectors, especially in the agricultural sector, construction sector, participating in public procurement and so forth.

It's likely to be a good first step, similar to a Free Trade Agreement (FTA), but maybe without the issues that a FTA would represent to Europe and certain economic sectors at this moment in time.

An FTA would first of all have to be negotiated from scratch while the modernization of the Customs Union is more likely to be done within a reasonable timeframe and with a better and more compromising solution for all parties involved, including all the different economic sectors.

So, from the SME perspective, it will prove beneficial, partly because we are already trading and cooperating a lot with our counterparts in Turkey, but also because a Customs Union reform will provide the most logical and fastest way to improve and facilitate increased economic growth in our SME sectors.

Is Turkey an important country for SME's today?

Absolutely. They are particularly important for SME's across Europe and Turkey in the fields of food production, industrial supply chains and tourism.

Turkey remains an important partner and is particularly important for SME's, since many have easy access to the Turkish market. This is also very much linked to the fact that Europe has such a big community of citizens with a Turkish background that live and work in Europe since decades and generations. They are often employed in the SME sector, which is very visible and relevant in countries like Germany, Austria, and the Netherlands. These relationships are therefore very important when it comes to sales and purchases from these sectors, as well as the obvious fact that Turkey is geographically well placed for European trade and interchanges of goods in the SME sectors. So yes – absolutely – Turkey remains important for SME's today in Europe.

Is the reform seen positively in terms of promoting ‘win-win’ growth and trade, instead of stalemate in politics, which has dominated EU-Turkey relations over the past?

I think the Customs Union reform will give a positive sign to both parties, whether in Turkey or inside the EU. Europe will signal to Turkey that there is a real and structural interest to have a good partnership with Turkey. That’s very important in this moment, both economically, but also very much politically. It also gives a very positive signal in terms of not only focusing on ideological motivations and maximum objectives like full membership. It can be good to take things step-by-step too, I suspect, to get things done.

Let’s call it a step-by-step approach, in order to increase cooperation and integration especially when it comes to the economic relationship.

In turn, this will also help Turkey to reach an average level of income comparable to European standards, thereby also making full membership a more plausible reality in the future. Customs Union reform would be a perfect signal and an urgent necessity to preserve a good relationship with Turkey, both politically and economically. And from our SME understanding, economic integration is both the fastest and simplest way to do so.



Dr. Çiğdem Nas

I Economic Specialists - Expert Interview I

Dr. Çiğdem Nas
Secretary General
European Development Foundation (IKV)

How is the perception about Customs Union reform among civil society and business groups in Turkey - what are the main expectations and do they differ among larger and export-oriented firms and domestic ones?

Perception regarding the modernization of the Customs Union is generally positive. In a survey conducted by IKV with a sample size of 152 companies, 65% of the respondents expressed a favorable opinion regarding the modernization of the Customs Union. For companies operating in the service sector this process presents challenges as well as opportunities. It is their shared belief that this process should proceed in close cooperation between the public sector and officials who will negotiate the deal with the European Union (EU) and the interested parties (i.e. related sectors of the economy). The umbrella organizations of the Turkish business world generally have a supportive attitude towards the modernization of the Customs Union. For export-oriented companies, the most important point regarding the modernization process is the improvement of the structural architecture of the Customs Union by making it possible for Turkey to negotiate and sign Free Trade Agreements (FTA's) in parallel with the EU. In this way, Turkish businesses and exporters will have the opportunity to have access to new markets via the Customs Union. As for agricultural producers, the Customs Union process still presents many unknowns since this sector is likely to present the largest adjustment cost upon liberalization in a modernized Customs Union with the EU.

Will a compromise be critical for delicate issues like visa liberalization when it comes to business people, road transport quotas and movement of natural persons for services?

Those issues will prove to be determining factors in the negotiations for a modernized Customs Union. While visas are considered to act as non-tariff barriers in a customs union involving industrial goods, it would be unacceptable for the continuation of the visa in a bilateral trade framework involving the liberalization and also the free movement of services. Visa liberalization has a symbolic significance in terms of the perception of Turkish citizens regarding being accepted by Europe. In addition and more critically, it has a pragmatic significance since the cumbersome procedures for the visa application create an undue burden for Turkish citizens who wish to engage in business transactions with EU counterparts. Road transport quotas are also another cumbersome issue posing a barrier in the free movement of goods from Turkey to the EU, which are also mostly goods produced by European companies investing in Turkey. This issue also needs to be resolved before the modernization of the Customs Union goes through. The third issue is the movement of persons for the provision of services, which is also a related issue that needs to accompany any reform of the Customs Union and/or the bilateral trade framework between Turkey and the EU to services.

How can a reformed Customs Union overcome the ‘asymmetry problem’ in the context of FTA’s?

In a reformed Customs Union the joint decision-making and dispute resolution mechanisms will need to be better structured. Regarding the problem of asymmetry, Turkey’s participation into the EU’s trade policy-making process as an observer could provide for an impetus regarding the modernization of the Customs Union. Turkey cannot be a voting member since it has not yet acceded to the EU. However, the presence of Turkish officials and continuous exchange and dialogue between them and their EU counterparts would have the effect of integrating Turkey further into the policy-making process of the EU in the area of trade policy. This could contribute to a gradual Europeanization of policy-making in Turkey and better align Turkey’s trade policy to that of the EU.



Dr. Erdal Yalçın

I Economic Specialists - Expert Interview I

Dr. Erdal Yalçın

Deputy Director

Center for International Economics (Ifo)

What is expected to change in sectors like agriculture, public procurement and services?

The modernization of the Customs Union between the European Union (EU) and Turkey on the agricultural and service sectors would have a strong and positive welfare effect on the Turkish economy. Gross Domestic Product (GDP) could rise by an additional 1,84% and Turkish exports to the EU could increase by almost 70%. However, the rise in exports would vary from sector to sector. Whereas exports to the EU could increase by 95% for the agricultural sector and 430% for the service sector, a fall in exports is to be expected in industrial sectors. By modernizing the Customs Union there will be a re-allocation of resources away from industry toward the service sector. Furthermore, the increase in exports to the EU will be the result of a sharp decline in Turkish exports to other countries. A deepening of the customs agreement could lead to per capita income growth of €158.

How will a reformed Customs Union help increase welfare in Turkey and Europe, compared to a basic Free Trade Agreement (FTA)?

If Turkey and the EU additionally mitigate the asymmetric aspects of the EU-Turkey Customs Union with respect to third countries, a modernization of the trade accord can result in even higher welfare gains.

A modernization of the EU-Turkey Customs Union including the elimination of asymmetric market access regulations with respect to third parties and the conclusion of basic FTA's between Turkey and the EU's new trading partners could result in a 2,13% rise in welfare for Turkey. Such a trade policy could increase per capita income in Turkey by almost €184. If Turkey is able to conclude FTA's as comprehensive as those concluded by the EU with the third countries, there will be a potential GDP growth of 2,5%. This would currently correspond to a nominal GDP increase of €16,6 billion.

The rollback of the existing EU-Turkey Customs Union to a bilateral FTA represents another trade policy option; however, this would result in a fall in welfare in Turkey. There would be a drop in GDP of 0,81%. In addition, new EU FTA's with third parties as Japan or the Southern Common Market (MERCOSUR)¹ would lead to a further drop in welfare of 0,96%. The main reason for this is the decline in European-Turkish production networks resulting from a rollback of the Customs Union to a FTA. Due to the need for certificates of origin in FTA's, European companies deem Turkey to be an increasingly unattractive location for the production of intermediate goods. Even if Turkey concludes FTA's with the EU's new partner countries in such a scenario, this will not lead to better welfare effects than in case of modernizing the existing Customs Union agreement. Although Turkish exports to the corresponding third countries will increase, since the problem of asymmetry would no longer exist with a FTA, trade with the EU would at the same time decrease, which is of greater importance due to current trade volumes. A rollback of the Customs Union to a FTA

¹ MERCOSUR is a sub-regional bloc. Its full members are Argentina, Brazil, Paraguay, Uruguay and Venezuela (which was suspended on December 1, 2016).

is not a wise trade policy for Turkey in comparison to the alternative of modernizing the Customs Union.

How does the German political landscape look vis-à-vis Customs Union reform with Turkey – do various institutions, groups and parties have different views on the matter?

During the last three years, when serious discussions about the future EU-Turkey economic relations were discussed, all relevant parties expressed their support for a modernization of the Customs Union per se. If some stakeholders have expressed their reluctance, this was generally related to very specific interests. A difficult area in the negotiations can for example be transport quotas for Turkish trucks in some transit countries like Austria. Equally, there has been an increasing divergence among EU member countries in how far the EU should introduce a visa-free travel for Turkish citizens. While the latter remains a crucial and important aspect of a well-functioning modernized Customs Union, it does not represent an insurmountable obstacle.



Prof. Canan Balkır

I Economic Specialists - Expert Interview I

Prof. Canan Balkır

Head of the Department of EU Studies and Jean Monnet Chair in European Economic Integration
Dokuz Eylül University (DEU)

How do you see the impacts of a reformed Customs Union on EU-Turkey relations?

The Turkish economy has a long-term economic relation with the EU under the Customs Union. The EU became Turkey's number one trading partner and Foreign Development Investment (FDI) source. The Customs Union has served as an external anchor for the transformation of the Turkish economy, but obligated Turkey to adopt large parts of the *acquis*, without participating in the EU decision-making and consultation mechanisms. This asymmetry has raised the question as to whether Turkey is an insider or outsider in the EU's trade deals with the third countries, but was accepted because the Customs Union is conceived as an interim agreement before Turkey would become a full member of the EU. However, Turkey's accession was not realized and EU's trade policy changed drastically, as a result of which the Customs Union became less equipped to deal with the present global challenges. Turkey began to face significant trade disadvantages both in third countries with which the EU has Free Trade Agreements (FTA) and in the EU.

The scope of the Customs Union remains narrow, and areas such as agriculture, services and public procurement can provide trade benefits to both parties. Many trade irritants can be handled and an effective dispute settlement mechanism can be established. All this will result in increasing welfare on both sides. Thus, achieving an upgraded and comprehensive Customs Union will be a functional form of integrating Turkey to the EU. The economy has always underpinned the relations between the EU and Turkey and upgrading the Customs Union may help to unleash the hindered economic potential between the parties, and open the way to positive dialogue on political issues.

Will an upgraded Customs Union face global and domestic economic challenges?

The biggest challenge would be if the EU decides to suspend accession negotiations with Turkey over concerns that Turkey no longer meets the Copenhagen political criteria. This will end all the good efforts, not only to upgrade the Customs Union, but also the potential of positive political dialogue between the EU and Turkey. It will have a negative impact on the perception of the Turkish people, who have been already disheartened by the rise of populism in some EU member states, complemented by Turcophobia and Islamophobia. This might lead Turkey to drift away from the Copenhagen criteria, while discouraging efforts to upgrade the Customs Union. In that eventual case, as the anchor to the EU loosens, the continuity of the structural reforms becomes problematic. This will not affect only the Turkish companies but also the European FDI in Turkey.

The upgrading of the Customs Union should not be intertwined with political claims coming from the EU, which will reduce Turkey's eagerness for structural reforms crucial for the successful upgrading process. The process should proceed in sincerity and determination with close cooperation between the public sector and the representatives of the related sectors of the economy of both parties.

The main domestic challenge that would obstruct the upgrading of the Customs Union will be the increase of terrorist threats to Turkey, and unrest in Turkey, which will leave little room for economic considerations. Unfortunately, the relationship between the domestic issues and external problems including the relations with the EU are becoming more intertwined and problematic, and needs a positive approach on both sides to break this vicious circle.

What do you regard the most contentious areas of the negotiations?

The Customs Union does not cover primary agricultural products, services and public procurement. The EU has been concluding FTA's, including primary agriculture with third countries, eroding Turkey's preferences. The negotiations on agriculture might not be easy, as the level of external trade protection of both parties differ, and Turkey's domestic support policies are not totally consistent with the Common Agricultural Policy (CAP). As for the services, although trade regulatory regimes for services in both parties share similar levels of openness, there are differences in many sub-sectors. As for the public procurement, resorting to exclusions and exemptions, and the issue of thresholds, domestic price preferences may be some of the contested issues.

Further trade integration between the EU and Turkey is in the interest of both parties and upgrading the Customs Union will pave the way if it is complemented with visa liberalization. It would be unacceptable for the continuation of the visa in an upgraded Customs Union involving the liberalization of services.

Customs Union: Where do we stand?

The creation of the EU's most important foreign Customs Union marked the end of the transition period stipulated in the Ankara (Association) Agreement from 1963¹.

The establishment of the Customs Union with the EU was a milestone in Turkey's liberalization process and its integration, not only with the EU, but also with other partners in the global economy. It helped the governments override the political pressure of domestic interest groups that were lobbying for trade protection and closure at the time.

When the Customs Union Decision (1/95 of the Association Council) came into being, Turkey faced domestic opposition, many of which agreed with the hypothesis that Turkey's industries were not sufficiently equipped to cope with the competitive pressures from the European industries. The results proved the contrary, as most analysts (including previously unconvinced economists) today acknowledge the structural and institutional impact of the Customs Union decision in terms of developing Turkey's economy. This is particularly relevant when looking at how it helped increase regulatory standards and raise the competitiveness of Turkish manufactured products. The trade integration between the EU and Turkey has quadrupled in the last two decades and the Customs Union impetus is also believed to contribute to overall factor productivity increases, FDI stocks, and export performance in Turkey².

Most economists would agree that radical moves toward pluralism were greatly facilitated by structural changes taking as a case reference the signing of the Customs Union in 1995. Analysis shows how this cementing policy led to growth, and societal transformation in Turkey that facilitated what has since been referred to as the 'golden days' of EU-Turkey relations throughout the 2000s. This correlation is particularly evident when analyzing the years prior to starting the accession negotiations and during the mid-2000s, which show a clearly defined causal relationship between economic relations and institutionalized political ties.

The Customs Union also enabled EU companies to increase their access levels to the Turkish domestic market, ultimately leading to a rise in manufacturing sector employment across the EU.

The bulk of the gains came through positive integration that facilitated the transformation of Turkish industry, based on Turkey's alignment of the regulatory standards with the EU's legislation in fields ranging from technical regulations to competition policy. Technically speaking, this led to direct effects, measurable immediately both in legislative, economic, institutional and social terms. From a political viewpoint, the Customs Union was largely acknowledged in Turkish domestic policy circles as a political step towards full EU membership, often ignoring its technical aspects and limitations.

1 All member countries of the EU are part of the European Union Customs Union, while the EU is also in separate Customs Unions with Andorra, San Marino and – most noticeably in terms of economic weight and singularity – Turkey.

2 The World Bank Report, Evaluation of the EU-Turkey Customs Union, No.85830-TR.

“ The Memorandum of Understanding from May 2015 clearly highlights the need to modernize the Customs Union to make it sustainable. It should be considered the first and very important ‘step toward preventing the impending breakdown in economic and trade relations between the two regions.’”

First of all, the Customs Union is a dynamic process towards further integration. In order to have more functional gains, it needs to be expanded to integrate other sectors of the economy including major areas like services and agriculture. This is particularly relevant in order for the EU and Turkey to fully reap the untapped potential of a deepened bilateral economic relationship. It should also be further developed in order to bring more coordinated policies and further harmonization of rules beyond the steps stipulated in the original Customs Union decision and its annexes.

Secondly, the Customs Union has not developed in a solitary vacuum over the past two decades. Economies have changed and trade routes are shifting rapidly. It can therefore not continue in its current form without taking into account global economic developments such as increasing competitive pressure as a result of the rise of emerging economies, augmented assertiveness of non-tariff and regulatory barriers that need to be tackled, changing patterns of global production chains as well as the need to conclude new trade deals with other partners. From an economic perspective, it should be noted that Turkey continues to face difficulties tied to trade asymmetries. This important case is linked to its exclusion from trade deals between the EU and third countries, an element which is likely to create a structural trade wedge between the EU and Turkey. We may already be seeing the undesirable political effects of these deep and structural economic differences that may get worse if ‘left unrepaired’ for much longer.

Despite its long-term impacts, the Customs Union between the EU and Turkey was never designed as a full-fledged mechanism for a long-term relationship. Instead, it was scheduled as a transitional arrangement towards the EU, while not being technically built to resist twenty-one years of economic global changes. And as time passed, these institutional deficiencies became more visible, which is increasingly obvious when looking at today’s need to reduce asymmetries in the decision-making processes and to bolster the effectiveness of consultation mechanisms.

Ultimately these can be achieved through a process of mutual political consensus. The Memorandum of Understanding from May 2015 clearly highlights the need to modernize the Customs Union to make it sustainable. It should be considered the first and very important ‘step toward preventing the impending breakdown in economic and trade relations between the two regions’³.

Next step: Which direction for EU-Turkey relations?

Based on the Ankara Agreement, a reformed and new Customs Union between Turkey and the EU must be geared towards strengthening EU-Turkey integration, both economically and politically. The Customs Union must reflect domestic and global expectations of all sides involved, particularly in light of rapidly evolving geopolitical and economic trends. This is relevant as they appear to affect EU countries and Turkey equally, including their electorates, business communities and civil society.

The preliminary economic and political considerations on both sides will be shaped throughout the subsequent negotiations, once they are agreed upon and officially start. However, for policy-makers and involved legislators this initial process should consider a range of critically important factors to avoid preliminary mistakes that can deeply affect the institutional process, relevant stakeholder and business communities.

- With the aim of achieving a reformed and fully-functional Customs Union, the following points are influential in shaping expectations and its success:
- Turkey is integrated into European value chains; therefore any loose integration model may not suffice to satisfy demands of market actors;

³ Gabriel Felbermayr, Rahel Aichele, Erdal Yalcin (2016) ‘EU-Turkish customs union: How to proceed’, <http://voxeu.org/article/eu-turkish-customs-union-how-proceed>

- The nature of “new generation” trade agreements is changing to be expanded into broader areas (agriculture, trade in services, public procurement etc.) and deeper regulatory issues;
- Regulatory harmonization is becoming a major part of any economic integration arrangement. This requires improved co-ordination of policy processes. In the case of the Customs Union between Turkey and the EU, a more effective consultation mechanism to facilitate Turkey’s compliance of the EU’s ever-increasing legislation is indispensable;
- Turkey is expected to grant tariff-free access to goods from a third country with which the EU has negotiated an FTA, without necessarily having a vote or say in the negotiations. Turkey expects to be taken on board either by means of parallel FTA negotiations with partners in line with the EU, or its products are considered to be originating from the EU in case of exportation to the EU’s FTA partners’ market;
- The institutional weaknesses or flaws attributed to the transitional nature of the Customs Union, or insufficiencies stemming from political choices, need to be repaired to mitigate negative consequences.

Impact assessments by both parties and independent empirical studies put forward several alternative routes for a possible new framework in Turkey-EU relations. The alternative scenarios proposed in the studies largely converges around **three main alternative assumptions**, with some variations:

- The first alternative will be **to keep the status-quo** without deepening the current economic sectors of the Customs Union into broader areas. It would continue with industrial and processed agricultural good only and have no changing impact on the current FTA asymmetries. According to the study by the German Ifo Institute (GED Study)⁴, this route will bring almost no welfare increase (in fact a marginal decrease is expected) while also lowering GDP for Turkey. It will bring a negligible increase in the EU’s welfare and Turkish exports destined to the EU market will decline if the EU successfully concludes its third country FTA’s. In the meantime, Turkey would continue to encounter problems in sectors like metals and transport-equipment.
- The second alternative is the **rolling-back of the Customs Union to an FTA or a DCFTA**. Under this scenario two options can be considered: the current Customs Union is transformed into an FTA for industrial goods or it becomes a DCFTA in which trade in all goods (industrial, agricultural etc.); trade in services are liberalized and public procurement markets are bilaterally opened. As far as the EU FTA’s are concerned, Turkey would no longer face asymmetrical challenges, as it would be able to apply its tariffs towards third countries in full sovereignty. It will however have to continue considering the costs associated with the complex rules-of-origin arrangement that need to be integrated.

Despite varying assumptions and modelling, all studies show that the result of this will be a significant drop in welfare and in GDP (0.81-1.21% in the GED study). According to Turkey’s analysis, a decline is also foreseen in the eventual case of downgrading the Customs Union to an FTA, whereas a DCFTA could raise the GDP by 1.6%. However, this welfare increase will not be as high as in the deepening (third scenario below) of the Customs Union. Similarly, the EU’s impact assessment also reveals that Turkey can have a marginal GDP gain under a DCFTA, but confirms that negative income effects are likely for many sensitive sectors.

4 Yalçın, Aichele, and Felbermayr (2016), Turkey’s EU integration at a crossroads’, GED Study, Bertelsmann Stiftung, available at: https://www.bertelsmann-stiftung.de/fileadmin/files/BSt/Publikationen/GrauePublikationen/NW_Turkey_s_EU_integration.pdf

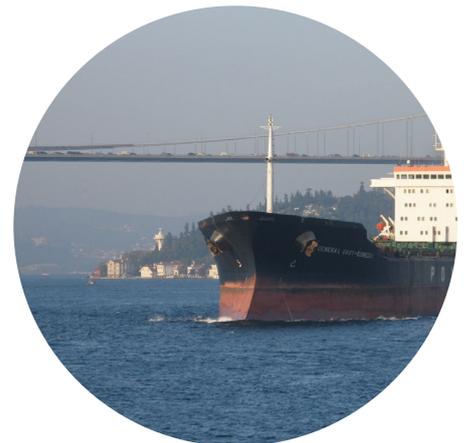
- The third alternative offers a **reformed Customs Union** that maintains the existing structure for industrial goods unchanged, while trade in agriculture and fishery products (partly or in full), trade in services⁵ (and establishment); non-tariff barriers; and public procurement is opened and liberalized under a modernized agreement.

The studies reveal that the highest gains in terms of welfare increases and GDP are made under the third scenario, while also demonstrating that a real change will occur in bilateral exports increase. According to the EC's impact assessment, the GDP increase in Turkey will be sizeable at 1.46% (though some sensitive Turkish agricultural sectors will end up with severe competitive pressures), and 1% to 1.9% in Turkey's assessment analysis. The GED study also proves that the welfare gain will be significant for Turkey in the case of a partial and comprehensive deepening. However, the highest gains are obtained for both Turkey and the EU (almost 2.5%; and 0.73% respectively) if this scenario is coupled with a case where Turkey can conclude basic or equivalent FTA's with partners of the EU.

An extension of the EU-Turkey Customs Union to the agricultural and service sectors would therefore stand to benefit both sides greatly, both in terms of diverse business sectors as well as wider societal welfare gains that affect individuals from across the EU and Turkey. The strong welfare correlation and positive economic growth effects on the Turkish economy are calculated at 1.84% GDP increase, while exports to the EU could increase by 70% overall.

The figures in the independent assessments illustrate that an enhancement of the Customs Union (i.e. third route) will bring further benefits compared to alternative scenarios like keeping the status-quo or a roll-back to an FTA or even a DCFTA, despite some of its advantages like mitigating asymmetries from EU FTA's.

Overall, it should be noted that the Customs Union reform carries both the economic advantages mentioned above, but also deep institutional, pluralistic, mitigation and political advantages. It plays an important co-anchor in economic terms to regain trust, institutional checks, and much-needed regional relations through trade, growth and institutionalism.



⁵ It should be noted that a strong impact will take place as a result of the service sector liberalization, which represents approximately 70% of the Turkish economy. This sector, more specifically, penetrates various layers of economy and employment. Its reform and exposure to EU rules and regulations are likely to dramatically increase intra-regional trade, as well as multi-layered positive societal impact. Similarly, visa liberalization – which is widely regarded as a complimentary step to the opening of trade in services – can equally help foster improved economic and social ties between the EU and Turkey.

I Recommendations I

Conclusion.

The impact of the Customs Union has been assessed empirically to be positive overall. It especially helped drive the Turkish manufacturing sector to improve its competitiveness; raise its factor productivity; as well as to motivate reforms in Turkey to comply with EU legislation. Besides market integration, Turkey's compliance with the EU acquis in areas relevant to the functioning of the Customs Union (i.e. beyond-the-border issues) helped provide a deeper policy integration, which reduced the cost of compliance for Turkish companies to operate in European and global markets, while becoming more involved in European value chains.

It also allowed European businesses to benefit from developments in the Turkish economy, while simultaneously raising the income level of Turkish people. Turkey's implementation of its commitments reduced trade barriers and helped European firms gain a smoother access to an emerging Turkish economy. The Customs Union enabled European industries (not only their Turkish counterparts) to use the opportunities of economies of scale, while the bilateral trade framework - largely shaped by the Customs Union - increased the value of trade by more than fourfold and allowed investments to grow dramatically.

However, the success of the bilateral framework has been diminishing and underperforming in recent years due to the lack of reform. The original Customs Union gradually became less effective in dealing with new and dynamic challenges arising from global developments and their domestic repercussions.

According to the EC's own impact assessment: "the Customs Union has become less well-equipped to deal with modern day challenges of trade integration". In Turkey, this is becoming visible in terms of how the domestic market and policy community are becoming increasingly vocal about inefficiencies linked to an unreformed Customs Union, especially when dealing with the EU's new FTA's.

Despite being an important agreement, the Customs Union was initially designed for a transitional period and as a result of trade diversion and global shifts it is now losing its bonding purpose and institutional strength as a win-win economic structure. Hence, it is clear that the current Customs Union suffers systemically from diminishing economic and institutional returns as a result of an unfinished architecture, both in terms of decision-making, arbitration, market openness, settlement of disputes, trade diversion and the other areas mentioned throughout the report.

As Turkey is unlikely to accede into the EU for the foreseeable future, it becomes ever more urgent to cement and repair institutional relations within the economic framework of the Customs Union, particularly to avoid an exacerbation of political tensions and a further deterioration of relations. The future trajectory of EU-Turkey relations therefore requires strong tools to intervene in order to redress these uncertainties. Accession negotiations are currently on hold and at a stalemate, while visa liberalization requires further motivation from both sides. In this context, a reformed Customs Union not only provides a tangible and structural solution, it also serves as an important vehicle of mutual trust and societal benefit.

“ It becomes ever more urgent to cement and repair institutional relations within the economic framework of the Customs Union.”

“ A reformed Customs Union not only provides a tangible and structural solution, it also serves as an important vehicle of mutual trust and societal benefit.”

On the EU side, the Customs Union reform will act as a vital part of ‘principled pragmatism’ by both serving as a regional anchor of foreign policy in economic terms, while also providing multilateral and soft-power institutions and mechanisms that will help uphold the rule of law inside Turkey. Civil society, social partners, and non-governmental organizations will have to effectively feed into the negotiations with identified flanking measures, to compensate for possible negative impacts and to assure legitimacy and public democratic scrutiny in Turkey.

However, it should be considered illogical to believe that the Customs Union negotiations can only start once specific political or democratic criteria have been satisfied. On the contrary, the Customs Union will only contribute in support of Turkish democracy, rule of law and the protection of human rights through its actual implementation and as a medium to long term effect – not as an ‘opening carrot’ in a transactional relationship.

Recommendations.

The recommendations (see table and numbered recommendations for more information) are expected to correct the deficiencies in the existing Customs Union structure by releasing unfulfilled trade potential; mitigating an insufficiently predictable and stable trading environment; and preventing poor implementation of the commitments, while also taking into consideration rule of law and societal transparency.

The recommendations surrounding trade widening, asymmetries and political issues are the following:

1. Widening trade: The reformed bilateral trade agreement needs to be broadened into all areas of trade to reap the maximum societal and economic benefits. It can be extended into new areas by means of establishing a DCFTA in primary agricultural goods, trade in services, and public procurement. Liberalization of digital trade can also be considered to make the new trade framework become more relevant to technological developments. However, only by reforming the Customs Union will a real increase in economic interdependence occur in both institutional, social and commercial areas. In this context, an improved functioning of the Customs Union in sectors like services, governmental procurement, agricultural sectors, and investments will help re-structure and cement the long-standing economic and political relationship. Simultaneously, all impact assessments show a significant welfare increase in the case of a reformed Customs Union.

A further alignment by Turkey of the European acquis will definitely improve predictability in business environment and investment climate. However, alignment requires more effective operation of consultation mechanisms, notifications, and institutional coordination.

2. Reducing asymmetries: The elimination of asymmetries by including Turkey in EU committees with respect to the FTA’s with third countries will encourage Turkey to fully harmonize its commercial policy. A joint World Trade Organization (WTO) linked coordination mechanism can be improved to help parties formulate a common action vis-a-vis WTO infringements by third countries. A lower level of trade asymmetry is likely to boost EU-Turkey relations by naturally allowing Turkey to participate in a more favorable economic climate and architecture that doesn’t unnecessarily disfavor entrepreneurs and businesses. Appealing to Turkish domestic business by rectifying an unfavorable economic agreement will serve as a political trade anchor and a way to avoid regional instability and Turkish discontent.

3. Settlement of disputes: This will prove important to institutionalize a non-politicized relationship in which arbitration and independent courts settle trade issues between the EU and Turkey. Currently the Association Council is the main settlement dispute mechanism when it comes to EU-Turkey relations, but ideally a Customs Union reform will implement technical arbitration to avoid political stalemate. It is likely that a reformed Customs Union will include new non-politicized provisions about mandatory judicial settlements, which will help settle issues concerning truck drivers and market openness. It is also likely to foster a concrete incentive for Turkey to work towards solving several trade issues.

4. Political issues: The Customs Union reform is likely to indirectly strengthen rule of law, transparency and good governance. From a foreign policy perspective, the EU may wish to move forward with the Customs Union reform as a domestic chance to boost welfare and growth, while cementing its economic regional alliance with Turkey against possible competitors. Both are likely to appeal to domestic electorates if properly communicated by national and EU leaders.



Types of Issues, Recommendations and Urgency Ranking Surrounding Customs Union Reform

| Issues | Recommendation | Urgency (rising from 1 to 5) |
|------------------------------|--|---------------------------------|
| Widening Issues | | 4/5 |
| Agriculture | <p>Tariff peaks and high tariffs should be curtailed.</p> <p>Domestic subsidies in Turkey can be regulated in line with the EU, while Common Agricultural Policy (CAP) alignment can further increase the gains.</p> <p>Export subsidies must be phased out in line with the schedule set out in WTO Nairobi MC.</p> <p>Agricultural adjustment costs will be high for Turkey. The issue needs a coordinated action between parties.</p> | 4/5 |
| Services | <p>Visa liberalization is essential especially in the context of free movement of services and freedom to provide services.</p> <p>Commitments on Mode 4 could be achieved for the entry and residence of professionals and to facilitate the provision of services.</p> | 5/5 |
| Public procurement | <p>Turkey must phase out public procurement thresholds and domestic price preferences. Transitional periods can be provided by consensus.</p> <p>Turkey's accession to WTO Agreement on Government Procurement can be encouraged.</p> | 4/5 |
| Investments | In view of the 2030 Agenda for Sustainable Development, parties can consider principles and provisions to facilitate investments that advance sustainability. | 3/5 |
| Digital trade and e-commerce | The updated agenda can include a chapter on the regulation and liberalization of digital trade and e-commerce. | 4/5 |

| Asymmetries and Institutional Issues | | 5/5 |
|--|---|-----|
| Decision making | <p>Turkey's effective participation in decision-shaping mechanisms (i.e. all relevant committees and agencies in areas directly relevant to the new framework) is very important to avoid structural asymmetries. This is essential to maintain a sustainable and stable economic and political relationship.</p> <p>The Customs Union Joint Committee (CUJC) must meet as stipulated in the 1/95 Decision and be empowered to take decisions necessary to eliminate trade irritants. It should adopt updated lists of EU instruments relating to the removal of technical barriers (acquis) that Turkey has to incorporate into its legal order.</p> | 5/5 |
| Consultation mechanism and notifications | <p>An effective and sustainable information sharing process is important for consultations, transparency and mutual trust.</p> <p>It would be helpful to allow Turkish authorities to participate – as an observer – to all relevant committees, including those in the widened areas. This will help Turkey in terms of economic convergence and legislative harmonization.</p> <p>A direct registration possibility for Turkish firms to the European Chemicals Agency (ECHA) may prove useful.</p> | 4/5 |
| Dispute settlement | <p>The EP's offer "for an effective dispute settlement mechanism to operate within a framework of impartiality and legal certainty in keeping with the rules and practice of the WTO" should be seriously considered.</p> <p>Efforts to find a 'mutually acceptable solution' can continue as stipulated, but fundamentally remains insufficient in many cases. A functional mechanism is needed to resolve questions by way of judicial settlement of disputes. A special arbitration procedure limited to certain issues should be extended into other areas, including agriculture, services and public procurement.</p> <p>The mechanism should allow either party to start the process unilaterally.</p> | 5/5 |

| | | |
|----------------------------------|--|------------|
| New monitoring mechanism | This mechanism should be established jointly to monitor the alignment and implementation by Turkey of the EU acquis, while also serving as a way to verify whether new protectionist measures or irregular practices are implemented by either side. | 3/5 |
| Free Trade Agreements | <p>The elimination of asymmetries will result in further welfare gains for both sides if Turkey can sign FTA's in parallel with the EU.</p> <p>In order to realize parallel negotiations, the EU should encourage unwilling partners to conclude similar deals with Turkey, while adding an incentive for Turkey to liberalize.</p> <p>A non-binding consultative joint-committee under Trade Policy Committee can be set up to provide coordination of FTA's with third parties (FTA coordination committee) for example.</p> | 5/5 |
| Other Issues | | 3/5 |
| Road transport quotas | <p>The transport quota issue should be resolved before the Customs Union is reformed. For the transport sector the reform is not the target in itself – but transport quotas are cumbersome issues which are costly not only to Turkish firms but also for European consumers.</p> <p>Ideally, this issue is tackled by investigating ways to eliminate social and security problems in the transport sector.</p> | 3/5 |
| Intellectual property protection | During the negotiations, Turkey's need for capacity building in effective implementation of intellectual property rights should be considered. | 3/5 |
| Trade defense instruments (TDI) | It is advisable to search for ways to coordinate the use of TDI's and eliminate mutual anti-dumping and anti-subsidy investigations. | 3/5 |

| Political Issues | | 4/5 |
|--|--|-----|
| Values (democracy, human rights and rule of law) | The current climate in Turkey is unlikely to respond positively to increased EU pressure concerning democracy. However, it is advisable to focus on a reformed Customs Union in order to improve Turkish rule of law, transparency and good governance over the long-term. The blocking of Customs Union reform is likely to lead to Turkish isolation from European norms and values. | 3/5 |
| Regional alliance-building | Considering the regional reality of competing economic and political alliances, the reformed Customs Union can provide a safe counter-measure, or counter-anchor, against possible competitors. | 4/5 |
| Cyprus | The suspension of 'Cyprus-related' chapters in accession negotiations with Turkey did not prove to have any positive or desired effects. It is therefore not advisable for specific EU countries to use Cyprus as a blockage point for a reformed Customs Union which will disadvantage the majority of EU countries and their entrepreneurs, while further complicating regional alliances and stability. | 4/5 |

