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TÜSİAD-KOÇ UNIVERSITY ECONOMIC RESEARCH FORUM  
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TAKING STOCK: THE CUSTOMS UNION BETWEEN TURKEY  
AND THE EU FIFTEEN YEARS LATER

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# **Taking Stock: The Customs Union between Turkey and the EU Fifteen Years Later**

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## **Abstract**

This article focuses on the customs union (CU) already in effect for almost a decade and a half now and links the impact of the CU with the sources of support as well as resistance within Turkey to further integration with the EU. Overall the CU had a positive impact on Turkish economy through improved productivity in manufacturing industries. While the increased import penetration after the CU increased the competitive pressure on several industries in the short run, this short-run impact helped them improve productivity in the medium- to long-term. The CU also led to significant improvements in the implementation of competition policy with additional positive effects on Turkish economy. With increased productivity and competitiveness manufacturing industries was able to weather the storm during 2001 economic crisis and in the wake of Chinese entry to world export markets. However, following the successful initial adaptation phase and the significant changes in the EU's trade policy framework towards preferential trade agreements, the CU has started to generate some strains on Turkish trade.

**Keywords:** Turkey, European Union, Customs Union, Free Trade Area, Welfare analysis, Computable General Equilibrium, Exports, Imports.

**JEL Codes:** F14.

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## **I. Introduction**

The 1990s was a lost decade for Turkey. Macroeconomic environment that could not be fully stabilised in the 1980s deteriorated further, leading to the economic crisis of 1994. With some quick fixes and financial support from the IMF, the economy went back to 'normal' within a year. However, as is always the case, quick solutions produced no lasting improvements: macroeconomic conditions deteriorated further over time, sowing the seeds of the 2001 crisis that brought the country to the brink of collapse.

Aside from increased political and economic uncertainty, the 1990s also witnessed the formation of the Customs Union (CU) between Turkey and the EU in 1996, an important milestone in Turkey's integration with the EU. Turkey was the first country to sign a CU agreement with the EU without being a full member and with very little financial support from the EU. However, we need to emphasize that Turkey was not forced by EU to sign the CU agreement. Turkish elites preferred to go ahead with the CU, because they wanted to successfully conclude the final phase of the Ankara Agreement that was signed between Turkey and the EU in 1963. Instead of seeking for an alternative preferential trade arrangement with the EU, they preferred the CU because it gave them the opportunity to pursue the economic integration with the EU without undertaking serious political and institutional reforms viewed as a precondition for the full membership.

This article provides a thorough analysis of the impact of the CU on the Turkish economy. The paper also aims at linking the impact of the CU on different industries and segments of the society towards the identification of the sources of support as well as resistance within Turkey to further integration with the EU. In section II, we provide a review of the Customs Union decision and discuss its major elements. In section III, we analyze the effect of the CU on tax revenues, on Turkish trade flows, on sectoral and aggregate production and productivity, on the overall welfare and on the welfare of different segments of the society. Section IV concludes the paper.

## **II. The Customs Union Decision**

The agreement to form a Customs Union between Turkey and the EU was signed in March 1995. However, the history of the Customs Union between Turkey and the EU goes back to September 1963, when the institutions of the EU-Turkey Association Council were established by the Association Agreement, signed in Ankara (also called as "Ankara Agreement"). Ankara Agreement initiated a three-stage process that would lead to the formation of a Customs Union. The first (preparation) phase of the process was aimed at strengthening the Turkish economy so that it would be ready for the second phase. The second (transition) phase of the Customs Union agreement was initiated by the additional Protocol of 1970. The European Countries eliminated all duties and other restrictive regulations with respect to imports from Turkey. Under the Ankara agreement and the additional protocol of 1970, Turkey accepted to go through an adaptation period of 12 years to meet its obligations stemming from the CU and a transition period of 22 years for lowering protection on its sensitive industrial products. While Turkey initially

fulfilled its promises to the EU, from 1976 to 1988 it had undertaken no further tariff reductions. Even though it had started to implement promised tariff cuts reductions after 1988, by 1995 Turkey was not able to achieve all of its promised tariff cuts. In its March 1995 meeting, the EC-Turkey Association Council decided to initiate the final phase of the process and establish the Customs Union as of January 1, 1996. In this final phase, the critical trade policy actions were expected from the Turkish side as the EU had already eliminated tariffs on Turkish imports in the first two phases.

The CU agreement assumes the adoption of a common customs policy and thus by signing it Turkey accepted to impose common external tariffs of the EU against the third countries. The EU accepted to eliminate quotas facing Turkish exporters of textiles and clothing. The Customs Union has more serious implications for Turkey compared to other forms of associations such as Free Trade Agreements (FTA) or Preferential Trade Agreements (PTA). As Turkey's EU membership process continues, it is expected to include service sectors as well as the public procurement and the agriculture. As such, the CU also entailed harmonisation of the Turkish competition policies with that of the EU. The CU agreement required Turkey to adopt the EU competition rules before the agreement went into effect in 1996. As part of the efforts to prepare for the CU, Turkish parliament passed the competition law in 1994, which also established the Competition Authority. This component of the CU potentially has substantial welfare gains for Turkish consumers because both service and industry sectors was at the time characterised by rather high profit margins.

At this point, it is important to discuss why Turkey and EU decided to go ahead with the CU. In the 1980s and 1990s it was the EU's practice to first sign FTAs with candidate countries. The CU is formed only when a candidate country becomes a full member. In its justification for signing the CU agreement in 1995, the Turkish government argued that in the 1963 Ankara agreement the two sides had already agreed to form a CU. The actual reason behind this decision, however, was quite different. In the past Turkey complied very little with the requirements of the Ankara agreement. After 1987, however, Turkey increased its efforts to become a full member of the EU. As its efforts were rebuffed by the EU in successive rounds, the Turkish government thought by finalizing the Customs Union process, Turkey could show everyone that it complies with the Ankara agreement. Turkey could then argue that the EU should also comply with the Ankara agreement and open the accession negotiations with Turkey.

As Öniş (2003) argued quite convincingly there was another, perhaps more important reason for the Turkish government to sign the CU agreement in 1995. The Turkish elites were not ready to undertake significant democratic and political reforms the EU expected Turkey to undertake before the initiation of the accession talks. In the absence of a desire for democratic and political reforms, they viewed the increased economic integration through a CU as a show of strong commitment to full integration of Turkey with the EU (Öniş, 2003, p. 33). Unfortunately, Turkish elites were proven wrong. The CU did not lead to a change in EU's attitude towards Turkey's membership (Öniş, 2000). Turkish government could not fully appreciate the increasing importance of the political and democratic elements in the European integration process. For the EU signing the CU agreement with Turkey was not meant to be a show of its willingness to

accept Turkey as a full member in the future. This attitude was apparent in the Luxemburg summit of 1997, when Turkey's application to be included in the next wave of enlargement was rejected by the EU.

Following the implementation of the CU, Turkish tariff rates on imports from the EU declined from 10.2 percent in 1994 to 1.34 percent in 2001. The tariff rates on imports from FTA partners of the EU declined even more dramatically, from 22 percent to 1.34 percent (Togan, 2000). As a result of the cuts in tariff rates, Turkey's applied MFN tariff rates for industrial products declined to lowest levels among the countries at the same level of development. Tariff rates on imports from non-preferential partners declined from an average of 22 percent in 1994 to 6.9 percent in 2001, whereas tariffs on imports from the beneficiaries of Generalised System of Preferences reduced from 22 percent in 1994 to 2.7 percent in 2001. Turkey's weighted and simple average tariff rates on industrial imports are substantially lower compared to tariffs in countries that joined the EU after the CU (Kaminsky and Ng, 2007).

Before the CU went into effect there was some visible and less visible opposition against the implementation of the CU. Labour unions showed a visible opposition claiming that as a result of the increased competition from imports the CU would lead to job losses in many sectors. In addition, there were some industries, notably the automotive industry, lobbied behind closed doors against the CU. As a result the automotive industry was able to convince the authorities to declare it as a sensitive industry, which enabled Turkey to implement tariffs on auto imports from the third countries above the EU rates until 2001. In addition, with another clause included in the CU agreement Turkey was able to restrict imports of used motor vehicles from the EU for 10 years.<sup>1</sup>

The sharp depreciation of the TL during the 1994 economic crisis was quite instrumental in keeping the increase in imports under control as the CU went into effect in 1996. In a matter of four months from the end of December 1993 to April 1994, Turkish Lira depreciated by 38 percent in real terms. At the end of 1995, the real exchange rate was still 18 percent below its level as of the end of 1993. Compared to its average value for the 1990-1993 period the real exchange rate at the end of 1995 was still 10 percent lower. As a result, even though the tariff cuts on products from the EU led to an increased demand for imports, an undervalued TL curtailed the increase in import demand.

As emphasized by Kaminski and Ng (2007), the CU changed the Turkish trade policy framework completely by bringing in predictability, transparency and stability as well as liberalizing market access for both preferential and MFN suppliers. As a result of the CU, the contestability in the Turkish markets for industrial and agricultural goods increased substantially. The increased contestability and competition in turn forced the domestic producers to become more ready to undertake productivity enhancing investment.

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<sup>1</sup> In August 2008, Turkey extended the implementation period of the import restrictions on used cars indefinitely until Turkey's full EU membership goes into effect.

Even though it has been classified as an emerging market economy, with the Customs Union, Turkey adopted the trade policy regime of a group of industrial countries. The EU member states can afford to apply low tariff rates on imports of goods in the labour-intensive industries. As production in these economies is tilted overwhelmingly towards human capital-, capital-, and technology-intensive industries, they rely on imports in the labour-intensive sectors. However, it is difficult to conclude the same for Turkey which has abundant supply of unskilled labour. As a result, Turkey over time had to learn how to effectively use non-tariff barriers (NTBs) to keep imports from low cost developing countries under control. One of the NTBs that have been frequently used by industrial countries is the anti-dumping duties. With 137 cases Turkey is ranked 10<sup>th</sup> among the WTO members in terms of the number of anti-dumping investigations initiated between 1996 and 2008.<sup>2</sup> The majority of these investigations (102 of them) were initiated between 2002 and 2008.

### **III. The Impact of the Customs Union Decision on Turkish Economy**

In this section we analyze the impact of the CU on Turkish economy from several perspectives. First, we evaluate the size of the impact on the tax revenues from imports which took place immediately as the CU went into effect. Second, we focus on the impact of the CU on Turkish trade flows. Third, we look into how the CU affected production, productivity and employment in various industries. Finally, we evaluate the findings of several studies on the economy wide welfare effects as well as the effects on different segments of the society.

#### *A. Tax Revenue*

Perhaps the most immediate effect of the CU was the tariff revenue loss for the government. There was a decline in import tax revenues as Turkey lowered tariffs on imports from the EU. Import tariff revenues fell from 2.8 percent of total tax revenues in 1995 to an average of 1.1 percent over the period 2001–05 (Taymaz and Yılmaz, 2007). The tariff revenue losses from the CU are not big and for that reason cannot be blamed for the chronic budget deficits of the 1990s that eventually led to the 2001 economic crisis.

The short run negative impact on tariff revenue cannot be used as an argument against the CU for several reasons. First, even if the CU had not gone into effect, Turkey would have to lower its tariffs in the longer run as a member of the World Trade Organisation. While tariff cuts as part of the CU agreement were larger compared to possible cuts that would be required under the world trade negotiations, the difference between the two in terms of the revenue loss would be in the vicinity of one percent of GDP. Second, as part of preparations to the Customs Union in 1996 and following the

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<sup>2</sup> During this period the number of anti-dumping investigations initiated against Turkish exports was only 44.

policy recommendations by the World Bank, the government increased and expanded the application of the VAT to a wider base enabling it to raise the forgone tariff revenues.<sup>3</sup> Finally, the CU agreement also entailed EU providing financial assistance to Turkey in order to compensate for the revenue losses and other effects. However, this promise could not be realised fully due to Greek veto.<sup>4</sup>

### *B. Trade Flows and Increased Competition from Imports*

In the literature it is a well established fact that North-South trade agreements, irrespective of whether it is a CU or an FTA, are more beneficial for Southern countries compared to South-South trade agreements. Because of differences in technology and factor abundance, the sectors in which Southern and Northern countries have comparative advantage tend to be different. Once lower income Southern countries gain free access to markets in their richer Northern trade partners, they are expected to export labour-intensive goods in which they have comparative advantage. In return, they import capital- and human-capital intensive goods in which Northern countries have comparative advantage. The outcome of increased trade based on the comparative advantage is definitely more beneficial for Southern countries (see Harrison, Rutherford and Tarr, 2003).

As the tariff rates on imports brought down substantially, imports from the EU and total imports were expected to increase. That was actually what happened in the first couple of years. Imports increased from \$35.7 billion in 1995 to \$54.5 billion in 2000. Over the same period imports from the EU increased from \$23.7 billion to \$28.5 billion. The increase in total imports translated into an increase in the import penetration rate (the ratio of imports to total sales in the domestic market) from 22.2 percent in 1995 to 27.8 percent in 1996 and almost 29.6 percent in 2000.<sup>5</sup> The increase in the overall import penetration (IP) rate within five years was mostly a result of the CU itself.

The EU had been the most important trade partner of Turkey before 1996. It stayed so over for some time after 1996. However, its share in Turkish imports declined over time and especially after China's becoming a WTO member in 2001 and its full entry into the world export markets. The share of imports from the EU followed a secular downward trend since 1995, from 66 percent to 52 percent in 2000 and further to 40 percent in 2007 and 35 percent in 2009 (Figure 1). Turkish imports from China and the other East Asian countries increased rapidly in the 2000s. From 2.2 percent in 2001, the Chinese share in Turkish imports rose to 7.8 percent by 2007.

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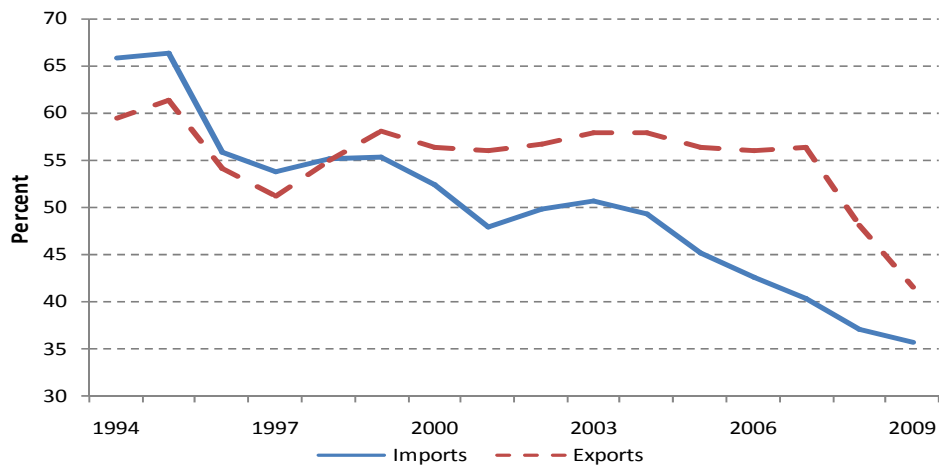
<sup>3</sup> Harrison, Rutherford and Tarr (1997) showed that the tariff revenue losses could be compensated by a uniform implementation of the value added taxes (VAT) across the sectors without any increase in the rates. A longer and a more detailed version of Harrison et al. (1997) was published as a World Bank working paper in 1995.

<sup>4</sup> As part of the Customs Union agreement the EU promised to provide 2.275 billion euros as financial aid (1.507 billion in loans and 768 million euros in grants) to Turkey between 1996 and 1999. However, the actual financial support amounted to only 557 million euros in loans and 52 million euros in grants (source: Turkish Secretariat General for the EU Affairs).

<sup>5</sup> The import penetration rate defined over the imports from the EU increased from 16.5 percent in 1995 to 22.3 percent in 1996 and to 23.6 percent in 2000 (Taymaz and Yilmaz, 2007).



**Figure 1. Turkey's Trade with the European Union (Percent of Total)**



Source: TurkStat

The CU agreement with the EU did not have much impact on Turkish exports in the first five years. The compounded annual growth rate of exports between 1996 and 2001 was 6.2 percent compared to 14.3 percent growth rate between 1980 and 1995. The EU had already removed tariffs on Turkish goods before the CU. In addition, despite the CU, the EU continued to reserve the right to impose antidumping duties on Turkish exports to the EU as well as keeping technical (regulation) barriers (Togan et al. 2005). Coupled with the appreciation of the Turkish lira, it is therefore not surprising that Turkish exports to the EU did not go through a serious surge immediately.

The positive impact of the CU on Turkish exports was realised with a long delay, only after the 2001 crisis. The depreciation of the Turkish Lira and the contraction in domestic demand that followed the economic crisis of February 2001 forced domestic producers to search for export markets. As the CU had already forced many sectors to become more productive, it was not very difficult to find export markets to supplement the collapsed domestic demand during the following 2001 economic crisis. Export revenues increased 12.6 percent in 2001. Exports grew faster in 2002 and 2003 even though the domestic demand resumed growth.<sup>6</sup> Better-than-expected export performance in 2002 and 2003 was achieved despite a 25 percent real appreciation of the Turkish Lira during this period, in part thanks to the appreciation of the Euro against the Dollar.

### *C. Sectoral and Economy-wide Effects on Production and Productivity*

The CU helped further open up Turkish economy to international competition. Trade figures show the changes in the structure of Turkey's foreign trade after the CU. The track record of the Turkish manufacturing industry in response to the CU has been better than initially expected, especially when one considers that Turkey received very little financial support from the EU to help ease the adjustment burden. Actually from 1996 to

<sup>6</sup> Exports grew by 15 percent in 2002, by 31 and 34 percent in 2003 and 2004, respectively and by 16 percent both in 2005 and 2006 (source: Turkstat).

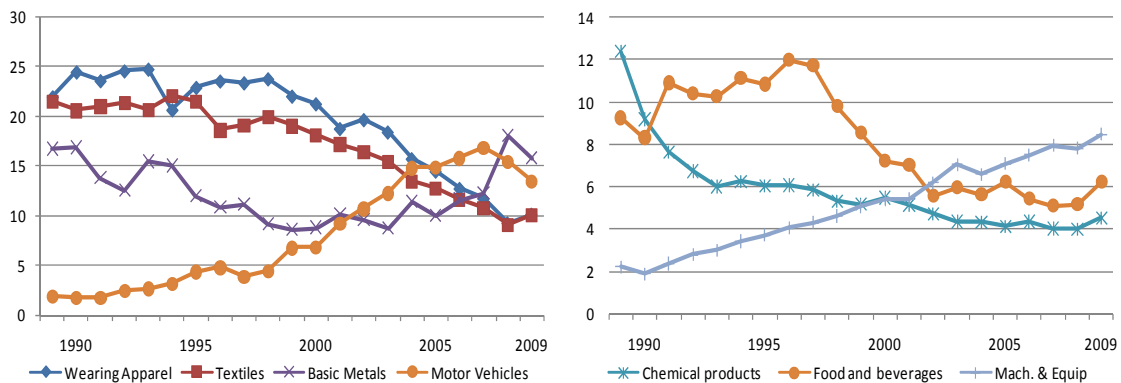
2000, Turkish industry has proven that it had the capacity to cope with competitive pressure from imports. Since 2001, it became apparent that the transformation of the Turkish industry following the CU had helped Turkish industry prepare itself for even more formidable competitors such as China and other East Asian countries.

The increase in imports following the CU was not necessarily harmful for the Turkish economy. From the perspective of the buyers, increase in imports will allow them (mostly consumers) to have access to a greater number of varieties at perhaps lower prices and/or higher quality. The increased competition from imports, therefore, was most likely beneficial for the consumers. On the other hand, the increased competition from imports can be quite harmful for the domestic industry if it were to take place rapidly in the short run. It could have led to factory shutdowns and job losses in the domestic industry, which could have damaged the growth prospects of the manufacturing industry. The official statistics show that this was not the case. Turkish industrial production increased by 10.2 and 15.3 percent in 1996 and 1997, respectively. This was perhaps due to the fact that export-output ratio increased from 21 percent in 1995 to close to 25 percent in the next three years.

The increased competition from imports led to important changes in the behaviour of domestic producers of manufactured goods. Before the CU some sectors such as automotive, durable home appliances, electrical machinery and basic metals had continued to receive protection behind high tariff barriers despite the import liberalisation process that started a decade ago. However, productivity growth in these and other import-competing sectors was higher compared to export-oriented and non-traded goods sectors (see Özler and Yılmaz, 2009). Taymaz and Yılmaz (2007), on the other hand, showed that the total factor productivity in the manufacturing industry as a whole did not increase much between 1996 and 2000, but increased substantially in those sectors that experienced significant increases in IP rates after the CU. This effect was statistically significant even after other variables such as the real exchange rate, the export-output ratio, as well as time variables (time trend or time dummies) were included as explanatory variables for the plant-level total factor productivity.

While the export revenue growth in the first four years after the CU was not very high, exports grew rapidly after the 2001 economic crisis. This was in part due to the disciplining effect of the CU. There were also differences across sectors in terms of export performance. Especially after the China's WTO membership in 2001 took place there has been a secular decline in the export shares of textiles and wearing apparel sectors. Together, two sectors accounted for 45 percent of total exports in the first half of 1990s, which slightly declined to 41.7 percent in the second half of 1990s (see Figure 2). The decline in their relative export performance gained momentum in 2000s as China had become a dominant player in export markets. In 2009, two sectors together accounted for only 20 percent of total exports of Turkey. Food and beverages and chemical products industries were also among the industries that experienced a decline of export shares from close to 12 percent in 1996 to less than six percent in 2009.

**Figure 2. Manufacturing Exports Share for Selected Industries ( percent)**



Source: TurkStat

The export share of the automotive industry (including parts and components) increased from two percent in 1990 to five percent in 1996 (Figure 2). Even though it was expected to be among the most affected sectors the automotive industry benefited enormously from the CU. After stalling for a couple of years after the CU, automotive exports started to increase at a rapid pace (45 percent per year) after the 2001 crisis. As a result, export share of the industry reached to 17 percent in 2007 (Figure 2). Another sector that has increased its export share over time is the machinery and equipment industry. Its export share increased steadily from a low of two percent in 1990 to reach eight percent in 2009. Finally, the consumer electronics exports grew at a rate 28 percent per annum from 2001 to 2005.

The increase in production and exports in the automotive and consumer electronics industries were fuelled by rapid improvements in productivity. Total factor productivity growth in the consumer electronics (and especially in the production of colour TV sets) increased by almost two-thirds from 1995 to 2001. Total factor productivity growth in the automotive industry was slow (less than 15 percent from 1995 to 2000), but improved further since the 2001 crisis by close to 30 percent (Taymaz and Yilmaz, 2008).

The automobile industry is dominated by multinational companies, which has a strong domestic supplier base, and has seized the opportunities opened up by the Customs Union by investing in new product and process technology and learning. The consumer electronics industry, on the other hand, is dominated by a few, large, domestic firms, and has become competitive in the European market thanks to its geographical proximity, productive domestic labour, and focus on a protected and technologically mature segment of the market, which also helps explain the recent decline in industry's fortunes. The substantial differences in the characteristics of the two industries led to significant divergence in their production performances since 2005. The fortunes of the consumer electronics industry are further worsened by the fact that it is losing market share not only in the EU market but also in the domestic market due to rapid switch from tube TV receivers to plasma and LCD TV receivers. As a result, from 2005 to 2008 the production of the consumer electronics industry declined by 55 percent, whereas that of the automotive industry increased by 26 percent.

Focusing back on the trends in the manufacturing industry as a whole, the CU pushed Turkish industry to go through the transformation towards higher productivity much faster than it would have otherwise experienced. In a country which is abundant in low-skilled labour, this obviously does not help bring the unemployment rate down. Most of the productivity gains due to the increased competition from the EU were realized until early 2000s. After 2003, the EU's share in Turkish imports has been decreasing steadily while the share of the East Asian countries has been on the rise. Whatever productivity gains that are accrued since 2000s are mainly due to increased labour productivity in those sectors that faced increased competition from China.

Turkish manufacturing industry achieved higher productivity growth through increased reliance on intermediate input imports from East Asian countries and especially from China (Yükseler and Türkan, 2006). While Turkey conducts approximately 50 percent of its export transactions with the euro, the euro's share in import transactions is less than 35 percent. The appreciation of the euro against the dollar after 2002 enabled Turkish exporters to rely more and more on imported inputs from China and other Asian economies in their quest to keep their production costs under control.

After a long analysis of the impact of the CU on Turkish industry, we can now turn our attention to the problems caused by the asymmetric nature of the CU agreement. As we discussed above, Turkey wanted to use the CU agreement as a strong signal that it was committed to full EU membership objective. As a result, Turkey accepted EU's trade regime as it was and was not able to convince the EU to include a clause which would force EU to consult with Turkey before signing FTA with the third countries. As a result, EU negotiated FTAs with third countries without any involvement of Turkey. As Turkey could not be part of the agreement, Turkey's interests were not taken into account while EU signed the agreement with the third countries. As a result, all FTAs of the EU with the third countries could potentially lead to unfair trade competition for Turkey. Turkey was supposed to sign FTAs of its own with these countries. However, it has proven rather difficult for Turkey to obtain similar concessions as lucrative as EU could receive. Nevertheless, Turkey has signed FTAs with 26 countries or country groups since 1996. As 10 of these countries had later become EU members, the FTAs with these countries were all cancelled. Finally, FTAs that have already been signed with four countries (Montenegro, Serbia, Chile, and Jordan) are waiting for parliamentary approval.

As part of its "Growth and Jobs Strategy" in 2006 the EU adopted a new trade policy framework which aims to enhance competitiveness and increase market share of the EU exports around the world. The EU Commission explicitly declared that it would pursue FTAs with Asian and Latin American countries. Expected FTAs with India, South Korea and other ASEAN countries can potentially be quite problematic for Turkey. If Turkey cannot sign FTAs when the EU concludes negotiations with them, some sectors such as textiles, electronics and motor vehicles will face serious competitive pressures.

Recently, it has become a common practice of some emerging market economies such as Chile to undertake what is called as "additive regionalism" in the literature. Harrison, Rutherford and Tarr (2002) estimate that if Chile were to sign FTA agreements with all its major trading partners, Chile could gain as high as 8% of its GDP in the long

run. This is not a negligible welfare gain. At the moment the CU agreement with the EU prohibits Turkey from negotiating FTA agreements with its other major trade partners independent of the EU. This we can also highlight as a welfare constraining impact of the CU which would have not experienced had Turkey and the EU established a Free Trade Area rather than a Customs Union in 1996.

#### *D. Welfare Effects*

The welfare effects of the CU on the Turkish economy have been analyzed by several studies. All of these studies are based on computable general equilibrium (CGE) models of the Turkish economy.<sup>7</sup> Harrison, Rutherford and Tarr (1997) showed that depending on the implementation of complementary policies, the CU would lead to an increase in Turkish welfare by an amount equal to between 1.0 and 1.5 percent of GDP on an annual basis.<sup>8</sup> This happens despite a loss of tariff revenue equivalent to 1.4% of GDP. They further estimated that the tariff revenue loss could be compensated by applying the VAT uniformly to all products and services. In that case the uniform VAT rate that would apply to all sectors was 12.8%, lower than the legal rate in most sectors before the CU went into effect. If the government would not prefer a uniform VAT tax rate, then it would have to raise the existing VAT rates by 16 percent in each sector – for example, if the VAT rate before the CU were 10 percent in many sectors then it would have to increase to 11.6 percent after the CU.<sup>9</sup>

CGE Simulation results reported by Bayar, Nuray and Recberoglu (2000) show that while the short run impact of the CU on Turkish welfare is negligible (equivalent to 0.12 percent of GDP), the most significant welfare impact will take place under the long run scenario which assumes that the CU leads to a decline in the country risk and to a significant increase in foreign direct investment (FDI) inflows, and enables Turkish producers to increase the speed of technological change. Under this scenario, the CU leads to a welfare increase of 7.7 billion USD (in 1995 prices), equivalent to 4.55 percent of GDP in 1995. The welfare impact of this scenario is rather big compared with that of Harrison et al. (1997). It was so because some of the assumptions of this scenario reflect more than what is entailed in the CU agreement. However, the assumption about the FDI

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<sup>7</sup> CGE models are a class of economic models composed of numerous equations describing major economic decisions including the production, consumption, employment, investment, trade, government finance decisions as well as the equilibrium conditions in the markets for goods and factors of production. These models are built using detailed input-output matrix data for the country of interest. They are used to study how an economy might react to changes in external factors in the long-run. Most importantly they are used to evaluate the long-run impact of permanent policy changes. They are important tools of policy analysis because they enable the researcher to consider economy wide effects of a change in any part of the economy. Over the last 40 years they have been extensively used to study trade policy changes around the world, but most importantly in developing countries. In order to parameterize the CGE models one need to use a plethora of information which are not consistently available in developing countries. For that reason, one has to be very careful in reaching sweeping policy conclusions based on the CGE analysis.

<sup>8</sup> Harrison et al (1997) note that by design their model could not measure the productivity gains from trade liberalisation, so the gains from the customs union were likely to be bigger than their estimates

<sup>9</sup> This is not a very significant increase in VAT rates. Turkey had to increase its VAT rates from 15 to 18 and impose special consumption tax on many goods after the 2001 economic crisis.

flows is not too far from reality, especially after the EU Council's December 2004 decision to open accession negotiations with Turkey. When the technological change assumption is removed, the alternative scenario produces welfare gains close to 2.5 percent of GDP.

De Santis (2001) developed a similar CGE model of Turkey and showed that the CU did not have trade diversion effects and the welfare losses associated with them.<sup>10</sup> This finding is consistent with the fact that Turkish imports from low cost third countries have partially substituted for the imports from higher cost EU countries over time. This was in part a result of the implementation of the EU's common external tariff to third countries by Turkey.

In order to undertake a complete welfare analysis of the CU, one should go beyond the trade policy measures. Aside from trade-related implications, the CU agreement foresaw changes in the commercial policy and its legislation that would imply "deeper integration" of the two economies. These "deep integration elements" include the harmonisation of Turkey's competition policy legislation to that of the EU, the adoption of the Community's commercial policy towards third countries (the free trade agreements with all the EU's preferential partners which worked against Turkey), and of the adoption of the EU *Acquis* regarding the standardisation of industrial products and consumer rights (see Zahariadis, 2002 and Togan et al., 2005).

Besides the efforts towards deeper integration of Turkish economy with that of the EU, EU did not stay away from imposing anti-dumping and anti-subsidy duties on some Turkish exports. In addition, EU's safeguard instruments on a limited number of products also imply restrictions on Turkish exports to the EU. Since the beginning of the CU, the EU has opened 18 anti-dumping and subsidy investigations against Turkish imports.<sup>11</sup> In some cases antidumping duties lasted years. Overall, the use of the anti-dumping measures against the partners is against the spirit of the Customs Union. It is encouraging that the EU's use of the anti-dumping and anti-subsidy measures declined substantially in recent years.

Zahariadis (2002) looked at the welfare effects of deep integration following the completion of the EU-Turkey customs union by focusing on technical barriers to trade (standards harmonisation), as well as barriers emerging from border formalities and

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<sup>10</sup> The welfare analyses of the CU or other forms of preferential arrangements focus on two effects on trade flows. These arrangements are beneficial to the extent that they create more trade (*trade creation*). Trade is created if those goods that used to be produced and consumed domestically are imported from more efficient partner country producers after the CU goes into effect. To the extent that the CU diverts imports from a low cost third-country to higher cost partner-country it leads to *trade diversion*. While trade creation is a welfare improving effect of the CU, trade diversion will have the opposite welfare effect. Whether the CU or an FTA is beneficial in a static sense will depend on the net of the two effects.

<sup>11</sup> Textiles (cotton fabrics, polyester fibres and yarn), steel (hot-rolled coils, hollow sections, steel ropes and cables, steel wire rod, welded tubes and pipes, etc.), pharmaceuticals (paracetamol and pentaerythritol), consumer electronics (color TV) are the Turkish sectors affected by the investigations (Based on statistics provided by the EU Commission, <http://trade.ec.europa.eu/doclib/html/113191.htm>). 16 out of 18 investigations resulted with imposition of anti-dumping or anti-subsidy duties on Turkish exports to the EU.

related procedures, and found that gains from deep integration are found to be smaller than tariff related ones. However, he concludes with a caveat that the estimated gains could be biased downwards because the multi-sector, multi-region CGE model used in the analysis does not take into account the efficiency gains that would emerge as a result of the adoption of EU standards by Turkish domestic producers.

Even though the assumptions about the relevant scenarios are of critical importance, all four studies briefly summarized above showed that the net effect of the Customs Union on Turkish welfare is positive. Based on these studies, it would not be wrong to conclude that Turkey performed well under the CU. Turkey stood against the competitive pressure from the EU and elsewhere, while it continued to increase its exports in a renewed product mix as well as taking steps towards deeper integration with the EU.

Experience with the CU so far demonstrates the resiliency and adaptability of Turkish manufacturing industries to rapidly changing conditions during a period with almost no net FDI flows. Actually, for many the lack of change in FDI flows into Turkey immediately after the CU was a major disappointment with the CU. It was a general expectation that FDI inflows (especially those from Europe) to Turkey would increase following the CU. Turkish governments had hoped that multinational companies would have taken advantage of the country's geographical location, low-cost and disciplined labour, and long experience with a market economy. Unfortunately, this expectation did not come true. According to UNCTAD figures, four years after the CU went into effect, in 2000 Turkey attracted US\$15 of FDI per capita. In the same year Poland attracted US\$105, Romania US\$50, Brazil US\$96, Algeria US\$32, and Ireland US\$4,750.

The CU did not lead to an increase in FDI flows because it was not the only factor foreign investors cared about. The consequences of the economic and political uncertainty surrounding Turkey in the 1990s were so grave that the foreign investors decided to stay away even after the CU. The importance of political and economic stability for attracting FDI inflows was proven again after the 2001 economic crisis. Turkey started to implement monetary and fiscal reforms immediately after the crisis. The AKP government that came into power after the November 2002 elections pursued the economic reforms further. In addition, AKP government gave priority to political and democratic reforms that were crucial for future EU membership of Turkey. Both political and economic reforms were critical in convincing the EU to open accession talk with Turkey. Unlike the CU, the EU's decision at the end of 2004 to start accession talks with Turkey together with economic and political stability had played a critical role in attracting FDI flows to Turkey. The EU accession process played a critical role in attracting FDI inflows because it invigorated the expectations for a more rapid and consistent implementation of the rules and regulations that ensure a playing field for all companies, domestic and foreign, alike. However, the rather long lull in the accession talks since the end of 2006, which is stemming mostly from political reasons than economic fundamentals, is a cause for concern for the future of global economic ties of Turkey.

Thanks to the bold reform agenda adopted and the EU decision to start membership negotiations with Turkey at the end of 2004, the improvements in business environment, increased Turkey's attractiveness as a destination for global savings glut. The benign external conditions helped Turkey change the composition of the financing of its current account deficit toward the type of capital inflows that contributes less to the foreign debt accumulation. Since 2003, the shares of long-term capital inflows, non-debt creating capital inflows and non-bank private sector borrowing from abroad have increased in total capital inflows. The performance of the Turkish economy after the 2001 crisis has shown that the short term influences of the CU had already played out, and the country started to benefit from the longer term influences of the CU.

As the Turkish accession to the EU proceeds, Turkey will have to change its legal and institutional structures to adopt the EU's Acquis Communautaire. This entails the adoption of EU rules and regulations in the services and utility sectors, such as the banking, telecommunications, transportation, electricity, and natural gas. While the establishment of competition authority along with the adoption of EU competition policies as part of the CU helped the convergence of competition policies to that of the EU, corporations in the service and utility sectors continued to enjoy high profit margins over the years. The establishment of regulatory authorities along with the competition authority did not help increase the competition and bring the profit margin to the levels observed in the EU. This was especially true because the political authorities never allowed the regulatory agencies to become independent authorities in their sectors.

A few years after the CU went into effect there were many questioning its usefulness as an anchor for Turkey. Uğur (2000), for example, argued that the CU did not deliver what it was expected to do: Turkey was not able to attract large sums of FDI; was unable to gain easy access to the EU and third country markets; deep integration with the EU did not take place. As a result he and others argued the CU could not be considered as an anchor for Turkey (for a discussion, see Eder, 2003). However, the performance of the Turkish economy after the 2001 crisis and especially after the EU's December 2004 decision to open accession talks with Turkey changed the perceptions of many in terms the anchor role of the CU and the EU membership for Turkish economy.

### *E. Identifying Winners and Losers*

So far we have shown that the CU had favourably affected the Turkish economy as well as the overall welfare of the society. However, we are also aware that showing that the impact is favourable does not imply all social groups and sectors are affected the same. Overall the analysis does not really respond to the concerns of many analysts as well as man on the street who believed that certain segments of the society as well as certain sectors would be worse off as a result of the CU.

When one reads through the Turkish press before the CU went into effect, job losses and bankruptcies among the small and medium enterprises (SMEs) were regarded



as the most important expected impact of the CU.<sup>12</sup> For that reason it is of great concern to have a closer look at the data. According to the productivity growth rates reported by Taymaz, Vovyoda and Yılmaz (2010) SMEs performed better than expected. Between 1995 and 2000, the average annual labour productivity growth in the manufacturing industry was 2.6 percent. SMEs attained a productivity growth rate of 2.5 percent while productivity growth in large scale enterprises (LSEs) was only 1.7 percent.<sup>13</sup> The bulk of productivity growth among the SMEs was due to within variation, which indicates that individual SMEs increased their labour productivity between 1995 and 2000. The second most important contribution to productivity growth during the period was the intra-industry between-effect, which implies that there was a reallocation of output from less productive to more productive SMEs within each industry. These findings show that SMEs did not perform as bad as some news analysts foresaw before 1996.

Bayar et al. (2000) analyzed the sectoral impact of the CU within the CGE model under the long-run scenario with lower risk, increase FDI inflows and technological change elements. They showed that in the short run the CU had positive impact on the production of the agriculture, textiles and wearing apparel, leather products and mineral products. The short run production impact of the CU on the machinery and equipment, automotive and consumer electronics, on the other hand, were negative. In the long run, all sectors make necessary adjustments and increase their production. However, those sectors that suffer in the short run turn out to experience the largest gains in production (motor vehicles production increases by 11.8 percent, consumer electronics by 12.2 percent, metal products by 12.8 percent, and machinery and equipment increases by 25 percent) in the long run. Those sectors that gained the most in the short run, on the other hand, experience smaller gains in production (agriculture production increases by 1.1 percent, processed foods by 4 percent, textiles by 5.7 percent and wearing apparel by 2.7 percent) in the long run. Bayar et al. (2000)'s estimates at the sectoral level are consistent with the results we have reached in our discussion of the sectoral impact of the CU.

A complete analysis of distributional effects is rather difficult to find. While some researchers use the CGE framework to undertake this analysis what is achieved as a result is rather the distributional effects implied by the particular structure of the CGE model and the available data as well as the CU itself. Keeping this caveat in mind we can report the distributional impact analysis by De Santis (2001) and Harrison et al. (2003). As such De Santis (2001) showed that the CU led to a decline in the welfare of urban households (equivalent to 0.5 percent of their income), along with an improvement in the welfare of the rural households (equivalent to 2.3 percent of their income). He argued that the rural households' welfare gains and the urban households' welfare losses were mainly due to the expansion of the traditional agricultural and industrial sectors at the expense of services sectors after the CU. Overall income inequality declines by between 1.1 and 1.7 percent, due to the rise in both agricultural capital income and farmers' earnings, which

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<sup>12</sup> See for example, Cumhuriyet, Mar. 8, 1995, and Dec. 15, 1995.

<sup>13</sup> Taymaz et al (2010) define SMEs (LSEs) as domestic firms employing less (more) than 150 employees. "Foreign firms" are defined as those joint ventures where foreign ownership is 10 % or more. Foreign firms are not classified by size because most of them are large.

brings about a substantial decline of inequality between urban and rural household groups.

Harrison et al. (2003) also showed that the CU had distributional effects. According to their simulation results after the CU the wage rate of the production labour declines by 2.9%, the greatest percentage decline among all factors. This was as expected. Before the CU the manufacturing industry received more trade protection than other sectors. As the CU went into effect, the manufacturing goods' prices declined, which in turn implied that the wage of the production labour, which was used more intensively in the manufacturing industry, had to decline. Unskilled production labour happened to be the factor which was most important for the four poorest urban household groups. Thus, it appears that the principal reason that the four urban poor household groups lose was that the wage of unskilled production labour declined. At the same time, their results also show that the richest two urban household groups also suffer welfare losses, mostly because of the return to their capital decreases after the CU. Overall, when measured by Gini coefficient income distribution slightly improves, a result similar to the one obtained by De Santis (2001).

#### **IV. Conclusions**

Until 2004, the EU-Turkey relations already had the largest influence on the economic rather than the political sphere. The CU has been an important milestone in the process of integration of the Turkish economy with that of the EU. In this study we undertook an overview of the research on the overall and sectoral impact of the CU on Turkish economy.

The evidence put together by many researchers suggests that overall the CU has been beneficial for Turkey, especially in the long run through improved productivity in manufacturing industries. While the increased import penetration after the CU increased the competitive pressure on several industries in the short run, this short-run impact helped them improve productivity in the medium- to long-term. The CU also led to significant improvement through the implementation of competition policy with additional favourable effects. With increased productivity and competitiveness manufacturing industries were able to weather the storm during the 2001 economic crisis and in the wake of Chinese entry to world export markets. Furthermore, the CU also involved the deep integration of the Turkish economy with that of the EU through the convergence of Turkish commercial policy and related institutions towards that of the EU.

There are some major shortcomings of the CU agreement for Turkey that should have been remedied at the beginning. With the benefit of hindsight and especially after the EU's 2006 change of trade strategy in favour of FTAs, we can now claim that it would have been better for Turkey to sign an FTA with the EU. That would have given Turkey more flexibility in terms of its trade policy with the third countries. With the membership objective alive Turkey has so far refrained from questioning the logic of the CU and renegotiating an FTA instead of the CU. However, since 2005 the EU's political

will to accept Turkey as a member at some future date has been fading away. With the current economic troubles in the Euro zone countries, the EU will be in no position for another wave of accession in the near future. Turkey's membership will be postponed to the indefinite future. On the other hand, the recent decline in the euro's value will further increase the competitive pressure on Turkish producers. Turkey's trade deficit will increase as the export growth decelerates. While the pressure on Turkish exporters mounting, the decision makers in Turkey will be hard pressed to bring the issue of converting the CU to an FTA on the negotiation table with the EU.

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