

CUSTOMS UNION: AN END IN ITSELF OR A STEP TOWARDS ACCESSION?

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Abstract

The Customs Union between Turkey and the European Union, which took effect on 1st January 1996, has been the utmost possible economic integration between the EU and a non-member country. Turkey's distinctive position as being the only country to conclude a customs union with the EU without being a full member has brought about both opportunities and challenges for Turkey. Practically, Turkey became part of the internal market for industrial goods and scheduled to take over substantial parts of the *acquis* regardless of what happens on the accession front. The CU has facilitated the transformation of Turkish industry and modernisation of Turkey's economic legislation, thus contributed to Turkey's competitiveness and integration with the global economy. On the other hand, the CU has been far from fulfilling the country's expectations in vital aspects such as adequate financial assistance and the eventual inclusion of agriculture and services. Besides, not being in the decision-making mechanisms of the EU concerning external economic relations, Turkey does not have a voice in the EU's free trade agreement negotiations with the third countries. Therefore, such a relationship is sustainable in the long term as long as the country's full integration with the EU is realized. Taking this into consideration, this paper concludes that the customs union between Turkey and the EU needs to be regarded as an integral part of a gradual process of integration rather than as an end in itself.

Introduction

The commencement of the official relations between the Community and Turkey dates back to 31 July 1959, when Turkey applied for association following the establishment of the European Economic Community (EEC). The EEC Council of Ministers accepted the application and following the negotiations, the Ankara Agreement establishing an association between Turkey and the EEC was signed on 12 September 1963.

The agreement envisioned three phases: a five-year preparation period, a transition period and a final period. A Customs Union (CU) was designed to be completed by the end of the transition period. With the ending of the preparation period, the responsibilities of the two sides were determined in the Additional Protocol, which took effect in 1973. Signing the Additional Protocol, Turkey has accepted abolishing customs duties on the European Community's (EC) industrial exports and adopting the Common Customs Tariff (CCT) of the EC that is applied to third countries¹. Accordingly, a transition period of 12 years for lifting tariffs on industrial goods and a 22-year-long tariff removal calendar for vulnerable industrial sectors were envisaged. On the other hand, the EC was to abolish all customs duties and equivalent taxes on industrial imports from Turkey with the exception of certain sensitive products such as cotton yarns, cotton textiles, and machine woven carpets. Petroleum products were subject to tariff reductions within quota limits. The Association Council was the governing body to oversee the timely implementation of the other complementary measures.

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¹ In the customs union relationship between Turkey and the Community, the EC is the main institutional mechanism in the legal text.

Following the oil crisis of 1973 and the military intervention of Turkey in Cyprus in 1974, the relations between Turkey and the EC deteriorated due to problems stemming from both sides. The timetable of the transitional stage was upset by the oil crisis and the following global recession of the mid 1970s. The first disappointment emerged after the first oil crisis, as the rising unemployment in Europe affected labour recruitment from Turkey, demonstrating the Communities inability to comply with the provisions concerning the free circulation of labour. Another major problem bounced from the extension of concessions by the Community to many developing countries under the General System of Preferences and the Lomé Convention, and also under the Global Mediterranean Policy, which eroded considerably the preferences granted to Turkey. Finally, the imposition of quotas on Turkish textile exports was another key factor which strained the relationship. Turkey, on the other hand, hit by the oil crisis and recession was able to reduce tariffs only twice, in 1973 and 1976, and had to delay further tariff reductions on EC manufactured products. It could not even commence the adjustment to the CCT. Faced with grave economic and balance of payments problems, Turkey presented a plan to revise the stipulations of the Association Agreement and also requested an aid package to revitalize its economy. However, this was not met by a favourable response from the Community and finally in 1978, Turkey took the step of freezing the terms of the Association Agreement under Article 60 of the Additional Protocol, which allowed both parties to take the requisite measures in case of fundamental sectoral or regional disruption or disruption of general economic stability.

The relations of Turkey with the Community came to a standstill after the military intervention in 1980. The fourth financial protocol was suspended due to this intervention, which almost ended Turkey's hopes for the anticipated benefits of integration. The volume of trade between the partners began to decrease. The free circulation of Turkish workers in the Community as of 1986 was put off. The decline in economic relations was accompanied by the emergence of diverging views on political issues. Promotion of democracy and human rights gained increasing weight in the Community agenda, with the outcome of reports attacking inhumane practices in Turkish courts and jails. The EC's insistence on democracy and the promotion of human rights was interpreted as interference in Turkey's internal affairs, as the Community was mainly perceived as an economic entity.

At the beginning of the second half of the 1980s circumstances changed. With Turkey's 1980 stabilization and structural adjustment program, aiming to integrate the domestic economy with the global economy, Turkey had made radical changes in its economic structure. The success achieved on this front was thought to enhance Turkey's possibility of accession to the EC. The Community has also reversed its stance, by reactivating the Association Agreement. The western-oriented business community began to voice the idea of application for EC membership. This was also backed up in other circles, not only for economic reasons but also to protect the recently gained civilian democracy. Thus on 14 April 1987, when Turkey applied for full membership, economic considerations were still at the forefront of the discussion². The Commission, in its reply in 1989, stated that along with the economic and political drawbacks concerning Turkey, the Community would not be able to accept a new

² For further discussion see Canan Balkır, "The Customs Union and Beyond", in Libby Rittenberg (Ed.), *The Political Economy of Turkey in the Post-Soviet Era Going West and Looking East?* Praeger, Connecticut USA, 1998.

member until it had completed its internal market harmonization; and suggested the reactivation of the Association Agreement and proposed a set of measures towards increasing interdependence between the partners which included the completion of the CU. For the EU, the conclusion of the CU was a natural step in conformity with the Additional Protocol's timetable, a commercial opportunity and the most appropriate way to revive the bilateral relationship after the events of 1987-1989³. For Turkey, as well, after the refusal of the full membership application, the customs union looked like the only viable option.

CU negotiations between EC and Turkey started in 1993. After long debates both on economic and political issues, the 36th Turkey-EC Association Council on 6 March 1995 took the decision concerning customs union which was to enter into force on 31 December 1995. On the way to the CU, Turkey took concrete steps in the enhancement of democracy. Both the European Parliament (EP) and the Council welcomed the legal and constitutional reform measures introduced on 23 July 1995 as sincere steps towards the improvement of the democratic situation in Turkey. Thus the customs union was not merely recognized as an economic issue but also a political link for Turkey to the market-based, liberal democracy of Europe. It was feared that without the customs union, a strong anti-western, particularly anti-European sentiment could win the upper hand in Turkey. The intense lobbying campaign of the Turkish government, with some support of the United States' diplomats in Community circles, resulted in the EP's assent on 13 December 1995 for the implementation of the final phase of the Customs Union⁴, the commencement date being in line with the timetable of the Ankara Agreement and the Additional Protocol. Thus after two years of negotiations, the Customs Union between Turkey and the EU took effect on 1 January 1996 with Association Council decision 1/95. Throughout this period, Turkey has officially clung to the idea of eventual full membership, while Europe has stayed away from linking the CU to the membership issue. Thus the creation of the CU did not in fact terminate the membership tension between the parties.

Scope of the Customs Union

The section entitled "Principles," Article (2) 2 of the Ankara Agreement provides that "a customs union shall be progressively established." The Agreement also lays down in Article 12 that "the Contracting Parties agree to be guided by Articles 48, 49, and 50 of the Treaty establishing the Community for the purpose of progressively securing freedom of movement for workers between them," in Article 13 that they "agree to be guided by Articles 52 to 56 and Article 58 of the Treaty... for the purpose of abolishing restrictions on freedom of establishment between them," and in Article 14 that they "agree to be guided by Articles 55, 56, and 58 to 65 of the Treaty... for the purpose of abolishing restrictions on freedom to provide services between them."

The CU mainly involves the free circulation of industrial goods between Turkey and EU and excludes trade in agricultural goods. Its basic components are the elimination of all customs duties and quantitative restrictions in trade of industrial goods; alignment of Turkish customs tariffs with the Common Custom Tariffs (CCT); harmonisation of Turkey's commercial policy with the Common Commercial Policy; progressive adoption of the EU's preferential trade agreements with third countries by Turkey; alignment of Turkish legislation with EU

³ Frédéric Misrahi, "The EC-Turkey Customs Union: Understanding Turkey's alignment performance", *ECPR Joint Sessions of Workshops*, Nicosia, 2006, p.2.

⁴ European Parliament, "Information Note on the Work of the EU-Turkey Joint Parliamentary Committee", http://www.europarl.europa.eu/intcoop/euro/jpc/turk/history2004_turkey_en.pdf.

legislation in the areas of competition rules and protection of intellectual, industrial and commercial property rights.

The EC would abolish all customs duties and equivalent taxes on industrial imports from Turkey with the exception of certain sensitive products such as cotton yarns, cotton textiles, and machine woven carpets. Petroleum products were subject to tariff reductions within quota limits. As the type of customs union specified was more than a usual customs union, coming closer to an establishment of a common market including free movement of workers, freedom of trade in services, harmonization of rules of competition, Kramer points out that it is “an additional indication that the relationship was not intended to stop here⁵.”

Although Turkey had taken enormous steps in liberalizing its trade regime in the 1980s, the concern was that the customs union would still create problems with regard to protected sectors such as automotive, pharmaceuticals, processed agricultural goods, and even textiles-clothing. Thus the harmonization to the CCT on some industrial goods from third countries, referred as sensitive sectors such as automobiles, shoes, leather products and furniture, were not to be accomplished before 01.01.2001.

The CU between Turkey and the EU signifies further than a customs union in the technical sense. Apart from the elimination of custom duties, quantitative restrictions and alignment with the CCT, it has obliged Turkey to harmonize its legislation with the Community legislation in relevant trade-related fields such as technical barriers to trade and competition policy and to negotiate trade agreements with third parties on the same terms as those benefited by the EU. Thus, the CU doesn't just mean opening to trade competition from the EU but also a considerable degree of “policy dependency”⁶.

According to Article 21 of the Additional Protocol, “Quantitative restrictions on imports and all measures having equivalent effect shall, without prejudice to the following provisions, be prohibited between the Contracting Parties”. However in Annex No 2 of the Protocol, it is stated that “the Community shall have the right to introduce new quantitative restrictions on imports from Turkey” only of “silkworm cocoons suitable for reeling” and “raw silk (not thrown)”⁷. Despite these provisions, a voluntary restraint agreement covering textiles sector had been concluded between the EU and Turkish exporters in 1982. The Turkish government had undertaken only to cooperate on the monitoring of the agreement. A similar agreement with Turkish exporters of clothing had also been signed in 1986⁸.

On goods that are included in the European Coal and Steel Community, the agreement that envisioned the establishment of a Free Trade Area between EU and Turkey was signed on December 21, 1995.

Agriculture is excluded from the Customs Union with the prospect of the free movement of the agricultural goods to be realized after Turkey's adoption of EU's Common Agricultural Policy. From the beginning, the Community granted tariff concessions on agricultural imports

⁵ Heinz Kramer, “Turkey and the European Union: A Multidimensional Relationship with Hazy Perspectives”, in Vojtech Mastny and R.C. Nation (Eds.), *Turkey between East and West: New Challenges for a Rising Regional Power*, Westview Press, Colorado and Oxford, 1996, p. 205.

⁶ Misrahi, p. 2.

⁷ Additional Protocol, Official Journal of the European Communities, No L 361/5, 31.12.1977.

⁸ Mehmet Uğur, *The European Union and Turkey: An Anchor/Credibility Dilemma*, Ashgate Publishing Ltd, Aldershot, 1999, p. 118.

and tried to protect its agricultural sector by the sophisticated non-tariff barriers of the Common Agricultural Policy (CAP). The concessions were broadened to the gradual elimination of duties by January 1987 on primary agricultural products having a regulated market in the EC. There are variable levies and additional duties for processed products. Concerning the manufactured agricultural goods, which are listed in the Council Regulation 3448/93 of the Community, they were also included in the Customs Union. The taxes applied to manufactured agricultural goods were separated into agricultural and industrial shares; of which the industrial taxes were removed, while the agricultural share was set to the tax rates applied in the Community.

The CU has been curtailed also with regard to services, although in the 1990s the liberalization of trade in services was to have a more profound impact on the Turkish economy than the completion of the CU in goods, as the share of services in the economy has risen to 58%⁹. Moreover, Turkey had already a strong competitive position in a number of services sectors, and for the liberalization of these services, it would have required the adoption of the *acquis* in the related areas, enhancing the integration into the Single Market.

However, in the case of the service sector the critical question was not the competitiveness of the Turkish service sector but rather finding the solution to the freedom of establishment which is a must condition for the freedom of services, because services are typically labor-intensive and the cross-border provision of services requires in most cases free movement of people¹⁰.

Perspectives on the Customs Union

Turkey has become the only country realizing CU without becoming a full member, while the latest ten acceding countries have adopted the *acquis* on CU upon their full membership to the EU, two of them being even granted a further period of full adoption for certain goods¹¹. Hence, Turkey's CU with the Community has been the most determined possible economic integration with the EU as a non-member country.

The discussions on the issue of CU were clear enough to show the divergent approaches of the two sides in defining the CU. According to the provisions of the Ankara Agreement, the CU is the final stage of the transitional phase during which both parties fulfill their reciprocal obligations. Thus for Turkey, it was the first step of an irreversible chain of events leading to full membership, as according to the Ankara Agreement under Article 28, Turkey has the right to ask for membership after the successful completion of the customs union, although

⁹ Commission of the European Communities, *2006 Regular Report on Turkey's Progress towards Accession*, Brussels, 8 December 2006, p. 30.

¹⁰ Kemal Derviş et. al., *The European Transformation of Modern Turkey*, Centre for European Policy Studies, Brussels, 2004, p. 76.

¹¹ One example can be cited as regards the import of aluminum into Hungary, which the EU has granted a transitional arrangement until 30 April 2007, enabling Hungary to import at a lower rate than the CCT, with a schedule of implementation involving the progressive increase of tariff duties and the progressive decrease of the import volumes. Likewise, within a period of transition until 31 December 2008, Malta will be able to import certain textile products at a lower rate than the CCT, with a schedule of implementation involving the progressive increase of tariff duties within an annual maximum quota (See Report on the results of the negotiations on the accession of Cyprus, Malta, Hungary, Poland, the Slovak Republic, Latvia, Estonia, Lithuania, the Czech Republic and Slovenia to the European Union, Commission of the European Communities, Brussels, January 2003, p. 5).

there is no automatic accession¹². Thus, Turkey never saw the CU as an end in itself. Indeed, given the fact that Turkey does not participate in the decision-making mechanisms of the Community concerning external economic relations regarding the third countries, it would have been admissible for Turkey to regard the CU as an end in itself. According to Turkish point of view, launching of the CU marked the end of the second phase of the path leading to the EU membership as foreseen by both the Ankara Agreement and the Additional Protocol, thus starting the third and the last phase of the process.

On the other hand, the European side assessed the CU as a way of developing close relations with Turkey and consistently refrained from making any reference to a link between the CU and the issue of membership. The CU looked like a skillful way to keep Turkey in the periphery of Europe¹³. It was even argued that the CU was part of 'the EU's containment policy for Turkey which was designed to strengthen EU-Turkey relations, while postponing the possibility of actual membership into the foreseeable future'. The EU's ex-Ambassador to Turkey, Michael Lake, explained the situation as follows:

The customs union created misconceptions on both sides. The European side felt that Turkey would be preoccupied with making it work and not press for full membership for the time being, while Turkey had the misconception that the customs union was a stepping stone towards full membership in the next year or two¹⁴.

The major difference between the two sides was that while Turkey concentrated on the economic aspects, the EC began to place utmost importance on the question of democracy, the significance of which was depicted by the 1991 political conditionality clause, which placed democracy and the protection of human rights as one of the main objectives of the EC's external relations. This divergence in the perception was to become one of the key tension issues between the two sides in the following years.

Customs Union: A Scapegoat for EU Opponents?

The debate concerning the CU in Turkey has been basically between the supporters who believe that the CU will yield positive results in the medium and long term, and the opponents, who argue that it will impair Turkey's economic interest. Furthermore, the distorted discussions in part of the Turkish media gave the impression that the CU was the result of an agreement concluded in 1995, although the commitment to establish a customs union was foreseen in the Association Agreement, and the timetables and rules were established in the Additional Protocol. Thus it was all decided in 1960s and 70s. However, irrespective of the political stance concerning the CU, there has been wide-ranging criticism concerning the attitude of the EC towards Turkey for not honoring its obligations under the financial cooperation and the free movement of labor.

The CU was perceived in big business circles as a cure-all that would impose discipline on the domestic market, correct the foreign trade imbalance, provide financial resource, and promote foreign investment. Assessing closer relations with the EU as a counter-weight to the inward-looking etatist economic policy, the business community controlled by large enterprises

¹² For the text of the Ankara Agreement, see Official Journal of the EC, 29 December 1964. For the text of the Additional Protocol, see Official Journal of the EC, 31 December 1977.

¹³ For the chain of events that led to the decision of 6 March 1995 see Balkır, 1998, pp. 51-77.

¹⁴ Harun Arıkan, *Turkey and the EU-An Awkward Candidate for EU membership*, Ashgate Publishing, Aldershot, 2003, p. 82.

around Istanbul supported the CU. On the other hand, the small and medium sized companies, whose demands were pronounced by the Eskisehir Chamber of Industry, were against the CU claiming that tariff dismantling beyond a critical point would eliminate domestic producers¹⁵.

It may well be argued that the timing of the CU was not the best for Turkey as far as the economic conditions were concerned. The economic crisis of April 5th 1994, the problems stemming from the subsequent devaluations, 1997 Asian and the following Russian crises, the severe stagnation in the Turkish economy after March 1998, general elections in 1999, disastrous earthquake in the same year, 2000 and 2001 economic and financial crises, have all had adverse impacts on the Turkish economy. Thus the CU was commenced and concluded at the timing stipulated by the Additional Protocol but untimely as far as the economic state of affairs in Turkey.

Financial Aspects of Customs Union

Despite the enormous economic disparity between the EC and Turkey, the CU has been set as an objective in the Ankara Agreement. Turkey was eager to get from the Community whatever was stipulated for Greece, and thus would not agree on anything less than a customs union. The Association Agreement clearly outlined, "in order to attain the objectives set out - in the Agreement- a customs union shall be progressively established". The objectives referred to in the Agreement were outlined in Article 2: "The aim of this Agreement is to promote the continuous and balanced strengthening of trade and economic relations between the parties, while taking full account of the need to ensure an accelerated development of the Turkish economy and to improve the level of employment and living conditions of the Turkish people".

The drafters of the Agreements realized that the liberalization of trade would entail painful adaptations and in order to counter balance the negative effects of such adaptations, financial assistance schemes were to be devised together. However, as these financial assistance mechanisms were designed for members, and Turkey being the first nonmember country concluding a customs union, it was deprived of the adequate financial support mechanism and also without being part of the Community's decision-making process concerning external economic relations vis-à-vis the rest of the world.

Table 1: Financial Protocols

	Loan (ECU mil)
First protocol (1964-69): ECU 175 million (EC loans / soft interest rate)	175
Second protocol (1971-77): ECU 195 million (EC soft loans/ soft interest rate): ECU 25 million (EIB loans)	220
Additional Protocol (1971-77): ECU 47 (EC soft loans/ soft interest rate)	47
Third protocol (1979-81): ECU 310 million (EC loans: ECU 220 mil / EIB loans: ECU 90)	310
Fourth protocol (This Protocol was negotiated and initialed in July 1980, although it was not implemented due to Greek veto in the Council.)	600

Source: Delegation of the European Commission to Turkey, www.deltur.cec.eu.int.

¹⁵ Uğur, pp. 91-92.

When the legal framework agreement setting the coverage and implementation schedule of the customs union, was approved by the EC-Turkey Association Council on 6 March 1995, there was agreement also on two more documents. The first document was the Resolution of EC-Turkey Association Council on the development of the Association. It is a kind of action plan calling for cooperation in matters such as economic cooperation and for political and institutional dialogue. The second document was the Community Declaration Concerning Financial Cooperation. Under the context of the unilateral declaration of the Community concerning financial cooperation, between the years 1996 to 2001, Turkey was to receive funds from four sources: the sum of ECU 375 million from the Community budget; ECU 300 to 400 million from the European Investment Bank (EIB) loans available under the 1992-1996 Mediterranean policy for the financing of infrastructure projects; from the EIB, loans over a five-year period starting in 1996 for improving the competitiveness of the Turkish economy, the amount which could reach a maximum of ECU 750 million; and in cases of need an “exceptional additional medium-term macro-economic financial assistance linked to the execution of the IMF approved programs.” Thus the overall aid over a five-year period was expected to be around ECU 1.5 billion¹⁶. But, actually, Turkey received only 52 million Euros from these sources¹⁷, which along with the earlier history of the Community not fulfilling its financial obligations, caused frustration on the Turkish side¹⁸. The table below gives the implementation rate for loans and grants prior to the CU and following the CU.

Table 2: Turkey-EU Financial Cooperation

Prior to the CU (1964-1995)	
Commitments	€1.605 million (Loan: € 1.152 m & Grant: €453 m)
Payments	€ 1.005 million (Loan: €927 m & Grant: €78 m)
Implementation Rate	% 63
Loan	% 80
Grant	% 17
Following the CU (1996-1999)	
Commitments	€2.275 million Loan: €1.507 m & Grant: €768 m
Payments	€ 755,3 million Loan: €557 m & Grant: €52 m
Implementation Rate	% 33
Loan	% 37
Grant	% 7
Candidacy Process Commitments (2000-2006)	
Grant	2000-2003: €698 m. 2004-2006: €1.050 m.
Loan	2000-2006: €2.520 m.

Source: Turkish Secretariat General for the EU Affairs, www.abgs.gov.tr.

¹⁶ Balkır, 1998, pp. 58-59.

¹⁷ Arzu Odabaşı, *Türkiye'ye Yönelik Avrupa Birliği Fonları ve Kullanım Koşulları*, İKV Publications, İstanbul, 2004, p. 8.

¹⁸ The current financial framework runs until the end of 2006; the next that has been negotiated by 25 members will run until 2013; the following one will run until 2018. Assuming accession by 2015, this would mean that the financial framework for the first three years would be decided by EU-27 or most probably EU-28. Therefore, Turkey will be fully part of the financial framework in the 2018-2024 round (for details see Derviş et.al. 2004).

As shown in Table 3, pre-accession grants committed for Turkey add up to around 1.7 billion Euros, and compared to some other candidate and accession countries, this amount is quite insufficient. EU allocated a fund of €21 billion 840 million to the Central and Eastern European Countries (eight new members and Bulgaria Romania) under SAPARD, ISPA and PHARE Programmes for the period between 2000 and 2006, while Turkey was allocated €1 billion 748 million for the same period. In 2000, the amount per capita was €2,7 for Turkey, while the amount per capita for Estonia was €46 and €17 for Czech Republic. Overall, the average financial assistance per capita was 9 times more for Central and Eastern Countries¹⁹.

Table 3: EU Financial Assistance between 2000-2006 (€ billion)

Romania	Bulgaria	Poland	Turkey
5.1	2.8	15.3	1.7

Source: Secretariat General for the EU Affairs, Turkey www.abgs.gov.tr.

From 2007 onwards, EU financial assistance to candidate and potential candidate countries is provided under the Instrument for Pre-Accession Assistance (IPA), a total amount of 11.5 billion Euros for the 2007-2013 period. Turkey is envisaged to receive about 2.256 billion Euros for the first four years of IPA²⁰. Thus, although the EU financial assistance to Turkey has increased gradually, the amount per capita is still much lower compared to the amount allocated to the other candidate and potential candidate countries.

Table 4: Allocation of Pre-Accession Assistance among Candidate and Potential Candidate Countries

	Population	Total Financial Support for 2007-2010 (Euro)	*Per capita Financial Support for 2007-2010 (Euro)
Croatia	4 437 000	589 900 000	132.95
The former Yugoslav Republic of Macedonia	2 022 547	302 800 000	149.7
Serbia	7 498 001	771 100 000	102.8
Montenegro	620 145	131 300 000	211.7
Albania	3 200 000	306 100 000	95.6
Bosnia and Herzegovina	4 000 000	332 000 000	83.0
Turkey	72 000 000	2 256 000 000	31.3

Source: European Commission Enlargement Website, http://ec.europa.eu/enlargement/albania/political_profile_en.htm; Communication from the Commission to the Council and the European Parliament Instrument for Pre-Accession Assistance (IPA) Multi-Annual Indicative Financial Framework for 2008-2010,

*Calculated by the authors using the data at the above mentioned sources.

¹⁹ Metin Gençkol, "Avrupa Birliği Mali İşbirliği Politikaları ve Türkiye", DPT Avrupa Birliği ile İlişkiler Genel Müdürlüğü Yayınları, Ankara, Eylül 2003, <http://Ekutup.Dpt.Gov.Tr/Ab/Genckolm/Malipoli.Pdf>.

²⁰ Delegation of the European Commission to Turkey, "EU Funding in Turkey", http://www.avrupa.info.tr/AB_Mali_Destegi/2007_Sonrasi.html

The Implications of the Customs Union for Turkey: Unfulfilled Expectations

From the outset, the Decision of 6 March 1995 looked more favourable to the EC's interest than to Turkey's, since while safeguarding European interests in sensitive sectors such as textiles and clothing, agriculture, iron and steel, and motor vehicles, it imposed new obligations on Turkey with respect to trade with third countries, intellectual property rights, competition law, and regulations regarding the technical trade barriers for manufactured goods. There was also the immediate challenge to the Turkish economy due to the diminishing public income as a result of dismantling of customs duties and the abolition of the Mass Housing Fund levy, which is collected from industrial product imports to finance housing projects in Turkey. On the affirmative standpoint, under the customs union, due to the harmonization of economic legislation and the application of the Community case law, the dynamic Turkish domestic market was expected to become a more secure environment for European firms both for investment and trade purposes. The experiences of Spain and Greece had already verified this. However, since they were already members at that time, the Turkish case deserves to be treated as a special case.

The Impact on Foreign Trade

The orthodox theory of customs union analyzes the effects of CU on resource allocation in terms of trade creation and trade diversion. As suggested by Jacob Viner, the most fundamental static impact of an economic integration based on the CU depends on its trade creation and trade diversion effects²¹. Trade creation refers to a union-induced shift from the consumption of higher-cost domestic products in favour of lower-cost products of the partner country. This can have a production effect by saving in the real cost of goods previously produced domestically as the domestic production is reduced or eliminated. Consequently, supply originates from a more efficient producer of the product in the CU. In all cases trade creation will raise a country's national welfare²².

On the other hand, trade diversion refers to a union-induced shift in the source of imports from lower-cost external sources to higher-cost partner sources. It increases the cost of goods previously imported from third countries, owing to a shift from foreign to union member sources. In many cases, trade diversion will reduce a country's national welfare but in some cases national welfare could improve despite the trade diversion.

This basic framework should be considered when evaluating Turkey's trade relations with the Community, the main trading partner even in 1963, at the beginning of the association. The principal trading partner in the Community has been Germany, followed by Italy, France, the United Kingdom, and Holland. In 1963, exports to the EC represented 38% of Turkey's total exports, and imports from the Community represented 28.5% of total imports. At the year of the CU, EC's share in imports was 47.2% and its share in exports was 51.2%. The volume of trade, \$336 million in 1963, has increased to \$28 billion by 1995. These figures demonstrate clearly the Union's priority position in Turkey's external trade. Following the recent enlargement, Turkey became the EC's 6th largest customer and its 7th biggest supplier. In

²¹ See Jacob Viner, *The Customs Union Issue*, Carnegie Endowment for International Peace, New York, 1950.

²² Marc Peters, "Outline the Static Welfare Case for a Customs Union. Does this Analysis Apply in a World of Imperfect Competition?", <http://www.mapeters.fsnet.co.uk/Essays/ec515.htm>

terms of trade volume Turkey was ranked as 6th in the EU's foreign trade with the share of 3.91% in 2005²³.

While the trade volume grew, the trade deficit with the Community also increased during the years to reach \$6 billion in 1995, just before the commencement of the CU. The deficit continued to widen in the years that followed the CU²⁴, as it was Turkey, not the Community, which was dismantling barriers to trade, since the Community had abolished all tariff and non-tariff barriers in 1971, with few exceptions. Therefore it was natural that imports from the EC would increase first, not to mention the fact that the growth rate in Europe in the mid 90s did not allow a booming market for Turkish exports.

It is sometimes claimed in Turkey that unilateral obligations undertaken under the CU create a barrier for Turkey to enter to the third country markets. However, the data indicates that there has been a significant increase in Turkey's imports from the third countries since 1996. The share of the exports to the EU has increased slightly; while imports from low cost third countries have partly replaced the imports from high cost EU countries. Thus, the tariff reduction to third countries due to the application of CCT has been an important factor in reducing the trade diversion costs of the CU for Turkey.

Table 5: The Breakdown of Turkey's Foreign Trade By Country Group (%)

	1995	1996	2000	2003	2004*	2005	2006
Export							
EU	51.2	49.7	52.2	51.8	54.5	52.3	51.6
Non-EU	48.8	50.3	47.8	48.2	45.5	47.7	48.4
Import							
EU	47.2	53.0	48.8	45.7	46.6	42.1	39.3
Non-EU	52.8	47.0	51.2	54.3	53.4	57.9	60.7

* EU-25 after May 2004

Source: Undersecretary of Foreign Trade, Turkey

Turkey looks less dependent on the EU oriented trade than most of the new members, mostly due to its geographical location which facilitates trade with the surrounding countries. In fact, it is clearly seen in the table below, that the share of the Community in Turkey's foreign trade has decreased from 48.7% in 1995 to 44% in 2006. Considering the significance of agriculture in Turkey's foreign trade and economy, the exclusion of agricultural goods from the CU creates a major setback. Turkey is a net exporter in agricultural products, the EU-25 being the primary destination²⁵.

²³ Undersecretary of Foreign Trade, Turkey,

<http://www.dtm.gov.tr/dtmadmin/upload/AB/EuromedEntegrasyonDb/Abnin3.xls>

²⁴ Ankara Chamber of Commerce is one of the institutions which voiced openly its criticism against the CU, claiming that Turkey experienced an import boom after the CU and there has been a flow of consumer goods such as automobiles and electrical household appliances. See Ankara Ticaret Odası, *Avrupa Birliği'nde Maskeli Balo Dayatmalar, Gerçekler*, ATO Yayınları NO: 74, 2004, pp. 39, 43.

²⁵ "Screening report Turkey, Chapter 11 – Agriculture and Rural Development", 7 September 2006, http://ec.europa.eu/enlargement/pdf/turkey/screening_reports/screening_report_11_tr_internet_en.pdf, p.2.

Table 6: The Share of the EU in Turkey's Foreign Trade (%)

Years	Export	Import	Volume
1995	51.2	47.2	48.7
1996	49.7	53.0	51.9
1997	46.6	51.2	49.6
1998	50.0	52.4	51.5
1999	54.0	52.6	53.2
2000	52.2	48.8	50.0
2001	51.4	44.2	47.3
2002	51.2	45.2	47.7
2003	51.8	45.7	48.2
2004*	54.5	46.6	49.7
2005	52.3	42.1	46.1
2006	51.6	39.3	44.0

* EU-25 after May 2004

Source: Undersecretary of Foreign Trade, Turkey

According to the 2006 Progress Report, Turkey's openness in terms of trade has continued to increase and trade partners became more diverse. Reflecting high growth rates in exports and imports of goods, their share became around 54% of GDP in 2005²⁶. On the other hand, the share of Turkey in the EU imports and exports is still modest although it has increased slightly over the years. Trade with Turkey accounted for 3.13% of EU-25 imports and 3.91% of total EU-25 exports in 2005.

Table 7: The Share of Turkey in EU's Foreign Trade (%)

Year	Share in Exports (%)	Share in Imports (%)
1995	2.36	1.70
1996	2.92	1.76
1997	3.10	1.77
1998	3.05	1.92
1999	2.71	1.96
2000	3.18	1.71
2001	2.08	1.99
2002	2.44	2.23
2003	2.88	2.46
2004*	3.90	3.18
2005	3.91	3.13

*EU-25 after May 2004

Source: Undersecretary of Foreign Trade, Turkey

Nevertheless, the CU has played a vital role in Turkey's integration with the EU single market and the global economy in general. Medium term and long term dynamic effects are crucial for assessing the full effects of the CU and they are more significant than the short term static effects. Through market expansion introducing stronger competition and consequently

²⁶ 2006 Regular Report on Turkey's Progress towards Accession, p. 31.

forcing an improvement in productivity, the CU has facilitated the transformation of Turkish industry, including the modernisation of economic legislation. Furthermore, compelling domestic industries to integrate with international webs of production and distribution, it has helped the rationalisation of the industrial structure²⁷. Overall, dynamic effects contribute to the reduction of uncertainty about economic policies and policy reforms, making planning and investment easier²⁸.

The fluctuations in the Turkish economy in the second half of the 1990s were strongly related to the macroeconomic and financial crisis rather than to the impact of the CU, although the contrary was claimed by the opponents of the CU. Since 2001, much progress has been made in stabilizing the economy addressing the fundamental causes of these crises. This is particularly visible in the resumed growth which beginning with 2002 has been respectively 7.9, 5.9, 8.9, 7.4 and 6.1%²⁹.

In the 2005 and 2006 Regular Reports, Turkey is regarded as a functioning market economy as long as it firmly maintains its recent stabilization and reform achievements. Over the course of negotiations, the convergence with the *acquis communautaire* will contribute to the institutional development as well as internalisation of liberal democracy and rule of law. Furthermore, the country is even on the way to meet the Maastricht criteria due to prudent fiscal policies and structural reforms. It is already meeting the budget deficit-to-GDP criterion and estimated to achieve public debt-to-GDP criterion by the end of 2007 and price stability in 2008³⁰.

The impact of the customs union on the Turkish economy concerns the overall economy as well as the economic competitiveness of the major sectors. Turkey's exports to the EC previously consisted of agricultural goods, but this structure changed fundamentally in the 1980s, and currently almost 85.4% of exports are manufactured goods while the share of agricultural products is 8.3%. The CU has given impetus for the modernization of the economic structure resulting in increased international competitiveness. Turkey's exports to the EU have been reoriented from consumption goods to higher value-added goods. In particular the exports of machinery and transport equipment to the EU have significantly risen over the past years and have accounted for 21.4% of total Turkish merchandise exports to the EU in 2006, up from 19% in 1998. Yet the main part of Turkish exports still consists of textile products, comprising around 29.6% of total EU imports from Turkey. Apart from these products, office and telecommunication equipment, iron-steel products, chemicals, non-agricultural raw materials, non-electrical machinery and energy are the other export items³¹.

²⁷ Sinan Ülgen and Yiannis Zahariadis, "The Future of Turkish-EU Trade Relations-Deepening vs Widening", *CEPS EU-Turkey Working Papers*, No.5 August 2004, pp. 5-6.

²⁸ Durmuş Özdemir, "Implications of Economic Integration and a Case for Peace Dividend", in Richard T. Griffiths and Durmuş Özdemir (Eds.), *Turkey and the EU Enlargement Processes of Incorporation*, Istanbul Bilgi University Press, Istanbul, 2004, p. 159.

²⁹ Eurostat, "Real GDP Growth Rate",

http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996,39140985&_dad=portal&_schema=PORTAL&screen=detailref&language=en&product=SDI_MAIN&root=SDI_MAIN/sdi/sdi_ed/sdi_ed_inv/sdi_ed1110.

³⁰ Serhan Cevik, "From Copenhagen to Maastricht", Morgan Stanley Equity Research, 10 January 2006, <http://www.morganstanley.com/views/gef/archive/2006/20060111-Wed.html#anchor1>

³¹ European Commission, "Bilateral Trade Relations Turkey-Trade Statistics", http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113456.pdf

Table 8: Breakdown of Turkey's Exports to the EU by Product Groups (%)

Year	Investment goods	Intermediate goods	Consumption goods
1995	2.9	31.8	65.3
1996	3.4	32.3	64.3
1997	3.5	33.5	63.0
1998	3.6	34.2	62.2
1999	4.4	34.7	60.9
2000	4.6	35.9	59.5
2001	6.0	35.7	58.1
2002	6.9	31.6	61.4
2003	8.5	30.4	61.0
2004*	11.0	31.3	57.4
2005	11.9	30.7	57.1
2006	11.6	35.3	52.9

* EU-25 after May 2004

Source: Undersecretary of Foreign Trade, Turkey

Increasing income level in Turkey created favourable conditions for the Community's consumer goods, doubling their share since 1995. The imports are closely correlated with the joint ventures in Turkey.

Table 9: Breakdown of Turkey's Imports from the EU by Product Groups (%)

Year	Investment goods	Intermediate goods	Consumption goods
1995	28.7	62.5	8.8
1996	31.9	55.7	12.4
1997	29.5	56.3	14.2
1998	29.8	55.1	15.0
1999	28.4	55.2	16.5
2000	27.3	53.0	19.2
2001	23.6	61.1	14.2
2002	23.0	61.8	13.7
2003	22.1	60.7	16.2
2004*	23	59.0	16.8
2005	23.7	59.3	16.4
2006	22.6	60.5	16.3

* EU-25 following May 2004

Source: Undersecretary of Foreign Trade, Turkey

The Impact on Foreign Direct Investment

According to the European Commission's 2006 Progress Report on Turkey, net foreign direct investment in Turkey more than doubled compared to the amount in 2004 and amounted to approximately €7.8 billion in 2005, with the share of foreign direct investment in GDP being 2.8%³². In 2005, FDI flows from EU to Turkey amounted to € 3.2 billion, while Romania received € 3.9 billion, Bulgaria € 2 billion and Croatia € 1 billion in the same year. The stock of EU FDI in Turkey at end-2005 amounted to € 16.6 billion³³.

Between 2002- 2006 approximately 75% of FDI inflows to Turkey have been from the EU countries, Netherlands, Belgium, Germany, France, UK and Italy being the major investing countries. Apart from these international investor countries, there are other EU countries ranking high in 2006 because of one big deal such as Greece (Finansbank) and Austria (Petrol Ofisi)³⁴.

Indeed, trade and investment have been the two key factors in Turkey's relations with the EC. Based on the previous enlargement experiences, the completion of the CU with the EC was expected to trigger substantial FDI by European companies. Due to the harmonization of economic legislation, the expectation was that the growing and dynamic Turkish domestic market would become a more secure environment for European firms for investment. However, contrary to expectations, FDI flow remained modest after the commencement of the CU. Both Turkish and international analysts have attributed the low level of FDI coming to Turkey following the CU to the political and macro-economic instability of the country and also a series of micro-level barriers including red tape³⁵. The Regular Report of 9 November 2005 took the view that low level of foreign direct investment relates to the difficulties in the privatization process and weaknesses in the business climate linked to reasons concerned with the judiciary or production cost structures. Although the legislative framework to facilitate foreign direct investment has improved, lack of an efficient administrative framework and an office attracting FDI was still limiting Turkey's performance³⁶.

Although CU was not a big impetus, the decision of December 2004 for the opening of negotiations with Turkey on 3rd October 2005 definitely had a positive impact on the FDI inflow, largely driven by inflows from privatisations³⁷. International Finance Institute has announced Turkey as one of the main recipient countries for the inflow of FDI in 2005. Turkey ranked 22nd among top FDI attracting countries in 2005, up from 53rd in 2003 and 37th in 2004³⁸. Following a similar trend, in 2006 the level of the FDI flow to Turkey reached about €14.5 billion of which almost 80% originated from EU member states³⁹.

³² 2006 Regular Report on Turkey's Progress towards Accession, pp. 30, 54.

³³ "European Union Foreign Direct Investment Yearbook 2007", *Eurostat Pocketbooks*, Luxembourg, 2007, http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-BK-07-001/EN/KS-BK-07-001-EN.PDF, p. 35.

³⁴ YASED, "Foreign Direct Investment Reports", July 2007, www.turkeynow.org/db/Docs/YASED_FDIReport-june07.pdf, pp. 3-4.

³⁵ Turkey revised its FDI law no.4875, enacted on 17th June 2003.

³⁶ Commission of the European Communities, *2005 Regular Report on Turkey's Progress towards Accession*, Brussels, 9 November 2005, pp. 51-52 and 61-62.

³⁷ *Ibid*, p.53.

³⁸ T.C. Başbakanlık Hazine Müsteşarlığı, *Uluslararası Doğrudan Yatırımlar 2006 Yılı Raporu*, Haziran 2007, http://www.hazine.gov.tr/guncelduyuru/20070613_UDYatirim_Rapor.pdf, p. 5.

³⁹ YASED, p.3.

There was also a major change in the structure of FDI in 2004, with almost 69% being directed to the service sector while the manufacturing sector received only 25%, a clear difference to previous years' sectoral distribution when manufacturing was the dominant sector. The purchase of shares in major Turkish Banks by European banks, particularly BNP-Paribas, Fortis and ING, in the first half of 2005 has signalled the continuation of this trend towards services sector in FDI inflows⁴⁰. Thus the share of services in cumulative FDI inflows has reached to 87.3% in the 2002-2006 period. In 2006, the highest level of FDI inflows was directed to the financial services with a share of 39%, whereas telecommunications, transportation and warehousing attracted approximately 37% of the inflows⁴¹.

Impact on Employment

Turkey's growth potential lies in its growing population of working age, which shows some remarkable features that distinguish it from the most EU-25 countries. The best-known difference is that Turkey's population is still growing, whereas the population in Europe has either been stagnating or growing rather slowly over the last three decades. For the next generation, Turkey's population growth will still remain much more dynamic compared to the EU members. Average annual population growth between 1998 and 2015 is expected to be 1.2% for Turkey. The highest population growth rate among the EU members for the same period belongs to Ireland with 0.6% growth rate⁴². However, a growing population provides economic opportunity only if employment opportunities increase as well. In Turkey, the ratio of total employment to total population is substantially below that of the EU member states. The low employment rate of women is an important factor in this issue (57.2 % for the EU 27, 23.9 % for Turkey in 2006)⁴³.

It was assumed that the CU would contribute to the solution of unemployment problem through the use of low labour costs to attract foreign direct investment. However, ten years of implementation of the CU has proved that the mentioned assumption is not valid. The unemployment rate was 5.9 % in 1997; it rose to around 10% in the 2000's (11.2 % in 2005). The main factor behind this rise in unemployment was the economic crisis and the restructuring process in the banking sector and state-owned enterprises⁴⁴ which also led to a decrease in the employment rate from 45.5% in 1997 to 41.7% in 2005. However, in 2006, due to macroeconomic stabilisation and reform achievements, the unemployment rate fell to 8.8% and the employment rate increased to 44.3%⁴⁵.

⁴⁰ 2005 Regular Report on Turkey's Progress towards Accession, p.52.

⁴¹ YASED, p. 4.

⁴² World Bank, "Europe and Central Asia",
<http://www.worldbank.org/depweb/english/modules/social/pgr/dataeuro.html>.

⁴³ Eurostat, "Population and Social Conditions",
http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996.39140985&_dad=portal&_schema=PORTAL&screen=detailref&language=en&product=Yearlies_new_population&root=Yearlies_new_population/C/C4/C41/em01_2

⁴⁴ Commission of the European Communities, *2002 Regular Report on Turkey's Progress towards Accession*, Brussels, 9 October 2002, p. 30.

2002 Regular Report, p.50; 2003 Regular Report, p. 87.

⁴⁵ For the years 1998, 2002, 2005, 2007, Household Labour Force Surveys, Institute of Statistics, Turkey
<http://www.tuik.gov.tr>.

Table 10: Employment in the EU and Turkey

	Employment rate (%, population aged 15- 64)*		Unemployment rate (%, labour force 15+)*		Employment growth rate
	1997	2006	1997	2006	
EU-15	60.7	66.0	9.2	7.4	1.3
EU-25	60.6	64.7	9.3 (1998)	7.9	1.5
EU-27	60.7	64.4	8.6 (2000)	7.9	1.6
Poland	58.9	54.5	10.9	13.8	3.3
Romania	65.4	58.8	5.3	7.3	2.8
Bulgaria	50.4(2000)	58.6	16.4(2000)	9.0	2.4
Czech Rep.	67.3(1998)	65.3	6.4 (1998)	7.1	1.6
Hungary	52.4	57.3	9.0	7.5	0.7
Croatia	53.4	55.6	14.7(2002)	11.1	2.0
Turkey***	45.5	44.3	5.9	8.8	1.2

Source: *Eurostat,

http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996,39140985&_dad=portal&_schema=PORTAL&screen=detailref&language=en&product=STRIND_EMPLOI&root=STRIND_EMPLOI/emploi/em011

** « Employment in Europe »,

http://ec.europa.eu/employment_social/employment_analysis/employ_2006_en.htm

*** Institute of Statistics, Turkey, <http://tuik.gov.tr>

Alignment with the Competition Policy

Concerning the regulatory framework of competition, such as state subsidies, anti-trust law, and the law concerning industrial and intellectual property rights, Turkey was expected to bring its legislation in line with that of the EC. Competition rules of the CU are set forth between article 32 and 43 under Chapter IV titled Approximation Laws. The article 32 of the CU, which is identical to article 81 of the EC Treaty, prohibits the agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between the Community and Turkey and which have as their object or effect the prevention, restriction or distortion of competition. The article 33 which is identical to article 82 of the Treaty prohibits the abuse by one or more undertakings of a dominant position in territories of the Community and/or of Turkey or in a substantial part thereof, but only in so far as the abuse may affect trade between the Community and Turkey. The article 34 is related to state aid and similar to article 87 of EC Treaty. Accordingly, any aid granted by EC Member States or Turkey through State resources which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between the Community and Turkey, be incompatible with the proper functioning of the Customs Union.

Turkey undertook to ensure that its legislation in the field of competition rules is made compatible with that of the European Community and is applied effectively under article 39 of CU. In compliance with its obligations, Turkey adopted the Law on Protection of Competition before the entry into force of the Customs Union and established the Competition Authority in 1997.⁴⁶ According to the Progress Report of Turkey in 2006, harmonization with the antitrust acquis is well advanced. The Law on Protection of Competition and regulation on mergers and acquisitions reflect the main principles of Community rules. The level of enforcement by the Competition Authority is satisfactory.

⁴⁶ Furthermore, the Competition Authority has issued the communiqués on block exemption in compliance with the principles contained in the block exemption regulation in force in the Community.

However, legislative alignment is needed on sector specific block exemption rules in insurance, telecommunications and postal services as well as incorporation of rules on horizontal cooperation agreements and de minimis⁴⁷.

Turkey was to adapt all aid schemes other than those granted to the textile and clothing sector⁴⁸ to the rules laid down in Community frameworks and guidelines under 87 and 88 of EC Treaty within two years after the entry into force of the CU. However, Turkey failed to adopt legislation on state aid and also to establish an independent state aid monitoring authority. According to the Progress Report of 2006, their absence delays the adoption of implementing rules for competition under the Customs Union Decision 1/95 and results in serious distortions of competition.

Under article 41 which is identical to article 86 of the Treaty, Turkey was to ensure adopting rules enabling public undertakings and undertakings having exclusive and special rights to be subject to rules on competition by the end of the first year following the entry into force of the CU. However, no development can be recorded with regard to alignment of rules on this matter. Lack of a rule similar to Article 86 of EC Treaty in Turkish law let the anti competitive conducts of public undertaking and undertaking granting exclusive or special rights based on state measures wholly remain out of scope of the competition rules.

According to article 43 of the CU, if the Community or Turkey believes that anti-competitive activities carried out on the territory of the other Party are adversely affecting its interests or the interests of its undertakings, the first party may notify the other Party and may request that the other Party's competition authority initiate appropriate enforcement action. The notification shall include an offer for such further information and co-operation the notifying party is able to provide. However, the experience with actual cooperation is still limited in Turkey, and so far no successful results have been achieved.⁴⁹ Lack of the implementation rules is one of grounds for the rejection of cooperation based on by competition authorities of EU members and EU Commission. Therefore, as long as the implementation rules are not adopted, enforcement of competition rules between the Community and Turkey are not deemed to be applicable.⁵⁰

⁴⁷The Court of Justice recognised that Article 81(1) prohibiting agreements liable to affect competition was not applicable where the impact of the agreement on intra-Community trade or on competition was not appreciable. The European Commission issued a notice (Commission Notice on agreements of minor importance which do not appreciably restrict competition under Article 81(1) of the Treaty establishing the European Community (de minimis) [Official Journal C 368 of 22.12.2001]) which defined agreements of minor importance (de minimis) and exemptions concerning them. The Commission quantifies, with the help of market-share thresholds, those agreements, decisions of associations of undertakings and concerted practices that do not constitute an appreciable restriction of competition. This approach is particularly useful when it is necessary to exempt agreements that do not affect competition but are not covered by the block exemption regulations.

⁴⁸ Turkey undertook to adapt all its aids granted to the textile and clothing sector to the rules laid down in the relevant Community frameworks and guidelines under 87 and 88 of CU, before the entry into force of the CU according to article 39/2(c).

⁴⁹ Competition Authority Decision, Case 2003-1-85, Decision No 06-55/712-202, Decision Date 25.07.2006; for further information: Yaşar Tekdemir, Suggestions For Enhancing The Effectiveness of Cooperation on CLP Issues At Regional Level : Lessons From Turkey, presented at the UNCTAD/Yeditepe Seminar on Competition Provisions in regional Trade Agreements, Istanbul, Turkey, 31 July-01 August 2006

⁵⁰ Under article 37(2), Until implementation rules are adopted “a) the authorities of the Community or Turkey shall rule on the admissibility of agreements, decisions and concerted practices on abuse of dominant position in accordance with Articles 32 and 33”. In the context of this provision and spirit of CU, the existence of direct effect can legitimately be raised for the enforcement of competition rules between the Community and Turkey.

Alignment with the Common Commercial Policy

The customs union not only brings the dismantling of tariff and non-tariff trade barriers for manufactured goods between the two partners, but also creates common trade barriers vis-à-vis third countries, since Turkey also applies the Common Customs Tariff of the Community. This application involves a reduction of tariffs against imports from third countries. However, for limited product groups⁵¹, Turkey retained customs duties higher than the CCT until January 2001.

The most intensely discussed cost and the immediate challenge to the Turkish economy has been the diminishing public income due to the dismantling of customs duties and the abolition of the Mass Housing Fund levy, which is collected from industrial product imports to finance housing projects in Turkey. This is estimated to be a loss of around \$2.5 billion annually, which according to the World Bank estimate is equal to 1.4% of GDP⁵². The application of the CCT for third countries is also expected to have an impact on public income.

As the Community has granted trade preferences to many third countries through either bilateral trade agreements or unilateral decisions, the application of the common customs tariff obliges Turkey to give preferential access to its markets to the countries to which the EC has given or will give preferential access⁵³. Article 16 states that Turkey shall gradually align itself with the preferential customs regime of the Community over a five-year period and the “alignment will concern both the autonomous regimes and preferential agreements with third countries”.⁵⁴

As most of these preferential agreements are negotiated reciprocally, Turkey should also gain from having preferential access to these markets. According to the World Bank estimates, “improved access to these markets would result in a gain in Turkish welfare of 0.5%”.⁵⁵ However, Turkey not only has to harmonize its foreign trade policy with respect to preferences but also has to apply the protective measures for imports from third countries and negotiate agreements on a mutually advantageous basis with the countries concerned (Article 12-16). On the other hand, the customs union does not impose any restraints on the subsidies on exports to third countries and this might divert resources to sectors and products oriented toward these countries.

Not being in the decision mechanism, Turkey has no voice in the agreements that the EU concludes with third countries. Once a FTA is concluded, this opens the entire customs union

⁵¹ For detailed assessment of trade relations see Balkır, 1993, 100-139.

⁵² Glenn W. Harrison et. al., “Economic Implications for Turkey of a Customs Union with the European Union”, *World Bank Policy Research Working Paper*, No. 1599, May 1996, <http://ideas.repec.org/p/wbk/wbrwps/1599.html>, p. 3.

⁵³ EFTA, Israel, Bulgaria, Romania, Macedonia, Croatia, Bosnia-Herzegovina Palestine and Tunisia.

⁵⁴ The autonomous regimes referred to in Article 16 of Association Council Decision nr. 1/95 are as follows: The Generalized System of Preferences, The regime for goods originating in the Occupied Territories, The regime for goods originating in Ceuta or Melilla, The regime for goods originating in the Republic of Bosnia-Herzegovina, Croatia, Slovenia, and the territory of former Yugoslav Republic of Macedonia. The same article refers to the following preferential agreements: The Europe Agreements with Bulgaria, Hungary, Poland, Romania, Slovakia and the Czech Republic, The Free Trade Agreement with Faroe Islands, The Association Agreements with Cyprus and Malta The Free Trade Agreements with Estonia, Latvia, and Lithuania, The Agreement with Israel, The Agreements with Algeria, Morocco and Tunisia, The Agreements with Egypt, Jordan, Lebanon and Syria, The Free Trade Agreement with Switzerland and Liechtenstein, The Agreement on the European Economic Area.

⁵⁵ Harrison et. al., p. 13.

area of the EU, which also includes Turkey. However, the concession by the third country concerns only the exports originating from EU countries, and not Turkey, since it is not a full member. It is up to the EU to take Turkey's interests into account during the negotiation process of the FTA⁵⁶.

Recently, business circles in Turkey have started to voice the need for revision of the CU and the revision demands do not imply re-negotiation of the CU decision but rather aim to address the difficulties faced in implementation⁵⁷. However, Ankara Chamber of Commerce goes a step further and claims that the CU is the main reason of Turkey's trade deficit in the last eleven years, and a hump in the back of Turkey. The President of the Chamber, Sinan Aygün argues that by the conclusion of the CU in 1996, Turkey has, by itself, abolished its chance of becoming an EU member and opened the way to the special status position. He concludes that it is necessary to reconsider the terms of the CU and replace it with a free trade agreement which protects the sensitive sectors of Turkey⁵⁸.

Complaints have also been voiced regarding the neglect by the EU of the necessity of consultation with Turkey before starting a FTA negotiation with a third country. In fact, changes in EU's commercial policies have been implemented without proper cooperation or consultation with Turkey. Although Turkey, due to its obligations under the CU, has to give the same concessions provided by the EU to these third countries, they are generally reluctant to give the reciprocal concessions to Turkey. Because, they get, indirectly, the opportunity of exporting their products tariff-free to the Turkish market due to free circulation of their goods in the Community. Therefore, Turkey faces the risk of losing tariff revenues generated from the third country products. In exchange, as long as they do not conclude a FTA with Turkey, only goods originating from the EU members states would profit from preferential arrangements. Additionally, this situation creates a disadvantage for Turkey in competing with EU exporters in third country markets⁵⁹.

The EU aims to increase the FTAs within the context of its new strategy introduced by a communication titled "Global Europe-Competing in the World" dated 4 October 2006⁶⁰. It is expected that in the near future, EU will conclude FTAs with Korea and India which are also significant trade partners of Turkey. Thus there is a rising concern in business circles that if Turkey's sensitivities are not taken into consideration in the FTA negotiations, Turkey will face the risk of trade diversion, especially in the automotive sector in the case of Korea and in textiles and clothing in the case of India. Hence, the General Secretary of the Economic Development Foundation, Kabaalioglu, suggests that Turkey should be included in EU's FTAs or at least given the opportunity for conducting FTA negotiations in parallel with the EU. In both situations it will be crucial that conclusion and ratification of FTA agreements with the third countries should take place simultaneously for both Turkey and the EU. The official bodies in Turkey are called to voice these demands in their meetings with the EU

⁵⁶ See Undersecretary of Foreign Trade for detailed information on FTAs , <http://www.dtm.gov.tr/dtmweb/index.cfm?action=detay&yayinID=341&icerikID=363&dil=TR>

⁵⁷ Referans Daily, "Gümrük Birliği'nin gözden geçirilmesine AB'den onay geldi", 03.08.2007, http://www.referansgazetesi.com/haber.aspx?HBR_KOD=75160&KTG_KOD=245&ForArsiv=1

⁵⁸ Ankara Ticaret Odası Basın Açıklaması, "Gümrük Kamburu Raporu", 25.03.2007, <http://www.atonet.org.tr/yeni/index.php?p=1054&l=1>.

⁵⁹ Ülgen and Zahariadis, pp.7-8.

⁶⁰ European Commission, Global Europe-Competing in the World, A Contribution to the EU's Growth and Jobs Strategy, http://trade.ec.europa.eu/doclib/docs/2006/october/tradoc_130376.pdf , p. 11.

officials⁶¹. Another alternative suggested by Undersecretary of the Prime Ministry for Foreign Trade, is to demand compensatory duty on the products coming through the Community but originated from countries with which Turkey has not concluded FTA⁶².

What is also problematic in the CU relationship is that safeguard instruments can still be imposed between the parties. Since the beginning of the CU, the Community has opened many anti-dumping and subsidy investigations. 2005 Regular Report stated that there were two anti-dumping measures in place against imports of steel ropes and cables, and of welded tubes and pipes originating in Turkey. The anti-dumping and anti-subsidy measures against these products were still in force as of 31 December 2006. In terms of safeguard measures, the investigation regarding the imports of farmed salmon was terminated in April 2005. A safeguard investigation on imports of frozen strawberries was opened in July 2005⁶³ and the anti-dumping and anti-subsidy investigations on pentaerythritol are pending as of 31 December 2006⁶⁴.

Conclusion

Turkey is the first country to conclude a customs union with the EC without being a full member. However, since the aid and the support mechanisms in the Community are designed in line with the full membership perspective, Turkey received very little financial support. Nevertheless, the medium term impact of the CU on Turkish economy should not be considered negative, but far from fulfilling the expectations. It is beyond discussion that some main features of this relationship are not to the advantage of Turkey and gave rise to frustration on the Turkish side, strengthening the euro skeptic trends in Turkey. Given the share of agriculture in trade and the share of service sector in the Turkish economy, the exclusion of both sectors from the CU has become a major shortcoming to Turkey, a point not seen ahead at the time when the Association Agreement was drawn but became apparent in the second half of the 90s.

The CU stipulated in the Ankara Agreement and the Additional Protocol was limited to abolishing customs duties and taxes having equivalent effects and imposing common customs tariffs on third countries. However, in parallel to the evolution of the *acquis communautaire* and the changes in the global perspective, such as the Generalized System of Preferences, and other preferential trade agreements concluded by the EU, the concept of customs union underwent vital changes and enlarged. Thus, it became of utmost importance to emphasize the fact that the CU between Turkey and the EU is not a kind of relationship in itself, but should be regarded rather as an integral part of a gradual process of integration, the origin that goes back to the initial phases of the relationship between the partners. Therefore, it is only by means of total integration that such a relationship could be sustainable in the long term.

In the preamble of the January 1995 Decision of the EC-Turkey Association Council, it is stated “the Customs Union represents an important qualitative step, in political and economic terms within the Association relations between the Parties.” The Decision refers to the

⁶¹ “İKV Başkanı Kabaalioğlu: AB'nin 3. ülkelerle yaptığı anlaşmalara Türkiye de dâhil edilsin”, 09.08.2007, http://www.abhaber.com/haber_sayfasi.asp?id=18487

⁶² “Türkiye, STA'lara karşı AB'den telafi edici vergi isteyecek”, 11.08.2007, http://www.abhaber.com/haber_sayfasi.asp?id=18508

⁶³ 2005 Regular Report on Turkey's Progress towards Accession, p.6.

⁶⁴ “Anti-Dumping Anti-Subsidy Safeguard Statistics Covering the Full Year 2006”, December 2006, http://trade.ec.europa.eu/doclib/docs/2006/october/tradoc_128626.pdf

objectives set out by the Ankara Agreement and in particular by its Article 28, as maintaining their significance at present. Article 28 stipulates that “as soon as the operation of this Agreement has advanced far enough to justify envisaging full acceptance by Turkey of the obligations arising out of the Treaty establishing the Community, the Contracting Parties shall examine the possibility of the accession of Turkey to the Community.”

Even though Turkey has started accession negotiations on 3rd October 2005, the CU still forms a fundamental part of the relations between Turkey and the EU. As stated in the European Commission’s 2005 Regular Report on Turkey’s Progress towards Accession “Despite the overall success of the Customs Union, there are a number of unfulfilled commitments by the Turkish side. This applies in particular to technical barriers to trade, state aids, to the enforcement of intellectual property rights and to provisions which discriminate between EU and Turkish operators.”⁶⁵ The Commission’s 2006 Regular Report draws attention to certain areas which are not yet aligned such as free trade zones, customs duty relief, fight against counterfeit goods, and post clearance. Other points emphasized in the Report are the need to abolish duty-free shops at incoming points and to strengthen administrative capacity.⁶⁶

Screening meetings on the chapter of customs union took place at the beginning of 2006. The screening report issued on 9 March 2007 highlights the considerable level of alignment of the Turkish customs law on the *acquis* in the field of customs union due to its presence since 1996. Discrepancies stated in the screening report covers issues such as control at the borders, customs status of goods, duty relief, rules of origin, counterfeit, and free zones which are considered as being outside Turkey’s customs territory.⁶⁷

On the other hand, the accession of Cyprus to the EU has raised a politically sensitive issue between Turkey and the EU regarding the signing of the Additional Protocol adapting the EC Turkey Association Agreement to the accession of ten new countries. The European Council of 16-17 December 2004 requested from Turkey to sign this Protocol as one of the preconditions to start accession negotiations with the EU. On 29 July 2005, Turkey signed the Additional Protocol and at the same time issued a declaration stating that signature of the Additional Protocol did not amount to the recognition of the Republic of Cyprus. On 21 September 2005, the EU adopted a counter- declaration indicating that Turkey’s declaration was unilateral, did not form part of the Protocol and had no legal effect on Turkey’s obligations under the Protocol. The EU declaration stressed that the recognition of all Member States was a necessary component of the accession process, as well as the full and non-discriminatory implementation of the Additional Protocol, and the removal of all obstacles to the free movement of goods, including restrictions on means of transport. According to the declaration of the EU, “Turkey must apply the Protocol fully to all EU Member States. The EU will monitor this closely and evaluate full implementation in 2006. The European Community and its Member States stress that the opening of negotiations on the relevant chapters depends on Turkey’s implementation of its contractual obligations to all Member States. Failure to implement its obligations in full will affect the overall progress in the negotiations.”⁶⁸

⁶⁵ 2005 Regular Report on Turkey’s Progress towards Accession, p. 5.

⁶⁶ 2006 Regular Report on Turkey’s Progress towards Accession, p.70.

⁶⁷ “Screening Report Turkey Chapter 29-Customs Union”, 9 March 2007, <http://www.abgs.gov.tr/index.php?p=94&l=1>.

⁶⁸ “EU Counter-Declaration on Protocol to the Ankara Agreement”, *Enlargement Newsletter*, 10 October 2005, http://europa.eu.int/comm/enlargement/docs/newsletter/latest_weekly_101005.htm#a3.

Furthermore, the Negotiation Framework Document for Turkey states that the advancement of negotiations will be guided by Turkey's progress in preparing for accession and this progress will be measured in particular against some requirements. "The fulfillment of Turkey's obligations under the Association Agreement and its Additional Protocol extending the Association Agreement to all new EU Member States, in particular those pertaining to the EU-Turkey customs union" is among these requirements.⁶⁹

Thus the CU has become one of the sensitive issues on the agenda of Turkey-EU relations during the negotiations. Indeed, this issue was raised also in the screening report pointing that "as long as restrictions on free movement of goods carried by vessels and airplanes registered in Cyprus or where the last port of call was Cyprus remain, Turkey will not be in a position to fully implement the *acquis* relating to the EU-Turkey customs union"⁷⁰. Following the Commission's recommendation on 29 November 2006 to partially suspend Turkey's EU membership negotiations, EU foreign Ministers decided, on 11 December 2006, to partially suspend negotiations with Turkey for eight of thirty-five chapters including the chapter on customs union⁷¹. Accordingly, the CU which is an area where Turkey has a significant level of alignment with the *acquis* and also representing an important qualitative step, in political and economic terms towards integration within the Association relations between the Parties, has become a bottleneck, due to the political positioning of the EU on the Cyprus issue.

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⁶⁹ "Negotiation Framework for Turkey", http://www.eu.int/comm/enlargement/docs/pdf/st20002_en05_TR_framedoc.pdf.

⁷⁰ Screening Report Turkey Chapter 29-Customs Union

⁷¹ Chapter 1: free movement of goods, Chapter 3: Right of establishment and freedom to provide services, Chapter 9: Financial services, Chapter 11: agriculture and rural development, Chapter 13: fisheries, Chapter 14: transport policy, Chapter 29: customs union and Chapter 30: external relations.

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