THE EU NEGOTIATIONS AS A REFORM STRATEGY:

TURKEY’S PROBLEM AHEAD

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Abstract

During the negotiation phase of accession to the European Union (EU), Turkey has to carry out a series of reforms. In this context, reforms are taken as production processes to setup new institutions by using available resources of the society. The EU reserves the right of not accepting Turkey as a member state, irrespective of her reform performance. Therefore, in reforming her institutions, Turkey has to consider this uncertainty. It is shown that reforms lead to a welfare loss vis-à-vis status-quo-preserving policies during the negotiations period. It is claimed that even if all political parties consider reforms as desirable, they will commit themselves to a pro reform strategy only if certain extra conditions are satisfied.

Keywords: EU accession, Institutional reform.
I. Introduction

In the December 2004 meeting of the European Council, the European Union (EU) decided to launch negotiations with Turkey to establish a timetable for accession. The term “negotiation” in this context refers to a phase in which the candidate country adapts and implements the EU legislation, *acquis communautaire*. In other words, the term “negotiation” is slightly misleading. What will actually happen is that the candidate country, i.e. Turkey, will undertake certain reforms to restructure some of her institutions to be compatible with the EU. In this context, the EU-compatible institutional structure defined as the one that satisfies the First Copenhagen Economic Criteria, i.e. those institutions that are necessary to create a market based functioning economy.\(^1\) Obviously, these minimal requirements that the EU imposes on Turkey are not negotiable; however, Turkey has a set of options in terms of sequencing and timing of her reforms. If feasible, Turkey can choose to go beyond satisfying these minimum requirements and lay institutional foundations of an economy that can cope with competitive pressure and market forces within the EU, i.e. the Second Copenhagen Economic Criteria.

In last two decades, economic reforms, especially in the context of transition economies, have extensively been discussed. These studies analyzed issues such as gradualism as opposed to a big bang strategy under aggregate and individual uncertainty concerning the outcome of reforms, status-quo bias in the presence of individual-specific uncertainty, whether this bias can be overcome by a gradualist approach, and alike.\(^2\) What makes the Turkish negotiation process an interesting case to analyze is that even in the absence of aggregate and individual uncertainty regarding the
outcome of reforms, there is still an important source of uncertainty: the so-called “EU’s absorption capacity”. That is, there are concerns of the EU countries on the Turkey’s membership. At the end of the negotiation process, Turkey may end up as a member of the EU or not. Even the negotiation process can abruptly come to an end due to reasons, irrespective of the performance of Turkey. The natural question then arises is why Turkey should continue with the negotiation process instead of reforming the economy according to its own agenda (domestic reform process). Under which conditions should Turkey follow the second route? Our basic aim is to answer these questions.

The plan of the paper is as follows: In the following section, we consider the EU negotiations as a process, in which the government radically changes the existing institutional structure of the economy, as opposed to an evolutionary change by the market mechanism and the government’s secondary and facilitating role in this evolutionary change. The institutional development is not “endogenous”; the government designs new institutions to replace the existing ones. That is, the government does not follow a “policy tinkering strategy” as in Iyigun and Rodrik (2004). Turkey’s membership creates controversy not only in the EU countries but also in Turkey. Since the latter affects the domestic politics, and consequently the strategies of the political parties, the major differences between the pro- and anti-EU views are delineated. In the third section, we present a simple framework to compare the welfare effects of different strategies. In this context, a distinction is made between the EU- and domestic reform approaches. We then analyze the welfare implications of government led institutional reforms financed by extra taxation making use of this model. We take the uncertainty around the EU membership into consideration in welfare calculations. In the fourth
II. The EU Negotiation Process: A Reform Agenda to Change the Institutional Structure of the Turkish Economy

Following North (1990, p.3), institutions can be defined as “...the rules of the game in a society or more formally, are the humanly devised constraints that shape human interaction”. In most instances, institutional development takes place as a result of a change in interactions among the members of a society. Such a change induces the society to allocate its time, energy and material resources to design new institutions that serve the social needs better. In a sense, such institutional development is akin to the Schumepeterian innovation process where the role of entrepreneur is taken by the society. This situation can be labeled as “evolutionary change”. In this framework, institutional development is “endogenous”, i.e. it is the outcome of the working of the market mechanism. In this case, the role that a government can play is to facilitate institutional development in line with the popular demands reflected by market signals. Using the terminology in Iyigun and Rodrik (2004), such a government can be said to follow a “policy tinkering (PT-) strategy”.

In many instances, societies, in order to cope with external shocks, change their institutional structure. In this case, in contrast to the former, designing institutions can be considered as an instrument to introduce a new mode of human interaction to replace the existing one. This situation can be labeled as “reform”. The EU negotiation process aims at transforming a subset of existing institutions into the ones that are externally given. This is a problem of finding the best path to achieve the targeted institutional set-
up. In this case, the government is expected to assume more responsibilities, and commit itself to an “institutional reform (IR-) strategy”, again, in the sense used in Iyigun and Rodrik (2004).4

The EU and Turkey agreed that the negotiations are open ended, i.e., even if Turkey satisfies all the necessary conditions for EU membership, the EU may still have an option of not accepting her membership. The concerns of the EU countries on Turkey’s membership are aggregated under the term “EU’s absorption capacity”, which combines factors ranging from psychological ones such as the prejudices against Turkey to more rational ones such as the concerns over the Turkish economy’s development level and its size. In any case, this implies that at the end of the negotiation process, the outcome may be one of the two qualitatively very different states: Turkey may end up as a member of the EU or may not. The social welfare function, then, should incorporate this information in taking into account society’s wellbeing after the completion of the negotiation phase. This point can be incorporated into the social welfare function in the following way:

\[
W[(y, \delta), \rho, (q^{EU}, z^{EU}), T] = \sum_{t=0}^{T} (1 + \rho)^{-t} U(y_t, \delta_t) + q^{EU} \sum_{t=T+1}^{\infty} (1 + \rho)^{-t} U(y_t, \delta_t, z^{EU}) + (1 - q^{EU}) \sum_{t=T+1}^{\infty} (1 + \rho)^{-t} U(y_t, \delta_t),
\]

where, \(y\) is the output level, \(\delta\) is the institutional structure, \(\rho\) is the social discount rate which is assumed to be given, \(q^{EU}\) refers to the probability of Turkey getting EU membership after successfully satisfying the FCEC, \(z^{EU}\) is the extra benefits that the EU is expected to create for Turkey after her membership (say due to better access to international markets, lower transaction costs and the implied gains from trade), \(t\) is the
time measured in years and $T$ is the closest date that is feasible for Turkey to complete the negotiations with the EU.

The first term on the right hand size of (1) is the intertemporal social welfare function for the negotiation period. The second term refers to the social welfare of the society after the negotiations period if Turkey becomes a member of the EU. The third term, however, refers the social welfare if it is not the case.

Turkey’s EU membership is a controversial topic not only in the EU but also in Turkey. At the expense of oversimplifying the issue, various expressed views can be clustered under “pro-” and “anti-EU” labels. A closer inspection of these views reveals that they differ in four major points that can be expressed in terms of the parameters of the framework introduced above. These points and the nature of the differences are summarized in Table 1.

[Insert Table 1 here]

As can be seen from Table 1, for the first three variables the disagreement between two sides is on their relative magnitudes. For the fourth variable, i.e. for the EU-related reforms, the views differ in their desirability in a broader perspective. The arguments put forward on each item by both sides are as follows:

1) $q^{EU}$. According to the anti-EU view, even if Turkey successfully completes the negotiations phase, the EU will not grant membership status to Turkey, i.e. $q^{EU} \equiv 0$. The pessimistic stance of the anti-EU view is based on the assumption that rather negative feelings concerning Turkey’s membership among the citizens of the EU countries as reflected in the opinion polls, have deep social, historical and political roots and will
remain unchanged in the foreseeable future. The pro-EU view, on the other hand, tends to treat the probability of Turkey getting EU membership depends on Turkey’s performance in reforming the economy and better appreciation of Turkey’s contribution to the welfare of the EU. Hence, the defenders of this view place more emphasis on the efficient use of the negotiations period to influence the EU public opinion.

2) \( z^{EU} \): The anti-EU view is confident that Turkey has alternative routes to integrate herself to the global economy and to sustain the same welfare level that EU membership can offer. Therefore, in terms of the formulation given above, the expected gain from joining the EU, i.e. \( z^{EU} \), may not be significant, especially after the relaxation of the constraints implied by the targeted institutional structure. The pro-EU view, on the other hand, argues that Turkey will benefit considerably from being a member of the EU, and questions the existence and/or feasibility of the alternative paths that can be compared with EU membership.

3) \( \rho \): According to the anti-EU view, the negotiations are expected to take quite a long time. Consequently, expected benefits of the EU membership lie far ahead. Nonetheless, uncertainties both concerning political developments within the EU and the prospects in the global economy reduce the relevance in taking long-term decisions concerning membership. In the terminology used above, this argument implies that \( \rho \) is very high and therefore the present value of the welfare of the society in the post-negotiation period is negligibly small. The pro-EU view, being more optimistic, argues that as Turkey consolidates her economic and political stability during the negotiations period, a significant and steady decline in \( \rho \) can be envisaged.
4) $\delta^{EU}$: According to the anti-EU view, the constraints on the institutional structure that the EU is imposing on Turkey are significantly different from those that the country needs to impose on herself if it implements its own restructuring program to integrate herself successfully to the globalizing world economy. In contrast, according to the pro-EU view, most of the reforms that the country has to undertake during the negotiations are not only necessary for Turkey to be eligible for EU membership, but also indispensable if the country wants to be successful in her efforts to integrate herself into the increasingly competitive global economy. To support their view, they point out the similarities between reforms envisaged in the Turkey’s own 2001 economic program and those indicated in the EU list.

III. Reform: Which Route?

We first present our benchmark model. Then, we analyze the welfare implications of IR- and PT-strategies. For simplicity, we take PT-strategies as defending the status-quo. In carrying out this exercise, two different IR-strategies, namely the “EU-compatible” and “domestic” strategies are distinguished.

For simplicity, we abstract from physical capital entirely and assume that the aggregate labor force is constant. Each identical firm has the linear production function,

$$y_t = A \delta_t,$$

where $y_t$ is per capita output, $A$ is the level of technology, and $\delta_t$ is the institutional structure prevailing at the beginning of period $t$. The level of technology is assumed to be
constant. The evolution of the institutional structure is determined by government expenditures which are completely financed by tax revenues.

\[ \delta_{t+1} = \delta_t + \beta \tau_{t-k} y_{t-k}, \]  

(3)

where \( \tau \) is the tax rate, \( \beta \) is a positive and constant conversion parameter and \( k (k=0, 1, \ldots, n) \) is one less the number of periods needed in order a reform process to change the institutional structure of the economy. Per capita consumption is given by

\[ c_t = (1 - \tau_t) A \delta_t. \]  

(4)

III.1 The Status-quo

Under the status-quo, the government makes no expenditures and the tax rate is zero. Accordingly, the institutional structure remains intact. Hence,

\[ \tau_t^{SQ} = 0, \delta_t^{SQ} = \delta_0, c_t^{SQ} = A \delta_0, \]  

(5)

where the superscript ‘SQ’ denotes the status-quo and \( \delta_0 \) is the initial level of the institutional structure.

III.2 Consequences of Economic Reform

We consider two reform strategies: the EU process and the domestic process. In both of these processes, the government aims at changing the institutional set-up of the country radically. This is accomplished by government expenditures which are fully covered by taxes. The change in the institutional structure increases the productivity level (a higher \( \delta_t \) in (2)).
At best, k=0 and government expenditures become effective with only one period lag. At the other extreme, k=T-1, where T is the end of the reform process. The reform process begins in the first period and \( \tau_t > 0, t \in [1, T] \). Note that \( \tau_0 = 0 \) and \( \delta_1 = \delta_0 \).

Under these conditions, for \( t \in [2, T + 1 + k] \):

\[
\delta_t = \delta_0 + \beta \sum_{j=1}^{t-1} \tau_{t-k-j} y_{t-k-j} .
\]  \( \text{(6)} \)

Since \( T \) is the end of the reform process, \( \tau_{T+j} = 0; j \geq 1 \) and accordingly

\[
\delta_t = \delta_{T+1+k}; t > T + 1 + k .
\]  \( \text{(7)} \)

Let, under both strategies, the targeted institutional structure be \( \delta^* \). Hence,

\[
\delta_{T+1} = \delta^* = \delta_0 + \beta \sum_{j=1}^{T} \tau_{T+1-k-j} y_{T+1-k-j} .
\]  \( \text{(8)} \)

For simplicity, assume that the tax rate is constant throughout the reform process. Using (2) in (8) gives the desired tax rate as

\[
\tau = \frac{\delta^* - \delta_0}{\beta \sum_{j=1}^{T} \delta_{T+1-k-j}} .
\]  \( \text{(9)} \)

This equation shows that the desired tax rate increases as \( \delta^* \) and \( k \) increase and decreases as \( T \) increases. In order to see the effect of \( k \), let us analyze two extreme cases. First take \( k=T-1 \). In this case

\[
\delta_1 = \delta_2 = ... = \delta_T = \delta_0; \delta_{T+j} > \delta_0, j \geq 1 ,
\]
\[ \tau = \frac{(\delta^* / \delta_0) - 1}{\beta A}, \]

\[ c_1 = c_2 = \ldots = c_T < \bar{c}_{SQ}; c_{T+j} > \bar{c}_{SQ}, j \geq 1. \]

When \( k=0 \), the situation changes sharply:

\[ \delta_{t+1} = (1 + \beta A \tau) \delta_0, \quad t \in [0,T] \quad \delta_{T+j} = \delta_{T+1}, \quad j \geq 1, \]

\[ \tau = \frac{(\delta^* / \delta_0)^{1/T} - 1}{\beta A}, \]

\[ c_1 < \bar{c}_{SQ}; \quad c_i > \bar{c}_{SQ}, \quad t \in [2,T] \quad c_{T+j} > \bar{c}_{SQ}, j \geq 1. \]

Hence, when \( k=T-1 \), the reform process necessitates a higher tax rate and has a potential to increase dissatisfaction given lower than the status-quo per capita consumption levels throughout the reform process. In contrast, when \( k=0 \), targeted level of institutional structure can be achieved by a much lower tax rate. The first period per capita level of consumption is below than that achieved when the status-quo is kept intact. For remaining periods of the reform process, comparison depends on the parameter values of the model. However, under plausible conditions, consumption levels attained during the reform process will outperform the status-quo consumption levels as time goes by. Finally, for \( t \in [T, 2T] \) per capita consumption levels, when \( k=0 \), will be higher than those obtained when \( k=T-1 \).
We now turn to effects of two different types of reform strategies. To simplify the analysis, we take $T=2$ and $k=0$ for both of the reform processes. Similarly, the targeted level of institutional structure is same in the EU and domestic processes. Consequently,

\[
\delta_1 = \delta_0, \delta_2 = (1 + \beta \tau A) \delta_0 = \delta_T, \delta_3 = (1 + \beta \tau A)^2 \delta_0 = \delta_{T+1+}, j \geq 0, \quad (10)
\]

\[
\delta = \frac{(\delta^* / \delta_0)^2 - 1}{\beta A}, \quad (11)
\]

\[
c_1 = (1 - \tau)c^{SO}, \quad c_2 = (\delta^* / \delta_0)^2 (1 - \tau)c^{SO}, \quad c_3 = (\delta^* / \delta_0)c^{SO}. \quad (12)
\]

Note that these consumption levels would be attained if there were no uncertainty regarding the EU and domestic processes.

### III.2.1 The EU reform process

Completion of the reforms envisaged by the EU negotiations process, although necessary, is not sufficient for securing Turkey’s membership to the EU. The EU reserves the right to say “no” to Turkey’s membership, for example, by referring to its absorption capacity. Here, it is assumed that even at the end of the first period, there is such a probability $(1 - q^{EU}_2)$. If this sudden stop realizes, there are two possibilities in front of the reformers: either switching to the domestic route and continue with the reform process, or turning back to the status-quo. Let the probability of choosing the domestic reform alternative be $q^{D}_2$. If there is not any sudden stop, the reform process continues in the second period. At the end of this period, the EU gives its final decision; the
probability of receiving a ‘yes’ from the EU is $q_{3}^{EU}$. The timing of events is shown in Table 2.

[Insert Table 2 here]

Using these probabilities expected per capita consumption levels as of the beginning of the reform process is as follows:

\[
E_{0}(c_{1}^{EU}) = (1 - \tau)c^{SO}, \tag{13a}
\]

\[
E_{0}(c_{2}^{EU}) = [q_{2}^{EU}(1 - \tau)(\delta^{*} / \delta_{0})^{1/2} + (1 - q_{2}^{EU})q_{2}^{D}(1 - \tau)(\delta^{*} / \delta_{0})^{1/2} + (1 - q_{2}^{EU})(1 - q_{2}^{D})]c^{SO}, \tag{13b}
\]

\[
E_{0}(c_{3}^{EU}) = q_{2}^{EU}[q_{3}^{EU}(\delta^{*} / \delta_{0})z^{EU} + (1 - q_{3}^{EU})(\delta^{*} / \delta_{0})]c^{SO} + (1 - q_{2}^{EU})[q_{2}^{D}(\delta^{*} / \delta_{0}) + (1 - q_{2}^{D})]c^{SO}, \tag{13c}
\]

where $E_{0}(x)$ is the expected value of $x$ as of the end of period 0, and $z^{EU} > 1$ is the additional economic benefit obtained having become a full member to the EU.

**III.2.2 Domestic reform process**

Note that, as mentioned above, we assumed that in the domestic reform process, reformers are able to complete reforms at the same duration as in the EU process. Notwithstanding this assumption, some analysts emphasize that one of the basic advantages of choosing the EU process is that completing the reforms in this process needs significantly less time than the domestic process. The rationale behind this argument is the strong anchoring role of the EU for the reform process.
In our set-up, the first difference between the two reform strategies is the additional benefit stemming from the advantages of full membership to the EU ($Z_{EU} > 1$). The only uncertainty in the domestic process is related with the decision of reformers whether continuing to the reform process or not. This decision is taken at the end of the first reform period ($t=1$). Let the probability of continuing the domestic reform process be $q_{2D}^1$. The timing of events is shown in Table 2. Note that in the EU process, conditional on a sudden stop (a ‘no’ from the EU at the end of the first period), the probability of continuing with the domestic reform process is $q_{2D}^1$. As a second difference, we take $q_{2D}^1 \geq q_{2D}^0$. The reason is simply that receiving a negative answer can decrease reform appetite of both reformers and the public. Based on these arguments, using the “D” superscript for the domestic process, one can derive the expected per capita consumption levels as of the beginning of the reform process as follows:

\[
E_0(c_1^D) = (1 - \tau)c^{SQ} \quad (14a)
\]

\[
E_0(c_2^D) = [q_{2D}^1 (1 - \tau)(\delta^*/\delta_0)^{\frac{1}{2}} + (1 - q_{2D}^1)]c^{SQ}, \quad (14b)
\]

\[
E_0(c_3^D) = [q_{2D}^1 (\delta^*/\delta_0) + (1 - q_{2D}^1)]c^{SQ}. \quad (14c)
\]

**III.2.2 Comparison**

The implied expected consumption levels are given in Table 3 and Table 4. Clearly, in the first period the status-quo (which is taken as the PT-strategy) dominates the IR-strategy. In periods following the second period, that is, after reforms are completed, all members of the society are in all, but two cases, better off compared to
the status-quo: Under the EU process, their consumption level reduces to the level under the status-quo when \( q^E_2 = 0, q^D_2 = 0 \). Under the domestic reform process, per capita consumption level reduces to the level under the status-quo when \( q^{D1}_2 = 0 \). Otherwise, the domestic reform process outperforms the status-quo. Per capita consumption comparisons of the second period generally depend on the parameters of the model. For the EU process only when \( q^E_2 = 0, q^D_2 = 0 \) and for the domestic process only when \( q^{D1}_2 = 0 \) consumers’ consumption levels remain unchanged compared to the status-quo. Otherwise, the PT-strategy can dominate or be dominated by the IR-strategy.

[Insert Table 3 here]

When the comparison is made within the IR-strategy, evidence is mixed. If there were not any uncertainty regarding EU membership, the EU would clearly be the dominant strategy. When a sudden stop is almost certain \( (q^E_2 \approx 0) \), just the opposite is highly likely. Based on a ‘no’ from the EU in the midst of the reform process, if resistance to reform becomes widespread, shifting to the domestic route can be infeasible \( (q^D_2 \approx 0) \). If this is the case then the domestic reform strategy will certainly outperform the EU-strategy. Moreover, taking the first period dominance of the status-quo and the parameter dependence of the second period into consideration, the EU-strategy can prove to be the worst strategy. However, after receiving a ‘no’ from the EU at the end of the second period, the reformers can continue with the domestic route. In this case, regarding per capita consumption, the EU-strategy becomes equivalent to the domestic strategy for \( t=3 \) and the following periods. Then the question is whether a sudden stop
can increase resistance to the reform process and cease reform appetite of reformers. We will turn to this issue in the following section.

[Insert Table 4 here]

Two further points deserve emphasis. Firstly, as discussed above, in the EU process, there is a positive probability that the reforms can be completed earlier than the domestic process. In this case, the EU process can dominate the domestic process. In our calculations, we did not take this probability into consideration. Secondly, the social discount factor is omitted for the sake of simplicity since the main aim is only to make comparisons between the IR-strategies.

IV. Political Competition and Reforms

In the previous section it is demonstrated that governments that implement structural reform programs will, at least in the initial phases of the program, be in a position of asking some sacrifice from the public. In the model of the preceding section, this sacrifice is in the form of a lower per capita consumption. Under certain conditions, for example when there is uncertainty regarding the continuation of the reform process – hence, uncertainty regarding future benefits- as in the presented model or future is discounted heavily, such losses can make these programs and the governments that implement them rather unpopular. Such a loss of popularity is a political cost for reformist governments. The magnitude of this cost, to a great degree, depends on the nature of the political process, notably the mode of political competition. In this section, the political environment of Turkey is simplified into a two-party model and the feasibility of reform in this particular political context is examined.
There are presently two major parties in Turkey; AKP the party in power and CHP the main opposition party. When the coalition possibilities are taken into account, the picture will not drastically change with respect to the EU accession problem even if more political parties are allowed into the scene. After the 2002 elections and during the episode that led to the Turkey’s candidacy to EU membership, the major political parties of the Turkish political arena seem to satisfy the following six assumptions:

**Assumption 1:** *Ex ante*, both of the political parties are in favor of Turkey’s accession to the EU.

**Assumption 2:** *Ex ante*, both of the political parties consider all the major economic reforms envisaged in the negotiation period as necessary for Turkey’s success in the global economy, irrespective of her membership to the EU.

**Assumption 3:** Political parties lexicographically order the state they are in power over any state they are not.

**Assumption 4:** The level of mutual level of trust is too low to make any cooperative effort (including forming a grand coalition) to be feasible.

**Assumption 5:** Both of the political parties are Wittman-type, that is, they are not only interested to be in power but they also have a preference over the actual outcomes of the policies followed.

**Assumption 6:** The negotiations period is expected to take around a decade, i.e. two election periods. It is highly unlikely that Turkey can squeeze her reforms to a shorter time period.
Since these assumptions treat both parties symmetrically, let us pick political party A, and examine its behavior. Note that based on the first assumption before the election both of the parties are in favor of EU accession. However, they can change their attitude after having won the election. Now suppose that the A wins the election. It can follow the EU-strategy (Strategy 1). Consequently, it may carry Turkey to EU membership ($X_{EU+}$) or it may fail to do so ($X_{EU-}$). The second option for the political party A is to follow the PT-strategy (Strategy 2), which makes EU membership infeasible for Turkey. This state is denoted by $X_{PT}$. The third option is to declare openly a withdrawal from EU membership and launch a domestic reform strategy (Strategy 3), whose outcome is denoted by $X_{DR}$. Since the political party A is the Wittman type (Assumption 5), it evaluates these strategies according to its own preference function. Let $Y_{ij}$ is the corresponding outcome of the policies followed when the political party B is in power and $\varphi^A$ and $\varphi^B$ be the preference functions of the political parties A and B, respectively. The outcomes of such evaluations for both of the political parties are given in Table 5.9

[Insert Table 5 here]

Then the above assumptions imply the following results for the political party A$^{10}$:

Since the A prefers Turkey’s EU membership (Assumption 1), then

$$\varphi^A(X_{EU+}) > \varphi^A(X_{EU-}), \quad (15)$$

$$\varphi^A(X_{EU+}) > \varphi^A(X_{PT}), \quad (16)$$

$$\varphi^A(X_{EU+}) > \varphi^A(X_{DR}). \quad (17)$$
The political party A believes the intrinsic merit of the reforms (Assumption 2). Hence,

\[ \varphi^A(X_{EU}) > \varphi^A(X_{PT}), \]  

\[ \varphi^A(X_{DR}) > \varphi^A(X_{PT}). \]  

The political party A lexicographically prefers a state that it is in power to any state that it is not (Assumption 3):

\[ \min_j \{\varphi^A(X_j)\} > \max_j \{\varphi^A(Y_j)\}, \quad j \in \{EU+, EU-, PT, DR\}. \]  

Therefore, for the sake of simplicity, the following assumption can be made:

\[ \varphi^A(Y_j) = \varphi^B(X_j) = 0, \quad j \in \{EU+, EU-, PT, DR\}. \]  

The political party A’s problem in the political competition sphere can be summarized as follows: Suppose that the A wins the first election and comes to the power. If it launches a reform program, its costs will be borne by those people who will vote in the next (second) election before receiving the benefits of the reform program. As the reform program proceeds, a decrease in the per capita consumption level and uncertainty regarding the attitude of the EU towards Turkey (uncertainty regarding future benefits) in the EU-strategy or uncertainty regarding the continuation of the program in the domestic strategy may lead to a decline in public support to the reform strategy. Such a change in the mood of the people can be incorporated into the above framework as a decrease in \( q^{EU} \) and \( q^{D} \). Suppose that voters are rational and base their political choices by looking at their intertemporal welfare. Let the social welfare function introduced in the first section corresponds to the intertemporal welfare of the median
voter. The decline in $q^\text{EU}$ and $q^\text{D}$, at one point, will lead the median voter to support the political party that proposes the PT-strategy. This being the case, under Assumption 3, the challenging political party will not hesitate to launch the PT-strategy to win the (second) election. The ruling political party, on the other hand, under Assumption 4, will expect such a challenge. If this is the case, the ruling political party may refrain from launching reforms, which endangers the chance of radically changing the institutional structure of the economy and increasing future per capita consumption levels. Clearly, such an outcome means an end to the EU journey of Turkey.

This problem can be formulated by a policy choice game between political parties A and B. Suppose that the A is in power and implements the EU-strategy and the B confines its election campaign on challenging the incumbent within the IR-policies sphere. Then the political competition will be between two reform-programs, none of them offering a higher current welfare.

Let $\pi_{ij}^A$ ($\pi_{ij}^B$) denote the probability that the political party A (B) attributes to its chance of winning the election when it chooses the strategy $i$ whereas the other party prefers the strategy $j$, $(i,j = 1,2,3)$. When both parties confine their choices to the EU endorsed reform programs, the probability that the political party A expects to win the election is $\pi_{11}^A \in (0,1)$. In this case the A expects the following outcome:

$$\pi_{11}^A \left[ q^\text{EU} \phi^A (X_{EU^+}) + (1 - q^\text{EU}) \phi^A (X_{EU^-}) \right],$$

which indicates that with a probability $\pi_{11}^A$, the A will win the election and continue to implement its reform program. When the program is completed, either Turkey will be a
member of the EU with a probability \( q^{EU} \) or end up as a non-EU member state that reformed its institutions in line with the EU requirements with a probability \((1-q^{EU})\).

Nonetheless, should the political party B choose the PT-strategy, then as shown in the previous section, it will be offering a higher level of current welfare than the alternative IR-strategy. Unless the present value of voters expected future benefits compensates such a difference, the B’s program may sound more attractive for the voters and it may win the elections. Let’s assume that this is the case. The A will evaluate this state by assigning 0.

If the A chooses the PT-strategy while the B sticks to the EU-strategy, following the same logic, the A will win the elections, and its evaluation of the outcome will be \( \varphi^A(X_{PT}) \). Nonetheless, if both parties choose the PT-strategy, the outcome will again be the state \( X_{PT} \). However, in this case, the A will evaluate the state considering the probability of winning the elections, i.e. \( \pi^A_{22} \). The results given above with their counterparts for the political party B are put together in a 3X3 matrix in Table 6.

From the assumptions made above it is clear that, for the political party A:

\[
\varphi^A(X_{PT}) > \pi^A_{22}\varphi^A(X_{PT}); \text{ (since } \pi^A_{22} < 1) \tag{23}
\]

On the other hand, the relation between \( \pi^A_{11}[q^{EU}\varphi^A(X_{EU+}) + (1-q^{EU})\varphi^A(X_{EU-})] \) and \( \varphi^A(X_{PT}) \) depends on both the election winning probability of the political party A and the difference in its evaluation of the outcomes of the EU- and PT-strategies. If the
probability of winning the election for the A, when both parties follow their IR strategies, is

\[
\pi_{11}^A < \frac{\varphi^A(X_{PT})}{q^{EU} \varphi^A(X_{EU^+}) + (1 - q^{EU})\varphi^A(X_{EU^-})}.
\]  

(24)

(21) and (22) together will imply that the political party A will choose the PT-strategy. Notice that this condition is more likely to be satisfied when the A does not have a strong preference in favor of following an IR-strategy. Since the same line of reasoning can be applied to the B, under these conditions, the above game has a unique Nash equilibrium, at which both parties chose the PT-strategy.

This prisoner’s dilemma type of result draws attention to a political difficulty that Turkey may face in carrying out the necessary reforms for EU accession. Ex ante both people and political parties may be sympathetic to the idea of undertaking reforms. However, as implementation starts, the costs of reforms coupled with the noises that may stem from many sources (for example from some EU members) may change electorate’s behavior. Under these circumstances, political parties may opt for the PT-strategy, simply by postponing socially costly reforms. This will certainly endanger Turkey’s membership to the EU.\(^{12}\)

What kind of solutions can one seek? Obviously, if the net return of the reforms is incomparably high vis-à-vis keeping the status-quo intact, the relative magnitudes in the above matrix will change and in that case the Nash equilibrium will be the state where both parties choose the EU-strategy. One way of achieving this result is by reducing the social cost of reforms through extensive external support. When the size of the country and the present world order are taken into account, such an outcome is highly unlikely.
Secondly, political parties may change their over-jealous attitude towards each other and seek for a cooperative solution. Such a strategy was successfully implemented in Spain during its EU accession. This is certainly not impossible, although unfortunately not very likely in the Turkish context. The last possibility is to reduce the advantage of the PT-strategy. That can be achieved if political parties launch effective threats against each other by launching populist programs if the other one diverges from its own reform program. Notice that such a strategy is effective only if

i) The political parties take each others’ reform programs seriously and therefore change their ordering of feasible states by attributing higher values to successful reform programs implemented by their competitors over their own PT-strategies. This implies Assumptions 1 and 2 should hold not only ex ante but also ex post. Continuation of the negotiations with the EU, in this context, is critically important since it enhances the public awareness and makes all the political parties explicitly accountable.

ii) None of the political parties has a comfortable and unbreakable majority in the parliament. If that is the case, such a party may ignore the threat and may not hesitate to implement the PT-strategy since whatever the opposition offers is infeasible. The reasoning behind this assertion is as follows: Political parties that compete for getting the support of the median voter, have to address different interest groups with varying expectations. In that sense, such political parties can be treated as coalitions, which are expected to reflect in the composition of their deputies. On the other hand, an economic program is implemented by taking a sequence of decisions that, eventually, requires the approval of the parliament. Suppose now that the opposition party threatens the ruling party by competing with it by launching a PT-strategy (or even a populist one) if it
diverges from following its own IR-strategy. Since the implementation of an economic program requires a long sequence of decisions to be taken, the ruling party is likely to face with such a threat at any moment of time. In other words, the relation between the ruling and opposition parties is akin to a repeated game.

Such a threat, however, can only be effective, if the opposition party is in the position of establishing a winning coalition by recruiting some members of the party in the power. Otherwise, the ruling party may easily ignore the threat and continue with the PT-program, without the fear of being challenged. Therefore, an agreement between the political parties on not challenging ruling party as long as it sticks to the IR program, will be binding only if the coalition that the ruling party represents is not strong.

Although the above discussion sheds some light on the conditions under which political parties will stick to the IR strategy, it fails to guarantee that they will, indeed, chose the EU-strategy. From Table 5, it can be seen that when \( \pi_j \)'s are very close, then the EU endorsed reforms will be the A's dominant reform strategy if

\[
q^{EU} > \frac{\phi^A(x_{DR}) - \phi^A(x_{EU^-})}{\phi^A(x_{EU^+}) - \phi^A(x_{DR})}
\]  

(25)

Notice that, for a given \( q^{EU} \), this condition is more likely to be satisfied, if the political party A does not expect much benefit from pursuing domestic reforms. On the contrary, if the political parties evaluate the outcomes of a domestic reform close to the EU endorsed ones, the former may indeed become a dominant strategy.
Conclusion

The so-called “EU’s absorption capacity” and the accompanying “too big to absorb” arguments for Turkey make the Turkish negotiation process an interesting case to analyze from the perspective of political economy. Concerns of the EU countries on Turkey’s membership masked by the EU’s absorption capacity phrase imply that even after successfully reforming her economy, Turkey may not end up as a member of the EU. Moreover, due to the same reason, the negotiation process can abruptly come to an end. The basic question that we ask in the paper is why Turkey should continue with the EU negotiation process instead of reforming the economy according to its own agenda (domestic reform process).

By making use of a simple model, we compared welfare implications of three strategies: the two reform strategies - the EU strategy and domestic strategy- and keeping the status-quo. Reform is defined as the tax financed government expenditures aimed at changing the institutional structure of the economy. Under both strategies, we assumed that the targeted institutional structure is same. Welfare comparisons are sensitive to the length of the reform process and the time lag necessary for the government expenditures to change the institutional structure of the economy.

The important result we obtained is that if there is not any uncertainty regarding EU membership, the EU strategy clearly dominates the other two. However, when it is a widespread expectation that the negotiation process will stop abruptly, just the opposite is likely. Furthermore, if a negative answer from the EU in the midst of the reform process increases resistance to all kinds of reform processes, and ceases reform appetite of reformers, then the EU process becomes the worst one. Under these
conditions, one becomes better of by following the domestic process. Even keeping the status-quo intact increases welfare of economic agents relative to the EU process.

Assuming a rather short (two-period) reform process and only one period of efficiency lag, we showed that the status-quo dominates both of the reform strategies in the first period. We demonstrated that an increase in the efficiency lag will also increase the number of periods in which the status-quo dominates the reform processes. This means that at least in the initial phases of the reform process governments will be in a position of asking sacrifice from the public. Moreover, given the uncertainty surrounded around the so called EU’s absorption capacity of Turkey, the future reward of this sacrifice is not certain to obtain. We analyzed the feasibility of reform in a two-party policy choice game. Under certain conditions specified in the paper we showed that the game has a unique Nash equilibrium at which both parties choose not to change the status-quo.

One way of preventing such an outcome is to reduce the social cost of reforms through a significant amount of external support. The second way-out of this prisoner’s dilemma is to seek for a cooperative solution as in the Spain’s accession to the EU. The third solution to this problem is to reduce the advantage of the policy tinkering strategy. We further showed that if the political parties evaluate the outcomes of the domestic reform process close to the EU process, following the domestic route may become a dominant strategy.
FOOTNOTES

1 The First Copenhagen criteria comprise the following elements:

i) Equilibrating supply and demand through market forces, i.e. liberalization of prices and trade,

ii) High share of private sector and reallocation of resources according to market principles,

iii) Absence of significant barriers to market entry and exit,

iv) Effective recognition of the property rights and the existence of a well established legal system that is capable of enforcing laws and contracts,

v) Macroeconomic stability, i.e., price stability coupled with sustainable public finances and external accounts,

vi) Strong potential of the economy, i.e. availability of sufficient human and physical capital,

vii) Capacity to attract foreign direct investment,

viii) Existence of a financial sector capable of allocating savings to productive investments,

ix) Broad consensus about the essentials of economic policy.


3 For example, in the non-competitive environment of the 1980s in Turkey, where rent seeking was widespread, “informality” was not a major concern for most economic agents. As the economy gradually became more open and competitive, the frequency of complaints concerning “informality” as a source of “unfair competition” increased. The changing mood of the society on this issue encouraged the political decision making body to consider informality as a major cornerstone of the reform process.

4 Some institutions, notably those that stem from tradition and moral codes change rather slowly and can hardly be considered in subject to reforms. (Revolutions, in contrast, aim at abruptly changing a subset of such elements.) For the purpose of this paper, we shall confine ourselves with those institutions that can be changed, within a reasonable time period, with some social effort.

5 We assume that turning back to the status-quo is costless.

6 The paper is finalized in September 2006.
If the political parties are the Wittman type [Wittman (1973)], i.e. if they have their own preferences over policies, then they can be considered evaluating alternative states according to their utility functions. Such parties then can be considered as taking into account not only the initial phase of the reform but also its aftermath, after suitably discounting it, in devising their strategies. For the discussion of the Downs and Wittman type political parties and the comparison of the political equilibria they generate under various assumptions, see Roemer (2001).

Under these circumstances the timing of events can be described as the following: The starting time is the 2007 elections. It is assumed that rather technical and passive “screening phase” will be completed before the 2007 (first) election. Hence, after the first election, the new government will be in the position of actually starting the negotiations with the EU. At that point the government has to make a policy choice. The EU-reform strategy can only be completed after the second election. That means most of the social costs of implementing such a strategy will be cumulated during the tenure of the existing government, and the social welfare enhancing benefits of the EU, if they can be realized, will be reaped after the second election. Nonetheless, if the ruling government does not follow an EU-endorsed reform program, Turkey will lose its chance to join to the EU.

Since Turkey cannot be a member of the EU without undertaking the EU-strategy, the cells that correspond to these options are left empty.

These results are relevant for the political party B as well.

On the other hand, reform process increases the uncertainty perceived by the people; consequently the social time preference, $\sigma$.

Notice that this problem remains in effect when the EU-endorsed reforms are substituted with the domestic reforms. Using south east corner of Table 5 as pivot, the above arguments can be repeated.
REFERENCES


Table 1: Views of Turkish Citizens on EU Membership

<table>
<thead>
<tr>
<th></th>
<th>Pro-EU View</th>
<th>Anti-EU View</th>
</tr>
</thead>
<tbody>
<tr>
<td>$q^{EU}$</td>
<td>$q^{EU} &gt; 0$</td>
<td>$q^{EU} \approx 0$</td>
</tr>
<tr>
<td>$z^{EU}$</td>
<td>$W(z^{EU} \neq 0) &gt; W(z^{EU} = 0)$</td>
<td>$W(z^{EU} \neq 0) \approx W(z^{EU} = 0)$</td>
</tr>
<tr>
<td>$\rho$</td>
<td>$\rho$ can be reduced to a sufficiently low level.</td>
<td>$\rho$ is high and will remain so.</td>
</tr>
<tr>
<td>$\delta^{EU}$</td>
<td>$\delta^{EU}$ is a necessary condition for Turkey’s integration to global economy.</td>
<td>$\delta^{EU}$ is necessary only for EU accession.</td>
</tr>
</tbody>
</table>
Table 2: The Timing of Reforms and Events (T=2, k=0)*

<table>
<thead>
<tr>
<th>EU Process</th>
<th>Domestic Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\tau &gt; 0$</td>
<td>$\tau &gt; 0$</td>
</tr>
<tr>
<td>$q_2^D$</td>
<td>$q_2^{D1}$</td>
</tr>
<tr>
<td>$q_2^{EU}$</td>
<td>$q_2^{EU}$</td>
</tr>
<tr>
<td>$\tau = 0$</td>
<td>$\tau = 0$</td>
</tr>
<tr>
<td>$q_3^{EU}$</td>
<td>$q_3^{EU}$</td>
</tr>
<tr>
<td>$\delta_1$</td>
<td>$\delta_1$</td>
</tr>
<tr>
<td>$t=1$</td>
<td>$t=1$</td>
</tr>
<tr>
<td>$\delta_2$</td>
<td>$\delta_2$</td>
</tr>
<tr>
<td>$t=2=T$</td>
<td>$t=2=T$</td>
</tr>
<tr>
<td>$\delta_3$</td>
<td>$\delta_3$</td>
</tr>
<tr>
<td>$t=3=T+1$</td>
<td>$t=3=T+1$</td>
</tr>
<tr>
<td>$\delta^*$</td>
<td>$\delta^*$</td>
</tr>
</tbody>
</table>

* T is the length of the reform process; k is one plus the number of periods needed in order a reform process to change the institutional structure of the economy (see the text).
Table 3. Ex-ante Consumption Comparisons with Respect to the Status-quo (T=2, k=0)*

<table>
<thead>
<tr>
<th>Probabilities</th>
<th>Result</th>
<th>Probabilities</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU-strategy</td>
<td></td>
<td>Domestic strategy</td>
<td></td>
</tr>
<tr>
<td>t=1:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No uncertainty</td>
<td>EU&lt;SQ</td>
<td>No uncertainty</td>
<td>D&lt;SQ</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>t=2:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 = 1$</td>
<td>EU?SQ</td>
<td>$q^D_2 = 1$</td>
<td>D?SQ</td>
</tr>
<tr>
<td>$q^E_2 = 0, q^D_2 = 1$</td>
<td>EU?SQ</td>
<td>$q^D_2 = 0$</td>
<td>D=SQ</td>
</tr>
<tr>
<td>$q^E_2 = 0, q^D_2 = 0$</td>
<td>EU=SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 = 0, q^D_2 \in (0,1)$</td>
<td>EU?SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 \in (0,1), q^D_2 = 1$</td>
<td>EU?SQ</td>
<td>$q^D_2 \in (0,1)$</td>
<td>D?SQ</td>
</tr>
<tr>
<td>$q^E_2 \in (0,1), q^D_2 = 0$</td>
<td>EU?SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 \in (0,1), q^D_2 \in (0,1)$</td>
<td>EU?SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>t=3:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 = 1, q^E_3 = 1$</td>
<td>EU&gt;SQ</td>
<td>$q^D_3 = 1$</td>
<td>D&gt;SQ</td>
</tr>
<tr>
<td>$q^E_2 = 1, q^E_3 = 0$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 = 1, q^E_3 \in (0,1)$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 = 0, \ldots, q^E_3 = 0, q^D_2 = 1$</td>
<td>EU&gt;SQ</td>
<td>$q^D_2 = 0$</td>
<td>D=SQ</td>
</tr>
<tr>
<td>$q^E_2 = 0, \ldots, q^E_3 = 0, q^D_2 = 0$</td>
<td>EU=SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 = 0, \ldots, q^E_3 = 0, q^D_2 \in (0,1)$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 \in (0,1)$ and $q^D_2 = 1$, (q^E_3 is irrelevant)</td>
<td>EU&gt;SQ</td>
<td>$q^D_2 \in (0,1)$</td>
<td>D&gt;SQ</td>
</tr>
<tr>
<td>$q^D_2 = 0, q^E_3 = 1$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^D_2 = 0, q^E_3 = 0$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^D_2 = 0, q^E_3 \in (0,1)$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 \in (0,1), q^E_3 = 1$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 \in (0,1), q^E_3 = 0$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$q^E_2 \in (0,1), q^E_3 \in (0,1)$</td>
<td>EU&gt;SQ</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* T is the length of the reform process; k is one plus the number of periods needed in order for a reform process to change the institutional structure of the economy (see the text); EU: the EU process; D: domestic process; SQ: status-quo; probabilities are denoted by q.
Table 4. Ex-ante Consumption Comparisons within the Reform Strategies (T=2, k=0)*

<table>
<thead>
<tr>
<th>EU probabilities</th>
<th>Domestic probabilities</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>t=1:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No uncertainty</td>
<td>No uncertainty</td>
<td>EU=D</td>
</tr>
</tbody>
</table>

**t=2 (Some interesting combinations):**

\[ q_2^{EU} = 1 \quad q_2^{DI} = 1 \]  \quad \text{EU=D}

\[ q_2^{EU} = 0, q_2^D = 0 \quad q_2^{DI} = 0 \]  \quad \text{EU=D}

\[ q_2^{EU} = 0, q_2^D = 0 \quad q_2^{DI} = 1 \]  \quad \text{EU?D}

**t=3 (Some interesting combinations):**

\[ q_2^{EU} = 1, q_3^{EU} = 1 \quad q_2^{DI} = 1 \]  \quad \text{EU>D}

\[ q_2^{EU} = 1, q_3^{EU} = 0 \quad q_2^{DI} = 1 \]  \quad \text{EU=D}

\[ q_2^{EU} = 0, q_3^{EU} = 0, q_2^D = 1 \quad q_2^{DI} = 1 \]  \quad \text{EU=D}

\[ q_2^{EU} = 0, q_3^{EU} = 0, q_2^D = 0 \quad q_2^{DI} = 1 \]  \quad \text{EU<D}

\[ q_2^{EU} \in (0,1), q_3^{EU} \in (0,1) \quad q_2^{DI} \in (0,1) \]  \quad \text{EU?D}

* T is the length of the reform process; k is one plus the number of periods needed in order a reform process to change the institutional structure of the economy (see the text); EU: the EU process; D: domestic process; probabilities are denoted by \( q \).
<table>
<thead>
<tr>
<th>EU-strategy</th>
<th>PT-strategy</th>
<th>Domestic strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turkey $\in$ EU</td>
<td>${\phi^A (X_{EU+}); \phi^B (Y_{EU+})}$</td>
<td>-</td>
</tr>
<tr>
<td>Turkey $\notin$ EU</td>
<td>${\phi^A (X_{EU-}); \phi^B (Y_{EU-})}$</td>
<td>${\phi^A (X_{PT}); \phi^B (Y_{PT})}$</td>
</tr>
</tbody>
</table>
Table 6. Pay-off Matrix of the Political Competition Game

<table>
<thead>
<tr>
<th>B follows EU Endorsed Reform Strategy</th>
<th>B follows PT-Strategy</th>
<th>B follows Domestic Reform Strategy</th>
</tr>
</thead>
</table>
| A follows EU Endorsed Reform Strategy | \[
\{\pi^A_{EU}[q^A_{EU}(x_{EU})+(1-q^A_{EU})\phi^A(x_{EU})]\};
\{\pi^A_{EU}[q^A_{EU}\phi^A(y_{EU})+(1-q^A_{EU})\phi^A(y_{EU})]\}\]
\{0\}; \{\phi^A(y_{PT})\}\] | \[
\{\pi^A_{EU}[q^A_{EU}(x_{EU})+(1-q^A_{EU})\phi^A(x_{EU})]\};
\{\pi^A_{EU}[q^A_{EU}\phi^A(y_{EU})+(1-q^A_{EU})\phi^A(y_{EU})]\}\]
\{0\}; \{\phi^A(y_{GR})\}\] |
| A follows PT-Strategy | \[
\{\phi^A(x_{PT})\}; \{0\}\]
\{\pi^A_{PT}[q^A_{PT}(x_{PT})]\}; \{\pi^A_{PT}[q^A_{PT}\phi^A(y_{PT})]\}\]
\{\phi^A(x_{PT})\}; \{0\}\] | \[
\{\phi^A(x_{PT})\}; \{0\}\]
\{\pi^A_{PT}[q^A_{PT}(x_{PT})]\}; \{\pi^A_{PT}[q^A_{PT}\phi^A(y_{PT})]\}\]
\{0\}; \{\phi^A(y_{PT})\}\] |
| A follows Domestic Reform Strategy | \[
\{\pi^A_{DR}[q^A_{DR}(x_{DR})]\};
\{\pi^A_{DR}[q^A_{DR}\phi^A(y_{DR})+(1-q^A_{DR})\phi^A(y_{DR})]\}\]
\{0\}; \{\phi^A(y_{PT})\}\] | \[
\{\pi^A_{DR}[q^A_{DR}(x_{DR})]\}; \{\pi^A_{DR}[q^A_{DR}\phi^A(y_{DR})+(1-q^A_{DR})\phi^A(y_{DR})]\}\]
\{0\}; \{\phi^A(y_{GR})\}\] |