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# ENC SUMMARY

## **TURKISH CUSTOMS UNION REFORM –** Setting the EU Turkey economic agenda.

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## BACKGROUND TO SUMMARY

The European Neighbourhood Council (ENC) held a European Parliamentary Roundtable Policy Discussion on the topic of customs union reform with economic experts and academics, including European and Turkish private sector groups and business associations on the 25<sup>th</sup> of January 2017.

The parliamentary roundtable included three key experts: Dr. Cigdem Nas, Secretary General of the Economic Development Foundation (IKV), Dr. Sait Akman, Director for G20 Studies Centre at the Economic Policy Research Foundation of Turkey (TEPAV) and Professor Murat Yülek, Professor of Economics and at Istanbul Commerce University.

Other speakers included Kati Piri, Member of the European Parliament and Rapporteur for Turkey (S&D), Mustafa Alperen Özdemir, EU and Brussels representative for MÜSİAD and Stefan Moritz, Managing Director of CEA-PME.

The first in a series of ENC roundtables on Turkey and trade, the parliament roundtable aimed at opening the floor to questions from the private sector, while providing expert advice and information to parliamentarians and commission officials about the concerns and expectations from the various fields and sectors.

Another objective was also to pre-empt unforeseen obstacles throughout the negotiation phase and to reinforce inter-institutional coordination and transparency between the private and public sectors when dealing with EU-Turkey customs union reform.

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## WHY CUSTOMS UNION REFORM?

Economic relations between the EU and Turkey were given a front-seat row in the mid-1990s, when the 1996 Customs Union Agreement between the EU and Turkey came into effect.

The agreement – based on the 1995 Decision of the EC-Turkey Association Council – allowed for goods to be traded between Europe and Turkey without customs tariffs and restrictions.

The lowering of restrictions had a major impact on EU-Turkey relations, paving the way for accession negotiations, and – importantly – strategic partnership in multiple areas of key national interest for EU countries and Turkey.

Trade played an imperative role in fostering those key relations, and continues to do so today.

The value of bilateral goods being traded between EU countries and Turkey has increased more than fourfold since 1996, amounting to EU 140 billion today. In 2015,

it created a positive trade balance for EU countries – around EUR 17 billion – whereas Turkey continues to be inter-connected to Europe with 41% of its global trade.

Due to instability in Syria and Iraq, trade volumes between the EU and Turkey have increased progressively over the years – even when political relations have encountered stumbling blocks.

Add to this that over two thirds of Turkey's foreign direct investment continues to come from EU countries. The 'trade anchor' in relations cannot be underestimated.

The implications for the wider EU economy – and its individual countries' national and local economies – must also be taken into consideration. Its importance as a driving force for regional cohesion and integration remains key.

***At a time when countries need growth and interdependence more than ever, an improved and reformed customs union is a necessity.***

According to the various impact assessments commissioned by the World Bank, European Commission and independent groups, there are clear reasons for this.

The official EU assessment report (*Evaluation of the EU-Turkey Custom union*) notes that increased trade between EU countries and Turkey would have been far lower had it not been for the current customs union. A basic free trade agreement would - for example - have led to 7.2 % less exports from Turkey to the EU.

The report's lead author, Ian Gillson, also mentions that the current customs union doesn't live up to today's needs – calling for further economic integration, or better coordination.

He primarily relates this to changing world trade conditions since the mid-1990s and the rise of Free Trade Agreements (FTA's) that run parallel with the customs union process.

There were exceptions to the rule of trade under the 1996 customs union. These included public procurement, agricultural products and services – all remaining untapped economic growth potential for both EU countries and Turkey.

But the reasons for reform are also linked to other factors, both economic and political.

According to Dr. Akman, Director for G20 Studies Centre at the Economic Policy Research Foundation of Turkey (TEPAV), the need for reform is of course due to a range of changing global and local circumstances, which increasingly affect trade, regulation, rules and fairness.

Firstly, the customs union was an interim process, and thereby not an end in itself. For it to run smoothly, most experts would agree that more guidelines and 'improved rules' between the EU and Turkey are needed.

Secondly – based on the 2014 World Bank Report – the customs union is technically ill equipped to deal with modern day trade shifts, challenges in the new economic climate – particularly as production networks naturally develop in unforeseen directions over two decades.

Changes in actors' interest and dynamics matter greatly. The EU alone has undergone new FTA's that deeply affect Turkish trade volumes and its own potential to develop economically. The major economic concern here is trade diversion, which means that Turkey is losing out economically.

Thirdly, one should look at the narrow coverage of the current customs union, which leaves out untapped trade potential between neighbouring EU countries and Turkey. As mentioned above, these sectors include agriculture, services and public procurement – thereby representing a giant portion of each sides' domestic growth markets.

Fourth, lacking judicial dispute settlement is an increasing problem, especially for certain sectors, since it slows down the process of trade and creates ill-defined rules. This – contrary to popular belief – is disliked by the private sectors on both sides as it fosters uncertainty and long periods of waiting.

Fifthly, the asymmetric structure of the customs union makes it more difficult for Turkey to take part in the decision making process. It also means that Turkey adapts more slowly to EU laws and often operates at sub-optimal levels because it isn't properly consulted.

It goes without saying that areas of *accountability* and *legislation* would be greatly improved through a reformed customs union – which, in turn, will impact Turkish society positively.

Sixthly, the customs union remains an uneven playing field for some sectors, which pushes Turkey to seek compensation and financial assistance, safeguard measures, and forms of adjustment assistance to minimize the negative impacts of certain sectors and the welfare of people.

Beyond the economic and social factors lay geopolitical factors. For decades, Turkey and the EU are tied together in terms of defence, energy and – more recently – migration balancing. The economic factor is widely deemed as a necessary step to anchor a relationship, which could deteriorate very rapidly if left unattended due to regional and global re-alignments.

As a result of legitimate trade concerns and economic growth for both sides (added with key EU foreign, security and energy concerns tied to Turkey) the customs union reform is regarded as an urgent policy priority – necessitating cross-institutional and multi-partisan support in Europe and Turkey.

In May 2015, the EU Trade Commissioner and Turkey's Minister of Economy agreed to enhance bilateral economic relations and launched the preparations for a future negotiation to modernise and extend the existing EU-Turkey customs union.

As of 2016, public consultations and preparatory steps have been taken, including impact assessments.

Now it remains up to the EU and Turkey to get a full mandate, from each respective government authority, to proceed.

Once this is granted by Turkey and the Council, the full customs union process, including negotiations, is expected to take approximately 3 years.

The European Parliament will also need to support the measures. Fortunately, the cross-committee amendments which have taken place since 2017 (and improved inter-institutional communication between the European Parliament and the European Commission) will give parliamentarians a broader oversight in regional relations and pressing foreign policy objectives like Turkey and trade.

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## WHAT THE EXPERTS SAY

In terms of Small and Medium Sized Enterprise representatives from Turkey and the EU, **Mr. Özdemir** and **Mr. Moritz** made the following comments on the subject:

Mr. Özdemir focused on how customs union reform is likely to enhance trade relations, as well as the positive effect that trade can have on diplomatic relations between the EU and Turkey, considering Turkey's role as the EU's strategic partner in its neighbourhood.

Mr. Moritz said that "equal treatment between the EU and Turkey" remained vital in this process, while focusing on the importance of impartial win-win economics.

In terms of the European Parliament's Turkey Rapporteur, **Ms. Piri** made the following comments on the subject:

She expressed her views about how the European Parliament will engage with the reform process, which could draw Turkey and the EU closer, while fostering jobs and economic growth in various new areas.

She noted that Turkey is the 6<sup>th</sup> biggest trading partner of the EU, whereas the EU continues to be Turkey's primary trading partner.

Due to a line of policy concerns - including Cyprus, energy diversification and security - it remains a top foreign policy priority to "anchor" Turkey and the EU, including trade and commerce.

Ms. Piri noted that special attention was needed on the issue of customs union reform, as it involved both ‘trade’ and ‘Turkey’, which could easily create a “mess” in the European Parliament if not dealt with properly.

In other words, it remains crucial that the various political parties, rapporteurs and chairmen or women in the European Parliament are involved in the process and stay informed about the importance of the customs union reform, both economically, socially, and politically.

Ms. Piri said that – despite calls for an accession freeze – it remains in Europe’s interest to concern itself with the economic difficulties of partners like Turkey in order to foster a better and stronger partnership.

In terms of the parliamentary roundtable experts, **Dr. Akman** made the following comments on the subject:

According to Dr. Akman, the impact assessments on customs union reform indicate that both the EU and Turkey are to benefit – in terms of employment and GDP – from a modernised customs union.

The current union has limited rules and insufficient openness. This has meant unfulfilled trade potential. A reformed union would mean increased trade and growth across EU and Turkish economic sectors, as many areas remain outside the scope of the current customs union, like public procurement, services and agriculture. A new agreement would also help Turkey gain more competitiveness on a global level, while guaranteeing soft power tools like increased *accountability* and *transparency*.

In turn, there are some fundamental design flaws tied to the customs union’s inefficiency in dealing with Turkey’s asymmetrical trade concerns and traditional problems of trade diversion.

Dr. Akman noted that the “old customs union” has increasingly locked Turkey into a so-called ‘liberal trade regime’, while adding competitive pressure on its manufacturing industry without relief. Another issue is the lower competitive level of Turkey in the area of agriculture and public procurement, which is also causing some concern.

The trade diversion problem derives from the fact that – in line with the current customs union rules – Turkey has to align its legislation to the EU’s common commercial policy. This obligation means that Turkey has to conclude preferential trade agreements, like FTA’s, with 3<sup>rd</sup> countries that conclude trade deals with the EU.

But having to sign parallel agreements hasn’t always been easy, as countries like Algeria and South Africa have simply refused to sign deals with Turkey, leaving the EU’s customs union partner with a losing economic situation.

The solution offered by Dr. Akman is tied to a customs union reform, or an alternative trade agreement with Turkey, so that this diversion does not occur.

According to Dr. Akman, it would be very beneficial for legal harmonization and Turkey's reform process, as well as improving factor productivity and the welfare of Turkish consumers.

In terms of the parliamentary roundtable experts, **Dr. Nas** made the following comments on the subject:

According to Dr. Nas, two core problems – seen from both sides of the spectrum – are growth and trade diversion. For Europe, the need to re-boost growth at home and increase economic ties with its strongest defence partner in Europe is essential, while Turkey can be better integrated into fair commercial structures and rules.

She also noted that the customs union continues to be an essential area of cooperation, as most business associations remain very favourable inclined towards the modernisation, while the Turkish government also supports the initiative.

However, the successful reforms rest on a series of factors, which must be resolved, like the visa liberalization issues and transportation restrictions for trucks on the EU-Turkish border, which remains a necessity for service providers to function properly.

Dr. Nas noted that – in terms of perception – the main barrier continues to be free visa travel, recognition of qualifications and quotas, according to the IKV study with 152 Turkish businesses. Importantly, only 6.6% of respondents were against the expansion of services to the customs union.

In terms of the parliamentary roundtable experts, **Professor Yülek** made the following comments on the subject:

From a politico-economic perspective, Professor Yülek said that – due to differences in standards and competition – the customs union reform should take into consideration more equal terms.

He also noted that “EU double standards” would not be acceptable and that figures spoke for themselves when comparing Turkish and German public procurement figures, in terms of who has the highest market access.

According to Professor Yülek, an ‘asymmetrical relationship’ exists, partly due to the size of the EU in comparison to Turkey, as well as the standards and size of companies in each respective area.

A necessary solution to this ‘bias’ would - for example - be economic compensations to adjust for impacted industries or sectors in Turkey.

In terms of the European Commission, **the Communication on Trade, Growth, and World Affairs** writes the following on the subject:

The European Commission stipulates that Turkey remains a strategic partner, while stressing the major importance of bilateral economic, trade and investment.



Broadly speaking, the EU's objective on trade remains to 'contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and on foreign direct investment, and the lowering of customs and other barriers.

According to the report, this includes:

- –□promoting smart, sustainable and inclusive growth
- –□lower consumer prices and other consumer benefits,
- –□improving Europe's competitiveness in global markets, and
- –□reinforcing cooperation on trade-related issues with a like-minded partner.

On the specific topic of customs union reform with Turkey - it does note that, "while the EU's public procurement market is largely open, there are various obstacles for EU companies' access to the Turkish market. This leads to unfulfilled trade potential for both merchandise and services trade".

In addition, it states that Turkey does not allow foreign suppliers unrestricted access to tenders in the public procurement market, which represents approximately 7.2% of Turkish GDP.

It therefore indicates that Turkey should also lower restrictive measures that hamper competition and equal access.

In terms of joint Turkish-EU institutional initiatives, the **Customs Union Joint Committee (CUJC)** has written the following on the subject:

Represented by the EU and Turkey, the CUJC coordinate market access and meet twice a year.

According to the CUJC, customs union reform will help "modernise the functioning (or design) of the Customs Union . . . and . . . address the problems related to the difficulty in achieving parallel conclusion of FTA's by the EU and Turkey".

Also, it will address "problems related to Turkey's difficulties in complying with its obligation on legislative alignment to EU law; introduce an effective dispute settlement mechanism; and extend the scope of the BPTF: mutually enhance market access for trade in agricultural and fisheries products; improve market access for trade in services and establishment for both the EU and Turkey, including through the elimination, reduction or prevention of unnecessary barriers; and enhance access to each other's public procurement market".

During the impact assessments, analysis also showed that the current customs union boosted bilateral trade between the EU and Turkey very substantially.

The EU's exports to Turkey and Turkey's exports to the EU were estimated to be 10% and 7% higher, respectively, than they would otherwise have been without the customs union.



Currently trade in services is governed by GATS commitments, which remain insufficient in scope, to deal with barriers in trade and general economic issues that need better arbitration.

In terms of the World Bank, the '**Evaluation of the EU-Turkey Customs Union**' analysis from March 2014 has written the following on the subject:

According to the World Bank, there are some noticeable indicators of economic relations between the EU and Turkey that call for customs union reform – and increased cooperation.

These include the fact that the EU and Turkey have deepened trade integration very significantly since the early 2000s.

According to the World Bank report, bilateral trade since 1996 has increased more than fourfold and Foreign Direct Investment has equally played a decisive role in deepening integration in production networks between Turkish and European companies. On a technical level, facilitated trade also helped modernise the Turkish Customs Administration.

The customs union provided the right structure for such developments and contributed majorly to the elimination of import tariffs on most industrial products – impacting productivity levels across Turkey, while helping legislation align with EU standards.

Other important factors included the improvement of infrastructure quality, facilitating reform of technical regulations in Turkey, which – in turn – has helped consumers.

Concerning reform, the report clearly shows the pressing need for regulatory convergence in sectors to enhance predictability for the various business sectors, that currently lack clear guidelines. Problems related to 'parallel FTA's' (trade diversion) and issues of ineffective settlement dispute mechanisms are also mentioned as concerns that call for a reformed customs union. This – in turn – would also allow Turkey to play an active role in decision making and shaping trade between itself and the EU.

Finally, based on the impact assessments, the report confirms that ample trade opportunities exist in areas of services and public procurement, which would enhance economic growth for both the EU and Turkey, at cross-sectoral levels and including small, medium and larger companies.

Two basic examples include the 'service sector' and 'agricultural sector', which account for 60 and 10 percent of Turkey's GDP, but nonetheless remain excluded from the scope of an un-reformed customs union.

The report also evaluates a range of other barriers to greater trade between Turkey and the EU, including transport quotas, business visas, and trade defence instruments, and makes recommendations on how to overcome existing blocks.

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## PARTNERS AND RESEARCH

**The parliamentary roundtable was supported by the Turkish private sector, represented by MÜSİAD, in cooperation with CEA-PME.**