

The EU-Turkey Customs Union and trade relations: what options for the future?



Authors:
Erdal YALCIN and Gabriel FELBERMAYR
European Parliament Coordinator:
Policy Department for External Relations
Directorate General for External Policies of the Union
PE 653.640 – July 2021

EN

IN-DEPTH ANALYSIS

The EU-Turkey Customs Union and trade relations: what options for the future?

ABSTRACT

This in-depth analysis summarizes the main effects of the Customs Union (CU) on EU-Turkey trade and the economic situation in Turkey. Whereas the CU offers Turkey several economic benefits, it also implies some downsides, in particular asymmetric tariffs in relation to third countries. Against the background of the dynamic development of EU-Turkey relations, the authors assess the impact of four different options for developing EU-Turkey economic and trade relations:

- (i) Continuation of the current Customs Union framework as it stands,
- (ii) Modernization and upgrading of the Customs Union,
- (iii) A transformation of the bilateral trade relations into a deep and comprehensive free trade agreement (DCFTA),
- (iv) Suspension of the Customs Union (in which case WTO rules would apply).

The in-depth-analysis describes the options, the challenges the EU-Turkey Customs Union faces and seeks solutions for these issues.

AUTHORS

- Erdal YALCIN, Professor of International Economics, University of Applied Sciences Konstanz, Germany
 - Gabriel FELBERMAYR, Professor of International Economics, IfW Kiel, Germany
- Coordinator: Bruegel

This study was originally requested by the European Parliament's Committee on International Trade (INTA).

CONTACTS IN THE EUROPEAN PARLIAMENT

Coordination: Mario DAMEN, Policy Department for External Policies

Editorial assistant: Balázs REISS

Feedback is welcome. Please write to mario.damen@europarl.europa.eu

To obtain copies, please send a request to poldep-expo@europarl.europa.eu

VERSION

English-language manuscript completed on 7 June 2021.

DISCLAIMER AND COPYRIGHT

Brussels © European Union, 2021

The content of this document is the sole responsibility of the author(s), and any opinions expressed herein do not necessarily represent the official position of the European Parliament.

Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the European Parliament is given prior notice and sent a copy.

© Cover image used under license from Adobe Stock.

This paper will be published on the European Parliament's online database, '[Think tank](#)'.

Table of contents

1	Introduction	5
2	Effects of the EU-Turkey Customs Union	8
3	Rules of origin – a special challenge in the Customs Union	15
	3.1 The asymmetry problem within the Customs Union	19
	3.2 Rules of Origin – and the system of Pan-Euro-Mediterranean cumulation of origin	21
	3.2.1 Rules of Origin	21
	3.2.2 Pan-Euro-Mediterranean cumulation of origin	22
	3.3 Turkey divergent tariff policy within the Customs Union	23
4	Different economic integration scenarios	25
	4.1 Continuation of the current Customs Union framework	25
	4.2 Modernization and upgrading of the Customs Union	27
	4.3 An EU-Turkey Free Trade Agreement	28
	4.4 Suspension of the Customs Union	29
	4.5 Summary of results and policy implications	30
5	Conclusion	31
6	Literature	32

List of Figures

Figure 1: Turkey's trade with the EU and the rest of the World (1990–2019)	9
Figure 2: Turkey's exports/imports in the manufacturing/agricultural sectors (1990–2019)	9
Figure 3: Trade in Services between the EU and Turkey (2010–2019)	10
Figure 4: Turkey's exports in the manufacturing industry to EU countries (2019)	12
Figure 5: Turkey's imports in the manufacturing sector from EU countries (2019)	12
Figure 6: Turkey's top-10 exporting industries to the EU	13
Figure 7: Turkey's top-10 importing industries from the EU	13
Figure 8: Turkey's GDP per capita in current USD (1990–2019)	14
Figure 9: Democracy Index – Turkey compared to other countries	14
Figure 10: Turkish exports to the EU and domestic employment	15
Figure 11: Non-tariff Barriers by Turkey – affected share of EU exports to Turkey	18
Figure 12: The EU's and Turkey's Free Trade Agreements (2021)	19
Figure 13: Trade deflection and rules of origin	22
Figure 14: Difference in tariffs between the EU and Turkey (industrial goods)	24
Figure 15: Turkey's additional tariffs on Industrial Goods (2020)	24

1 Introduction

The Turkish Republic's integration into the EU began in 1959 when Turkey applied to join the European Economic Community (EEC). In 1963 this application was followed by an association agreement between Turkey and the EEC, also known as the Ankara Agreement. The Ankara Agreement (OJ L 217, 1964) and its Additional Protocol of 1970 (OJ L 293, 1972) define the scope and content of the association relationship, while the final phase of the Customs Union is defined in Decision 1/95 of the Association Council (OJ L 35, 1996). In 1987, the relationship was deepened by Turkey's application for full membership in the European Community based on Article 237 of the Treaty of Rome.

After many delays due to political and economic difficulties, and after tough negotiations in the Association Council, in December 1995 the Decision No. 1/95 of the EC-Turkey Association Council was passed and the Customs Union between the EU and Turkey was established. Since January 1, 1996, almost all industrial and processed agricultural products (except coal, steel and agricultural products¹) can be imported duty-free into the EU or Turkey with the A.TR movement certificate. That document certifies that a specific product has cleared the importation procedures in either country and, therefore, is in free circulation in either the EU or in Turkey.

A separate free trade agreement on coal, iron and steel products was concluded in 1996 between the European Coal and Steel Community (ECSC) and Turkey.² In addition to the Customs Union, in 1998 the Association Council agreed on a free trade agreement for agricultural goods.³ At the 1999 Council meeting in Helsinki, Turkey received the status of a candidate for the EU. Six years later, in 2005, official accession negotiations between the EU and Turkey began.

Since its introduction, the Customs Union has established itself as the backbone for the economic relationship between EU member states and Turkey. During the years of political and institutional alignment between the EU and Turkey – broadly within the time interval 2002 to 2006 – international trade and investment between Turkey and EU member states increased significantly.

The EU-Turkey Customs Union represents a deep economic integration agreement going far beyond a classical free trade agreement. It obliges Turkey to follow the EU's Common Customs Tariff (CCT) and rules for imports from third countries, to align domestic legislation with the EU *acquis* on goods, and to adapt EU rules on commercial and competition policy, and intellectual property rights.

As such, the Customs Union has facilitated the integration of the Turkish industrial sector into EU value chains. In a Customs Union, exporters benefit from much simplified rules of origin; this lowers bureaucratic barriers to trade substantially and enables seamless integration in European production networks.

Bilateral trade in goods between Turkey and the EU was worth EUR 132.5 billion in 2020. Around 40 % of all Turkish export in goods are sold to EU member states, while imports from the EU countries represent 33 % of all Turkish imports. Over the last decades, the EU is also by far the biggest source of foreign direct investment in Turkey. On the other hand, Turkey is the EU's 6th biggest trade partner, representing 3.6 % of the EU's total trade in goods with the world in 2020.

However, due to the stagnation in Turkey's EU integration process, particularly after 2006, and because of the Customs Union's nature of representing a trade agreement that was framed as an intermediate stage in Turkey's effort to become a full EU member, over the past years, the Customs Union has increasingly led to problems in the EU-Turkish trade relations. In recent years, the EU's new free trade agreements with

¹ Agricultural products that are not covered by the Customs Union are defined in Annex I of the Amsterdam Treaty.

² OJ L 227, 1996: Agreement between the European Coal and Steel Community and the Republic of Turkey on trade in products covered by the Treaty establishing the European Coal and Steel Community.

³ Decision No 1/98 of the EC-Turkey Association Council of 25 February 1998 (OJ L 86 of 20.03.1998).

third countries (e.g., with Vietnam or Japan) have exposed companies located in Turkey to potentially problematic asymmetric competition.

Due to the Customs Union, Turkey has committed to open its market in principle to new free trade partners of the EU but not automatically receiving equivalent free access to the markets of the respective third countries through EU's free trade agreements. Turkey would have to strive for its own free trade agreement with the respective new trading partners of the EU to facilitate market access for Turkish companies in the respective countries.

Additional tensions arising from the increasingly outdated EU-Turkey Customs Union are due to the lack of a modern and effective dispute settlement mechanism and due to foreign content threshold problems of Turkish goods under the existing rules of origin.

Already in 2015, with the objective to improve these deficits, the EU and Turkey formulated a memorandum of understanding, stipulating a modernization of the Customs Union framework. However, because of the worsening domestic political conditions in Turkey, following a failed coup attempt in 2016, the EU commission stopped its attempts to update the Customs Union. Since then, compliance to the rules of the outdated Customs Union agreement has been highly imperfect, highlighting the need of reform.

Moreover, since 2015 Turkey's economy is in continuous turmoil driven by worsening political and institutional conditions in the country and by the uncertainty regarding the future relationship of the country with the EU.

Besides the contractual shortcomings of the Customs Union arrangement, more recently, political tensions in the East Mediterranean region (Turkey has been sending drilling ships with a military escort to explore natural gas fields off the coast of EU member Cyprus) but also domestic developments in Turkey have prevented a constructive approach between Turkey and the EU. In his joint communication to the European Council from March 2021, the High Representative of the Union for Foreign Affairs and Security Policy documents a long list of policy areas with increasing tensions (for details, cf. EC-Join 2021).

Already, in its October 2019 resolution on Turkish military action in Syria and its consequences, the European Parliament (EP) called on the Council to consider suspending trade preferences under the agreement on agricultural products and, as a last resort, suspending the EU-Turkey Customs Union. In addition, several Members of the European Parliament (MEPs) have called for a total suspension of the Customs Union, arguing that Turkey has repeatedly breached its obligations under the existing trade agreement. In its resolution of 26 November 2020 on escalating tensions in Varosha, the EP went one step further and called on the European Council to impose tough sanctions in response to Turkey's illegal actions, while recalling that further sanctions can only be avoided through dialogue, sincere cooperation and concrete progress on the ground.

Moreover, in its effort to cut down the tension in the eastern Mediterranean, in October 2020, the European Council launched a positive political EU-Turkey agenda with a specific emphasis on the modernization of the Customs Union and trade facilitation. In March 2021, the EU Council became more specific under which conditions a modernization of the Customs Union is possible. Accordingly, the "European Union is ready to engage with Turkey in a phased, proportionate and reversible manner to enhance cooperation in a number of areas of common interest and take further decisions at the European Council meeting in June" 2021, including a possible start of the Customs Union modernization (cf. SN18/21, 2021).

Importantly, the EU leaders noted that, in case of renewed unilateral actions or provocations in breach of international law, the EU would use "all the instruments and the options at its disposal, including in accordance with Article 29 TEU and Article 215 TFEU", in order to defend its interests and those of its Member States.

Likewise, in its recent resolution (19 May 2021)⁴ the European Parliament stresses that a modernization of the existing Customs Union has the potential to benefit both parties, the EU and Turkey, and at the same time it can keep Turkey economically and normatively anchored to the EU. An updated Customs Union can create a renewed opportunity for the recently announced positive dialogue and cooperation, and moreover, provide a better regulatory framework for EU investments in Turkey. However, as stated in the resolution, a modernization of the Customs Union is a difficult roadmap due to Turkey's deviation from its trade related obligations: such as the fact that the EU and Turkey are in a dispute before the World Trade Organization to resolve bilateral trade conflicts, or Turkey's recent call to boycott EU member states. Finally, the resolution emphasizes that a modernization of the Customs Union has to be based on a strong conditionality related to human rights and fundamental freedoms as defined by the Copenhagen criteria, on good relations with the EU and all its Member States. Specifically, it is emphasized that Turkey has to fully implement the Additional Protocol to extend the Ankara Agreement towards all Member States including Cyprus (cf. P9TA(2021)0243).

Under these conditions, it is no exaggeration to state that the economic and political relationship between Turkey and the EU is hampered by severe difficulties. This deadlock has strong negative effects for Turkey's economy and Turkey seems increasingly caught in a vicious circle. The Turkish government instrumentalizes the deteriorating economic conditions in the country by holding the EU responsible for the difficult economic developments. The resulting political tensions further jeopardize the economic situation in Turkey. Given the important role of Turkey as a host of almost 4 million Syrian refugees the economic downturn has strong implications for the Turkish peoples' capacity to bear the socio-economic costs resulting from the refugees in the country.

Therefore, in the medium term, repairing the contractual weaknesses of the Customs Union could be an important positive impulse to improve the bilateral economic relationship of the EU with Turkey and hence, the situation of the Turkish economy. This background explains the desire – which initially existed in both the EU and Turkey – to modernize the Customs Union.

Considering these developments, in a first step, the present in-depth analysis aims at, summarizing the main effects of the Customs Union on the EU-Turkey trade and how the economic conditions developed in parallel. Because trade between the EU and Turkey also depends on political and institutional developments in Turkey, the analysis briefly accounts for the dynamic development in these political and institutional dimensions.

In order to assess the impact of different policy objectives currently discussed in the European Parliament and European Commission with respect to the Customs Union, the in-depth analysis considers four possible options:

- (i) Continuation of the current Customs Union framework as it stands,
- (ii) Modernization and upgrading of the Customs Union,
- (iii) A transformation of the bilateral trade relations into a deep and comprehensive free trade agreement (DCFTA, similar to the EU-Canada trade agreement),
- (iv) Suspension of the Customs Union (in which case WTO rules would apply).

The logic behind the ongoing political debate is that by updating the Customs Union the EU can support Turkey's economic development and hence, stimulate political improvements. In this sense the modernization of the Customs Union represents a possibly powerful incentive. Alternatively, by keeping

⁴ P9TA(2021)0243

the current unsatisfactory status quo or by suspending the Customs Union, Turkey could experience further negative economic challenges, and hence should have incentives to change its policy towards the EU. In this sense a suspension or keeping the status quo of the Customs Union could represent an economic threat.

As shown in this report, in the long-run, a sustainable strategy to stabilize the EU-Turkey relations should also account for a third option. It is unlikely, that Turkey will pivot its policy very soon towards the EU, as recent developments in Syria and the Mediterranean region indicate. However, by not addressing possible supportive reforms in the economic relations, due to political tensions, the EU might be risking an economic collapse in Turkey which may in turn trigger a worsening of the current relations with unforeseeable effects for both, the EU and Turkey (e.g., the risk of less Turkish cooperation with respect to the EU's efforts to mitigate the conditions of refugees in Turkey).

In this sense, the analysis also accounts for a less discussed adjusted economic integration strategy, that may allow to stabilize the Turkish economy in the presence of ongoing political tensions with the EU: a transformation of the trade relations from a Customs Union into a deep and comprehensive free trade agreement (DCFTA) represents a viable option for this scenario. Notice that the United Kingdom no longer has a customs union with Turkey but a free trade agreement. Hence, a DCFTA represents an executable alternative economic integration roadmap for Turkey and the EU, which could be structured like the EU-UK trade agreement. However, such a scenario would have further implications for the existing EU-Turkey value chains, because a DCFTA necessitates rules of origin which are of course much less of an issue in the Customs Union.

Overall, the in-depth analysis presents not only possible different economic consequences that may follow the four different economic integration strategies but discusses the political sustainability of each of the four viable options that Turkey and the EU can pursue.

The study is structured in the following way. The next chapter uses appropriate statistical data to illustrate how the Customs Union influenced trade between the EU and Turkey and how it affected GDP growth in both economies. The third chapter discusses the main challenges and aspects of rules of origin that play a major role in the EU-Turkey trade relationships. Among other technical aspects, the chapter explains how countries that are not members of the EU but have a free trade agreement with the EU can simplify rules of origin through the regional agreement on Pan-Euro-Mediterranean preferential rules of origin. This aspect of an EU-Turkey analysis is important because trade between non-EU members, Turkey and the EU come along with different rules of origin. The fourth chapter summarizes possible quantitative effects of the four considered economic integration scenarios based on existing studies. Following the quantitative analysis, we discuss the possible long-run implication of the considered strategies by accounting for possible political developments before we conclude.

2 Effects of the EU-Turkey Customs Union

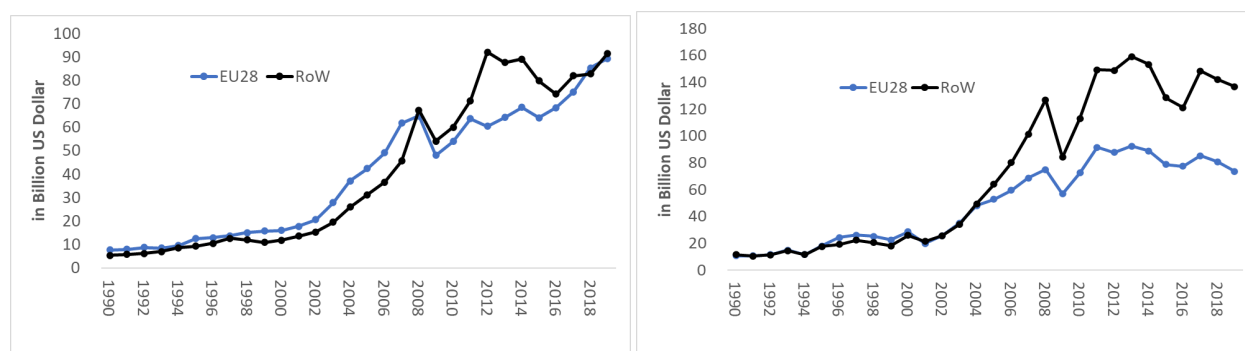
With the introduction of the Customs Union in 1995 and the free trade agreements for agricultural goods, steel and coal, combined with the political and institutional stability starting in 2002, Turkey experienced a very significant increase in exports, especially to the EU countries. Until 2008, the EU was Turkey's most important export market. A similar pattern can be observed for imports from the EU. This trend temporarily changed in the following years and Turkey started to increasingly export to other countries around the world, although the share of exports to the European domestic market has remained at a high level. In the last four years between 2015 and 2019, a stagnation in Turkish exports to the rest of the world can be observed, while the EU market for exports still is of major importance.

While Turkish exports to the EU stayed below USD 10 billion between 1990 and 1995, after the implementation of the Customs Union exports to the EU continuously increased and reached USD 89 billion in 2019. Turkish imports from the EU stand at USD 73 billion.

Figure 1: Turkey's trade with the EU and the rest of the World (1990–2019)

Panel a) Development of aggregated exports from Turkey to EU and rest of the world (1990–2019)

Panel b) Development of aggregated imports to Turkey to EU and rest of the world (1990–2019)



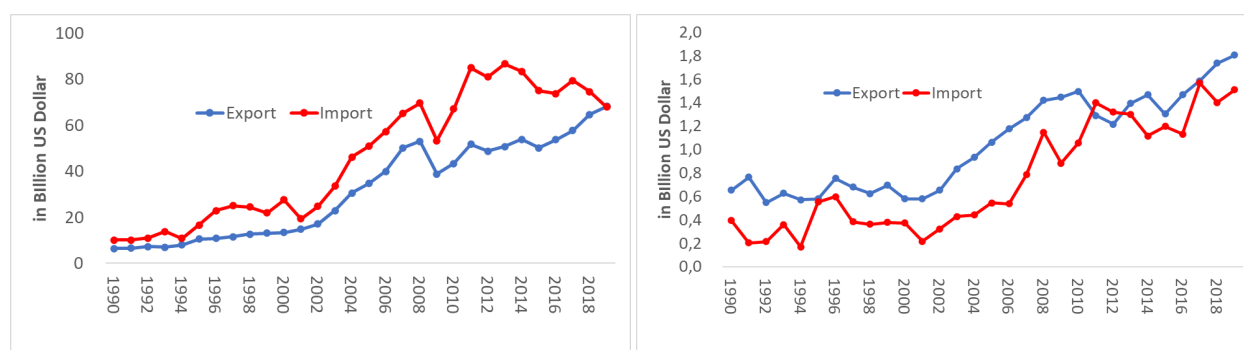
Note: Numbers are in US-Dollar due to the longer time window going back to 1990.

Source: OECD; own illustration.

Figure 2: Turkey's exports/imports in the manufacturing/agricultural sectors (1990–2019)

Panel a) Turkey's exports/imports of manufactured goods

Panel b) Turkey's exports/imports of agricultural/fishery products

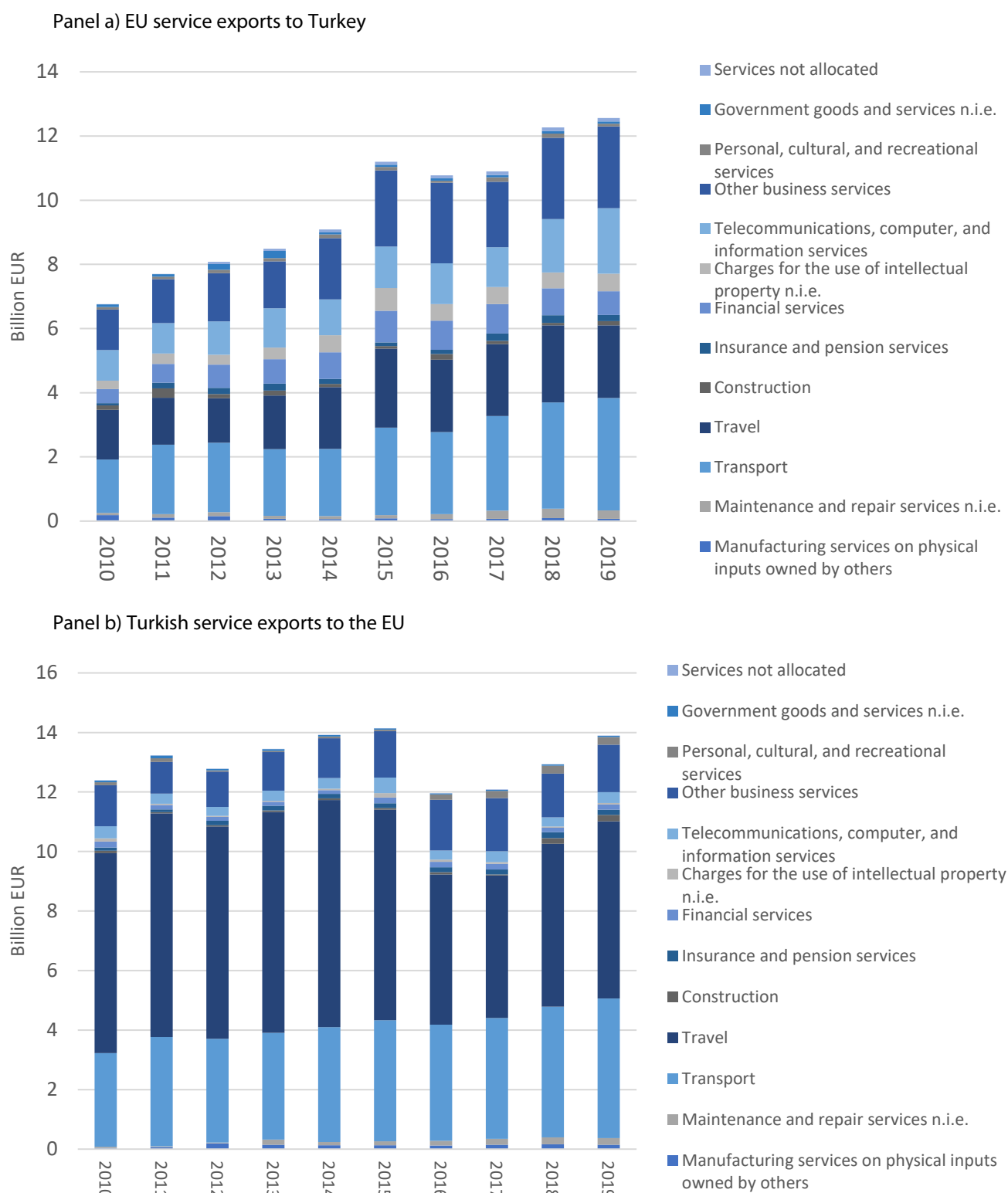


Source: OECD; own illustration.

Accordingly, the major share of EU-Turkey trade is made up by manufactured goods and organized within the Customs Union, while the extent of trade in agricultural and fishery goods is less dynamic. Trade in agricultural and fishery good is governed by a separate trade agreement (Decision No 1/98 of the Association Council of 1998). Between 2002 and 2019 Turkish exports in manufactured goods quadrupled reaching a volume of almost USD 70 billion. While in the same period exports in agricultural and fishery goods increased from 650 million to USD 1.5 billion. In contrast Turkish imports of agricultural and fishery goods show a strong increase in the same period.

Figure 3 presents trade in services between the EU (excluding UK) and Turkey. Compared to 2010, EU service exports doubled and reached a total volume of over EUR 12 billion. The largest contributors to service exports in the EU are transport, construction, telecommunication, and other business services. Interestingly, exports of financial, insurance and pensions services turn out to be moderate. One reason for this moderate performance can be traced back to the fact that service trade rules are less harmonized between the two parties and hence, represent a field that should be addressed in a modernized trade agreement.

Figure 3: Trade in Services between the EU and Turkey (2010–2019)



Note: The EU covers 27 member states (excluding the UK)

Source: Eurostat; own illustration.

Interestingly, in all considered years, Turkey managed to export more services to the EU than vice versa. However, while the EU experiences a continuous increase in service exports to Turkey, year on year, in contrast, Turkish service exports turn out to be stagnant. The illustrated varying service export pattern can be explained by the fact that the main drivers of Turkey’s service exports are the tourism industry (travel)

and transport services, accounting for more than two-thirds of all service exports. Due to the political developments in Turkey, the tourism industry did not grow further in recent years. Moreover, Turkey's service exports to the EU in other businesses have been stagnant due to a missing deep liberalisation in the service trade between the two parties. In contrast, EU service exports to Turkey are based on various businesses which have been expanding along the presence of EU enterprises located in Turkey, even so restrictions to services and non-tariff measures are still high in this trade segment.

So far, trade in services is not covered by the Customs Union and hence, is confronted with high regulation and trade barriers. A harmonization of trade rules in services has the potential to increase exports for both parties.⁵

As regards Turkish export volumes for 2019 in the manufacturing industry, Germany is by far the most important export market (USD 16 billion), followed by the UK (no EU member anymore) Italy, France, and Spain. This pattern prevails also in the earlier years. For Turkey's imports from the EU, Germany equally turns out to be the most important trading partner, with USD 19 billion, followed by Italy, France, and Spain with significantly lower export volumes to Turkey.

Looking at Turkey's top-10 export industries to the EU for three different years (1993, 2006, 2019), the motor vehicles industry is the sector with the largest. While this sector barely exported goods to the EU in 1993, after the introduction of the Customs Union trade with the EU increased by an impressive volume of around USD 18 billion in 2019. The apparel industry has been one of the few sectors which was exporting significant volumes already before the Customs Union was established. However, after the market liberalisation with the EU export volumes grew by over 100 %, reaching a volume of USD 8 billion in 2019. Overall, Figure 6 nicely illustrates that except for the apparel industries Turkish exports to the EU were on a relatively low level, until the Customs Union started.

For most of Turkey's top-10 importing sectors from the EU for the years 1993, 2006, and 2019, again, imports from the EU were on a moderate level before the Customs Union was in place. In the succeeding years imports from the EU to Turkey increased impressively. The most important sector is the chemical industry with imports worth USD 11 billion in 2019, followed by the motor vehicle and machinery industries, also on similar import volume levels.

An important development in bilateral trade between Turkey and the EU is the high share of trade in intermediate goods which is particularly pronounced for the leading Turkish trading industries such as chemical and machinery, indicating the participation of Turkish companies in European value chains. In case of the chemical industry, which is the largest importing sector of EU goods in Turkey, the share of intermediate goods amounts to around 80 % of total trade.

The integration of the Turkish automotive and chemical industry into the network of European enterprises is a good example for the supportive effects of the Customs Union in the past two decades. From a technical perspective, because Turkey must align and follow EU tariff rules (CCT) and legislation (EU *acquis*), European companies find an environment similar to the EU domestic market, enabling the exchange of intermediate goods at lower costs compared to third countries.

⁵ Quantitative simulations in Chapter 4 confirm that a harmonization of service rules between the EU and Turkey can increase exports significantly.

Figure 4: Turkey's exports in the manufacturing industry to EU countries in billion USD (2019)

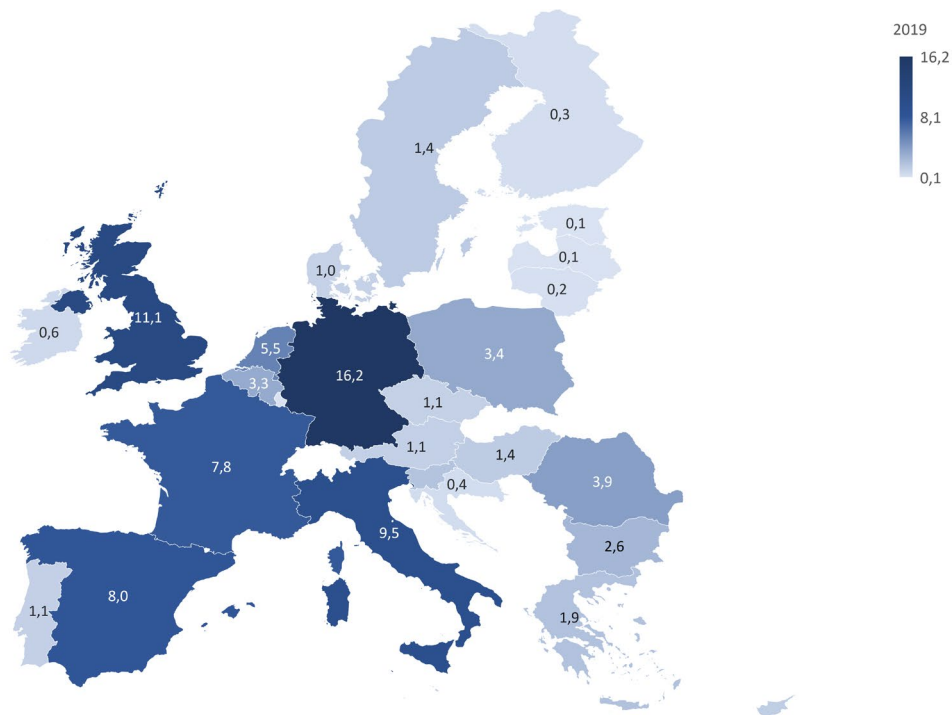
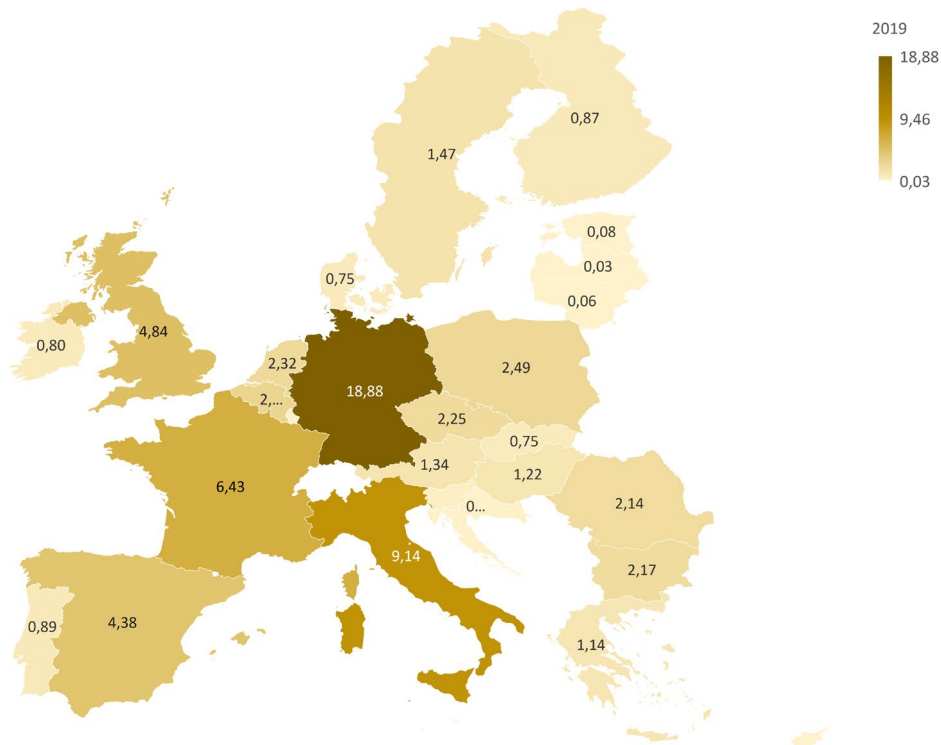


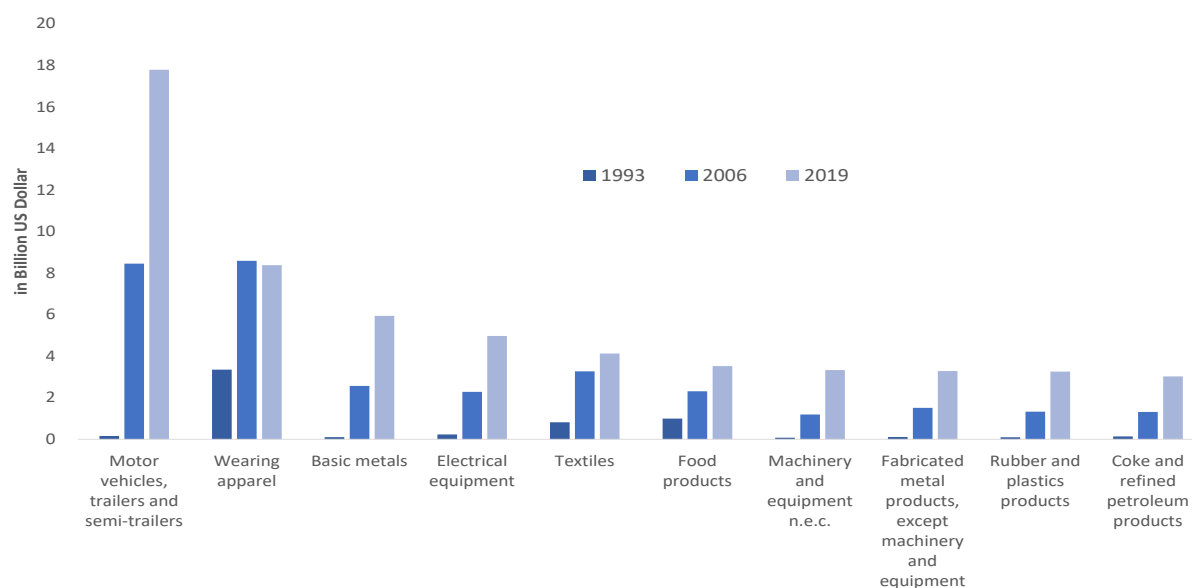
Figure 5: Turkey's imports in the manufacturing sector from EU countries in billion USD (2019)



Source: OECD; own illustration.

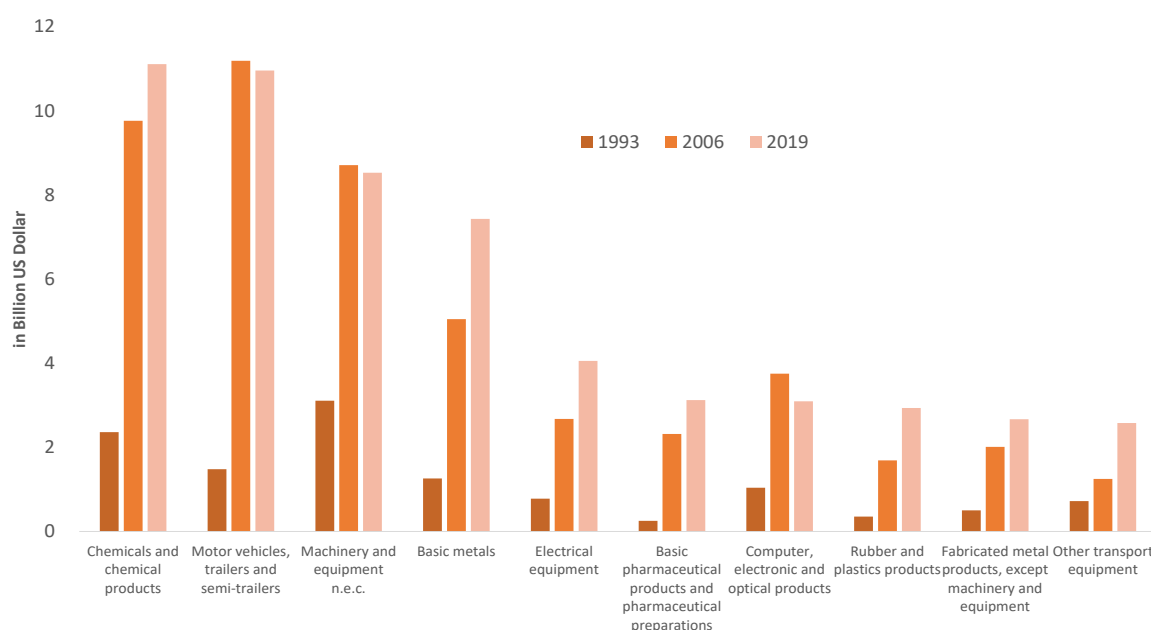
As regards the evolution of GDP per capita for Turkey over the last 30 years three trends can be identified. After the establishment of the Customs Union Turkey did not experience an immediate improvement in national income. On the contrary, due to a severe financial crisis at the end of the 90s coupled with a large earthquake that hit the country, severely, GDP per capita was around USD 4 000.

Figure 6: Turkey's top-10 exporting industries to the EU



Source: OECD; own illustration.

Figure 7: Turkey's top-10 importing industries from the EU

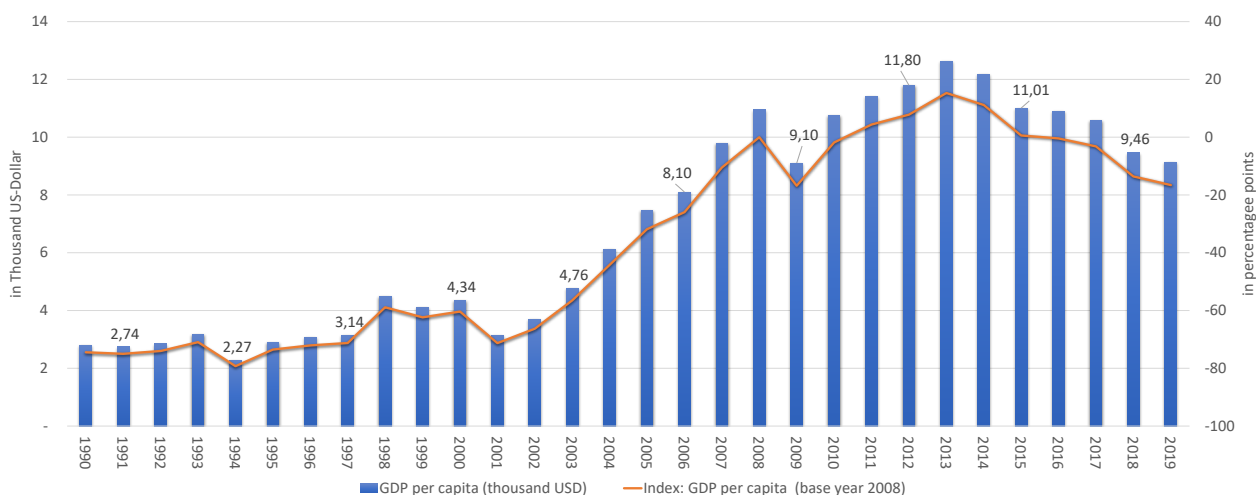


Source: OECD; own illustration.

However, with the improvement of the political environment when a single party government came to power in 2002, Turkey was able to experience high growth rates in GDP along the early shown trade increase with the EU. In the following years until 2008, Turkey experienced annual growth rates of 6 to 8 %

and belonged to the fastest growing countries in the world. After the financial crisis, Turkey was able to maintain a sizeable annual growth in income, but the strength of the earlier years is no longer visible. A third period with a special pattern can be identified after 2013. Turkey’s GDP per capita started to drop after this year which continues until today. The years after 2013 are characterized by an increasing devaluation of the Turkish Lira, double digit inflation and high political uncertainty. Figure 8 shows a GDP per capita index with the base year 2008. Accordingly, the average income per capita in 2019 is 16 % lower if compared with the income of 2008.

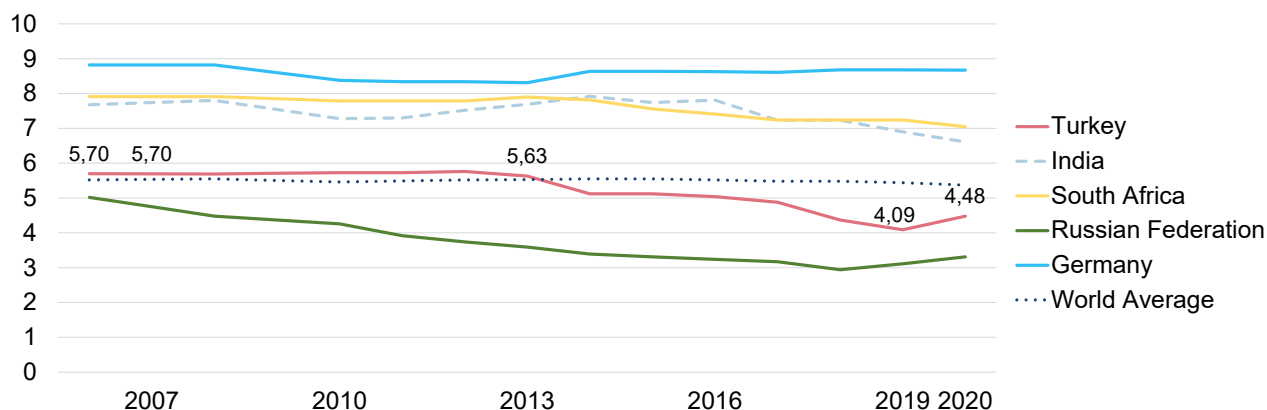
Figure 8: Turkey’s GDP per capita in current USD (1990–2019)



Source: World Bank Group; own illustration.

An important reason for Turkey’s disappointing economic performance since 2013 can be found in the country’s weakening political and institutional conditions. Figure 9 illustrates how Turkey’s democracy has developed over the past years in comparison to other countries based on the Democracy index of the Economist Intelligence Unit. Accordingly, Turkey is increasingly moving away from western democracies such as the EU member states and shows a strong similarity to developments in Russia. Particularly, the recent years show a dramatic worsening of Turkey’s democracy, which can partly explain Turkey’s weak economic performance.

Figure 9: Democracy Index – Turkey compared to other countries



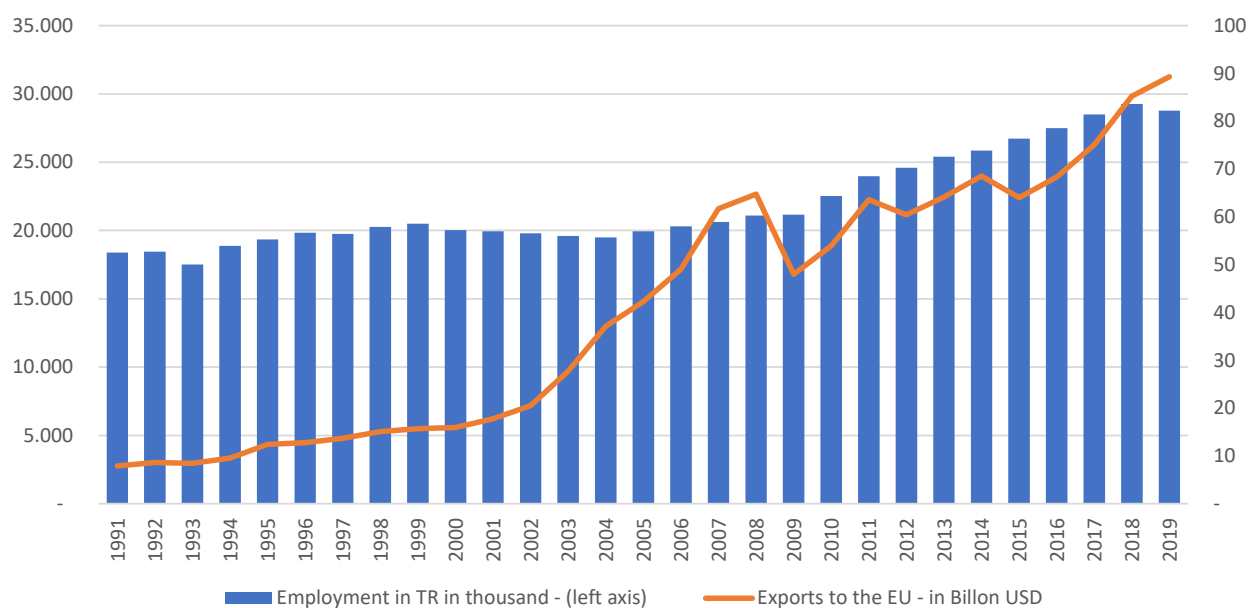
Source: The Economist Intelligence Unit (EIU); own illustration.

Scale 0-10, where 10 = best value

Finally, it is possible to compare the evolution of trade between the EU and Turkey with employment effects. However, a derivation of a causal relationship between trade and employment is difficult due to

the various overlapping effects that take place along the implementation of the Customs Union. Figure 10 shows the total number of employed people in Turkey (left axis) for the period between 1991 and 2019.

Figure 10: Turkish exports to the EU and domestic employment



Source: International Labor Organization, UNCTAD, own illustration.

Accordingly, total employment in Turkey did not show strong changes between 1995 and 2000. In the years after the start of the Customs Union total employment in Turkey slightly declined, until 2005, although exports to the EU started to increase significantly. Empirical studies by De Santis (2000) and more recently by Egger et al. (2020) show that export shocks, e.g., in form of a Customs Union have an impact on employment predominantly along the extensive margin (number of employed people) and less so at the intensive margin (hours worked).

Figure 10 supports these findings. Particularly, after 2005, when Turkey became a candidate country for the EU, the increasing export volume to the EU is accompanied by a strong and continues rise in total employment.

The descriptive findings indicate that the combination of a deep integration of Turkey into the EU based on the Customs Union together with improving institutional conditions which appeared particularly in the early 2000s resulted in a continuous increase in bilateral trade between Turkey and the EU. As a result, Turkey experienced both a steady growth in its GDP and with a certain time lag also a rise in domestic employment.

Inversely, in more recent years, Turkey is experiencing a strong drop in its political and institutional conditions (cf. Figure 9) which is accompanied by a decline in both, GDP per capita and employment.

3 Rules of origin – a special challenge in the Customs Union

The Custom Union was created along the Association Agreement with Turkey to support the frictionless exchange of industrial goods between Turkey and the EU. As shown in the previous chapter this objective has been achieved, particularly, during the years in which Turkey improved its domestic political and institutional conditions.

The Customs Union is now 25 years old and has become outdated, particularly, in view of the numerous new free trade agreements (FTAs) that the EU has concluded or is negotiating with further key economic partners (third parties). Therefore, the trade agreement has significant shortcomings that have become increasingly apparent in recent years.

The following issues have been identified as problematic within the existing Customs Union framework:

1. Constraint scope of the Customs Union

The Customs Union does not cover trade in services, harmonized public procurement and trade in agricultural and fishery goods (except processed agricultural products). Its main function has been to remove tariffs on goods, but it does little to reduce or abolish non-tariff barriers (NTBs), which also impede trade in goods but particularly in services.

2. Regulatory challenges

Since Turkish legislation does not permit mutual recognition of regulations – the principle of EU law under which a product that is sold in one member state can be sold without further regulations in another member state – specific industries are confronted with additional trade restrictions. These sorts of trade restrictions can be observed for example in the medical and chemical industry which are regulated within the EU by the European Medicines Agency and the European Chemical Agency. While all EU member states transpose those agencies rules into domestic laws and hence enable trade without non-tariff barriers in the EU, in case of trade between Turkey and EU members companies are confronted with additional regulatory barriers created by Turkish governments.

3. Limited transportation quotas

The Customs Union allows the free movement of goods between the EU and Turkey for defined products. However, the road freight transport of goods is regulated within the Multilateral Quota System which regulates transport licenses for pan-European road haulage.

The European Conference of Ministers of Transport (ECMT, which evolved into the International Transport Forum (ITF in 2006), organizes these licenses that enable hauliers to undertake an unlimited number of multilateral freight operations in 43 European member countries participating in the system. EU states and Turkey are part of the ECMT.

The number of ECMT permits is limited for each member state and they are distributed at national level by the competent authorities of each member state. It turns out that several member states grant Turkey only a limited number of licences resulting in administrative hurdles at the border of those countries (e.g., Bulgaria, Greece, Hungary, and Romania).⁶

4. Insufficient dispute settlement mechanism

Trade disputes between the EU and Turkey are rarely solved within the existing dispute settlement mechanism (DSM). In principle, the Ankara Agreement includes a DSM for a wide range of potential conflicts, however, it requires a mutual consent of both parties for a dispute settlement initiation. Hence, establishing a new mechanism where both parties can bring a case for a broader case of trade disputes is essential for a more effective DSM. However, it is important to emphasize that the creation of a new DSM has to be aligned with common commercial policy and technical regulations between the EU and Turkey. Otherwise, both Turkey and the EU would be exposed to the risk that unilateral changes in commercial policies or technical rules can result in a situation in which Turkey or the EU do not comply with those new policies, respectively. As a result, Turkey and the EU would challenge each other in the new DSM, if there is no ex-ante consultation and agreement

⁶ A detailed analysis of the transit licenses problems can be found in the IKV brief (2017).

on common commercial policies and regulations. Current disputes between the EU and Turkey within the WTO illustrate the necessity of a new DSM combined with further commercial and regulatory policy alignments (cf. e.g., WTO dispute between Turkey and the EU, DS583).

5. Travel restrictions (Visa obligation)

Turkish businesspeople affected in their commercial activities in the EU by EU's visa policy. Moreover, besides limited transit licenses Turkish hauliers also face challenges of acquiring required visas before entering the EU.

6. Public procurement rules

The Customs Union does not include common rules for public procurement. Hence, access to public procurement by tender is only accessible to domestic parties both in the EU and Turkey, respectively. In light of the deteriorating institutional conditions in Turkey, with a worsening rule of law, and with specific stakeholders close to the ruling government being favoured, a liberalisation and harmonization of procurement rules is of increasing relevance.

7. Challenges in law implementation

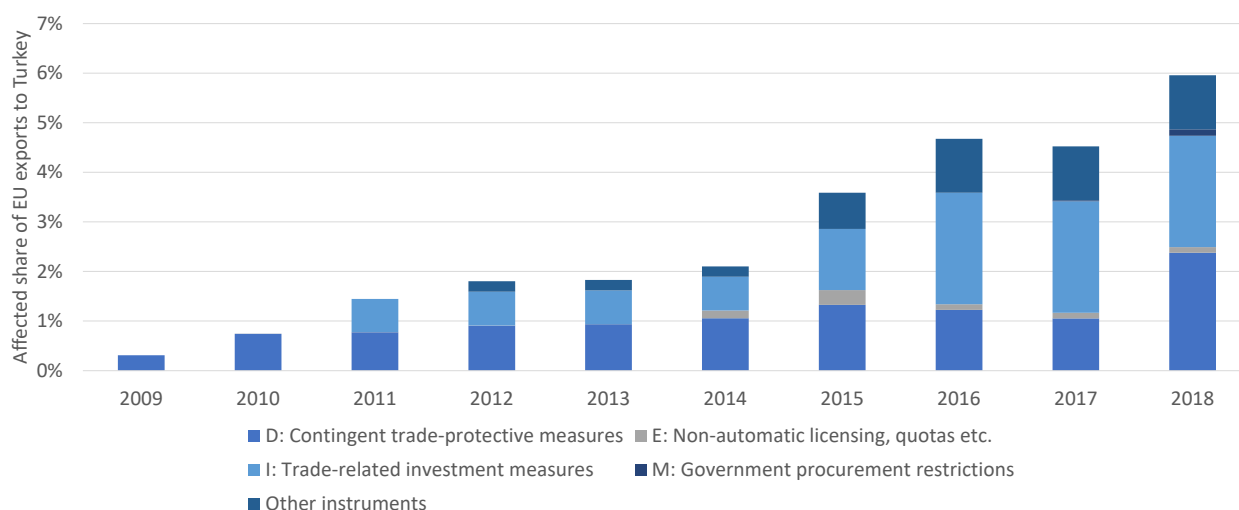
While Turkey has to implement the EU's *Acquis Communautaire* into domestic law in order to become a full member state, the Customs Union itself does not require a full implementation of the EU legislation. Hence, if Turkey does not continue to implement the *Acquis* – either because the EU does not continue the membership process, or Turkey abstains from implementation – laws and regulations across a wide range of trade related topics vary and hence, hamper bilateral trade.

8. Asymmetry problem due to new FTAs between the EU and third parties

Since the early 2000s, due to a slowdown in the liberalisation of the multilateral trading rules within WTO, the EU has accelerated its ambitions to sign FTAs with third parties, following a global policy trend. Turkey, having a Customs Union with the EU, is not automatically included in these FTAs. Countries such as Algeria, Mexico, South Africa, and more recently, Japan and Vietnam, which all have trade agreements with the EU, do not have an incentive to sign an equivalent FTA with Turkey since the CU allows a preferential access to the Turkish market via the EU. The resulting asymmetric trade relationship exposes Turkish enterprises in the manufacturing industry to foreign competition with third parties without the ability to compete on a reciprocal basis. As a result, Turkey has been reacting to this asymmetry by implementing origin controls on imports from the EU, particularly in sensitive sectors, to determine whether they originate from countries that have an FTA with the EU.

9. Non-tariff barriers by Turkey against EU exporters

Commercial policies and technical regulations in many industries are often implemented by Turkey and the EU without coordination. As a result, EU exporters are confronted with various non-tariff barriers (NTB) in Turkey. Figure 11 illustrates the share of EU exports to Turkey negatively affected by NTBs. These barriers include e.g., specific licences, certification, quotas, or minimum local content requirements resulting in higher trade costs for EU exporters.

Figure 11: Non-tariff barriers by Turkey – affected share of EU exports to Turkey

Source: Global Trade Alert, own illustration.

10. Turkey's exclusion from EU's strategic trade decisions

Besides the aforementioned asymmetry problem, the Customs Union has led to trade conflicts between Turkey and both the EU and third parties. The main reason for these problems is since Turkey as a non-EU member has no say in the EU's international trade policies or its common market policy. While Turkey has to align its domestic and international trade policies with the EU, practically necessary steps often do not take place, either because Turkey simply does not or cannot establish equivalent laws and rules, particularly, with respect to third parties.

The EU Commission and the Turkish government are aware of the necessity to address the presented list of challenges within the outdated Customs Union. Moreover, several evaluation studies, including the EU Commission's own study (BKP, Panteia and AESA, 2016) emphasize the negative effects resulting from the latter weaknesses of the Customs Union and suggest a modernization of the trade accord, accordingly.⁷

Three of the latter challenges, namely Turkey's exclusion from the EU's strategic trade decisions, the asymmetry problem, and NTBs are of particular importance, as they lead to increasing trade tensions between Turkey and the EU.

In their Joint Communication on the "State of play of EU-Turkey political, economic and trade relations" which was requested by the European Council in December 2020, the High Representative and the Commission conclude:

After an initially positive trend of increased Turkish alignment to the Customs Union rules, Turkey has been diverging in an increasingly systemic fashion from these rules over the past years. The main issue is additional customs duties levied on third country imports (even when imported from the EU). There are also numerous other market access issues of increasing concern to individual EU firms, industry associations and Member States, such as surveillance measures, requiring disclosure of sensitive data, discrimination against EU tractor producers, and excessive testing and certification. In addition, Turkey

⁷ Certainly, the outdated Customs Union includes further challenges in specific areas. A good overview of further issues can be found in the DG for Trade's study on the EU-Turkey bilateral preferential trade framework (BKP, Panteia and AESA, 2016), in the study by Yalcin et al. (2016), and in the World Bank evaluation study of the EU-Turkey Customs Union (World Bank, 2014).

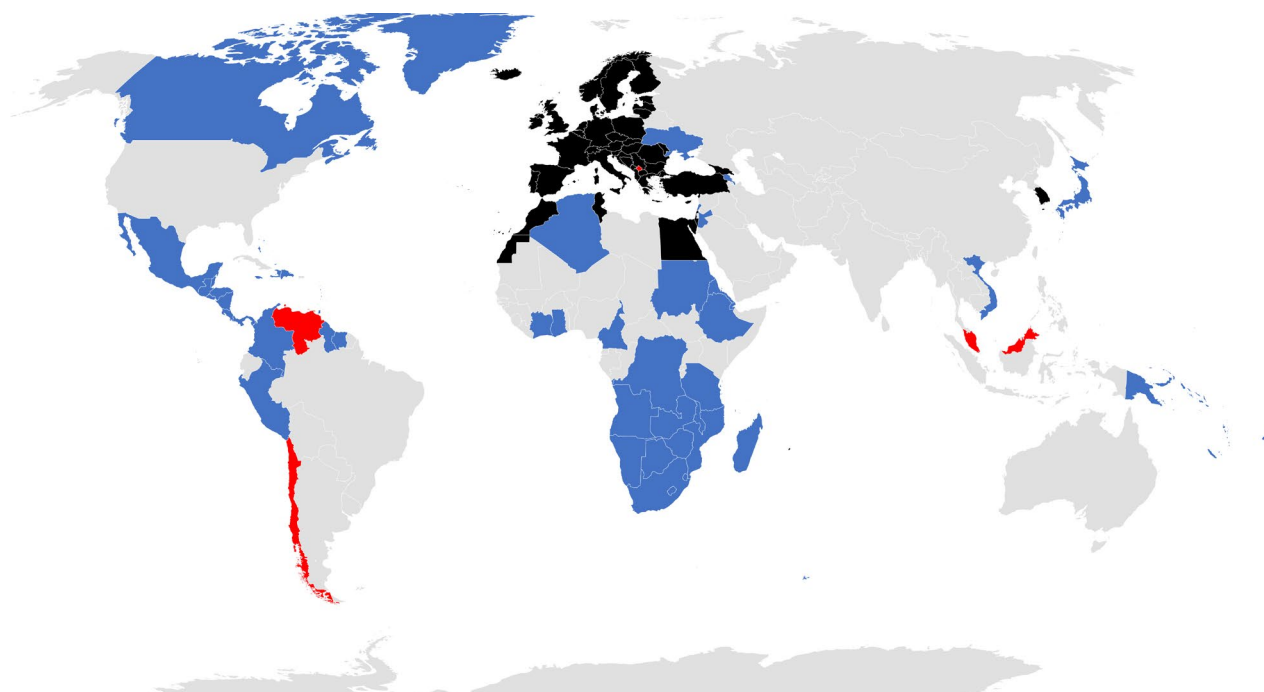
has concluded trade agreements not in line with those of the EU, despite its obligation under the Customs Union to do so (SN 21/18, 2021).

This criticism in Turkey's adverse behavior is factually correct, however, it is important to emphasize that besides Turkey's political negligence to align its trade policies and technical regulations with the EU, there are also structural obstacles originating in the outdated Customs Union which also contribute to the trade policy disputes. Within the current Customs Union, due to the asymmetry problem combined with the fact that Turkey has not aligned its regulatory policy with the EU, bilateral trade frictions are increasing. Moreover, the EU's successful trade agreement policy with third countries accelerates the tensions in trade with Turkey.

3.1 The asymmetry problem within the Customs Union

Figure 12 presents an overview of all free trade agreements applied by the EU and Turkey. Until 2021, the EU applied 44 major trade agreements with 76 partner countries. Although Decision 1/95 of the Association Council obliges Turkey to adopt the EU Common Customs Tariff and to align its trade agreements with the EU's trade partners, Turkey has not signed an equivalent FTA with all third parties that apply a trade agreement with the EU. Until 2021, Turkey has concluded FTAs with 38 countries, 11 of which were repealed due to the accession of these countries to the EU. Currently, Turkey has 22 FTAs in force.

Figure 12: The EU's and Turkey's Free Trade Agreements (2021)



Note: Countries highlighted with colors have a free trade agreement (FTA) in force with both, EU and Turkey (black); only EU (blue); only Turkey (red).

All other countries do not have an FTA with one or both.

The FTAs between Turkey and Syria as well as between the EU and Syria have been suspended.

Further ongoing but not listed trade agreement negotiations exist with the Economic Cooperation Organization (ECO) and based on the Protocol on Trade Negotiations (PTN), in which Turkey is also included.

Source: WTO/RTA Database, Ministry of Trade (Republic of Turkey), own illustration.

For all countries in Figure 12 that are depicted in blue, the EU applies an FTA while Turkey does not have an equivalent trade agreement, yet. There are various reasons for the observed asymmetry in the signed FTAs of the EU and Turkey. One technical reason stems from the fact that free trade negotiations often last long and Turkey has not been able to finalize FTAs with some countries so far. However, more importantly, due to the Customs Union, for third parties that signed an FTA with the EU there is no economic incentive to sign a follow-up equivalent FTA with Turkey, since the Customs Union enables third parties to access the Turkish market with preferential conditions while Turkey does not receive the equivalent market access to the third-party markets.

From Turkey's perspective this asymmetry problem creates two trade related challenges, particularly for its manufacturing industry which is covered by the Customs Union.

The first challenge is the increasing competition for domestic companies in Turkey if the EU applies an FTA with a third party, e.g., Vietnam, and Turkey is unable to establish an equivalent FTA with the same third country. While imports from Vietnam can now enter the Turkish market at lower preferential duties via the Customs Union, Turkish exporters still experience high customs duties in Vietnam. Technically, Turkey is obliged to reduce its border tariffs for Vietnam to the level as agreed on with the EU and at the same time Vietnam keeps import tariffs for Turkey in place. As a result, Turkish exporter of manufactured goods can be confronted with tariffs of up to 35 % and more, while the Vietnamese exporter experience significantly lower tariffs. For a large set of product groups tariffs can be eliminated in total.

The same negative effect for Turkish enterprises and exporters appears in every country that signed an FTA with the EU but not with Turkey.

The second negative effect resulting from the asymmetry problem affects Turkish exporters of intermediate goods to original equipment manufacturers (OEMs) located in EU member states. If, e.g., automotive producers in Germany intend to export final products (automotives) to a third party, e.g. Mexico, which has an FTA with the EU, the German exporters may experience additional tariffs, due to the origin of intermediate goods in Turkey, since Turkey has no equivalent FTA with the third country.

Hence, Turkish enterprises do not only experience a direct negative effect in form of a stronger import driven competition on their domestic market, but in addition, the attractiveness of Turkey as a location with low labor costs that has been utilized by European multinational enterprises over the past decades declines.

From Turkey's perspective this disadvantageous situation resulting from the asymmetry problem can be mitigated in several ways. One solution would be a full membership of Turkey in the EU, which gives Turkey the same rights as to all EU states. However, this option is unlikely to become reality in the near term, due to the political and institutional developments in Turkey. Alternatively, Turkey can sign FTAs with the same third parties as the EU, but as explained earlier, the incentives for third parties to sign an equivalent FTA with Turkey are low.

In light of the asymmetry problem in the Customs Union, Turkey can try to defend its trade interests by introducing tariffs for imports from third countries which apply an FTA with the EU.

It is important to emphasize that according to Decision No 1 /95 of the EC-Turkey Association Council, article 44 ff., both parties, the EU and Turkey, can unilaterally implement additional protective trade measures against imports from third countries, in case e.g., that one party has introduced anti-dumping measures or other trade policy instruments. However, this rule is intended to offer each party a temporary option to protect its market against unfair imports such as dumped products. The paragraph is not meant as a mechanism to allow Turkey the implementation of higher import tariffs against third countries that signed an FTA with the EU.

From a legal perspective Turkey's introduction of higher tariffs than the EU against third countries undermines EU's Common Customs Tariff which has to be observed by Turkey.

The current Custom Union, hence, puts Turkey into a dilemma, at least temporarily, if third parties do not sign an FTA with Turkey, particularly, with respect to intermediate goods producers. For a better understanding of the technical aspects the next section briefly explains the relevance of rules of origins which play a major role in the asymmetry problem and Turkey's increasing deviation in its tariff policy with respect to third countries.

3.2 Rules of Origin – and the system of Pan-Euro-Mediterranean cumulation of origin

The central difference between a customs union and a conventional free trade agreement relates to the existence of rules of origin (RoOs). In a fully-fledged and well-functioning customs union any product in free circulation within one party to the customs union can be exported duty-free to any other member of the customs union. The reason is that all members share the same common external tariff (CET) on imports from third parties. When a customs union covers only certain sectors (such as manufacturing) but not others (such as agriculture), as is the case in the EU-Turkey Customs Union, certain amendments are needed.

However, in an FTA, members set their external tariffs independently. This makes RoOs necessary. These rules lay down the conditions under which a product qualifies for preferential treatment (e.g., for duty-free export to another FTA member). Complying with RoOs is potentially costly for firms, since their sourcing from third countries may be limited, and proving compliance with RoOs requires red tape.

It is commonly thought that RoOs lower the preference utilization rates in FTAs (see, e.g., BDI, 2020; Felbermayr et al., 2019). Moreover, RoOs are crucial for countries' participation in production value-chains. Any changes in the EU-Turkey CU will affect the RoOs and affect the degree of economic integration between the two parties. However, there are various arrangements that are used by the EU and that have different implications for the flow of goods. One important determinant of the optimal stringency of RoOs is the structure of the external tariffs of the trade partner that is shaped by the Most Favoured Nation tariff schedules and by FTAs with third parties.

3.2.1 Rules of Origin

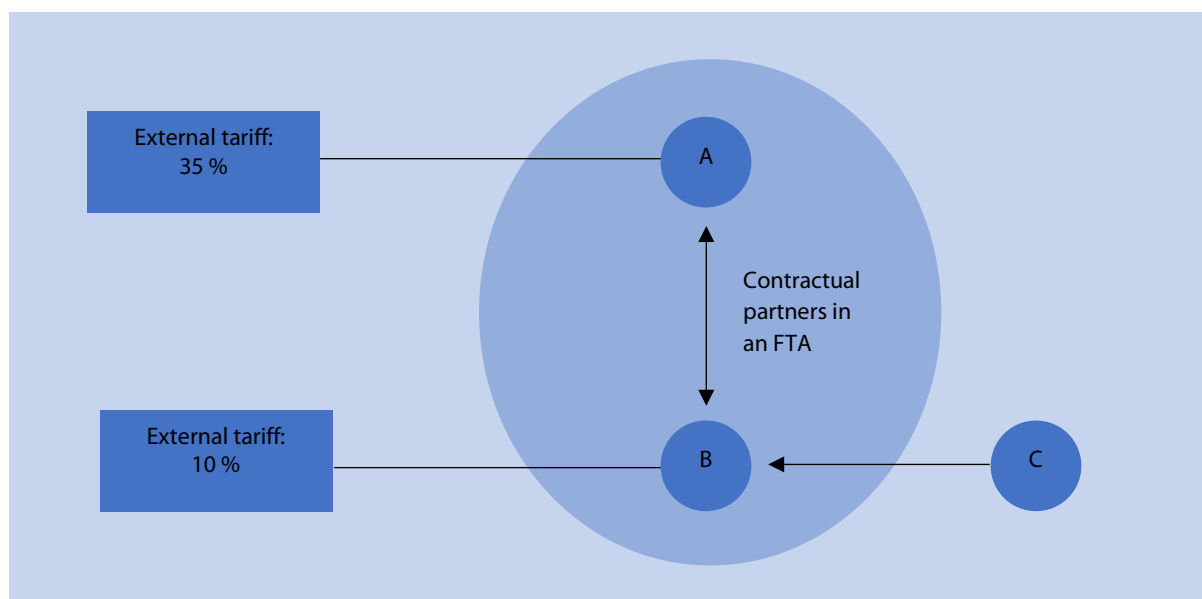
If one country offers preferential tariffs to another country, under a free trade agreement, rules of origin are defined to determine whether a product benefits from preferential tariff treatment (Felbermayr et al., 2019). RoO define criteria needed to identify the national origin of a product to ensure that only the products of the contracting parties receive preferential access under the agreement. Thus, RoOs tend to prevent exports from third countries via further FTA members with the lowest tariff rate (trade deflection).

If two parties A (e.g. Moldova) and B (e.g. the EU) apply a free trade agreement they may agree on eliminating all tariffs for bilateral trade. However, each FTA partner can maintain different external tariffs for imports from other countries. For example, party A applies 35 % for imports from other countries while party B has imposed a tariff of 10 %.

Country C (e.g., Russia), which is not a member of the exemplary FTA, has the option to export goods into the free trade area comprising party A and B, via the country with the lower external tariff. Hence, the exporter from country C could export to A, by first exporting the good to country B, and the selling it from country B to A.

To prevent such trade deflections, signing parties of FTAs agree on RoO. These rules require that, for the movement of goods with preferential tariffs within the free trade area, products must originate in one of the two contracting parties. In this example, country C would not obtain a certificate of origin for exports to country B. Therefore, country C must first pay a tariff of 10 % in country B and then a further 35 % for imports to country A.

Figure 13: Trade deflection and rules of origin



Source: own illustration.

Only if the product from country C undergoes sufficient processing or further processing in country B, it can be assigned an originating status of country B and the product delivered to country A receives a preferential tariff. Very detailed rules are established in the free trade agreements that define the upper limit for added value, for example in country C. An important principle in the context of RoO within FTAs is the so-called cumulation.

Cumulation is a deviation from the principle that goods must be produced entirely in the exporting country, or have undergone sufficient processing in the same country, to qualify as originating goods. The EU's preferential rules of origin include the concept of cumulation. It provides exporter and importer with flexibility in terms of sourcing inputs from suppliers outside the EU or other partner countries and still qualify for a preferential tariff application. There are three important types of cumulation: bilateral, diagonal, full cumulation. The three types differ regarding the number of countries involved in the operation, and what types of materials can be cumulated.⁸

3.2.2 Pan-Euro-Mediterranean cumulation of origin

While RoO represent an import tool to establish an intended preferential treatment of traded goods among members of FTAs, they come along with a significant amount of administrative costs. Over the past years multinational enterprises have created international supply-chains by scattering the production of intermediate goods across various countries to utilize cost advantages. At the same time an ever-growing number of countries started to sign bilateral and plurilateral FTAs. The growing number of FTAs – which are intended to reduce customs duties – can have unintended negative effects on international supply-chains due to the RoO.

⁸ For a detailed explanation, readers are referred to <https://trade.ec.europa.eu/access-to-markets/en/content/cumulation-0>.

To reduce the possible trade hampering effects of RoO in light of the increasing number of FTAs with varying partner countries, the EU and further countries have established the Pan-Euro-Mediterranean (PEM) rules of origin. It forms a network of about 60 bilateral protocols on rules of origin in the Pan-Euro-Mediterranean zone and is now to be replaced by a single agreement: PEM Convention (ST 13592, 2019).

The PEM Convention on rules of origin aims at establishing common rules of origin among the EU and the 24 countries in the PEM zone (EFTA, Turkey, Western Balkans, Eastern Partnership countries and Mediterranean countries). A main objective is to move towards the application of identical rules of origin for the purpose of cumulation of origin for goods traded between all the countries concerned. In the PEM Convention, a product is considered originating in the EU or in a contracting party of the PEM Convention, if it is wholly obtained or manufactured in the EU or in a party to the PEM Convention using non-originating materials, provided that such materials have undergone sufficient working or processing.

Hence, with the PEM convention the EU is participating in a framework which reduces the potential costs of RoO in interconnected FTAs of the EU and its trading partners. At the same time each participating country can maintain its own border tariffs with respect to third parties.

3.3 Turkey divergent tariff policy within the Customs Union

Because of the Customs Union, Turkey's industrial goods exports can access the EU market without complex RoO. As shown in chapter 2, the Customs Union has enabled Turkey to increase its trade with EU members continuously and to establish itself as an important location for European multinational enterprises that have utilized the cost advantages in Turkey to produce intermediate goods for factories in the EU.

Even though the Customs Union represents a cornerstone of EU-Turkey trade relations, in recent years, Turkey has started to introduce new tariff increases on certain products of non-EU origin circulating freely within the Customs Union. Moreover, for a range of traded industrial goods Turkey has started to apply lower tariffs on imports of non-EU origin.

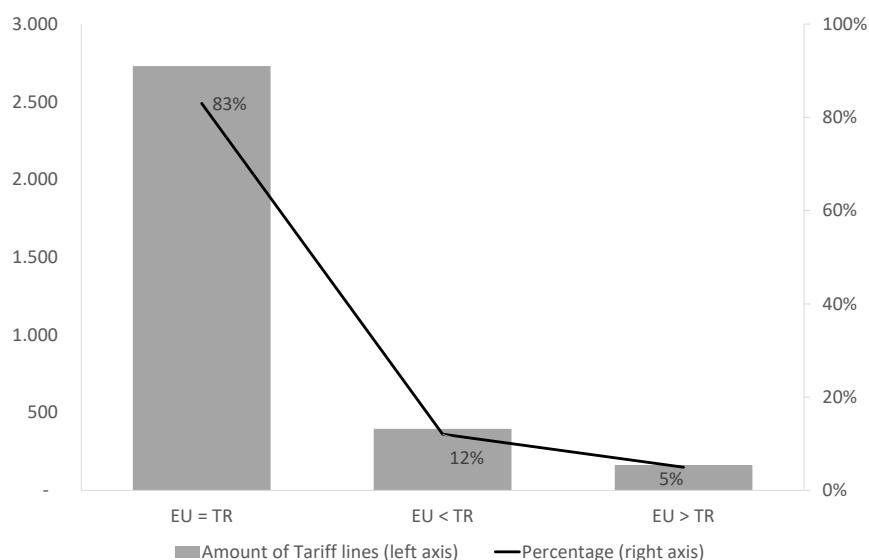
Both trade policies represent an undermining of the Customs Union agreement according to which Turkey has to apply the EU's Common External Tariff – for all goods covered by the Customs Union.

The EU's and Turkey's external tariffs can be compared based on the World Bank's WITS database (Figure 14). For the year 2018, which represents the latest available comprehensive tariff declaration by both parties, the WITS data base lists 4242 product lines for industrial goods (on the HS6-digit level) that are covered by the EU-Turkey Customs Union. Within these product lines, both the EU and Turkey have a total of 3 289 positive (non-zero) external tariff declaration.

Accordingly, the EU and Turkey show the same positive external tariffs for 83 % of the product lines observed. The external tariffs differ for 17 % of the listed product lines. More precisely, the EU imposes lower tariffs than Turkey for around 12 % of the listed external tariffs. For around 5 % of the product lines with non-zero tariffs, Turkey has imposed lower tariffs than the EU.

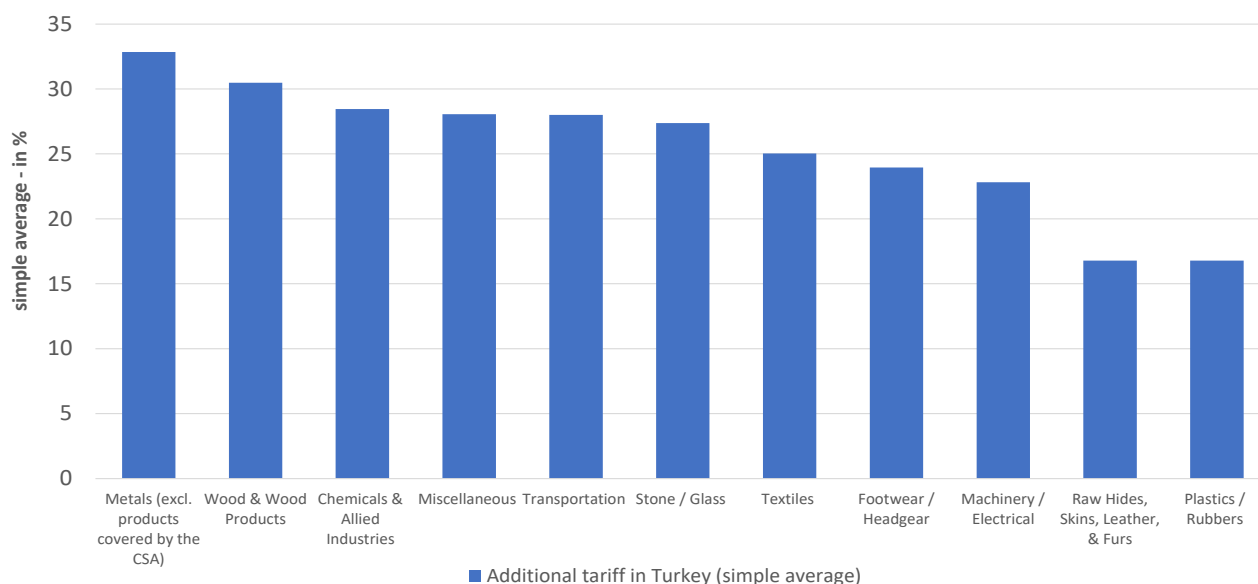
Besides the divergent external tariffs across a wide range of industrial products in recent years Turkey repeatedly introduced very large temporary additional customs duties for certain product groups. Figure 15 shows additional temporary customs duty rates for textile, garment, leather, shoes and similar products, as well as certain industrial products. The additional customs duty rates were introduced based on the Presidential Decrees dated April 20, 2020 and were applicable until September 30, 2020.

Figure 14: Difference in tariffs between the EU and Turkey (industrial goods)



Source: WITS – TRAINS Tariff Data, own illustration.

Figure 15: Turkey’s additional tariffs on Industrial Goods (2020)



Source: WITS – TRAINS Tariff Data, own illustration.

On average, these additional tariffs are ranging between 15 and 35 %.⁹ Such high additional tariffs rates certainly reduce imports to Turkey by a significant amount. At the same time the free movement of products within the Customs Union was distorted as long as the tariffs were in place. Although these measures are no longer in place, they show the high tariff burden that is increasingly introduced by Turkey to protect domestic industrial goods producers. It is highly likely that Turkey will come back to similar trade measures as long as there is no solution to the asymmetry problem.

Turkey’s additional customs duties unilaterally levied on third country imports (even when imported from the EU) represent a major problem for affect industries in the Customs Union. Higher external tariffs may

⁹ On the disaggregate product level for some products Turkey imposed temporary additional tariffs of 45 %.

protect domestic final goods producers in Turkey – which is the policy intention of Turkey- but at the same time, exporters from EU countries to Turkey, both final and intermediate goods producer, are confronted with dramatic additional costs. As briefly explained in section 3.1. such protective measures are only allowed within the CU for special temporary cases (e.g., unilateral anti-dumping policies) but the extent of Turkey’s tariff policy deviation from the EU’s CCT can be considered as not in compliance with Turkey’s obligation under the CU. While final good producers can react with reduced exports to Turkey, in case of intermediate goods exporters involved in European supply chains, trade flows are less flexible when it comes to reorganize production locations. Hence, Turkey’s deviation from the EU’s Common External Tariff is undermining the EU’s attempt to support European value-chains (e.g., based on the PEM Convention).

4 Different economic integration scenarios

As illustrated in the previous sections, the Customs Union between the EU and Turkey is outdated in many respects and leads to increasing trade policy tension with Turkey.

In order to assess the impact of different policy objectives currently discussed in the European Parliament, the Council, the European Commission, and among stakeholders in public debate with respect to the Customs Union, this chapter considers four possible options how the EU and Turkey can proceed:

- (i) Continuation of the current Customs Union framework as it stands,
- (ii) Modernization and upgrading of the Customs Union,
- (iii) A transformation of the bilateral trade relations into a deep and comprehensive free trade agreement (DCFTA, similar to the EU-Canada trade agreement),
- (iv) Suspension of the Customs Union (WTO rules would apply).

The analysis draws on existing econometric studies and simulation work such as by BKP, Panteia and AESA (2016) and Yalcin et al. (2016).¹⁰

4.1 Continuation of the current Customs Union framework

Continuation of the current framework assumes that trade in goods is organized through the Customs Union, and other products through dedicated agreements, CSA and AFTR. Effects in this scenario are driven, to a large extent, by new free trade agreements between the EU and third countries and due to the asymmetric participation of Turkey in those agreements. Possible long run effects of this scenario have been simulated by Yalcin et al. 2016.

The underlying analysis applies a general-equilibrium model for international trade, in which 140 countries in 57 goods and service sectors can conduct trade with each other, and in which the trade flows are reduced by tariffs and non-tariff barriers. In the simulations, it is assumed that the EU concludes new free trade agreements with third countries and eliminates tariffs and non-tariff barriers with the new FTA countries. Specifically, the analysis assumes that the EU signs FTAs with Japan, MERCOSUR, India, CETA (Canada), ASEAN, and the USA, while Turkey is not able to sign equivalent FTAs and hence, experiences the earlier described asymmetry problem.

Table 1 summarizes the main findings for the EU member states and Turkey. A clear effect in this scenario is the drop in Turkish exports to the EU’s new FTA partners. Due to an EU-Japan FTA, e.g., the simulations

¹⁰ All existing quantitative analyses are based on recent but historical data. Hence, in all know studies simulation results consider the UK still as an EU member.

predict a drop in Turkish exports to Japan by 2.8 % but an increase in imports from Japan amounting to 13 %.

Bilateral trade (imports and exports) between the EU and Turkey is predicted to decline in the long run. The combined effect across all considered FTAs results in a drop in EU imports from Turkey by 0.5 % and a decline in EU exports to Turkey by 2.3 %.

Table 1: Economic effects of an unchanged Customs Union

Panel a) Effects for the Turkey

	USA	Japan	CETA	India	MERCOSUR	ASEAN	Combined Effect
ΔGDP (USD billions)	0.04	-0.03	0.01	-0.03	-0.02	-0.07	-0.08
ΔGDP per capita (USD)	0.51	-0.36	0.09	-0.33	-0.22	-0.89	-1.08
ΔWages (%)	0.02	0.01	0.00	-0.01	0.01	0.00	0.02
ΔGDP (%)	0.01	0.00	0.00	0.00	0.00	-0.01	-0.01
ΔExports TUR – EU28 (%)	-0.27	-0.50	0.10	-0.11	0.43	-0.19	-0.51
ΔExports TUR – RoW (%)	-0.15	0.23	-0.10	-0.14	-0.28	0.15	-0.29
ΔExports TUR – FTA (%)	-1.28	-2.82	-1.20	-7.04	-8.05	-0.72	-2.56
ΔImports TUR – EU28 (%)	-0.77	-0.59	-0.14	-0.24	-0.26	-0.33	-2.27
ΔImports TUR – RoW (%)	0.10	0.12	0.08	0.02	0.23	0.13	0.66
ΔImports TUR – FTA (%)	5.05	13.05	2.72	0.86	3.86	8.42	5.17

Panel b) Effects for the EU

	USA	Japan	CETA	India	MERCOSUR	ASEAN	Combined Effect
ΔGDP (USD billions)	51.51	15.12	8.76	8.72	12.21	13.96	109.04
ΔGDP (%)	0.32	0.09	0.05	0.05	0.08	0.09	0.67
ΔExports EU28 – TUR (%)	-0.77	-0.59	-0.14	-0.24	-0.26	-0.33	-2.29
ΔExports EU28 – FTA (%)	41.38	59.50	55.64	63.92	68.28	45.86	46.75
ΔImports EU28 – TUR (%)	-0.27	-0.50	0.10	-0.11	0.42	-0.19	-0.51
ΔImports EU28 – FTA (%)	41.36	56.16	45.81	37.70	40.19	33.11	41.61

Source: Yalcin et al. (2016).

In terms of GDP effects, Turkey is predicted to experience no major changes, while the EU can expect positive GDP effects resulting from the new FTAs. The combined total increase in the EU's GDP would be around 0.7 %, while Turkey is predicted to experience a very small negative effect of 0.01 %.

Main findings in this scenario are that the EU's new free trade agreements have minor negative consequences for Turkish GDP. Although the cumulative negative GDP effects are not too big at first, the respective study illustrates that important export sectors in Turkey are experiencing a significant drop in trade. The Customs Union's asymmetry problem, which disadvantages Turkish exporters on the markets of the EU's new trading partners, is one reason Turkey is predicted to experience a sharp fall in sectoral exports. Bilateral trade between the EU and Turkey is predicted to decline by around 2.3 % due to trade agreements between the EU and other third parties. The negative effects turn out to be larger in case of FTAs between the EU and third parties which have a strong and competitive industry, such as in the case of the USA or Japan.

Importantly, the predicted negative effect on bilateral trade between the EU and Turkey is not only driven by the described asymmetry problem, but also to a large extent driven by the fact that new EU FTAs are reducing NTBs between the EU and the respective third parties, while similar NTBs in Turkey remain in place. As illustrated in section 3, an ever-increasing share of exports from the EU to Turkey are confronted with NTBs (in 2018, almost 7 % of EU exports to Turkey were negatively affected by NTBs). The extent of trade protection through NTBs can be translated into tariff equivalent values. In some industries such as the metal or chemical sector NTBs correspond to ad-valorem equivalent tariffs of up to 30 % (cf. Felbermayr et al. 2015). The underlying simulations assume that exporters in the EU experience a drop in these costs

by up to 15 % if a comprehensive FTA is signed with a third party. As long as Turkey does not align its common commercial policy and technical regulations with the EU, bilateral trade between the EU and Turkey is affected negatively by the new EU FTAs with third parties. Yalcin et al. (2016) illustrate that trade between the EU and Turkey would drop by around 1.6 %, if only tariffs are eliminated between the EU and third parties. Hence, the preservation of NTBs in Turkey is a major reason for a drop in bilateral EU-Turkey trade. Similarly, if Turkey does not comply with the CU agreement by aligning its trade policy with the EU, (e.g., signing FTAs with the EU's new FTA partners) frictions in trade between the EU and Turkey increase and as a result Turkey experiences the predicted drop in trade and welfare.

4.2 Modernization and upgrading of the Customs Union

In this scenario it is assumed that the EU and Turkey extend the scope of the Customs Union by including the agricultural and service sectors. Table 2 summarizes main findings of quantitative simulations conducted by Yalcin et al. (2016). Specifically, it is assumed that Turkey is not part of the EU's new FTAs but must open its market to the EU's new trading partners in all sectors. Hence, the problem of asymmetry remains in place.

Table 2: Effects of a modernized Customs Union

Panel a) Results for Turkey

ΔGDP (USD BN)	13.30
ΔGDP per capita (USD)	171.10
Δwages (%)	2.40
ΔGDP (%)	1.84
Δexports TUR – EU28 (%)	69.86
Δexports TUR – RoW (%)	-7.83
Δimports TUR – EU28 (%)	40.12
Δimports TUR – RoW (%)	5.60

Panel b) Results for the EU

ΔGDP (USD BN)	9.51
ΔGDP (%)	0.06
ΔExports – TUR (%)	41.79
ΔImports – TUR (%)	69.63

Panel c) Changes in trade flows

	Agriculture	Manufacturing	Services
Δexports TUR – RoW (%)	-3.82	-6.72	-14.93
Δexports TUR – RoW (M USD)	-552	-3960	-2602
Δexports TUR – EU28 (%)	94.51	-7.33	429.13
Δexports TUR – EU28 (M USD)	6090	-4647	56544

Source: Yalcin et al. (2016).

Main findings are that a modernization of the EU-Turkey Customs Union by covering trade in the agricultural and service sectors – has a strong positive welfare effect on the Turkish economy. Gross domestic product is predicted to rise by 1.84 %. Bilateral trade between Turkey and the EU are expected to grow significantly. Turkish exports to the EU are expected to increase by almost 70 %. However, this rise in exports varies across the three main sectors, i.e., agriculture, manufacturing, and services. Exports to the EU increase by 95 % for the agricultural sector and by 430 % for the service sector. The manufacturing sector is predicted to observe a drop in exports. Moreover, updating the Customs Union is predicted to lead to a reallocation of resources from the manufacturing industry to the service sector. Furthermore, the rise in exports to the EU is made possible by a fall in Turkish exports to other countries.

A main reason for the strong positive trade effects in this scenario results from the elimination of NTMs between the EU and Turkey. Implicitly, Turkey is also harmonizing technical regulations along the EU's new FTAs with third parties. Such a trade policy is not only beneficial for the bilateral EU-Turkey trade, but also supportive for intermediate goods exchange, e.g., in case of multinational enterprises located in the EU, Turkey and in the EU's new FTA partner countries.

Yalcin et al. (2016) also consider an even deeper integration of Turkey with the EU, in which the Customs Union is not only modernized but moreover, Turkey aligns its trade policy with respect to the EU's new FTA partners. As a result, Turkey's exports are predicted to also increase with the EU's FTA partners due to the elimination of the asymmetry problem, while trade with the EU does not change significantly.

Welfare gains for Turkey and the EU turn out to be the largest in this comprehensive scenario. Turkey is predicted to gain more than 2 % additional growth in its GDP. The EU can expect an additional GDP growth by about 0.7 %. If Turkey aligns its trade policy one by one with the EU, meaning that Turkey signs equivalent FTAs with the EU's new trading partners, the predicted GDP growth reaches 2.5 %.

Hence, if Turkey complies with the Customs Union rules, aligns its NTBs with the EU regulations, and continues to follow the EU's FTA policy with third parties, both the EU and Turkey are predicted to experience significant growth effects.

4.3 An EU-Turkey Free Trade Agreement

One alternative option to adjust the trade relationship between the EU and Turkey is the transformation of the existing Customs Union into an FTA. So far, this trade policy option has not been on the agenda of the EU and Turkey. However, due to the difficult political developments between Turkey and the EU, the chances for a further political integration of Turkey into the EU, at least in the coming years, appear to be not to be very positive. Given the fact that the Customs Union between the EU and Turkey has been defined as a temporary integration stage on Turkey's way to a full membership, the recent developments motivate the consideration of an alternative trade policy that may allow Turkey and the EU to stabilize the bilateral trade relations such that bilateral trade can still prosper and cope with international developments even so Turkey does not progress in its efforts to become a full EU member.

This policy option has become a real economic alternative, particularly, after the UK's exit from the EU. Since the Brexit, the EU has a trade policy framework at hands which can be applied to a large economy like Turkey that appears to be politically too far away from the EU's policy requirements to become an EU member.

By transforming the EU-Turkey Customs Union into a bilateral free trade agreement, Turkey regains full sovereignty over its trade policy and does not have to grant unilateral trade facilitation to any of the EU's new free-trade partners. Hence, Turkey is no longer confronted with the explained asymmetry problem. However, such a trade policy strategy would necessitate RoO between Turkey and the EU but at the same time Turkey would gain more flexibility in its external tariff setting. At the same time, due to the RoO the attractiveness of Turkey for EU enterprises as a location for intermediate goods productions is likely to decrease.

Yalcin et al. (2016) simulate a deep and comprehensive FTA (DCFTA) between Turkey and the EU which covers all traded goods and services. Tariffs and non-tariff barriers are assumed to be eliminated by a similar amount as e.g., in case of CETA. Table 3 summarizes the main findings.

Effects of a bilateral DCFTA between the EU and Turkey are complex, due to the strong structural changes in the legislation. According to the quantitative simulations based on historical data Turkey's trade with the EU is predicted to decline.

Table 3: A deep and comprehensive FTA between the EU and Turkey

Panel a) Effects for Turkey		Panel b) Effects for the EU	
ΔGDP (USD BN)	-5.85	ΔGDP (USD BN)	-4.74
ΔGDP per capita (USD)	-75.26	ΔGDP (%)	-0.03
Δwages (%)	-0.77	ΔExports – TUR (%)	-12.39
ΔGDP (%)	-0.81	ΔImports – TUR (%)	-16.27
Δexports TUR – EU28 (%)	-16.16		
Δexports TUR – RoW (%)	1.58		
Δimports TUR – EU28 (%)	-13.42		
Δimports TUR – RoW (%)	0.10		

Source: Yalcin et al. (2016).

If the EU-Turkey Customs Union is transformed into a DCFTA, the level of Turkey's integration in the European economy would be reduced. Rules of Origin had to be applied, which is likely to reduce trade between Turkey and the EU in comparison to a Customs Union scenario. Since the EU is an important market for Turkish exports, a decline in trade with the EU also implies a drop in Turkey's overall economic output and as a result Turkish GDP decreases.

At the same time Turkey gains control over its external tariff policy, since the country has no longer to follow the EU's foreign trade policy and hence, could experience a positive trade effect with the rest of the world. Indeed, simulations predict that Turkey is likely to extend its trade with the rest of the world, but the reduction in trade with the EU turns out to be significantly larger. Overall, Turkey is predicted to experience a drop in GDP by 0.8 %. The EU experiences no major changes in GDP.

Clearly, from a purely economic point of view reorganizing the EU's trade with Turkey based on a DCFTA is not extremely attractive, because the policy adjustment is predicting a drop in Turkey's GDP with no major large changes for the EU. However, in the long run a Customs Union between the two parties is only sustainable, if Turkey is going to align its economic policy including commercial and regulatory policies with the EU.

4.4 Suspension of the Customs Union

In recent years, some policy makers in the EU repeatedly called for a suspension of the Customs Union, as a reaction to the worsening political developments in Turkey. Interestingly, to the best of our knowledge, a similar quantitative analysis like the previous three policy options has not been conducted. One possibility to quantify, at least trade effects, if the Customs Union is suspended can be achieved by relying on empirical research which has estimated the trade effects of the Customs Union between the EU and Turkey. The estimated effect is a good proxy by how much Turkish trade may be affected in case of a suspension. Suspension would put Turkey back into a WTO framework forcing the country to comply with the rules of the multilateral trading system.

Baier et al. (2019) and Larch et al. 2019 estimate the Customs Union effect for the EU's and Turkey's trade. Results of the empirical estimations suggest that EU exports to Turkey increased by 49 % and Turkish exports to the EU have risen by 74 %. Under the assumption that a Customs Union suspension puts Turkey into a trade policy framework similar to the one before signing the Custom Union with the EU, it is legitimate to expect that Turkey and the EU are likely to experience similar but negative trade effects. Accordingly, in case of a suspension the EU would experience a drop in Exports to Turkey by 33 %, while Turkey's export are expected to decline by around 43 %.¹¹

¹¹ Possible export effects after the suspension can be calculated as $(1.00/1.49-1)*100=33\%$.

A comparison of these potential trade effects with the previous scenarios shows that a suspension results in the largest negative trade effects for both the EU and Turkey. Implicitly, effects on Turkey's GDP are also the worst among the considered scenarios. These results are not surprising, because the underlying policy would not solve any of the existing trade problems. Moreover, Turkey's trade rules with respect to regulatory policies (NTMs), commercial policies or required new rules for services and investments would remain unchanged.

4.5 Summary of results and policy implications

A comparison of the different policy options which can be applied by the EU and Turkey in the coming years illustrates, that a modernization of the Customs Union promises the highest welfare gains for both parties, but particularly for Turkey. However, it is important to emphasize, that the existing quantitative simulation models require strong assumptions that are not easy to be met in reality.

The current status quo between the EU and Turkey is a partial Customs Union, which deviates from the textbook case in several dimensions. First, it is partial in that it does not cover all trade between the EU and Turkey; agri-food and certain manufacturing sectors are exempted. Second, it is asymmetric in the sense that Turkey has to apply the common external import tariffs that the EU 27 negotiates with third parties but reciprocal tariff concessions of third parties do not automatically apply to Turkey's exports to these countries. Finally, Turkey has only very limited political influence in the setting of the EU's common external tariff. There is a risk that tackling the first deviation from an ideal Customs Union without tackling the latter two issues does not improve EU-Turkey trade relations. The point is that, with the two latter problems persisting, incentives to comply with the rules will remain imperfect. It is, thus, likely, that the functioning of a deepened and widened Customs Union will be hampered by similar problems as the current design. These points, however, cannot be appropriately addressed in a necessarily stylized quantitative simulation model. The quantitative results presented here should be interpreted with caution.

In the view of the authors, overcoming the second and third limitations listed above does not appear realistic under the prevailing political conditions, at least not soon. As illustrated, a solution would necessarily require a much stronger degree of political alignment between Turkey and the EU which is probably out of reach soon: Turkey has to improve and align not only its trade policy (tariffs, NTMs, commercial policies etc.) with EU rules but has to fulfill deeper institutional and policy objective such as the Copenhagen criteria.

Considering these conditions Turkey applies increasingly divergent tariff policies which are de facto undermining the existing Customs Union rules. Moreover, as has been illustrated, Turkey's unilateral tariff policies are hampering European value-chains, while the EU tries to reduce trade costs in the EU and its neighborhood e.g., based on the PEM convention.

In light of these developments, it is quite surprising that the current debate about Turkey's economic integration into the EU is predominantly discussed along the lines whether the EU should start a modernization of the Customs Union or not, without duly acknowledging the two further limitations mentioned above. Hence, in the view of the authors, it would be advisable to open the solution space much more widely and also investigate the case for a modern preferential trade agreement that is more similar to the types of agreements that the EU has with countries such as Canada, Japan or the UK. These require much less political integration, and they retain a larger degree of trade policy autonomy for Turkey. This would increase compliance incentives and stabilize the EU-Turkey relationship. Such an arrangement would require a rethinking of rules of origin and could borrow from elements that have been put in place between the EU and the United Kingdom after the latter left the European Customs Union.

From a purely economic perspective a DCFTA does not look to be rational, given the predicted negative GDP effects, particularly, for Turkey. However, all quantitative simulations that consider a Customs Union integration strategy for Turkey into the EU assume a stable and sustainable policy environment in Turkey,

and between the EU and Turkey. The weakness of these existing quantitative simulations is that they can barely predict the consequences of political strains which have been experienced between the EU and Turkey over the past years.

Hence, given the increasing political tension between the EU and Turkey, decision makers should assess in how far a Customs Union is still a reasonable framework for Turkey. The short run economic costs of choosing a DCFTA will be certainly negative but at the same the suggested alternative integration path offers a less confrontational trade agreement, particularly, in a policy environment in which both parties are politically diverging instead of converging.

Needless to say, if the political environment changes, the partners could upgrade their relationship to a broader partnership comparable with the EEA, in the long run keeping the door open for a full membership of Turkey in the EU.

5 Conclusion

The existing Customs Union between the EU and Turkey has been very successful in creating trade between the two partners and fostering economic development on both sides. According to various studies, compared to a situation where the partners were to trade under the conditions of the World Trade Organization without any preferential trade agreement in place, trade in goods is about 60 % higher.

However, since the creation of the Customs Union some 25 years ago, the situation has changed. Turkey's path towards full membership in the EU has become increasingly difficult to see. The current arrangement, initially designed as a transitory system on the way to full membership, has become more and more prone with problems. These relate to insufficient incentives on the Turkish side to fully comply with the rules of the Customs Union. In particular, amongst other problems, Turkey levies additional tariffs on large shares of its external trade, which contradicts the Customs Union's common external tariff. This practice has the potential to undermine the integrity of the EU Single Market; it also generates negative externalities for the EU's trade partner in the Mediterranean area with which it has free trade agreements.

It is, thus, important to seek solutions to the malfunctioning of the Customs Union. In this study, we have described the structure and depth of the various problems. Relying on existing simulation studies, we find that extending the Customs Union to areas not yet covered would increase trade and welfare for both partners. However, it is important to understand that the essential feature of a Customs Union – the existence of a common external policy – requires a substantial amount of political integration which does not appear realistic in the present circumstances. Without political integration, the Customs Union will have to remain asymmetric – Turkey has to enact the EU's tariffs regarding other countries while not automatically receiving reciprocal treatment by those other countries. This asymmetry is the central reason for fading compliance of Turkey. If it is not dealt with, problems will persist in the future.

For these reasons, the present study argues that European decision-makers should not only envisage a choice between (i) keeping the status quo unchanged, (ii) extending the customs union, or (iii) suspending it. They should also think about the possibility of a modern free trade agreement shaped after the EU's deals with the UK, Japan or Canada. Formally, these arrangements are less deep than an ideal Customs Union. They require rules of origin which can, if designed inappropriately, disrupt value chains. But an FTA can function with a much smaller degree of political integration. Importantly, it would maintain incentives for compliance. A Customs Union without political integration is likely to come with lasting compliance problems and continuous tensions which could easily hamper bilateral economic relations by more than moving to an FTA.

6 Literature

Baier, Scott, Zylkin and Yoto Yotov (2019), On the widely differing effects of free trade agreements: Lessons from twenty years of integration, *Journal of International Economics* 116: 206-226, <https://doi.org/10.1016/j.jinteco.2018.11.002>.

BDI (2020), Aiming for Better Utilization of EU Free Trade Agreements, <https://english.bdi.eu//article/news/text>.

BKP, Panteia and AESA (2016), Study of the EU-Turkey Bilateral Preferential Trade Framework, Including the Customs Union, and an Assessment of Its Possible Enhancement'. Report for the EU Commission, https://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2016/turkey_anx6_en.pdf.

EC-Join (2021), Joint Communication to the European Council, State of of play of EU-Turkey political, economic and trade relations.

Peter H. Egger, Pinar Kaynak, Benedikt Zoller-Rydzek (2020), Indirect effects of trade shocks on Turkish local labor markets, *Regional Science and Urban Economics*, Volume 83, <https://doi.org/10.1016/j.regsciurbeco.2020.103537>.

Felbermayr, Gabriel, Feodora Teti, Erdal Yalcin (2019), Rules of origin and the profitability of trade deflection, *Journal of International Economics* 121, 103248 <https://doi.org/10.1016/j.jinteco.2019.07.003>

Felbermayr, Gabriel, Mario Larch, Finn Krüger, Lisandra Flach, Erdal Yalcin, Sebastian Benz (2015), Dimensionen und Auswirkungen eines Freihandelsabkommens zwischen der EU und den USA, ifo Forschungsbericht 62.

IKV brief (2017), The Quota Issue of the Turkish Road Transport Sector in the EU, Economic Development Foundation.

De Santis, Roberto A. (2000), The Impact of a Customs Union with the EU on Turkey's Welfare, Employment and Income Distribution: An AGE Model with Alternative Labour Market Structures. *Journal of Economic Integration*, vol. 15, no. 2, 2000, pp. 195–238. JSTOR, www.jstor.org/stable/23000498.

World Bank (2014), Evaluation of the EU–TURKEY Customs Union, World Bank Group.

Yalcin, Erdal, Rahel Aichele and Gabriel Felbermayr (2016), Turkey's EU Integration at a Crossroads, GED Study, Bertelsmann Foundation https://www.bertelsmann-stiftung.de/fileadmin/files/BSt/Publikationen/GrauePublikationen/NW_Turkey_s_EU_integration.pdf

PE 653.640
EP/EXPO/INTA/FWC/2019-01/LOT5/1/C/08

Print ISBN 978-92-846-8337-6 | doi: 10.2861/095901 | QA-02-21-863-EN-C
PDF ISBN 978-92-846-8338-3 | doi: 10.2861/714643 | QA-02-21-863-EN-N