



British Embassy
Ankara

TUSIAD

**A NEW
ERA FOR THE
CUSTOMS UNION
& THE BUSINESS
WORLD
EXECUTIVE
SUMMARY**



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FOREWORD AND ACKNOWLEDGEMENT

TUSIAD (Turkish Industry and Business Association) is a civil society organization established by Turkish industrialists and businessmen in 1971 in order to represent the business World.

TUSIAD aims to contribute to the formation and development of a social order based on the adoption of the universal principles of human rights, freedom of thought, belief and action, a secular state of law, concepts of participatory democracy, a liberal economy, the rules and regulations of a competitive market economy and a sustainable environmental balance.

TUSIAD works to achieve the realization of the main objectives stated above based in the belief that businessmen working in line with the targets and principles envisaged by Atatürk guided by a concept of Turkey's reaching and surpassing the norms of contemporary civilization and bolding to the equality of men and women in politics, the economy and education, comprise a pioneering and enterprising group in society.

As a representative body of the Turkish business world working for the public good, TUSIAD strives to manifest activities to entrepreneurs in conformity with the universal principles of business ethics, TUSIAD constantly aims for progress and enhancement in Turkey's competitiveness, social welfare, employment and productivity, as well as the country's capacity for renewal and the scope and quality of education and training during the globalization process.

TUSIAD contributes to the formation of national economic policies by correctly evaluating regional and sectoral potentials in Turkey's economic and social development in an environment in which social peace, compromise and reconciliation is maintained. TUSIAD contributes to

the promotion of Turkey globally and supports the EU accession process through efforts to develop international political, economic, social and cultural relations as well as communication, representative and cooperative networks. TUSIAD conducts research, forms views, and develops projects and activities in the context of accelerating international integration and influence building, regional and local development.

TUSIAD aims on behalf of the Turkish business World to encourage and develop a unity of thought and action in line with these objectives through the direct and indirect dissemination of its views and recommendations to the Turkish parliament, government, other states, international organizations and public opinion, through the press and other means.

TUSIAD, in accordance with its mission and in the context of its activities, initiates public debate by communicating its position supported by scientific research on current issues.

The modernization of the Customs Union, in order to broaden its scope, resolve its asymmetries and establish a more advanced cooperation mechanism between Turkey and the EU appears to be an important opportunity for the Turkish economy. With bilateral technical discussions coming to an end in May 2015, this issue has become an important item on the agenda.

To this respect, as TUSIAD, we had prepared a report on the impacts of a modernized Customs Union, which has a key role in successfully concluding both EU accession negotiations and the process of joining TTIP.

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A NEW ERA FOR THE CUSTOMS UNION & THE BUSINESS WORLD

Following the political understanding announced in May 2015, the process for the deepening of the Customs Union has been officially initiated. Turkey remains committed to the EU membership objective. The deepening of the Customs Union is viewed as an undertaking that will accelerate Turkey's integration with the European economy and thus enhance the dynamics of the accession process. At the same time, the deepening of the Customs Union is set to have a significant impact on the Turkish economy. The current Customs Union which has been in force since 1995 covers only industrial goods and processed agricultural goods, consisting only 20% of the national economy. With the deepening of the Customs Union, service industries and the agricultural sector will be included in addition to public procurement thus incorporating all areas of the national economy related to international trade.

Liberalization of Trade in Goods

The principle of liberalization of trade in goods has been in effect since the initiation of the Customs Union in 1995 which includes industrial goods and processed agricultural goods. However in practice this principle had nonetheless a few exceptions. Among the most important exceptions are Turkey's ban on used machinery imports including used vehicles, and the non-application of the principle of the exhaustion of intellectual property rights for the pharmaceutical sector. These exceptions will need to be terminated as an outcome of the next round of negotiations. It is very likely that the EU will include the ending of this exception related to the import ban on used vehicles and machinery imports in its list of demands. Therefore, even though it is outside of the scope of this analysis, it will be necessary to review the effects of the end of this prohibition on the competitiveness of the Turkish automotive and heavy machinery sectors.

Furthermore another obstacle for the liberalization of trade in goods is the continued application of trade defense instruments such as anti-dumping and anti-subsidy measures. It is important to emphasize that the use of such measures is contradictory to the principles of the Single Market. For example trade defense instruments are not utilized in intra EU trade. It may therefore be relevant to discuss terminating the use of trade defense instruments, with the exception of safeguard measures, for the Turkey-EU bilateral trade. Nonetheless it is important to notice that Turkey has been using these instruments more frequently.

Liberalization of Trade in Services

The most significant transformation of the deepened Customs Union will be caused by the opening of the Turkish services industries, which represent almost 70% of the Turkish economy, to EU competition. The essence of liberalization of trade in goods is the elimination of tariff and non-tariff barriers. However in trade in services, the national legislation and regulatory framework create the greatest impediment to market entry. Hence in trade in services, there are several models for liberalization depending on the degree of legal harmonization agreed between the parties.

The most ambitious of such models is European Economic Area (EEA) comprising the EU and EFTA members. This model is based on total legal harmonization and EU acquis adoption, allowing the liberalization of trade in services to be undertaken in ideal circumstances. Due to the complete harmonization of legislation it is possible to overcome the impediments to trade caused by legislative and regulatory differences. Nevertheless this model has a serious handicap in so far as it creates total policy dependency for EFTA nations. EEA nations are obliged to follow public policies decided by the priorities and choices of EU politics, without the freedom of amending them according to their priorities and circumstances. If the EEA model is chosen in liberalization of trade in services, Turkey will be completely integrated in the EU Single market, hence economic integration will be consolidated. Moreover the EEA model will create an important advantage for the full membership objective. The legal harmonization carried out for the liberalization of trade in services will enable chapters linked to the membership talks to be completed. Therefore the EEA model has the potential to fast forward Turkey's membership talks.

In the opposite spectrum of the liberalization of trade in services, with no legislative integration, is the General Agreement on Trade in Services (GATS) model. According to this model which underpins the World Trade Organization (WTO) led multilateral efforts for the liberalization of trade, all parties commit to lifting barriers to market entry and national treatment resulting from national legislation. If the political disadvantages of the EEA model are more substantial than the economic benefits, using the principles of GATS model for the trade in services with the EU is another option. The disadvantage of the GATS model is it leads a less advanced form of economic integration compared to the EEA model. For example with this model, more exceptions to EU Single Market rules can be expected. Especially limitations on establishment rights and movement of workers may continue. Complete trade liberalization may not be possible for a range of industries including financial services. Since it does not foresee legal harmonization, this model will not create a particular advantage for the membership talks.

Finally, a hybrid model entitled Deep Free Trade Agreement is possible. Accordingly, in areas where legal harmonization is achievable and desirable, parties can move forward with the EEA model, and in areas where legislative integration is not desired the GATS model would be applied. Hence with this model a higher integration than the GATS model but a lower integration than the EEA model could be targeted. The EU recently has made a similar agreement with Ukraine. Taking into account all the prevailing political and economic conditions, a Deep FTA may indeed represent the most suitable model for liberalization of trade in services between EU and Turkey. This option will still prove to be beneficial for the full membership talks albeit less so than the EEA model.

Agriculture

The deepening of the Customs Union between EU and Turkey in the agricultural sector could be achieved in several ways. In a study published in 2014 the World Bank examined the impact of several models of agricultural integration in terms of changes in income, unemployment, foreign trade, food prices and production prices. The scenario that will provide the highest but still small increase in total incomes is the deepening of the Customs Union to include trade in primary agricultural commodities. Yet even under this scenario, value added in agriculture tends to diminish. A drop in food prices (between 0.34-1.28 percent) and increase in wages (between 0.11-1.21 percent), is expected to create more beneficial results in income distribution in addition to income increase. Moreover there are significant differences across product groups. For example import increases for wheat can total current imports. Additional imports of dairy and dairy products could be as high as one billion dollars. The highest export increases will be in fruits and vegetables, grains and sugar.

Public Procurement

Despite its commitment under the Customs Union, Turkey has been unwilling to fully comply with the EU for the framework on public procurement. Additionally as mentioned in various Progress Reports, more recent legal amendments have distanced Turkey further from EU standards. A principle reason for this approach is the threat that EU compliance will pose for the sustainability of the osmosis between public procurement and political financing more than the fear of competing with EU companies under same conditions for public procurement markets. For Turkey moving forward in this area will only be possible when the benefits of the deepened Customs Union package are materialized in other areas.

Given that Turkey's choice of threshold values and domestic price in public procurement protects Turkish companies from competition that would arise from mid-income European countries, opening of the public procurement market to EU will bring about an increased competitive environment for Turkish companies. Especially the multilateral opening of public procurement markets, under the WTO Agreement on Government Procurements (GPA) will increase the intensity of competition. On the other hand it is important to analyze how competitive Turkish companies will be in EU public procurement markets. Construction and transportation sectors where Turkey's competitive edge is increasing are due to benefit from this environment. Another issue that will directly affect this analysis is whether visa obstacles can be lifted for the temporary movement of workers. This will be particularly important for the construction and contracting industries where Turkey is highly competitive. For this reason it would be useful to link the public procurement talks to the freedom of establishment, the freedom to supply services and temporary movement of workers that will be negotiated under the trade in services.

State Aids

The state aid regime forms a regulatory framework influencing competition rules in the economy and determining the conditions of competition between private and public institutions. The deepening of Customs Union will compel Turkey to adapt and practice a state aid regime in accordance with the EU acquis. Turkey has already committed to such obligation under the Association Council Decision no 1/95 and with its National Programme. It is worth noting that the concept of state aid, in EU terminology, goes beyond Turkey's investment promotion regime and includes many different actors and areas of implementation. For example a decision of the Banking Regulation and Supervision Agency on the utilization of the Savings Deposits Insurance Fund, a Central Banks decision to provide liquidity to a bank, a local government allocating realty or privatizing parking management, a Treasury decision guaranteeing select private sector projects, a Council of Ministers decision for preferential taxation regulations targeting specific industries, a Ministry of Finance decision allowing for the postponing of the payment of tax arrears to select industries or companies will be considered as state aid.

From the perspective of Turkish business world, a state aids regime that would allow the monitoring of state aids and the enforcement of the associated restrictions would be important and of benefit. Such a change would be complementary to the Competition Law in effect since 1994, and just as the Competition Law has prohibited the anti-competitive practices of companies, the State Aids Law will prohibit the anti-competitive

behavior of the state and its agencies. As a result, competition rules will be consolidated and the state will genuinely protect this environment of fair competition. The new regime will lead to better transparency in the relationship between market players and the state. For example in the wake of this legal amendment, the state authority will not be able to create a politically motivated unfair competitive advantage neither for public companies nor for private companies. A regime for the monitoring and supervising state aid covering the service industries and in accordance with the EU acquis has the potential to become an important pillar of the next Structural Reform Programme of Turkey.

Foreign Trade Policy

Negotiations to deepen the Customs Union will also enable the reopening of negotiations to re-evaluate the problems of the current Customs Union. Both in Turkey and in the EU there are several sets of problems pertaining to the practice of the Customs Union. One of Turkey's major problems is the asymmetrical structure of the Customs Union. Due to the nature of a customs union, Turkey has to abide by EU's preferential trade regime. Therefore whenever EU signs a free trade agreement with a third country, Turkey is expected to follow and sign a similar agreement with the said country. However in some cases the third country is not willing to sign a similar agreement with Turkey.

There is however no easy solutions and quick fixes for the asymmetrical structure of the Customs Union and the problem of Free Trade Agreements. EU's attempt to overcome this problem has been to occasionally demand the third party in negotiations to start talks with Turkey. This approach has been partially successful. The solution to completely overcome this obstacle would be to condition the conclusion of its free trade agreement with a third party to its initiation of a negotiation with Turkey. However political and economic realities has not allowed for this option to be fully enforced. The EU has for instance not imposed this condition on states such as the USA and India with whom free trade agreements are being negotiated.

Another option to mitigate the problems of the current practice of the Customs Union is for the EU to include Turkey as much as possible into its dialogue and decision making mechanisms. The first step in this would be to include Turkey as an observer to the "Trade Policy" Committee where EU's trade policy is deliberated and decided. Furthermore in trade policy, institutional cooperation could also be strengthened. For example it could be established that before and after all talks between EU and third world countries, the EU would inform and brief Turkey. This briefing could be delivered by the Commission's DG Trade in Brussels to the members of the Permanent Representation of Turkey to the EU.

Similarly talks between the EU Trade Commissioner and the Turkish Minister of Economy could become more regular and involve a more comprehensive exchange of views on developments related foreign trade.

Settlement of Disputes

It will be realistic to expect procedures related to the Settlement of Disputes to be discussed in detail during the negotiations for the deepening Customs Union, and to eventually see the current narrow scope to be replaced by a more comprehensive mechanism. It can be claimed that this will be one of EU's foremost important objectives.

Currently the Association Council is the focal point for the settlement disputes in EU-Turkey relations. But the Association Council is a political organ, and consensus is necessary for any decision. Hence EU or Turkey can easily block a decision of the Association Council. As a result the Association Council has been an ineffective platform in resolving disputes. Turkey and EU have on occasion blocked the decisions of the Association Council. Consequently the topic of Settlement of Disputes remains an area open to improvement for both Turkey-EU relations and the good functioning of the Customs Union.

The EU's particular interest in redressing this situation is mainly due to the fact that many problems dating back to the beginning of the Customs Union in 1995 still remain unresolved. The other reason why EU will pay special interest to this topic is that the current Settlement of Disputes is based on the Ankara Agreement of 1960, whereas the EU has established a different framework since 1980's in its partnership and free trade agreements. In each of these agreements, the EU has without exception avoided consensus bound political decision making and has resorted to the settlement of disputes in courts or by way of mandatory arbitration. In such schemes parties are unable, unlike the situation between EU and Turkey today, to block decisions that would be contrary to their interests. This will be the principle that the EU would like to incorporate in the deepened Customs Union. The renewed framework for dispute settlement under the deepened Customs Union will in all likelihood entail mandatory judicial settlement or arbitration provisions and obviate the system outlined in the Article 25 of the Ankara Association Agreement.

One of the most significant impacts of the deepened Customs Union will be achieved by the renovation of the Settlement of Disputes. The disputes will no longer be left unsolved by political blockage. In situations where the Association Council is unable to resolve the issue at hand, it will be transferred to courts or arbitration. This novation will

enable problems previously left unresolved to be settled using judiciary procedures. The Turkish side needs to assess the possible consequences of this requirement carefully. The EU is likely to resort to these amended provisions to try to resolve the ongoing dispute related to Turkey excluding Cyprus from the Customs Union and prohibiting Cypriot flagged vessels to call at Turkish ports. In addition Turkey will also presumably try to resolve for its favor the issue of EU requiring visa from Turkish truck drivers, utilizing the new settlement of disputes mechanism.

Regulatory Harmonisation

One of the most critical and sensitive issues of the deepening of the Customs Union will be the topic of regulatory harmonisation. The integration model is expected to partially or totally be based on regulatory harmonisation. Thus at the initial stage legal and regulatory harmonisation must be achieved and in the following stages this conformity must be preserved. Negotiations should also address the required institutional cooperation to resolve the challenge of continuous harmonization. Since the EU acquis is constantly evolving, the successful establishment of a process of dynamic harmonization will be conditioned on the emergence and maintenance of a political will. This observation pertains to both parties. For example none of the parties did comply with the provisions of the current Customs Union for institutional cooperation. As a result, the good functioning of the Customs Union was affected and the spirit of partnership was undermined. The same threat is valid for the situation of the deepened Customs Union. After all the Customs Union is not an endeavor that ends when the negotiations are over. On the contrary daily work, attention and commitment is necessary to ensure its good functioning. The internalization of this responsibility in Ankara and in Brussels both at political and bureaucratic levels will be a key success factor for the functioning of the deepened Customs Union.

Transatlantic Trade and Investment Partnership (TTIP)

The Transatlantic Trade and Investment Partnership (TTIP) talks between the EU and the US is also part of Turkey's foreign economic agenda. Turkey aspires to become a party to TTIP. Due to the complexity of the negotiations neither Brussels nor Washington has made any concrete openings towards third parties. The priority for both parties has been to first move forward with the bilateral negotiations. However, whether following a possible agreement TTIP will be opened to third parties is still uncertain. For countries such as Turkey, the objective should be to convince the US and the EU to accept the

principle of a future opening of the partnership and including an “accession” clause in the agreement confirming to this principle. Once this principle is adopted, Turkey will need to fulfill the necessary obligations for liberalizing and harmonizing its legislation for the policy areas covered by TTIP.

Furthermore with a more political outlook, it can be stated that the deepening of the Customs Union will be a necessary criteria for TTIP membership. Since for TTIP to expand to new members, new accessions will have to be approved both by the EU and the USA. It is worth noting that BUSINESSEUROPE, the EU’s umbrella organization for business associations is supporting Turkey’s eventual TTIP membership and has stated in its Position paper on regulatory cooperation in TTIP in 2013 that “Turkey is a fast growing entrepreneurial European economy and its association to the TTIP would be an added-value for the business communities of both sides.” Yet EU’s approval of Turkey will depend primarily on the situation of the Customs Union. Without a renewed Customs Union, the EU may not give the green light to Turkey for its TTIP membership. In fact, the TTIP membership agenda has been one of the main reasons that have motivated Turkey to agree to this round of negotiations on the deepening of the Customs Union, revising its former approach of linking this revision to the EU membership negotiations. The situation is similar from the perspective of Washington. US officials have mentioned the necessity for Turkey to carry out economic reforms before they can assess Turkey’s TTIP membership claims.

Taking into account the possible expansion of TTIP and its political context, Turkey should seek to strengthen its position by cooperating with other third countries, such as Norway, Mexico and Canada, with similar aspirations to join this partnership. These “like-minded” countries should initially lobby Washington and Brussels with a view to get their agreement in principle that TTIP can eventually be pluri-lateralized. An appropriate clause enshrining this principle should be included in the negotiated agreement. Lastly, after TTIP’s entry into force, Turkey should seek to initiate and end its accession talks concomitantly with other interested third parties so that the opportunity to present TTIP’s enlargement as a viable package for its ratification by the US Congress would be possible.

Conclusion

The deepening of the Customs Union will move forward on the basis of the “win-win” principle. Thus negotiating parties should end with a scorecard of wins and losses that both perceive to be of benefit. The deepening of the Customs Union will also have disparate effects on many sectors of the economy. In other words, even if it will be beneficial overall, it will entail distributional costs. To better understand the potential effects of the agreement it is important to examine in more detail its potential positive and negative impacts.

First and foremost, the deepening of the Customs Union will have a positive influence on Turkey’s economic governance. Such an ambitious agreement seeking to integrate Turkey with the EU’s Single Market will bring about a convergence of Turkey’s economic legislation and regulatory framework, shaping Turkey’s business and investment environment, with the EU. Hence it will improve the predictability of public policy that impacts economic endeavors. Furthermore the introduction of more competition in services industries and public procurement will positively influence economic productivity. This outcome will allow the Turkish economy to improve its investment environment, attract more investments and reach its potential growth. As a matter of fact good governance, policy predictability and rule based governance were emphasized as recommendations for enhancing growth in OECD’s 2014 economic report on Turkey.

Another outcome of the deepened Customs Union of major interest for the business community will be the set of institutional provisions that on the one hand will allow a faster resolution of disputes and on the other will constrain the ability of the state to skew fair market competition. This will allow the business community, in a way that was unavailable until then, to monitor and challenge the state’s actions that could infringe the principle of fair competition.

The deepened Customs Union will also encompass a strengthened mechanism for the settlement of disputes. Even though this mechanism is designed to resolve the EU-Turkey disputes promptly without political blockage through courts and mandatory arbitration, its practical impact will be the consolidation of the implementation of public policies covered by the Customs Union in conformity with EU norms. In cases of violation of these norms, the government can be taken to court or to arbitration. This improvement is akin to the influence of European Court of Human Rights (ECHR) on the Turkish judiciary. Akin to how the ECHR has helped the Turkish judicial system to evolve towards European norms, the new and more extended settlement of disputes under the Customs

Union will also influence the implementation of public policies to be more in line with EU norms and practices.

Another positive impact on good governance of the agreement will be its role in strengthening Turkey's independent regulatory institutions. In various sectors the EU acquis gives an important role to independent and competent regulatory authorities and compels the government to share its executive functions with these independent institutions. Therefore the deepening of the Customs Union, in so far as it will entail regulatory harmonization or convergence with the EU, will enhance and consolidate the role of independent regulatory authorities in public policy. As a result, the role of institutions with competence for horizontal policies such as the Competition Board and or also sectoral policies such as the Banking Regulation and Supervision Agency or Energy Market Regulatory Authority will be increased.

From a wider perspective, the reforms needed for the deepening of the Customs Union will provide one of the strongest pillars for a new, ambitious and broader economic vision that Turkey seeks. With this will and rhetoric, Turkey will more easily demonstrate its ambition to build a modern and market friendly economic future. The anchoring role of the EU acquis for Turkey's economic legislation will on the one hand improve the predictability of Turkey's economic agenda and on the other by accelerating the opening up of additional sectors of the economy to regulated and fair internal and international competition and forcing the convergence in terms of the implementation of public policies to EU norms will allow Turkey to become a more attractive destination for foreign direct investments thereby raising the income generating potential of the national economy.

The deepening of the Customs Union will also create advantages for the EU full membership objective. Turkey's EU membership remains the overall and formal objective of the relationship. Many reforms necessary for the implementation of the deepened Customs Union will enhance the degree of convergence and harmonisation and with the emergence of a more positive political environment will accelerate the closing of the relevant chapters of the membership negotiations. There are residual fears on whether a deepened Customs Union will push Turkey farther away from the membership and sentence Turkey to a special relationship model defined formerly as a privileged partner. However in the long term, the fate of accession will be determined more by the degree of compliance with the political criteria. EU membership will remain as the main perspective for a Turkey strengthening its democracy and enforcing the rule of law, independent from the level of its economic integration with the EU.

Arguably the most difficult dimension for Turkey of the slated revision of the Customs Union will be the selection of the appropriate model for the integration and regulatory harmonisation. As discussed in this report for Turkey to be included in the EU Single Market, Turkey has to commit all obligations of the EU acquis in areas pertaining to the Single Market. A complete legal and regulatory harmonization will have many advantages. Initially it will allow Turkey to be a part of the EU Single Market. In addition it will be advantageous in terms of the accession negotiations. It will imply the convergence in many areas of public policy covered by the accession talks and will allow the closing of the relevant chapters possibly even before they are officially opened. The path of regulatory harmonization or convergence will also be beneficial for the TTIP objective.

But despite its manifold advantages, the model of full regulatory harmonization has a significant drawback for a country with an important state tradition and an experience of being for more than 70 years a multi-party democracy. Accepting a commitment for the full adoption of the EU without being an EU member is tantamount to agreeing to implement this acquis devoid of the ability to contribute to its shaping. The consequence will be to create a situation of policy dependency in all the policy areas covered by the deepened Customs Union. This will lead to the transfer of sovereignty to an institution to which Turkey is not a member. This situation also has consequences for Turkey's democracy as Turkish lawmakers will be devoid of the possibility to properly legislate on policies covered by the Customs Union. The role of the Turkish Parliament will be limited to adopting harmonization laws for compliance with the Single Market legislation. Negotiations should strive to find novel ways to address this conundrum and enhance provisions for better institutional cooperation. Yet no overarching and fully satisfactory solution will be found in the absence of Turkey's EU membership.

Consequently a careful and detailed assessment is needed before deciding on the specific model to be adopted for regulatory harmonization. Despite the advantages of full market access, faster progress in membership talks and facilitation of TTIP membership, a model of full regulatory harmonization is not recommended. In its stead, a more flexible and hybrid approach should be prioritized. Accordingly, on the basis of an evaluation carried out with reference to a set of pre-specified criteria, in some policy areas the principle of full regulatory adoption can be adopted while in others bilateral trade should be liberalized without the commitment of regulatory compliance. The criteria to be utilized for this evaluation can include the degree to which market access can be guaranteed without acquis adoption, the overlap of the current EU acquis with Turkey's long term objectives, whether the adoption of the relevant EU acquis will enhance Turkey's growth prospects and finally the stage of advancement of the accession talks.

Ultimately, it is vital that negotiations that are set to have such broad and permanent impact on the Turkish economy should proceed as open, transparent and inclusive as possible. To fulfill this objective, the government should adopt from the outset an approach incentivizing a regular and robust exchange of information between the state authorities responsible for the Customs Union negotiations on the one hand and relevant economic and social stakeholders on the other hand. Only through this inclusive approach, an integration project so fundamental to the economic future of Turkey will turn into a real success.

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