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# The Customs Union between the European Union and Turkey and its Impacts on Turkey's Economy

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## Abstract

Since World War II nations have formed alliances for reasons of security and trade. Countries have seen international integration as an appropriate approach to resolving domestic and international political issues, improving their welfare by both transforming their infrastructures and increasing their foreign trade. While the majority of these relationships are straightforward Turkey's relationship with the European Union is more complex due to differences in religion and, at times, political ideology from other Union members. As a candidate country Turkey has made advances towards the full membership of the European Union with the customs union being the most significant. The impact of customs union membership is discussed and the effects of the customs union on Turkey's trade and economy are examined from a perspective of different economic theories.

**Keywords:** Customs Union, Economic Integration Theory, Static Effects, Dynamic Effects, Turkey.

**JEL Classification Codes:** F13, F14, F15, F16, O57.

## 1. Introduction

Following the Second World War, in a search for stability, security against an increasing Soviet threat and economic growth Turkey decided to seek political as well as economic integration with the Western world. This decision, a quite natural one given Turkey's long historical relations and ties with Europe,

resulted in participation in the foundation of many Western organizations, among which were the United Nations, the North Atlantic Treaty Organization and the Organization for Economic Cooperation and Development. In 1959 Turkey applied to the European Economic Community to become a party to the Treaty of Rome as well as a member of that community. While the application was rejected on the basis of not being prepared for membership, in 1963 Turkey was offered a partnership arrangement until such time as standards were met. This settlement, termed the Ankara Agreement, envisaged a three-step process that would prepare Turkey for full membership. The three stages were: the preparatory stage; transitional stage and final stage. The stages were organized as a framework agreement with provisions for the gradual realization of free movement of goods, services, capital and people.

As part of the framework and to reach the objective of the free movement of goods, Article 5 of the Ankara Agreement considered that Turkey would secure a customs union with the European Economic Community at the end of the transitional stage. The transitional stage was completed and the customs union with the European Economic Community (later called the European Community; then the European Union (EU)) was put into force. This relationship was idiosyncratic as it granted to Turkey customs union membership without the status of being a full member of the EU or the ability to participate in the decision-making process of its institutions.

With the advent of the customs union relationship Turkey pursued a policy to eliminate unilateral quantitative restrictions and tariffs, as well as seeking to apply the Union's common external tariff to non-member countries for imports of industrial products and processed agricultural goods. These policy changes had effects on the Turkish economy, as throughout the last two decades trade volume with the EU has seen a significant increase. However, there is some controversy regarding how this increase has affected Turkey's economy.

The customs union relationship between the EU and Turkey has an interesting historical background and a conflicted cultural/political relationship, as well as contentious economic and foreign trade policy changes that have led to controversial and often debated outcomes.

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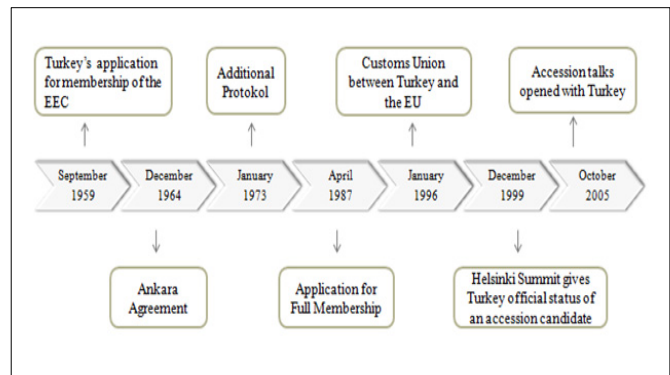
## 2. Customs Union between the EU and Turkey

### 2.1. Overview of the EU and Turkey Relationship

In its more modern form, the relationship between Turkey and the EU began when the former began to emulate the Western Europe economic, political and social structures in the nineteenth century, which acted as a model for its secular structure. Progress was disrupted during World War I when the war's political developments distorted the relations of Turkey with western European countries. Relations with Western Europe changed direction again after World War II due to perceived impending Soviet threats and the cold war environment. Turkey, for security and stability, decided to integrate with the Western world both in a political and economic manner, opting to join such corporative organizations as the United Nations, the North Atlantic Treaty Organization and the Organization for Economic Cooperation and Development (Sander, 2002).

Seeking to expand on these relationships, Turkey applied for European Economic Community membership in 1959. However, the application was rejected and instead a partnership agreement was offered, which was eventually ratified by both sides in 1964 (European Community, 1973). The Ankara Agreement, with its Articles 2-5 and 28 three-stage process (preparatory stage, transitional stage and final stage), became the main legal framework of the relationship between the EU and Turkey. Each stage outlined an agenda for accomplishing a specific movement towards the four freedoms related to the free movement of persons, services, goods and capital. Accomplishment would ultimately lead to full integration by establishing a legal framework that would guarantee full community membership status (European Community, 1973).

In order to address the commitments, various institutions were established, which included: the Association Council, the top decision-making body to solve disputes; the Association Committee, whose function is to assist the Association Council by scrutinizing details and addressing technical issues; the Turkey–EU joint parliamentary commission, which consists of members of parliaments from both sides; and the Customs Cooperation Committee and Customs Union Joint Committee whose main functions are to solve customs issues (Delegation of the EU to Turkey, 2015). In 1995, three decades after the signing of the Ankara Agreement, the customs union between the EU and Turkey was official and the final stage for full integration began. Candidate status was awarded in 1999 by the European Council at the Helsinki Summit and accession negotiations began in 2005, accelerating the process of the EU and Turkey integration (Delegation of the EU to Turkey, 2015). Figure 1 depicts the cornerstones of the Turkey–EU relationship.



Source: Authors' Own Creation

**<Figure1>** Cornerstones of the Relationship of the EU and Turkey

### 2.2. Changes in Turkey's Industry Policies and Foreign Trade Regime

During the period between the 1930s and the 1970s, protectionism and an inward-oriented import substitution development strategy played a predominant role in the economic policies of Turkey as with most developing countries. The basis of these policies was that to achieve internal industrialization, internal operations needed to be protected by a variety of trade barriers (such as tariffs, surcharges, import bans, quotas) and foreign exchange controls. There was an additional belief that in the early stages of the industrialization period, rapid industrialization could only be accomplished with the enactment of the import substitution policies for the production of consumption commodities, followed by the protection of capital goods (Akkoyunlu, Mihci, & Mihci, 2006).

From 1930 until 1980 Turkey had to deal with significant structural and institutional problems, which were a consequence of inadequate entrepreneurial and managerial capacity in the private sector, which resulted in the state intervening in many economic areas and establishing a dominant role in economic development. Under the new state-led inward-looking development strategy a number of state economic enterprises were established that produced agricultural, mineral, and manufactured commodities which previously had been imported. Protectionist measures were applied to protect infant industries from international competition and the quantity as well as price of credit was controlled to allocate resources into planned industrial sectors. The success of these policies was demonstrated by the fact that during this time Turkey built a well-diversified industrial structure that produced a greater variety of industrial commodities – including intermediate and capital products – than most developing countries. Of importance was that during these years Turkey was successful in reducing poverty and raising education, health, and nutritional standards, despite increasing regional income inequalities (Sahin, 2014). Unfortunately, these accomplishments were not sustainable due to a lack of international competitiveness in terms of cost and quality of products. The reality was that most of the state enterprises were not profitable and suffered from

overemployment. Their protected status led to inefficient resource allocation, inflexible labour markets dominated by the state and price distortions in the economy. Throughout this era, technology, intermediate and capital goods support was provided to imports needed to sustain domestic production, resulting in import increases and an external debt surge. To sustain development, national currency was kept overvalued via exchange controls and fixed exchange rates (Utkulu & Ozdemir, 2004).

By the late 1970s the inward orientation and import-substitution growth strategy had caused severe economic and social crises in Turkey, resulting in external debt increases, foreign exchange shortages and negative growth rates. The exchange shortages, coupled with the monetary expansion in 1980, led to high inflation rates, soaring to 120% (Sahin, 2014). In an attempt to address these difficulties, in January 1980 a new economic reform program, known as the January 24th Decisions, was enacted. The January 24 Decisions are considered to be one of the most important turning points in Turkish economic history. With these decisions, Turkey's economic structure started to change from the import-substitution development strategy to an export-oriented growth strategy. With some initial successes it was anticipated that the export-oriented growth model could bring gains to the economy in terms of more efficiency in resource allocation, economies of scale and scope, increased competition, easier transfer of technology and increased access to inputs and intermediate goods, better education and economic growth in line with the increase in skilled labour employment. Much of these expectations were actualized throughout the following years as Turkey experienced impressive transformation moving from an inward-oriented and state-led economic system to economic liberalization.

### 2.3. Turkey's Macroeconomic Circumstances Prior to the Customs Union

The crisis at the end of the 1970s was overcome in the early 1980s by virtue of the orthodox stabilization policies in parallel with the structural transformation towards a liberal economy. As a result of these policies, the inflation ratio, which reached three-digit figures, decreased to slightly over 30 per cent in the early 1980s. The early reform steps progressed into more trade liberalization in 1984 and financial liberalization in 1989, culminating with the customs union between the EU and Turkey in 1996 (Boratav & Yeldan, 2001).

Macroeconomic developments between 1980 and the year of customs union in 1996 are separated into one stage ending in 1989 and the second post-stage starting at that time. Throughout the first phase, the government of Turkey applied the policies of export promotion, gradual import liberalization, floating exchange rate and restricted capital movement. In addition, economic policy included a depreciated national currency, supply-side fiscal policy and low wage incomes and significant restriction in agricultural aids (Boratav & Yeldan, 2001).

**<Table 1>** Gross Domestic Product Shares by Economic Activities at 1987 Price

	1980	1985	1990	1995
Agriculture	24.8	19.8	16.8	14.8
Industry	22.0	24.9	26.4	28.0
Service	52.8	54.6	53.5	54.1
Import Duties	1.2	2.3	4.1	3.9
GDP	100.0	100.0	100.0	100.0

Source: Data from Turkish Statistical Institute (2015a)

Table 1 shows some economic indicators for Turkey within the period between 1980 and 1995 when the Turkish exports experienced a significant transformation in favour of industrial production. As seen in Table 1, the sector ratios in GDP remained relatively stable during the period.

The significant aspect of this export boom was the relative non-existence of investment. After the mid 1980s, during the customs union years, public investment increased. However, the increase was considered irrelevant to the export growth because of the composition of the investment. Private investment suffered from unstable economic conditions during this period and experienced a downward trend (Rodrik, 1990). The exceptional export boom was substantially based on the production capacities created throughout the years of 1960s and 1970s. As a consequence of the economic and political crisis of the 1970s the capacity utilization rate had been reduced by 55 per cent and remained in this condition until 1980.

### 3. Economic Impacts of the Customs Union on Turkish Economy

The following section examines the theory of customs union as a mechanism of integration and discusses the welfare effect expected. According to Krueger (1999), in order for an economic integration to stimulate welfare for the union members certain conditions must be extant. These are: high common trade volume among members, high external trade barriers among the member state prior the union, diversity in economic and industrial development level and, finally, more elastic demand-and-supply curves in the member countries. In this context, trade creation and diversion effects and long-term dynamic effects of integration increase intra-union trade and eventually bring welfare increases for the union's member countries. While some reservations existed, for the most part it was generally expected that the customs union between the EU and Turkey would increase Turkey's trade volume, and specifically exports to the EU. However, although the volume of foreign trade between the EU and Turkey increased throughout the customs union period, in total, the ratio of trade with the EU, in terms of Turkey's foreign trade volume, experienced a slightly downward trend during the two decades between 1996 and 2014. To understand this unexpected development it is necessary to analyze a variety of

dependent variables, both related and unrelated to the customs union.

In accord with Union agreements Turkey was required to align its import policy with third countries in parallel with the EU's preferential agreements. This situation created an asymmetry for Turkey's foreign trade (World Bank, 2014). It is important to note that the EU, as a party to the customs union, is a vast and complex integrated economic area whose diverse foreign trade policies are able to affect world commodity prices. Therefore, it is necessary to evaluate the customs union's effects on Turkey's economy and foreign trade by separating the EU's effects from the impacts of the world economic environment. In addition, Turkey has not completed its industrial and economic transformation nor stabilized trading and political relationships with different regions of the world. For example, since 1996 Turkey has experienced several significant economic disputes with Russia and some nations in Asia. In the same period, Turkey had been struggling with economic problems, such as chronic inflation and economic instability and trying to transform its economy and industrial infrastructure towards more competitive and value-added strategies. All of these developments, as well as Turkey's reaction to them, have resulted in a diverse range of outcomes. The following paragraphs explore some of the specific situations and resulting impacts of customs union membership on Turkey's economy, considering the scope of static and dynamic characteristics of economic integration theory while taking other dependent variables into account.

### 3.1. Economic Developments throughout the Period of the Customs Union

Table 2 depicts the figures and ratios of Turkey's foreign trade with both the world and the EU in the post-customs union period. The table shows an upward trend, both in general import volume and in the imports from the EU, in the period of the customs union except during the crisis years of 1999, 2001 and 2009. At the same time Turkish exports to the world, and specifically to the EU, experienced a steady growth. What is interesting, in spite of the increases, is that an overall trade balance deficit persistently increased from 1996 as a consequence of the value of imports exceeding that of exports. The increasing trade balance deficit indicates that the Turkish industry structure had not completed its transformation, which began with the 24th January Decisions in the 1980s, and as a result industry production continued to rely on the intermediate and capital goods imports.

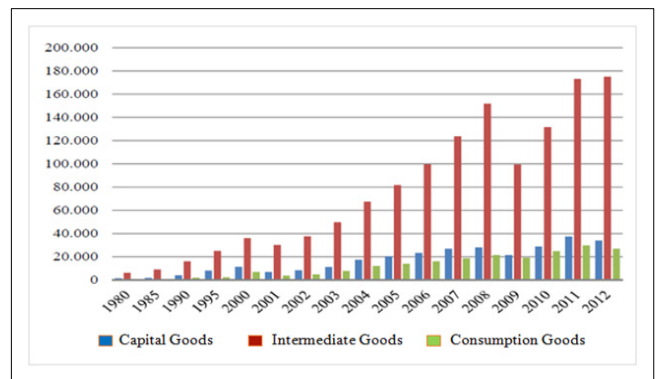
Figure 2 shows how intermediate goods imports steadily increased in parallel with Turkey's exportation trend, except in the crisis years, throughout the liberalization period after 1980 (Sacik, 2010). This structural problem of Turkey's industry has been causing foreign trade and current account deficits for decades. Over a significant period of time, to finance the deficit the government applied fiscal policies that resulted in higher interest rates and depressed exchange rates. These policies

resulted in the replacement of domestic inputs for imported ones in industry production, creating a kind of vicious financial circle.

<Table 2> Figures and Ratios of Turkey's Foreign Trade(Million USD)

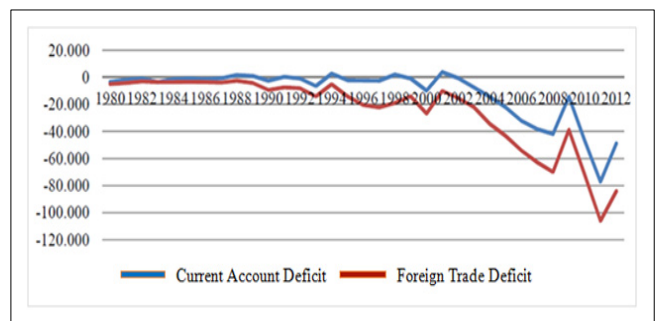
	Total				Foreign Trade with the EU				Share of the EU	
	Exports	Change (%)	Imports	Change (%)	Exports	Change (%)	Import	Change (%)	Exports	Imports
1996	23.224		43.627		12.590		24.349		54.2	55.8
1997	26.261	13.1	48.559	11.3	13.471	7.0	26.128	7.30	51.3	53.8
1998	26.974	2.7	45.921	-5.4	14.837	10.1	25.297	-3.2	55.0	55.1
1999	26.587	-1.4	40.671	-11.4	15.454	4.2	22.538	-10.9	58.1	55.4
2000	27.775	4.5	54.503	34.0	15.688	1.5	28.552	26.7	56.5	52.4
2001	31.334	12.8	41.399	-24.0	17.576	12.0	19.841	-30.5	56.1	47.9
2002	36.059	15.1	51.554	24.5	20.458	16.4	25.698	29.5	56.7	49.8
2003	47.253	31.0	69.340	34.5	27.479	34.3	35.157	36.8	58.2	50.7
2004	63.167	33.7	97.540	40.7	36.699	33.6	48.131	36.9	58.1	49.3
2005	73.476	16.3	116.774	19.7	41.533	13.2	52.781	9.7	56.5	45.2
2006	85.535	16.4	139.576	19.5	48.149	15.9	59.448	12.6	56.3	42.6
2007	107.272	25.4	170.063	21.8	60.754	26.2	68.472	15.2	56.6	40.3
2008	132.027	23.1	201.964	18.8	63.719	4.9	74.513	8.8	48.3	36.9
2009	102.143	-22.6	140.928	-30.2	47.228	-25.9	56.616	-24.0	46.2	40.2
2010	113.883	11.5	185.544	31.7	52.934	12.1	72.391	27.9	46.5	39.0
2011	134.907	18.6	240.842	29.8	62.589	18.2	91.439	26.3	46.4	38.0
2012	152.462	13.0	236.545	-1.8	59.398	-5.1	87.657	-4.1	39.0	37.1
2013	151.803	-0.4	251.661	6.4	63.040	6.1	92.458	5.5	41.5	36.7
2014	157.610	3.8	242.177	-3.8	68.514	8.7	88.784	-4.0	43.5	36.7

Source: Data from Turkish Statistical Institute (2015a)



Source: Data from Turkish Statistical Institute (2015b)

<Figure 2> Turkey Imports Based on BEC (Million USD)



Source: Data from Turkish Statistical Institute (2015c)

<Figure 3> Changes in Current Account and Foreign Trade Deficit

As shown in Figure 3, changes in foreign trade deficits directly affected the current deficit of the country in the same direction and at approximately the same rate. This circle could also be observed in the interdependency between gross domestic product (GDP) growth rates and current account deficits. As shown in Figure 3, in the years when economic growth occurred current deficits increased in accordance with the level of the import elasticity for GDP growth rates. It would seem, then, that Turkey's current industry structure and government fiscal policies have actually, as its exportation increases, been creating a situation that forces the nation to increase imports over and above that which was previously required.

Even throughout the years prior to the customs union EU countries had become the leading partner for Turkish foreign trade, as with the implementation of the Additional Protocol in 1971 Turkish industrial products benefited from zero tariff rates when entering EU countries. European Union countries have experienced high purchasing power in addition to a geographical advantage. In addition, the large number of Turks living in European nations creates natural customers for Turkish commodities exported to these countries. In attempting to understand the decreasing share of Turkey's foreign trade with the EU a possible explanation could be that the world economic crisis of 2007 has unfavourably affected the purchasing power of people in the EU, creating adverse impacts on Turkey's exportation trend to EU countries. Another explanation could be the improved access of Turkish exports to developing country markets with the preferential trade agreements Turkey has signed.

#### 4. Static Effects of the Customs Union on Turkish Economy

The neoclassic customs union theory postulates assumptions for simplifying the reality, such as perfect competition, consistent returns to scale, no technological change, homogeneous goods, and no market entry restrictions. It is important to note that the theory does not consider regional differences within the union. The static effects of the customs union could be explained by theoretically plotting the demand-and-supply curves of commodities; however, while a number of econometric formulas have been suggested there really is no accurate way to analyze the economic data and indicate clearly the welfare gains in terms of trade creation and diversion effects of the customs union.

##### 4.1. Trade Diversion Effects

With the advent of a customs union, a common external tariff application leads to a trade shift from non-member countries to member countries, commonly referred to as the trade diversion effect of a customs union. According to the assumption of the neoclassic theory, countries at similar levels of development will trade with other countries by specializing in different industries. The outcome of this should be that all countries derive benefits

from international trade (Torelli, 2013). It would be expected, then, that a customs union between the EU and Turkey would result in significant trade diversion as a consequence of price differences among third countries and EU countries. However, it does not appear that this expectation has taken place in Turkish foreign trade since 1996.

As previously noted, in the years between 1996 and 2014 both Turkish exports and imports experienced a steady upward trend in the trade with all member countries. Table 3 illustrates, in a detailed manner, that the increase in both the exports and imports with EU countries was remarkably less than trade with other countries. Contrary to the general expectation, the imports of Turkey from the other countries rocketed from approximately 18.9 billion USD to 152.1 billion USD, while Turkey's imports from the EU countries rose approximately from 24.3 billion USD to 88.7 billion USD. To analyze whether there had been a trade diversion towards the EU in Turkey's foreign trade, Table 3 presents the ratios of the changes in Turkish foreign trade with selected nations during the period of the customs union.

**<Table 3>** Percentage of Imports of Turkey by Country Groups

	Export Share (%)					Import Share (%)				
	1996	2002	2005	2010	2014	1996	2000	2005	2010	2014
European Union	54	56.0	56,5	46,5	43,5	56,0	52	45,2	39,0	36,7
Free Zones in Turkey	2	3.0	4,0	1,8	1,4	0,2	1	0,7	0,5	0,5
Other countries	44	41.0	39,4	51,7	55,1	44,0	47	54,1	60,5	62,8
Other European Countries	11	7.0	7,7	9,8	9,6	9,0	11	17,4	16,2	15,0
North African Countries	4	4.0	3,5	6,2	6,2	4,0	4	1,4	1,7	1,4
Other African Countries	0,1	0,1	1,5	2,0	2,5	0,2	1	1,4	0,9	1,0
North American Countries	7	12	7,2	3,7	4,6	9,0	8	5,0	7,1	5,7
Central America	0,1	0,1	0,6	0,5	0,6	0,1	0,1	0,2	0,3	0,5
South American Countries	0,1	0,1	0,4	1,1	1,2	0,2	1	1,5	1,6	1,6
Near and Middle Eastern	11	9.0	13,9	20,5	22,5	8,0	6	5,2	7,0	8,5
Other Asian Countries	8	5.0	4,1	7,5	7,4	11,0	13	17,6	21,7	23,2
Australia and New Zealand	0,1	0,1	0,4	0,4	0,4	0,2	1	0,3	0,3	0,3
Other Countries	0,1	0,1	0,3	0,1	0,1	7,0	2	4,2	3,6	5,6
Total	100	100	100	100	100	100	100	100	100	100

Source: Data from Turkish Statistical Institute (2015a)

As seen in Table 3, the EU has sustained its leading position in Turkish foreign trade for the years between 1996 and 2014, although its position has been weakened. After the implementation of the customs union, the ratio of the EU in Turkish export and import has decreased considerably from 54 per cent to 43.5 per cent in exportation and from 56 per cent to 36.7 per cent in importation. One would note, however, that the total share of other countries has impressively increased respectively from 44 per cent to 55.1 per cent in exports and 44 per cent to 62.8 per cent in imports during the 1996 and 2014 time period. It could be said that the trade diversion effect on Turkey's foreign trade did not occur throughout the period of the customs union. Reviewing the table closely, it can be seen

that Turkish export rates to both North African and Middle Eastern countries steadily increased over 50 per cent in this period whereas Turkish import ratios from those countries respectively had decreased by over 50 per cent for the North African countries, remaining rather stable for the Near and Middle Eastern countries. Contrary to this, Turkish export rates to Asian countries slightly decreased (during the customs union) while Turkish import ratios from those countries climbed impressively.

There may be several reasons to explain this unexpected trend of Turkish foreign trade. First, one could point towards the enlargement of the EU in the 1990s and 2000s. After these extensions, the EU nations focused on the trade opportunities within those countries. A second consideration is that in 1999, 2000 and then 2001 Turkey suffered a major earthquake disaster followed by a major economic crisis. Then in 2007 it was the EU countries' time to experience financial strains resulting from the world economic crisis. It would be difficult not to expect that these events would have a strong adverse effect on the trade environment between the EU and Turkey. Another factor was that during this 2000s time frame the Turkish government decided to broaden its economic and political relations and began to focus attention towards diversifying its foreign trade to especially include the Central Asian, Middle Eastern and African countries. In accord with this thinking, Turkey advanced a long-term energy policy with the development of pipeline connections with Russia, Kazakhstan, Azerbaijan, Iran and Iraq (World Trade Organization, 2012).

## 5. Dynamic Effects of the Customs Union on Turkish Economy

Economic integration creates significant impacts on the factors of economic growth, including market size, market structure and technology. The dynamic effects of a customs union are directly related with changes in resource allocation and long-lasting economic effects. Hosny (2013) has broadly defined the dynamic effects of economic integration as anything that affects the country's rate of economic growth over the medium term.

### 5.1. Resources Allocation Effects of the Customs Union

According to traditional trade theories, based on the writings of David Ricardo and the Heckscher–Ohlin theory, relative price differences across countries ultimately end in international specialization in the export of goods as a result of trade. This recognizes that "the law of comparative advantages does, however, assume stable trade performance of economies" (Torelli, 2013). Under these classic economic theory assumptions, it is expected that with the implementation of the customs union, the common external tariff policy will bring about specialization in Turkish industries in which they have comparative advantages.

When attempting to measure comparative advantages there is a distinct problem that relates to knowing pre-relative trade prices, as

these are not easily observable. One solution proposed by Balassa (1961) is that comparative advantage could be calculated via trade data, which are observable. The Balassa Index, known as the revealed comparative advantage index, is an accepted method to analyze foreign trade data and to measure the comparative advantage of a country despite its internal limitations or restrictions. The Balassa Index does not cover state interventions, scale economics or the changes in bargaining power and competition of a country. The values in this index show trade volume changes for a specific commodity or commodities according to the total imported and exported commodities belonging to the group (Voigt, 2008).

According to the revealed comparative advantage index calculations conducted by Voigt (2008), based on the Standard International Trade Classification (SITC) Revision 3, the revealed comparative advantage index values had not changed notably and remained rather stable in the period between 1996 and 2007. In this period, Turkey had developed a slight comparative advantage: in capital-intensive products, which include beverages and tobacco (SITC 1), electronics (SITC 35), manufactured goods like manufactured rubber (SITC 62), iron and steel (SITC 67), road vehicles (SITC 78); in labour-intensive products, which include textile, yarn and fabrics (SITC 65), non-metallic mineral products (SITC 66), metal products (SITC 69), miscellaneous manufactured articles, including prefabricated buildings (SITC 81), furniture, bedding, mattress supports and cushions (SITC 82), apparel articles and clothing accessories (SITC 64); and in some raw materials, which include food and live animals (SITC 0). In addition, in the period of the customs union, Turkey strengthened its position notably in plastics in non-primary forms (SITC 58), electronic machinery apparatus and appliances (SITC 77) and other transport equipment (SITC 79). However, Turkey started to lose its comparative advantageous position in crude animal and vegetable materials (SITC 29), travel goods, handbags and similar containers (SITC 83) and footwear (SITC 85).

Based on these calculations it could be said, in accordance with the classic economic theory, that in the period between 1996 and 2007 Turkey's comparative advantage had developed to great extent in the labour-intensive production and trade with the EU countries. Taking this into account one would expect that the challenge now facing Turkey is that of export diversification from labour-intensive products to innovative and highly technological products.

### 5.2. Dynamic Effects of the Customs Union on Turkey's Competitiveness

An export-oriented development strategy, based on the factor proportion theory (the Heckscher–Ohlin theory), suggests that free trade is the optimal way for the efficient allocation of resources. This, however, does not consider several aspects of developing nations attempting to enter established and competitive markets. As such, free trade policies derived from the theory can at times be a trap for underdeveloped and developing countries. Most now agree that relying only on free trade will not necessarily overcome international per capita disparities due to lack of human capital accumulation and, at times, the adverse effects of foreign direct investments may



result in less human capital accumulation. Lohrmann (2000) notes that under conditions of fierce competition, low technological exportation has often actually resulted in a deterioration of the competitiveness for developing countries' foreign trade. With regard to this, the 'new growth theory' proposes that the three main factors of (1) imitation of technology, (2) innovation of technology and (3) creating one's own capacity should be considered in any attempt to find a solution to overcome this problem.

These three factors, however, are sufficiently broad to cover almost all dimensions of a country's economic and social policies. The important consideration is that if a country does not obtain sufficient human capital accumulation the likely result is that free trade will lead to divergence and ultimately an inability to catch up in the trade relationships with its partners (Lohrmann, 2000).

The implications of these resolutions also point to the development of a trade pattern movement towards intra-industry trade rather than the one that the Heckscher-Ohlin theory envisaged. To analyze Turkey's competitiveness in the customs union the authors used the Grubel and Lloyd Index. According to the Grubel and Lloyd Index, an analysis conducted by Voigt (2008) based on SITC Revision 3 in the second level segmentation, demonstrated that there had been a considerable increase in the volume of intra-industry trade between the EU countries and Turkey between 1999 and 2006. In recognition of these product groups, Turkey's trade with the EU countries after the custom union showed a slight tendency towards intra-industry trade in capital-intensive and labour-intensive products.

### 5.3. Dynamic Effects of the Customs Union on Economies of Scale in Turkey

One aspect of economic integration is that economic welfare increases occur not only as a consequence of comparative advantages but also as a result of scale economics. In an integrated economic area, such as a customs union, the concomitant increase in market size allows companies that had previously produced below manufacturing capacity to increase production to more optimum (profitable) levels.

Lohrmann (2000) suggests, however, that trade liberalizations do not necessarily result in convergence for the less developed countries, as would be envisaged by the neoclassic theory. Often trade liberalization entices companies of more developed countries to obtain a monopoly and thus increase market power as a consequence of, in addition to other factors, scale economics. Prior to customs union membership many considered that Turkey would not be in a position to compete with the more established EU companies as the majority of Turkish companies were small and medium-sized. In addition, since most of the EU countries were members of the customs union prior to 1996, their industries had completed transformation and were benefiting from the derived scale economics.

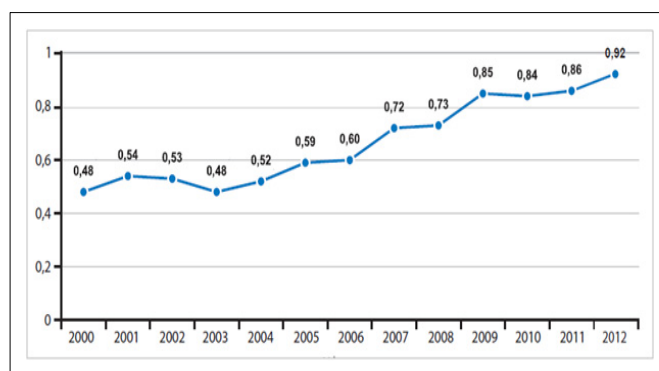
Erzan & Filiztekin (1997), reviewing the effects of the customs union on the Turkish small and medium-size enterprises in 1997,

found that those companies suffered from exchange rate volatility, inflation, wage increases and import penetration rather than from competition from larger-sized companies. It was noted that the data on the small and medium-size enterprises show that the expected negative impacts did not occur and both the small and medium-size enterprises and large enterprise firms in Turkey increased production, competitiveness and foreign trade volume. According to the European Commission Report on small (Turkish) businesses, performance increased slightly from 2008 through to 2013, although there was a gap in terms of general evaluation criteria for the small and medium-size enterprises (European Commission, 2014).

### 5.4. Dynamic Effects of the Customs Union on Turkey's Technological Progress

The catching-up theory envisaged that as a consequence of gradual human capital accumulation, free trade would assist the less developed or developing countries, to close their technology gap through technology transfers resulting in convergence. The theory holds that increasing trade transactions, as well as faster implementation of technology and innovation, would result in technology changes, which, due to spillover effects, would affect all economic sectors (Lohrmann, 2000). While the level of a country's technological change is not directly measurable there are a number of indicators that would indicate the general technology level or technology usage capacity. These indicators include: the education expenditure ratios, research and development (R&D) ratios, the number of educated employees, engineers and scientists as well as the number of patents. In the years since 2002, broad economic and social programs were initiated to strengthen Turkey's economic and physical infrastructure. As a consequence of these, as well as a favourable economic environment, the technology capacity of the country significantly improved.

According to the Turkish Statistical Institute, R&D expenditure in Turkey tripled between 2000 and 2012. At the same time the percentage of R&D expenditure in GDP terms doubled due to the fast-growing GDP ratios in Turkey (Turkish Statistical Institute, 2012). Figure 4 provides data related to the trend of R&D expenditure ratios in GDP.

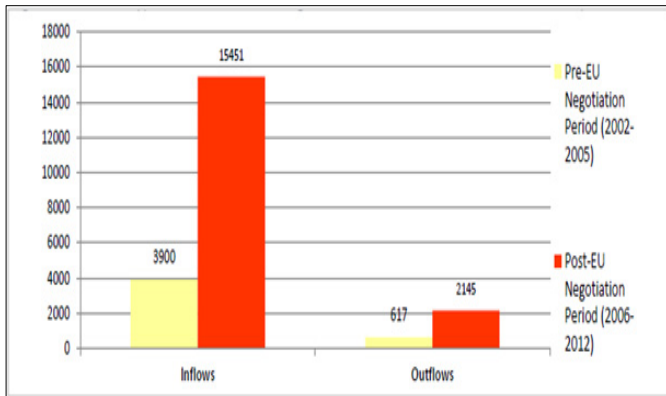


Source: Data from Turkish Statistical Institute (2012)  
**<Figure 4>** Percentage of R&D in Turkey's GDP

### 5.5. Dynamic Effects of the Customs Union on Turkey's Foreign Direct Investments

Foreign direct investments tend to be significantly associated with the general economic conditions, value chain performance and competencies of the countries rather than the advantages of economic integration. This seems to be the early case with Turkey, as prior to 2005 it failed to attract important foreign direct investment inflows (far below one billion dollars annually) due to the economic and political uncertainties combined with repeated economic crises. In the 2000s, in the scope of broader national programs Turkey enacted significant legislative reforms to improve the investment climate and to attract foreign direct investment inflows. Building on the improved economic and political climate in this time frame, the Turkish governments initiated a program of privatization of state-owned enterprises. Political stability, improvements in the foreign direct investment environment and the beginning of the EU membership negotiations eventually led to impressive increases in foreign direct investment inflows in this period.

Figure 5 depicts the significant trend in foreign direct investment inflows from the EU countries in the pre- and post-customs union period of 2005 which was the initial year of EU membership negotiations.



Source: Data from European Commission (2013)

<Figure 5> FDI Inflows and Outflows for Turkey (Million USD)

Between 2007 and 2012, EU countries were the leading source of the foreign direct investments inflows to Turkey, with a ratio of 46.3 per cent (European Commission, 2013). The results of a survey of European country investors, Turkey had an impressive potential due to its domestic market size, proximity of neighboring markets, reasonable labour costs, skilled workforce, developed service sector, R&D capability, quality infrastructure and growth potential (European Commission, 2013). Despite both its strengths and opportunities, during that time Turkey was not able to attract enough foreign direct investment inflow from either the EU countries or the developed world compared with its potential and economic scope. Turkey's above-average (50s) ranking in the Global Competitiveness Index, both in general and in its sub-components, combined with the EU nations' need to

access promising markets, could present a significant short-term window of opportunity for foreign direct investment in Turkey.

## 6. Conclusions

Turkey's customs union membership has brought a variety of policy alignments and changes beyond the classical concept of benefits envisaged by the General Agreement on Tariffs and Trade. With the implementation of the provisions of the customs union, the requirements of the World Trade Organization have been achieved. This has advanced Turkey's integration with international markets and especially with the European Union, which stands as one of the most significant world economic blocs.

Turkey's trade creation effects of its customs union membership have been positive during the post-customs union period, as both Turkey's export to and import from the EU countries have significantly increased. This was in spite of a downward trend in the share of the EU for the last few years. Between 1996 and 2014 it appears that the trade diversion effect on Turkey's foreign trade did not occur, as the EU's exportation and importation with Turkey considerably decreased from 54 per cent to 43.5 per cent in exportation and from 56 per cent to 36.7 per cent in importation.

In spite of the positive static effects of the custom union, imports of intermediate goods steadily increased in parallel with Turkey's exportation trend throughout the liberalization period after 1980. This tends to indicate that the volume of Turkey's exports have been dependent on the intermediate and capital goods imports. Turkey's trade balance deficits have steadily increased and the Turkish export dependency on intermediate and capital goods imports confirms that the Turkish industry structure has not completed the transformation that began with the 24th January Decisions in 1980.

In spite of impressive technological progress in education, increases in R & D ratios, the number of educated employees as well as the number of patent applications, increasing foreign direct investment, and the improving conditions of Turkey's small and medium-sized companies, one might argue that the nation has not yet succeeded in either the production of high value-added or innovative technological products. Turkey's comparative advantage seems to be focused on labour-intensive production and trade with the EU countries, resulting in an increase in the volume of intra-industry trade between the two in the post-customs union period.

The data seem to indicate that membership in an economic integration does not necessarily provide members within the integration area with increased productivity, higher quality production or competency in international markets. Despite the opportunities and advantages of membership, nations must also apply public policies to assist and strengthen the country's infrastructure and education system in accordance with the country's priorities and comparative advantages, based on its natural and potential conditions. These policies need to focus on



innovation, technology, R&D and an adequate and functional education system that is able to respond to industries' demands. It is clear that simply having a large market is not sufficient to stimulate growth. For Turkey to achieve growth targets and financial goals a reduction in the technology gap and an increase in technology usage in production must be addressed by both the government and private sectors. To achieve a balanced foreign trade with EU nations Turkey will need to develop a strategy that slowly substitutes goods from labour-intensive sectors with sectors involving innovative and value-added products. As private sector companies replace government ones, policies will continue to need to be designed that can attract the foreign direct investment necessary for their funding.

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