



# TRADE AS TURKEY'S EU ANCHOR

Sinan Ülgen



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Carnegie Endowment for International Peace  
Publications Department  
1779 Massachusetts Avenue NW  
Washington, DC 20036  
P: +1 202 483 7600  
F: +1 202 483 1840  
[CarnegieEndowment.org](http://CarnegieEndowment.org)

Carnegie Europe  
Rue du Congres 15  
1000 Brussels  
Belgium

P: +32 2 735 56 50  
F: +32 2 836 62 22  
[CarnegieEurope.eu](http://CarnegieEurope.eu)

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## About the Author

**Sinan Ülgen** is a visiting scholar at Carnegie Europe in Brussels, where his research focuses on Turkish foreign policy, nuclear policy, cyberpolicy, and transatlantic relations.

He is a founding partner of Istanbul Economics, a Turkish consulting firm that specializes in public and regulatory affairs, and chairman of the Center for Economics and Foreign Policy Studies, an independent think tank in Istanbul.

Ülgen has served in the Turkish Foreign Service in several capacities: in Ankara on the United Nations desk (1990–1992); in Brussels at the Turkish Permanent Delegation to the European Union (1992–1996); and at the Turkish embassy in Tripoli (1996). While in Brussels, he was part of the Turkish diplomatic team that negotiated the Turkey-EU Customs Union agreement.

He is a regular contributor to Turkish dailies, and his opinion pieces have been published in the *International New York Times*, the *Financial Times*, the *Wall Street Journal*, and *Le Figaro*. He was a member of the international security experts group set up by former NATO secretary general Anders Fogh Rasmussen and tasked with preparing a report on the transatlantic relationship in advance of NATO's September 2014 summit.

Ülgen is the author of *Governing Cyberspace: A Road Map for Transatlantic Leadership* (Carnegie Europe, 2016), *Turkey's Nuclear Future* (Carnegie Endowment for International Peace, 2015), *Handbook of EU Negotiations* (Bilgi University Press, 2005), and *The European Transformation of Modern Turkey* with Kemal Derviş (Centre for European Policy Studies, 2004).



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## Summary

Having reached a dead end on Turkey's path of EU accession for the time being, Ankara and Brussels have instead invested their hopes in an upgraded Customs Union. Revamping this trade arrangement would unlock numerous economic benefits for both sides by further liberalizing trade between Turkey and the EU.

Yet this initiative is now under threat as a group of EU members led by Germany have formally opposed any new trade deal with Turkey. These countries should reconsider their position, because blocking the renewal of this trade deal would all but eliminate the most feasible means of encouraging rules-based governance in Ankara and maintaining EU engagement with Turkey.

### The Likely Benefits of Modernizing the Customs Union

- Reworking the Customs Union could help spark economic growth in Turkey and the EU by extending the union's scope beyond manufactured and processed agricultural goods to cover the agricultural sector writ large, as well as public procurement and trade in services.
- Such a restructuring would entail significant reforms in four key areas: dispute settlement, public procurement, state aid, and services regulation.
- Reforms in these areas would help bind Turkey more closely to rules-based economic governance, provide a more viable vehicle for adjudicating trade disputes, and preserve the remaining momentum of EU-Turkey economic engagement.

### The Risks of Forestalling a Customs Union Modernization

Given that the Turkey-EU political relationship is in deep crisis with no real prospect of recovery in the foreseeable future, a failure to upgrade the Customs Union with Turkey would be counterproductive for the EU because it would entail:

**Leaving current economic problems unaddressed.** The Customs Union would remain plagued by a dysfunctional dispute resolution mechanism and



limited regulatory convergence between Turkey and the EU in economic sectors critical to future growth.

**Undermining the EU's most feasible vehicle for pursuing economic and diplomatic engagement with Turkey and encouraging domestic reforms in Ankara.** The EU would, without a modernized Customs Union, lack viable ways to press Turkey to align its economic regulations more closely to EU standards and to encourage the changes in Turkey's political economy that such reforms could potentially unlock.

**Taking the onus off Turkey to make difficult economic and political decisions.** German-led European obstructionism could conceivably allow the Turkish government to evade responsibility if it ultimately opts to reject a Customs Union deal that is keenly supported by many domestic constituencies, so as to preserve the Turkish state's ability to direct domestic economic resources to consolidate political control.

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## Introduction

With Turkey's path to European Union (EU) accession facing a roadblock for the foreseeable future, Ankara and Brussels have turned instead to negotiating an upgraded Customs Union as the central framework for guiding the future of their relationship. The proposed overhaul would aim to extend the coverage of this trade regime to service industries, agriculture, and public procurement; modernize its governance framework with a new dispute settlement mechanism; and help foster greater convergence between Turkish and EU trade policy.

Yet this effort is now under threat from a group of EU members led by Germany that has decided to break the consensus over whether to start negotiations to modernize the Customs Union. This new posture came in the wake of a bilateral diplomatic crisis between Berlin and Ankara following a severe degradation of democratic norms and the rule of law in Turkey. It is understandable that Germany may want to toughen its stance, and it is unsurprising that a policy shift in Berlin would have implications for the Turkey-EU relationship.

But this attempt to obstruct the start of talks to modernize the Turkey-EU Customs Union is shortsighted and ultimately counterproductive for at least two reasons. First, blocking a revamp of this trade deal would be tantamount to eliminating the most promising avenue of engagement with Turkey aimed at fostering greater rules-based governance. In an era when the Turkey-EU political relationship is in a deep crisis with no real prospect of recovery for the foreseeable future, the Customs Union remains the sole institutional pillar for sustaining a constrained, yet real and collaborative Turkey-EU framework. Second, the Customs Union is also the best strategy for deconstructing the increasingly discretionary and volatile political economy that clouds Turkey's long-term economic future.

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## The Politics of Renewing the Customs Union

The prevailing Customs Union regime between Turkey and the EU dates back to 1995 and needs an overhaul. Ankara and Brussels have reached a political understanding for the renewal of the Customs Union. The European

Commission prepared and submitted to the European Council a mandate for this new round of trade negotiations with Turkey in December 2016, though German obstructionism has since stalled these efforts.

### Potential Benefits of a Revamped Customs Union

The European Commission mandate and an accompanying impact analysis give a clear account of why the Customs Union regime should be modernized. Firstly, the current regime only covers some economic sectors, namely manufactured goods and processed agricultural products, so renewing it could spark sustained economic growth. These sectors represent approximately 20 percent of the economies of both Turkey and the EU.<sup>1</sup> The upgraded Customs Union is expected to extend coverage to the services and agricultural sectors as well as public procurement markets, and therefore it will likely have a more substantial and mutually beneficial welfare impact than the current arrangement. The impact assessment projected the expected gains to reach 5.4 billion euros (\$6.3 billion) or about 0.01 percent of gross domestic product (GDP) for the EU and 12.5 billion euros (\$14.6 billion) or 1.44 percent of GDP for Turkey.<sup>2</sup>

Moreover, like any ambitious trade liberalization agreement, the renewed Customs Union will have distributional consequences. Some sectors and companies will not be able to remain competitive. The inevitable domestic economic readjustments that will ensue will require a reallocation of productive assets. It is essentially this redistribution that will drive the projected welfare gains from trade. But these economic changes may create social and political tensions as less resilient companies and industries are forced to exit the market. This adjustment will be more significant for Turkey than the EU, given that the former's economy is much smaller and will likely face a larger expected welfare impact stemming from the trade deal. This readjustment will not happen overnight. Consequently, social and economic tensions will almost certainly continue over a number of years with frontloaded switching costs and backloaded economic benefits.

In essence, the eventual implementation of commitments associated with a renewed Customs Union can be likened to a set of structural reforms that have generally proved to be difficult for policymakers to adopt, absent an economic crisis. The short-term economic, social, and, ultimately, political costs of these reforms, balanced out only in the long term by economic gains, have tended to discourage policymakers from looking beyond the next electoral cycle. Ultimately, the prospect of short-term pain in return for long-term gain may not appear very enticing to Turkish leaders fixated on the presidential elections of November 2019.

Despite these difficulties, there are compelling reasons for Turkey to pursue the long-term economic gains that a renewed Customs Union could help

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unlock. The short-term incentive for Ankara is to leverage the start of the Customs Union negotiations as a strong signal that Turkey is firmly committed to modernizing its economic governance and improving its investment climate. An updated Customs Union could indeed address a key concern of domestic and international investors, greatly enhancing policy predictability and making economic governance more rules-based by harmonizing Turkish regulations with the EU acquis, the accumulated norms and practices that constitute EU law. It would also help Turkey improve its credit ratings, reducing the cost of accessing international debt.

Turkey's long-term incentive is to benefit from an updated Customs Union's positive welfare impact. Given the significant implications for Turkey's political economy of transitioning to the new Customs Union regime, a clear political mandate will have to be cemented, shaped by the realization among the country's top political leaders that reforming economic governance and improving the rule of law are indispensable requirements for sustainable growth. The Turkish economy has rebounded strongly from the difficulties created by the failed coup of July 2016. Year-end growth expectations for 2017 are around 5 percent.<sup>3</sup> And yet, much of this economic performance is predicated on unsustainable policies of fiscal profligacy and easy credit. As a result, by 2018, the economy will again face the inevitable question of how to engineer lasting growth.

Another motivation behind renewing the Customs Union is to address long-standing Turkish and EU grievances over the functioning of the current regime. For Turkey, a top priority is to redress the asymmetry linked to the EU's preferential trade agreements. At present, Turkey is expected to follow the EU and conclude its own free trade agreement (FTA) with the countries that have become preferential EU trade partners. But there is little incentive for these countries to want a separate FTA with Turkey, since they can rely on their existing FTAs with the EU to freely export their goods to Turkey without opening up their own markets to Turkish exports. As a result, Turkey has been unsuccessful in concluding trade deals with some of the EU's partners (Algeria and South Africa). The economic costs of this asymmetry for Turkey are due to increase, as the EU has concluded a new FTA with Japan and is still seeking to do so with other large economies like India and potentially the United States. Through the renewed Customs Union, Ankara expects the EU to agree to a more coordinated approach to external trade policy. Turkey also wants to resolve the issue of road transport quotas, which constitute a competitive disadvantage that increases the cost of transporting Turkish goods to EU markets.

For the EU, the primary objective is to design a more effective dispute settlement mechanism, which should facilitate the adjudication of manifold trade irritants ranging from nontariff barriers to claims of Turkey's noncompliance with the provisions of the agreement. Due to the dysfunctionality of the current dispute settlement provisions, these trade problems have accumulated over the years and remain unaddressed. The EU also wants to force Turkey to enhance its track record on harmonizing its legislation with the EU acquis.

Both parties are also willing to explore institutional provisions designed to give Turkey more of a role in influencing EU decisionmaking in the policy areas covered by the renewed Customs Union, so as to improve regulatory compliance and facilitate the exchange of relevant information. At the same time, an updated Customs Union with improved procedures for addressing ongoing disputes also would have benign diplomatic consequences. Instead of generating acrimony and eroding trust between Turkey and the EU, a better functioning Customs Union would help to rejuvenate good will between the two sides.

### Resurgent Turkey-EU Tensions

Given all these potential benefits, it may seem curious that Germany and some other EU members oppose renegotiating the Customs Union. The German government, for instance, has asked the European Commission to halt efforts to lay the groundwork for negotiations with Turkey, arguing that to move forward with such efforts would send the “wrong signal.”<sup>24</sup> Berlin has linked the start of the negotiations to improvements in Turkish rule of law and particularly to the release of German citizens who have been arrested in Turkey, including a *Die Welt* daily correspondent named Deniz Yücel.

But interestingly, the European Commission's asymmetric findings that Turkey would seemingly benefit much more economically than Europe from

renewing the Customs Union may provide a more real-politik rationale for the political resistance in the EU to negotiations with Turkey. But these estimates, provided by a computable general equilibrium model, have their own limitations and should not be taken too literally. The projected gains for the EU likely have been underreported, partially because estimates of welfare gains from liberalized trade in services, where the EU has a competitive edge, are notoriously difficult to capture due to methodological

limitations.<sup>5</sup> On the EU side, most benefits would come from liberalized trade in services and reduced costs for trade in goods. Meanwhile, Ankara's expected welfare gains would be driven by reduced trade costs with its biggest trading partner, which may lead to improvements in Turkey's global competitiveness.

The gains that a renewed Customs Union could garner may be even more necessary at a time when the Turkey-EU relationship seems to be moving toward almost inevitable confrontation. Current trend lines in Turkish politics toward consolidated political control and illiberal tendencies can be expected to continue, until at least after the country's November 2019 presidential election; this makes the prospect of clear improvements in the rule of law or an end to emergency rule seem remote. As a result, Turkey's diplomatic relationships with key EU countries will likely continue to be under duress.

These tensions are reflected in public opinion polls on both sides. Skepticism about Turkey has reached high levels among citizens of France, Germany,

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Ireland, Italy, the Netherlands, Poland, Romania, Spain, and Sweden. According to a May 2017 survey carried out on behalf of the European People's Party and published in the German daily *Bild*,<sup>6</sup> opposition in Europe to an eventual Turkish accession to the EU stood at 77 percent. A subsequent August 2017 survey published in the German daily *Die Zeit* confirmed the hardening of German public opinion toward Turkey: 60 percent of respondents were in favor of “clear dissociation” from Ankara, while an additional 27 percent supported a course that “tend[s] toward dissociation.”<sup>7</sup>

Turkish public opinion toward Europe is becoming more negative as well, as demonstrated by a July 2017 survey on public perceptions of Turkish foreign policy carried out by Kadir Has University. The survey found that—for the first time since the start of accession talks in October 2005 when domestic support for Turkey's aim to join the EU had reached 74 percent—there is now more popular support in Turkey for ending the talks than continuing them: 51.6 percent of respondents were against accession, while 48.4 percent still supported Turkey's EU membership bid.<sup>8</sup>

### **The Transformative Potential of Trade**

Under the circumstances, an upgraded Customs Union could play an instrumental role as the sole rules-based anchor of the Turkey-EU relationship. While the relationship has other components like the refugee deal, cooperation on counterterrorism, and an energy dialogue, these other elements are inherently transactional and lack the long-term, potentially transformative agenda of a rules-based trade reconfiguration.

Interestingly enough, this was exactly the motivation back in the early 1990s when Turkey and the EU decided to launch the Customs Union in the first place. At the time, the political relationship had soured, with Europe focused on engaging the countries of Central and Eastern Europe and Turkey resisting calls for political reform. The political dialogue between Ankara and Brussels was suspended at the time. The two sides nonetheless embraced the idea of completing the Customs Union, with the hope of creating an anchor for an endangered relationship. Despite the odds, the negotiations were successful and Turkey assumed all the obligations associated with implementing the Customs Union. This non-negligible political commitment was a key factor in rejuvenating the European agenda in Turkey. The ensuing positive change in the political atmospherics surrounding the deal finally pushed EU governments to grant Turkey accession candidate status at the EU Helsinki Summit in 1999. In that sense, the Customs Union proved to be a critical, historical step that quite possibly helped avert a full collapse of Turkey-EU relations.

Turkey and the EU are now at what seems to be a similar and dangerous juncture. But now, unlike two decades ago, even the role of the Customs Union as the remaining pillar of this important relationship is at risk for purely political reasons. With accession talks stalled and the associated framework of

political conditionality largely evaporated, the Customs Union likely remains the sole EU-led institutional arrangement capable of shaping the evolution of the rule of law in Turkey. Consequently, the modernization of the Customs Union should be viewed as the only transformative agenda that the EU can realistically embrace for shaping its future relations with Turkey. Any decision to block the Customs Union negotiations could leave Europe with no real concrete framework for positive engagement with Turkey.

Such a veto would trigger questions both in Europe and Turkey about the sustainability of the current Customs Union as well. In Turkey, the Customs Union is viewed as a transitional arrangement that was stipulated in the 1963 Ankara Association Agreement as a pre-accession regime. The drawback of Turkey's dependency on EU trade policy, inherent to the Customs Union arrangement, was offset by the carrot of eventual accession. But if accession is no longer a prospect, the political sustainability of the Customs Union needs to be re-evaluated. Failing to modernize the Customs Union would be tantamount to accepting that the accumulated problems and dysfunctions undermining the current arrangement will remain unaddressed. The accumulation of these trade irritants could sap the EU's willingness to continue with this trade regime as well.

An obvious alternative would be for the two sides to replace the Customs Union wholesale with a free trade agreement. But as the recent European Commission impact study showed, replacing the existing Customs Union with a shallow FTA would have its own economic costs, primarily driven by the introduction of rules of origin; if the two sides were to pursue this option, it would cost an estimated 1.2 billion euros (\$1.4 billion) for the EU but as much as 6.8 billion euros (\$7.9 billion) for Turkey, or almost 0.5 percent of the country's GDP.<sup>9</sup> It is also debatable whether Ankara and Brussels could find the political space to initiate, in good faith, a new round of FTA negotiations to redefine the future structural underpinnings of their relationship. After all, the ratification of new trade agreements is becoming more difficult against the background of rising European populism, as illustrated by the difficulties surrounding the passage of the Comprehensive Economic and Trade Agreement (CETA), the EU's recent FTA with Canada.<sup>10</sup>

## How a Renewed Customs Union Would Impact Turkey

But beyond these political considerations, the stalling of the Customs Union negotiations has profound implications for Turkey's economic and political future. To underscore the importance of the proposed Customs Union upgrade, it is helpful to describe how Turkey's political economy has evolved under President Recep Tayyip Erdoğan and the ruling Justice and Development Party (AKP) and what impact the Customs Union might have.



Revamping the Customs Union would help bind Turkey to a form of rules-based economic governance. The original Customs Union provided a sound framework that complemented the Turkish economic reforms of 2000–2001, which strengthened the institutional underpinnings of the country’s economy. In the words of one Turkish scholar, this break with the discretionary populism that had previously characterized Turkish political economy involved the “delegation of the decision-making power to relatively independent agencies, and the establishment of rules that constrain the discretion of the executive.”<sup>11</sup> Turkey’s commitments to harmonize its legislation with the EU acquis in the policy areas covered by the Customs Union (trade, competition, customs, and intellectual property rights) and to establish the obligatory regulatory structures were major features of this reform agenda. Economists Daron Acemoglu and Murat Ucer have explained the importance of strengthening institutions and the rule of law for helping Turkey achieve its miracle of economic growth in the early 2000s when per capita income was growing on average by more than 6 percent per year.<sup>12</sup>

As a corollary, failing to recast the Customs Union could have far-reaching negative consequences. Acemoglu and Ucer further contend that the stalling of Turkey’s reform agenda and the weakening of institutional, rules-based governance has coincided with the country’s loss of faith in the EU accession process. Similarly, political scientist Isik Ozel has underscored the concomitant risk of jeopardizing some of the key institutions that helped the Turkish economy recover from its turbulent past.<sup>13</sup> She writes, “In this process of institutional erosion, not only the independence of the regulatory agencies is imperiled; some of the key legal institutions established in the recent past under the fervent reform programs either drift apart, become layered, or are entirely reversed.” The World Bank–compiled World Governance Indicators illustrate this downward trend in Turkey’s governance indicators: the country’s percentile ranking in the rule of law index decreased from 57 in 2014 to 49 in 2016, while its government accountability score fell from 36 to 30 over the same time span.<sup>14</sup>

Why would the Turkish leadership want to jettison a model of economic governance that helped the country achieve an impressive growth record? The answer lies in the realm of politics. As President Erdoğan and the ruling AKP established and then consolidated their domestic political dominance, economic governance has increasingly been shaped by the aim of maintaining and extending this political hegemony. There is nothing alien to this aspiration, as economic health is a key factor determining the outcome of democratic contests. But there is a growing and palpable concern that economic policy decisions are being made in a way that jeopardizes growth and prosperity so as to consolidate long-term power.<sup>15</sup> Pro-market policies and institutional rule have

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given way to more discretionary, populist measures designed to channel economic rents to pro-government groups to create a malleable, clientelist business community ready to redirect funds for political purposes. The independence and competence of Turkey's regulatory institutions have been undermined by a combination of political attacks and legislative acts, including a 2011 law that authorized line ministries to inspect the activities of regulatory agencies.<sup>16</sup> In the parlance of Daron Acemoglu and James Robinson, Turkey is moving from "inclusive" to "extractive" economic institutions.<sup>17</sup>

The centralization of Turkish political power accelerated after the April 2017 referendum that paved the way for a transition toward a presidential system à la Turque and the concomitant weakening of the country's institutions and rule of law. Turkey faces the major challenge of how to re-establish the balance between discretionary and rules-based governance. The weakness of Turkey's current institutions will likely be a structural impediment to the country's medium- and long-term growth prospects.

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**A renewed Customs Union could provide a strong foundation for strengthening the rule of law by fostering a more predictable environment for economic actors.**

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The modernization of the Customs Union would help counter the degradation of institutionalized economic decisionmaking in Turkey. A renewed Customs Union could provide a strong foundation for strengthening the rule of law by fostering a more predictable environment for economic actors, at least in the policy areas that would be covered by the new agreement. As opposed to the accession

track, for which the enhancement of democratic norms and the rule of law was an explicit objective, the modernization of the Customs Union could upgrade the rule of law in Turkey implicitly. The impact would likely be particularly significant in four areas: dispute settlement, public procurement, state aid, and trade in services.

### **Dispute Settlement**

At present, the dispute settlement mechanism in the Turkey-EU relationship, particularly on trade issues, is dysfunctional. The current procedures date back to the Ankara Agreement of 1963, which introduced an overtly political mechanism for dispute settlement with no mandatory adjudication, unlike in later EU agreements. The process centers on the Turkey-EU Association Council, the highest political platform defined in the Association Agreement; the council gives Turkey and the EU one vote each to either settle a given dispute or to refer it to arbitration. But all Association Council decisions must be unanimous, which gives a right of veto to either party. Turkey and the EU can, and have, blocked disputes from being submitted to the European Court of Justice or separately to arbitration. As a result, there is no functioning dispute settlement mechanism in the Turkey-EU relationship, which means that both parties can essentially violate their mutual commitments without any fear of legal redress. The only real recourse at the disposal of complainants remains political

retaliation. The dysfunctional nature of this kind of dispute settlement has seriously weakened enforcement of the rule of law and has encouraged breaches of Turkey and the EU's mutual obligations, weakening the overall relationship.

But the negative impact on the rule of law is asymmetrical and has been vastly more serious for Europeans decrying Turkey's alleged violations than vice versa. Due to the principle of the supremacy of EU law and the doctrine of direct effect, the EU and EU member states can be taken to court for failing to uphold their obligations under the Association Agreement with Turkey. This reality extends to the secondary legislation adopted by the Turkey-EU Association Council.<sup>18</sup> So even though the Turkish government cannot force a dispute arising from alleged misconduct by the EU or some of its member states to be directly adjudicated, private Turkish parties affected by such a breach of obligation can still take the responsible EU government to court.

But the same recourse is not available for Europeans with economic interests in Turkey. Affected parties cannot seek redress before the Turkish courts for any alleged Turkish breaches of the obligations undergirding its ties with the EU, unless the relevant provision has been directly transposed into national Turkish law. Even then, it takes a notoriously long time to seek redress against the government in domestic administrative courts and then inevitably before the Danıştay or the Council of State, the country's supreme administrative court. As a result, the enforcement of contractual obligations under the Turkey-EU Association Agreement remains particularly ineffective on the Turkish side, which almost inevitably undermines the overall effectiveness of the rule of law.

The lack of effective dispute resolution is a serious shortcoming that the new round of Customs Union negotiations will seek to address.<sup>19</sup> From the initial set of evaluations published by the European Commission, it can be surmised that the restructuring of dispute settlement procedures will be a key goal for EU negotiators. An overhauled dispute settlement mechanism that introduces mandatory recourse to a mutually agreed-upon form of adjudication so as to eliminate the current practice of blocking disagreements at the political level will be a major condition of any new deal between Ankara and Brussels.

## **Public Procurement**

Under a renewed Customs Union, it is expected that Turkey would in effect adopt the EU *acquis* on matters of public procurement, bringing added transparency and competition to Turkey's current practices. But this is known to be a very sensitive area for the Turkish government. Public procurement represents around 7 percent of Turkey's economy.<sup>20</sup> Opening this rather large and hitherto protected part of the economy to external competition would be an unpopular measure for many vested economic interests. The third party impact study completed on behalf of the European Commission on the potential modernization of the Customs Union demonstrates that between 2011 and 2014, virtually all public contracts (99.7 percent) were granted to domestic companies (see table 1).<sup>21</sup>

**Table 1. Turkish Public Procurement Contracts (2011–2014)**

	<b>Number of Contracts</b>	<b>Percentage of Total Contracts</b>	<b>Value in Turkish Lira</b>	<b>Value in Euros</b>	<b>Percentage of Total Tender Value</b>
<b>Turkey</b>	183,533	99.71	88.5 billion	31.4 billion	97.28
<b>EU</b>	291	0.16	1.7 billion	600 million	1.83
<b>United States</b>	120	0.07	80 million	30 million	0.09
<b>Other Countries</b>	125	0.07	724 million	260 million	0.8
<b>Total</b>	184,069	-	91 billion	32.3 billion	-

Source. Kamu Ihale Kurumu

Note. The euro conversion used the conversation rate in December 2014 of 2.82 Turkish liras per euro.

More importantly, public procurement is a core feature of the Turkish political economy that the ruling AKP and its leaders preside over. Public contracts have always been a major source of financing for political activities in Turkey. Pro-government groups that win tenders are expected to pay back this political patronage either by way of direct kick-backs to political decisionmakers or by indirectly underwriting certain expenses on behalf of their political associates. Over the past decade and a half with the AKP at the helm, the Turkish economy has grown substantially, as the country's aggregate GDP at current prices rose to \$800 billion in 2016 from \$220 billion in 2002.<sup>22</sup> The public procurement market has also grown during this time. The government is, therefore, able to channel far more resources than in the past for public purchasing. As a result, Turkey's public procurement market has become an even more important resource for political financing. Even a small share of this almost \$50 billion market is several orders of magnitude greater than the official treasury funding allocated to political parties, which amounted to \$60 million in 2016 with half of that earmarked for the ruling party.<sup>23</sup>

Because large public contracts allow for economic rents to be redistributed to government-friendly companies, they also serve the ideological purpose of gradually shifting economic power within society. Political scientist Elise Massicard examined this trend in a study on Turkey's residential housing sector, in which the government's housing development agency, TOKI, has a dominant role.<sup>24</sup> She concluded that "the unequal distribution of these partnerships has awakened suspicions of favoritism," given that between 2002 and 2007 only 700 out of the 70,000 construction firms eligible to bid for public works contracts received TOKI contracts, with some sixty firms monopolizing about 60 percent of the overall value of these contracts.

If allowed to continue, such economic practices would likely constrain Turkey's future economic growth. According to official statistics, the construction industry accounted for more than 8 percent of the country's GDP in 2015.<sup>25</sup> Moreover, 30 percent of construction contracts were funded by the state by 2014.<sup>26</sup> These interdependencies demonstrate the Turkish economy's overreliance on the construction industry as well as the critical role of state

intervention for helping maintain the health of the construction industry. In the absence of technological breakthroughs or structural reforms designed to boost total productivity, the Turkish economy will continue to depend on the construction sector to fuel its growth.

The failure to launch needed structural reforms and eliminate remaining economic bottlenecks to fair competition, such as Turkey's large informal economy, has had consequences for capital accumulation in general. Private companies remain reliant on informal support from state and municipal authorities, or at the very least on their willful ignorance, to significantly grow their balance sheets. In an influential study on the evolving political economy of Turkey under AKP rule, Ayşe Buğra and Oğuz Savaşkan assert that “despite the opening up and liberalization of the economy, capital accumulation and business growth still essentially depend on relations with the government in sectors such as large-scale infrastructure as well as energy, but also the metallurgical industry, construction and health services.”<sup>27</sup>

Generally speaking, the political utility of public procurement is also the main reason behind the Turkish government's regular efforts to disharmonize pertinent domestic law with EU and World Trade Organization standards. The main Turkish law on public procurement has been subject to thirty-seven revisions at the last count since its promulgation in 2002.<sup>28</sup> The fact is that public procurement practices, and especially the tendering of public works, are intimately linked to corruption. A 2014 study by the Turkish Industry and Business Association examining Turkish perceptions about the scope of domestic corruption, for instance, identified the construction industry as having the highest rate of perceived corruption.<sup>29</sup> Turkey has been unable to achieve much progress on fighting corruption in recent years: the country's rank in Transparency International's corruption index fell from 53 in 2013 to 75 in 2016.<sup>30</sup>

A renewed Customs Union that commits Turkey to adopting the EU's public procurement standards would help the Turkish government better address its gradually worsening record on battling corruption. More competition and greater transparency requirements in public contracts would likely reduce room for corrupt practices. This would also help create a much more equitable playing field for all economic actors seeking to participate in Turkey's large public procurement market.

### State Aid

Negotiations to modernize the Customs Union would also aim to introduce a state aid monitoring regime in Turkey, mirroring relevant regulations in the EU. The existing Customs Union happens to incorporate provisions to that effect, but so far Turkey has refused to comply with these nominally binding

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clauses. Despite adopting a law back in 2010 designed to control state aid, Turkey has regularly postponed its enforcement. The reason for this resistance is very similar to the government's motivations on public procurement: state aid plays an equally important role in Turkey's political economy and is seen as another critical tool for shaping not only economic but also political outcomes. The widespread impact of state aid can be linked to government interventions in areas such as infrastructure investment and state-owned enterprises (SOEs).

#### *Infrastructure Investments*

Over the years, the AKP-led Turkish government has prioritized large-scale infrastructure investment projects. Some examples include Istanbul's third airport, a third bridge crossing over the Bosphorus Strait, the country's first (Russian-built) nuclear power plant, the Korfez Bay Crossing, and an underwater rail tunnel that crosses the Bosphorus. This pattern of decisionmaking has proven to be beneficial both economically and politically. Such projects have created investment and employment opportunities, while also upgrading the country's infrastructure. Enhanced transportation links and energy assets also will likely improve the country's international competitiveness. These projects have proved to be popular with the Turkish public, and it is common for Turkish political rulers to mention these accomplishments in their speeches.

In Turkey, it is not uncommon for projects to be implemented under the build-own-transfer model of public-private partnerships, and in such cases there is no way to challenge the income guarantees that the Turkish government grants to operating companies, even if they are generally seen as overly generous and could, therefore, constitute an unfair transfer of public funds. To cite one example, according to media-published figures supplied by the Turkish government, the treasury's financial exposure due to revenue guarantees the government granted to the private company operating the Korfez Bay Crossing reached about 43 million euros (\$50 million) in the project's initial twelve months of operation.<sup>31</sup> According to the terms of the contract, the treasury reportedly has ongoing liabilities for another eighteen years.

#### *State-Owned Enterprises*

Another problematic area when it comes to compliance with potential state aid rules is SOEs. Although Turkey has a free market economy, it also has a number of large SOEs, as well as other companies in which the state has a controlling influence. Examples include Türk Telekom, the former telecommunications monopoly; Turkcell, the market-leading mobile operator; BOTAŞ, the natural gas transport company; Turkish Airlines, Turkey's flagship air carrier; TCDD, the national railway company; Halkbank and Ziraat Bank; and TRT, the public broadcaster.

The market behavior of these companies occasionally has violated the principles of free and fair competition. Privately owned airlines, for instance, have complained about the advantages the state has granted to Turkish Airlines in terms of the distribution of air traffic slots and international routes protected by bilateral air transport treaties.<sup>32</sup> To cite another example, the funding streams of public broadcaster TRT have also raised concerns, especially since it has increasingly come to be perceived as lacking political impartiality. TRT is funded by levies on electricity consumption and on imported electronics, including a previously 6 percent levy on mobile phone imports that was raised to 10 percent in August 2017.<sup>33</sup> Given its massive budget, TRT lacks the type of effective expenditure management or cost control measures that should be obligatory for a company that is so reliant on taxpayers' money to cover its losses.<sup>34</sup> The lending activities of state-owned commercial banks are also known to be subject to political pressure.<sup>35</sup> As a result, they are occasionally forced to grant favorable loan conditions to, or continue to roll over the credit lines of, politically linked groups instead of flagging nonperforming loans to prevent the bankruptcy of politically protected customers.

The case of Turkey's SOEs is likely to come under increased scrutiny with the establishment of the country's sovereign wealth fund (SWF), which has become the umbrella entity for the Turkish government's equity holdings in state-held companies since its establishment in 2016. The stated objective of Turkey's SWF is to improve the international financing conditions for Turkey's large infrastructure projects and act as a stabilizing force against speculative attacks on Turkish financial assets. The fund includes the state's shares in Ziraat Bank and Halkbank, the oil producer TPAO, BOTAŞ, Türk Telekom, the PTT post office, the satellite communications company Türksat, the mining company Eti Maden, tea producer Çaykur, and Turkish Airlines. According to Treasury Undersecretary Osman Çelik, "The fund's value has already reached \$160 billion, with \$35 billion of that in equity."<sup>36</sup> But the SWF will also allow cross subsidies between portfolio companies using the revenues of one SWF-held firm to cover the expenditures of another, an arrangement that would potentially undermine the ideal of level playing fields in relevant markets. Moreover, this funding will not have to be budgeted in advance and can be invoked opportunistically by the fund's management without any constraining framework or need for parliamentary approval.

In all these cases, the introduction of EU-compatible state aid rules would help constrain the ability of Turkish government actors to use their discretionary power to assist politically connected groups; such state aid rules would bring greater transparency to the use of public funds for the benefit of select industries or companies and would enable legal challenges to such government action. Doing so would potentially help foster a fairer business environment in Turkey by curtailing the capacity of government agencies to distort competitive market forces.

### Liberalized Trade in Services

Another core component of an updated Customs Union would be the liberalization of trade in services by extending the principle of free movement to this economic sector. The liberalization of trade in services portends a number of different challenges compared to free trade in goods. Liberalizing trade in goods relied on countries' reciprocal removal of tariffs and nontariff barriers. However, when it comes to services, national laws and regulatory frameworks represent more severe obstacles to market access. Modern trade agreements, therefore, need to incorporate rules for tackling this hindrance.

The EU has adopted different models for liberalizing trade in services that feature differing levels of ambition regarding the degree of legislative harmonization being sought. The European Economic Area (EEA) agreement, which the EU concluded with members of the European Free Trade Association, is the most comprehensive option. The EEA members, which include Iceland, Liechtenstein, and Norway in addition to the EU countries, have willingly taken on the whole EU *acquis* in return for seamless access to the European Single Market. This model, based on full legislative harmonization, provides for the liberalization of trade in services under ideal conditions, allowing obstacles that arise from participating states' legislation or regulatory frameworks to be removed altogether.

However, this model has a serious handicap. It binds EEA countries to the EU in all the policy areas covered by the agreement. EEA states are obliged to follow EU policies that ultimately are shaped by EU member states' priorities and preferences. This state of dependency has consequences for the quality of democracy in these countries. EEA policy areas are essentially removed from the sphere of domestic democratic deliberations since decisions are made in Brussels rather than in the capitals of EEA member states that are not in the EU. For this reason, a country like Turkey, with strong sovereign proclivities and an imperial heritage, would likely find it difficult to implement the EEA model wholesale.

The other option for liberalizing trade in services is the General Agreement on Trade in Services (GATS) model, whereby EU partners undertake commitments to lift barriers to market access and national treatment for each service sector separately, while also indicating what limitations to market access and national treatment will continue. Compared to the EEA model, the GATS approach represents a lower level of market integration.

In the case of Turkey, a third hybrid approach that combines features of the EEA and GATS models could be contemplated. For some service industries in which the degree of regulatory harmonization is already well advanced, the EEA option could be favored, leaving the GATS option for the remaining areas. The European Commission's recommendation for the negotiations mandate with Turkey seems to emphasize this option, stating: "As regards trade in services, the two sides would commit to a very substantial coverage and depth



of liberalization, in particular through harmonization of Turkish legislation with EU law in certain specific areas.”<sup>37</sup>

In a 2015 report previously penned for the Turkish Industry and Business Association on the implications of the potential modernization of the Customs Union, the author of this paper and Pelin Yenigün Dilek also championed this option, stating that it would be beneficial to adopt a more flexible approach instead of a compliance obligation that would apply to all policy areas without exception.<sup>38</sup> Decisions about the exact model to adopt for liberalizing trade in services could be made on the basis of a predetermined set of criteria, including:

- the degree to which current Turkish law and the standards of the EU *acquis* align in a given economic sector;
- the extent to which reciprocal market access can be achieved without aligning Turkish law with EU standards;
- whether the existing EU *acquis* overlaps with Turkey’s long-term development objectives;
- whether such reforms would increase Turkey’s potential for economic growth; and
- the stage reached in the accession process.<sup>39</sup>

Another key dimension of this approach to liberalizing trade in services is its impact on Turkey’s governance and regulatory institutions. The latter’s power and independence have been eroded to the benefit of politicized cabinet positions and their line ministries. The reforms undertaken in 2001 had greatly enhanced the role and independence of these institutions with the stated objective of structurally improving good governance. But since the beginning of the 2010s, legal measures backed by a political desire to now downgrade the power of these agencies have undermined their effectiveness. Criticizing this political backtracking, Işık Özel of Sabanci University has contended that “the challenge facing Turkey today is the risk of jeopardizing some of the key institutions that helped its economy recover from a severe crisis.”<sup>40</sup>

A recent example that illustrates this conundrum pertains to the establishment of the Turkish Data Protection Authority. Despite a commitment to set up this key agency in line with EU-enshrined principles of regulatory independence, Turkish lawmakers passed a law in March 2016 that allows Parliament to select five of its members, while the Council of Ministers can select two and the president can choose two others. Given that Parliament is under the control of the ruling AKP, which is the sole party in the executive branch and is chaired by President Erdoğan, the country’s current regulatory structure seems insufficient to allay concerns about its potential independence.

To the extent that liberalization in the trade of services would imply regulatory convergence with the EU, Turkey will need to vastly improve the framework governing its domestic regulatory institutions, which need to be



re-empowered and must regain their independence from political authority. EU market access and therefore the enjoyment of the full economic benefits of an ambitious new Customs Union deal will be conditional on Turkey improving its regulatory standards in many areas ranging from banking to the digital economy.

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**Turkey's economic governance framework potentially stands to benefit from an eventual model for the liberalization of trade in services.**

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Turkey's economic governance framework potentially stands to benefit from an eventual model for the liberalization of trade in services between Turkey and the EU to the extent that such a process relies on the harmonization of legislation as a prerequisite for full market access. This commitment would greatly enhance the predictability of Turkey's policy framework, constrain the scope for discretionary rule making, and improve the independence of regulatory institutions.

## The Future Anchor of the Turkey-EU Relationship

The Customs Union is more than a framework for advancing economic integration between Turkey and the EU. In the absence of a positive political dynamic, and with slim odds of recovering one for the foreseeable future, the Customs Union has acquired a political significance as possibly the only option to keep the EU engaged with Turkey. Modernizing it may help Ankara and Brussels create momentum that could act as an insurance policy against the very real threat of Turkey becoming totally unanchored from Europe.

The Customs Union is the only realistic rules-based framework that can underpin the EU's future engagement with Turkey. The current relationship certainly has more dimensions than trade, including ongoing cooperation on refugees and counterterrorism. But these other spheres of engagement are essentially transactional and rest on the perception of a mutually advantageous exchange of short- to medium-term benefits. As such, they lack a long-term transformative impact guided by the acceptance of a common set of rules and norms.

The deepening of the Customs Union would help improve economic governance, and possibly by extension the rule of law, by facilitating a convergence of legal regulatory frameworks backed by a set of more effective enforcement rules. Expected improvements in the rule of law, which one could argue would initially affect mainly Turkey's economic sphere, may gradually cross over into the political domain. Political and economic considerations are not amenable to clear lines of separation when it comes to the enforcement of rules-based governance. Possible infringements on the economic and social rights of individuals and companies, even if driven by political and public security motivations, could perhaps be redressed under the modernized Customs Union framework

for economic rights. This overriding framework of dispute settlement would also prompt Turkey to adapt its legal norms and culture to EU rules. Turkish judges forced to follow the EU rulebook in economic disputes may be more disposed to follow the jurisprudence of the European Court of Human Rights when adjudicating about democratic norms if the role of nondomestic, European legal standards becomes more widely accepted in the Turkish judicial system. Brussels can only benefit from the gradual strengthening of these liberalizing and democratic principles in this key candidate country.

Yet a full-fledged and sustained commitment from Ankara to this process is not a foregone conclusion. Approving the start of the negotiations for the modernization of the Customs Union would in fact put the Turkish government in a quandary. On the one hand, Ankara understands the political importance and the long-term economic benefits of this additional step for trade integration. Yet a commitment to implement the deepened Customs Union would be incompatible with the discretionary path that increasingly bedevils Turkey's economic governance. Ankara will need to choose. It cannot go in one direction and its exact opposite at the same time. It may be that Turkish policymakers will eventually decide that their vision for the future of their country is incompatible with the rules-based framework of the modernized Customs Union.

But with its diplomatic efforts to hinder the start of the negotiations, Berlin and other EU capitals aligned with it are deciding on Ankara's behalf and giving the Turkish government an easy opt out. If this continues, Ankara may be able to evade the responsibility of this agonizing decision. This German-led alliance's obstructionism also allows the Turkish government to escape the unpalatable scenario of having to ultimately pull away from a Customs Union deal that is keenly supported by many domestic constituencies ranging from business associations to young people that harbor expectations of an improved rule of law and governance model for the country.

Based on these considerations, EU member states wary of negotiating with Turkey may want to review their position on the start of the Customs Union talks. Most member states have wisely resisted calls by Berlin to formally suspend the accession talks with Ankara. For the sake of preserving engagement with Turkey, they should now build a winning coalition to allow for the start of the Customs Union negotiations.

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**The Customs Union is the only realistic rules-based framework that can underpin the EU's future engagement with Turkey.**

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## Notes

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