
EFFECTS OF EUROPEAN UNION-TURKEY CUSTOMS UNION ON TURKISH FOREIGN TRADE

BAYAR Yılmaz

Karabuk University, Turkey

OZEKICIOGLU Halil

Cumhuriyet University, Turkey

Abstract:

Financial liberalization together with the globalization led countries to constitute economic integration in form of preferential trading area, free trade area and customs union especially since 1980s. European Union, which has been at the stage of Economic and Monetary Union, is one of the biggest and most advanced economic integration models in the world. This study examines the effects of European Union-Turkey Customs Union on Turkish foreign trade between 1995-2011 by using static analysis and Balassa index. We found that there was trade creation effect and no trade diversion effect of the Customs Union. Moreover Turkey increased its comparative advantage on 50 product classes and lost its comparative advantage on 17 product classes, while Turkey sustained its comparative advantage on 188 product classes relative to European Union after establishment of the Customs Union.

Key words: *Customs Union Theory, Comparative Advantages, Static Analysis, Balassa Index*

1. Introduction

The roots of relationship between Turkey and EU (European Union) traced to July 1959 when Turkey first applied for associate membership of the EEC (European Economic Community), and then Ankara Association Agreement, which determined the framework of the Customs union, signed in 1963, this agreement was supplemented by an Additional Protocol which came into effect on 1st January 1973, signed in November 1970. The Additional Protocol determined the details of Customs Union between Turkey and EU. EEC abolished customs duties on import of industrial products originating in Turkey and began to apply quota on import of textiles from Turkey as from 1971, on the other hand Turkey began to apply reduced customs duty on import of selected products from EEC and took no steps for application of common customs tariff. Transitional Period foreseen in Additional Protocol was completed and it was agreed on that Customs Union between Turkey and EU came

into effect as of 01 January 1996 with Decision No. 1/95 of the EU-Turkey Association Council of 22 December 1995.

Customs Union between EU and Turkey is an economic integration model which includes free circulation of manufactured goods and processed agricultural products. Turkey undertook harmonization of legislation with regard to the intellectual and industrial property rights, harmonization of competition rules and implementation of a common commercial policy with Customs Union. Customs Union entered the 18th year with 1 January 2013. This study examines the effects of Customs Union on Turkish foreign trade between 1996-2012 by using Vinerian analysis and Balassa index and disregarding the potential negative effects of national, regional and international financial and economic crises.

The remainder of the study is organised as follows. Section 2 outlines the theoretical and empirical literature. Section 3 presents the data and method, Section 4 presents empirical application and introduces the main findings. Section 5 concludes the study.

2. Literature Review

2.1. Theoretical Review

Viner is accepted as the pioneer of customs union theory and he firstly proposed the concepts of trade creation and trade diversion in literature. Viner showed that if a customs union causes a shift from high cost domestic production to lower cost production in a partner country, it results in trade creation (welfare enhancing effect); if customs union causes a shift from lowest cost external producer to a higher cost partner, it results in trade diversion (welfare reducing effect) (Viner, 1950:44). Viner accounted for the effects of customs union on the world welfare by using partial equilibrium analysis and proposed that net effects of customs union on economic welfare can be varied depending on relative size of trade creation and trade diversion effects.

The second major development in theory of customs union is the analysis of the welfare effects of the substitution between goods which is arisen from the changes in relative prices due to customs union. Viner's analyses were related to production effects of customs unions and assumed implicitly that goods are consumed in some fixed proportion which is independent from relative prices. Meade, Gehrels and Lipsey conducted searches about the consumption side of customs unions by using partial equilibrium analysis. Meade was the first to consider the consumption effect. Meade (1955), Gehrels (1956-1957) and Lipsey (1957) proposed independently that customs unions change relative prices, the changes in relative prices lead to substitution between goods and this results in change in trade volume (while cheaper goods are bought more, more expensive goods are bought less). This increases country's import volume from trade partner in customs union, while it decreases both import volume from external world and consumption of domestically produced goods.

Lancaster and Lipsey (1957) introduced the second best theory into the analysis of customs unions. In accordance with this theory, perfect competition and free trade are the first best policy in terms of maximizing world welfare. But since there are barriers to free trade such as tariffs and quotas in real world, taking measures which compensate these barriers are more useful for welfare of the country. This is called as the second best theory and the second best theory is valid in real world due to monopolies and government interventions. Because some trade restrictions are removed in customs union, customs union is the most important example of the second best theory (Dura, Atik, 2003:11).

Cooper and Massel compared the effects of customs union with unilateral tariff reduction and they concluded that an unilateral tariff reduction may be preferred in order to avoid some losses which are emerged as a consequence of customs union and therefore customs union is an attempt to gain a political advantage rather than an economic advantage (Cooper, Massel, 1965:743). Balassa suggested the use of dynamic efficiency as primary indicator in evaluating the effects of economic integration. He meant it should be taken into account both changes in the efficiency of resource allocation in the static sense and the dynamic effects of integration (Balassa, 1961:183).

Mundell (1964), Vanek (1965), Kemp (1969), Negishi (1969), Pearce (1970) and Caves (1974) focused on the effects of customs unions on terms of trade. General equilibrium analysis was also begun to be used instead of partial equilibrium analysis. Kemp and Wan asserted that there exists a common tariff vector and a system of lump-sum compensatory payments, involving only members of the union, such that there is an associated tariff ridden competitive equilibrium in which each individual whether a member of a customs union or not would be better off after establishment of customs union in a competitive world with any pattern of trade taxes (Kemp and Wan, 1976:95).

Traditional theory of customs union assumes that there is perfect competition and returns of scale in production are fixed. But trade patterns are accounted for by imperfect competition and economies of scale in the new trade theory which has been developed since 1970s. Relative factor prices lead inter-industry trade and economies of scale lead intra-industry trade. As differences in factor endowments of countries increase, trade volume increases in inter-industry trade. On the other hand as development levels and similarities in production structures increase, intra-industry trade increases (Cooke, Karakaya, 2002:5). Corden incorporated static economies of scale into theory of customs union by assuming economies of scale internal to the firm and he identified two effects respectively cost reduction arisen from scale economies and trade suppression arisen from increasing production in the region replacing imports from outside the region in his study (Corden, 1972:465).

2.2. Empirical Review

Vinerian analysis, also called static analysis, have been used mostly in the studies about the effects of the Customs Union on Turkey's foreign trade. Besides,

econometric methods, GL (Grubel–Lloyd) and Balassa indexes were used in some studies. We will give findings of major empirical studies in this section. Uyar made static analysis of trade between Turkey and EU between 1991-1999 and found that the trade creation effect was in favour of EU and there was no trade diversion effect (Uyar, 2000). TUSIAD (Turkish Industry & Business Association) conducted a research about the effects of the Customs Union on Turkish trade by using static analysis and found that the Customs Union increased Turkey's total trade volume and there was no increase in Turkey's trade deficit in the first 6 years (TUSIAD, 2003). ATO (Ankara Chamber of Commerce) researched the effects of the Customs Union and found that Turkey reached a 99,8 billion dollars of trade deficit with EU countries from January 1996 to 2006.

Güney examined effects of the Customs Union on Turkey's foreign trade by using Balassa index based on data of export to EU by sector between 1994 and 2003 and he found that while there was a moderate decrease in the competitiveness of textile-clothing and agriculture sectors which were the traditional export products, there was increase in the competitiveness of iron and steel, machineries, electrical and electronic products and motor vehicles and their parts (Güney, 2004).

Malkoç examined the trade between EU and Turkey by using GL index. He calculated GL indexes by sectors for the periods respectively 1990-1995 and 1996-2001. He found that there was increase in GL index except food, agricultural raw materials and chemicals in 1996-2000 period relative to 1990-1995 period. He reached that there was intra-industry trade between EU and Turkey in nearly every sub-branch of manufacturing industry (Malkoç, 2002). Kaya measured specialization level of Turkey in export within EU-15 by using Balassa index based on data between 1991/1996-2003 and found that Turkey specialized more in export of labour intensive products which don't need excessive technological investment in manufacturing industry. Turkey sustained its comparative advantage in textile, clothing and accessories, industries which have low value-added manufacturing goods such as iron and steels, manufactures of metals (Kaya, 2006). Temiz examined the effects of the Customs Union on Turkish net export by an empiric model between 1992 and 2007 and she found that there was an increase in trade volume, a decrease in net export after the Customs Union (Temiz, 2009:115)

3. Data And Method

3.1. Data

We used the annual data of foreign trade statistics during the period 1995-2011 to investigate the effects of Customs Union on Turkish foreign trade. The foreign trade statistics were taken from the database of the Turkish Statistical Institute.

3.2. Method

We firstly conducted a static analysis of trade between Turkey and EU by using descriptive analysis and then analyzed the comparative advantages between

Turkey and EU by using Balassa index. Although it is not possible to measure comparative advantages empirically, Revealed Comparative Advantage (RCA) is commonly used in studies in order to determine strong and weak sectors of any country. RCA, also called Balassa index (BI), measures comparative advantage but doesn't reveal any result about the resources on the basis of comparative advantage. There are a lot of methods of calculating RCA index in the literature. Balassa (1965) index which is the first and the most common of these methods is as follows:

$$BI_{[cst/w]} = \frac{\frac{X_{cS}}{X_{cS}}}{\frac{X_{wS}}{X_{wS}}} = \frac{X_{cS}}{X_{wS}} \quad (1)$$

'c' represents a particular country, 'w' represents world economy or a group country in the analysis, 's' represents a particular sector, 'S' represents all sectors of the economy, 't' shows a time period. So X_{cS} is export of Turkey in a particular sector, on the other hand X_{cS} is total export of Turkey. X_{wS} is export of world or a group of countries in a particular sector, X_{wS} is total export of world or a group of countries. Consequently BI compares the share of a sector in national export with share of the same sector in world export. If BI is greater than 1, the country in question has revealed comparative advantage in that sector or product class. Revealed comparative advantage is high to some extent BI is greater than 1. If BI is equal to 1, that country has the same comparative advantage as world or a group of countries have.

4. Empirical Application and Findings

4.1. Static Analysis of Trade Between Turkey and EU

EU has a substantial place in Turkish foreign trade. Nearly half of Turkish foreign trade is made with EU countries. Share of EU in trade volume, total export and total import respectively was about 52.72%, 56.42% and 50.48% as seen in Table 1, in other words Turkey is making more than 50% of foreign trade with EU countries before the Customs Union. It was not seen any significant increase in export of Turkey to EU countries following the Customs Union, share of EU-27 in total export of Turkey stayed above 50% until 2007, and then it has begun to decrease gradually to 37.70% due to successive financial crises including global financial crisis and Eurozone sovereign debt crisis. The share of non-EU countries in Turkish export has increased due to preferential agreements at the same period. No significant increases in export to EU-27 by Turkey are mostly arisen from while Turkey gained the right of duty-free access to EU markets for manufactured goods unilaterally in 1971, EU countries gained the same right in 1996. In other words establishment of the Customs Union didn't bring a new advantage in nominal tariff rates to Turkish exporters. Although removal of quotas on textiles seemed advantageous, EU economies in recession and Far Eastern countries' gaining advantages in textiles prevented Turkey from increasing export of

textile and textile products to EU. Moreover contraction of foreign markets by negative effects of global and regional financial crises also contributed to the not to increase export of Turkey to EU-27.

The share of EU-27 in total import of Turkey stayed above 50% until 2004, and then it has decreased to 36.66% due to global financial crisis and Eurozone sovereign debt crisis. The ratio of export to import decreased to 51% at the first two years of the Customs Union, then it has began to increase gradually and it is going about 68%. On the other hand the fact that Turkey's trade volume with EU-27 between 1995-2011 increased approximately 4 fold which is a sign of trade integration and also indicates that trade creation effect emerged after the Customs Union. Trade creation effect of the Customs Union is on behalf of the EU. This is mostly arisen from differences in the competitiveness of Turkish and EU economies.

Table 1. Turkey's Foreign Trade With EU-27

Year	Trade Volume with EU-27 (000 \$)	Share of EU-27 in Trade Volume of Turkey (%)	Share of EU-27 in Total Export of Turkey (%)	Share of EU-27 in Total Import of Turkey (%)	Ratio of Export to Import for EU-27
1991	18,459,265	53.29	57.26	50.72	0.73
1992	19,991,187	53.19	57.61	50.34	0.74
1993	23,185,884	51.78	53.91	50.68	0.55
1994	21,032,633	50.83	51.86	50.04	0.81
1995	30,231,328	52.72	56.42	50.48	0.68
1996	36,883,984	55.17	54.10	55.75	0.52
1997	39,553,686	52.87	51.16	53.79	0.51
1998	40,091,497	55.00	54.90	55.06	0.59
1999	37,954,176	56.43	58.01	55.40	0.68
2000	44,191,323	53.71	56.40	52.34	0.55
2001	37,369,024	51.38	55.99	47.88	0.89
2002	46,103,867	52.62	56.62	49.83	0.79
2003	62,533,901	53.63	57.97	50.68	0.78
2004	84,676,530	52.69	57.91	49.31	0.76
2005	94,060,755	49.44	56.30	45.13	0.78
2006	107,321,776	47.68	56.04	42.55	0.81
2007	128,793,371	46.44	56.30	40.22	0.88
2008	137,798,198	41.26	48.01	36.84	0.85
2009	103,522,333	42.59	46.03	40.10	0.83
2010	124,865,010	41.70	46.26	38.90	0.73
2011	153,475,882	40.85	46.22	37.84	0.68
2012	146,645,497	37.70	38.83	36.97	0.68
2013	155,107,274	38.44	41.39	36.66	0.68

Source: (TURKSTAT, 2013)

On the other hand the share of Turkey in import of EU-27 is 2.7% (the 7th country) and the share of Turkey in export of EU-27 is 4.7% (the 5th country) as of 2012 as seen in Table 2. Consequently Turkey and EU are each other's major trade partners.

Table 2. Extra-EU27 trade by Turkey

Year	Import from Turkey		Export to Turkey	
	(million of ECU/EURO)	%	(million of ECU/EURO)	%
2000	18,740	1.9	31,902	3.8
2001	22,085	2.3	21,869	2.5
2002	24,591	2.6	26,624	3.0
2003	27,257	2.9	30,852	3.5
2004	32,733	3.2	40,126	4.2
2005	36,027	3.0	44,564	4.2
2006	41,709	3.1	49,967	4.3
2007	47,050	3.3	52,781	4.2
2008	45,963	2.9	54,415	4.1
2009	36,228	2.9	44,385	4.0
2010	42,397	2.8	61,747	4.5
2011	48,143	2.8	73,096	4.7
2012	47,836	2.7	75,201	4.5

Source: (EUROSTAT, 2014)

The share of EU in total trade deficit of Turkey increased above 50% in the first years of the Customs Union, and then it has decreased gradually since 2000 and it is going between 25% and 35%. While the ratio of total export to total import is generally going about 60%, the ratio of export to import of Turkey in trade with EU is generally going above 70% as seen in Table 3. This is a sign of increasing competitiveness of Turkey against EU-27 countries. Moreover the share of EU in increasing trade deficits of Turkey has decreased relatively. Trade deficits are mostly arisen from import of oil and energy based raw materials from non-EU countries and especially increasing oil and natural gas prices. In other words import of Turkey with non-EU countries has increased more than export of Turkey with these countries.

Table 3. Trade Balance Between Turkey and EU-27

Year	Trade Balance with EU-27 (000 \$)	General Trade Balance (000 \$)	Share of Trade Balance with EU-27 in General Trade Balance (%)	Ratio of Total Export to Total Import	Ratio of Export to Import for trade with EU-27
1991	-2,891,570	-7,453,552	38.79	0.65	0.73
1992	-3,037,380	-8,156,426	37.24	0.64	0.74
1993	-6,641,014	-14,083,303	47.16	0.52	0.55
1994	-2,254,513	-5,164,147	43.66	0.78	0.81

Year	Trade Balance with EU-27 (000 \$)	General Trade Balance (000 \$)	Share of Trade Balance with EU-27 in General Trade Balance (%)	Ratio of Total Export to Total Import	Ratio of Export to Import for trade with EU-27
1995	-5,817,826	-14,071,970	41.34	0.61	0.68
1996	-11,757,294	-20,402,178	57.63	0.53	0.52
1997	-12,684,208	-22,297,649	56.89	0.54	0.51
1998	-10,472,911	-18,947,440	55.27	0.59	0.59
1999	-7,105,700	-14,084,047	50.45	0.65	0.68
2000	-12,862,481	-26,727,914	48.12	0.51	0.55
2001	-2,277,890	-10,064,867	22.63	0.76	0.89
2002	-5,273,800	-15,494,708	34.04	0.70	0.79
2003	-7,746,377	-22,086,856	35.07	0.68	0.78
2004	-11,514,812	-34,372,613	33.50	0.65	0.76
2005	-11,330,831	-43,297,743	26.17	0.63	0.78
2006	-11,452,284	-54,041,498	21.19	0.61	0.81
2007	-7,996,368	-62,790,965	12.73	0.63	0.88
2008	-11,017,360	-69,936,378	15.75	0.65	0.85
2009	-9,495,503	-38,785,809	24.48	0.72	0.83
2010	-19,494,401	-71,661,113	27.20	0.61	0.73
2011	-28,781,000	-105,934,807	27.17	0.56	0.68
2012	-28,249,894	-84,083,404	33.60	0.64	0.68
2013	-29,400,003	-99,782,010	29.46	0.60	0.68

Source: (TURKSTAT, 2014)

Negative production effect or trade diversion effect is shift production from the countries outside customs union which have optimum production to member countries of customs union. We can see the development of Turkish foreign trade with EU-27 and non-EU countries in Table 4. Turkey's trade volume with non-EU countries has increased as trade volume with EU-27 following the Customs Union. This demonstrates that there has been no trade diversion effect in favour of EU during the Customs Union. Most of Turkey's import consists of capital goods and intermediate goods. While Turkey imports major capital goods from EU which includes developed countries, Turkey imports major energy sources such as oil, natural gas from Middle East, North Africa and Russia. Because EU countries aren't rich in terms of energy resources, they can't be competitor against countries such as Middle East, North Africa and Russia. These countries which are rich in terms of energy resources also cannot be competitor against EU countries because they have not had advanced technologies. Therefore it is normal that there is no trade diversion effect.

Table 4. Turkey's Foreign Trade with EU-27 and Non-EU Countries (000 dollars)

Year	Export		Import	
	EU-27	Non-EU Countries	EU-27	Non-EU Countries
1991	7,783,847	5,809,615	10,675,418	10,371,596
1992	8,476,903	6,237,726	11,514,284	11,356,771
1993	8,272,435	7,072,632	14,913,449	14,514,921
1994	9,389,060	8,716,812	11,643,573	11,626,446
1995	12,206,751	9,430,290	18,024,577	17,684,434

Year	Export		Import	
	EU-27	Non-EU Countries	EU-27	Non-EU Countries
1996	12,563,345	10,661,120	24,320,639	19,306,004
1997	13,434,739	12,826,333	26,118,947	22,439,774
1998	14,809,293	12,164,658	25,282,204	20,639,188
1999	15,424,238	11,162,987	22,529,938	18,141,334
2000	15,664,421	12,110,485	28,526,902	25,975,919
2001	17,545,567	13,788,650	19,823,457	21,575,626
2002	20,415,034	15,644,055	25,688,833	25,864,964
2003	27,393,762	19,859,074	35,140,139	34,199,553
2004	36,580,859	26,586,294	48,095,671	49,444,095
2005	41,364,962	32,111,446	52,695,793	64,078,358
2006	47,934,746	37,599,930	59,387,030	80,189,144
2007	60,398,502	46,873,248	68,394,869	101,667,845
2008	63,390,419	68,636,777	74,407,779	127,555,795
2009	47,013,415	55,129,198	56,508,918	84,419,503
2010	52,685,304	61,197,915	72,179,705	113,364,627
2011	62,347,441	72,559,428	91,128,441	149,713,235
2012	59,197,802	93,263,935	87,447,696	149,097,445
2013	62,853,636	89,014,915	92,253,638	159,396,922

Source: (TURKSTAT, 2014)

4.2. Analysis of Comparative Advantages Between Turkey And EU

We calculated the RCA indexes of Turkey relative to EU-27 in terms of SITC¹ Rev.3 by using Balassa index and found that Turkey has lost its comparative advantage on 17 product classes relatively including live animals; fish, aqua. invertebrates, prepared, preserved, n.e.s.; non-alcoholic beverages, n.e.s.; tobacco, manufactured; worn clothing and other worn textile articles; aluminium ores and concentrates; animals oils and fats; manufactures of leather, n.e.s.; saddlery & harness; copper and trailers & semi-trailers.

On the other hand we found that Turkey has increased its comparative advantage on 50 product classes relatively including birds' eggs, and eggs' yolks; egg albumin; fish, fresh (live or dead), chilled or frozen; rice; wool and other animal hair (incl. wool tops); nickel ores & concentrates; tubes, pipes and hoses of plastics; pottery; wire of iron or steel; aluminium; manufactures of base metal, n.e.s.; vapour generating boilers, auxiliary plant; parts; tractors; textile & leather machinery, & parts thereof, n.e.s.; motor vehicles for the transport of persons; jewellery & articles of precious materia., n.e.s. and gold, non-monetary (excluding gold ores and concentrates) and have sustained its comparative advantage on 188 product classes relatively.

¹ **Standard International Trade Classification(SITC):** S0 Food and live animals, S1 Beverages and tobacco, S2 Crude materials, inedible, except fuels, S3 Mineral fuels, lubricants and related materials, S4 Animal and vegetable oils, fats and waxes, S5 Chemicals and related prod, n.e.s., S6 Manufactured goods classified chiefly by material, S7 Machinery and transport equipment, S8 Miscellaneous manufactured articles, S9 Commodities and transactions n.c.e (EC, 2013).

5. Conclusion

EU, which is one of the largest economies in the world, stand out in Turkey's economic and trade relations due to Turkey's geographic location. Turkey is also an important market for EU in terms of its population potential, young population and consumption preferences. So EU and Turkey are one of the major trade partners of each other and they have established customs union as of 1995 as a part of Turkey's EU membership process.

Trade creation effect has been seen in the trade between EU and Turkey and also no trade diversion effect has been seen in trade between Turkey and non-EU countries following the establishment of the Customs Union. On the other hand while trade deficit of Turkey has continued to increase, the share of EU in increasing trade deficits has decreased relatively. These trade deficits are mostly arisen from import of oil and energy based raw materials from non-EU countries and especially increasing oil and natural gas prices.

Turkey has lost its comparative advantage on 17 product classes, and increased its comparative advantage on 50 product classes and sustained its comparative advantage on 188 product classes relative to EU between 1996 and 2011. While Turkey has lost its comparative advantage in livestock sector and some agricultural and textile products, Turkey has increased its comparative advantage in labor-intensive manufacturing industrial products (such as manufactures of base metal, vapour generating boilers, auxiliary plant; parts; tractors; textile & leather machinery, & parts thereof, motor vehicles for the transport of persons etc.) and sustained its comparative advantage in major textile and agricultural products.

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