

Strengthening EU-Turkey Economic Relations

The customs union and services

By

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Summary

- Potential and possible consequences of extending free trade between the EU and Turkey to *services*, in a wider sense
- Importance of services in overall Turkish exports has been declining over the last decade.
- Turkish exports mostly services related to *tourism* and *transport*:
 - Tourism faces few trade barriers.
 - Leaves transport as the focus of services trade liberalisation, but at least road transport operates under strong political economy constraints (new EU MS).
- Turkey does not seem to possess a strong potential for exports of other, higher value added services.
- Services are also linked to FDI, in markets as well as in the design of FTAs and to free movement of persons.
- We find FDI quite liberally treated, unlike the movement of persons. Much can be improved on the latter, in particular for visa's

Motivation I

- Turkish-EU relations are currently at an impasse due to political frictions.
- Value of the existing trade arrangements between the EU and Turkey based on a bilateral *Customs Union* agreement dating from the mid-1990s
- At first the idea was to have a parallel track of pre-accession but after some initial though slow progress, track is no longer moving for political reasons.
- Before the recent political difficulties the question had arisen whether the existing arrangements could be improved
 - Extending free trade and mutual market access to services.
- Services trade still encounters high barriers but has a large weight in the economy: large economic gains expected.

Motivation II

- Examine the **existing barriers to trade in services** in both the EU and Turkey, (comparing options to deepen the bilateral exchange with the arrangements foreseen in the Canadian EU FTA and the DCFTA with Ukraine)
- ... examine the nature of the services exported by Turkey, evaluate the likely potential for exports of high value added services by looking at the level of education of the work force.
- Preliminary conclusion: extending the *Customs Union* to services might *not* have the large effect on trade and production of services.
- Number of recent contributions emphasise the *asymmetry* in the customs union that arises when the EU concludes a *free trade agreement (FTA)* with a third country without ensuring that these countries grant Turkey the same market access as does the EU.

Motivation III

*Table 1:
Overview of the current EU-Turkey Bilateral Preferential Trade Framework.*

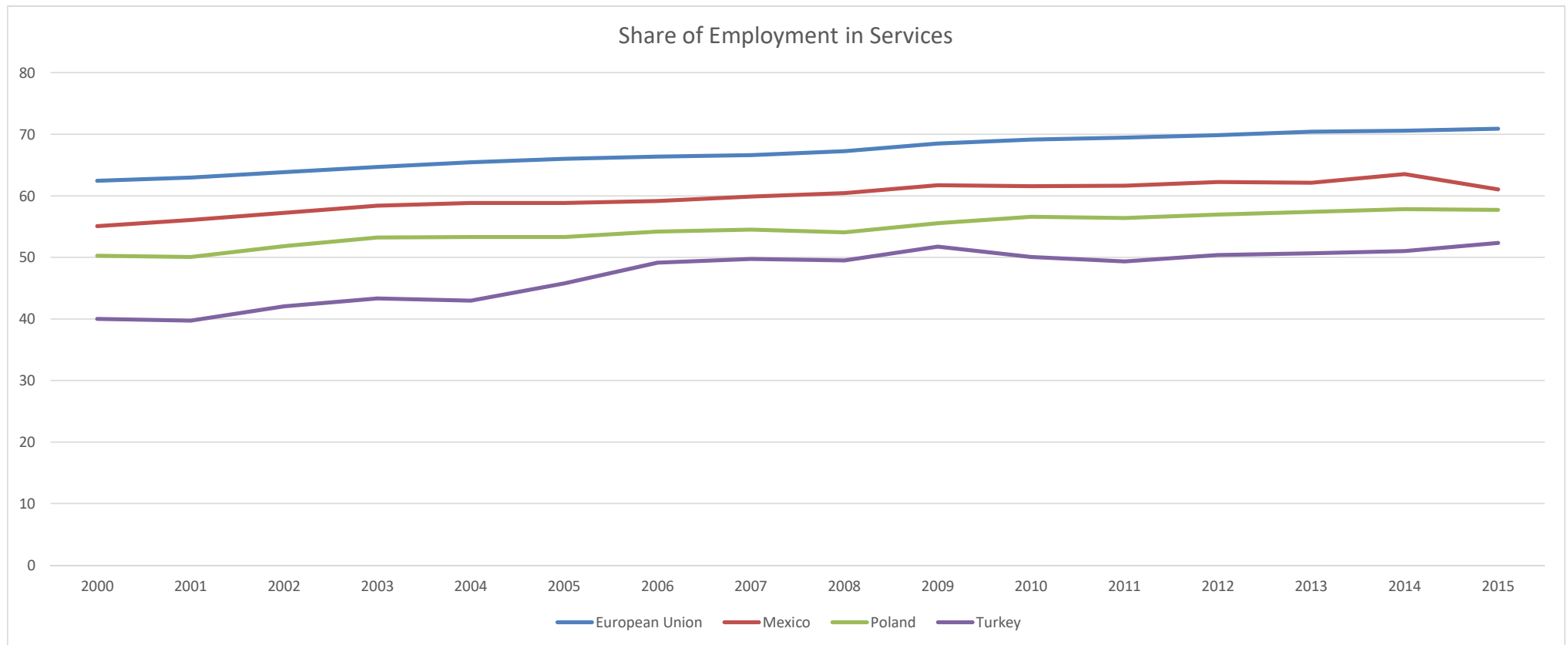
Trade in goods:	
- Industrial goods	1995 Customs Union Decision (CU) – customs union for all industrial goods (except coal and steel); including processed agricultural products (except their agricultural element); <u>free circulation of goods</u> (by use of A.TR certificate)
- Agricultural and fishery goods	1998 bilateral preferential concessions – <u>partial coverage</u> , notably as regards Turkey's liberalisation towards the EU, which is more limited than the EU liberalisation towards Turkey
- Coal and steel products	1996 FTA – full coverage of such products; but FTA, not customs union
Customs	Common customs code and legislation (CU)
Non-tariff barriers	Technical barriers to trade: Turkey has to align to EU technical legislation (CU) Sanitary and phytosanitary measures: not covered
Trade defence measures	Possible to impose anti-dumping measures against each other if justified; Bilateral safeguards also possible (CU)
Trade in services; Establishment	<u>Not covered</u> (except for a standstill clause in the 1970 Additional Protocol)
Investment	Not covered (bilateral investment treaties between Turkey and 26 EU Member States)
Intellectual property rights	Turkey has to align its legislation to the EU acquis, including enforcement (CU)
Public procurement	Not covered
Regulatory cooperation	Legislation related to the CU: Turkey's obligation to align to EU law Other legislation: <u>not covered</u> ; however, as candidate country, under pre-accession Turkey has politically committed to align to EU acquis in all areas including economic chapters, social rights, environment etc.
Rules (Trade and sustainable development, Trade in energy and raw materials, SMEs, Transparency, etc.)	<u>Not covered</u> ; however, in several areas there is strong cooperation between the EU and Turkey in the frameworks of both the CU and the accession process

Why focus on services? I

- *Services* are important as a driver of growth and the sector provides key inputs for the overall economy and thus also for trade in goods.
 - Extension of the BPFT (bilateral preferential trade framework) to services would help to **foster bilateral trade in services** and would lead to an **opening of this sector**, spurring competition and productivity.
- Share of services in economy wide value added (GDP) is now around 60 %, but services seem relatively less important in Turkey in terms of employment.

Why focus on services? II

Figure 1: Share of Employment in Services.



Why focus on services? III

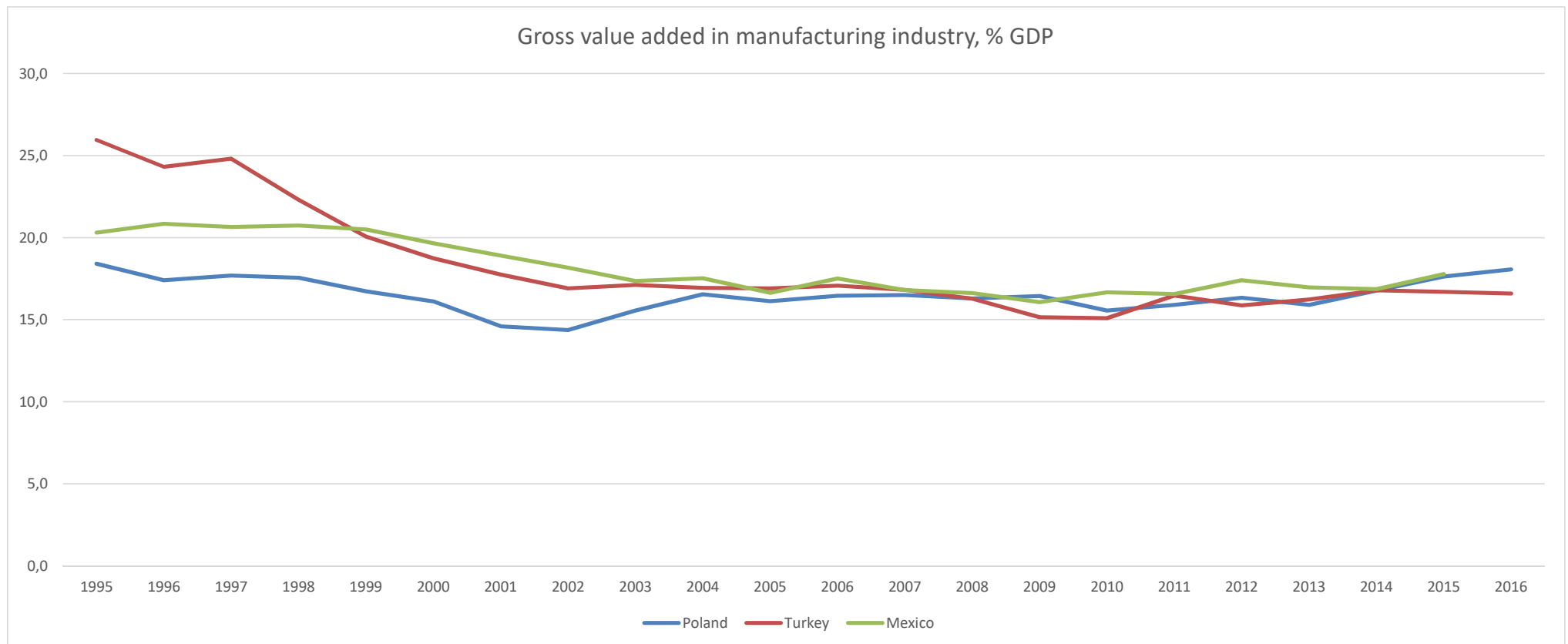
- **Reducing the regulatory restrictiveness** of service sectors provides **incentives** for new firms to enter and for old and new firms to lower the costs of such services and invest in a greater variety and higher quality of supplied services.
- Service sector liberalization has secondary effects on other industries.
- Gains from service-intensive sectors (according to world bank calculations) that would be realised as a results of liberalisation of professional services could be as high as 0.75 percent or \$ 1.1 bn in economic welfare.

Why focus on services? IV

- Moreover, the work of the (“Trade in value-added” (TIVA) database, OECD) has shown that trade in manufacturing goods also contains **indirectly a large proportion of services value added**.
- The **composition** of the services value added embodied in manufacturing exports was **different from other countries** (concentration on low value added services).
- A more competitive **services** sector could thus represent a competitive advantage for trade in **goods** as well.

Why focus on services? V

Figure 2: Gross value added in the manufacturing industry.

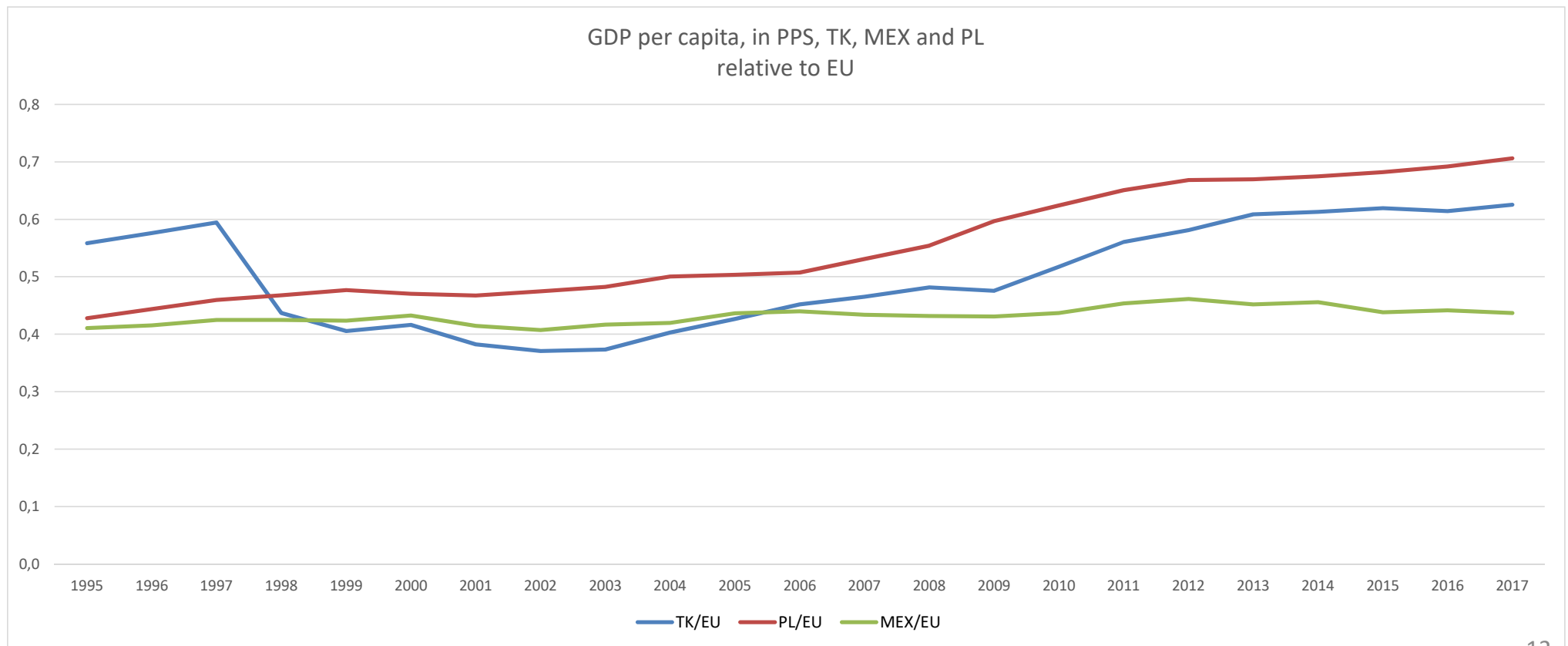


Macroeconomic background I

- Aim of the Customs Union had been to foster growth in Turkey by opening up the economy
 - Difficult to judge whether this has been the case because macroeconomic developments in Turkey have been so variable.
- Customs Union started economic boom, followed by a deep financial crisis.
- Since stabilisation of the early 2000s: decade of solid growth, levelled off over the last few years.
- In the long run Turkey has performed little better than Mexico, which entered NAFTA at about the same time the Customs Union was concluded; experience of Poland, which joined the EU (in 2004) is better than that of Turkey. (Figure 3)

Macroeconomic background II

Figure 3: GDP per capita in purchasing power standard for Turkey, Mexico and Poland.



2. Broad patterns in EU-TK trade over the last 20 years

- Trade in *industrial goods* has become more important over the last two decades; **services trade has expanded less than goods trade** and Turkey's exports concentrated in sectors related to tourism.
- Regarding *exports*, there has been a shift away from developed markets (OECD), but exports expanded mainly towards MENA.
- Agreement that trade integration between the EU and Turkey has progressed significantly in the last two decades
 - EU's exports to Turkey and Turkey's exports to the EU were 9.1% and 6.5% higher than they would have been without the BPTF.

Broad patterns in EU-TK trade over the last 20 years II

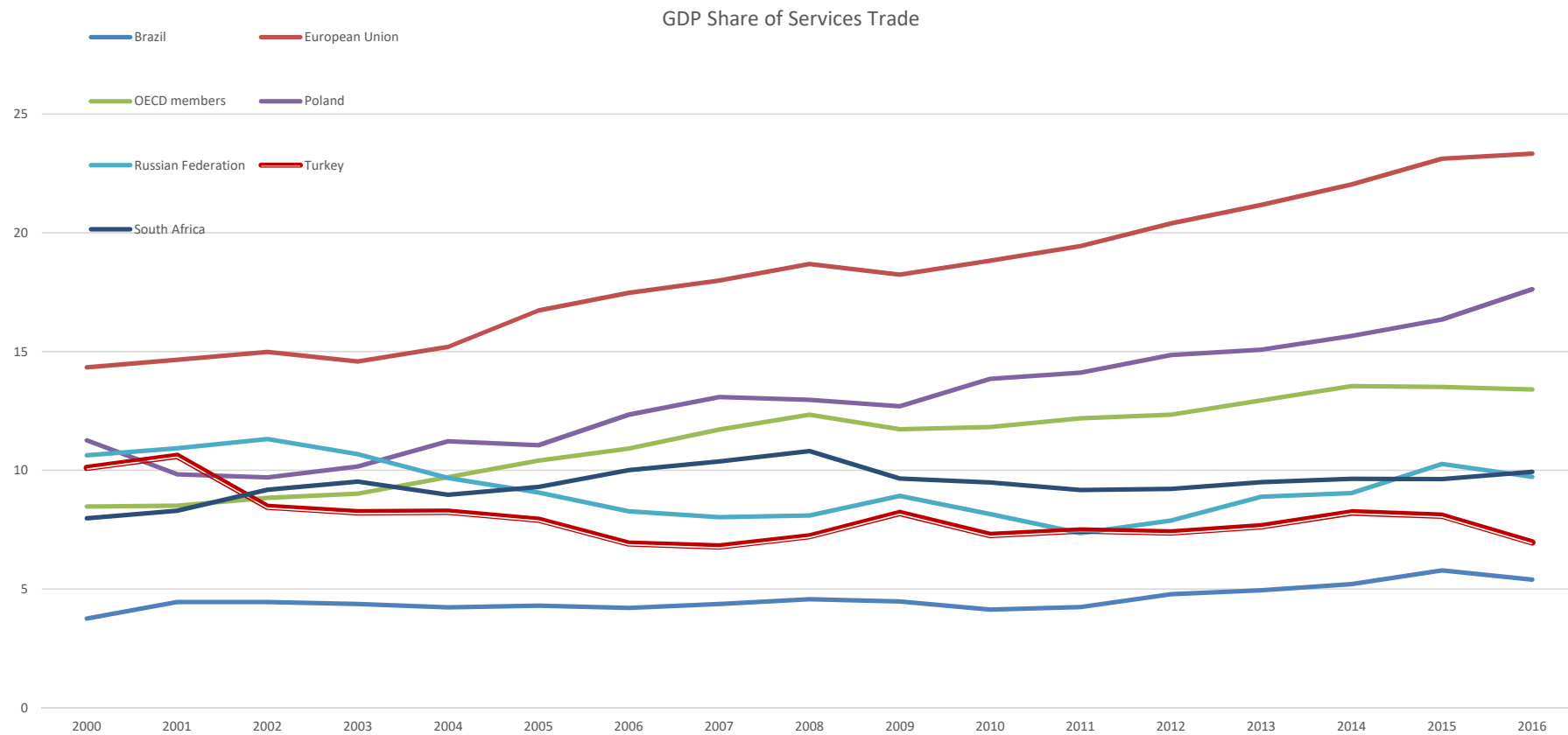
- Purpose of a customs union is not necessarily to foster only bilateral trade, possibly at the expense of trade with third countries.
- If trade between the two partners were to expand at the expense of trade with third countries the customs union would be said to cause 'trade diversion', which does not bring economic gains.
- However, **trade diversion does not seem to have happened since Turkey's overall trade has expanded rapidly.**
- The declining share of the EU in Turkey's overall exports is often cited as an indication of the limited impact of the BPTF, ...
- ... but the share of the EU in Turkey's trade has actually fallen less than that of other OECD countries, such as the US (although the US market has grown somewhat more than that of the EU) = Another indirect **confirmation of the impact** of the existing arrangements on bilateral trade.

2.1 Services in EU-TK trade I

- Considerably shift away from services to manufacturing exports (Table 2).
- Ratio of services trade to GDP has declined since 2000 and remains well below that of EU members and the OECD average (Figure 4).
 - Finding runs counter to the general tendency of an increase in the relative importance of services in the economy and in trade flows.
- The data on the **shares of manufacturing and services in the domestic value added** (DVA) contained in Turkish exports show that the Turkish industry has since 2000 become **increasingly integrated** in the **global**, or rather the **European, value added chain** (Table 2).
- For Turkey the **share of domestic value added** in gross exports of manufacturing has fallen, but it remains higher than for Poland, Morocco or Mexico (Figure 5).
 - Turkey seems still less integrated in international value chains than these comparators.

Services in EU-TK trade II

Figure 4: Trade in services as a share of GDP.



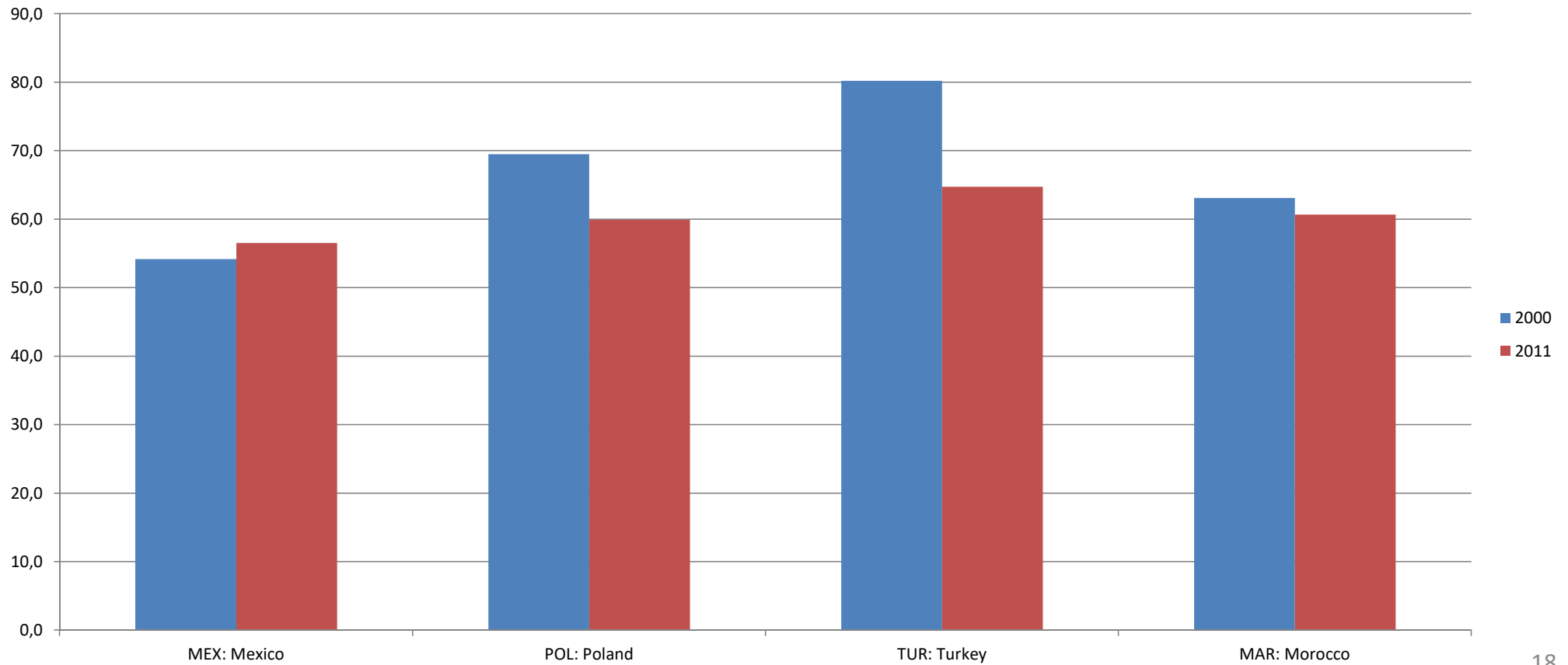
Services in EU-TK trade III

Table 2: Manufacturing vs services in Turkish exports.

		Total manufactures	Total business sector services
Shares in total gross trade	Change between 2011 and 2000	20	-17
	Share in 2011	63	30
Shares in domestic value added	Change between 2011 and 2000	15	-13
	Share in 2011	56	37

Services in EU-TK trade IV

Figure 5: Integration in value added chains: the share of domestic value added content in gross exports.



2.2 A closer look at the services sector

Table 3: Sectoral export shares within the services sector.

	C50T74: Total Business Sector Services	C50T74: Total Business Sector Services					
		Wholesale and retail trade; Hotels and restaurant s	C50T55: Wholesale and retail trade; Hotels and restaurants		C60T64: Transport and storage, post and telecommunicatio n	C65T67: Financial intermediation	C70T74: Real estate, renting and business activities
			C50T52: Wholesale and retail trade; repairs	C55: Hotels and restaurants			
Change in share 2011- 2000	-13	-6	-3	-3	-6	-2	1
Share in 2011	37	18	12	7	14	1	19 3

A closer look at the services sector

Figure - Sectoral structure of Turkish exports

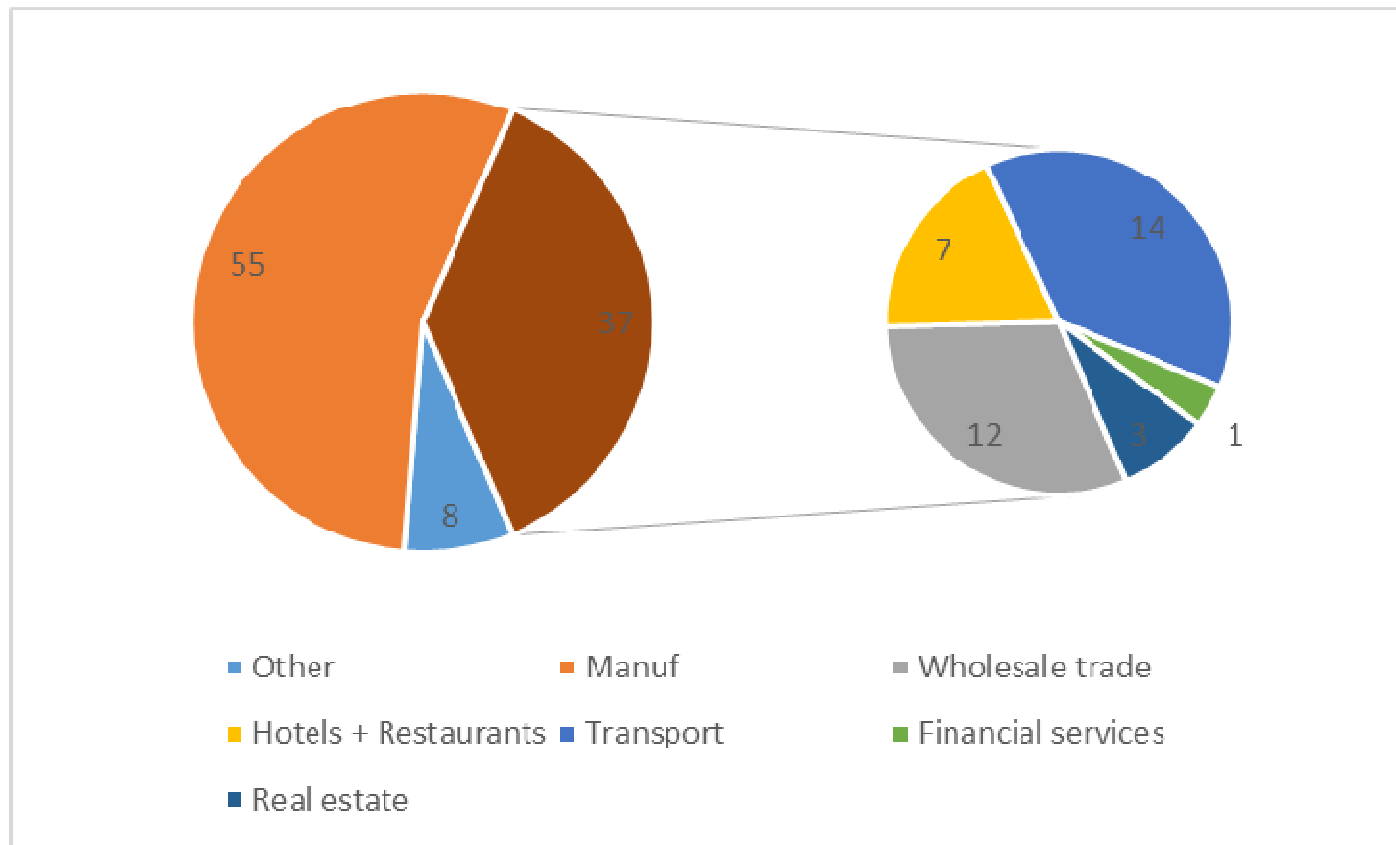
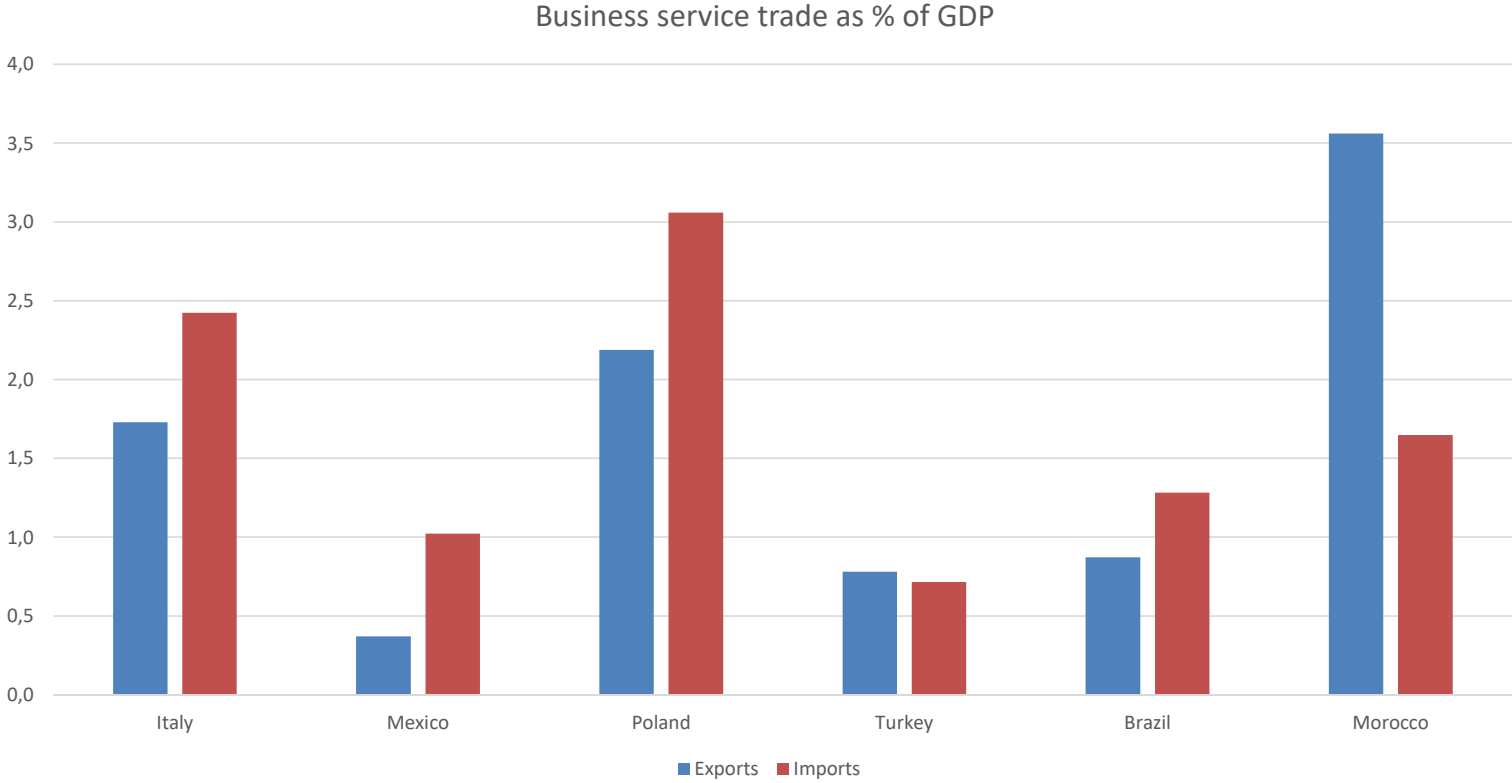


Figure 6: Business service trade



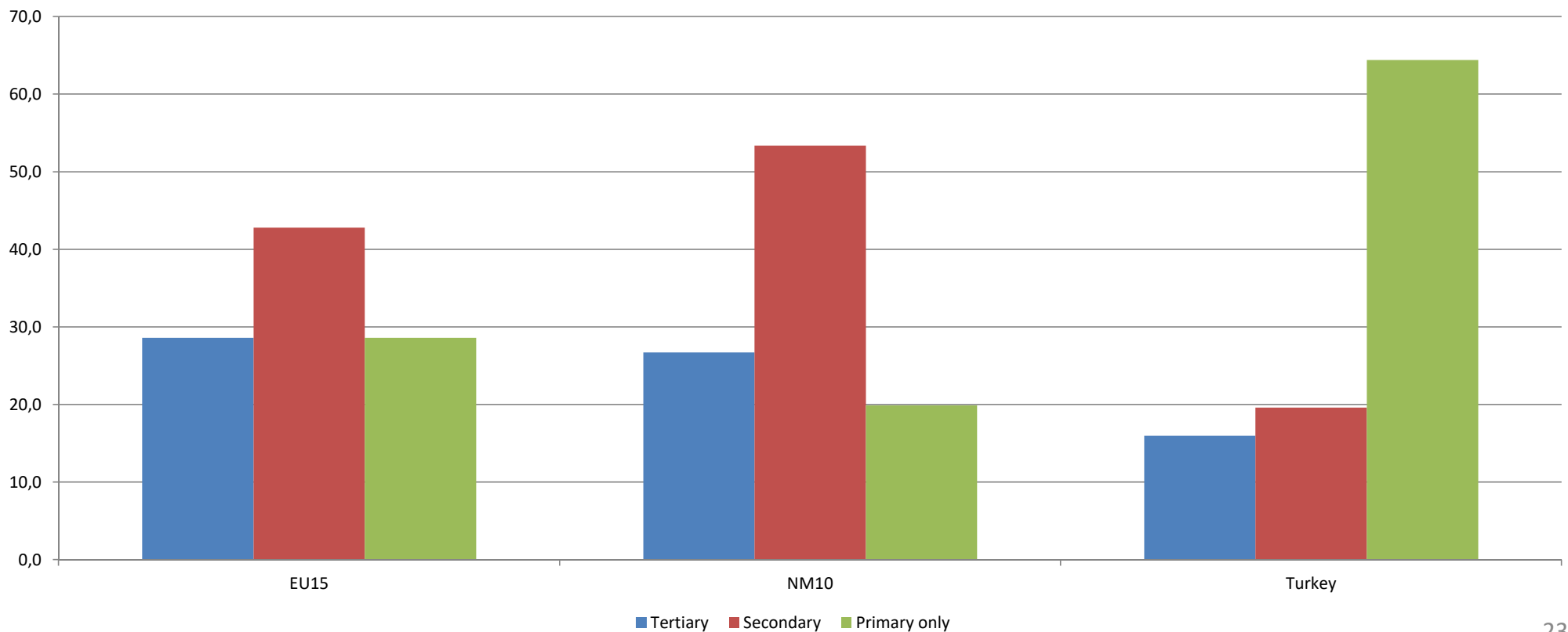
Source: OECD, TIVA database

A closer look at the services sector III

- Figure 6 shows the importance of business services exports and imports **relative to GDP**.
- It is apparent that trade in business services is **much less important for Turkey** (for exports and imports, separately, between 0.5 to 1 % of GDP) **than for peers**, like Brazil, Morocco and Poland.
- For a more developed economy, like Italy, trade in these services amount to close to 2 % (less for exports, more for imports).
- Only Mexico shows an even lower importance of business services exports to GDP than Turkey.

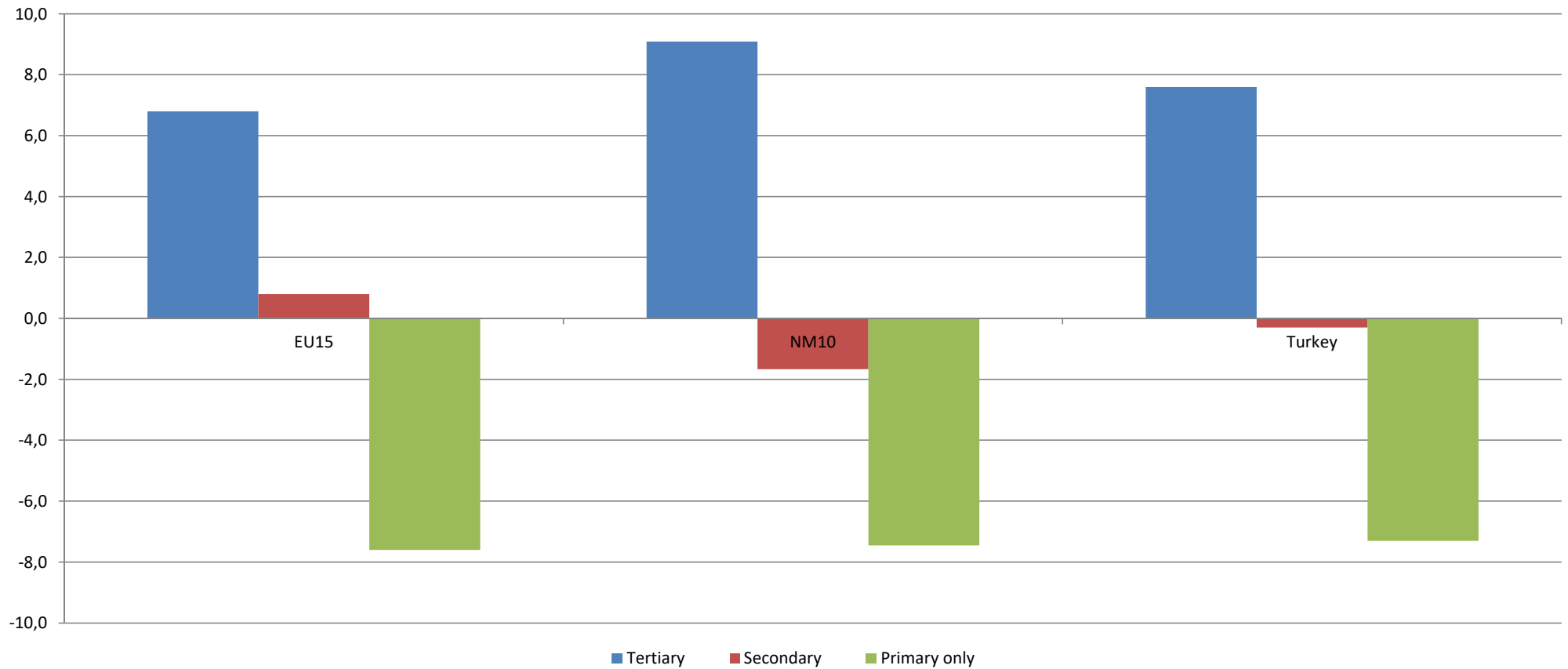
2.3 Services and skills: Can Turkey become an exporter of high value added services? I

Figure 7: Shares of working age population by skill class.



Services and skills: Can Turkey become an exporter of high value added services? II

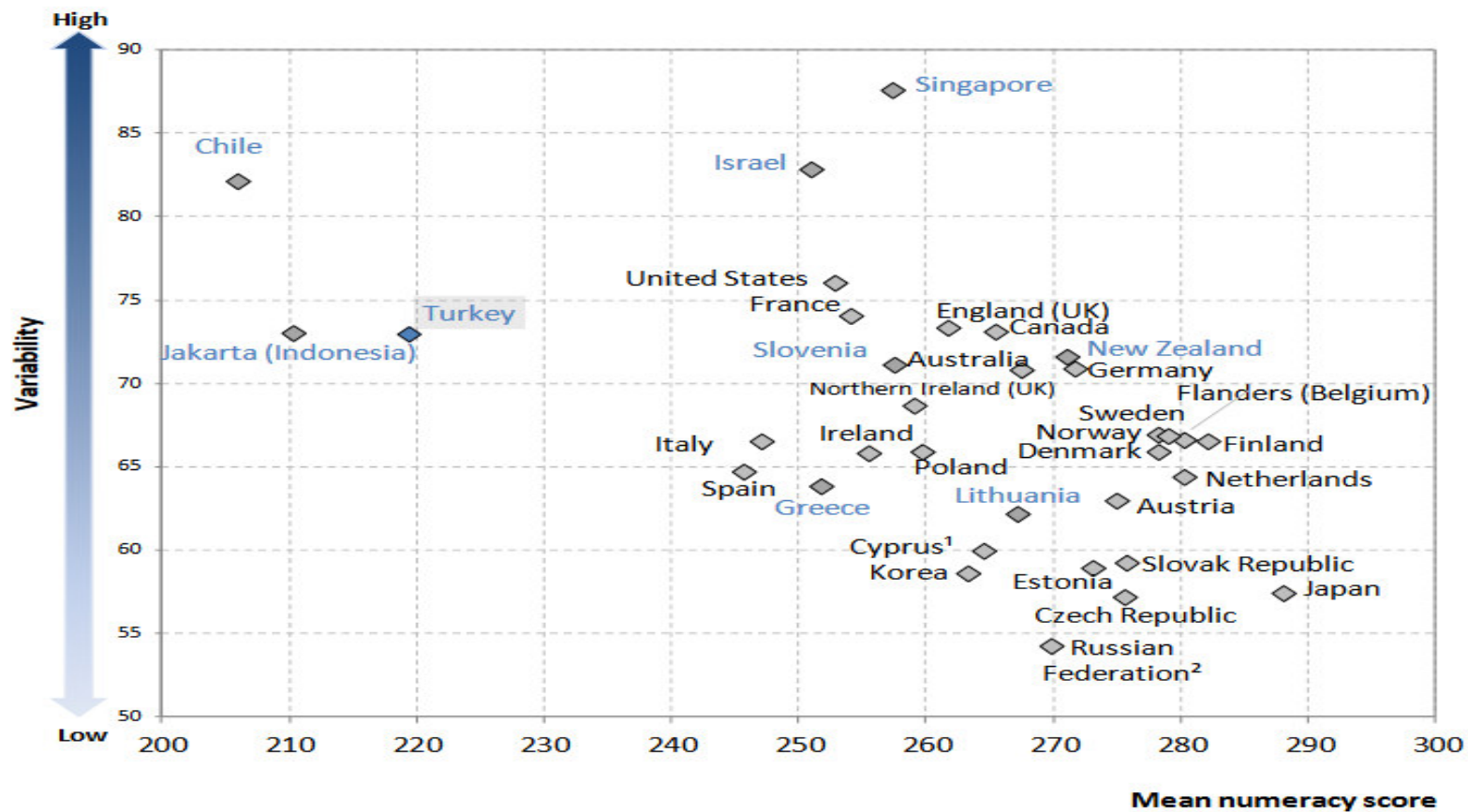
Figure 8: Change 2016-2006, in the shares of working age population by skill class.



Services and skills: Can Turkey become an exporter of high value added services? III

Figure 9:

Figure 4 Average and distribution of numeracy scores
Relationship between mean numeracy proficiency score and variability



3. Services in the EU/Turkey customs union: What can be done?

- Some background to the framework conditions for services trade
- Could start by summarising how the recently concluded free trade agreement between the EU and Canada (CETA) and the Ukraine DCFTA deal with services, thereby getting some idea of how an arrangement with Turkey could look like. (Not done today!)
- Overview on how restrictive Turkey is concerning the provision of services (regulation), or indeed concerning trade in services, by means of **STRI (services trade restrictiveness indices)** of the OECD.
- It contains a comparison at the sectoral level and with some [4] core EU countries.

3. Services in the EU/Turkey customs union: What can be done?

- Measuring restrictiveness in services is difficult and remains always somewhat subjective.
- There is also a 'STRI' from the World Bank which differs from that of the OECD but the latter alone should be sufficient to obtain some first idea of what that would service liberalisation would imply for Turkey (and, maybe, for the EU).
- This section also provides some initial thoughts on **what regulatory restrictiveness will have to be overcome in order to extend the BPFT to services.**
- Finally, it provides a short overview of Turkey's investment climate e.g. by employing the OECD's FDI regulatory restrictiveness index. FDI is often linked to services and this is also justified in the case of Turkey.

3.1 The 'how': Options for an extension to services

- EU-Turkish trade **in services** is governed by the respective commitments **under the GATS** annexes
 - Fairly restrictive set of conditions as multilateral concessions have typically remained modest and highly selective.
- *4 options:*
 - Purely sector-based approach
 - Approach governed by a commonly agreed framework but littered with exceptions and restrictive applications and/or subject to further elaboration
 - Approach used in CETA, the most advanced FTA-plus-plus in the world
 - Approach of the DCFTA with e.g. Ukraine.

Services in CETA I

Table 4: Services: Liberalisation and regulation in CETA.

Mode 1, GATS	<p>Cross-border trade in services</p> <p>Negative listing</p> <p>Reservations of both Parties in Annex 1 (existing restrictions, with ratchet when liberalised) and Annex 2 (restrictions, with freedom to regulate/revise later)</p> <p>Annex 1 and 2 in chapter 35, CETA</p> <p>Understanding national treatment (intra-Canada trade)</p>
Mode 3, GATS	<p>Investment</p> <p>Negative listing</p> <p>Reservations of both Parties in Annex 1 and 2 [in ch. 35] as for cross-border services [see above]</p> <p>Annexes and Declarations</p>
Mode 4, GATS	<p>Temporary entry</p> <p>Liberal specifications for temporary entry of 6 categories of business persons</p> <p>annexes and appendices, App. B EU MS specific reservations</p> <p>mutual recognition of professional qualifications</p> <p>Annex with Guidelines on how to negotiate such (private) MRAs</p>
Sectoral chapters	<p>Financial services</p> <p>Annex (with reservations like Annex 1 and 2 in ch. 35) but only for financial services</p> <p>Guidance on prudential carve-out</p> <p>Maritime services</p> <p>Telecoms services</p> <p>Electronic commerce</p>
Other chapters	<p>Domestic regulation (e.g. on predictability and licensing)</p> <p>Transparency</p> <p>Annex 1 and 2, reservations on services & investment</p> <p>(from negative listing) by Canada, EU and EU MS, belonging to chapters 10 and 11</p>

Services in CETA II

- CETA is ambitious in services and investment.
- To better appreciate how services and investment liberalisation and remaining regulation are dealt with in CETA, Table 4 provides a stylised overview. (“Negative listing”, exceptions from liberalisation)
- If Turkey would adopt or accept a CETA-type approach, it would almost certainly go far beyond its GATS commitments.
- One would have to reflect on what sectors would fall under the general market access clause and what not.
- If Turkey is interested in pro-competitive market reforms, the services agreement with the EU would be a forceful mechanism.

The DCFTA with Ukraine

- DCFTA is surprisingly similar to CETA in structure and details, except for two important features
 - It is assumed that the final obligations and rights in the DCFTA will only be attained after a lengthy transition period.
 - An ‘integration into the EU internal market’ is envisaged, after successful harmonisation and proper implementation.
- If Turkey were keen to enjoy a deep and comprehensive services agreement with the EU, this would be possible.
- EU should do what it does (better) in goods: link more firmly the external trade-in-services approach with the internal-EU services market.

3.2 How promising?

What restrictiveness would have to be addressed? I

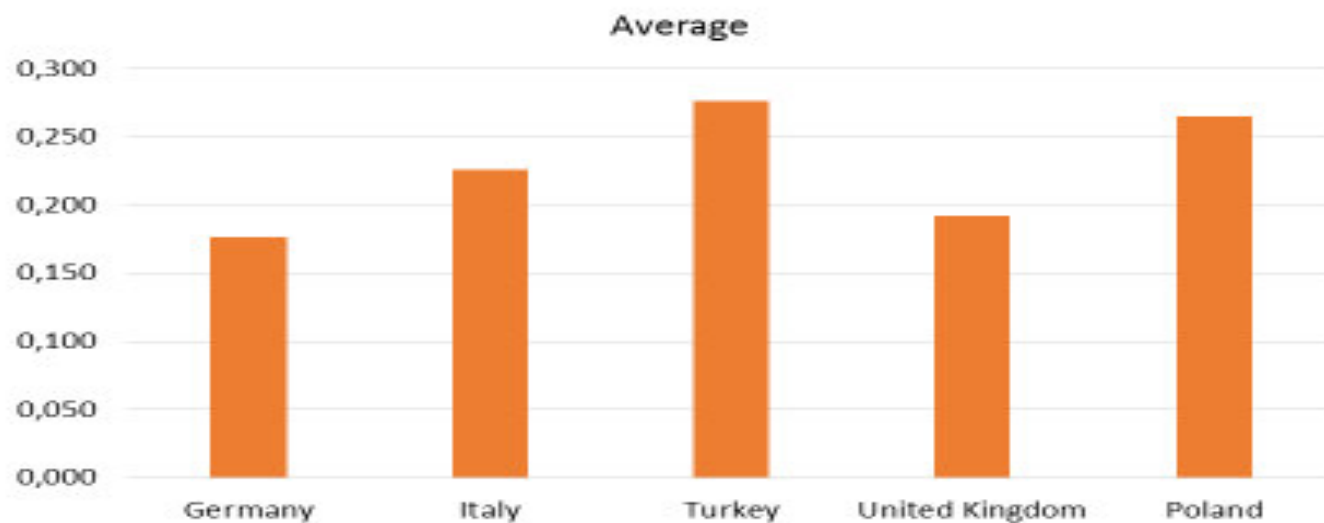
Table 5: Turkey's STRIs compared to four EU countries (OECD), 2016.

Sector	Germany	Italy	Turkey	United Kingdom	Poland
Engineering	0.204	0.160	0.147	0.217	0.432
Logistics cargo-handling	0.153	0.228	0.303	0.169	0.180
Rail freight transport	0.191	0.222	0.197	0.179	0.218
Maritime transport	0.176	0.264	0.176	0.199	0.202
Logistics storage and warehouse	0.141	0.207	0.232	0.158	0.147
Logistics freight forwarding	0.142	0.204	0.204	0.148	0.163
Logistics customs brokerage	0.143	0.214	0.218	0.161	0.161
Accounting	0.213	0.290	1.000	0.316	0.234
Architecture	0.203	0.236	0.173	0.264	0.439
Legal	0.243	0.199	0.475	0.170	1.000
Motion pictures	0.173	0.248	0.170	0.200	0.196
Broadcasting	0.191	0.279	0.381	0.181	0.347
Sound recording	0.154	0.268	0.163	0.137	0.150
Telecom	0.158	0.159	0.243	0.178	0.192
Air transport	0.385	0.386	0.508	0.382	0.416
Road freight transport	0.187	0.218	0.190	0.187	0.190
Courier	0.130	0.226	0.444	0.187	0.189
Distribution	0.106	0.166	0.113	0.129	0.147
Commercial banking	0.152	0.172	0.197	0.170	0.245
Insurance	0.131	0.209	0.173	0.149	0.180
Computer	0.170	0.216	0.180	0.182	0.187
Construction	0.130	0.203	0.186	0.168	0.214
Average	0.176	0.226	0.276	0.192	0.265

How promising?

What restrictiveness would have to be addressed? II

Figure 10: Services trade restrictiveness indices compared (OECD).



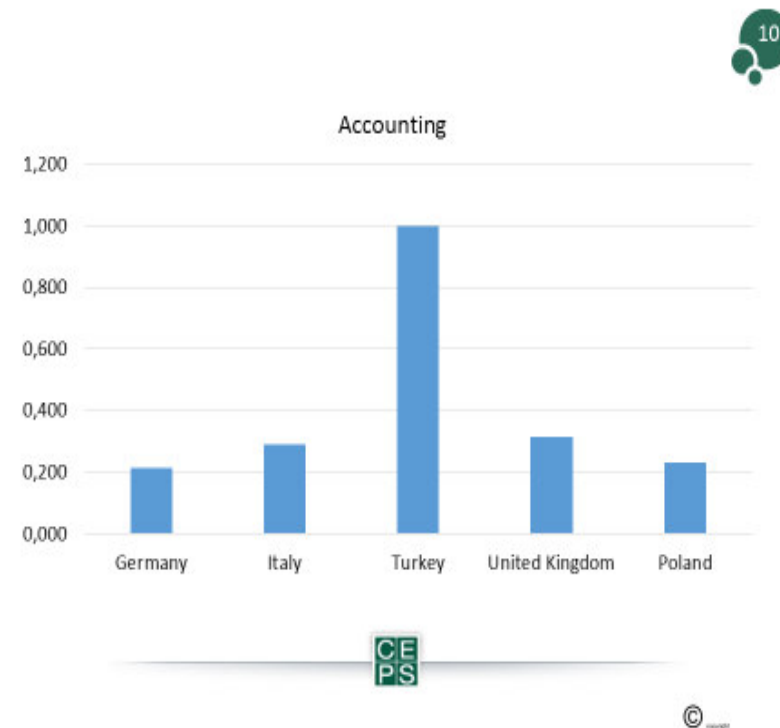
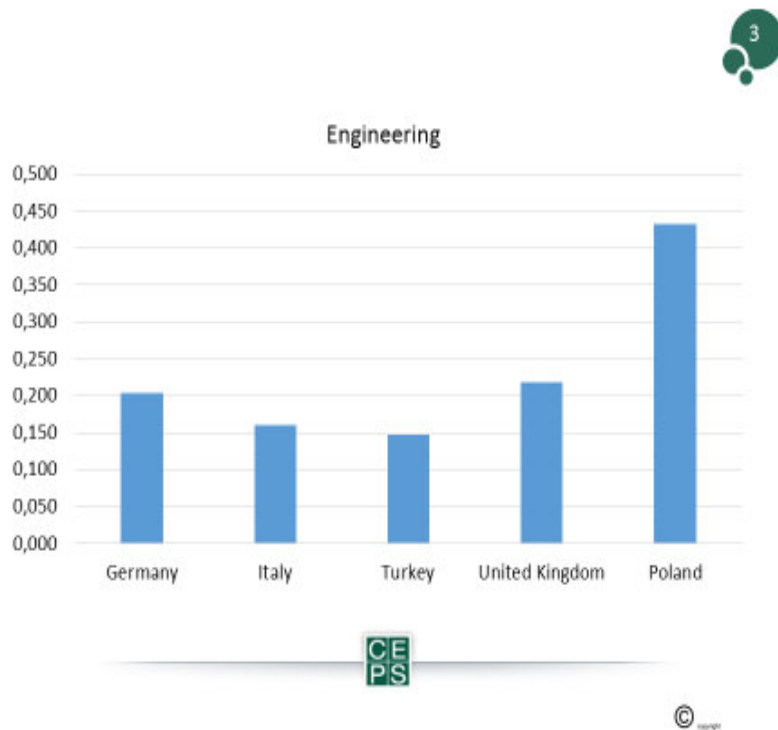
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How promising?

What restrictiveness would have to be addressed? III

Figure 11: STRI in different sectors (OECD).

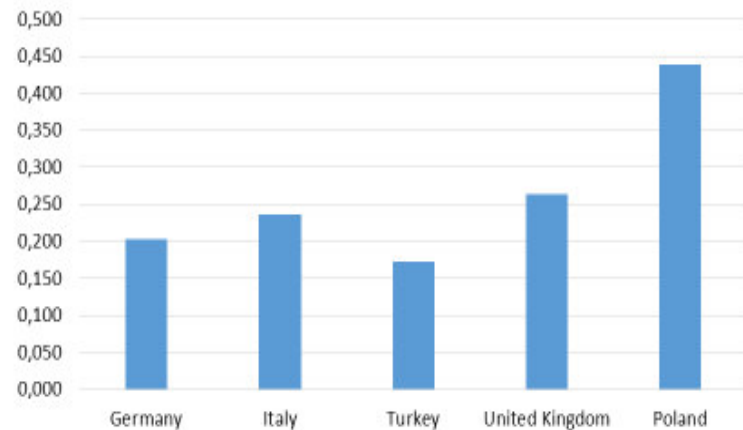


How promising?

What restrictiveness would have to be addressed? III

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Architecture

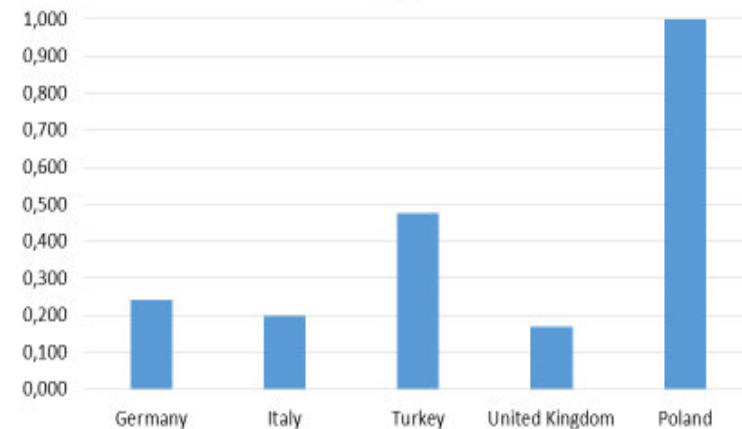


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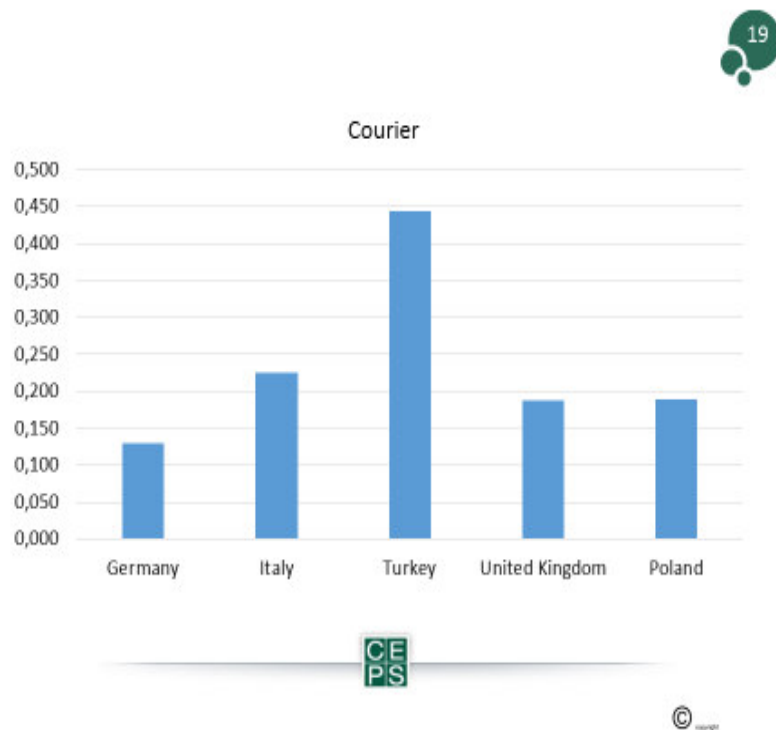


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How promising?

What restrictiveness would have to be addressed? III



- Difficult to quantify (cross-border) barriers to services trade
 - Two key terms here are AVEs and STRIs.
- On average, Turkey has the highest STRI followed by Poland and Italy (OECD)
 - Question is whether this overall STRI is a strong and reliable indicator of how difficult, but perhaps also how desirable, the extension to services might be for Turkey.
- Turkey is the most restrictive country in eight sectors; in four sectors, Turkey has the lowest STRIs.

3.3 Foreign direct investment climate in Turkey

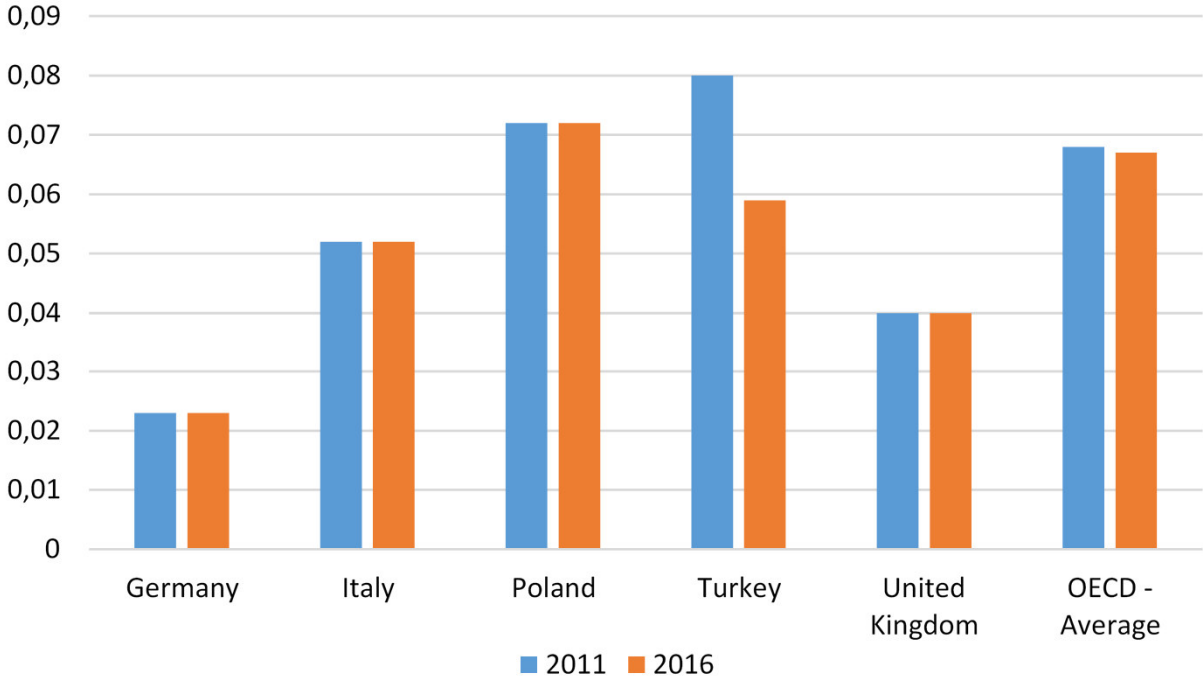
- FDI proven important for Turkey for stimulus to its productivity growth but just as much for trade/FDI nexus, including via value chains.
- World Bank (2014, pp. 5–7) only reports FDI inflows into Turkey (but no detail before 2007) and no stocks. Commission reports a 2014 EU FDI stock in Turkey of € 64.9 bn which is considerable.
- Trend has been that EU has invested nearly $\frac{3}{4}$ of inward FDI into Turkey.
- However, World Bank (op. cit.) holds that the inflows of FDI into Turkey are relatively low compared to other dynamic emerging economies.
- They ascribe this performance to hindrances such as concerns over the judiciary, inadequate skills of the workforce, relatively high wage levels and macro-economic stability.
- On the other hand, **Turkey's location is a favourable factor, and its young workforce and improving infrastructure are positive elements as well.**

Foreign direct investment climate in Turkey II

- Turkish investment climate can be expressed by referring to the OECD FDI Regulatory restrictiveness index (with 19 sectors and numerous measures included).
- Figure 7 shows that Turkey is relatively liberal for inward FDI and has further improved when comparing 2011 with 2016.
- Note that the OECD average is higher than that of Turkey (in 2016); the EU average is lower however.
- Compared to emerging economies such as Brazil or China, Turkey performs far better (e.g. China has 0.42 for 2011 ; 0.33 for 2016).

Foreign direct investment climate in Turkey III

Figure 1 Turkey's FDI Regulatory Restrictiveness Index, change 2011-2016



Source: OECD FDI Regulatory Restrictiveness Index

4. Obstacles to the free movement of people and services trade potential in the BPTF

- Establishment of the free movement of goods through the CU constituted one important step of Turkey towards becoming a full-fledged member of the EU; other freedoms would be gradually achieved
 - More than two decades after its official agreement the free movement of goods has been guaranteed by the CU; however, **other freedoms have not seen the parallel progress.**
- While the CU does not provide visa-free travel for Turkish nationals, since both the EU and Turkey are part of the GATS agreement, certain international commitments pertinent to the movement of natural persons would apply in services trade.

4.1 EU Visa restrictions for Turkish nationals I

- Turkey is the **only candidate country without a visa-free regime** with the EU.
- Turkish business people and economic operators **need to travel frequently** to EU.
- Because of visa requirements imposed on Turkish nationals, most of the business related activities involving travelling to the EU are hampered, which in turn **increases the costs** or even renders some of the **business activities impossible**.
 - But existence of visas has not impeded travel from Turkey to the EU.
- Visa restrictions to business people in destination countries create significant distraction to business and can even result in cancelling all relationship.
- **Visa restrictions are asymmetric**. Most EU nationals do not need a visa, or can obtain one cheaply and quickly at the airport. Turkey being a major tourist destination had of course a long standing interest in minimising visa formalities for tourists.

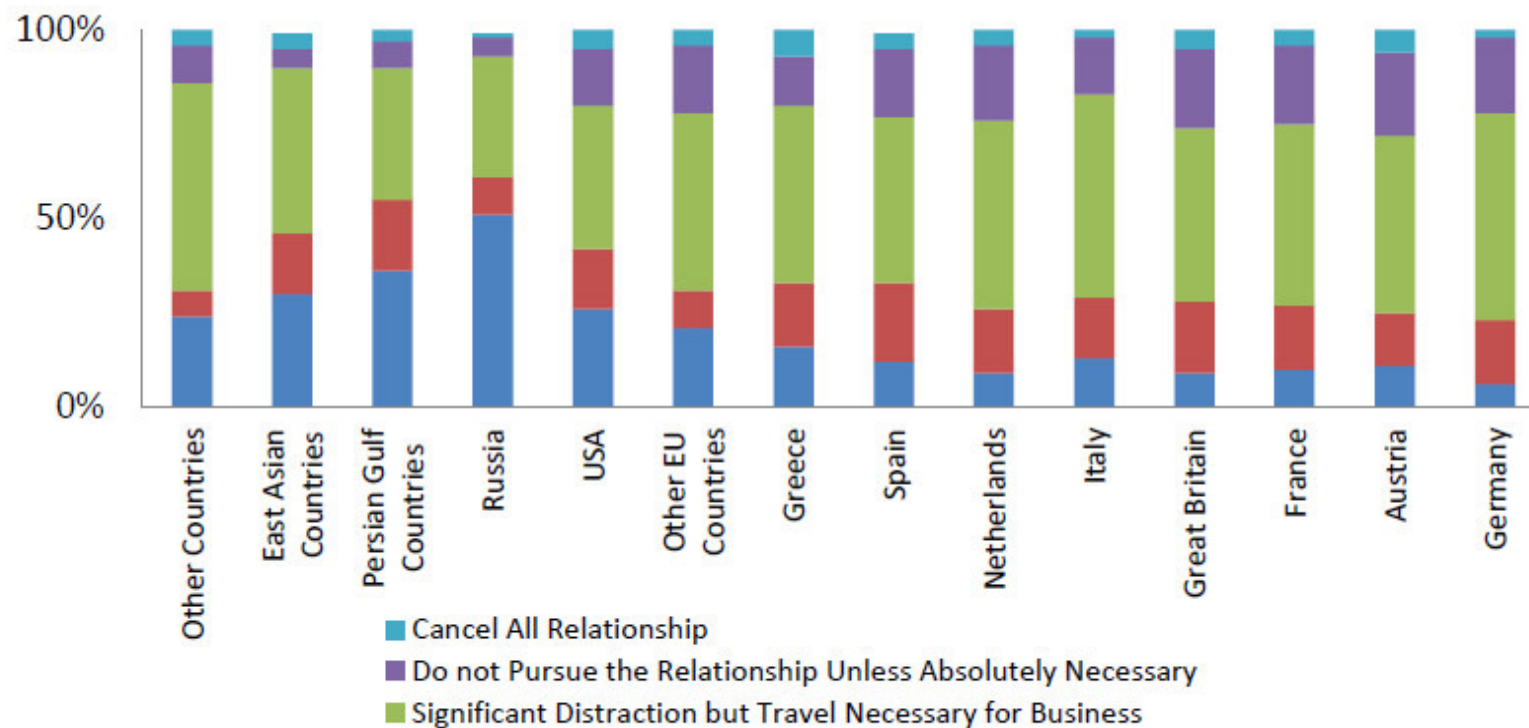
EU Visa restrictions for Turkish nationals II

Table 6: Schengen visa statistics: Turkey compared to other large countries.

	Uniform visas applied for	Total uniform visas issued (including MEV)	Multiple entry uniform visas (MEVs) issued 1)			Not issued rate for uniform visas	Share of MEVs
Grand Total	15.2	13.9	8.2			6.9	58.7
Russian Federation	3.2	3.1	2.5			1.2	80.6
China	2.2	2.1	0.7			3.1	33.9
Ukraine	1.4	1.4	0.8			3.2	59.9
Turkey	0.9	0.9	0.7			4.4	75.8
Share of Turkey	6	6	8				42

EU Visa restrictions for Turkish nationals III

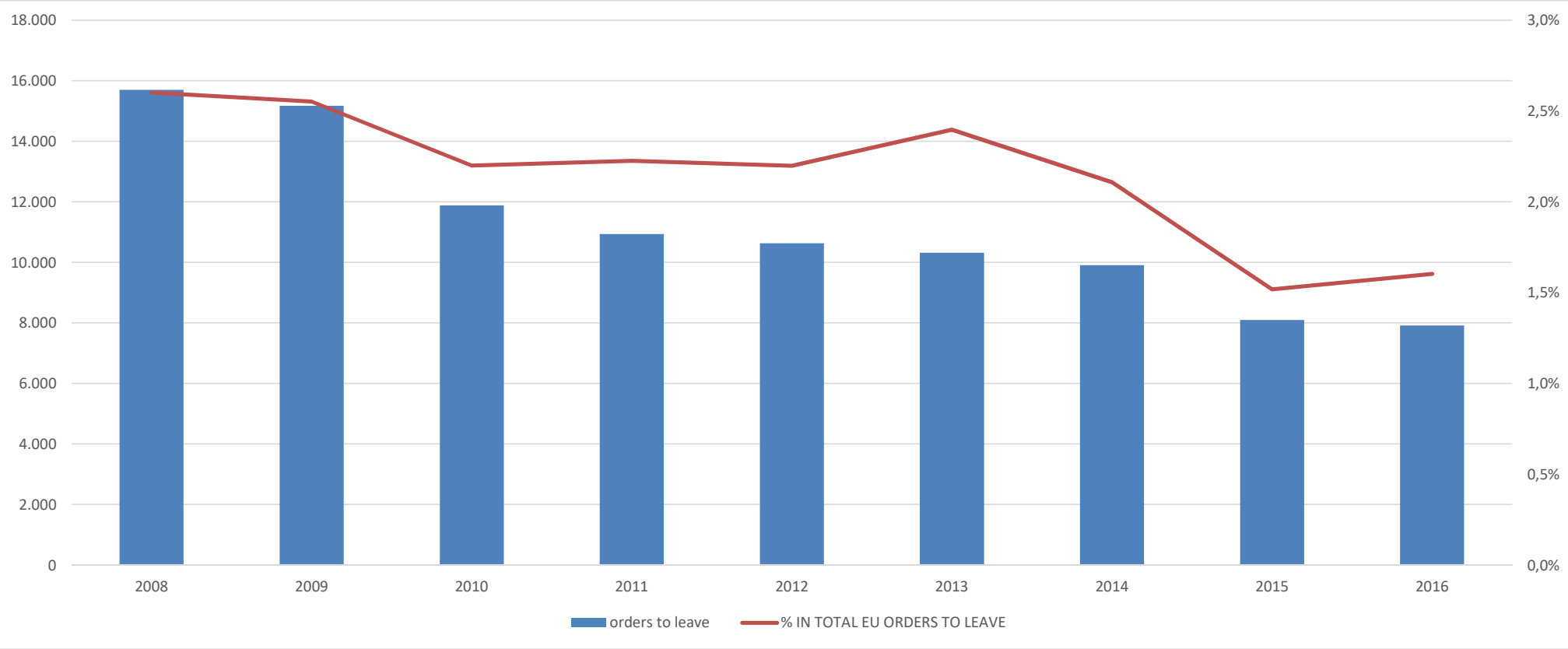
Figure 13: Impact of visa regulations on business activities for selected EU and non-EU countries.



Source: World Bank Survey on Visa Restrictions faced by Turkish Businesses.

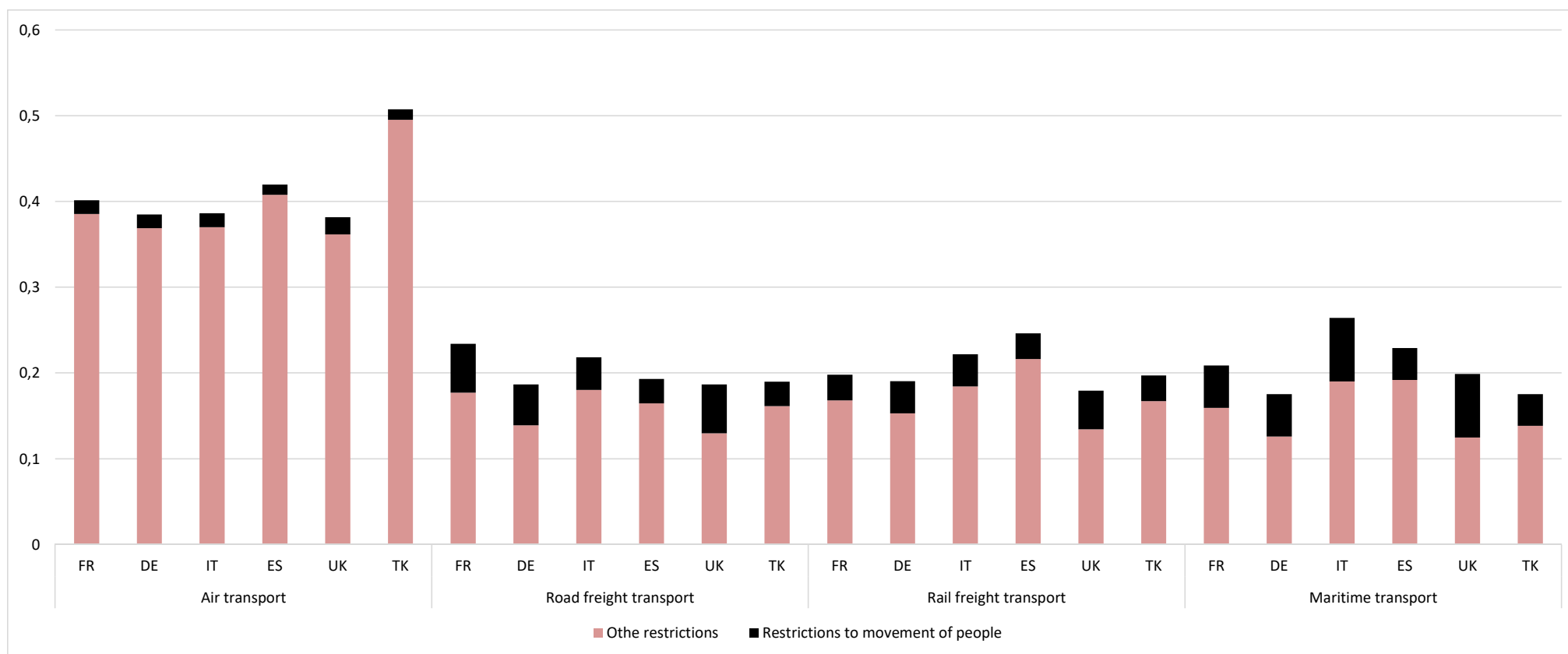
EU Visa restrictions for Turkish nationals IV

Figure 14: Ordered Leaves from Turkish origin.



4.2 Road transport: the key role of quotas I

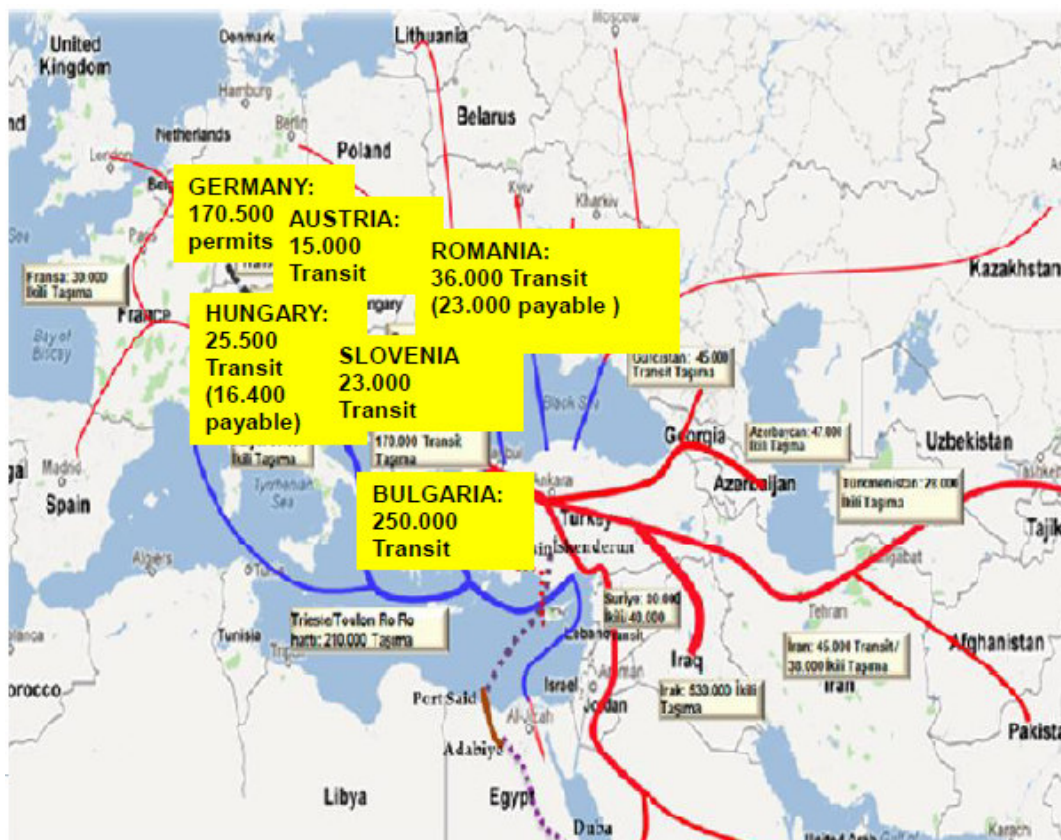
Figure 15: Restriction index in transportation sector.



Source: Authors' own elaboration based on OECD Services Trade Restrictiveness Index, 2016.

Road transport: the key role of quotas II

Figure 16: Transit permits in the EU for Turkish transporters.



Source: Figure taken from Kabak et al. (2015).

- Maritime transportation is the main transportation method for Turkish exports, while the road transportation follows the former closely.
- Movement of goods is also not completely free within the CU; this is particularly the case in road transport.
- Road transport quotas control the number of transit permits available for a truck to make a journey
 - Turkish exports to the EU are subject to technical barriers.
- Transport quotas in the form of transit permits vary by EU country, are generally not cheap and have been imposed to Turkey by 24 out of 27 EU Member States
 - Turkish authorities state that Turkey's annual export loss due to quotas imposed by the EU is at least \$7 billion.