

REFORMING AND RENEGOTIATING THE EU- TURKEY CUSTOMS UNION

The EU-Turkey Customs Union of 1995 has been economically beneficial for both parties, and its revamping could go a long way towards improving the relationship between Brussels and Ankara, despite the numerous obstacles present. In this article, the authors argue that in its current form, the Customs Union no longer meets the requirements of a 21st century trade agreement. Its modernization should include the signing of a free trade agreement covering agriculture, services, public procurement, investment protection, dispute settlement, and sustainable development. While difficult to achieve for Turkey, these are necessary steps if the country wants to remain a competitive player in the world economy and increase its exports and FDI inflows.

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The EU-Turkey Customs Union (CU) of 1995, which applies to industrial goods and the industrial components of processed agricultural products produced in the Community or Turkey, does not cover most of the chapters included in recent trade agreements concluded or under negotiation by the EU.¹ These chapters include but are not limited to: agriculture, services, government procurement, “food safety, animal and plant health” (SPS) measures, regulatory coherence, sustainable development, small and medium-sized enterprises, investment protection, and dispute settlement. Both the EU and Turkey are aware that the EU-Turkey CU no longer meets the requirements of trade relations in the 21st century. Consequently, both parties are interested in updating EU-Turkey trade and investment relations.

Recently, the World Bank and the European Commission have prepared comprehensive studies on the modernization of the EU-Turkey CU.² While the World Bank study emphasizes that opportunities for widening Turkey’s trade relationship with the EU should concentrate on liberalization of agriculture, services trade, and public procurement, the European Commission studies compare future options for the CU. The three options are: “no policy change,” “CU modernization and free trade agreement (FTA) in additional areas,” and “Deep and Comprehensive Free Trade Area.” The European Commission concludes that the preferred option is the modernization of the CU plus FTA covering services, public procurement, and further liberalization in agriculture.³

This article proposes that the EU-Turkey CU should be modernized and modified to take into account the various growing criticisms of the CU, and that economic integration between the EU and Turkey should be further strengthened by signing a complementary FTA between the EU and Turkey covering agriculture, SPS

¹ The chapters refer on the one hand to those in the EU-Canada Comprehensive Economic and Trade Agreement (CETA) that entered into force provisionally on September 21, 2017, and to those agreed upon during the Transatlantic Trade and Investment Partnership (TTIP) negotiations between the EU and US. The TTIP negotiations that started in July 2013 has recently been put in deep freeze by the Trump administration. Hence, they have yet to be concluded.

² World Bank, “Evaluation of the EU-Turkey Customs Union,” Report No. 85830-TR (Washington D.C.: The World Bank, 2014). Henceforth, the study will be referred as “World Bank, EU-Turkey Customs Union”; European Commission, “Study of the EU-Turkey Bilateral Preferential Trade Framework, including the Customs Union, and an Assessment of Its Possible Enhancement,” Final Report prepared by BKP Development Research & Consulting in consortium with Pantela and AESA, (Brussels: European Commission, 2016); and European Commission, “Recommendation for a Council Decision Authorizing the Opening of Negotiations with Turkey on an Agreement on the Extension of the Scope of the Bilateral Preferential Trade Relationship and on the Modernization of the Customs Union,” Commission Staff Working Document Impact Assessment, COM (2016) p. 830, (Brussels: European Commission, 2016). Henceforth, the two studies will be referred to as “European Commission, Modernization of the Customs Union.”

³ According to the European Commission, “CU modernization and FTA in additional areas” will increase economic welfare in the EU by EUR 5.4 billion and EU exports to Turkey by EUR 27.1 billion. For Turkey, real GDP will rise by EUR 12.5 billion and Turkish exports to the EU will grow by EUR 5.0 billion. Additionally, under the “no policy change” and “Deep and Comprehensive Free Trade Area” chapters no significant gains in overall welfare are expected in either the EU or Turkey.

measures, services, government procurement, investment, dispute settlement, and sustainable development.

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Reforming the EU-Turkey Customs Union

As Turkey was trying to implement the requirements of the EU-Turkey CU, major changes were taking place in the world economy. Since the mid-1980s developments in the telecom and internet industry triggered a series of information-management innovations that made coordinating complex production activities from a distance easier and cheaper. Due to the revolution in information and communications technology, production stages previously performed in close proximity were dispersed geographically. As a result of these developments, manufacturing today is increasingly managed through global value chains (GVC). The heart of GVC trade, according to Richard Baldwin, is an intertwining of trade in goods; international investment; and cross-border flow of know-how.⁴

Since multilateral trade negotiations conducted within the context of the World Trade Organization (WTO) have not dealt with the issues raised by the GVC trade, the US, EU, and Japan have decided to sign FTAs with deep provisions that are pro-GVC trade.⁵ They also signed Bilateral Investment Treaties tackling different investment issues. Since these agreements address issues that are not covered by the EU-Turkey CU mentioned above, both the EU and Turkey recognize that the 1995 CU decision is outmoded. In this article, we maintain that economic integration between the EU and Turkey should be strengthened by signing an FTA complementary to the CU, which covers (i) agriculture and SPS measures, (ii) services, (iii) public procurement, (iv) investment, (v) dispute settlement, and (vi) sustainable development.

Agriculture and SPS Measures

The EU *acquis* on agriculture covers numerous binding rules. In particular, the *acquis* on agriculture concerns the creation of management systems such as a payment

⁴ Richard Baldwin, “Global Supply Chains: Why they Emerged, Why they Matter, and Where they are Going,” DDeborah. K. Elms and Patrick Low eds. *Global Value Chains in a Changing World* (Geneva, World Trade Organization, 2013), pp. 13-59.

⁵ Deep integration is a term frequently used in the context of regional trade agreements where the focus is on integration processes which deal with “behind the border” barriers such as services, government procurement, investment, intellectual property protection, and competition policy. See Rober Z. Lawrence, *Regionalism, Multilateralism and Deeper Integration* (Brookings Institution Press, 1996).

agency, the Integrated Administration and Control System, and the capacity to implement rural development actions. Furthermore, the *acquis* requires the integration of a range of agricultural products, including arable crops, sugar, animal products and specialized crops into common market organizations. The Common Agricultural Policy (CAP) was reformed in 2013 and set out new rules for the CAP for the next seven-year period. On the other hand, the *acquis* on SPS measures consists of a very large number of regulations, directives, and decisions aimed at ensuring a high level of food safety, animal health, animal welfare and plant health within the EU through coherent farm-to-fork measures and adequate monitoring, while maintaining the effective functioning of the internal market. For the implementation of food safety legislation, each member state must have appropriate administrative structures to be able to carry out the inspection and control of food products along with suitable laboratory capacity. In the areas of veterinary and phytosanitary policy, EU legislation lays down rules for internal trade and imports from third-party countries in the veterinary, plant health, and animal nutrition sectors to safeguard public health, plant, and animal health along with animal welfare.

In agriculture, the challenge for Turkey is to achieve free movement of agricultural products between the EU and Turkey which requires full compliance with agricultural *acquis*. This will require Turkey to adjust its agricultural policy by adopting and implementing CAP measures and EU rules on SPS issues.⁶

Currently, agricultural producers in Turkey are protected from international competition by an array of import tariffs, export subsidies, and premium payments for specific crops. Turkey has one of the highest tariff rates of agricultural import protection among OECD countries and all of Turkey's agricultural tariffs are bound albeit at very high rates. In comparison to the EU, WTO statistics show that Turkey's agricultural import tariffs averaged 42.7 percent in 2015 compared to an average of 10.7 percent for the EU.⁷ Of course, Turkey is entitled to use export subsidies to support the trade of some of its agricultural products, including exports of them to the EU, since WTO commitments allow export subsidies on a number of product groups. However, regarding SPS measures, we note that Turkey adopted the "Production, Consumption and Inspection of Food" Law in 2004, the "Food" law in 2006, and the "Veterinary Services, Plant Health, Food and Feed" law in 2010. These three laws require all food processing firms to conform to EU food safety standards along with animal and plant health. It has been emphasized by various economists that public

⁶ See Commission of the European Communities, *Screening Report Turkey* on Chapter 11 "Agriculture and Rural Development," (Brussels; Commission of the European Communities, 2006); and Commission of the European Communities, *Screening Report Turkey* on Chapter 12 "Food Safety, Veterinary and Phytosanitary Policy," (Brussels: Commission of the European Communities, 2007).

⁷ World Trade Organization, *World Tariff Profiles* (Geneva: WTO, 2016).

standards have presented a lower hurdle to agricultural trade than private standards for high-valued agricultural goods.⁸

Turkish firms are aware of the legal and reputational repercussions of selling contaminated food products. Thus, they have implemented their own hazard management systems that trace a product from field to fork, whether the product is sourced locally or imported. Nevertheless, a World Bank report has pointed out gaps in compliance with EU food safety requirements as well as remaining issues that leave the food processing chain vulnerable to food safety hazards.⁹ It must be noted that meeting EU-standards will require substantial investments in animal disease control, traceability, hazard analysis, critical control points procedures, and border-inspection-and-control capacity.¹⁰

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Services

Services cover a broad range of markets, encompassing network industries such as electricity, natural gas, and communications; other intermediate services such as transport, financial intermediation, distribution, construction, and business; along with services destined for final consumption such as tourism and travel, recreation, education, health, and environmental services. In the EU, services are classified under three headings: (i) services where EU wide regulations apply such as financial services, telecommunication services, energy services, and transportation services; (ii) services regulated by Services Directive 2006/123/EC such as legal services, accounting services, business-related services, and construction services; and (iii) services regulated by national regulations such as public services including health services, education services, and social services.¹¹

Studies reveal that barriers to trade in services, which are typically regulatory in

⁸ Donald Larson, Will Martin, Şebnem Şahin, and Marino Tsigas, “Agricultural Policies and Trade Paths in Turkey,” *The World Economy*, Vol. 39 (2016), pp. 1194-1224.

⁹ World Bank “Turkey Food Safety Programmatic Technical Assistance Needs: Assessment for Modernization of Food Establishments,” Report of II GAP Analysis of Agri-Food Enterprises, Document 75453, (Washington D.C.: The World Bank, 2010).

¹⁰ Alison Burrell and Arie Oskam, *Turkey in the European Union: Implications for Agriculture, Food and Structural Policy* (Wallingford: CABI Publishers, 2005).

¹¹ Note that the first set of services are regulated by a very large number of Regulations, Directives and Decisions, aimed at ensuring the effective functioning of the internal market.

nature, lead to inefficiencies in service sectors and to high costs of services. Since the productivity and competitiveness of goods and services firms depend largely on access to low-cost and high-quality producer services such as transportation, distribution, telecommunications, and finance and given the powerful influence these firms have on economic growth, it is of utmost importance for Turkey to increase the efficiency of service industries by trade liberalization in different service sectors. The challenge for Turkey is to achieve free trade of services between the EU and Turkey but this will require Turkey to adopt and implement the regulatory framework of the EU for each of the service sectors it intends to liberalize.¹² Thus, a future FTA covering liberalization of services between the EU and Turkey will most probably include all of the services with EU-wide regulations and some of the services subject to the Services Directive 2006/123/EC.

Public Procurement

In February 2014, the European Council adopted the legislative package for the modernization of public procurement in the EU, the guiding principles of which are competition, non-discrimination, transparency, and integrity.¹³

The Turkish Public Procurement Law No 4734 of 2002 sets out principles and requirements to ensure a transparent and fair tendering process, as well as provisions to control corruption and probity. However, the enforcement records of such provisions are poor.¹⁴ In addition, procurement practices have been criticized for becoming less transparent, as amendments to procurement law placed tenders in numerous sectors outside the purview of the monitoring watchdog, Public Procurement Authority. Moreover, judicial reforms in 2012 reduced criminal charges for bid-rigging in public tenders.¹⁵

Currently, both Turkish and EU companies face obstacles in winning public contracts in each other's markets. If both parties can agree on rules that ensure they are not discriminated against in public procurements, maximize transparency in tendering public contracts, observe the principle of integrity, and optimize opportunities for firms of both parties to participate in tenders at all government levels,

¹² Sübidey Togan, *Economic Liberalization and Turkey* (Routledge, London and New York, 2010); and Sübidey Togan, *The Liberalization of Transportation Services in the EU and Turkey* (Oxford University Press, Oxford, 2016).

¹³ Carlo Maria Cantore and Sübidey Togan, "Public Procurement in the EU," *The Internationalization of Government Procurement Regulation*, Aris C. Georgopoulos, Bernard Hoekman and Petros C. Mavroidis eds. (Oxford University Press, 2016).

¹⁴ Sübidey Togan, Bedri Kamil, Onur Taş and Servet Alyanak, "Public Procurement in Turkey," *The Internationalization of Government Procurement Regulation*, Aris C. Georgopoulos, Bernard M. Hoekman, and Petros C. Mavroidis eds. (Oxford University Press, 2016).

¹⁵ Freedom House, *Freedom in the World*, (Washington D.C.: Freedom House, 2014).

both Turkey and the EU would win. Subsequently, market opening based on the principles of competition, transparency, non-discrimination, and integrity would be beneficial for Turkey. For public authorities with tight budgets, it can bring (i) better money for value, (ii) more choice, (iii) greater economic efficiency, and (iv) good governance. In addition, we recommend a comprehensive procurement chapter in a future FTA between the EU and Turkey that would also require Turkey to accede to the WTO Government Procurement Agreement (GPA). Such a step would provide the necessary platform for reforming the Turkish public procurement system and would present major benefits to Turkey, including sheltering Turkish firms from EU instruments such as the proposed International Procurement Instrument (IPI).¹⁶

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Investment

The EU strategy in the area of investment is ensuring a high-quality and equal playing field to all investors. Article 63 of the Treaty on the Functioning of European Union (TFEU) prohibits all restrictions on the movement of capital and payments between EU member states. The functioning of the internal market is based on the fundamental notion of non-discrimination and the understanding that restrictions and exceptions to the free movement of capital should be limited as much as possible. However, until recently, foreign direct investment (FDI) agreements with third-party countries were concluded bilaterally by individual member states through Bilateral Investment Treaties (BITs). The goal of this was and still is to promote investments by guaranteeing inter alia, non-discriminatory treatment of investors from either party by ensuring fair and equitable treatment, most-favored-nation (MFN) treatment, unrestricted and free transfer of capital, and compensation in case of unjustified expropriation. Since the implementation of the Lisbon Treaty in 2009, FDI is now part of EU’s common commercial policy, and the EU Commission may legislate on FDI, although the individual BITs of member states will be preserved until they are replaced by EU wide investment deals.

An EU-Turkey deep integration FTA with an investment chapter could benefit both

¹⁶ European Commission, “Amended proposal for a Regulation of the European Parliament and of the Council on the access of third-country goods and services to the Union’s internal market in public procurement and procedures supporting negotiations on access of Union goods and services to the public procurement markets of third countries,” COM (2016) p. 34 final, (Brussels, European Commission, 2016).

Turkey and the EU's overall investment strategy since:¹⁷

- The EU and Turkey are concerned with securing protection against discrimination for their investors in terms of MFN treatment and national treatment;
- In the case that expropriations are not meant for public policy use or fairly compensated, both parties will seek to protect their investors' assets against expropriation;
- Both parties strive for fair and equitable treatment and the right to transfer capital

Dispute Settlement

There have been developments regarding investment arbitration during the TTIP negotiations and also in the amended CETA. During the TTIP negotiations, Investor-State Dispute Settlement (ISDS) had been extensively criticized on the grounds that it infringes on the right of member states to achieve legitimate policy objectives through regulation. These objectives include the protection of consumers and transparency of the investment dispute system through international arbitration. The latter of which may lack independence and impartiality. Furthermore, the risk of arbitrators being chosen from an elite group may lead to inconsistency and unpredictability in decision making.

Recently, the EU has tried to address such criticism within the context of TTIP negotiations and formally presented its new proposal on investment protection and investment dispute resolution to the US on 12 November 2015.¹⁸ The objective of the new proposal is to safeguard the EU and its member states' right to regulate, while continuing to provide effective protection to foreign companies against unfair treatment, and discrimination or other obligations through the Investment Court System. This will be ensured through a new and fully transparent system, intended to resolve investment disputes by publicly appointed judges, the guarantee of high ethical standards and the chance to have errors corrected through an appeal instance.

As emphasized by Sinan Ülgen, the dispute settlement mechanism in the current

¹⁷ An attractive investment model already exists in the CETA which includes a set of core obligations such as (i) providing for MFN and national treatment, (ii) providing minimum standard of treatment for investments including protections against denial of justice and failure to provide police protection, (iii) ensuring that if a government expropriates an investment, it does so for a public purpose, in accordance with due process of law, and subject to prompt, adequate and fully realizable and transferable compensation, (iv) allowing for transfer of funds related to an investment covered under the Agreement, (v) barring specified performance requirements, including local content requirements, export requirements, and technology transfer or technology localization requirements, and (vi) ensuring investors have the ability to appoint senior managers without regard to nationality, and ensuring that any nationality-based restrictions on the appointment of board members do not impair an investor's control over its investment.

¹⁸ "Transatlantic Trade and Investment Partnership Trade in Services, Investment and E-Commerce," http://trade.ec.europa.eu/doclib/docs/2015/november/tradoc_153955.pdf.

EU-Turkey relationship is dysfunctional.¹⁹ The lack of effective dispute resolution is a serious shortcoming and an issue the next FTA between the EU and Turkey must address. Similarly, the EU and Turkey could adopt an approach like that one adopted in the modified CETA and thus resolve the problems surrounding the dispute settlement mechanism shared by Turkey and the EU.

Sustainable Development

The EU trade and investment strategy includes sustainable development objectives. It seeks to engage with partners to promote human and labor rights along with environmental, health, and consumer protection laws. The objective is to support the sustainable development objectives and ensure that any changes to social, labor, or environmental protection are positive.

Given that EU trade agreements that are under negotiation or have been recently concluded have all incorporated provisions or even chapters on trade and sustainable development, labor, and environment, it is very likely that the new trade agreement between the EU and Turkey will also seek to regulate these issues.

Conclusion

This article argues that the most tangible options for the modernization of EU-Turkey trade and investment relations are, on the one hand, to modify the present EU-Turkey CU to take into account the various criticisms of the CU²⁰ and, on the other hand, to complement the prevailing CU with a deep and comprehensive integration agreement covering agriculture, SPS measures, services, government procurement, investment, dispute settlement, and sustainable development. It will be quite a challenge for Turkey to achieve free movement of agricultural commodities with the EU since the rules of EU *acquis* on agriculture and SPS measures are

¹⁹ Sinan Ülgen, "Trade as Turkey's EU Anchor," *Carnegie Europe*, 2017.

²⁰ According to Akman ("The European Union's Trade Strategy and its Reflection on Turkey: An Evaluation from the Perspective of Free Trade Agreements", unpublished paper presented at the IKV Workshop on the Interface between the World Trading System and Global Issues: Challenges for the WTO, Turkey and the European Union., Istanbul, IKV, 2010) the major problems facing the EU-Turkey CU are: (i) The EU has its own priorities reflected in its FTAs that are concluded, and these agreements do not take into account Turkey's special interests; (ii) Turkey suffers tariff revenue losses. In particular, imports from third countries by way of trade deflection via the EU induce tariff revenue losses for Turkey; (iii) Turkey cannot enter into FTAs with third countries with which the EU has not accorded a deal; (iv) There are latecomer effects. In particular, Turkey can conclude FTAs only after the EU has concluded the FTAs. This puts Turkish exporters into disadvantageous position with regards to EU exporters, who can obtain preferential status by penetrating into third country markets several years earlier; and (v) Some of EU's trade partners that had concluded FTAs with the EU or continue to negotiate FTAs with the EU refrain from concluding FTAs with Turkey despite the "Turkey Clause" included in FTAs concluded by the EU. In addition the World Bank, EU-Turkey CU considers the following as problems: (a) the road transport quotas and transit permits hinder the free circulation of goods covered by the CU; (b) the frequent use of Trade Defense Instruments such as anti-dumping and safeguard measures harm trade; and (c) the current visa regime has a negative impact on EU-Turkey trade and business.

quite different from those in Turkey. It will be a further challenge for the country to achieve liberalization of services and government procurement since the rules of the EU *acquis* on services and public procurement are also very different from those in Turkey. However, liberalization of agriculture, services, and public procurement, while costly, is a must for Turkey if it wants to remain a competitive player in the world economy, and increase its exports and FDI inflows. Similar considerations apply to investment, dispute settlement, and sustainable development issues.

Deepening EU-Turkey integration would offer significant benefits to Turkey as well as the EU. Turkey recognizes the growing importance of global value chains trade, and how concluding a deep and comprehensive FTA with the EU would potentially generate economic growth. Therefore, the challenge for Turkey is to achieve liberalization of agriculture, services, government procurement, and investment with the EU, along with observing EU rules on dispute settlement and on “trade and sustainable development, trade and labor, and trade and environment.” For the EU, this is an opportunity to harness the economic and political potential of deeper integration with Turkey, through further liberalization of trade in goods, services, agriculture. It also presents an opportunity to encourage investment and sustainable development complemented with appropriate dispute settlement mechanisms.