



STRENGTHENING EU-TURKEY  
ECONOMIC RELATIONS  
**CAN SERVICES REVITALIZE  
THE CUSTOMS UNION?**

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DANIEL GROS, JACQUES PELKMANS, MEHTAP AKGÜÇ,  
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## ABSTRACT

This paper critically examines the potential, methods of implementing, and possible consequences of complementing free goods trade between the European Union (EU) and Turkey with services, in a wider sense. It finds that the importance of services in overall Turkish exports has been declining over the last decade and that Turkey exports mostly services related to tourism and transport. We also verify the regulatory restrictiveness of services in Turkey and find a mixed picture, with considerable need for reforms in several sectors. Tourism faces few trade barriers. This would leave mainly transport. So far, at least in road transport, many EU member states protect the position of their own trucking industry to some degree. Not only do these restrictions seem incompatible with the very idea of a customs union under EU law, which is based on the principle of free circulation of goods, but it is clear in any event that the restrictions will have to be lifted in a new services agreement. Outside these two sectors, Turkey does not yet seem to possess a strong potential for exports of higher value-added services, although services incorporated in exported goods (due to European value chains) have become important. Raising higher education and skill levels in Turkey would seem to be essential to increase domestic value-added in goods exports and direct and indirect services exports.

Realistic options for a “deep and comprehensive” services agreement with Turkey imply a choice between the CETA model between the EU and Canada (far-reaching but without harmonization) and the DCFTA with Ukraine (with harmonization and later participation in the single services market). These options—but especially the latter—are bound to have major implications for services regulation in Turkey, including more horizontal issues and principles of rules-based governance.

However, there is an EU side to examine, as well. EU member states still maintain many (often petty) restrictions in services trade with third countries, as the CETA annexes have shown. These ought to be addressed.

Services are also linked to FDI, in markets as well as in the design of FTAs, and to free movement of persons, including cross-border services provision, mode 4 in GATS. We find FDI to be quite liberally treated, unlike the movement of persons. Much can be improved on the latter, in particular for Schengen visas linked to business activities, e.g., with conscious efforts toward visa facilitation. However, although FDI has been stimulated by the Customs Union, it is clearly performing below its potential, and this might well be explained (apart from skills) by worsening economic governance (as shown by indicators). A reliable rules-based regime would help inward FDI to recover structurally, which would in turn support a stronger service sector in EU-Turkey relations.

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## I. INTRODUCTION

Turkey-EU relations are currently at an impasse. Political frictions are mounting, with senior figures on both sides questioning the future of the relationship. So far, few have questioned the value of the existing trade arrangements between the EU and Turkey based mainly, but not exclusively, on a bilateral Customs Union decision [1/95] of the European Commission and the Turkey Association Council dating from 1995. Together with a bilateral free trade area in coal and steel<sup>1</sup> and selected liberalization in agricultural and fisheries products,<sup>2</sup> the overall commercial relationship is now described as a “Bilateral Preferential Trade Framework” (BPTF). However, since the Customs Union constitutes the core of the relationship, the term Customs Union is often used to describe what is more precisely the BPTF. Initially, the idea was to establish a parallel track for pre-accession, but after some initial, albeit slow, progress, the pre-accession track is no longer moving for political reasons.<sup>3</sup>

Before the recent political difficulties, the question had arisen as to whether the existing arrangements could be improved. Following an Inception Impact Assessment from August 2015 and options in the

2016 Impact Assessment<sup>4</sup> in December 2016, the Commission asked the Council for authorization to begin talks with Turkey and agreed on the draft mandate, which is unpublished to date. There are two main ideas as to the substance of the mandate:

- 1 | The one is to complement free trade in goods with trade in services (in a broader sense), public procurement, and further liberalization in agro-food products.
- 2 | The other is to modernize the Customs Union, inter alia, by implementing a proper dispute settlement system and finding a solution for the asymmetry between Turkey and the EU vis-à-vis third countries with which the EU concludes free trade agreements (FTAs).

Given that the Customs Union already established free trade in (most) goods, a convenient step forward would be to complement free goods trade and mutual market access with services. Given that services trade still encounters considerable barriers and given the large weight of services in the economy, the expectation was that an extension of free goods trade to services would yield large economic gains. The present contribution concentrates on complementing the Customs Union with services in a wider sense (e.g., also

1 First excluded in the Customs Union as, at the time, these products fell under the ECSC treaty.

2 Decision 1/98, as amended in Decision 2/2006.

3 See Boehler, Pelkmans, and Selçuki for a detailed state of progress of the 35 chapters of pre-accession. Little has changed since 2012. P. Boehler, J. Pelkmans, and C. Selçuki, “Who Remembers Turkey’s Pre-Accession?” *CEPS Special Report* no. 74 (Brussels: CEPS, December 2012).

4 European Commission, “Recommendation for a Council Decision: Authorising the Opening of Negotiations with Turkey on an Agreement on the Extension of the Scope of the Bilateral Preferential Trade Relationship and on the Modernisation of the Customs Union,” COM (2016) 830, December 21, 2016, [http://ec.europa.eu/smart-regulation/impact/ia\\_carried\\_out/docs/ia\\_2016/swd\\_2016\\_0475\\_en.pdf](http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2016/swd_2016_0475_en.pdf); European Commission, “Study of the EU-Turkey Bilateral Preferential Trade Framework, Including the Customs Union, and an Assessment of Its Possible Enhancement - Final Report,” October 26, 2016, Impact Assessment, SWD (2016) 475 of December 21, 2016, [http://ec.europa.eu/smart-regulation/impact/ia\\_carried\\_out/docs/ia\\_2016/swd\\_2016\\_0475\\_en.pdf](http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2016/swd_2016_0475_en.pdf).

establishment for FDI). Therefore, it does not deal with the other aspects of “enhancing” that relationship.

This study examines existing (regulatory) barriers to trade in services in both the EU and Turkey and compares options to deepen the bilateral exchange with the arrangements on services foreseen in the Canadian-EU Free Trade Agreement (CETA) and the Deep and Comprehensive Free Trade Agreement (DCFTA) with Ukraine. It empirically examines the nature of the services exported by Turkey. It was found that Turkish exports of services are dominated by transport services (closely related to goods trade), which encounter selected restrictions, and tourism and related activities that are generally not high value-added and do not encounter many trade barriers. Turkish exports of other services are rather small at present, but they encounter higher barriers. Could exports of these other services, especially high value-added ones, expand quickly once trade barriers disappear? The likely potential for exports of high value-added services was critically evaluated through looking at the level of education of the work force—finding it lacking, both in terms of quantity and in terms of quality.

A preliminary conclusion is that extending the Customs Union to services<sup>5</sup> might not have as large of an effect on trade and the production of services as expected at the political level.

Cheaper imports of business services might make manufacturing goods production more competitive in Turkey. Service liberalization might thus indirectly foster exports of goods. However, this is a channel that is difficult to quantify.

### **The Nature of the Status Quo**

The EU-Turkey trade relationship is in large based on the Customs Union, which (including the legislative alignment, especially in technical regulatory harmonization) provides deep integration in the industrial goods sector. However, trade in agricultural and fishery products is only partially liberalized, and significant policy areas are not even covered, namely trade in services, public procurement, sanitary-phytosanitary measures, and rules in various policy areas, as indicated in Table 1 below.

<sup>5</sup> A point to note on semantics: “extending the Customs Union” to services would mean that Turkey would have to adopt the same policy towards third country imports of services as the EU. But, this is not what is being considered. What might be possible is that the barriers to bilateral trade in services might be reduced, without implying the same policy towards third countries. This is entirely possible under the GATS.

**Table 1: Overview of the Current EU-Turkey Bilateral Preferential Trade Framework (BPTF)**

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); free circulation of goods (by use of A.TR certificate)
Agricultural and fishery goods	1998 bilateral preferential concessions – partial coverage, notably as regards Turkey’s liberalization towards the EU, which is more limited than the EU’s liberalization 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 with EU technical legislation (CU) Sanitary and phytosanitary measures: not covered
Trade defense measures	Possible to impose anti-dumping measures against each other if justified; Bilateral safeguards also possible (CU)
Trade in services; Establishment	Not covered (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: not covered; 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.)	Not covered; however, in several areas there is strong cooperation between the EU and Turkey in the frameworks of both the CU and the accession process

Source: European Commission, “Study of the EU-Turkey Impact Assessment, SWD (2016) 475 of December 21, 2016.”

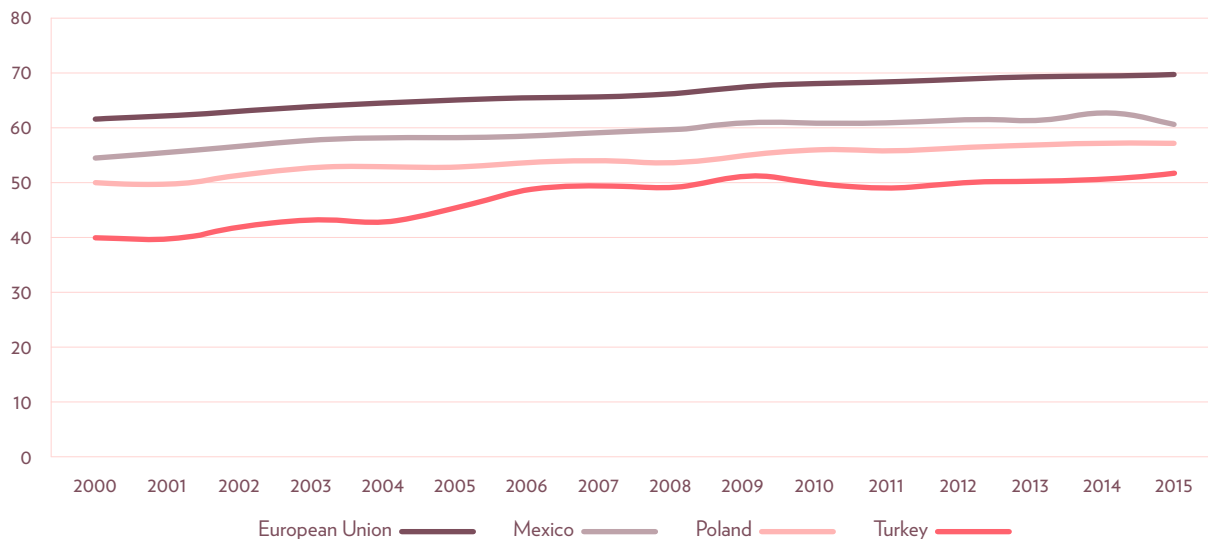
### Why Focus on Services?

There are two reasons to concentrate on this sector: services are important in their own right as a driver of growth, and the sector provides key inputs for the overall economy and thus also for trade in goods. One could argue that complementing the BPTF with services would play a similar role as the Customs Union agreement in 1996. It would help to foster bilateral trade in services, and it would lead to a greater competitive exposure of this sector, spurring competition and productivity.

The latter effect could be very important since services play an important role in the Turkish economy. The share of services in economy-wide value-added (or GDP) is now around 60%, not much lower than in other comparable countries (if one uses international databases).

However, as shown in Figure 1, services seem relatively less important in Turkey in terms of employment, accounting for only a little over half of total employment (compared to a share closer to 60% in comparable countries and 70% in the EU).

Figure 1: Share of Employment in Services



Source: World Bank, "Employment in services," 2017, <https://data.worldbank.org/indicator/SL.SRV.EMPL.ZS>.

Reducing the regulatory restrictiveness of important service sectors (such as energy, transport, communications, and professional services; see also section 3.2) 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. Moreover, given that many industries grow partly due to outsourcing (specialization of services) and that services are a key input for many sectors, service sector liberalization has secondary effects on other industries. In other words, to the extent that the service provision is compromised, other sectors are affected in their growth in output, value-added, and productivity. Sectors that rely more intensively on the provision of such services in their production are more severely affected.

According to a World Bank calculation,<sup>6</sup> aligning gains from service-intensive sectors that would be realized as a result of liberalization of services, including utilities, with Organization of Economic Cooperation and Development (OECD) best practices could amount to a 0.75 percent increase in real GDP or 1.1 billion USD in economic welfare. This is an appreciable gain but not at all impressive.

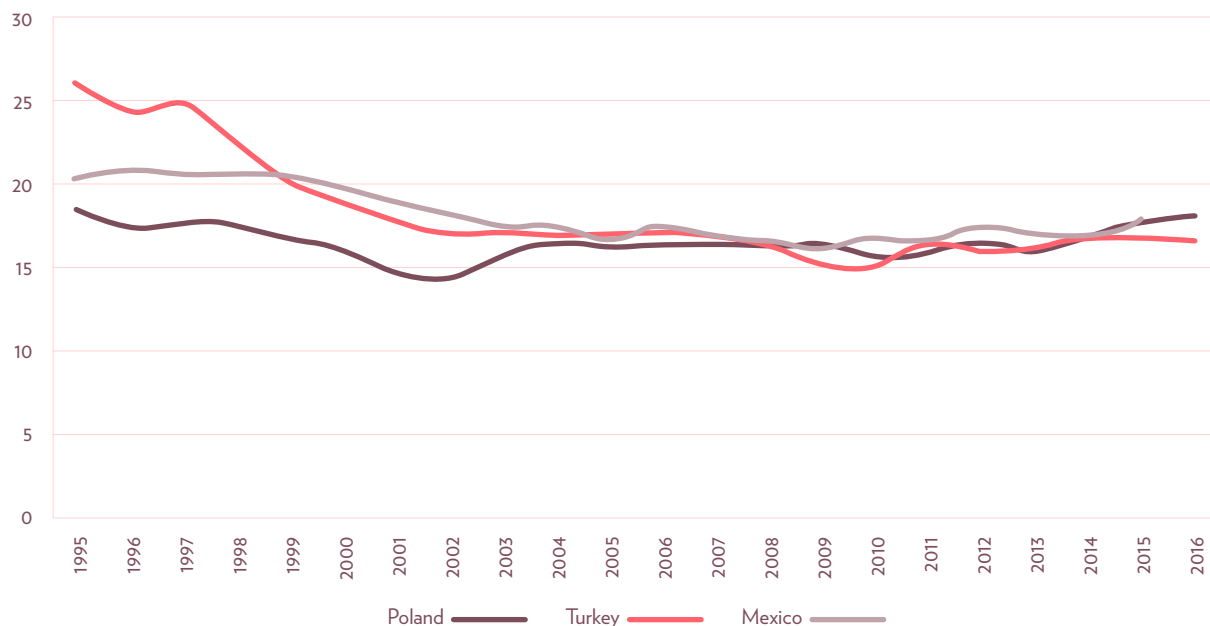
Moreover, the work of the OECD (TIVA database) has shown that trade in manufacturing goods also indirectly contains a large proportion of value-added services. OECD reports that 38.2% of the total value of Turkish manufactured goods exports reflected the service sector's value-added, which

<sup>6</sup> See annexes 21 and 22 in World Bank, *Evaluation of the EU-Turkey Customs Union* (Washington, DC: World Bank, Group, 2014), <http://documents.worldbank.org/curated/en/298151468308967367/Evaluation-of-the-EU-Turkey-customs-union>.

is slightly above the OECD average (36.9%).<sup>7</sup> The composition of the services' value-added embodied in manufacturing exports was different from other countries. Wholesale, retail, and hotels sectors accounted for 15.1% of total gross exports, with transport and telecoms and business services accounting for 9.8% and 7.7%, respectively. This concentration on low value-added services, except for business services, will be analyzed in more detail below.

A more competitive service sector could thus represent a competitive advantage for trade in goods, as well. The share of the manufacturing sector in the economy has been roughly stable over the last decade as can be seen from Figure 2. However, it is somewhat surprising that the entry into force of the Customs Union was followed by a fall in the share of manufacturing in the economy. This fall is structural (like in many countries with a similar level of development) and dominates the positive trade effect, an increase in the share of manufacturing in total exports.

**Figure 2: Gross Value-Added in Manufacturing Industry, percent of GDP**



Source: Authors' own calculations based on AMECO database, "European Commission Economic and Financial Affairs, 2017," [http://ec.europa.eu/economy\\_finance/ameco/user/serie/SelectSerie.cfm](http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm).

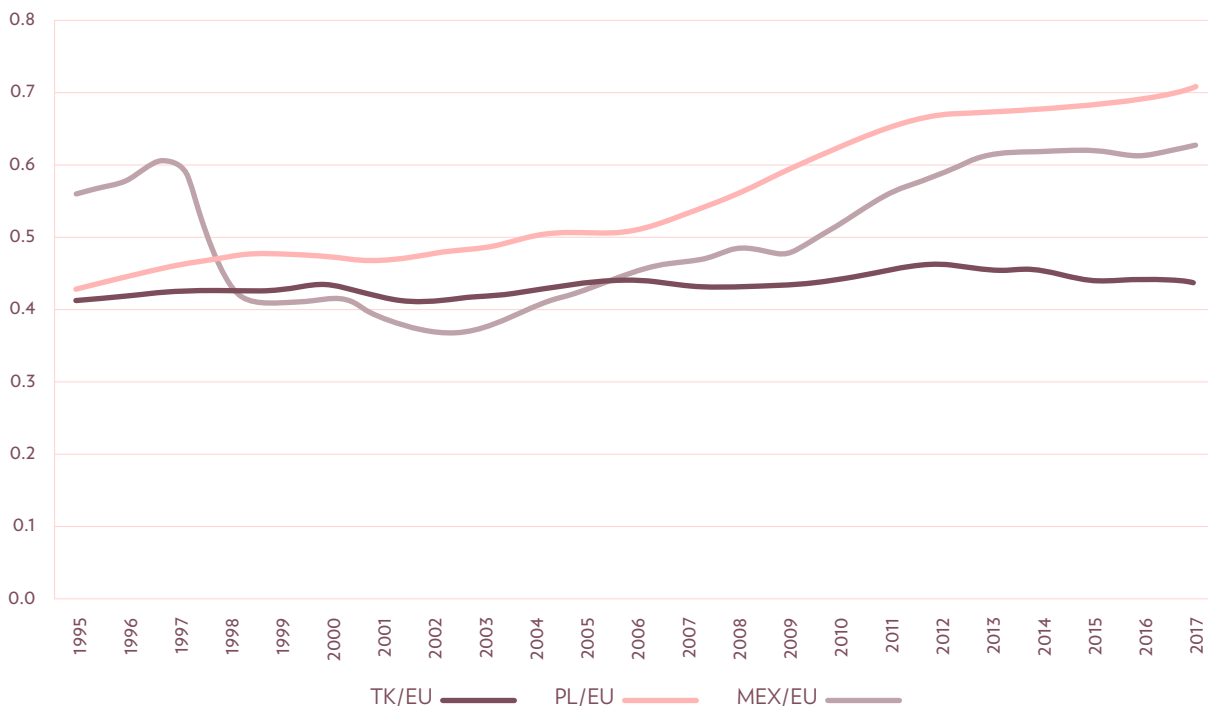
<sup>7</sup> "Services Trade Restrictiveness Index," OECD, <http://www.oecd.org/tad/services-trade/services-trade-restrictiveness-index.htm>.

### Macroeconomic Background

The broader aim of the Customs Union had been to foster growth in Turkey by opening up the economy. It is difficult to judge whether this has been the case because macroeconomic developments in Turkey have been so variable. The establishment of the Customs Union was followed by an economic boom, and then, subsequently, a deep financial crisis, which led to a large drop in output. However, since the stabilization of the early 2000s, Turkey has experienced a decade of solid growth, which has leveled off over the last few years. Turkey’s GDP per capita measured in purchasing power standard (PPS) is thus today at a level only slightly higher than 20 years ago, when the Customs Union was first implemented (see Figure 3).

However, over the longer run Turkey has thus performed only a little bit better than Mexico, which entered the North Atlantic Free Trade Agreement (NAFTA) at about the same time the Customs Union was concluded. Mexico’s GDP per capita at PPS today is at about the same level as 20 years ago, but it has been much less variable. The experience of Poland, which joined the EU in 2004, is superior to that of Turkey in that when Poland joined the EU it reported similar median income to that of Mexico; however, Poland has since overtaken both Mexico and Turkey in per capita income.

Figure 3: GDP per Capita in PPS, Relative to the EU



Source: Authors’ own elaboration on AMECO database.

## 2. TRENDS IN EU-TURKEY SERVICES TRADE AND SERVICES POTENTIAL

This section will deal with bilateral services trade and its potential when services trade would be liberalized under a new agreement. Section 2.1 focuses on trends in bilateral services trade, whereas section 2.2 zooms in on its sectoral composition and section 2.3 on underlying educational and skill-level determinants of higher value-added services exports.

Before beginning this analysis, a brief word on the impact of the Customs Union on bilateral goods trade: a general observation concerning the EU-Turkey trade pattern is that trade in industrial goods has become more important (in relative terms) over the last two decades. Services trade has expanded less than goods trade and Turkey's exports concentrated in sectors related to tourism (hotels, restaurants) and transport (related to goods trade and tourism). Apart from goods trade-related transport, the share of Turkey's services exports to the EU seems to be largely determined by the number of tourists from abroad.

As far as goods exports are concerned, there has been a shift away from developed markets; however, Turkey's exports to emerging markets (EMEs), such as China and India, have not been very dynamic. Turkey's exports have expanded mainly towards the Middle East and North Africa (MENA) region, which has seen rapid but unstable growth mainly related to fluctuations in oil prices.

One should keep in mind that the purpose of a customs union is not to foster bilateral trade 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 occurred since Turkey's overall trade has expanded rapidly since the signing of the Customs Union.

The EU's declining share in Turkey's overall exports is often cited as an indication of the limited impact of the BPTF; however, the EU's share in Turkey's total trade has actually fallen less than that of other OECD countries' share, such as the United States (although the U.S. market has grown somewhat more than that of the EU). This is another indirect confirmation of the impact of the existing arrangements on bilateral trade.

There is a general agreement that trade integration between the EU and Turkey has progressed significantly in the last two decades, with a fourfold increase in bilateral trade flows. The EU remains by far the single most important trading partner for Turkey, accounting for some 41% of Turkish imports. The BKP et al. study for the European Commission provides the latest estimate of the trade-creating impact of the BPTF by comparing growth in bilateral trade in BPTF-covered goods to goods not covered by the BPTF.<sup>8</sup> The BKP study estimated that in 2016, the EU's exports to Turkey and Turkey's exports to the EU were 9.1% and 6.5% higher, respectively, than they would have been without the BPTF.<sup>9</sup> These numbers are significant but too small to allow one to consider the BPTF a game changer. But the

8 BKP Development Research & Consulting with Panteia and ALSA, "Study of the EU-Turkey Bilateral Preferential Trade Framework, Including the Customs Union, and an Assessment of Its Possible Enhancement," European Commission, October 2016, [http://ec.europa.eu/smart-regulation/impact/ia\\_carried\\_out/docs/ia\\_2016/turkey\\_anx6\\_en.pdf](http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2016/turkey_anx6_en.pdf).

9 This is based on comparing trade falling under the BPTF with bilateral trade not covered by the BPTF. However, this comparison is dubious as non-BPTF trade consists mainly of agro-food/fisheries. Some scholars hold that major factors include the change from FTA to a customs union in 1996 (no certificates of origin anymore) and the drastic reduction of Turkish external tariffs to third countries. This, in turn, caused a "cold shower" stimulating industrial competitiveness which, later, prompted FDI in European value chains, including Turkey, boosting two-way trade significantly.

creation of the Customs Union has reduced non-tariff barriers as well, and this could better explain the huge increase in volume, with implied (but not quantified) welfare benefits.

As usual, the smaller partner, Turkey, reaped substantially greater gains, both in percentage terms and in terms of absolute value. Not surprisingly, the BPTF had a much greater impact on Turkey than on the EU.<sup>10</sup>

### 2.1. Services in EU-Turkey Trade

There have been significant changes in the composition of Turkish trade.

Many studies have focused on the technological content of goods trade and have found that Turkey tends to specialize in medium- to low-technology products and that there has been little change in this respect. However, the share in overall exports of services relative to manufacturing has changed considerably. As Table 2 below illustrates, there has been a considerable shift away from services to manufacturing exports. Between 2000 and 2011, the share of manufactured goods in overall exports has increased from 43% to 63% of the total and that of services had declined by a similar percentage.

Another metric would be to look at overall services trade (exports plus imports) relative to GDP, as shown in Figure 4. In this metric Turkey is not doing well. The ratio of services trade to GDP has declined since 2000 and remains well below that of EU members as well as below the OECD average. Even looking at comparable countries like Mexico, Morocco, or Poland, there seems to be room for growth for Turkey's share in services trade.

<sup>10</sup> A recent CEPS study found a similar result, i.e., the smaller partner is more affected by trade liberalization, considering all the estimates of the economic cost of Brexit. See M. Emerson, M. Busse, M. di Salvo, D. Gros, and J. Pelkmans, "An Assessment of the Economic Impact of BREXIT on the EU27," Study for the European Parliament, March 2017, [www.europarl.europa.eu/studies](http://www.europarl.europa.eu/studies) under no. PE 595.374.

This finding runs counter to the general increase in the relative importance of services in the economy and in trade flows.

The declining importance of services can be seen from the fact that in 2000, services exports were slightly larger than manufacturing goods exports, but by 2011, manufacturing exports had grown to double that of services exports. Given that the BPTF covers mainly manufactured goods, this suggests that the Customs Union has indeed had an impact. The share of the EU in manufacturing exports from Turkey in 2011 was still close to 50%, but "only" 40% for services.

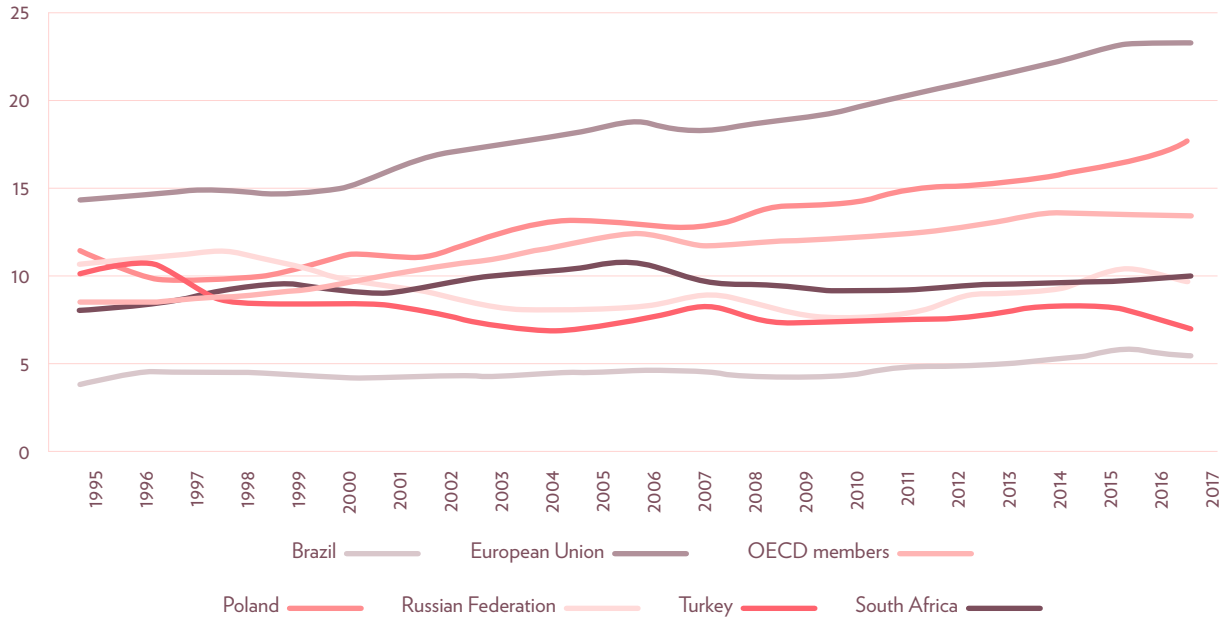
Some re-orientation in Turkey's export of goods was to be expected given that the closest major markets, the MENA region and Eastern Europe plus Central Asia (grouped under CIS in International Monetary Fund (IMF) statistics), have been considerably more dynamic than the EU market itself. In 1996, the EU market was about eight times larger than these two regions combined, but today the ratio is only about 3.5:1.

For services trade, especially tourism, the growth of income in these two regions has also played an important role as the number of travelers from these regions has soared over the last two decades.

The OECD publishes the value-added content of trade by taking into account the fact that exports often contain a large share of imported intermediate goods.

The data on the shares of manufacturing and services in domestic value-added (DVA) show a somewhat less dominant role for manufactured goods (and less change), because apparently an increasing part of exports contained a large share of intermediate inputs. In 2011, manufactured goods accounted for 56% of the value-added contained in Turkish exports, somewhat less than the 63% share based on gross exports. Moreover, the change

**Figure 4: Trade in Services as a Share of GDP**



Data source: OECD, "Trade in goods and services, 2017."

with respect to 2000 was "only" 15 percentage points (against 20 points based on gross exports). This suggests that Turkish industry has, in these 10

years for which data is available, become increasingly integrated in global, or rather European, value-added chains.

**Table 2. Manufacturing vs. Services in Turkish Exports**

		TOTAL MANUFACTURES	TOTAL BUSINESS SECTOR SERVICES
Shares in total gross trade	Change between 2000 - 2011	20	-17
	Share in 2011	63	30
Shares in direct value-added	Change between 2000 - 2011	15	-13
	Share in 2011	56	37

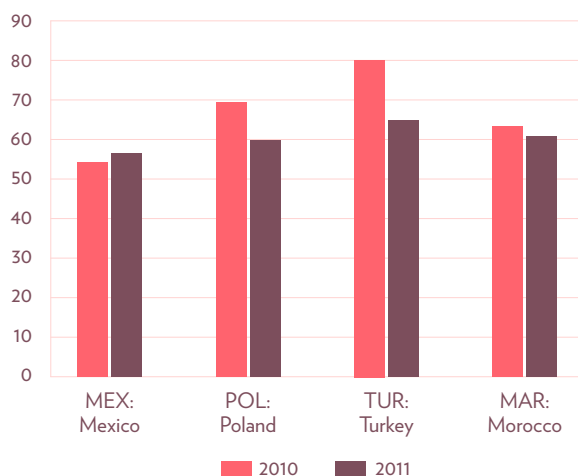
Data source: OECD-WTO, TIVA database, "Trade in Value Added: Turkey," OECD, October 2015, [http://www.oecd.org/sti/ind/tiva/CN\\_2015\\_Turkey.pdf](http://www.oecd.org/sti/ind/tiva/CN_2015_Turkey.pdf).

Figure 5 below provides a comparison between Turkey and selected larger emerging economies. It is apparent that, for Turkey, the share of domestic value-added in gross exports of manufacturing has indeed fallen (from about 80% to 62%, which indicates a greater participation in global or European value chains), but it remains higher than for Poland, Morocco, or Mexico (which has benefitted from NAFTA). In this sense, Turkey seems still less integrated in international value chains than these comparable countries.

### 2.2. A Closer Look at the Service Sector

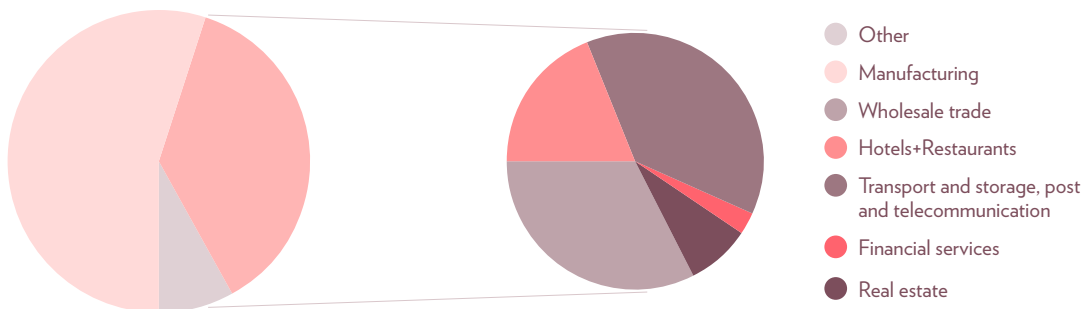
As the focus of this study is on services, we provide some detail of different subsectors' contributions to overall service exports. Figure 6, below, shows that about one-half of the share of services in total exports came from the sectors "wholesale" and "hotels + restaurants," (19 out of 37 percentage points) while the majority of the other half came from "transport and storage, post and telecommunication." Both of these groups comprise mostly low value-added services.<sup>11</sup> Figure 6 shows the various major elements of total exports.

**Figure 5: Integration in Value Chains: Shares of Domestic Value-Added Content in Gross Exports**



Source: Authors' own calculations based on OECD TIVA database, "Trade In Value Added: Turkey."

**Figure 6: Sectoral Structure of Turkish Exports**



Source: Authors' own calculations based on OECD-WTO, "Trade in Value Added: Turkey."

<sup>11</sup> The exception is telecommunication, but for this subsector the data is not available separately for 2011.

Table 3 also shows the longer-term evolution of service exports by comparing data between 2000 and 2011. For the latter year some more detail is available, showing that the telecommunications subsector was extremely small.<sup>12</sup>

Other identifiable service subsectors, like “financial intermediation” or the group “real estate renting and business activities,” contribute little to Turkey’s services exports.

**Table 3: Changes in Sectoral Export Shares within Services**

	C50T74: TOTAL BUSINESS SECTOR SERVICES	C50T74: TOTAL BUSINESS SECTOR SERVICES					
		Wholesale and retail trade; Hotels and restaurants	C50T55: Wholesale and retail trade; Hotels and restaurants		C60T64: Transport and storage, post and telecommunication	C65T67: Financial intermediation	C70T74: Real estate, renting and business activities
			C50T52: Wholesale and retail trade; repairs	C55: Hotels and restaurants			
Change in share between 2000 - 2011	-13	-6	-3	-3	-6	-2	1
Share in 2011	37	18	12	7	14	1	3

Source: OECD-WTO, “Trade in Value Added: Turkey.”

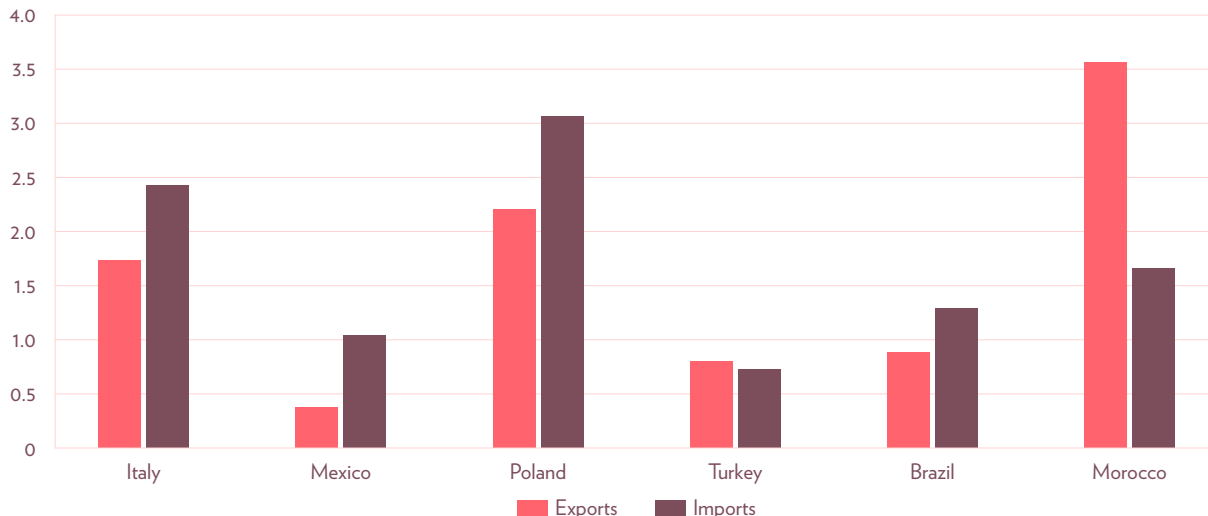
A comparison with other major emerging economies of similar size and comparable level of development shows that Turkey “under trades” in high-value services, namely in what is called business services (finance, real estate, ICT, legal, accounting, architecture, engineering, etc.).

Figure 7 below 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% and 1% of GDP) than for its peers like Brazil, Morocco, and Poland. For a more developed economy, like Italy, trade in these services amounts 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.

<sup>12</sup> OECD-WTO, “Trade in Value Added: Turkey.”

Figure 7: Business Services Trade, Percent of GDP



Source: OECD-WTO, “Trade in Value Added: Turkey.”

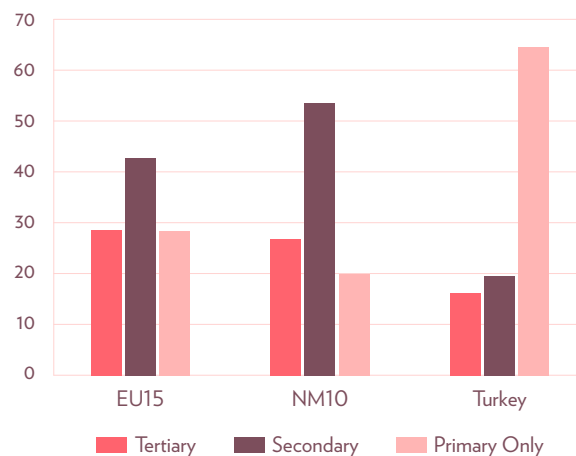
### 2.3. Services and Skills: Can Turkey Become an Exporter of High Value-Added Services?

The production of high value-added services requires a well-educated work force. However, Turkey seems to lag behind its European partners in this respect, and this might at least partially explain its poor trade performance in high value-added services. The latest available data shows that the share of low-skilled workers (those who have not completed secondary education) in the labor force is still over 60% in Turkey, compared to less than 30% in the EU-15 and even less than 20% in the ten new member states—i.e., the EU-10—whose income levels are closer to that of Turkey (see Figure 8 below).

In contrast, the differences in the proportion of high-skilled workers (those who have completed tertiary education) between Turkey and these two groups of EU members are somewhat smaller in absolute terms: around 15% of the Turkish work force has finished tertiary education, compared to around 28% in both the EU-15 and the EU-10. What is missing in Turkey is the so-called “middle class”

in the labor market, i.e., those who have finished secondary education, which make up over 50% in the ten new member states but only less than 20% in Turkey.

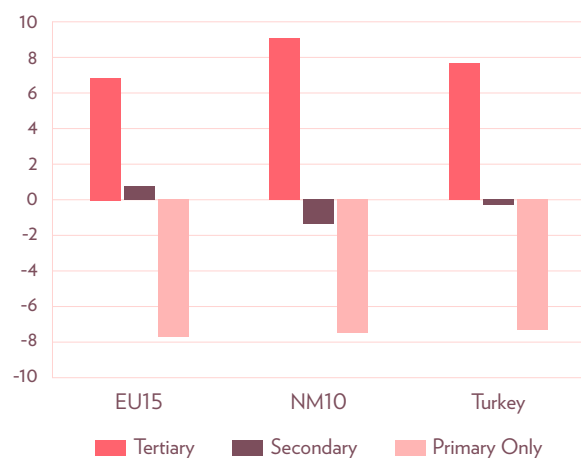
Figure 8: Shares of Working-Age Population by Skill Class



Source: Eurostat, “Eurostat database,” 2017, <http://ec.europa.eu/eurostat/data/database>.

Turkey has made some progress in increasing its levels of education; however, the educational gap between Turkey and EU members has not narrowed much over the last decade (for which comparable data is available) as levels of education inside the EU have also progressed. Figure 9 below shows that, for all three cases, the share of low-skilled workers has fallen by 6–8%, whereas the share of high-skilled workers has increased by a similar amount. The share of the “middle class” has not changed much anywhere (i.e., the lack of middle-level skills in Turkey has existed for some time).

**Figure 9: Change, 2006-2016, in the Shares of Working-Age Population by Skill Class**



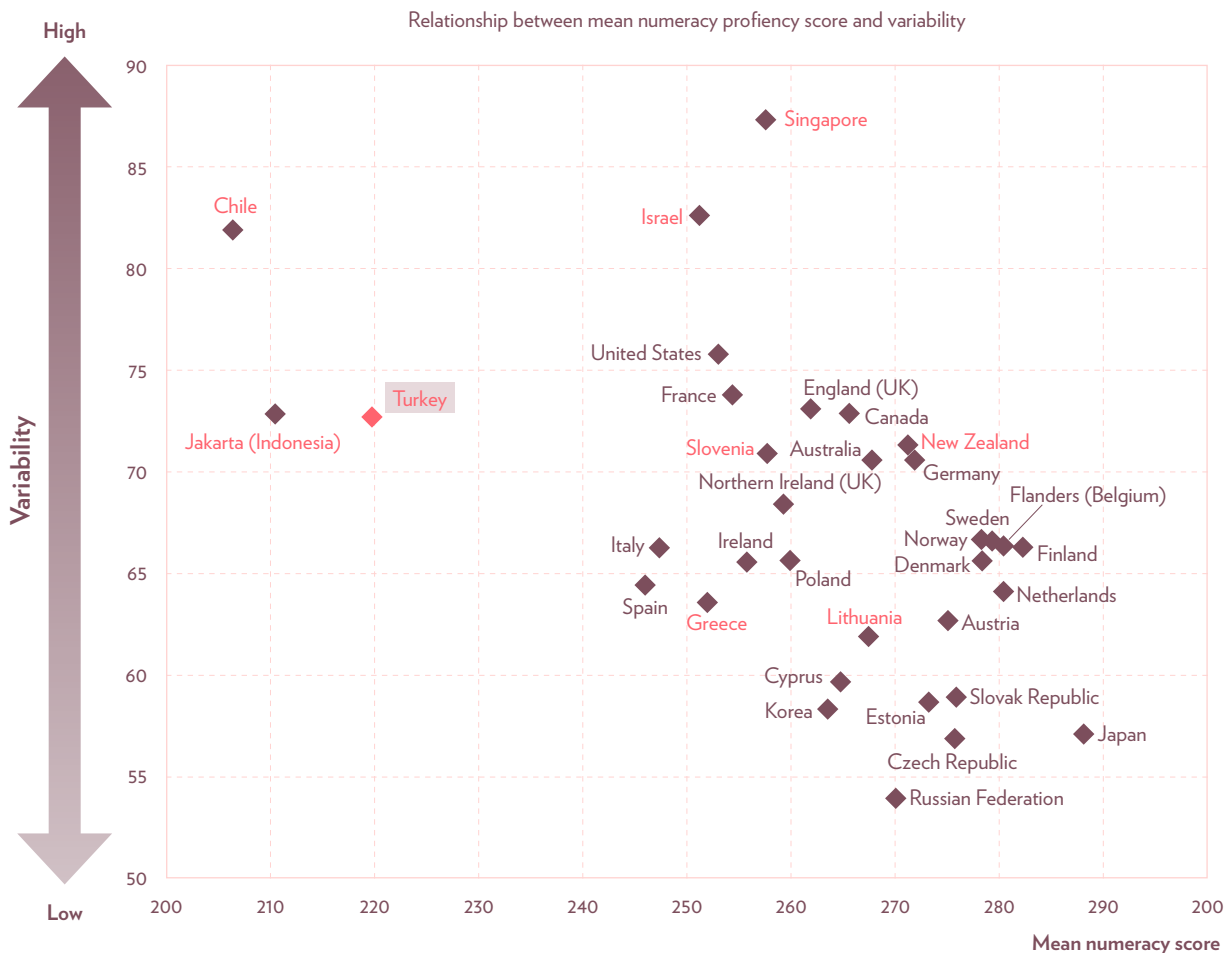
Data source: Eurostat, “Eurostat database,” 2017, <http://ec.europa.eu/eurostat/data/database>.

The skill composition of the Turkish labor force today is similar to that of the Mediterranean EU member countries in the mid-1990s. Compared to these countries, which have a higher GDP per capita but struggle to compete, Turkey has about 20 years to catch up. This suggests that the capacity of the country to produce and export high value-added services is rather limited today. Moreover, one has to take into account the well-known problems with the quality of schooling as measured by the Programme for International Student Assessment (PISA) tests organized by the OECD. In the 2015 exercise, Turkey ranked considerably below the OECD average, with an average score of 425, and behind the worst performers within the EU (Romania, Bulgaria, and Greece). There has been no progress in the quality of secondary education since 2000.<sup>13</sup>

Figure 10 shows the average numeracy score of adults in OECD countries (according to the Programme for International Assessment of Adult Competencies (PIAAC) survey). The chart further highlights the variation of performances within the country. Turkey exhibits one of the lowest scores among OECD member countries. With a score of 220, Turkey lags far behind its European peers, of which most score between 250 and 280 points. Moreover, the variability in the results is also at the higher end; that is, pointing towards large differences in performance within the country.

<sup>13</sup> OECD, “Pisa results in focus.”

Figure 10: Average and Distribution of Numeracy Scores



Note: The interquartile range is used as the measure of variability, i.e., the difference between the third quartile and the first quartile.

Source: OECD, *Skills Matter: Further Results from the Survey of Adult Skills, OECD Skills Studies* (Paris: OECD Publishing, 2016), <http://www.oecd.org/skills/skills-matter-9789264258051-en.htm>.

### 3. SERVICES IN THE EU-TURKEY CUSTOMS UNION: WHAT CAN BE DONE?

This section provides some background on the framework conditions for services trade. It starts by summarizing how the recently concluded free trade agreement between the EU and Canada (CETA) and the EU and Ukraine (DCFTA) deal with services—thereby giving some idea of what an arrangement liberalizing trade in services with Turkey could look like.

Subsequently, we try to identify the barriers hindering market access in services: barriers that might have to be addressed in a new Turkey/EU agreement. However, in services there are no simple border measures like tariffs. Services markets are regulated, and such regulation often comprises instances of discrimination against foreign services provisions under the World Trade Organization's General Agreement on Trade in Services (GATS) mode 1 (direct cross-border trade) and/or mode 3 (establishment, usually FDI, enabling local provision) as well as typically under mode 4 (temporary cross-border supply of services).<sup>14</sup> Market access in services depends, among other things, on whether, how, and how much Turkish, resp. EU (or member states') law discriminates against EU providers, resp. Turkish providers, under the various GATS modes.

A second obstacle for market access is the restrictiveness of services regulation. Even if not discriminatory, hence equally valid for local providers, services regulation can be disproportionately restrictive and undermine the business case of entering the partner's market. A variant of too much restrictiveness is that local regulation and supervision is permissive with respect to anti-competitive structures or conduct of dominant players or cartels, severely hindering or excluding market access for actors outside the market.

<sup>14</sup> Under mode 2 there are rarely problems of this nature. For Turkey, mode 2 is about tourists visiting the country, and Turkey has every interest to facilitate tourist services.

Bilateral agreements liberalizing services tend to emphasize the removal of horizontal discriminatory regulation (quantitative or qualitative) whilst stipulating OECD-type “better regulation” principles just against disproportionate services regulation and disciplining domestic issues such as a sound licensing regime. Sectoral services regulation, however, tends to appear in separate chapters under the overall “positive listing” or “negative listing.” The former consists of a list of what is going to be liberalized, whereas the latter stipulates what is excluded from liberalization.

Nowadays, the economic literature on services trade utilizes quantitative measures of “regulatory restrictiveness.” Although such measures give an idea of restrictiveness, they are rather imperfect for understandable reasons. More important still, the degree of restrictiveness is also a function of the relevant market failure that is addressed by such regulation. Therefore, one should not be simplistic and consider measures of regulatory restrictiveness as “equivalent” to a measure of trading costs to enter a market. In contrast, comparisons of such measures per service sector for different countries (with, presumably, similar market failures) do make sense. Large disparities between countries' service sectors should be a *prima facie* indicator of undue hindrances to market access for (some) trading partners; and for the home country—if operating in a restrictive market—a *prima facie* signal to consider sector reforms, with greater freedom for market players, thereby tapping into greater potential for economic growth.<sup>15</sup>

<sup>15</sup> Apart from regulatory barriers, cross-border services trade is also determined by the intrinsic economic difficulty of service provision at a distance, unlike for goods. Nowadays, there are more services that can be successfully supplied at a distance, also over borders, due to the internet, but many services still require a close relationship of trust between the supplier and the consumer or user. For this reason alone, mode 3 (local establishment) is relatively more important in services than in goods, and it is thus not surprising that “establishment” and services are often negotiated together in bilateral FTAs (here, a customs union-plus).

This section also provides an overview of how restrictive Turkey is (compared to some relevant countries) concerning the provision of services (regulation) or concerning trade in services by means of the services trade restrictiveness indices (STRI) of the OECD. It contains a comparison at the sectoral level and with some core EU countries.

Measuring restrictiveness in services is difficult and remains always somewhat subjective. At times, this study will also refer to the World Bank's STRI (which we also quote briefly), which differs from that of the OECD. However, the latter alone should be sufficient to obtain some initial idea of what service liberalization would imply for Turkey (and with some notes on how it would affect the EU).

Furthermore, this section also provides some initial thoughts on what regulatory restrictions will have to be overcome in order to extend the BPFT to services. A short overview of Turkey's investment climate is provided, 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. For the EU side, there is no problem of access here since EU countries have a comparatively low score in this index. In addition, some qualitative remarks on the Turkish investment climate are included, as well.

### 3.1. Identifying the “How”: Options for a Services Agreement

At present, EU-Turkish trade in services (all four modes) is governed by the respective commitments under the GATS annexes. This is a fairly low-key set of conditions as multilateral concessions have typically remained modest and highly selective. For purposes of discussion, all of these can have different degrees of application (also over time). A full-fledged analysis of such options would be a major exercise—not least, given that services trade is often sector-specific, unlike trade in goods, and that many service sectors tend to be regulated, often heavily. This study indentified four distinct options for bilaterally negotiating

liberalization of services beyond the GATS commitments in the annexes: a) a purely sector-based approach (cherry-picking); b) an approach governed by a commonly agreed framework but littered with exceptions and restrictive applications and/or subject to further elaboration, such that effective market access is uncertain and/or narrow or shallow; c) the approach used in CETA, the most advanced FTA-plus-plus in the world (not counting possible associations with the EU); and d) the approach of the DCFTA with, e.g., Ukraine, which is one of the most relevant associations with a powerful agenda for services. The European Economic Area (EEA) is not an appropriate option for Turkey today, even though formally one can characterize it as an FTA. The EEA mimics the single market, also for services, with “freedom of movement” as the very ambitious guiding principle; and with it all the tenants of positive integration—such as common regulation and even EU agencies as well as equivalent enforcement to that in the EU itself—are implied. Such integration would not take place until the advanced stages of Turkey's “pre-accession,” which is simply not in the books right now.<sup>16</sup>

Options (a) and (b) are implemented in various older FTAs that the EU has concluded. It is unlikely that the EU would wish to negotiate such extensions with Turkey, a close economic partner for decades, because its current ambitions in FTAs with many other countries is typically to strive after “ambitious, deep and comprehensive” FTAs (e.g., with Korea, Singapore, Vietnam, Japan; currently, Mexico and Chile; also Peru and Colombia, etc.) in order to generate non-trivial beneficial economic effects.<sup>17</sup> This leaves options (c) and (d).

16 As noted above, a detailed overview of the 35 chapters of the accession negotiations is found in Boehler, Pelkmans, and Selçuki, “Who Remembers Turkey's Pre-Accession?” Little progress has been made since 2012.

17 Note that the Commission's Impact Assessment speaks of “a real potential in upgrading ... in a very ambitious way.” See European Commission, “Study of the EU-Turkey,” 11.

### 3.1.1. Services in CETA as an Option

CETA is ambitious in services and investment. However, that is not easy to see. The cluster of services and investment is itself a rather heterogeneous and complicated set of different sub-sectors. Moreover, the EU has agreed with Canada to base services liberalization on so-called “negative listing.” This means that liberalization of market access is the guiding principle, and whatever is not liberalized has to be “listed” in annexes. Before CETA, the EU used positive listing: i.e., only what was listed in CETA’s “commitments” was liberalized.

In order to better appreciate how services and investment liberalization and regulation are dealt with in CETA, Table 4 provides a stylized overview. One best comprehends the approach when thinking in GATS terms, that is, in the four “modes” of services trade. Table 4 distinguishes three modes within a total of four CETA chapters (mode 2 is nowhere explicitly dealt with, as it is seen to be of marginal importance). The sectoral chapters are no different but emphasize sector-specific aspects that are crucial for an assessment of the prospects.

**Table 4: Services: Liberalization and Regulation in CETA**

GATS MODE	CHAPTER	CONTENT
Mode 1, GATS	Ch. 9	Cross-border trade in services Negative listing Reservations of both Parties in Annex 1 (existing restrictions, under the ratchet clause when liberalized) and Annex 2 (restrictions, with freedom to regulate/revise later) Annex 1 and 2, CETA (separately published)
Mode 3, GATS	Ch. 8	Investment Negative listing Reservations of both Parties in Annex 1 and 2 as for cross-border services [see above] Annex 1 and 2 and Declarations (separately published)
Mode 4, GATS	Ch. 10	Temporary entry Liberal specifications for temporary entry of six categories of business persons Annex 10-A, B, C, D, E on various reservations Mutual recognition of professional qualifications
	Ch. 11	Annex 1, 1-A, with Guidelines on how to negotiate such (private) MRAs, based on art. 11.6, CETA
Sectoral chapters	Ch. 13	Financial services Annex III-A, B only for financial services; Annex 13-A, B Guidance on prudential carve-out (art. 13-16)
	Ch. 14	Maritime services (reservations, Annex I and II)
	Ch. 15	Telecoms services
	Ch. 16	Electronic commerce
Other chapters	Ch. 12	Domestic regulation (e.g., on predictability and licensing)
	Ch. 27	Transparency

Note: Chapter numbers are from the final official text, as published by the EU Council on September 14, 2016 under no. 10973/16.

Source: EU Council on September 14, 2016 under no. 10973/16, <http://data.consilium.europa.eu/doc/document/ST-10973-2016-ADD-6/en/pdf>.

Although investment (FDI) can also be in goods sectors, the investment mentioned in Chapter 8 is commonly related to services because the low “tradability” of many services often compels firms to employ mode 3 (establishment through FDI) as the only effective way of providing services in host countries. Indeed, in CETA the specific reservations from both sides with respect to market access are organized in such a way that cross-border services and investment are presented together. Chapter 27 on domestic transparency and the many reservations to open market access in services (littered over many chapters) are also critical. It goes without saying that altogether this nexus of chapters and reservations renders the services and investment components of CETA rather complicated.

The logic of providing market access in services differs from that in goods, where tariffs play a role and quantitative restrictions are, as a rule, forbidden in the WTO. For services, it is all about regulatory restrictions that might discriminate against foreign suppliers or investors, where GATS non-discrimination disciplines do not apply. In the case of a bilateral agreement or FTA, foreign suppliers are divided between those of the “other Party” (Canada, EU) and those of third WTO partners. Thus, whereas in goods CETA applies “national treatment” but not the most-favored-nation (MFN) principle (so that tariff removal only applies to the two partners of CETA), this is different in cross-border services. Both national treatment and MFN are provided for (CETA, Ch. 9, Arts 9.3 and 9.5), with some exceptions listed in Annex I and II. There are also horizontal exclusions from the services chapter for some sectors, such as cultural industries for Canada, audio-visual services, and air transport for the EU.<sup>18</sup> The core provision on market

access (Ch. 9, Art. 9.6; for FDI/establishment, Ch. 8, Art. 8.4) opens the market by forbidding parties to maintain measures limiting the number of service suppliers (for example, with an economic needs test or with a specific limit), restraining the total value of the services or the assets, and the total number of service operations or other analogue quotas. The reservations to this market access provision and to the application of MFN and national treatment are listed in two annexes.<sup>19</sup>

This method boils down to what is called a “negative list”: everything is liberalized for purposes of market access, except for what is explicitly restricted or excluded in the negative list. The use of a negative list approach to scheduling provides for detailed transparency on what is not subject to liberalization. The EU has to date used a positive list approach, which identifies precisely what is liberalized for market access: if not explicitly listed, it is not liberalized. Positive listing does not reveal what precisely the restrictions are in services markets or investment for the other party. Canada and the United States have generally used negative listing in previous FTAs. The two approaches are sometimes held to differ in that negative listing creates more incentives to liberalize. However, it all depends on the actual lists and the options to liberalize further. Both Canada and the EU have included two major annexes linked to the chapters on services and on investment. Annex I to the services chapter concerns preexisting restrictions, which are “locked in” by CETA. This means that governments (both the federal government in Canada or the EU, and the sub-central government or member states) are bound not to add to, or extend the restrictiveness of, these measures. In this sense, Annex I acts like a standstill in restrictive regulation. Moreover, in case a party decides to reform a particular service market or withdraws (or reduces the restrictiveness of) such a measure, there is an automatic ratchet

18 Since air transport does not fall under the WTO (except for ancillary services), countries typically agree on special Air Services Agreements on a bilateral basis. In CETA, however, these ancillary air transport services (like ground handling, repair of aircrafts, etc.) are excluded in art. 2 of the investment chapter (ch. 8).

19 And special ones for financial services only, see Table 4.

effect: the reduction of restrictiveness is also locked in, which prevents the reintroduction of any restrictions.

Thus, Annex I can only shrink or stay the same; it cannot grow. The purpose behind Annex I is to create transparency in local regulation and predictability, which are important for foreign business. Annex II, on the other hand, lists areas of restrictive regulation that are not locked in. In these areas, the parties retain discretion or “policy space” by permitting changes in policy or legislation restricting access, subject only to an obligation to notify other parties of such measures. This list typically comprises public or social services, such as health care, public education, audiovisual, and/or cultural services, etc., as well as the right to regulate and exercise sovereign control over the development of natural resources. The purpose here is transparency, too, but access is either more difficult or prohibited, and if access is allowed, the importing country can set the conditions as it wishes. The country might also alter such conditions over time.

Comparing the annexes presented by the two sides, one finds that the Canadian lists are short, suggesting Canada is quite open and even the provinces maintain relatively few restrictions. The EU’s, especially some member states’, lists are long, partly because there are many member states, but also because of an apparent desire to retain restrictions. The EU member states’ exercise of putting the two lists together would have been much more difficult without the 2006 services directive. The screening at the domestic level imposed by that directive, followed by the implementation of “mutual evaluation” between member states in 2010, could be said to have greatly facilitated the shift to negative listing. Now that member states have become transparent about the many restrictions maintained (at least, for third countries’ service providers; here, for example, Canada), one

might actually begin to ask critical questions such as whether all these restrictions are compatible with EU law (e.g., the internal market) and whether they are necessary and/or justifiable. The negative lists of the EU under CETA show how strongly the internal market and EU trade policy have become intertwined.

The services chapter is not only the most advanced chapter ever negotiated by the EU and Canada, but also by any other WTO partner. However, one has to be careful about the significance of “advanced” in trade negotiations terms. The combination of the basic liberalization of access and Annex I (lock-in of existing regulation) is ambitious in negotiation terms, especially when some sectors also shift from Annex II to Annex I. However, this does not in and of itself open the market more.<sup>20</sup> That would only happen if reforms or a unilateral opening would take place. There are five market advantages of the approach:

- a | A general clause on open market access for services, essentially prohibiting the conditioning of access via various quantitative restrictions (unless measures are listed in the two annexes).
- b | The “locking-in” of existing restrictions, as in Annex I.
- c | Unprecedented transparency on exactly what restrictions (in what laws) in what areas fall under Annex I and II. One can hold the view that such transparency does not in and of itself enlarge the scope of market access in services, which would be correct. However, there is a significant value-added to such transparency. Market access is more costly,

<sup>20</sup> Except when horizontal principles forbidding the partners to introduce various quantitative limits (such as on the number of service suppliers or on the total value of market transactions, etc., as stipulated in, e.g., art. 9.6 of CETA) have the effect of rendering some existing restrictions unenforceable, i.e., amount to effective liberalization of market access.

especially for small and medium-sized enterprises (SMEs) if they must identify regulations and restrictions with certainty and at various levels of government: hence, the support of European service providers for negative listing and greater transparency.

**d |** Unlike in goods, services negotiations are typically not about better access (except in the margin usually) but more about reform of domestic regulation. However, in CETA a few sector-specific improvements of access to the Canadian market have been incorporated (see below). If one wants to improve market access jointly, the logic in CETA would point to Chapter 21 titled Regulatory Cooperation. If one party in CETA liberalizes market access in a service unilaterally (because of a domestic regulatory reform) and it falls under Annex I, nothing more has to be done—it is locked in automatically. In addition, better market access might arise for the EU for another reason, namely the application of MFN (for the EU by Canada) to access granted to other WTO partners in other agreements in future. Applying MFN means that the EU automatically benefits from the same type of access.

**e |** The most liberal approach in allowing temporary service providers (mode 4) with no less than six categories liberalized, including spouses for up to three years.

There is also a political advantage in applying these detailed specifications in Annex II because, together with transparency, decision-makers, voters, domestic consumers, and workers can be assured that the current and future right to regulate in the specified areas remains untouched and unrestricted. This reduces the scope for mistrust or fear by local interests that ambiguity will leave room for slippage and for further liberalization commit-

ments in implementation. If a sector or area listed in Annex II is currently privatized, it can be brought back under state control if a party to CETA sees a need. Even when Canada or the EU would engage in other FTAs, Annex II will remain untouched.

If Turkey would adopt or accept a CETA-type approach, it would almost certainly go far beyond its GATS commitments. This means that the horizontal clauses on market access might actually imply significant liberalization. In addition, one would have to reflect on what sectors would fall under the general market access clause and what not (negative listing). Here, the EU is bound to be very ambitious. If Turkey is interested in pro-competitive market reforms, the services agreement with the EU would be a forceful mechanism, as it locks in such reforms.

But, there is also an EU side to a bilateral agreement in services with Turkey. CETA has revealed that many EU member states maintain considerable negative lists, with some elements of dubious legal validity under EU law. These lists are also not compatible with the clear and often repeated objective to strive after a single services market—the latter imply only an EU-level negative list, and the one of today (e.g., in CETA) is relatively short. Rather than letting Turkey negotiate with all member states on their lists, as Canada had to do, it is far better for the EU to accelerate the achievement of the single services market and do away with the member states' lists. Often, these lists detail aspects that appear incompatible with EU law for other member states but are supposedly acceptable when it comes to third countries.

### *3.1.2. The DCFTA with Ukraine*

The Deep and Comprehensive FTA (here, for Ukraine) is surprisingly similar to CETA in structure and details except for two important features. First, as Ukraine must undergo deep reform and still suffers from some legacies of the

former Communist era, it is assumed that the final obligations and rights in the DCFTA will only be attained after a lengthy transition period. This is not so for the partners in CETA, of course. Second, the DCFTA is also about harmonization, unlike CETA. Selectively—and especially in four specific services sectors, postal and courier services, electronic communications (e.g., telecoms and digital), financial services, and international maritime transport—an “integration into the EU internal market” is envisaged, after successful harmonization and proper implementation. The Trade Committee of the DCFTA may grant “reciprocal internal market treatment” in the four sectors. This means that all barriers must be lifted. The exact nature of this treatment remains to be fully explained: e.g., is it tantamount to free movement in these services? Many other specifications in the services, investment, and temporary cross-border (mode 4) services are quite similar to CETA.

Contrary to what one might perhaps expect, Ukraine is already a genuine service economy and advanced in digital services. Not unlike the arrangements in CETA, it is the EU, especially its member states, who are the more restrictive party in services. However, it must also be noted that restrictions are applied very unevenly between EU countries. Thus, since the DCFTA was established, Ukraine<sup>21</sup> has no horizontal reservations on MFN or national treatment. In contrast, the EU has implemented three reservations across 21 sectors. When it comes to cross-border services trade, the EU (and its member states) has 190 reservations for mode 1 and 72 for mode 2; Ukraine has 27 for mode 1 and one for mode 2. One really wonders whether these member states’ restrictions are in line with the single services market acquis. A stark example is found in the 18 subsectors of (temporary)

21 The following is based on Emerson and Movchan, in particular ch. 9 on services. See Emerson, Busse, di Salvo, Gros, and Pelkmans, “An Assessment of the Economic Impact.”

contractual services providers where some member states have even listed an “economic needs test” for some services, although the 2006 services directive strictly forbids this. While steady but slow progress is made in deepening the EU single services market, Turkey might find fewer such restrictions, eventually.

If Turkey were keen to enjoy a deep and comprehensive services agreement with the EU, this would be possible. The EU—for its own sake and to move toward its true ambition to establish “deep and comprehensive” agreements with important partners—should do what it does in goods: more firmly link the external trade-in-services approach with the internal EU services market. Given the recent EU/Singapore FTA ruling,<sup>22</sup> this linkage can now be pursued much more effectively.

### 3.2. How Could Restrictiveness Be Addressed?

It is notoriously difficult to quantify (cross-border) barriers to services trade.<sup>23</sup> The two key terms here are ad valorem equivalents (AVEs) of services barriers and STRIs. AVEs have been increasingly used in (CGE) simulations of (services) trade liberalization. However, recent empirical studies differ quite a lot in their AVEs for services given the considerable difficulties in the empirical techniques

22 Court of Justice of the European Union, “Opinion of the Court (Full Court) of 16 May 2017 - Opinion pursuant to Article 218(11) TFEU Opinion pursuant to Article 218(11) TFEU – Free Trade Agreement between the European Union and the Republic of Singapore,” 2017, <http://curia.europa.eu/juris/liste.jsf?num=C-2/15>.

23 See F. Mustilli and J. Pelkmans, “Access Barriers to Services Markets – Mapping, Tracing, Understanding and Measuring,” *CEPS Special Report* no. 77 (Brussels: CEPS, June 2013); Box 18.1 in J. Pelkmans et al., *Tomorrow’s Silk Road: Assessing an EU-China Free Trade Agreement*, CEPS Paperback (Brussels: CEPS, 2016), e-version available at <https://www.ceps.eu/publications/tomorrow%E2%80%99s-silk-road-assessing-eu-china-free-trade-agreement>; K. Berden and J. Francois, “Quantifying Non-Tariff Measures for TTIP,” *CEPS Special Report* no. 116 (Brussels: CEPS, July 2015); Y. Jafari and D. Tarr, “Estimates of Ad Valorem Equivalents of Barriers against Foreign Suppliers of Services in Eleven Services Sectors and 103 Countries,” Policy Research Working Paper no. WPS 7096 (Washington, DC: World Bank Group, 2015).

obtaining them. AVEs are expressed as if they are tariffs. The idea is that regulatory restrictions (here, in services) raise the trading costs of accessing a market; the AVEs quantify those restrictions and their costs to foreign service providers as if these costs were a tariff of  $x\%$ . In the World Bank study of the EU-Turkey Customs Union, the AVEs of services are calculated for 24 EU countries and Turkey using the World Bank's definition of STRIs (note that, below, the OECD version of STRIs are employed, which are distinct).<sup>24</sup> Such AVEs are sensitive to several specifications, including the elasticity of substitution. For an elasticity of 1.95, Turkey is found to have the second highest AVE (61.93%), only exceeded by Belgium (62.86%). In other words, Turkey is more restrictive than 23 of 24 EU countries in services. For an elasticity of 5.6, the ranking is similar (though the percentages are far higher, all above 100%). That is, Turkey is again the second most restrictive country after Belgium. With all the technical caveats in mind, one might tentatively conclude that Turkey is relatively restrictive in services regulation, relevant for mode 1 (trade). While this is relatively restrictive compared to EU countries, such restrictiveness is similar to comparable countries such as Brazil, Korea, and Russia.<sup>25</sup>

Below, the OECD version of the STRIs for Turkey are presented. The alternative is the World Bank STRIs series which—if need be—can be used as a control factor. However, in Pelkmans, Francois, di Salvo et al., we show that the two indices can sometimes be very different (e.g., in telecoms).<sup>26</sup> In Mustilli and Pelkmans, a fuller explanation of the two methodologies is provided.<sup>27</sup>

24 See Table 35 in World Bank, *Evaluation of the EU-Turkey Customs Union* (Washington, DC: World Bank, Group, 2014), 128, <http://documents.worldbank.org/curated/en/298151468308967367/Evaluation-of-the-EU-Turkey-customs-union>.

25 World Bank, *Evaluation of the EU-Turkey Customs Union*, 71–72.

26 Pelkmans et al., *Tomorrow's Silk Road*, 161–162.

27 Mustilli and Pelkmans, "Access Barriers to Services Markets," 53–61.

STRIs try to measure the regulatory restrictiveness of services sectors for trade and investment. The data requirements are not only huge, but the qualitative data have to be converted into ordinal measures for them to be given a quantitative value. Clearly, this is far from easy to do.

In Table 5, the (OECD) STRIs for 2016 for 22 service sectors are provided and compared for Germany, Turkey, Italy, the UK, and Poland. Higher STRIs reflect greater restrictiveness.

Some immediate inferences can be made. As seen in Figure 11, on average Turkey has the highest STRI followed by Poland and Italy. Interestingly, the UK, often said to be relatively liberal in services regulation, has a higher overall STRI than Germany, often said to be restrictive. The question is whether this overall STRI is a strong and reliable indicator of how difficult—or perhaps how desirable—it might be to complement a customs union including services for Turkey. A juxtaposition with the World Bank STRIs might confirm the relatively restrictive stance for Turkey (or not). If done by means of AVEs, Turkey is relatively restrictive in services overall.

With respect to sectors, the reader can observe for her/himself. The Table can give a prima facie idea of how sectoral negotiations might be conducted and/or what reservations might possibly be expected. Turkey is the most restrictive in eight sectors: logistics, storage/warehousing, freight forwarding, customs brokerage, accounting, broadcasting, telecoms, air transport, and courier services. On the other hand, in four sectors, Turkey has the lowest STRIs: engineering, maritime transport, architecture, and motion pictures. Three of these sectors are rarely directly traded (at least in mode 1, but might be relevant for modes 3 and 4), but maritime transport could be potentially relevant.

Although STRIs are not the same as the OECD product market regulation indicators (PMRs), they are, of course, somewhat similar. It might be

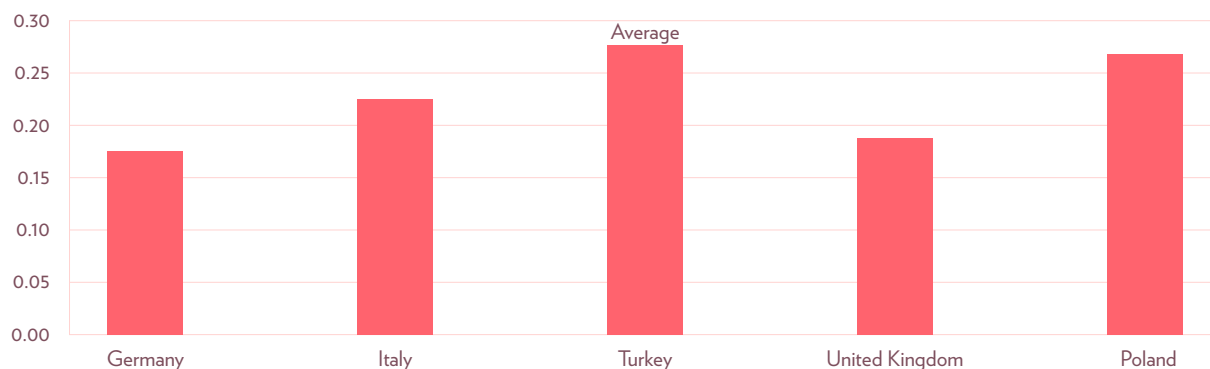
**Table 5: Turkey’s STRIs Compared to Four EU Countries, 2016**

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
<b>Average</b>	<b>0.176</b>	<b>0.226</b>	<b>0.276</b>	<b>0.192</b>	<b>0.265</b>

Note: Average is the simple average of the 22 sectors listed

Source: Service Trade Restrictiveness Index, OECD-WTO, “Trade In Value Added: Turkey.”

**Figure 11: Services Trade Restrictiveness Indices Compared**

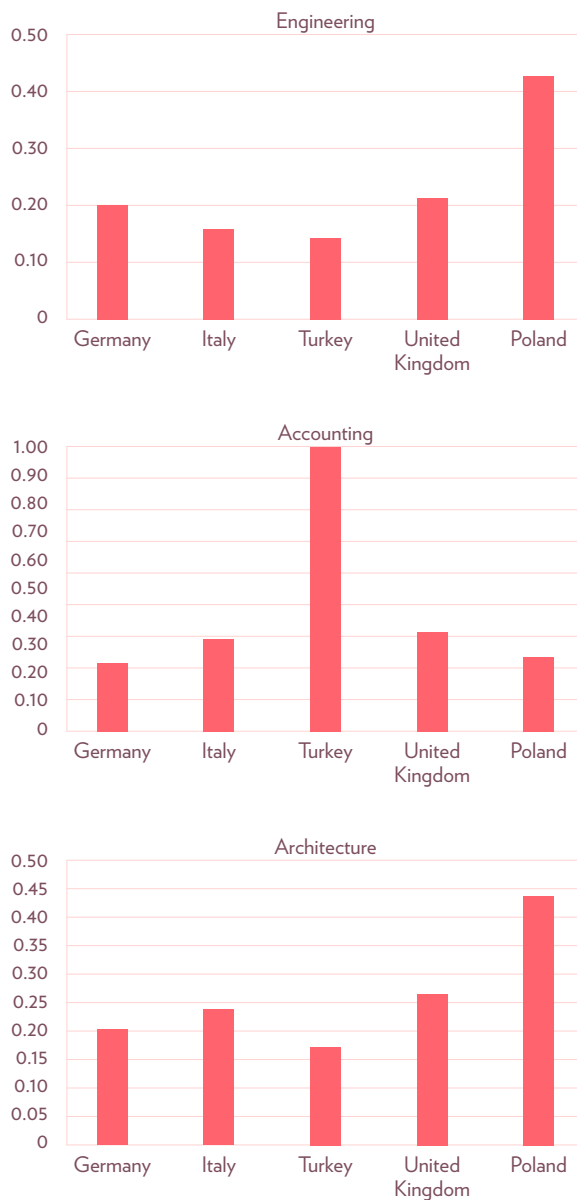


Note: Average across all 22 service sectors.  
Source: “Services Trade Restrictiveness Index,” OECD, 2016.

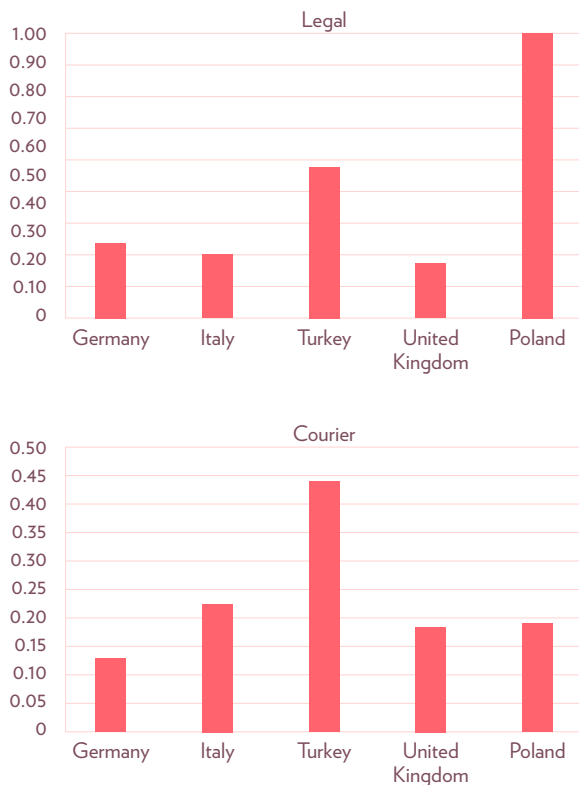
interesting to test the robustness of these STRIs for professional services (available for the EU-28, not for Turkey) because the European Commission has recently published an improved version of the PMR of professional services, including ten more components. In the EP report by Pelkmans,<sup>28</sup> the new indicator has been juxtaposed with the former OECD PMRs for four leading professional services; however, this data does not seem to be in line with some of the STRIs shown above, casting some doubt on these measures.

Finally, below, we provide a few graphs of STRIs (in Figure 12, identical to Table 5) as an illustration for the reader. First, Figure 12 shows that Turkey is less restrictive in engineering than the other four comparator (EU) countries, whereas in accounting (the second figure) Turkey is not only the highest but has reached a maximum STRI of 1. The latter extreme can be explained by two factors: (i) the combination of a nationality requirement to practice together with ownership restrictions limited to those “qualified” and “licensed”; (ii) the absence of limited or temporary licensing in place. In this way, all channels for entry are effectively closed, according to the OECD, and foreign competition in the sector is prevented. In courier services, Turkey has the highest STRI but nowhere near 1. In architecture (third figure), Turkey scores the lowest, and in legal services it assumes a quite restrictive position, yet not as restrictive as Poland.

**Figure 12: STRI in Different Sectors, 2016**



28 J. Pelkmans, “The New Restrictiveness Indicator for Professional Services: An Assessment, Study for the IMCO Committee of the E.P.” September 2017, [www.europarl.europa.eu/RegData/etudes/STUD/2017/607349/IPOL\\_STU\(2017\)607349\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2017/607349/IPOL_STU(2017)607349_EN.pdf).



Source: "Services Trade Restrictiveness Index," OECD.

### 3.3. Foreign Direct Investment Climate in Turkey

FDI has proven to be important for Turkey not only for the stimulus to its productivity growth but just as much for the trade/FDI nexus, including via value chains. The World Bank only reports FDI inflows into Turkey and no stocks, and there are no details of this before 2007.<sup>29</sup> The 2017 briefing for the European Parliament reports that, in 2015, 57.6% of FDI inflows into Turkey originated from the EU.<sup>30</sup>

29 World Bank, *Evaluation of the EU-Turkey Customs Union*, 5–7.

30 European Parliament, "Reinvigorating EU-Turkey bilateral trade: Upgrading the customs union," Briefing, March 2017, [http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/599319/EPRS\\_BRI%282017%29599319\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/599319/EPRS_BRI%282017%29599319_EN.pdf).

The Commission reports a 2014 EU FDI stock in Turkey of 64.9 billion EUR, which is considerable. The trend has been that the EU is the origin of two-thirds to three-quarters of inward FDI into Turkey. However, the World Bank holds that the inflows of FDI into Turkey are relatively low compared to other dynamic emerging economies.<sup>31</sup> 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 favorable factor, and its young workforce and improving infrastructure are positive elements, as well. If the Global Competitiveness Index of the World Economic Forum is any guide, two conclusions about the Turkish business climate can be drawn: (a) Turkey does not rank very high (no. 53 in the 2017/18 edition), with countries such as Taiwan, Malaysia, Thailand, the Czech Republic, Chile, Spain, Poland, Bulgaria, Panama, and Mexico ranking higher; (b) the variability of the index in the case of Turkey is striking, illustrated by being no. 61 in 2010/11, no. 44 in 2013/14, no. 55 in 2016/17, and no. 53 in 2017/18. The index reflects many sub-indicators, but market and other economic institutions ("rules" and the rule of law, for instance) play a considerable role. Therefore, it can be argued that these rankings are broadly in line with the concerns from the World Bank. The point of striving for a more rules-based economic governance in Turkey, with the enhanced Customs Union as an anchor, is emphasized by Sinan Ülgen.<sup>32</sup> The author holds that "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 harmonising Turkish relations with the EU *acquis*, the accumulated norms and practices that constitute EU law."<sup>33</sup> As the author notices,

31 World Bank, *Evaluation of the EU-Turkey Customs Union*, 5–7.

32 Ülgen, "Trade as Turkey's EU Anchor,"

33 Ülgen, "Trade as Turkey's EU Anchor," 3.

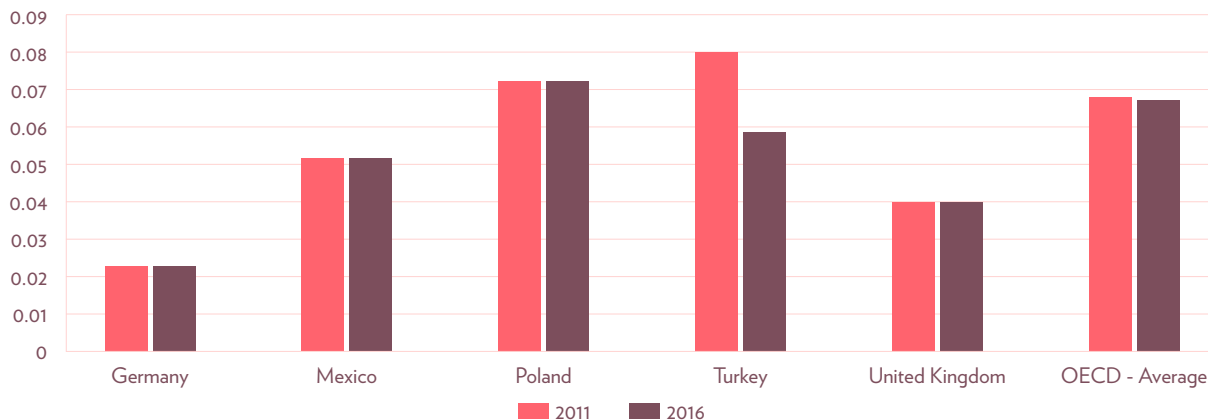
this would have major implications for domestic political sensitivities not only in areas such as public procurement, state aid, and state-owned enterprises but also in services (hence, by implication, for FDI). Regulatory institutions for selected services had become independent in the 2001 reform, but this has been eroding over the last few years. If and insofar as a services deal with the EU would follow a kind of DCFTA model, with harmonization and regulatory convergence with the EU, “...Turkey will need to vastly improve the framework governing its domestic regulatory institutions.”<sup>34</sup>

The Turkish investment climate can also be expressed by referring to the OECD FDI Regulatory Restrictiveness index (with 19 sectors and numerous measures included). It should be noted that not all the above concerns are necessarily incorporated in these indices. Figure 13 below 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); however, the EU average is lower. 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).

Given that the FDI restrictiveness index is relatively low for Turkey, one might see a considerable interest from foreign (mostly, EU) investors in company ownership in Turkey. One should expect, therefore, a positive impact on Turkish growth and development as well as exports. This is confirmed in academic literature. Atıcı and Gürsoy find a significantly positive effect of foreign ownership on Turkish exports.<sup>35</sup> It seems that these firms, over time, even re-organize themselves so as to benefit more from foreign ownership and enhance their export orientation. Güner finds that foreign ownership in Turkey has the effect of improving corporate performance, and this relation is statistically significant.<sup>36</sup>

**Figure 13: Turkey’s FDI Regulatory Restrictiveness Index, Change 2011-2016**



Source: OECD, “FDI Regulatory Restrictiveness Index,” <http://www.oecd.org/investment/fdiindex.htm>.

34 Ülgen, “Trade as Turkey’s EU Anchor,” 11.

35 G. Atıcı and G. Gürsoy, “Foreign Ownership and Export Orientation: Evidence from Turkey,” *International Research Journal of Finance and Economics* 115 (October 2013).

36 A. Güner, “Foreign Ownership and Corporate Performance in Turkey,” *Journal of Business, Economics and Finance* 4, no. 3 (2015): 422–429.

## 4. OBSTACLES TO THE FREE MOVEMENT OF PEOPLE AND ROAD TRANSPORT SERVICES

The establishment of the free movement of goods through the Customs Union constituted one important step for Turkey towards becoming a full-fledged member of the EU; other freedoms would be gradually achieved.<sup>37</sup> More than two decades after the official decision, the Customs Union has largely achieved the free movement of the goods; however, other freedoms have not seen parallel progress. It does not require much sophistication to understand that restrictions by many EU member states in the realm of road transport services supplied by Turkish firms and drivers tend to undermine the very purpose of a customs union. The idea of the customs union is “free circulation,” a core principle in EU law. How can free circulation be credible if quotas are imposed on the number of truckloads towards a member state and/or the freedom of Turkish drivers to deliver the freight in the EU is curtailed? Under the General Agreement on Tariffs and Trade (GATT)/WTO, there are clauses that can be invoked to nullify the benefits of a trade agreement due to other indirect restrictions. Thus, quota restrictions placed on Turkish firms and drivers are inspected below as indirect restrictions on trade. It is clear that any enhancement of the Customs Union cannot possibly avoid the resolution of this long overdue issue, especially given its inconsistency with the founding principle of the Customs Union. Another issue is that all Turkish citizens—regardless of their economic status—are required to obtain a visa in order to enter an EU country, either to visit for touristic or business purposes or to enter the EU to establish a business or provide services. This situation implies a setting where goods can

circulate freely in the internal market, while their owners and producers cannot.<sup>38</sup> Analytically, one can distinguish visa facilitation from the issue of whether or not visas are judged to be a necessary requirement. Both questions have played a role in EU-Turkey relations for a long time.

The Customs Union does not provide visa-free travel for Turkish nationals. Visa requirements are typically under the competence of immigration departments, and there is no link with trade policy. Nevertheless, since a customs union is a fairly ambitious form of trade integration, one would expect the partners to trust one another more than in many other bilateral relationships. Therefore, at the very least, one would expect visa facilitation to be implemented if visa requirements cannot be lifted. Such visa facilitation could lower the transaction and fee costs for applicants while increasing the speed of processing. For business travelers and selected mode 4 purposes, one could facilitate a multiple-entry visa for a longer duration. One could also consider—similar to “authorized traders”—recognizing business travelers with sound records and allow them still better facilities. As will be shown below, none of this is the case at present. If visas are required for some justified reason, it is very hard to see why further difficulties, slow processing, and high fees have to be added on, as this is not the purpose of visas. The purpose is the control and management of inflows of people, not to make the lives of Turks, including business, difficult and costly. A critical principle of the EU’s “better regulation” is proportionality—minimize the requirements and costs in order to effectively pursue one’s goal. For Turkish visas, the EU is not abiding by its own

37 I. Karataş, “The EU-Turkey Customs Union: Towards a Revision of the Legal and Institutional Framework?” Faculty of Law, University of Ghent, 2015.

38 Karataş, “The EU-Turkey Customs Union.”

principle here. Recourse to the GATS is of little use. Since both the EU and Turkey are part of the GATS agreement, certain international commitments pertinent to the movement of natural persons apply in services trade. As Nielsen and Taglioni put it, GATS commitments are binding for WTO members and are “guaranteed minimum treatment offered to other WTO Members; countries are always free to offer better treatment if they wish, but they cannot offer worse.”<sup>39</sup>

The GATS contains four modes of supply depending on the territorial presence of the supplier and the consumer at the time of transaction. The case of the movement of people is covered in *Mode 4 - Presence of Natural Persons* of the GATS agreement. According to mode 4, GATS covers services provided by a service supplier of one member through the presence of natural persons of a member in the territory of any other member.<sup>40</sup> Mode 4 encompasses natural persons providing services in any of the services sectors on a “temporary” or non-permanent basis.<sup>41</sup> However, the definition of temporary is not standardized across members, and WTO members are free to interpret the term as they wish. Overall, not much is done in liberalizing the temporary movement of service suppliers, and most countries made only limited commitments on mode 4.<sup>42</sup>

#### 4.1. EU Visa Restrictions for Turkish Nationals

Turkey is the only candidate country without a visa-free agreement with the EU. There have long been discussions about visa-free travel for Turkish

nationals to the EU. However, it seems that the initially promising agreement of 2015 that the EU (or rather the Schengen area) would lift its visa requirements soon have not borne fruit. The EU has refused to move so far, especially after the Turkish response to the coup attempt.

At present it is not possible to predict whether EU visa restrictions will be lifted any time soon. We thus concentrate on an analysis of the status quo and its consequences for economic relations. As noted, one can take the view that the visa requirements for Turkish citizens coming to the Schengen area and the UK is a separate issue, unrelated to an enhanced customs union as envisaged in, e.g., the 2016 Commission Impact Assessment. However, one may also defend the position that the two are related for functional reasons. The functional linkages are related to both goods and services, indeed, often linked to European value chains, but—in services—both in mode 1 (e.g., visa for truck drivers), mode 2 (Turkish tourists), and mode 4 (temporary cross-border services or business persons exploring a future investment, etc.). Therefore, already under the current BPFT, FDI in Turkey (or, for that matter, Turkish FDI in the EU) for manufacturing benefits from greater freedom under mode 4, also with smoother visa procedures or other facilitation. In a deep and comprehensive customs union including services, in turn linked with FDI, such functional linkages are much stronger still. It is not convincing to argue that visas are a separate issue, or worse, that an enhanced customs union can be combined with visa requirements, let alone with disproportional transaction and fee costs as well as long wait times.

From the start, the BPFT was limited to goods and did not include visa-free travel for natural persons from Turkey to the EU. However, as mentioned by Karataş, because Turkish goods are in large part exported to the EU, Turkish business people and economic operators need to travel frequently to the EU to attend trade fairs, negotiate business

39 J. Nielsen and D. Taglioni, “A Quick Guide to the GATS and Mode 4,” Background document prepared for the joint OECD, World Bank, and IOM seminar on Trade and Migration, November 12-14, 2003, Geneva.

40 WTO, “Basic Purpose and Concepts,” GATS Training Module: Chapter 1, [https://www.wto.org/english/tratop\\_e/serv\\_e/cbt\\_course\\_e/cls3p1\\_e.htm](https://www.wto.org/english/tratop_e/serv_e/cbt_course_e/cls3p1_e.htm).

41 Nielsen and Taglioni, “A Quick Guide to the GATS.”

42 Nielsen and Taglioni, “A Quick Guide to the GATS.”

contracts, meet customers or clients, and attend meetings or scientific conferences for research and development and so forth.<sup>43</sup> Such travel and professional visits are even more relevant in the context of deeper economic integration such as the Customs Union. Because of the 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.

The existence of visas has not impeded actual travel from Turkey to the EU, though it has probably limited its potential. The Schengen visa statistics show that Turkey is among the top five countries to which Schengen visas are issued and the number of visas issued to Turkish citizens has increased in recent years (from 770,000 in 2014 to 890,000 in 2016) despite worsening political relations.

Table 6, below, shows that nearly one million Schengen visas are issued every year in Turkey (to this one would need to add the visas issued by the UK, as it is not in Schengen) and the corresponding data for some other major countries.

The rejection rate is under 4% for Turkey, compared to 7% overall. However, the movement of people between the Schengen area and Turkey seems to be less intense than with the two larger Eastern neighbors of the EU, namely Ukraine and Russia. In Ukraine, which has about half the population of Turkey, 50% more visas are being issued (implying that Ukrainians are three times more likely to obtain a Schengen visa than a Turkish resident). The population of Russia is about 70% larger than that of Turkey, but it also accounts for over three times more Schengen visas. Both Turkey and Russia have a relatively large share of multiple-entry visas (MEVs), implying that business travel is important in both cases.

We note, *en passant*, that the 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, has had a long-standing interest in minimizing visa formalities for tourists.

**Table 6: Schengen Visa Statistics: Turkey Compared to Other Large Countries**

	UNIFORM VISA APPLICATIONS	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		

Note: MEV stands for multiple entry visas.

Source: "Schengen Visa Statistics by Third Country - 2015," Schengen Visa Info, April 19, 2016, <https://www.schengenvisainfo.com/schengen-visa-statistics-third-country-2015/>.

43 Karataş, "The EU-Turkey Customs Union."

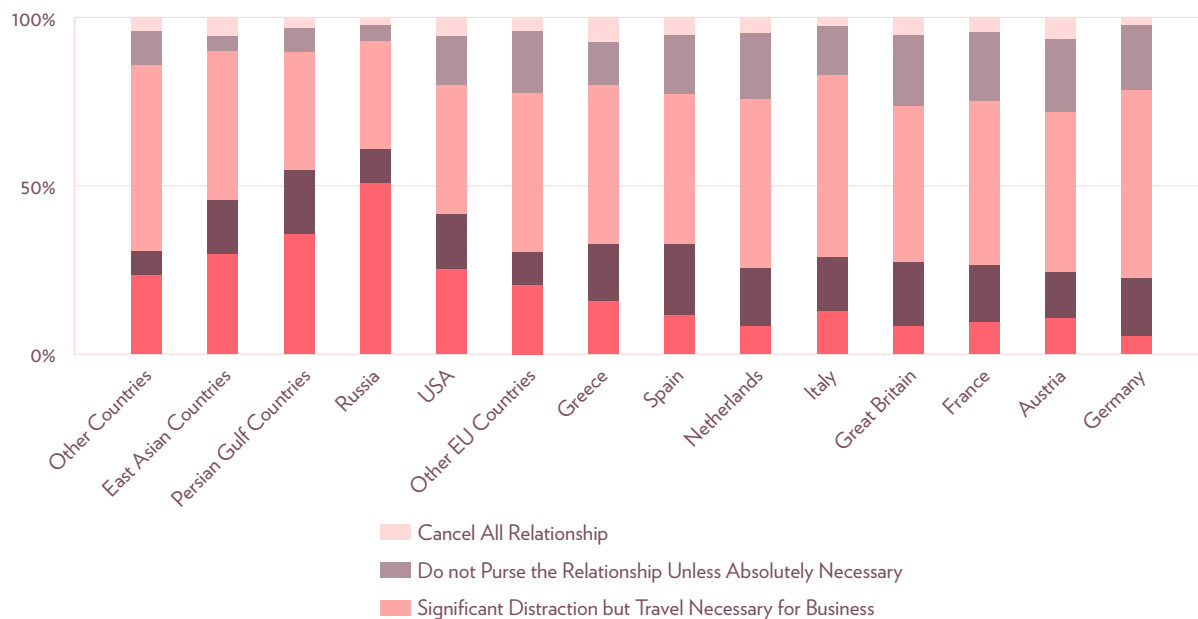
To understand the extent of the visa-related problems in business sectors in Turkey, the World Bank and Chambers of Industry and Commerce carried out a large-scale representative survey of Turkish firms. The results of the survey suggest that business travel—mainly to the EU—is rather common for Turkish businesses.

At the same time, the majority of the respondents stated that it is difficult to obtain travel visas from EU member states compared to other key trading partners and that the visa applications involve excessive paperwork and high visa and service fees paid to consulates and intermediary firms, respectively. These are exactly the issues that a visa facilitation policy disciplined by proportionality could solve.

Figure 14 illustrates the impact that visa regulations have on the business activities of Turkish firms in selected countries based on the survey. It shows that visa restrictions for businesspeople in destination countries create significant distractions to conducting business and can even result in cancelling business relationships. This upshot cannot be the purpose or consequence of visa regulations.

Moreover, EU services providers do not face these obstacles and can thus be said to have a significant competitive advantage.

**Figure 14: Impact of Visa Regulations on Turkish Business Activities, Selected EU and Non-EU Countries**



Source: World Bank, *Evaluation of the EU-Turkey Customs Union*, 2014.

There is a concern from the EU side that visa-free travel would lead to increased permanent and undocumented migration of Turks to the EU.<sup>44</sup> Another related fear of allowing visa-free travel from Turkey could be linked to its geography, which is used by many undocumented migrants as a transit country to enter the Schengen area.

However, it is not clear whether concerns about visa-free travel leading to illegal migration (i.e., overstayers) are justified, except perhaps in exceptional circumstances such as the “refugee crisis” of 2015. Evidence from the migration literature suggests that visa policies not only affect the inflows of individuals to the receiving country, but they also impact outflows; hence, the overall effect of restrictive visa policies on net migration is ambiguous.<sup>45</sup> Moreover, one could even observe the opposite of the desired outcome: by decreasing circulation, restrictive visa policies might encourage long-term settlement.<sup>46</sup> From an empirical point of view, while

we do not have data on the number of Turkish citizens overstaying their visas in Europe, there is data on the number of Turkish citizens ordered to leave the EU, which includes overstayers as well as other categories. Figure 15 shows the trend in the number of Turkish citizens “ordered leaves” from the EU as well as the share of individuals of Turkish origin among all other non-European individuals ordered to leave. The declining trend in both measures suggests that fears of illegal migration from Turkey might be exaggerated.

Moreover, the share of Turkish nationals ordered to leave (about 1.5%) is far below the share of Schengen visas issued in Turkey, which is around 6% for ordinary Schengen visas and 8% for multiple-entry visas. This suggests that Turkish holders of a Schengen visa are several times less likely to overstay or produce other reasons for expulsion than other nationalities.

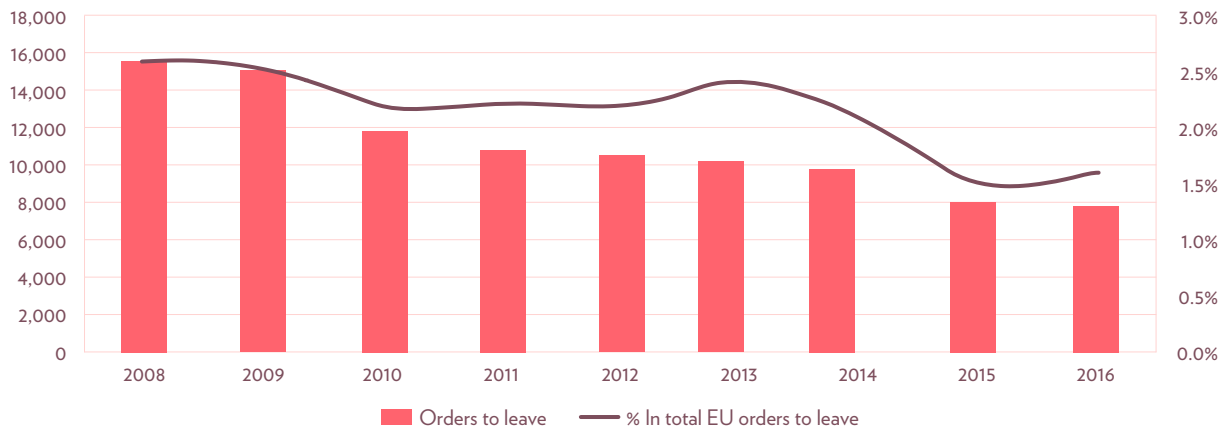
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44 One reason for this fear might be due to the past experience of migration from Turkey to Europe within organized labor migration programs, also known as the guest worker programs, implemented by several European countries in the aftermath of World War II. These programs had been designed to temporarily fix the (mainly low skilled) labor shortages in receiving countries. However, Castles, among others, has asserted that such organized temporary labor programs led to permanent migration, as family members reunited with labor migrants. From the early 1960s until the oil crisis of the 1970s, Turkey sent millions of labor migrants to Europe. Germany, which is Turkey’s largest trading partner, is the prime example of a country having implemented such temporary migration programs: mainly recruiting labor from Turkey, former Yugoslavia, and Southern Europe. Now, the country hosts more than three million Turkish migrants and their descendants. What is more, the political activism on behalf of the Turkish-origin population during the recent political tensions between the governments of Turkey and Germany has increased the political obstacles of encouraging freer movement with Turkey (although strictly speaking visa-free travel has no link to permanent migration).

45 M. Czaik and H. de Haas, “The Effect of Visa Policies on International Migration Dynamics,” International Migration Institute Working Paper 89, University of Oxford, April 2014.

46 K.F. Zimmermann, “Circular Migration: Why Restricting Labor Mobility Can Be Counterproductive,” IZA World of Labor, May 2014, <https://wol.iza.org/uploads/articles/1/pdfs/circular-migration.pdf>.

Figure 15: Ordered Leaves of Turkish Origin



Data source: Eurostat, "Eurostat database, 2016."

#### 4.2. Road Transport: Various Quantitative Restrictions

To carry goods, maritime transportation is the main method of transportation for Turkish exports, while road transportation is a close second.<sup>47</sup> In particular, about 40% of Turkish foreign trade is carried by its international road transport sector. The Customs Union implies that the goods can circulate without barriers between member countries. To this aim, Turkey has removed all customs duties, equivalent charges, and quantitative restrictions. However, the physical movement of Turkish export goods is not completely free within the EU customs territory. This is particularly the case in road transport, for the latter is not dealt with under the general principle of free movement of goods but rather was considered a service.<sup>48</sup>

To give an idea about the constraints in services

trade, the OECD has collected a set of indicators to measure the regulatory restrictiveness in trade in services by sectors. The regulatory restrictiveness index (see above, section 3.2) has several components ranging from restrictions on foreign entry to barriers to competition and regulatory transparency. Another important component of the index relevant in the transport sector is the restrictions on the movement of people. Figure 16 displays the index distinguishing four transport modes for a selected set of countries (including Turkey) in 2016. Through the construction of the data, the index does not give information on the restriction of movement specifically for people from Turkey in a given country, but rather it gives a general restrictiveness index for each country that would apply to any other country's nationals. Regarding Turkey's two largest export sectors, namely road and maritime transport, the overall index suggests that the main countries where Turkish exports are heading or transiting, such as France, Germany, and Italy,

47 F. Novak-Lehmann, D. Herzer, I. Martinez-Zarzoso, and S. Vollmer, "The Impact of a Customs Union between Turkey and the EU on Turkey's Exports to the EU," *Journal of Common Market Studies* 45, no. 3 (2007): 719–743.

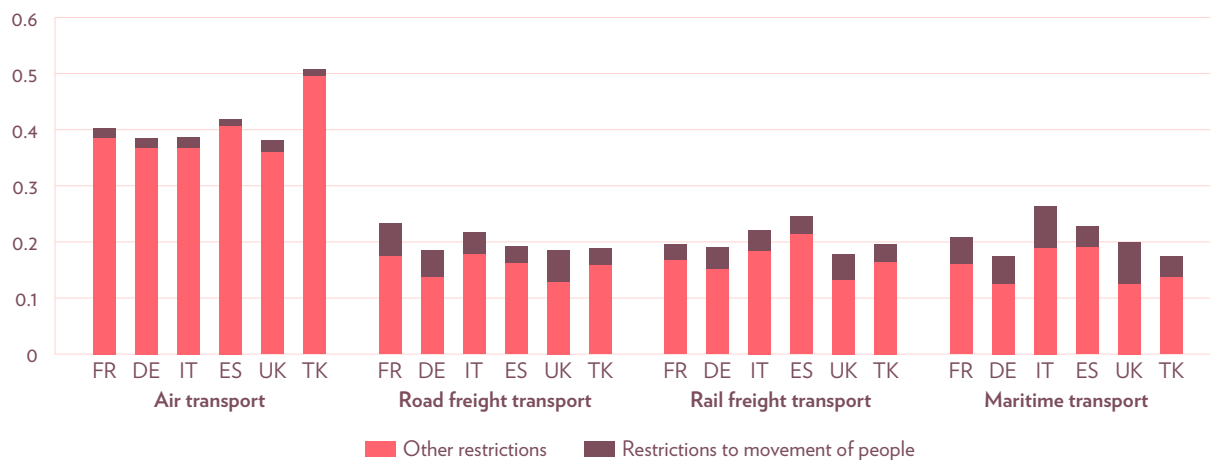
48 World Bank, *Evaluation of the EU-Turkey Customs Union*.

are as restrictive in transport as Turkey.<sup>49</sup> When it comes to the component of the restrictiveness index related to the movement of people, the EU countries seem to impose relatively more restrictions to the movement of people both in road freight and maritime transport compared to Turkey. However, the restrictions relating to the movement of people seem to be less relevant than other restrictions as one can see from the small parts of the bars in Figure 16. Other restrictions refer to other difficulties encountered by the transport sector, such as customs controls, quotas for Turkish companies on major roads, etc.

The trade relations between Turkey and the EU are regulated by a set of bilateral and multilateral agreements restricting quantity and capacity of transport movements by road.

In this respect, road transport quotas control the number of transit permits available for a truck to make a journey.<sup>50</sup> This implies that Turkish exports to the EU are subject to quantitative restrictions, be they quotas or measures with an equivalent effect to quotas, specified in art. 34 of the Treaty of the Functioning of the European Union (TFEU) as forbidden inside the EU. As described in Ülengin et al., road transport quotas are carried out through licenses allocated annually to a specific country by a destination or transit country.<sup>51</sup> This means that if an EU country has set a particular number of licenses, the exporting country carrying its goods to these countries will be obliged to limit its transport journeys to the number of permits (see the examples in Figure 17).

**Figure 16: Restriction Index in the Transportation Sector, 2016**



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

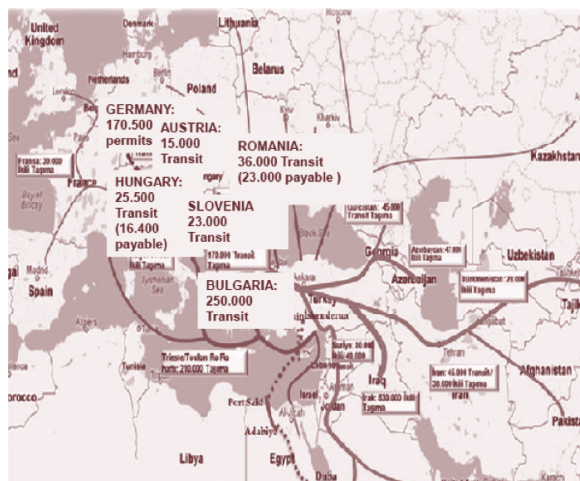
<sup>49</sup> One has to distinguish between EU and non-EU providers. All EU countries have harmonized road transport technical and social regulation—this means that a given level of restrictiveness in these countries is due to the EU and does not represent a barrier. For Turkey, this would depend on the degree of harmonization with the EU acquis. If harmonization is not very high, regulator disparities are bound to generate extra trading costs for market access.

<sup>50</sup> F. Ülengin et al., “Effects of Quotas on Turkish Foreign Trade: A Gravity Model,” *Transport Policy* 38 (2015): 1–7.

<sup>51</sup> Ülengin et al., “Effects of Quotas on Turkish Foreign Trade.”

Transport quotas in the form of transit permits vary by EU country, are generally not cheap, and have been imposed on Turkey by 24 out of 27 EU member states (excluding Croatia). This amounts to a significant restriction of the free circulation of goods as agreed under the Customs Union and, consequently, is a barrier to trade.<sup>52</sup> The restriction is both an impediment to free goods trade between the EU and Turkey and a hindrance to road transport as a mode 1 form of service provision. Turkish authorities state that Turkey's annual export loss due to quotas imposed by the EU is at least 7 billion USD, which is a major cost.<sup>53</sup>

**Figure 17: Transit Permits in the EU for Turkish Transporters**



Source: Figure taken from Ö. Kabak, “Effects of Quotas on Turkish Foreign Trade: A Gravity Model,” Presentation at the Economic Commission for Europe – Inland Transport Committee, Working Party on Road Transport, October 2014.

52 The EU itself terminated such bilateral internal quotas shortly after 1985 when the Court of Justice of the European Union (CJEU) ruled against the Transport Council for not having implemented a common EU transport policy—which of course cannot implement quotas. It is, to say the least, a curious interpretation of a customs union that allows bilateral road haulage quotas for what otherwise is free trade and free circulation of goods.

53 Ülengin et al., “Effects of Quotas on Turkish Foreign Trade.”

Last but not least, two other elements in road transportation are the national licensing systems and visa restrictions for truck drivers imposed by some EU countries.<sup>54</sup> The national licensing system refers to the detailed specialization for each type of road transport activity and is a restriction for a transport operator interested in carrying various categories of goods. The visa restrictions for truck drivers are similar to the issues raised in section 4.1 and mainly related to the constraints of short visa duration (maximum 90 days), not mentioning the visa application costs. According to the World Bank report, the costs of obtaining visas for drivers, custom transit documents, and transit permits make up about 10% of overall transport costs.<sup>55</sup> In a proper customs union, none of these costs should be there.

Looking at the implications of this trade obstacle in transport, Ülengin et al. analyze the effect of road quotas on Turkish foreign trade with EU countries between 2005 and 2012.<sup>56</sup> They find that quotas on road transportation mainly affect Turkish textile exports to European countries, which is principally related to the fact that Turkey's comparative advantage in textiles lies in its use of trucks for short transportation time (“time-to-market”). Employing an extended version of the gravity model to investigate Turkey's sectoral trade flows to the EU under the Customs Union framework, Novak-Lehmann et al. find that transport costs and the difference in transport costs between trade competitors significantly influence exports in sectors such as vegetables and fruits, while they turned out to be irrelevant for cotton, iron and steel, and machinery.<sup>57</sup>

54 World Bank, *Evaluation of the EU-Turkey Customs Union*.

55 World Bank, *Evaluation of the EU-Turkey Customs Union*.

56 Ülengin et al., “Effects of Quotas on Turkish Foreign Trade.”

57 Novak-Lehmann, Herzer, Martinez-Zarzoso, and Vollmer, “The Impact of a Customs Union.”

## 5. CONCLUSIONS

One of the ways to complement today's EU-Turkey Customs Union is to conclude an additional services agreement, liberalizing various services trade (GATS) modes and possibly, to some extent, harmonizing regulation and, where relevant, supervision. Indeed, it is one of the routes suggested in the 2016 Commission Impact Assessment of the enhancing of the Customs Union, supporting the draft mandate sent to the Council of Europe. The present study reports basic trends in Turkish services and trade in services, zooming in on the changing composition of services trade, the relevance of services in European value chains to which Turkish companies are increasingly linked, and the educational and skills base as a foundation for a shift to higher value-added services in Turkey compared to the “old” and “new” EU countries.

Section 3 of the study considers two realistic options for an EU-Turkey services agreement, the CETA model and the example of the DCFTA with Ukraine, followed by an analysis of the regulatory restrictiveness of 22 service sectors in Turkey compared to four EU countries and a short assessment of the investment climate in Turkey, including the FDI regulatory restrictiveness index after 2010. Section 4 calls attention to two outstanding issues that hinder doing business under the existing Customs Union: namely, the lack of visa facilitation for Turkish business travelers (which typically make impossible mode 4-type journeys to the EU, related to goods, services, and FDI, e.g., mother companies or critical suppliers) and the persistence of a range of restrictions for road haulage by Turkish firms with EU destinations (imposed by many EU countries). In a service agreement, it would be more than odd not to lift the transport restrictions, even if one were to deny that the present restrictions amount to “measures with an equivalent effect” to quotas.

Such measures are inconsistent with the notion of a customs union under EU law, if not incompatible.

We find that the importance of services in overall Turkish exports has been declining over the last decade and that Turkey exports mostly services related to tourism and transport. We also verify the regulatory restrictiveness of services in Turkey and find a mixed picture, with considerable need for reforms in several sectors. Tourism faces few trade barriers. This would leave mainly transport. Today, at least in road transport, many EU member states protect the position of their own trucking industry to some degree. Outside these two sectors, Turkey does not yet seem to possess a strong potential for exports of higher value-added services, although services incorporated in exported goods (due to European value chains) have become important. Turkish education levels in the labor force are relatively low though improving recently, except for medium-skilled workers. Raising higher education and skill levels in Turkey would seem to be essential to increase domestic value-added in goods exports and direct and indirect services exports.

Given that the EU has a strategy of concluding “deep and comprehensive” FTAs in several parts of the world, a new agreement on services with Turkey cannot but be ambitious, too, the more so as it is a long-standing associate partner. We conclude that the choice is essentially between a CETA model—far-reaching but without harmonization—and the DCFTA model of Ukraine for services, which assumes considerable harmonization with the EU *acquis* as well and explicitly foresees eventual participation in the internal services market. Both models, but in particular the Ukraine model, would have far-reaching implications for the Turkish regulation of the service sector and for the underlying, but critical, horizontal forms of governance

and leading principles of a rules-based regime. Yet, there is also an EU side to this option. The EU member states still maintain many (often petty) restrictions in services trade with third countries, as the CETA annexes have shown. These ought to be addressed.

Services are also linked to FDI, in markets as well as in the design of FTAs, and to free movement of persons, including cross-border services provision, mode 4 in the GATS. We find FDI to be quite liberally treated, unlike the movement of persons. Much can be improved on the latter, in particular for Schengen visas linked to business activities. In particular, even if visas are judged to be necessary (our study does not enter into this judgment), elementary principles of better regulation suggest implementing visa procedures under proportionality. There is no doubt that EU member states maintain disproportional measures and undertake neither efforts to increase the speed of visa delivery nor of setting cost-based fees, which should be far lower. With respect to inward FDI, although having been stimulated by the Customs Union, it is clearly not reaching its potential, and this might well be explained (apart from skills) by a worsening of economic governance (as shown by indicators). A reliable rules-based regime would help inward FDI to recover structurally, which would in turn support a stronger services sector in EU-Turkey relations.

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