

MODERNIZING THE EU-TURKEY CUSTOMS UNION: IDENTIFYING THE SCOPE TO BRING EU-TURKEY TRADE AND INVESTMENT RELATIONS UP TO DATE

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Introduction

This paper assesses the case for modernizing the EU-Turkey Customs Union and, where necessary, it considers how such changes could be made.

This analysis of the EU-Turkey CU and its possible modernization is set out as follows: Section 1 first examines what the structure of the CU and what it has meant for both Turkey and the EU. Section 2 then considers the pros and cons of the EU-Turkey CU, for both parties. Section 3 considers the wider context of recent developments in the world economy, before focusing on the question of how to up-date EU-Turkey trade and investment relations to identify the various options facing Turkey and the EU. Finally, Section 4 concludes.

1. The European Union-Turkey Customs Union

This section first identifies the legal framework governing the EU – Turkey Customs Union and assesses how it has functioned to structure trade relations between the two parties. It then focuses on regulatory and behind the border policies before looking at the quantitative impact that can be attributed to the Customs Union.

1.1 The Framework Regulating EU – Turkey Trade and Investment Relations

Turkey first applied for associate membership of the then-European Economic Community (EEC) in 1959. The application resulted in an Association Agreement (the Ankara Agreement) between the EEC and Turkey in 1963, whereby the parties agreed to create, *inter alia*, a Customs Union (CU). In 1970, an Additional Protocol was signed, setting out a timetable for abolishing tariffs and quotas on goods circulating between the parties. The CU was established on January 1, 1996 through the European Union (EU)-Turkey Association Council Decision 1/95, covering industrial goods including industrial component of processed agricultural commodities but excluding European Coal and Steel Community (ECSC) products. A free trade agreement (FTA) between the ECSC and Turkey was signed on February 29, 1996, with European Commission Decision 96/528/ECSC covering the ECSC products.

The EU-Turkey CU Decision 1/95 of 1995 required Turkey to eliminate all customs duties, quantitative restrictions, charges with an equivalent effect to customs duties, and all measures with an equivalent effect to quantitative restrictions in the trade of industrial goods with the EU as of January 1, 1996. In addition, Turkey was required to adopt the EU's Common External Tariffs (CET) on third-country imports and adopt all the preferential agreements the EU had/has concluded and would/will conclude with third countries. Thus, over time, Turkey has concluded FTAs with Israel, Macedonia, Bosnia-Herzegovina, Palestine, Tunisia, Morocco, Syria, Egypt, Albania, Georgia, Montenegro, Serbia, Chile, Jordan, Mauritius, South Korea, and Malaysia.¹

In 2004, an anomaly emerged when the European Council opened the accession negotiations with Turkey by emphasizing that the:

¹ In 1991, Turkey signed a FTA with European Free Trade Association (EFTA) countries. The FTA between Turkey and Syria was suspended on December 6, 2011. Currently, the FTAs signed with Lebanon,

..[N]egotiations are an open-ended process, the outcome of which cannot be guaranteed beforehand’ but that ‘while having full regard to all Copenhagen criteria, including the absorption capacity of the Union, if Turkey is not in a position to assume in full all the obligations of membership it must be ensured that Turkey is fully anchored in the European structures through the strongest possible bond.

This accession process thus established an alignment by Turkey with EU regulatory regimes that extends far beyond other EU trade partners regulatory obligations. However, third parties that are not in accession to the EU, have nevertheless been able to secure commitments from the EU that extend far beyond those provided by the legal framework of the EU-Turkey CU. Compared to the state of the art agreements signed between the EU and Canada, for example, or the emerging mega-regionals such as Trans-Atlantic Trade and Investment Partnership (TTIP), the shallow and narrow nature of the EU-Turkey agreement is all too apparent.

1.1.1 The Scope of the EU – Turkey CU

The CU immediately appears outmoded because it applies only to industrial goods, including the industrial components of processed agricultural products produced in the Community or Turkey. The CU also includes those goods wholly or partially manufactured from products coming from third countries but are in free circulation in the Community or in Turkey.² The CU is broadly consistent with the EU’s approach across all of its preferential agreements. The rules determining the origin of a good are based on the principle of goods being wholly obtained in the exporting country, or substantially transformed there in accordance with product-specific rules. Products not wholly obtained are subject to origin criteria that specify how much transformation of non-originating materials must have taken place before a product can be considered eligible for preferences. Consequently, for the EU-Turkey Customs Union, products from third countries can only be considered to be in free circulation in the Community or in Turkey under the following circumstances: a) if the import formalities have been complied with, b) if any customs duties or charges having equivalent effect have been levied in the Community or in Turkey, and c) if they have not benefited from a total or partial reimbursement of such duties or charges.

As a result, since the entry into force of the CU Turkey’s average MFN tariffs for industrial products has fallen significantly, and has remained low due to the ‘anchor’ provided by the Common External Tariff (CET). However, for those sectors not covered

² Decision No. 1/95 Article 3.

by the CU, Turkey's applied MFN tariffs have in more cases increased since the formation of the CU and sometimes significantly so, in the case of sugar and meat for example.

1.1.2 Institutional Requirements

As with the other Association Agreements negotiated by the EU, the institutional requirements of the EU-Turkey CU are set out to establish equal representation of the parties. Article 23 of the Ankara Agreement requires that *the Association Council shall consist of members of the Governments of the Member States and members of the Council and of the Commission of the Community on the one hand and of members of the Turkish Government on the other*. The CU requires i) an association council, ii) an association committee and iii) a parliamentary committee are established by the completion of the CU in 1996. The Association Agreement requires the Association Council *to act unanimously*. Given there is equal representation of each party, both party possess the right to veto any decision. However, the composition and the functioning rules of the decision-making organ of the treaty – the Association Council - precludes representation by individual EU Member States, preventing internal EU dissonance from emerging during decision-making.

The Parliamentary Committee set up under the Agreement serves to 'ensure that everything functions well' within the CU. Its mandate is to carry out exchange of views and information, formulate recommendations to the Association Council and deliver opinions with a view to ensuring the proper functioning of the customs union. Further, *'the Parties shall consult within the Committee on any point relating to the implementation of the customs union decision which gives rise to a difficulty for either of them'*. This means that there is no provision for either a competent jurisdiction or a similar institution to the European Commission that could independently monitor implementation or address weaknesses identified by the Parliamentary Committee. At the limit, this structure has been considered by Neuwahl (1999) to be an 'institutional void' denoting not so much to a lack of institutional structure for the implementation of the agreements but rather its diplomatic or intergovernmental character. This structure translates in practice into a lack of parliamentary control and an absence of recourse to judicial dispute settlement. Again, this presents a structure out of line with both EU and international norms and guidelines on transparency and inclusive governance.

1.1.3 Dispute Settlement

To facilitate enforcement the Ankara Agreement contains a bilateral dispute settlement mechanism. While disputes can be submitted to the Association Council, the Ankara

Agreement also provides for the possibility of references to the EU's Court of Justice (CoJ). The Ankara Agreement therefore puts in place both a political and judicial method of dispute settlement. The political settlement of disputes constitutes the privileged method because disputes related to the application or the interpretation of the agreement shall be *a priori* settled by the 'political will' of the contracting parties. As noted above, the Association Council must make unanimous decisions and as a result both parties are provided with the right to veto. Nevertheless, it is reasonable to assume that the Community has been in a more powerful situation, holding more potential to undermine the strength of Turkey in diplomatic, as compared to judicial relations.

In the event that a diplomatic solution to a difference concerning the operation of the CU cannot be found, there are therefore theoretically three judicial methods available to settle disputes. For those related to the application or the interpretation of the agreement, the CoJ is potentially available. The Association Council must however take a unanimous decision to submit the dispute to the Court, again providing each party with the right to veto. Turkey may be reluctant to accept that the internal court of the EU would be wholly objective or impartial in settling disputes concerning the application and the interpretation of the Ankara Agreement. Indeed, the Association Council has not so far referred any dispute to be settled by the CJEC. Nor has it utilized either of the other two options of submitting disputes to another existing unnamed court or tribunal or to arbitration. Decision 1/95 permits, for a limited number of cases, the rules and modalities of the establishment of an arbitral tribunal to which the contracting parties can submit the dispute during the definitive stage of the CU. Yet the enforcement of these decisions is limited by Article 25 of the Association Agreement which states *each party shall be required to take the measures necessary to comply with the decisions*, yet it does not provide for sanctions or remedies concerning non-compliance with these decisions. This clearly could be a source of further disputes.

1.1.4 Excluded Sectors:

As asserted, it is becoming increasingly significant that Turkey and the EU still do not have a treaty framework that binds market access services commitments, nor those covering the temporary movement of service providers, commercial presence or investment. With regard to public procurement, Decision 1/95 only pledged future negotiations and given that Turkey is not a signatory to the World Trade Organization's (WTO) Agreement on Government Procurement, it is not a beneficiary of the EU's commitments under that regime. Although intellectual property rights and obligations are treated by Decision 1/95, there is still an entire field of geographical indications (GIs) that is absent. This subject is notably present and accounted for in all the new EU trade agreements. Indeed, Table 3 indicates that with regard to the regulatory border and

behind the border policies that are covered by the EU-Turkey CU, there are numerous divergences between this and the other deep integration agreements that the EU is currently negotiating and signing.

1.2 Regulatory Border and Behind-the-Border Policies

In addition to tariffs and related issues, the EU-Turkey CU requirements extend to rules and disciplines on various regulatory border and behind-the-border policies, such as customs modernization, eliminating technical barriers to trade (TBTs), competition policies, intellectual property rights, and trade policy instruments. The following section looks at the specific policies in turn.

1.2.1 Customs Reform

Prior to the formation of the CU, Turkey had a complicated import regime. The customs administration was a traditional paper-based organization and declarants had to go to customs offices to register declarations. Since almost all shipments had to be physically inspected, the process at customs was very intrusive and time consuming. It often led traders to pay substantial facilitation money to speed up the process or to curry favour with customs officials in charge of their inspections. With the support of the World Bank, in 1995 Turkey began to modernize its customs administration, to speed up the release of goods, collect customs duties and related charges effectively, rationalize the clearance process, and simplify procedures while enhancing customs control and creating and transferring statistical data in a timely and reliable manner. The focus of the project was on modifying customs legislation according to CU requirements and the requirements of international customs standards developed by organizations such as the World Customs Organization. Other aims included developing and implementing computer systems and reorganizing customs administration by creating a balance between customs control and trade facilitation in harmony with other international agreements and conventions that Turkey is party to. As a result, Turkey had to ensure that the necessary implementation and enforcement capacities, including links to the relevant EU computerized customs systems, were in place so that special rules laid down in related areas of the *acquis* could be followed.

With the CU, Turkey adopted a new customs law similar to the EC's Customs Code, and as part of its trade facilitation work the Turkish Customs Administration (TCA) developed its ability to undertake its control function without the need to open every

cargo shipment yet retain effective control over the flow of goods and duties payable. Thus, over time Turkey has achieved all of these goals.

1.2.2 Technical Barriers to Trade

There are essentially two ways to eliminate TBTs: harmonization and mutual recognition. Since the establishment of the CU, Turkey has harmonized its standards with European and international ones. It has also harmonized its technical legislation with that of the EU, particularly in the New Approach area. Harmonization of the legislation in the Old Approach area, however, is still incomplete. In addition, Turkey has established the quality infrastructure comparable to the EU's, encompassing the operators and operation of standardization, testing, certification, inspection, accreditation and metrology. Finally, Turkey took the necessary measures to develop the market surveillance and import control system as in the EU.

In areas where the elimination of TBTs requires the adoption of mutual recognition approach, an EU Member State of destination has to allow Turkish products free access to its market, as long as the products provide an equivalent level of protection of the various legitimate interests involved.³ Thus, the EU Member State of destination has still the right to verify the equivalence of the level of protection provided by the product under scrutiny as compared to that provided by its own national rules. In order to avoid the verification processes by EU Member State of destination, Turkey has to establish trust in its system of standards and conformity assessment procedures. As a result, the mutual recognition approach requires a relatively high degree of harmonized standards and testing procedures between the EU and Turkey.

Until the formation of the CU, Turkey had neither the infrastructure nor the required technical knowledge required for the elimination of TBTs. In the 20 years that have passed since the establishment of the CU, Turkey has harmonized its standards to a very large extent with European and international ones; harmonized its technical legislation with that of the EU; established quality infrastructure comparable to the EU's; and developed a market surveillance and import control system as in the EU. Although these are remarkable achievements, there are still areas where Turkey needs further alignment of its legislation and implementation with the *acquis* as emphasized recently by the European Commission (2015).

³ Pursuant to Communication 2003/C265/02.

1.2.3 Competition Policy

Until the adoption of the EU-Turkey CU, Turkey had no specific competition legislation and thus no competition policy enforcement. The agreement required Turkey to adopt EU competition rules, including measures regarding public aid. As a result, Turkey adopted the Law on the Protection of Competition, and established a Competition Authority (CA), aiming to ensure the formation and development of markets for goods and services in a free and sound competitive environment, observe the implementation of the Competition Law, and fulfill the duties assigned to it by the law. The CA has played an important role in moving the Turkish economy towards greater reliance on competition-based and consumer-welfare-oriented market mechanisms. Turkey has shown significant progress on anti-trust issues, and the CA has a clear track record on implementing competition rules.

Article 34 of the Customs Union Decision 1/95 prohibits Turkey and EU Member States from providing state resources to aid undertakings or economic sectors where doing so distorts or threatens to distort competition between the EU and Turkey. Under the requirements of Article 39(2), Turkey must adapt all of its existing aid schemes to EU standards and comply with the notification and guideline procedures established by the EU to control aid provided by Member States. Although the law on State aid and subsidies was passed by Parliament in October 2010 the EU State Aid rules could still not be implemented because the implementing regulations have not been adopted. Thus, State aid is an area where Turkey needs further alignment of its legislation and implementation with the *acquis*.

1.2.4 Intellectual Property Rights

Article 31 and Annex 8 of Decision 1/95 require that Turkey must ensure adequate protection and enforcement of intellectual property rights (IPR), have implemented the Uruguay Round Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) by 1999, adopt legislation by January 1, 1999 to secure the patentability of pharmaceutical products and processes, and accede to various international conventions on IPR specified in the CU Decision 1/95.

Turkey has made substantial efforts to align its legislation with the *acquis* since 1995, and the Turkish Patent Institute (TPI) was established in 1994. The main problem with intellectual property rights (IPR) in Turkey, however, is enforcing legislation, as it requires specific skills. Although a relatively large number of judges, lawyers, enforcement staff, police force members, and customs officers have been trained in IPR-related issues, more are needed. Turkey is aware of the fact that it has to provide the

measures, procedures, and remedies necessary to ensure fair and equitable enforcement of IPR.

1.2.5 Trade Policy Instruments

The CU requires that Turkey approximates and implements the EU's commercial policy regulations, including procedures for anti-dumping, countervailing duties, surveillance, and safeguards measures, as well as administering quantitative quotas and procedures for officially supported export credits. Since the formation of the CU, Turkey has successfully adopted all related EU rules and regulations and is effectively implementing them.

1.3 Quantitative Analysis of the EU-Turkey Customs Union

This section considers rather briefly the Turkish trade performance prior to the formation of the CU and thereafter, Turkish foreign direct investment (FDI) performance prior to the establishment of the CU and thereafter, and quantitative studies of the EU-Turkey CU.

The CU has had positive effects. Prior to the formation of the CU, Turkey's economy-wide nominal protection rate (NPR) in trade with the EU amounted to 10.2%, and in trade with third countries 22.1% (Togan, 1997). With the formation of the CU, NPRs decreased substantially in almost all sectors. The economy-wide NPR during 2001 in trade with the EU amounted to 1.3%, and in the case of trade with third countries, the average NPR amounted to 6.9%. For example, the average NPR decreased from 22.1% to 1.3% for Israel and Central and Eastern European countries that the EU had FTAs with. For developing countries that are granted generalized system of preferences (GSP) treatment, the average NPR decreased from 22.1% in 1994 to 2.7% in 2001. Finally, for countries like the US, Japan, and Canada, for which the EU applies most favored nation (MFN) tariffs, average NPR decreased from 22.1% in 1994 to 6.9% in 2001. Thus, regarding access to the Turkish market, almost all countries in the world have benefited from NPR reductions in Turkey. Regarding access of Turkish goods to the EU market, the EU had abolished nominal tariff rates on imports of industrial goods from Turkey on September 1, 1971.

1.3.1 Trade Performance

Table 1 shows the developments in Turkish trade prior to and after the formation of the CU. In 1995 Turkish exports to EU-28 amounted to \$12.2 billion (56.3% of Turkey's exports); while imports from the EU-28 amounted to \$18 billion (50.4% of Turkey's imports).⁴ With the formation of the CU the share of imports from the EU-28 in total imports went up from 50.4% in 1995 to 55.8% in 1996, fluctuated around 54.2% during the period 1997-2000, and then declined considerably over the period 2001-2008 reaching 36.9% in 2008. By 2014 the share of imports from the EU in total imports stood at 36.7%. On the other hand, the share of exports to the EU-28 in total exports declined from 56.3% in 1995 to 51.3% in 1997 and increased to 58.1% in 1999, but thereafter the share fluctuated during the period 2000-2007 around 57%, and started to decline thereafter. By 2014 the share of exports to the EU in total exports had reached to 43.5%.

Comparison of the growth rate of imports from the EU-28 prior to the formation of the CU with those observed after the formation of the CU reveals that the average growth rate of imports from the EU-28 has declined from 9.1% experienced during 1990-1995 to -2.5% during the period 1996-2001, but thereafter picked up and increased to 16.9% over the period 2002-2008. During 2010-2014 the average growth rate of imports from the EU-28 amounted to 4.2%. On the other hand the effect of the CU on exports seems also to be of limited importance initially. Whereas the annual average growth rate of exports to the EU-28 was 8.5% prior to the formation of the CU, it had declined to 6.2% over the period 1996-2001, but increased thereafter to 18.8% over the period 2002-2008. The average growth rate of exports to EU-28 over the period 2010-2014 declined to 5.2%.

{Insert Table 1}

The above considerations reveal that the formation of the CU between Turkey and the EU lead to increases in exports to the EU only after an adjustment period of almost six years. Similar considerations hold also for imports from the EU. The reasons may be various. First, the formation of the CU did not lead to substantial decreases in trade barriers on the EU side, as the EU had abolished the nominal tariff rates on imports of industrial goods from Turkey long before the formation of the CU, namely in 1971. With the formation of

⁴ In 1958 Belgium, France, Germany, Italy, Luxembourg and Netherlands became members of the European Economic Community (EEC) that was formed by the Treaty of Rome in 1957. In 1973 Denmark, Ireland and United Kingdom joined the European Community (EC); Austria, Finland and Sweden joined the EU in 1995; Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia joined the EU in 2004; Bulgaria and Romania became members of the EU in 2007; and Croatia joined the EU in 2013. Although in 1990 16 of the above mentioned members were not members of the EC we consider in the following for reasons of consistency data for EU-28 consisting of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, and Croatia over the entire period 1990-2014.

the CU certain quotas applied by the EU were abolished, but the parties retained the right to impose anti-dumping duties. Second, Turkey started to take measures in order to eliminate TBTs only after 2003. Third, during the 1990's economic crises began to affect the Turkish economy with increasing frequency. Periods of economic expansion have alternated with periods of equally rapid decline. Finally, with substantial decreases in trade barriers on the Turkish side experienced during 1996 the increase in imports was inevitable as long as it was not accompanied by real devaluation of the Turkish Lira. But there was essentially no change in the real exchange rate (RER) during 1996, and thereafter we observe in fact appreciation of the RER which has lasted until the currency crisis of 2001, when the RER depreciated considerably. Thereafter, the RER started to appreciate again stimulating the import growth and hampering the growth of exports and thus leading to substantial trade balance deficits.

1.3.2 Foreign Direct Investment

Turkey was not successful in attracting foreign direct investment (FDI) inflows for a very long time. During the period 1990-1995 annual FDI inflows amounted to only \$745 million as indicated in Table 2. The country's failure to attract large foreign investment inflows was mainly due to economic and political uncertainties surrounding the country and the enormous institutional, legal and judicial obstacles faced by foreign investors in Turkey. Foreign-owned firms had been subject to special authorisations and sectoral limitations. According to the Foreign Investment Advisory Service (2001a, 2001b) seven major problems impeded the operations of FDI enterprises up until the early 2000s: (i) political instability, (ii) government hassle, (iii) a weak judicial system, (iv) heavy taxation, (v) corruption, (vi) deficient infrastructure and (vii) competition from the informal economy. During the period 1996-2000 annual FDI inflows amounted to \$846 million.

Thus, there was no substantial increase in FDI inflows after the formation of the CU. The FDI inflows started to increase only after 2001, and reached \$20.2 billion in 2006, \$22 billion in 2007 and \$19.9 billion in 2008. This considerable increase in FDI inflows seems to be due mainly the EU's 2004 decision to begin membership negotiations with Turkey, liberalisation measures introduced during the period after the 2001 crisis and implementation of the privatisation program after 2002. During 2009 FDI inflow decreased to \$8.6 billion and attained a value of \$9 billion during 2010. Finally, during the period 2011-2014 it has fluctuated around the average value of \$13.7 billion.

{Insert Table 2}

Although we have data on total FDI inflows collected by the Central Bank of the Republic of Turkey over the period 1990-2014 data on FDI inflows from the EU started only recently in 2002. Table 2 reveals that total FDI inflow has grown during the period 1990-1995 at the annual rate of 0.4% . After the formation of the CU the growth rate of FDI inflow during the period 1996-2000 increased to 5.9%, but then decreased to -1% during the period 2001-2004. After increasing at the annual rate of 21.4% during the period 2005-2008, the rate of growth of FDI inflows decreased to -7.8% during the period 2011-2014. On the other hand, consideration of the share of FDI inflows from the EU countries in total FDI inflows reveals that the share has fluctuated during the period 2002-2014 between 33.2% and 71.8%. As of 2014 the share of FDI inflows from the EU countries in total FDI inflows amounted to 43.2%. The annual growth rate of FDI inflows from EU countries has decreased from 79.8% during 2002-2008 to -25.3% during 2011-2014. These developments could be explained by the change in perception of EU investors about course of Turkish accession negotiations. Initially, the perception was that Turkey's investment climate would improve over time as accession negotiation progressed. But this perception changed over time as can be seen from Table 2. The various international competitiveness studies like the Doing Business Survey of the World Bank did also not reflect an improvement in Turkish investment climate, and in 2016 Doing Business Survey Turkey is still ranked as the 55th country among 189 countries.

1.3.3 Impact of the EU-Turkey Customs Union

The existing literature on the effects of the EU-Turkey CU has focused on the one hand on ex-ante studies and on the other hand on ex-post studies. While the ex-ante studies are of computable general equilibrium (CGE) type, ex-post studies use mostly the gravity model to assess the impact of the CU on trade and welfare.

One of the earliest ex-ante studies of the EU-Turkey CU is that by Harrison et al. (1997). Using a CGE model the authors conclude that the CU generates welfare gains for Turkey of 1-1.5 % of its GDP. On the other hand, Lejour and de Mooij (2005) estimate the effects of the EU-Turkey CU for both the EU countries and Turkey. On the basis of a CGE model for the world economy, the authors find that the effects of Turkey's accession to the single market are substantial and positive for Turkey, small but positive for mainly the Central and Eastern European (CEE) countries that have acceded to the EU in 2004, and negligible for the EU-15. Moreover, according to the authors the agricultural, textile and apparel sectors would suffer a small decline in the EU countries, whereas the chemicals, metals and transport equipment sectors were predicted to expand marginally in the EU countries.

Among the ex-post studies of the EU-Turkey CU two recent studies are of major importance. The World Bank (2014) estimates a gravity model using a dummy variable for the EU-Turkey CU. The coefficient estimate was 0.2 suggesting a 22 % increase in bilateral trade due to CU, though this effect was not statistically significant. On the other hand, Magee (2015) concludes that the CU has generated more than twice as much trade creation as trade diversion, but that the overall impact of the CU has been relatively small.

2. The Pros and Cons of the EU-Turkey Customs Union

The EU-Turkey CU of 1995 has been a major instrument of integration into the EU and global markets for Turkey, offering the country powerful tools to reform its economy. It has credibly locked Turkey into a liberal foreign trade regime for industrial goods. As a result, Turkish producers of industrial goods have become exposed to competition from imports and they operate within one of the largest FTAs for industrial products in the world. They are protected by tariffs from external competition to exactly the same extent that EU producers are, and as such, face competition from duty-free imports of industrial goods from world-class pan-European firms. In return, Turkish industrial producers have duty-free market access to the European Economic Area.

But the EU-Turkey CU has not been without its critics. Akman (2010) points out the following problems:

- i) The EU has its own priorities reflected in its FTAs that are concluded, and these agreements do not take into account Turkey's special interests.
- ii) Turkey suffers tariff revenue losses. In particular, imports from third countries by way of trade deflection via the EU induce tariff revenue losses for Turkey.
- iii) Turkey cannot enter into FTAs with third countries with which the EU has not accorded a deal.
- iv) There are latecomer effects. In particular, Turkey can conclude FTAs only after the EU has concluded the FTAs. This puts Turkish exporters into disadvantageous position with regards to EU exporters, who can obtain preferential status by penetrating into third country markets several years earlier.
- v) Some of EU's trade partners that had concluded FTAs with the EU or continue to negotiate FTAs with the EU refrain from concluding FTAs with Turkey despite the 'Turkey Clause' included in FTAs concluded by the EU.

On the other hand, the World Bank (2014) considers in addition to the criticisms stated above the following problems:

- (a) The road transport quotas and transit permits hinder the free circulation of goods covered by the CU.

(b) The use of Trade Defence Instruments like anti-dumping and safeguard measures harms trade.

(c) The current visa regime has repercussions on EU-Turkey trade and business relationships.

2.1 Strengths and Weaknesses: The Legal Framework

The framework of the CU offers incentives to Turkey to align with EU law due to its hints towards the accession process, yet it does not offer binding commitments beyond the trade in industrial goods, on the part of the EU. Nevertheless, as noted in Section 1.2, due to the accession process, Turkey's actual alignment to EU internal market law has advanced in certain areas, such as free movement of goods, competition policy and State aid, energy, economic and monetary policy, enterprise and industrial policy, as well as in consumer protection, statistics, Trans-European Networks, and science and research. Yet there have been various delays in opening new chapters for negotiation under the accession process. There are clear political, economic and legal dimensions to the structure of the CU plan. Perhaps as a consequence, the association law with Turkey has been characterized by Byzantine complexity, consisting of different norms deriving from primary and secondary association rules and interpretation through CJEU case law.

This section identifies poor rules alignment as well as any legal anomalies caused by the growing reality gap between this static legal framework and a dynamic modern economy. It divides this analysis into 'internal' and 'external' legal requirements.

2.1.1 Internal Requirements of EU-Turkey Customs Union

While commercial agreements between the EU and third parties are explicitly provided by Article 207 of the Treaty on the Functioning of the EU (TFEU), the association agreements, such as with Turkey, have been concluded under the broader and more flexible wording provided for under Article 217. This provision can provide for deeper integration agreements extending beyond purely commercial purposes such as those with economic, social, political and cultural relations, as well as agreements that adopt CU. Thus the Turkish association agreement aimed to achieve a CU over three stages and alignment to the four freedoms with the long-term goal of preparing Turkey for accession. However, as noted, it does not provide a binding roadmap for accession.

The Association law consists of different layers of legal norms made up from the Ankara Agreement, the Additional Protocol from 1970 and the Association Council Decisions

2/76, 1/80, 3/80 and 1/95. Since 1987 and the *Demire* case, the CoJ has been regularly called upon to rule on the legal implications of this body of EU-Turkey Association law. Since the attainment of the CU in 1995, directly effective rights have been given to migrant Turkish workers and social security rights. However, rights these were specified by the Association Council Decisions and not by the Association Agreement or Additional Protocol. The CoJ has stated that the fundamental freedoms enshrined in Articles 48, 49 and 50 EC Treaty must be extended, as far as possible, to Turkish workers. This interpretation by analogy was extended to secondary legislation in relation to association law. Thus although no internal market is established, the Turkey participates fully in the common commercial policy due to the joint CU.

A further step in the interpretation of this body of law has been taken by the court in the recent cases of *Ziebell* and *Demirkan* in 2011 and 2013 respectively. In *Ziebell*, the second chamber of the CJEU ruled on whether or not the so-called Citizenship Directive⁵ can be extended by analogy to the reading of the Article 14(1) of Turkish Association Council Decision 1/80. The Court denied this extension on the grounds that the Citizenship Directive is built on the inherent rights of EU citizenship, which is not connected to a worker's status and results in substantial differences between the association with Turkey and the EU Treaty. The next pertinent Court ruling was in 2013, which confirmed that the standstill clause of the association agreement could not be utilised to extend further developed EU principles to Turkish nationals. The Court has since considered that any such interpretation would be applied only if there are express provisions to that effect laid down by the agreement itself. Critics noted that this decision was a form of 'selective associationism,'⁶ which would lead to arbitrary interpretations.⁷

In sum: the Turkish association suffers from a case-by-case approach built on a static association initiated over 50 years ago. The EU institutions are not required to interpret the Ankara Agreement, the Additional Protocol from 1970 and the Association Council Decisions in the same dynamic teleological fashion as employed when interpreting the EU Treaty provisions. Further legal developments can only be achieved through novel

⁵ Article 28(3)(a) of the Directive 2004/38

⁶ B. Pirker, 15 Apr. 2013 AG Cruz Villalon in Case C-221/11 *Demirkan*: Selective Associationism, at <http://europeanlawblog.eu/?p=1713#sthash.KGHd44QD.dpuf>.

⁷ Maresceau, The Court of Justice and bilateral agreements, in A. Rosas et al. (eds.) *The Court of Justice and the construction of Europe*, TMC Asser Press, the Hague, 2013, pp. 693 (at p. 714) and Maresceau, A reflection on the *Ziebell* judgment, in V. Kronenberger, M. T. D'Alessio and V. Placco, (eds.) *De Rome à Lisbonne: les juridictions de l'Union européenne à la croisée des chemins*, Bruylant, Brussels, 2013, p. 103

Association Council Decisions specifying rights and redrafting of a more dynamic legal framework.

2.1.2 External Requirements of GATT Article XXIV

GATT Article XXIV conditions the formation of preferential trade agreements by WTO Members. It requires, *inter alia*, the application of ‘substantially the same’ duties and other regulations of commerce to the trade of non-members. While the EU does not have to align itself to Turkey’s agreements, it must still comply with GATT Article XXIV’s custom union requirements for a harmonized external regime. For its part, Turkey must take the necessary measures and negotiate agreements on mutually advantageous basis with the countries concerned in order to align its commercial policy with the EU’s autonomous regimes, such as under the Generalised System of Preferences scheme (GSP) or preferential trade agreements.⁸ An anomaly arises however, because while under the CU Turkey is obligated to align with the preferential agreements that the Community signs with third countries, these third countries do not have any obligation to conclude such agreements with Turkey. Indeed, it is more advantageous for these countries not to conclude preferential agreements with Turkey because they already have access to the Turkish market through the EC-Turkey CU. However, if Turkey does not conclude agreements with third parties signing preferential agreements with the Community, Turkey must apply reduced or zero-rates for the imported products from these countries.

A compensatory levy provision has been established⁹ that aims at reducing Turkey’s economic burden but it is a complicated calculation: Where Turkey maintains a tariff policy different from that of the Community, goods imported from third countries into the Community and released for free circulation with preferential treatment by reason of their country of origin or of exportation shall be subject to the payment of a compensatory levy if they are imported into Turkey from countries to which the same preferential tariff treatment is not granted by Turkey and *inter alia*, the duty to be paid in Turkey is at least five percentage points higher than that applicable in the Community, and an important distortion of traffic related to these goods has been observed.

There is therefore a systemic imbalance in the CU framework as set out under the Association Agreement that serves to undermine its perceived legitimacy. Turkey cannot take part in the negotiations between the EU and third countries’ and moreover, neither can Turkey unilaterally apply new EU negotiated preferences to the trading partner since this would trigger violations of the GATT (and the GATS) most-favoured nation

⁸ Article 16 of Decision 1/95.

⁹ Article 16 of Decision 1/95.

obligation (Mathis, 2013). Article 16 of Decision 1/95 of the Association Council does not permit the associated country to make choices other than those adopted by the Community.

In sum, the existing legal and institutional framework of the CU translates into a relationship of dependency both economically and politically of Turkey upon the EU. Turkey is obliged to adopt a considerable part of the *acquis* in several fields and to align its custom and commercial legislation with the EU legislation, without involvement in the associated decision-making. Without setting out a binding roadmap to membership this anomaly undermines the legitimacy of the relationship and creates for Turkey a sovereignty shortfall. The obligation to fall into line with the preferential agreements of the Community is coupled with the obligation not to participate to other free trade agreements.

3. Recent Developments in the World Economy

This section assesses the international context in which the out-moded CU now operates. It submits that during the period when Turkey was trying to implement the requirements of the EU-Turkey CU, major changes were taking place in the world economy. Since the mid-1980s developments in telecom and internet have triggered a suite of information management innovations that made it easier and cheaper to coordinate complex production activities from a distance. As a result some production stages previously performed in close proximity were dispersed geographically.

Manufacturing today is increasingly managed through global value chains (GVC). While before 1985 successful industrialization meant building a domestic supply chain, today developing countries join GVCs and grow rapidly because offshored production brings elements that took Germany and Korea decades to develop domestically. A good example is China. According to Baldwin (2013) the heart of GVC trade is an intertwining of trade in goods; international investment; and cross-border flow of knowhow. To benefit from increased GVC trade it is very important that tariffs are eliminated, transport cost and administrative costs are low, and delays do not occur. On the other hand, lower barriers to investment are a must for participating in GVC trade, as they facilitate investments by lead firms leading to integration of economies in international production networks. Furthermore, a high quality transport infrastructure with major international gateways and corridor infrastructures such as airports, harbors, railways and highways facilitates economies' participation in GVCs.

During the period when traditional trade, referring to goods made in one nation and sold to another, dominated world trade, rules of international trade after World War II were set first by General Agreement on Tariffs and Trade (GATT) and thereafter by World Trade Organization (WTO), which provides a rule based trading system based on norms that are almost universally accepted. Within WTO disputes are adjudicated by an international court whose rulings are almost universally implemented, membership to WTO is almost universal, and decisions at WTO are made by consensus. These are positive aspects of the WTO. On the negative side we note that the DOHA Round of Multilateral Trade Negotiation, which started in 2001, could still not be concluded. Furthermore, DOHA is mainly about tariffs, agricultural subsidies and unfair trade practices, and it does not deal with the issues raised by the GVC trade.

The industrial countries US, EU and Japan, noting that GVC trade is not global and rather regional, have decided to establish the rules of GVC trade regionally rather than multilaterally. They started to sign free trade agreements (FTA) with deep provisions that are pro GVC trade. They also signed Bilateral Investment Treaties (BIT) tackling

different investment issues. As a result, the centrality of WTO in global trade governance started to erode. Recently, US and the EU started to negotiate mega regionals such as the Trans-Pacific Partnership (TPP) and Trans-Atlantic Trade and Investment Partnership (TTIP). In addition, the EU and US have concluded deep and comprehensive FTAs with Korea, and EU with Canada. It seems that in the future, as emphasized by Baldwin (2014), WTO will keep governing the traditional trade while mega-regionals will set the rules in general for the 21st century international trade.

3.1 The Arrival of Deep Integration Agreements

Table 3 compares the TPP and TTIP among themselves as well as TPP and TTIP with the EU-Korea FTA (KOREU), Canada-EU Comprehensive Economic and Trade Agreement (CETA) and the EU-Ukraine Deep and Comprehensive Free Trade Area (DCFTA). Among these agreements TTIP will probably be the most comprehensive trade and investment agreement. Although at this time we do not have a text of the TTIP agreement, the EU Commission has made a large body of EU negotiating texts publically available.¹⁰ On the other hand, Ministers of the TPP countries – Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States, and Vietnam – announced on October 4, 2015 conclusion of their negotiations, and made the text of the agreement public.¹¹ Note that the KOREU was ratified on May 4, 2011, and that the Canada-EU summit on September 26, 2014 in Ottawa marked the end of the negotiations of the EU-Canada trade agreement. Finally, note that the EU and Ukraine signed the DCFTA on June 27, 2014 as part of their broader Association Agreement, and the EU and Ukraine started to apply the DCFTA on January 1, 2016.

{Insert Table 3}

The TTIP agenda can be summarized under three headings: market access, regulatory co-operation, and rules. While market access comprises the traditional tariffs and customs matters, services, origin rules, and government procurement, regulatory co-operation focuses on elimination of TBTs and issues related with food safety, animal and plant health. Finally, rules concentrates on sustainable development, trade facilitation, investment protection, competition policy, intellectual property rights (IPR) and geographic indicators (GI), investor-to-state dispute settlement and government-to-government dispute settlement. Since, differences in regulation between the parties may

¹⁰ See the website <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1230>.

¹¹ See the website <https://ustr.gov/tpp/>.

render bilateral trade to be more costly than it needs to be, the emphasis in TTIP is on regulation.

TPP covers more or less similar issues as the TTIP. The main differences between TTIP and TPP is stemming from the characteristics of the negotiators involved. While TTIP is negotiated between rather homogeneous trading blocks EU and US, TPP is negotiated among countries with different incomes per capita and levels of development of public governance. Hence emphasis in the two agreements is quite different. The main differences between TTIP and TPP can be summarized as follows: First, while TTIP encompasses articles on elimination of TBTs and on sanitary and phytosanitary (SPS) measures in specific sectors of importance to the EU and US such as cosmetics, engineering, medical devices, pesticides, information and communications technology, textiles, vehicles, pharmaceuticals and chemicals, TPP covers the elimination of TBT and SPS measures in general terms and include to a large extent material that has been agreed upon in WTO. Second, TPP has adopted the negative list approach to liberalization of services liberalizing every service sector unless otherwise specified. Sector specific issues are discussed in financial services and telecommunications. Furthermore TPP has specific chapters on electronic commerce and temporary entry of business persons.

Third, TPP when considering the removal of direct trade barriers and lowering tariffs concentrate in addition in contrast to TTIP on problems specific to textile and apparel sector. Fourth, while TTIP has a separate chapter on energy and raw materials, the same is not true in the case of TPP. Fifth, while TPP includes specific provisions on state-owned enterprises, the same is not the case in TTIP as the role of state enterprises in the EU and US are less important. Sixth, while TPP has a separate chapter on trade remedies, TTIP does not. Seventh, TPP has separate chapters on co-operation and capacity building for the lesser developed TPP countries, on transparency and anti-corruption, competitiveness, and administrative and institutional provisions. These issues are not covered in TTIP as they are considered of less important for the EU and US. Finally, on November 12, 2015 the European Commission finalized its approach on investment protection and investment dispute resolution for TTIP. The proposal submitted to the US aims to safeguard the EU and its Members' right to regulate, while providing effective protection to EU companies through a transparent system for resolving investment disputes with publicly appointed judges, highest ethical standards and possibility to have errors corrected through an appeal instance. On the other hand, TPP considers the role of investor protection through investor-to-state dispute settlement (ISDS) approach via international arbitration.

In the case of KOREU, although less ambitious than TTIP, it is still a very advanced FTA covering most of the chapters of TTIP. It has sectoral annexes on electronics, motor

vehicles and parts, pharmaceutical products and medical devices, and chemicals dealing with non-tariff barriers in those sectors. Similarly, when considering the liberalization of services KOREU uses the positive list approach for opening Korean services and has sector specific sub-sections on computer services, postal and courier services, and international maritime transport services. Furthermore, KOREU in contrast to TTIP does not have an investment chapter nor investor-state dispute settlement provisions. On the other hand, Canada-EU CETA is a deep and comprehensive FTA covering almost all of the chapters of TTIP. It has a sectoral annex on motor vehicles dealing with non-tariff barriers. Canada-EU CETA uses the negative list approach to opening of services with reservations listed in two annexes. In addition, Canada-EU CETA has sector specific sub-sections on computer services, postal and courier services, and international maritime transport services. Furthermore, Canada-EU CETA has a very extensive chapter on promoting and protecting investment as well as on private-to-state dispute settlement and government-to-government dispute settlement. Finally, note that the EU-Ukraine DCFTA is also a deep and comprehensive agreement covering most of the issues covered by TTIP and TPP, however Turkey is more advanced on many of the issues covered in the DCFTA than Ukraine.

There have been several attempts to quantify the effects of TTIP and TPP. Two of the latest studies on the impact of TTIP are Egger et al. (2015) and Felbermayr et al. (2015). Their results differ considerably. While according to Egger et al. (2015) estimated gains in real income range between 1% and 2.25% for the US and the EU respectively, the estimated gains according to Felbermayr et al. (2015) amount to 3.9% of the EU GDP for the EU and 4.9% of the US GDP for the US. On the other hand, the effects of TPP have been analyzed among others by Petri et al. (2011) and Kawasaki (2015). While according to Petri (2011) estimated gains in real income for the US amount to 0.19% of US GDP, Kawasaki (2015) shows that US benefit would amount to 0.8% of US GDP.

3.2 Up-Dating the EU-Turkey Trade and Investment Relations

Table 4 shows the chapters covered in the EU-Turkey CU together with those in TTIP. The table highlights a key narrative of this paper, which is that the EU-Turkey CU does not cover most of the chapters included in TTIP such as agriculture, services, government procurement, SPS measures, regulatory coherence, sustainable development, small and medium sized economies, investment protection, and dispute settlement. Similar considerations apply in the cases of TPP, KOREU, and CETA.

{Insert Table 4}

Turkey, a net debtor to the rest of the world, has been facing problems with the sustainability of its current account. During 2014 the current account deficit had decreased from 9.7% in 2011 and 7.9% in 2013 to 5.8% of its GDP, and its external debt-to-GDP ratio according to International Investment Position data has amounted to 55.2%. To achieve sustainability of current account, Turkey has to increase its exports considerably over time, and also increase the FDI inflows into Turkey, which are much more stable than portfolio investment inflows. Once TTIP is implemented Turkey will have to adjust to TTIP rules on trade and investment as otherwise it will have difficulty in increasing its exports to the lucrative US and EU markets and attracting the FDI inflows. According to Egger et al. (2015) and Felbermayr et al. (2015) Turkey, if it would not adopt and implement the TTIP rules, could suffer welfare losses amounting to 0.75% and 1.56% of Turkish GDP, respectively. The above considerations reveal that the trade and investment relations between the EU and Turkey are in need of a major up-dating.

Recently the World Bank, commissioned by the European Commission, prepared the report 'Evaluation of the EU-Turkey CU'. In that report the World Bank concluded that opportunities for widening Turkey's trade relationship with the EU should concentrate on the liberalization of agriculture, services trade, and public procurement. In addition it is emphasized that a solution should be found to current visa restrictions. The next section briefly considers what the liberalization of agriculture, services and government procurement would entail for Turkey.

3.2.1 *Agriculture*

In agriculture the real challenge for Turkey is to achieve free movement of agricultural products between the EU and Turkey. This will require that Turkey adjusts its policy on the one hand in such a way as to adopt the Common Agricultural Policy (CAP) measures, and on the other hand adopts and implements EU rules on SPS issues.

In the EU, the *acquis* on agriculture covers a large number of binding rules. The latest CAP reforms, approved by the European Council in December 2013, set out the new rules for the CAP in the next seven-year period until 2020. They are designed to equip the European agricultural sector for the opportunities and challenges of the future. The main objectives of the reforms are to make the CAP greener and more targeted. They seek to effect a more equitable distribution of income support to farmers across the EU Member States, along with a more effective rural development policy. The CAP reform package comprises four main legal texts. First is the Regulation establishing rules for direct payments to farmers (1307/2013). This regulation provides the basic rules for

granting direct income support to farmers in order to reward them for the provision of public goods and services. It also contains a number of specific support schemes (particularly for young farmers, small famers and farmers in areas with natural constraints) and rules for granting a limited amount of coupled support (linked to production). Second, it includes the Regulation establishing a common organization of the markets in agricultural products (1308/2013). The single common market organization regulation aims to streamline, expand and simplify the current provisions on public intervention, private storage, exceptional measures and aid to specific sectors, as well as to facilitate cooperation through producer and inter-branch organizations. Third, the CAP reform includes the Regulation on support for rural development (1305/2013). This regulation covers voluntary measures for rural development, adapted to national and regional specificities, whereby member states draw up and co-finance multiannual programs under a common framework in cooperation with the EU. Lastly, the Regulation on the financing, management and monitoring of the CAP (horizontal regulation) (1306/2013) lays down rules concerning expenditure, the farm advisory system, the management and control systems to be put in place by member states, the cross-compliance system and the clearance of accounts.

The *acquis* on ‘food safety, veterinary and phytosanitary policy’ consists of a very large number of Regulations, Directives and Decisions, aimed at assuring a high level of food safety, animal health, animal welfare and plant health within the EU through coherent farm-to-fork measures and adequate monitoring, while ensuring the effective functioning of the internal market. For the implementation of food safety legislation, each Member State must have appropriate administrative structures to be able to carry out inspection and control of food products including an appropriate laboratory capacity. The basic rules are defined by the general food and feed law consisting of regulations providing the general principles and requirements of food production, processing, packaging, labelling, marketing and distribution. In the areas of veterinary and phytosanitary policy, EU legislation lays down rules for internal trade and importation from third countries in the veterinary, plant health and animal nutrition sectors while safeguarding public health, plant and animal health and animal welfare. The EU regime is based on the implementation of the same rules by the authorities in the Member States. A substantial part of Community *acquis* in this field also covers hygiene aspects related to processing and placing on the market of food of animal origin, the control of animal diseases and the protection of plants.

3.2.2 *Services*

Services cover a broad range of industries, encompassing network industries such as electricity, natural gas, and communications; other intermediate services such as transport,

financial intermediation, distribution, construction, and business services; and services destined for final consumption such as tourism and travel, recreation, education, health, and environmental services. Barriers to services trade, which are typically regulatory in nature, lead to inefficiencies in service sectors and to high costs of services. Since the productivity and competitiveness of goods and services firms depend largely on access to low cost and high-quality producer services such as transportation, distribution, telecommunications and finance, and since they have powerful influence on economic growth, it is of utmost importance to increase the efficiency of service industries which in turn can be achieved through liberalization of trade in different service sectors. As in the case of agriculture the challenge for Turkey is to achieve free trade of services between the EU and Turkey. But this will require that Turkey adopts and implements for each of the service sectors it intends to liberalize the regulatory framework of the EU.

In the EU services can be classified under three headings: (i) services where EU wide regulations apply such as financial services, telecommunication services, energy services, and transportation services; (ii) services regulated by Services Directive 200/123/EC such as legal services, accounting services, business related services, and construction services; and (iii) services regulated by national regulations such as public services including health services, education services, and social services. A future deep integration trade agreement covering liberalization of services between the EU and Turkey will most probably include services in the first group and some of the services in the second group, but will exclude services regulated nationally.

3.2.3 *Investment*

In the area of investment, the EU aims to offer a level playing field of high quality to all investors. Article 63 TFEU prohibits all restrictions on the movement of capital and payments between the EU Member States as well as between EU Member States and third countries. The functioning of the internal market is based on the fundamental notion of non-discrimination and the understanding that restrictions and exceptions to the free movement of capital should be limited as much as possible. In the EU, FDI agreements until recently were concluded bilaterally by individual Member States through Bilateral Investment Treaties (BITs), the aim of which has been and still is to promote investments by guaranteeing, *inter alia*, non-discriminatory treatment of investors from either party by guaranteeing most-favored nation (MFN) treatment, fair and equitable treatment, free transfer of capital without restrictions, and compensation in case of unjustified expropriation.

BITs provide investors dispute settlement options. The investor-to-State dispute settlement (ISDS) clauses in the BITs allow disputes between an investor and a State

when the latter is alleged to have breached its commitments under the BIT. ISDS allows a foreign investor access to an international tribunal, and the decisions of the tribunal are binding and final. Thus, an appellate mechanism similar to that of the WTO dispute settlement body does not exist. Besides, state-to-state disputes can be activated under most BITs. After entering into force of the Lisbon Treaty in 2009 the EU according to Article 207 of the Treaty on the Functioning of European Union (TFEU) has exclusive common commercial policy competence on FDI. Thus, FDI is now part of EU's common commercial policy, and EU Commission may legislate on FDI. It is emphasized that the BITs of Member States will be preserved until they will be replaced by EU wide investment deals.

ISDS has been extensively criticized on the grounds that it affects the right of Member States to regulate in order to achieve legitimate policy objectives such as the protection of consumers, and that investment dispute system through international arbitration lacks transparency. Arbitrators may lack independence and impartiality; they may be chosen from an elite group of arbitrators; ISDS may also lead to inconsistency and unpredictability of decisions. More recently, the EU has tried to satisfy such criticism within the context of TTIP negotiations formally presented its new approach on investment protection and investment dispute resolution to the US on November 12, 2015.¹² The objective of the new approach is to safeguard the EU and its Member States' right to regulate, while continuing to provide effective protection to foreign companies against unfair treatment, discrimination or other obligations through the Investment Court System.

A deep integration RTA with an investment chapter could serve both the EU and Turkey. Both parties are interested in securing for their investors protection against discrimination in terms of most-favoured-nation treatment and national treatment. Both parties desire protection against expropriation of their investors' assets, if these expropriations are not for public policy purpose and not fairly compensated, as well as fair and equitable treatment and the right to transfer capital – for these are also basic requirements of the more recent investment treaties. In addition, performance requirements and other sustainable development and public policy safeguard provisions could be included to ensure that the liberalization of investment between the EU and Turkey does not lead to a relaxing of labour or environmental standards to attract more investment, or that fundamental domestic policy objectives are undermined.

One attractive model is the TPP Agreement Investment Chapter. This includes a set of core obligations such as (i) providing for national treatment and most favored nation

¹² See website http://trade.ec.europa.eu/doclib/docs/2015/november/tradoc_153955.pdf.

treatment, (ii) providing minimum standard of treatment for investments including protections against denial of justice and failure to provide police protection, (iii) ensuring that if a TPP government expropriates an investment, it does so for a public purpose, in accordance with due process of law, and subject to prompt, adequate and fully realizable and transferable compensation, (iv) allowing for transfer of funds related to an investment covered under the Agreement, (v) barring specified performance requirements, including local content requirements, export requirements, and technology transfer or technology localization requirements, and (vi) ensuring investors have the ability to appoint senior managers without regard to nationality, and ensuring that any nationality-based restrictions on the appointment of board members do not impair an investor's control over its investment. The TPP countries have agreed to accept these obligations on a negative-list basis.

3.2.4 Public Procurement:

Tendering for public contracts is about how public authorities spend taxpayers' money when buying goods, services or works. Currently, Turkish companies face obstacles in winning public contracts in the EU and EU companies face obstacles in winning public contracts in Turkey. It is claimed that further market opening would be good for both the EU and Turkey. For public authorities with tight budgets it can bring (i) better money for value, (ii) more choice, (iii) greater economic efficiency, and (iv) good governance. If parties could agree on rules which will ensure that they are not discriminated against in public procurements, agree on rules to maximize transparency in tendering for public contracts, and maximize the opportunities for firms of both parties to participate in tenders at all government levels, both parties would win.

The EU's regional procurement chapters are fully in line with the WTO Government Procurement Agreement (WTO GPA) as regards the rules governing procurement procedures, transparency, eligibility, administration and domestic remedies. The plurilateral WTO GPA provides a limited number of 45 parties with a framework for ensuring that the procurement covered under the Appendix to the chapter is conducted in a competitive non-discriminatory and transparent manner. It includes tender procedures, performance requirements, the prohibition of offsets, transitional measures, public policy exceptions and a requirement for a bid review mechanism at the domestic level, to provide redress to disappointed bidders, and an opportunity to bring the complaint to the State level through notification to the TPP implementation body (Dawar and Evenett, 2011). The TPP Procurement Chapter 15 is also fully comprehensive and based on the WTO GPA model.¹³ Given that the EU is also an active party to the WTO GPA, it is likely that the commitments will either conform to the WTO GPA or include further

concessions in certain areas of coverage, and could therefore be considered a WTO GPA+ RTA. An EU-Turkey procurement chapter could usefully include more detailed wording on electronic procurement websites which conform to intra-EU arrangements, and it could also seek to prevent corruption in procurement tenders, as with the 2014 WTO GPA. This would be of further benefit in opening up the de facto access of smaller firms to procurement markets in both the EU and Turkey. The market access coverage of the procurement chapter could also be tailored to ensure that Turkey is able to gain transitional measures where necessary to open up procurement markets on a more incremental basis, until they reach a level comparable with the EU.

A comprehensive procurement chapter would provide Turkey shelter from EU instruments such as the proposed International Procurement Instrument (IPI).¹⁴ The IPI as currently proposed, lays down procedures for contracting authorities to reject tenders or contracts of an estimated value of €5 million or above and consisting of more than 50% of goods or services, which are not subject to the EU's international procurement commitments in the WTO GPA or its RTAs. This instrument provides the EU with a unilateral tool to increase leverage when negotiating access to public procurement markets of other trading partners, not currently party to the WTO GPA or its RTAs, such as Turkey. However, from the EU perspective, liberalization of procurement markets is more transparent and better achieved through negotiating a comprehensive chapter with deep concessions.

In sum: it will be quite a challenge for Turkey to achieve free movement of agricultural commodities between the EU and Turkey since the rules of EU *acquis* on agriculture and food safety, veterinary and phytosanitary policy are quite different from those prevailing in Turkey. It will be a further challenge for the country to achieve the liberalization of services and public procurement since the rules of the EU *acquis* on services and public procurement are again quite different from those prevailing in Turkey. But, the liberalization of agriculture, services, investment and public procurement, although costly, is a must for Turkey if it wants to stay competitive in the world economy, and increase its exports and FDI inflows. Similar considerations apply to investment and dispute settlement issues. For the EU, the benefits of extending the level playing field for EU trade and investment are conclusive.

¹⁴ Amended proposal for a Regulation of the European Parliament and of the Council on the access of third-country goods and services to the Union's internal market in public procurement and procedures supporting negotiations on access of Union goods and services to the public procurement markets of third countries. Brussels, 29.1.2016 COM(2016) 34 final. (henceforth: the IPI Proposal)

3.3 Choices Facing Turkey

The above considerations reveal that the present EU-Turkey CU could be modified to take into account the various criticisms of the CU summarized in section 1.3. On the other hand, liberalization of agriculture, services and public procurement could be achieved by signing a FTA with the EU covering those sectors. In addition to the areas covered by the World Bank (2014), it is our strong belief that a deep integration agreement between the EU and Turkey should also cover issues related with investment and dispute settlement.

According to United Nations Conference on Trade and Development (2015) the average FDI inflow into Turkey during the last three years amounted to \$12.6 billion, average outflow \$4.8 billion, the FDI inward stock during 2014 \$168.6 billion, and FDI outward stock \$40.1 billion. On the other hand, the average FDI inflow into the EU during the last three years amounted to \$318.5 billion, average outflow \$294 billion, the FDI inward stock during 2014 \$9.2 trillion, and FDI outward stock \$10.4 trillion. Since FDI is increasing competition and boosting trade, it will optimize resource allocation in the economy, create jobs, and transfer technology and skills. Hence, FDI is very important for both the EU and Turkey. Following the TTIP negotiations, the final text on investment will be incorporated into the TTIP and Turkey will be forced to adjust its investment system to the new rules. Therefore, it would be expedient for both parties to use the TTIP investment chapter as the basis for negotiating concessions.

3.4 Choices Facing the EU

Strengthening the global role of the EU is among the ten priorities of the European Commission for the 2014-19 period. The increase in the strategic importance of Turkey-EU relations is undeniably significant, due mainly to changes in international and regional relations related to the Middle East and the refugee crisis. The EU needs to act jointly with Turkey. This cooperation requires a foreign policy vision that embraces enlargement negotiations and a progressive neighborhood policy. Turkey and the EU share mutual benefits in foreign policy security, border management, and migration policies.

Turkey is important to the EU's political as well as economic wellbeing. The EU is striving to maintain its competitiveness and recover fully from the impact of the 2008 fiscal crisis. It is therefore significant that the available evidence from the EU Member

States indicates that a 1% increase in the openness of the economy results in a 0.6 % rise in labour productivity the following year. The EU Union has more to lose than gain from adopting protectionist measures, since it is dependent on many imported products. Raising their cost would reduce the EU's competitiveness inside and outside the Union leading directly to a loss of European production and jobs. A 10 % rise in trade restrictions could lead to a 4 % loss in national income. (European Commission, 2014)

The existing quantitative research suggests¹⁵ that European companies are not effectively informed about either the Turkish market or Turkey's accession process to the European Union (Eurochambers 2013). As a result, trade and investment opportunities for European companies in Turkey remain under-exploited. Improving the business environment in Turkey as well as actively promoting the Turkish market in Europe, is therefore a major component of untapping this potential. European companies state that the CU should be improved and extended to new areas, such as services, investment, agricultural products as well as consumer protection and food safety, for instance. This would improve the regulatory environment in Turkey, and generate new business opportunities. The majority of European companies (82%) operating or investing in Turkey consider that important barriers to trade and investment remain, the most important ones being: logistics, burdensome customs procedures as well as differences in technical standards and certification requirements. This would build on the existing progressive alignment of Turkish legislation to the EU *acquis*, which has been considered to have already changed the business environment since 1995.

Turkey is already well advanced in implementing several essential legislative and administrative reforms in relevant areas. However, the legal and administrative situation and developments in Turkey, as well as its overall cooperation with the EU, have not yet reached a stage that would enable the Commission to propose to the Council and the European Parliament, that the Schengen visa requirement for the Turkish citizens be lifted. Turkey has relatively low results in detecting and dismantling the criminal organisations operating in the country or involved in transnational networks. Cooperation remains lower than necessary, with difficulties including differences between EU and Turkish legislation, external agreements and approaches.

¹⁵ See website http://trade.ec.europa.eu/doclib/docs/2015/november/tradoc_153955.pdf.

¹⁵ EU-Turkey Relations: Perspectives from the European Business Community Eurochambres and TOBB – 2013.

3.5 Identifying Options:

Of the four options discussed below, the first two are considered to be *non-options* – doing nothing, and full accession. Nevertheless, they are briefly included in order to put forward the full spectrum of possible choices for analysis.

3.5.1 Baseline Scenario: Do Nothing

While this option has the advantage of requiring no further resources, legal instrument or legislative mobilisation, for all the reasons discussed in this report, this option is not considered further. Without adapting or modernising EU-Turkey commercial relations, the opportunities identified will be lost and the challenges arising from the status quo, could risk creating greater issues of economic irrelevance, political illegitimacy and ultimately inapplicability.

3.5.2 Turkey Gains Full EU Membership

The legal avenue for enlarging the EU to incorporate Turkey entails Turkey complying fully with the *acquis*. This would entail a continuation of Turkey accession process. Indeed, unless new initiatives are established, this option could *de facto* result in the base scenario option of doing nothing.

Turkey applied for full membership in 1987, was confirmed as candidate in December 1999 and negotiations started in October 2005 when Turkey had met the conditions for accession talks extending the CU with the EU to all new Member States, including Cyprus. However, after failing to ratify the CU and not opening its ports and airports to Cypriot traffic, the EU responded by freezing accession talks in eight policy areas in 2008.

The new “positive agenda” initiated in May 2012 began with the EU and Turkey identifying areas for expanding co-operation, but then stalled when Cyprus took up the EU's six-month rotating presidency in July 2012 and communications between Turkey and the Cyprus authorities broke down. As a result of these protracted delays, only 13 of Turkey's 35 negotiating chapters were opened, and only one closed. The opening of chapter 17 in the EU's membership talks in 2015 marked the first formal discussions since 2013 and what many see as a fresh start for EU-Turkey ties after years of uneasy relations. Underlying that change is Turkey's promise to help stem the flow of migrants to Europe in return for cash, visas and renewed talks on joining the EU, to which Ankara formally started its membership talks a year ago.

While full accession would remove the external legal constraints on Turkey participating in EU external trade relations and allow the full potential of integration to be realised. It is politically very unlikely in the short term, and moreover, Turkey would still need to be in compliance with the *acquis* before this could happen.

3.5.3 Modernise the Current CU

This option would require amendment of Decision 1/95 but without changing its sectoral scope. It would allow for enhancing bilateral trade relations while providing for improved implementation and dispute settlement mechanism. It could potentially also address agriculture, the exchange of services and establishment between Turkey and the existing member states. An enhanced CU expected to increase FDI-flows from the EU, in addition to expanding trade into a diversified range of sectors, is likely to offer an effective remedy to the “middle income trap.” The negative aspect of this side is that Turkey remains locked out of EU-third party negotiations, with repercussions of tariff preference erosion, and various other deep integration issues are required to modernise EU-Turkey economic relations.

3.5.4 Replace / Complement the Current CU with a New Comprehensive FTA

This option could involve negotiating a completely new agreement along the lines of the more recent deep integration RTAs that the EU has negotiated with Canada, Korea or in the future TTIP, discussed above. Thus, it would comprehensively cover industrial goods, agriculture, services, TBT, IPR, investment, dispute settlement, competition and public procurement. The other option is to extend the CU to incorporate agriculture, while negotiating a complementary deep integration RTA covering services, government procurement, investment, dispute settlement. The RTA could also extend the rules on TBTs, IPR and competition present in the EU-Turkey CU, if they were not handled under the modernisation of the CU.

This option would require substantial adaptations to the Association Agreement because it represents a major shift in EU-Turkey contractual relations. Approval would have to be granted either through a new Decision of the Association Council or through a new Protocol to the Association Agreement, which would require a full treaty-making procedure, pursuant to TFEU Articles 217 and 218. This choice has the advantages of incorporating the necessary new issues that would modernise the agreement and bring it in line with more contemporary developments in regional agreements. If a comprehensive

RTA replaced the CU, it would remove the difficulty of Turkey's exclusion from EU Trade external relations negotiations.

However, completely replacing the CU with a deep integration RTA could be perceived as backtracking on accession-oriented aspects of CU. It might also incur increased transaction costs linked to rules of origin.

4. Conclusions

The present paper maintains that the EU-Turkey CU of 1995 covering industrial goods should be modernised and modified to take into account the various and growing criticisms of the CU. Further economic integration between the EU and Turkey should be directed towards signing a complementary deep integration RTA between the EU and Turkey covering agriculture, SPS measures, services, government procurement, investment, and dispute settlement. Such an approach should increase competition and lead to better allocation of resources in both Turkey and the EU. Despite raising doubts about full accession in the short run, there is nevertheless absolutely no evidence that either Turkey or the EU and its Member States wants to unilaterally break with Turkey's accession process. This is because of the various interdependencies, as well as the high potentials of their partnership in terms of politics and security, economy, trade and energy, as well as socio-cultural relations.

The EU continues to face various internal and external challenges. Internal fissures are appearing caused by growing inequality and the difficulties in post-crisis recovery of the Euro zone. There is an urgent need to identify new sources of growth and employment. Private investment in innovation is falling short of the target, while there is a growing brain drain mostly from regions worst affected during the crisis and the subsequent austerity measures. Externally, the Union's neighbourhood has become an area of high risk with an increasing number of open conflicts challenging Europe's security. They pose immediate threats to Europe's security and trigger asylum seeking immigration that puts pressure on EU external borders and relevant policies from migration to humanitarian assistance and development cooperation.

Deepening EU-Turkey integration would offer gains for the EU as well as for Turkey. Signing a deep integration RTA should increase market access through eliminating tariff and non-tariff barriers to the EU market, and will facilitate the fulfillment of the requirements of TTIP. These are considerable advantages for Turkey. Turkey understands the growing importance of global value chains trade, and how concluding a deep and comprehensive FTAs such as TPP, KOREU or EU-Canada CETA would potentially allow them to grow economically. This process would also allow them to realize further

achievements in the TTIP negotiations. The country is aware that the twenty-year old EU-Turkey CU no longer meets the requirements of the 21st century trade. It is consequently interested in up-dating the EU-Turkey trade and investment relations, but it is not sure how this up-dating should take place.

This suggests that the most tangible option is to complement the CU with a deep integration agreement to bring EU-Turkey trade and investment relations into line with current EU RTAs, such as the KOREU, EU-Canada CETA, and the TTIP. The chapters of the TTIP will most probably contain stronger provisions than the EU-Turkey CU. Since under the TTIP negotiations it is likely that a harmonization approach will be followed in some areas, while in other cases a mutual recognition or mutual equivalence approach. As such, meeting the requirements of the EU will make it easier for Turkey to fulfill the requirements of TTIP. In sum, for Turkey the challenge is to achieve liberalization between the EU and Turkey. For the EU this is an opportunity to harness the economic and political potential of deeper integration with Turkey, through the further liberalisation of trade in goods, services, agriculture, and encouraging sustainable investment.

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Table 1: Foreign Trade, 1990-2009

	Total Exports (million US\$)	Exports to the EU-28 (million US\$)	Share of Exports to the EU-28 in Total Exports	Total Imports (million US\$)	Imports from EU-28 (million US\$)	Share of Imports from the EU-28 in Total Imports
1990	12,959	7,468	57.63	22,302	10,595	47.51
1991	13,593	7,769	57.15	21,047	10,676	50.73
1992	14,715	8,446	57.40	22,871	11,511	50.33
1993	15,345	8,237	53.68	29,428	14,922	50.71
1994	18,106	9,376	51.79	23,270	11,643	50.04
1995	21,637	12,188	56.33	35,709	18,006	50.43
1996	23,224	12,590	54.21	43,627	24,349	55.81
1997	26,261	13,471	51.30	48,559	26,128	53.81
1998	26,974	14,837	55.01	45,921	25,297	55.09
1999	26,587	15,454	58.13	40,671	22,538	55.41
2000	27,775	15,688	56.48	54,503	28,552	52.39
2001	31,334	17,576	56.09	41,399	19,841	47.93
2002	36,059	20,458	56.73	51,554	25,698	49.85
2003	47,253	27,479	58.15	69,340	35,157	50.70
2004	63,167	36,699	58.10	97,540	48,131	49.34
2005	73,476	41,533	56.53	116,774	52,781	45.20
2006	85,535	48,149	56.29	139,576	59,448	42.59
2007	107,272	60,754	56.64	170,057	68,472	40.26
2008	132,027	63,719	48.26	201,964	74,513	36.89
2009	102,143	47,228	46.24	140,928	56,616	40.17
2010	113,883	52,934	46.48	185,544	72,391	39.02
2011	134,907	62,589	46.39	240,842	91,439	37.97
2012	152,462	59,398	38.96	236,545	87,657	37.06
2013	151,803	63,040	41.53	251,661	92,458	36.74
2014	157,617	68,514	43.47	242,177	88,784	36.66

Table 2: Foreign Direct Investment, 1990-2014

	Total FDI Inflow (million US\$)	FDI Inflow from the EU countries (million US\$)	Share of FDI from the EU countries in total FDI inflow
1990	684	NA	NA
1991	810	NA	NA
1992	844	NA	NA
1993	636	NA	NA
1994	608	NA	NA
1995	885	NA	NA
1996	722	NA	NA
1997	805	NA	NA
1998	940	NA	NA
1999	783	NA	NA
2000	982	NA	NA
2001	3,352	NA	NA
2002	1,082	455	42.05
2003	1,702	565	33.20
2004	2,785	1,027	36.88
2005	10,031	5,006	49.91
2006	20,185	14,489	71.78
2007	22,047	12,601	57.16
2008	19,851	11,077	55.80
2009	8,585	4,942	57.57
2010	9,099	4,737	52.06
2011	16,176	11,495	71.06
2012	13,282	7,303	54.98
2013	12,457	5,272	42.32
2014	12,763	5,517	43.23

Source: Central Bank of the Republic of Turkey

Table 3: Comparison of TTIP, TPP, KOREU, CETA, and EU-Ukraine DCFTA

	TTIP	TPP	EU-Korea FTA	EU-Canada CETA	EU-Ukraine DCFTA
Market Access					
Trade in Goods and Customs Duties		National Treatment & Market Access for Goods	National Treatment & Market Access for Goods	National Treatment & Market Access for Goods	National Treatment & Market Access for Goods
		Textiles and Apparel		Agriculture	
Services		Cross Border Trade in Services	Trade in Services, Establishment and Electronic Commerce	Cross Border Trade in Services	Establishment, Trade in Services and Electronic Commerce
		Financial Services	Financial Services	Financial Services	Financial Services
		Telecommunications	Telecommunications Services	Telecommunications	Electronic Communications
		Electronic Commerce	Electronic Commerce	Electronic Commerce	Electronic Commerce
		Temporary Entry for Business Persons		Temporary Entry	Temporary Presence of Natural Persons for Business Purposes
			Computer Services		Computer Services
			Postal and Courier Services		Postal and Courier Services
			International Maritime Transport Services	International Maritime Transport Services	Transport Services
			Exceptions		
			Payment and Capital Movements		Current Payments and Movement of Capital
				Mutual recognition of professional qualifications	
				Domestic regulation concerning services	
Public Procurement		Government Procurement	Government Procurement	Government Procurement	Public Procurement
Rules of Origin		Rules of Origin and Origin Procedures	Rules of Origin	Rules of Origin and Origin Procedures	Rules of Origin
Regulatory Co-operation					
Regulatory Coherence		Regulatory Coherence		Regulatory co-operation	Regulatory Framework
Technical Barriers to Trade (TBTs)		Technical Barriers to Trade (TBT)	Technical Barriers to Trade (TBTs)	Technical Barriers to Trade (TBT)	Technical Barriers to Trade (TBT)
				Mutual recognition on conformity assessment	
				Good manufacturing practices for pharmaceutical products	
Food Safety and Animal and Plant Health (SPS)		Sanitary and Phytosanitary (SPS) Measures	Sanitary and Phytosanitary (SPS) Measures	Sanitary and Phytosanitary (SPS) Measures	Sanitary and Phytosanitary (SPS) Measures
TBTs and SPS in Specific Industries			TBTs and SPS in Specific Industries	TBTs and SPS in Specific Industries	
			Chemicals		
			Cosmetics		
			Engineering		
			Medical Devices	Medical Devices	
			Pesticides		
			Information and Communication Technology (ICT)		
			Pharmaceuticals	Pharmaceuticals	
			Textiles		
			Vehicles	Motor vehicles and parts	Motor Vehicles
			Electronics		
Rules					
Sustainable Development			Trade and Sustainable Development	Sustainable Development	Trade and Sustainable Development
Labour	Labour	Labour	Labour	Labour	
Environment	Environment	Environment	Environment	Environment	
Energy and Raw Materials					Trade-Related Energy
Customs and Trade Facilitation		Customs Administration and Trade Facilitation	Customs and Trade Facilitation	Customs and Trade Facilitation	Customs and Trade Facilitation
Small and Medium-Sized Enterprises		Small and Medium-Sized Enterprises			
Investment Protection		Investment		Investment	
				Subsidies	
Competition		Competition Policy	Competition	Competition policy	Competition
		State-Owned Enterprises		State owned enterprises	Public Enterprises and State Monopolies
					State Aid
Intellectual Property and Geographical Indicators		Intellectual Property	Intellectual Property	Intellectual Property and geographical indicators	Intellectual Property
Dispute Settlement		Dispute Settlement	Dispute Settlement	Dispute Settlement	Dispute Settlement
Investor-to-State Dispute Settlement		Investor-to-State Dispute Settlement		Investor-to-State Dispute Settlement	
Government-Government Dispute Settlement		Government-Government Dispute Settlement	Government-Government Dispute Settlement	Government-Government Dispute Settlement	
		Trade Remedies	Trade Remedies	Trade remedies	Trade Remedies
Other Issues					
		Cooperation and Capacity Building		Domestic regulation	
		Competitiveness and Business Facilitation			
		Development			
		Transparency and Anti-Corruption	Transparency	Transparency	Transparency
		Administrative and Institutional Provisions		Administrative and Institutional Provisions	
		Exceptions		Exceptions	
		Final Provisions	Institutional, General and Final Provisions	Final provisions	Common Provisions
					General Provisions

