

Analysis Paper on Treatment of Trade in Services under the Kosovo-Turkey Free Trade Agreement of Services

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Abstract

The Government of Kosovo has recently signed an agreement with Turkey on a bilateral Free Trade Agreement in Goods. However, the negotiations in signing a free trade agreement in services are still ongoing. This is the first time since Kosovo became independent in 2008 that the Government of Kosovo has been engaged in trade negotiations, as its so-far single trade agreement, the CEFTA 2006, was negotiated by UNMIK. The absence of experience in trade negotiations in itself creates challenges for the government when negotiating with Turkey on such a complex issue, as service trade liberalization. An additional challenge is created by parallel negotiations with CEFTA partners and the European Union. The purpose of this paper is to provide background information on services trade negotiators with Turkey, in order to formulate an appropriate position for the proposed negotiations. The paper focuses on the regulatory (legal) aspects of possible liberalization measures/commitments by Kosovo and Turkey.

Key words: *Trade in Services, Trade Agreement with Turkey, economic impact, liberalization of trade in services, restrictions of trade in services.*

Services, trade in services and their role in Kosovo's economy

Services represent the fastest growing sector of the global economy and account for two thirds of global output, one third of global employment and nearly 20 percent of global trade¹.

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In Kosovo, services account for a high share of GDP, owing in large part to donor presence in the country. Services contributed 68 percent to GDP in 2010² representing an almost 4 percentage point increase from 2004 when the GDP contribution was 64.3 percent³. Nathan Associates Inc. (2008) found that the 2004 figure had been already very high compared to values for upper middle-income countries and well above the LMI-EE&CA median of 54.4 percent, Albania's 55.7 percent, and Macedonia's 57.7 percent. "This breakdown, however, is a bit misleading given that, on average, 17 percent of GDP between 2002 and 2004 was attributable to UNMIK, inflating services' contribution to GDP"⁴.

Services are predominantly concentrated in retail and wholesale trade, contributing to 9.4 percent to GDP in 2007, while real estate and business services reported together by the Kosovo Agency of Statistics, representing 12.4 percent.⁵ Services are the key component of Kosovo's private sector. Approximately 80 percent of business falls within the tertiary (service) sector, whereas only 2 percent of are registered in the primary sector (agriculture/extraction) and 16 percent in the secondary sector (manufacturing).⁶ Service enterprises tend to be very small and mostly family-run. There is vigorous business creation, but most companies do not achieve significant growth.⁷

¹ World Trade Organization, "Trade Policy Review of Turkey, Report by the Secretariat", Rev.1, 7 March 2012. pg.10. http://www.wto.org/english/tratop_e/tpr_e/tp359_e.htm

² World Bank, "World Development Indicators 2012", International Bank for Development and Reconstruction / World Bank, Washington DC, 2012., pg.23.

³ Nathan Associates Inc., *Kosovo Economic Performance Assessment, report for the United States Agency for International Development*, 2008., pg.35. http://pdf.usaid.gov/pdf_docs/PNADL767.pdf

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⁵ Embassy of Switzerland in Kosovo, *Economic Report Kosovo*, Pristina, 2014., pg.15. http://www.s-ge.com/schweiz/export/de/filefield-private/files/42914/field_blog_public_files/47652

⁶ Id.

⁷ European Commission, *Staff Working Document accompanying the document Commission Communication on a Feasibility Study for a Stabilisation and*

The banking sector is estimated to be among the sectors with the best performance in Kosovo's economy. It is generally stable, deposits and credits to the private sector have been growing, despite the global financial crisis. The value of the banking sector assets and liabilities in Kosovo in September 2011 was EUR 2.63 billion, or around 48% of the country's GDP. The sector is characterized by a large presence of foreign capital (89.2% of total assets, i.e. six out of eight banks have complete or majority foreign capital). The presence of foreign financial institutions in Kosovo has contributed towards the modernization of the financial system by bringing more advanced practices in finance to managing banking operations. The lending activity of Kosovo's commercial banks represents one of the main sources of financing for consumption and investments in the country.

The service sector's estimated share of the labour force increased from 53.5 percent in 2004 to 58.3 percent in 2006, much higher than all comparator benchmarks.⁸ The structure of employment by sector in 2007 indicates that the service sector is the largest provider of employment in Kosovo, accounting for 71.3 percent of total employment.

Employment by main economic sectors (percent)		
Main Economic Sectors	2005	2007
Agriculture	18.8	14.6
Industry	14.4	14.1
Services	66.8	71.3
Total	100	100
Source: Statistical Office of Kosovo (SOK), Labour Force Survey (2005-2007) ⁹		

Association Agreement between the European Union and Kosovo, 2012., pg.30. http://ec.europa.eu/enlargement/pdf/key_documents/2012/package/ks_analytical_2012_en.pdf

⁸ Op.Cit. Nathan Associates Inc., pg.70.

⁹ Quoted in "Kosovo Debate on European Issues, A compilation of eight Policy Papers in the area of education, rule of law and economy", Prishtina December, 2009, "European Union Support for organizations active at European level in the field of active European Citizenship".

Within the service sector, wholesale and retail trade as well as education represents the largest sub-sectors in terms of employed labour (respectively 17.4 percent and 13.4 percent).

Employment by selected (services or service-related) economic activity (age 15 - 64)	
Electricity	4.5
Construction	7.9
Trade	17.4
Hotels	4.6
Transport	5.8
Banking and insurance	2.2
Business	2.9
Education	13.4
Health	7.0
<i>Source: Kosovo Agency of Statistics, Labor Force Survey 2009</i>	

A comparison of output and employment structures implies that labour productivity is much higher in services than agriculture, but slightly less that in the industry. On this basis, industry and services are the most productive sectors in the economy of Kosovo.

	Services	Industry	Agriculture
Output (% of GDP)	64.3	27.1	8.6
Labour force (% of total labour)	58.3	20.05	21.4
Output / unit labour	1.102916	1.351621	0.4018692

In international comparison, services labour productivity in Kosovo is lower than in the lower-middle-income countries in the Eastern Europe and Central Asia, but slightly higher than in the lower-middle-income countries. This is shown in the following table.

Services labour productivity in international comparison			
	Kosovo	LMI-EE&CA	LMI
Output (% of GDP)	64.3	54.4	52.9
Labour force (% of total labour)	58.3	42.5	48.8
Output / unit labour	1.102916	1.28	1.0840164
LMI-EE&CA = Lower-middle-income countries in the Eastern Europe and Central Asia			
LMI = Lower-middle-income countries			

These cross-sectorial and international comparisons of labour productivities have important implications for economic policies, as they are indicators of the sectors that need structural transformations, and in the case of trade policy, they signal the desired directions of trade and investment. The above aggregated figures are nevertheless not sufficient to formulate evidence-based trade policy. For that more detailed – sub-sector level – data would be needed.

Regarding trade in services, overall, Kosovo is a net exporter of services. This is the only sector, where Kosovo has a positive trade balance; however, according to Nathan Associates Inc. (2008), the low contribution of trade in services to GDP is among the weaknesses of Kosovo’s economy. The export of services represents approximately 10 percent of GDP, while imports account for approximately 7.5 percent of GDP. The positive balance mainly reflects increased revenues from the communication and travel services. Service exports have an important potential for faster economic growth. During the next three years, exports of services are expected to grow by 6.5 percent in real terms. The main contributors to this growth are travel services, which mainly depend on visits of diaspora in Kosovo.¹⁰

¹⁰ Op.Cit. European Commission, pg.14.

Trade relations between Kosovo and Turkey in the context of services

The purpose of this section would be to provide information to services trade negotiators on the present importance of bilateral trade in services with Turkey. Appropriate information would include data for each sector and sub-sectors mentioned in the WTO classification of services (WTO document MTN.GNS/W/120) per the four GATS Mode (cross-border; consumption abroad; commercial presence; and movement of natural persons). Unfortunately, such data do not exist in Kosovo, not only per trading partners, but at aggregate level either. However, a Trade in Services Database is currently being developed by the EU Trade Policy Project that will bridge this informational gap.

In the absence of appropriate statistics from the Kosovo side, we have investigated Turkish statistics whether data are available for bilateral trade in services with Kosovo. However, it appears that the Turkish Statistical Institute¹¹ either does not collect statistical data on trade in services per trading partners or they do not publish them. This seems to be confirmed by the fact that neither the WTO Secretariat's Trade Policy Review Report on Turkey nor any of the volumes of the "OECD Statistics on International Trade in Services - Tables by Partner Country" contains data for Turkey (except for Turkish export data on travel services).

In sum, there exist no data for bilateral trade flows in the area of services. Anecdotal information indicates that most services traded between the two countries are originating in Turkey and provided to Kosovar services consumers mainly through mode 3 (Commercial Presence). By the end of 2011 Turkish foreign direct investment (FDI) stock in Kosovo has reached \$1 billion of which a large part is presumed to be in services sectors, led by insurance and banking services and services related to mining.¹² Other most notable Turkish

¹¹ Ministry of Economy Turkey, 2012

¹²Hiziroglu, A. et al. "Competitiveness in Services: Turkey versus European Union", *Procedia-Social and Behavioral Sciences*, Elsevier. Vol 62, 2012., f.436. <http://www.sciencedirect.com/science/article/pii/S1877042812035124>

services are road and airport construction, operation of airport services, and energy distribution.¹³ In the area of contracting and consultancy services, Turkish firms held and are holding 4 projects in Kosovo with a total value of 502 million dollars up until now.¹⁴

In the absence of appropriate statistics on bilateral trade, some general information on Turkey's service economy as well as aggregate-level data on Turkey's services trade with the world by service sectors may provide useful information for Kosovo's FTA negotiators on the partner country's strengths in the service sector, and in trade in services in particular.

Although agriculture and manufacturing remain important, Turkey has become an economy dominated by services. In terms of the number of people employed, and excluding governmental services, the main sectors are wholesale and retail trade; transport, storage, and communication; real estate, renting, and business activities; construction; architecture; engineering; and hotels and restaurants. The highest value added (per employee) is in electricity, gas, and water supply.¹⁵

Turkey's share in global exports of services was 0.92 percent in 2011.

The Balance-of-Payments statistics for services of Turkey is shown in the following table:

¹³ Borko Handjiski and Lazar Sestovic, , *Barriers to trade in services in the CEFTA region*, Washington DC, 2011., f.28. <http://siteresources.worldbank.org/INTMACEDONIA/Resources/BarriersToTradeinServicesintheCEFTARegion.pdf>

¹⁴ Ministry of Finance Kosovo (2012)

¹⁵ Op. Cit. World Trade Organization., pg.40

Million \$	2008	2009	2010
BALANCE ON SERVICES	17.748	17.316	15.4
Total Services Exports	35.564	33.922	34.7
Total Services Imports	-17.816	-16.606	-19.2
1.Transportation	208	1.840	1.4
Credit	8.246	8.262	9.5
Debit	-8.038	-6.422	-8.1
2.Travel	18.445	17.103	15.9
Credit	21.951	21.250	20.8
Debit	-3.506	-4.147	-4.8
3.Construction Services	974	1.090	8
4.Insurance Services	-684	-527	-4
5.Financial Services	-133	-355	-2
6.Other Business Services	-1.040	-1.286	-1.3
7.Government Services	-778	-846	-8
8.Other Services	756	297	

Source: Ministry of Economy of Turkey: Economic Outlook, December 2012, www.economy.gov.tr/files/economic_outlook.ppt

Although there has been a dramatic surplus in service trade of Turkey, since 1980s, Turkey has managed to catch up the rest of the world in terms of the service trade growth. Apart from the fact that the service export rates of Turkey in comparison with the world and EU in 1980's were below 0.5 percent, these figures have substantially increased until the year of 2000 and the increase has become stable after that year.

Comparative advantages and possible winners and losers of services liberalisation

As of writing, there exist no statistics that would permit to measure the comparative advantages of Kosovo's services sector in general or for particular service sub-sectors. The Trade in Services Database referred to above, once available, will provide basic statistics and appropriate proxies that will help determine the sectors and sub-sectors where Kosovo enjoys comparative advantages or suffers comparative disadvantages, and how these comparative

(dis)advantages might be altered by a Kosovo/Turkey FTA covering trade in services.

Regarding Turkey, its main strengths in the area of trade in services appear to be the following^{16 17}:

- Tourism: Turkey ranks as the 6th in the world and the 4th in Europe among the most favourite tourism destinations; It is targeting revenue of US\$60 billion from 60 million tourist arrivals annually by 2023;
- Construction services: Turkey has an estimated 200,000 contractors in the construction sector; Turkey ranks 2nd in the world (following China) in terms of the number of top contracting companies; 31 out of the world's top 225 contracting companies are Turkish; The sector spans from a large number of small, mostly family-owned businesses to some 150 large contractors working internationally. The construction industry accounts for more than 5 percent of Turkey's GDP directly, but its indirect effects on the economy are thought to be significantly larger; Outside of Turkey, Turkish contractors have undertaken about 6,500 projects for a total value of US\$205 billion over the last 40 years. The annual project volume has risen from US\$2.4 billion in 2001 and 2002 to exceed US\$22 billion every year since 2006. The internationally oriented segment of the Turkish construction industry has become increasingly diversified in terms of markets, products, and business models. In 2010, Turkish contractors undertook 577 projects in 50 countries, ranging from infrastructure projects (roads, bridges, tunnels), residential housing, sports facilities, energy projects, tourism establishments, etc. Geographically, the

¹⁶ Ministry of Economy of Turkey, "Economic Outlook", December 2012

¹⁷ Loc. Cit. World Trade Organization.

Russian Federation, Libya, Turkmenistan, Kazakhstan, and Iraq have been the leading markets, representing around 50% of the business volume;

- Transportation services: Turkey has Europe's biggest truck fleet (45 thousand trucks and 1,420 companies); Turkey's air transport services (almost 1 million flights in 2011, 2.3 million tonnes freight and 117 million passengers); Turkey's fleet is the 25th biggest in the world;

Barriers to trade in services in Kosovo and Turkey

A FTA with Turkey would need to provide for the Parties' commitments to eliminate barriers to trade in services, i.e. limitations to Market Access and National Treatment as defined in GATS Articles XVI and XVII. Though Kosovo is not a member of the WTO, Turkey is, so a future bilateral FTA covering services (in the WTO parlance "Economic Integration Agreement") would need to comply with the minimum requirements of GATS Article V with respect of such agreements.

GATS Article V permits agreements liberalising trade in services between or among the parties to such an agreement, "provided that such an agreement¹⁸:

- (a) *Has substantial sectorial coverage, and*
- (b) *Provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under subparagraph (a), through:*
 - (i) *Elimination of existing discriminatory measures, and/or*
 - (ii) *Prohibition of new or more discriminatory measures,*
either at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI, XII, XIV and XIV bis."

According to a footnote to the text, the condition that the agreement has "substantial sectorial coverage" is "understood in terms of number of sectors, volume of trade affected and modes of supply.

¹⁸ Ibid., pg.

In order to meet this condition, agreements should not provide for the *a priori* exclusion of any mode of supply". It is clear therefore that a future Kosovo/Turkey Economic Integration Agreement should not necessarily cover all sectors, but should cover a substantive number of them for which discriminatory measures should be abolished in practically all modes of supply.

Beyond agreeing with Turkey on the minimum sectorial scope of the future agreement to comply with this legal requirement of the GATS, Kosovo's negotiators have to ensure that the negotiations will have fair results, i.e. that the concessions given to Turkey are truly reciprocal and that no restriction remains, discriminatory or not, to Kosovo's services and service providers on the Turkish market in the sectors to be liberalised. Obviously this will also be the objective of the Turkish side¹⁹.

This means that all existing measures (laws, regulations, or any other administrative acts, written or not) limiting Market Access and National Treatment should be identified prior to the start of the negotiations. The identification of such barriers to trade has two main objectives: (1) making a pre-negotiation assessment of the overall situation of both sides' trade restrictiveness, in general and sector-by-sector, which is important to judge whether it is useful to start the negotiations (if there is a huge imbalance in the starting conditions between the Parties they might not have the same level of interest to negotiate a services FTA. "Which Party will have to make greater sacrifices (bigger concessions) for the sake of the free trade agreement?"); (2) allowing Kosovo's negotiators to have a clear view of what they might ask, or what is worth to ask, from Turkey.

Current trading conditions for Turkish services in Kosovo's market

Kosovo's has a very liberal trade regime for services. The legal framework for trade in services allows for a relatively open economy

¹⁹ CEFTA Secretariat, *Consolidated List of Existing Discriminatory or Restrictive Measures in Services*, 2012., pg.62.

to foreign service providers. In terms of market access, for most services, there are no legal restrictions on foreign firms establishing a commercial presence in Kosovo. Once they are established, foreign-owned firms are subject to the same rules as domestic ones. Foreign-owned local firms are free to determine their ownership structure (allowing up to 100% foreign ownership) and whether they will enter into a joint venture with local or other foreign-owned firms. Within the overall privatisation policy, specific service providers are in the process of being privatised, such as the Post and Telecommunications of Kosovo (PTK).

Some of the most notable restrictions and limitations to trade in services in Kosovo for sector specific are the following²⁰:

- **Air transport services:** citizenship requirement for freight transport services;
- **Accounting services in Mode 1:** a foreign provider supplying services from abroad (i.e. in Mode 1) is not allowed to perform tax advice, tax representation or legal advice and representation;
- **Accounting/auditing in Mode 3:** practitioners cannot exercise their profession in limited liability partnership; Mode 3: stand-alone foreign branches are not permitted; unrestricted integration between local and foreign accounting firms is not permitted;
- **Accounting/auditing in Mode 4:** entry is subject to discretionary authorization, even if requirements are met; minimum wage requirements; Labor Market Test applies: a proof from Job Center that no local employee is interested for the job concerned is required; quantitative limitations: the Government of Kosovo sets out the yearly number of foreign workers authorized to work.
- **Architectural services in Mode 3:** stand-alone foreign branches are not permitted; unrestricted integration

²⁰ Ibid., pg.

between local and foreign architectural firms is not permitted;

- **Engineering services in Mode 3:** stand-alone foreign branches are not permitted; unrestricted integration between local and foreign engineering firms is not permitted;
- **Legal services in Mode 1:** a domestic resident firm/individual cannot obtain professional services directly from a foreign legal services firm or office located outside Kosovo for the following: legal counsel/advice on matters predominantly regulated by domestic host State law (criminal law); legal counsel/advice on matters predominantly regulated by domestic host State law (civil law); rights of audience or representation of clients before courts in the host country; conveyancing, transferring of title to real estate; probate, wills and regulation of family matter; representation before administrative agencies, including on tax matters; advice and representation on patent law; permanent residency requirement in order to be enlisted in Bar Register. For notaries-Permanent residency and numerical quota; reciprocity requirement (denial of MFN treatment) for mediators;
- **Legal services in Mode 3:** stand-alone foreign branches are not permitted; unrestricted integration between local and foreign law firms is not permitted;
- **Medical and dental services in Mode 1:** Not allowed;
- **Medical and dental services in Mode 3:** Licence for foreign doctors and dentists limited to six (6) month.
- **Medical and dental service in Mode 4:** Licence for foreign doctors and dentists limited to 1 month.
- **Veterinary services in Mode 1:** Not allowed;
- **Veterinary services in Modes 3 and 4:** Licence for foreign veterinary doctors limited to 1 month;

Current trading conditions for Kosovo's services in the Turkish market

Turkey has made extensive commitments under the WTO General Agreement on Trade in Services (GATS); its schedule covers 72 activities out of a total of 161 in nine sectors. It also became a party to the Interim Agreement on Financial Services in 1995, the 1997 Agreement on Telecommunication Services, and the 1997 Agreement on Financial Services.

In the past decade, Turkey has progressively relaxed restrictions to trade in services in some sectors, notably as far as right of establishment (Mode 3) is concerned. Companies with 100 percent foreign ownership may operate in nearly all sectors of the Turkish economy. All companies established according to the Turkish Commercial Code are regarded as Turkish companies, with equal rights and responsibilities as stated in the Constitution and in other laws. The rights include national treatment, guarantee against expropriation without compensation, transfer of proceeds, the right to expatriate personnel, and access to international arbitration or any other means of dispute settlement. However, today a few services remain closed to FDI, and FDI restrictions still exist in media, transportation, and business services and the acquisition of real estate also bares restrictions²¹.

Remaining **restrictions on foreign ownership** are laid down in legislation regulating specific activities. Under recent liberalization in the area of **broadcasting**, the limitation on foreign equity participation in a media service provider was raised from 25 to 50 percent in March 2011. However, other restrictions, such as the requirement that foreign equity participation may not exceed 49 percent in **aviation and in maritime services** provided under concession agreements, and that foreigners may not obtain a **fishing** licence in Turkey. Special permission under specific laws is required to provide **accounting, auditing, and bookkeeping services**; for the establishment of **private**

²¹Loc. Cit. Hiziroglu, A. et al.

employment offices; and for investments in the financial sector, petroleum, mining, electricity, and education services. Acquisition of **real estate** by foreigners remains restricted, or subject to reciprocity provisions. In accordance with the Land Registry Law No. 2644, foreigners purchasing land plots between 2.5 and 30 hectares need permission from the Council of Ministers. Foreigners may not purchase land exceeding 30 hectares.²²

Conclusion:

Concluding arguments behind the rationale for concluding an economic integration agreement (Free Trade Agreement) on services with Turkey

In the recent literature on international political economy, non-anti-WTO or non-anti-globalisation writers have amply stressed the positive role that trade agreements play in the context of services. In general a services trade agreement might have multiple advantages, including the following:

First, such an agreements bind current level of liberalization of trade regime in services in both contracting parties (this would bind adopted reforms). The advantage of this would be that the agreement collaborates in the liberalization process if vested national interests oppose liberalization and block initiatives to open access or prevent the establishment of an appropriate regulatory framework.

Second, trade agreements create a more stable framework for trade because they are international contracts that may not be changed unilaterally. Therefore, they may also create a path for introducing reforms in a gradual manner and provide rules that cannot be arbitrarily modified. A services trade agreement may create new market access opportunities; service providers can access foreign markets more easily and with lower costs. In cases where the other party's trade regime is already liberal, the advantage of the agreement

²² Op. Cit. World Trade Organization., pg.13.

is that it guarantees that the liberal trade regime will be maintained in the future.

The agreement may enhance transparency, predictability of trade policy regime in both contracting parties. The agreement may stimulate domestic service suppliers to increase competitiveness in order to be better competitive in comparison with service suppliers from the other contracting party (cost reduction, modernization of facilities, improvement of services, bigger choice of services, cheaper, more competitive services).

By stimulating import competition, the agreement may contribute to: increasing the number of service providers, increasing the choices for customers; lowering the prices of services in the market; increasing the quality of services provided (citizens and companies can profit from this).

When combined with effective national competition policy and law, the agreement may contribute to reducing the power of national monopolies, oligopolies when misusing their dominant position on the market (leads to lower prices, introduction of new services - e.g. in telecom, banking, transport).

The agreement may provide articles on mutual recognition of professional qualifications (architects, engineers, doctors, etc.) thereby easing market access for professionals.

Finally, trade agreements provide political support for the liberalization of the trade in services because they ensure reciprocal market liberalization.

When it comes to the particular agreement with Turkey, there are a number of arguments that might create a rationale for it:

- First, the shared history and the traditional cultural ties between the two countries, as well as the some 20 thousand Kosovo citizens of Turkish origin, can all be seen as facilitators of future enhanced services trade.
- By providing contractual guarantees to Turkey that trading conditions in Kosovo will not only remain as liberal as they are but all remaining restrictions will be removed, Kosovo might attract more advanced services and service providers from Turkey which, in certain

sectors, could contribute to the development of more efficient Kosovar service industry. However, such effect cannot be expected in infrastructural services, consumer services or services provided through Mode 1 in general, to list of few exceptions. In order for such impact to happen, Turkish providers should have a long-term commitment in the Kosovo market, i.e. established through FDI, should use advanced technologies and production methods, must employ and train local professionals.

- Third, in principle Turkey might be a good choice for Kosovo's service providers seeking access to a big and geographically close export market. Whether or not this is a realistic choice at present depends on the particular comparative advantage of the potential exporter. Whilst one cannot exclude that in some particular service sub-sectors Kosovo might enjoy a comparative export advantage over their Turkey, the potential scope is so limited that this does not warrant for concluding an FTA.
- Finally, irrespective of considerations based on comparative advantages, one might consider that getting Turkey remove its remaining restrictions to trade in services under a bilateral FTA might be a good idea because that would guarantee unlimited market access for Kosovo service providers and investors which they could use once they feel strong enough to venture in the Turkish market.

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