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Turkey Country Practice Review

Comments on GSP Eligibility of Turkey

USTR-2018-0031

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On August 3, 2018, the U.S. Trade Representative (USTR) announced a new Generalized System of Preferences (GSP) eligibility review of Turkey. USTR identified the "market access" criterion in its initiation of this review. Under the statute (19 USC 2462), the factor including market access also includes "the extent to which such country has assured the United States that it will refrain from engaging in unreasonable export practices."

U.S. Wheat Associates (USW) objects to continued GSP eligibility for Turkey based on its failure to reform practices that subsidize exports of wheat flour, harming both the interests of U.S. wheat farmers and their customers in third-country markets.

Overview

From the perspective of USW, it is difficult to understand how Turkey has continued to maintain preferential access through GSP to the U.S. market. Turkey has failed to accomplish some of the most basic functions of a member of the World Trade Organization (WTO) with regard to its agriculture policies.

Turkey provides substantial domestic support for its wheat producers, primarily through a market price support mechanism that guarantees a minimum price for farmers from the state if market actors are not willing to pay a higher price. Much of this excess wheat production is milled into flour and exported due to the substantial benefits provided by hidden export subsidies.

Turkey has argued in WTO committees and elsewhere that its flour exports are market-driven and simply reflect the competitiveness of its flour milling sector.[1] However, it would take a willful suspension of disbelief to think that one of the most protected wheat markets in the world (Turkey's applies a 45 percent tariff; until 2017 it was 130 percent) could somehow become the world's most competitive wheat flour exporter on purely commercial terms.

Inflation
We recognize that the current economic challenges facing Turkey – particularly the collapse of the lira – may result in market behavior and policies different from that described in this submission. Our description is based on recent experience under more normal economic conditions and applies to what we believe is likely to continue once the economic situation stabilizes provided that Turkish policies continue or resume after the crisis passes.

Market Impacts
Our concern with Turkish flour began almost a decade ago, when this flour started to arrive in the Southeast Asian countries of Indonesia and the Philippines at prices well below other flour export origins and domestic flour prices. In the Philippines, Turkey still maintains a substantial share of the domestic flour market, though it has slowly declined following imposition of anti-dumping duties in 2014. In 2017, Turkish flour imports were just under 70,000 MT. That compares to the 2012 peak of 163,000 MT, which had increased more than ten-fold since 2008. Imports by Indonesia increased at a similar pace but have fluctuated since the imposition of safeguard measures in 2012.

Flour exports from Turkey were over 50 percent higher in 2017 than the next largest exporter (Kazakhstan where over 99 percent of its flour exports went to neighboring land-locked countries) and almost five times higher than the European Union, which is the third largest flour exporter. Most of Turkey's flour exports are to war-torn neighboring countries that may lack sufficient milling infrastructure or operating capital, but that does not explain how Turkey routinely manages to sell over 100,000 tons to competitive markets in Southeast Asia and the Caribbean.[2]

Other affected markets include Angola and Iraq. Angola is the fourth largest export market for Turkish flour, and one with potential for U.S. wheat exports. Iraq is the largest market for Turkish flour by far, and Turkish flour had until recently displaced nearly all wheat imports in that country. Iraqi policymakers have imposed new tariffs on Turkish products and increased wheat imports from other countries, including the United States. However, since the flour export incentives remain, much of this displaced flour will likely end up in other markets.

Certainly, Turkey absorbs much Black Sea wheat that would otherwise compete with U.S. wheat in markets such as these, but our preference is to compete on a level playing field and be able to work with vibrant domestic milling industries. Flour export subsidies are particularly challenging because not only do they provide a market advantage to our competitors, they provide our competitors a market advantage over our flour milling customers. A wheat export subsidy may actually help our customers (though not U.S. farmers), but a flour export subsidy can put them out of business, causing U.S. farmers to lose that customer permanently.

These unreasonable export practices are detailed below. The submission concludes with recommendations that we believe Turkey should implement before continued GSP eligibility is granted.

Notifications
Transparency is critical to informing the work of the WTO. Country notifications are the primary mechanism to provide information to the WTO membership. Without a clear understanding of the situation on the ground, the work of the relevant WTO committees and negotiating bodies becomes much more difficult. In the areas of export subsidies and domestic support – the topics of this submission – Turkey has notified its programs through 2000 and 2004 respectively. In other words, Turkey has not submitted a WTO domestic support or export subsidy notification to the WTO in fourteen years; an astounding lack of transparency for one of the world's top 10 agricultural producing countries and top 15 wheat producers.

Furthermore, it cannot be claimed that Turkey was unaware of its obligations or that other countries gave it a pass. In September 2012, Australia asked Turkey when it would submit its outstanding notifications and Turkey responded that it aimed to do so in 2012. Since then, other countries have asked Turkey about its overdue notifications in the WTO Committee on Agriculture no fewer than 24 times.

This should not be an overly difficult task for Turkey. Nearly 40 countries with a GDP per capita lower than Turkey's have submitted domestic support notifications covering years through 2015 (i.e. more than a decade ahead of Turkey), including Afghanistan, Barbados, Botswana, Brazil, Burundi, Cameroon, Chile, Colombia, Congo, Costa Rica, Cuba, Ecuador, Egypt, Fiji, Gabon, Georgia, Guatemala, India, Jamaica, Kyrgyz Republic, Laos, Malawi, Mali, Mauritius, Mexico, Moldova, Nicaragua, Nigeria, Panama, Paraguay, Philippines, Saint Vincent, Senegal, Thailand, Togo, Tunisia, Uruguay, and Vanuatu.[3]

While we are not in any way endorsing the accuracy or methodology of these notifications, these countries are at least attempting to appear transparent. That is more than can be said for Turkey. Turkey's profound disregard for the transparency commitments of the WTO Agreement on Agriculture should be considered as USTR evaluates Turkey's GSP eligibility.

Unreasonable Export Practices
Turkey does not meet the criteria outlined in 19 U.S.C. 2462(c)(4) that countries should not engage in unreasonable export practices. In the case of wheat flour, Turkey certainly engages in these practices, both through indirect and direct means. The indirect factor is Turkey's price support program, which clearly violates WTO domestic subsidy (AMS) commitments and leads to excess production of wheat. The direct factor is Turkey's inward processing regime, which effectively subsidizes the movement of wheat flour into international markets.

Excess Production Driven by Price Supports
The centerpiece of Turkey's domestic support for wheat farmers is a WTO-inconsistent price support program. In 2017, Turkey's support price was $261 per metric ton (MT),[4] while its fixed external reference price (as previously notified) is $98.50.[5] With total production at 21 million MT, and no known restrictions on eligibility for Turkish wheat farmers, that means Turkey's

amber box subsidies would total over 60 percent of its value of production that year, when its WTO *de minimis* limit is just 10 percent.[a]

This simplification does not consider other forms of product-specific support, such as wheat premiums and input subsidies, which can provide an additional 150 TL/MT to wheat farmers.[6] If Turkey exceeds its AMS limit of 10 percent for wheat, it is acting inconsistently with its obligations under Articles 3.2 and 6.3 of the WTO Agreement on Agriculture.

This results in inflated price signals to Turkish farmers that suggest higher demand for wheat, leading to overproduction. Much of this excess wheat is sold to flour mills that process and export the wheat in the form of flour, pasta, and other wheat-based products.

Manipulating Inward Processing

An inward processing regime (IPR) is a form of duty-drawback that allows a country normally applying tariffs on a certain imported product (in this case wheat originating outside Turkey) to import that product duty-free if it is used as an input in a processed exported product (flour).[7] Under Turkey's IPR, the exporter of the processed product can use a domestic input in the exported product and still have access to duty-free imports if certain conditions are met.

Under Annex I of the SCM Agreement, an IPR is supposed to ensure that "home market inputs" (e.g. Turkish wheat) used in the exportation of processed products, should be the same quantity and have "the same quality and characteristics" as the imported inputs that will substitute for them.

Turkey has acknowledged in response to questions at the WTO Committee on Agriculture that the IPR statistics are compiled on the basis of tariff codes.[8] We find no evidence that Turkey distinguishes between different kinds of wheat, except for the standard distinctions between durum (*triticum durum*) and common wheat (*triticum aestivum*) and the subcategories of wheat for planting and wheat for all other uses.[9] For someone who is unfamiliar with the wheat industry, it may not be clear that there is significant variation between types of wheat. But in the country where common wheat likely originated,[10] there should be no such excuse.

Consider the kernels in Exhibits A and B. Both are common wheat meant for uses other than planting so would fall under the same Turkish tariff code. In Exhibit A, we see a kernel of U.S. soft red winter (SRW) class wheat. It's somewhat lighter in appearance than the kernel of U.S. hard red spring (HRS) class wheat in Exhibit B, but they're roughly the same size and when ground finely they both turn into flour. So one might be forgiven for thinking that Turkey's method of verifying "same quality and characteristics" through tariff codes is adequate.

However, those with a sophisticated understanding of wheat properties – Turkish flour millers surely fall into this category – know that different kinds of wheat are used for very different purposes. For example, HRS is used in bagels, hearth breads, pizza crusts, and a flour improver.

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[a] ($261-$98.5)*21,000,000 = $3.4 billion. Total value of production estimated by multiplying 21 MMT by support price ($261) = $5.5 billion. Inflation has substantially reduced USD value of Turkey's price supports in recent years.

SRW is primarily used for cookies, crackers, and cakes. The demand for these products and thus these different types of wheat can vary enormously and therefore so can prices.

Exhibit A. *Kernel of soft red winter wheat.*

Exhibit B. *Kernel of hard red spring wheat.*

At the most basic level, a kernel of SRW and a kernel of HRS each cost about a thousandth of a penny. But get a bushel (60 lbs) of each and the difference is about $2. Fill two 45,000 MT vessels and the one carrying SRW will have a value of about $3 *million* less than one carrying HRS at today's prices. This is not to say that one is better than the other, but simply that markets are willing to pay a premium right now for high protein HRS over low protein SRW. It also does not begin to describe variation within classes and a host of non-class factors that affect prices.

Of course, this example only covers wheat from the United States and there is significant variation in wheat prices and quality across the globe. The majority of wheat imported by Turkey is from Russia, with the remainder mostly originating in Ukraine and the European Union. We don't have data on the quality or prices of the imported wheat compared to the wheat used in exported flour, but that is part of the problem. Turkey is required under the SCM Agreement to have a system in place to verify that that its IPR meets the definition of a permitted program.

Based on observations from industry and government contacts in Turkey, wheat exporting countries, and flour importing countries, it appears that Turkish flour mills are generally exporting lower protein flour and using the IPR certificates generated from those exports to import higher protein wheat duty-free. Higher protein wheat usually commands a higher price than lower protein wheat (as in the HRS/SRW example) and Turkish flour millers need more higher protein wheat than is domestically available. By milling and exporting lower protein wheat, it allows these millers to access higher protein wheat duty-free instead of paying the current 45 percent tariff.

Consider a simple example. A Turkish flour milling company buys lower protein domestic wheat equivalent to a ton of flour for $300 (typically a metric ton of flour requires 1.33 metric tons of wheat). After adding milling costs it can break even by selling the flour at $400/MT in the domestic market. It also wants to sell higher protein flour but needs to import foreign wheat. Even though the equivalent amount of foreign wheat is available for $250, the 45 percent tariff bumps that price up over $360. Add the same milling costs and that's $460. In this example, if a miller sells a ton of flour from domestic wheat and a ton of flour from foreign wheat, the market price would be $860 for two metric tons of flour to break even.

Now another milling company follows the same first step and exports the flour milled from domestic wheat. This gives it access to the foreign wheat duty-free at $250 per ton of flour equivalent, so this second milling company can price it in the domestic market at $350/MT instead of the $460/MT quoted by its domestic-only competitor that has not exported and so must pay the 45 percent duty. The break-even price for the exporting mill would be $750 for two metric tons of flour, giving it a substantial margin advantage over the competing mill that is only focused on the domestic market.

Cost Table	**Exporting Mill**	**Domestic-Only Mill**
Domestic Wheat Purchase	$300	$300
Milling Costs (domestic)	$100	$100
Imported Wheat Purchase	$250	$360
Milling Costs (import)	$100	$100
Total Costs	$750	$860

The exporting mill in this case still has the same domestic wheat purchase costs but has $110 margin to lower the export price of flour, which would help it compete with rival mills. This set-up could incentivize selling the domestic wheat flour below cost because as long as the imported wheat flour is priced below $460, the mill will undercut its domestic-only competitor. Exporting the domestic wheat flour becomes a means to the end of accessing imported wheat at a cheaper price.

Sales from TMO
According to USDA attaché reports, the Turkish government no longer sells wheat directly to exporters within the scope of the IPR.[11] Until recently, this was the clearest example of an export subsidy. TMO – the state-run Turkish grain handler – sold wheat to exporters at prices well below world market rates and its own procurement price, a clear violation of Article 9.1(c) of the WTO Agriculture Agreement. While Turkey has apparently shifted away from this direct practice, at least for the time being, it helped establish Turkey's position as the leading flour exporter and other policy incentives remain in place to encourage flour exports.

Secondary Market for Inward Processing Certificates
Turkey grants flour exporters an IPR certificate allowing duty-free imports of wheat when they can demonstrate exports of an equivalent wheat flour. One piece of evidence that this system effectively subsidizes exports is a secondary market that existed for IPR certificates, where millers can sell their duty-free import rights to traders. The sale of those certificates breaks the import and export chain that should be linked under the IPR and acts as a subsidy to the exporting millers who gain additional revenue from the sales. These certificates have been known to sell for over $100 per metric ton.

Anecdotally, it seems that this practice is not as prevalent as it was a few years ago, but the fact that this has occurred demonstrates that the IPR conveys a direct financial benefit to the millers, making it an impermissible subsidy under Article 9.1(c) of the Agreement on Agriculture and Article 3.1(a) of the SCM Agreement. Regardless of what is occurring now, the profits from the sale of IPR certificates over the past decade have allowed the Turkish milling industry to build a vast export infrastructure through impermissible subsidies.

Verification System

Annex I (i) of the SCM Agreement allows firms benefiting from an IPR to "use a quantity of home market inputs" to manufacture product for export, provided that 1) the quantity of inputs used is equal to the quantity imported; and 2) the domestic product has the "same quality and characteristics" as the imported product. Annex III adds precision to this requirement, specifying that the home market inputs must have the same "quality and characteristics" as the imported product. Annex III also obliges a Member using a substitution system to be able to verify that the system meets the definition of a permitted program.

If a country fails to adhere to the provisions of Annex I and Annex III, i.e. if it allows for the substitution of domestically produced product that does not have the "same quality and characteristics" as the imported product under an IPR, then exports of the processed product are viewed under WTO rules as receiving an export subsidy.

Specifically, Turkey has an obligation under Annex III to maintain a verification system related to the use of the IPR for wheat and wheat products. We have found no evidence of a verification system that meets the requirements of the SCM Agreement. If Turkey does not maintain a verification system that ensures same "quality and characteristics" it is in violation of WTO rules.

A verification system for wheat will be complicated because, as described above, wheat is an apparently simple commodity but its intrinsic properties – and thus its value – can vary immensely. However, there are some common elements of a wheat contract like protein content, test weight, dockage, bug damage, foreign material, and falling number. Including elements like these in determining same quality and characteristics would significantly improve the validity of a Turkish verification system under IPR. Including even these basic quality parameters would present implementation challenges but implementation challenges do not nullify WTO obligations.

U.S. Wheat Associates is willing to work with USTR and Turkey in designing a verification system that would better align quality and characteristics of imported wheat and domestic wheat used in exported flour.

Nairobi Decision

The Nairobi Ministerial Decision on Export Competition allows developing country Members like Turkey to continue benefitting from the provisions of Article 9.4 of the Agreement on Agriculture until the end of 2023. Article 9.4 allows these countries to subsidize some of the processing and delivery costs for agricultural exports. Turkey's IPR for flour should not be covered under this article. This is a hidden subsidy that is not tied to the costs included in the Article 9.4 exemption. There is no evidence that Turkey has attempted to equate the two or compare the costs that can be covered under Article 9.4 and the incentives provided by the IPR. In response to questions posed in the WTO Committee on Agriculture, Turkey has always insisted that this is not a subsidy, which would mean it is not eligible for coverage under Article 9.4. Finally, even if Turkey were to somehow convince a WTO panel that Article 9.4 completely covered its IPR for wheat flour, this should still be considered an "unreasonable export practice" under the GSP statute.

Disclaimers

A couple disclaimers are warranted regarding the Turkish situation. First, Turkey is literally situated geographically in a way that gives it natural advantages in exporting flour. On the southern end of the Black Sea, it is the closest major wheat importer to the wheat exporters on the northern end of the Black Sea. It also has large ports on the Aegean and Mediterranean. To its near south are several wheat deficit countries with deficient capital for a strong milling sector. If the following recommendations are met, we do not expect Turkey to stop exporting flour, but it should not be artificially competitive with efficient flour mills that are importing wheat in far flung countries.

Finally, Turkey is currently going through a very difficult economic situation where inflation is a major challenge. Obviously, this has had some influence on the wheat flour markets, including the Turkish government's steps to lower the tariff last year from 130 percent to 45 percent to help fight inflation. It remains to be seen what further steps will be taken, though to date USDA projects only expects a slight decline in wheat product exports from last year due to bilateral issues with Iraq.[12] However, the underlying policies remain and until those are permanently addressed, there will be continued negative effects on U.S. wheat farmers and their customers.

Recommendation

In order to maintain GSP eligibility, Turkey should meet four criteria related to wheat production and flour exports:

1) Submit all overdue domestic support and export subsidy notifications at least through 2015, including with incomplete information if comprehensive information is not immediately available.
2) Implement a verification system to ensure that the quality and characteristics of imported wheat are the same as the domestic wheat used in exported flour.
3) Prohibit the sale of inward processing certificates to ensure that there is a link between the use of certificates for duty elimination and the import of wheat by flour millers.
4) Prohibit the sale of wheat for export from state-directed entities at prices below acquisition costs, a practice that is clearly inconsistent with Turkey's WTO commitments.

We also propose an alternative to the entire inward processing system for wheat and wheat products. Recognizing the inherent challenges of administering something as complicated as ensuring the same quality and characteristics of wheat, the simplest solution would be for Turkey to implement a duty-free TRQ based on recent annual imports. The most recent 3-year period average was just under 4 MMT for common wheat and 550,000 MT for durum wheat.[13] If duty-free imports are allowed under a TRQ this will allow Turkish millers to import the wheat that they need without preventing exports of flour or other wheat byproducts in situations where Turkish products are competitive.

About U.S. Wheat Associates
USW's mission is to "develop, maintain, and expand international markets to enhance the profitability of U.S. wheat producers and their customers." USW activities in more than 100 countries are made possible through producer checkoff dollars managed by 17 state wheat commissions and cost-share funding provided by USDA's Foreign Agricultural Service. For more information, visit our website at www.uswheat.org.

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[1] See, for example, the Q&A between the United States and Turkey at Turkey's 2012 Trade Policy Review. WT/TPR/M/259/Add.1
[2] Global Trade Atlas
[3]WTO Agriculture Information Management System database retrieved August 15, 2018. GDP per capita figures are 2017 estimates from the CIA World Factbook.
[4] GAIN Turkey Grain and Feed Update July 2017 https://www.fas.usda.gov/data/turkey-grain-and-feed-update-6
[5] Cf. WTO Document G/AG/N/TUR/10
https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/G/AG/NTUR15.pdf
[6] GAIN Turkey Grain and Feed Update July 2018 https://www.fas.usda.gov/data/turkey-grain-and-feed-update-9
[7] World Customs Organization Revised Kyoto Convention, Specific Annex F, Chapter 1
http://www.wcoomd.org/en/topics/facilitation/instrument-and-tools/conventions/pf_revised_kyoto_conv/kyoto_new/spanf.aspx
[8] See, for example, the Q&A between the United States and Turkey at the June 7, 2016 COA meeting. ID 80029.
[9] Turkey Tariff Schedule – 2017
https://eb.ticaret.gov.tr/portal/content/conn/UCM/path/Contribution%20Folders/web/%C4%B0thalat/G%C3%BCmr%C3%BCk%20Vergisi%20Sorgulama/ekler/G%C3%BCmr%C3%BCk%20Giri%C5%9F%20Tarife%20Cetveli_2018.pdf
[10] Bilgic, H., Hakki, E., Pandey, A., Khan, M. and Akkaya, M. (2018). *Ancient DNA from 8400 Year-Old Çatalhöyük Wheat: Implications for the Origin of Neolithic Agriculture*.
[11] GAIN Turkey Grain and Feed Annual March 2018 https://www.fas.usda.gov/data/turkey-grain-and-feed-annual-2
[12] GAIN Turkey Grain and Feed Update July 2018 https://www.fas.usda.gov/data/turkey-grain-and-feed-update-9
[13] Global Trade Atlas