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INVESTING IN TURKEY'S FUTURE

Competing for, "seducing", "winning" and "enduring" the benefits of foreign direct investment (1)

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Overview

Capital formation is central to achieving sustainable growth, development and modernization. The resources needed to finance capital accumulation must be augmented by foreign sources of capital – direct, portfolio investment and borrowed funds – in addition to mobilizing domestic savings for investment. In a dynamic country like Turkey with ambitious projects to prepare for the future, domestic savings are not enough (or timid due to the lack of confidence) to fund the economy's fixed investment requirements. Besides, the currency and banking crises were major blows to the highly leveraged Turkish private sector and the bulging public–sector debt stock crowds out private enterprises. As a result, the Turkish economy needs increasing amounts of foreign capital to fuel the engines of growth.

The problem, however, is that the limited foreign capital Turkey has been able to receive so far is mostly in the form of highly volatile international portfolio flows. Even if such capital movements partially fill the funding gap in the short term, they are also a major source of systemic risk for the whole economy. It is often argued that if the Turkish economy had received foreign direct investment (FDI) instead of 'speculative' capital flows in 2000, the recent crisis may have never occurred at all. But one has not to overrate the importance of FDI because its share in gross domestic capital formation is still minimal. What's important is to maximize FDI's benefits through spillover and multiplier effect in achieving greater integration with world markets, technology learning and dissemination, managerial skills, access to financial markets. FDI also improves, in most case, environmental, social and labor standards.

Where Does Turkey Stand In The World League Of FDI Recipient Countries?

As the largest economy in Eastern Europe, the Balkans, the Black Sea basin and the Middle East, and the European Union's sixth biggest trading partner, Turkey represents a striking example of how a high potential country could fail to attract minimum levels of FDI to its economy. Between 1980 and 2001 foreign companies invested $17 billion in Turkey, an annual average of $850 million. (2) The FDI inflows between 1995 and June 2002 was $9 billion, but $3 billion of this amount was due to a large license fee paid by Telecom Italia to operate Aria (with which there is a serious contract compliance problem likely to be taken to international arbitration) and HSBC's purchase of a local bank. The prospects for 2003 do not seem very promising either. This compares with $36 billion to Poland, $21 billion to the Czech Republic and $14 billion to Hungary over the same period. Brazil and Mexico each attracted around $20 billion of FDI in 2002. On average, Turkey has brought in net FDI flows of 0.32 percent of GDP in the 1975–2001 period (and only 0.44 percent in the 1990s when global FDI flows reached the peak). This can be compared with around 4 percent for newly liberalizing competitors such as Hungary and the Czech Republic.

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Turkey's EU accession process can be an important trigger for FDI flows that may help to finance the economic convergence process. With EU membership anticipated for 2012, Turkey could potentially attract annual FDI flow of over $10 billion by 2015, which would help to ease concerns about the income gap between Turkey and the EU (and income discrepancies within Turkey). This is on a conservative assumption of attracting net FDI flows of 2.2 percent of GDP in the 2002–2015 period. The EU convergence is imperative not just for what it entails in terms of job creation and quality of life, but also for being a lighthouse for sustainable economic and institutional development. Although the IMF programme has had an important structural reform context, EU candidacy and membership would be even a better anchor for structural renovation and economic rejuvenation in the long run.

To understand why Turkey's has under–performed, one should revisit the key factors determining investment location. The location of FDI reflects the match of corporate strategy with three major location determinants: economic; political–institutional; and enabling environment. There is significant evidence that Turkey has a strong competitive position in relation to the economic determinants of investment location as it is particularly well placed compared to competitor locations due to its economic size and dynamism and quality of its labor force. But in terms of the political–institutional determinants of FDI location, Turkey has long been in a relatively weaker position. Political and economic instability, manifested as chronic inflation, fragile coalition governments and negative attitudes towards foreign investors are major obstacles to FDI, which are compounded by a weak enabling environment for privatization–related FDI and a total lack of effective investment promotion.

If Turkey starts to get FDI flows similar to, for example, the experience of central European countries, annual FDI flows may even reach over $22 billion by 2015. Unlike multilateral/bilateral funding, this form of long–term external financing is not a source of moral hazard and would help the Turkish economy in reaching its potential growth rate of 7.5 percent. To achieve a meaningful income convergence, Turkey must sustain a much higher growth rate over the next decade. For instance, an average growth rate of 7.5 percent could boost income convergence and almost double the income level to 45 percent of the EU average by 2015.

Global Race To Attract FDI

Today all countries are racing with each other to attract as much FDI as possible in an increasingly competitive environment, where the global coalitions cannot be joined without FDI and trade. Yet, it is still fresh in our memories that in the seventies FDI was considered an " agent of imperialism ". A lot of development economics literature sprouted about the " evils of FDI ", how it exploited the natural resources of poorer countries and sneaked into national markets, making the rich richer and the poor poorer. Today this perception has changed significantly, despite persistence of similar rhetoric in some isolated quarters.

A few countries–essentially Japan and South Korea–have been able to grow rapidly with minimal reliance on FDI. Many countries have attempted to imitate the Japanese or South Korean model, but with limited success. Korea has changed its pre–Asian crisis policy and is now actively "seducing" FDI. De facto, most other fast–growing countries have relied heavily on FDI (for example Chile, China, Malaysia, Singapore, and Thailand). Most astonishingly, Ireland–despite being a relatively advanced country–has managed to grow at some 8 percent per year for most of the 1990s due in large part to effective attraction and deployment of foreign investment.

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Yet there should be no illusion: FDI cannot be the main source for solving the developmental problems. FDI should be seen as a valuable supplement to levels of domestically provided fixed capital and other external finance rather than a primary source of finance. Also, one should not paint a picture that is too rosy because there are also some drawbacks from FDI, such as deterioration of the balance of payments, inadequate linkages with local enterprises and communities, environmental impact –– particularly in extractive and heavy industries –– effects on competition, corruption and the like. The best response to this challenge is to strengthen the environmental, social safeguards, and governance mechanisms rather than attempting to limit FDI flows and foregoing the benefits that these bring.

On balance, there is no doubt that the benefits of FDI−such as capital inflows, employment, information, technology and knowledge transfers, access to international markets, competition−far exceed the costs. FDI is different from other capital flows, such as loans, for instance, which incur interest, or short−term portfolio investments, which enter the economy quickly and exit it with the same speed if speculative assessments so warrant. FDI is a long−standing commitment to a country's economy. So, foreign investors put their money and technology in a country's future and thus, in a way, help shape the future of that country.

Global and Regional Trends in FDI

Over the past two years, the world's financial and investment landscape has changed considerably. The surge in FDI flows and the decline in ODA have transformed external finance to the developing countries. Changes in the world FDI scene are not only in terms of ups and downs in global FDI flows, but also in the scope, structure, and methods of participation and in the composition of its principal actors. The scope of FDI has vastly expanded, from traditional manufacturing to services including information technology, finance and banking and the media. It is no longer a phenomenon of big countries seeking cheap labor and raw materials in developing countries. The scene has altered with new entrants such as China, India, Brazil, Russia and Malaysia, although OECD countries still provide the bulk of worldwide FDI flows. The contractual form of foreign enterprise participation has also changed, with licensing, joint ventures and franchises assuming importance along with the traditional form of FDI.

These changes should be carefully considered and reflected in the strategies of governments and corporations:

· **Country Policies:** More and more countries have continued to liberalize their economic policies over the last decade or two, becoming more open both to trade flows (lower tariffs, fewer quantitative restrictions, currency convertibility) and to FDI flows (fewer restrictions on which sectors are open or the percentage of foreign ownership allowed, abandonment of case−by−case approval procedures, etc.). The ones that are not open are experiencing difficulties in maintaining growth.

· **Company Behavior:** More and more multinational enterprises (MNEs) are adopting integrated regional or even global strategies, using both subsidiaries and strategic allies to locate interdependent facilities in various countries so as to maximize their competitive edge worldwide. This is a change from the dominant behavior of 10 or 20 years ago, when MNE subsidiaries in foreign countries were operated more or less independently of each other and were located anywhere there was a market and without regard to whether the locale offered the conditions necessary for world−competitive price and quality production.

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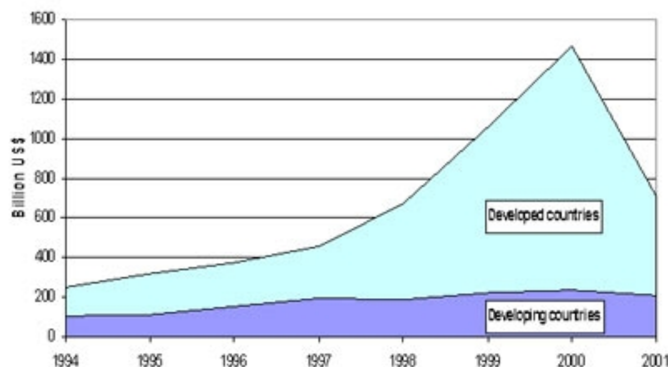
· **Technology:** Huge improvements in international transportation and communications, combined with greater use of electronic controls and information storage and transmission, have made the opening of countries, and the change in behavior of companies, viable and important. Changes in communications technology have drastically reduced many of the costs of locating interdependent activities in more than one location. The changes in technology, behavior and policies reinforce and validate each other. Because of this, the world is separating into two kinds of countries: those that offer competitive conditions for production, attract FDI and trade, and experience continuing increases in productivity and hence in incomes; and those that do none of these things and stagnate.

Cross–border investments in the world economy have risen dramatically over the past decades. Between 1973 and 2000 worldwide annual FDI flows increased fifty–fold from $25 billion to $1.271 billion. Then, they have declined significantly – by around two thirds between 2000 and 2002 – because of geopolitical uncertainties, security risks, sluggishness in the global economy, sagging stock prices and concern over corporate earnings and governance practices. Most of the decline in FDI flows to developed countries (more than halved) was due to the fact that a flurry of cross–country mergers and acquisitions came to an end in 2001. By 2002 only 40 percent of global investors chose M&A in preference to other modes of entry, compared with 71 per cent in 2000.

World Inward FDI Flows, 1994–2001



Developing and emerging economies were also affected –– but somewhat less so than the developed countries. Developing and emerging countries presently receive more than 30 per cent of worldwide FDI flows. Net FDI flows to emerging markets have dropped by about 22 per cent between 2000 and 2002, with more severe impact on Latin America. The 49 least developed countries remain marginal recipients, with only 2 per cent of all FDI to developing countries or 0.5 per cent of the global total in 2002. The problem here is the relatively poor infrastructure facilities in these countries, low endowments of human capital and the absence of effective corporate structures and meaningful macro economic policies, all of which are essential ingredients for successful utilization of FDI in the development process.

The relatively low share of FDI to developing countries needs to be qualified by a couple of observations.

- First, the low share of developing country FDI reflects the "investment bubble" in the developed countries in the late 1990s and year 2000.

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- Second, the present slowdown in FDI returned the share of developing countries to their long–term average of about one third of global FDI flows.
- Third, those funds flowing to developing economies are concentrated in a handful of countries such as China, Mexico and Brazil, which received more than half of the $204 billion of FDI that went to developing countries in 2001. But do not forget that they are also among the largest of developing economies.
- Fourth, the potential benefits of FDI are perhaps best measured not only by the volume, but also by the extent of foreign corporate presence relative to the size of the host economy.

China provides a vivid example in this context. It is worth bearing in mind that China receives far less FDI per head than many developing as well as developed countries and that much FDI in China still takes the form of short–term, labor–intensive manufacturing, while investment in high–tech activities, particularly in services sectors, lags behind. There is therefore still much scope for raising the quality of FDI as well as continuing to increase its quantity.

This year China hit the headlines when it had become the world's largest recipient of FDI in 2002, when inflows totaled $52.7 billion, while FDI into the United States fell to $30.1 billion. Chinese government figures now show that the country has received nearly US $450 billion in FDI in the past quarter of a century. These huge figures appear to make China a difficult competitor to beat, and many countries are now concerned that FDI is being diverted away from them and towards China's vast pool of surplus labor and its huge potential market.

However, China has a population of nearly 1.3 billion, and it is far from dominant if this is taken into consideration. FDI per capita in 2001 was only US $30.1, well below that of many other developing countries in Asia and Latin America (Singapore $1,547.2; Argentina $ 314.8; Chile $241.6; Brazil $195.4; Malaysia $162.8; and Thailand $54.0). FDI inflow to China was only just over 10 percent of fixed investment and 0.4 per cent of GDP; but foreign–invested enterprises accounted for 28 percent of industrial output and 52 percent of two–way trade.

How Do Countries Attract FDI?

The analogy is a love relationship. FDI should often be competed for, "courted", "seduced" and "won". It is not like the state investment or official development assistance, which can be allocated at discretion to specific sectors or regions. FDI comes only if investors are convinced that they will obtain a reasonable rate of return on capital and adequate security and stability will be offered by host countries. There is not a single success story in attracting and making best use of the FDI. Every country has different characteristics and comparative advantages, and every aspect of host countries' economy and governance practices has repercussions for the investment environment.

While formulating FDI attraction strategies, policy–makers should bear in mind that cost control is not a top priority for investors, according to business surveys; they are most interested in access to customers and a stable economic/political environment. No amount of incentives can be a substitute for a stable economic environment–that is, stable macro policies, including exchange rate policies, stability and transparency of polices towards foreign firms, an open economy free of import tariffs and export subsidies mainly designed to placate sectional interests or to pursue the unattainable so–called economic self sufficiency, and policies designed to develop infrastructure and human skills.

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As practitioners in the field are well aware, investors are increasingly selective in their choice of locales for investment. They seek, inter alia, market opportunities, stability of policies, non−discrimination vis−à−vis local investors and a threshold level of human capital and infrastructure facilities. In the absence of these basic ingredients, foreign investors may not be able to meet their objectives of profit maximization and market expansion nor would their operations promote the development objectives of host countries. Integrity, transparency and accountability of governments and corporations are fundamental conditions for providing an effective investment framework. They bring huge domestic governance challenges, not only for the benefit of foreign investors, but also for domestic business and society at large. Among regulatory reforms, the transparency of the investment−related system, the removal of corruption and bribery (one indicator of poor governance and a disincentive to investment), and sound corporate governance come up as the priority items of the agenda.

Progress in improving the investment climate provides important signals in establishing the country's credentials as a location where investors feel optimistic about economic prospects and the climate for doing business.

Barriers cause high transaction costs for the foreign investor and may deter future investment. These issues also include, for example, the rule of law, personal security, arbitrary government behavior changing the investment climate, corruption, discrimination against foreign investment, secure and regulated financial systems, free flow of capital, and international standards of accounting and arbitration. Fundamental problems of law and order and large−scale corruption can result in investors' avoidance of particular countries altogether. Many countries have addressed these problems on a national level, but their image remains negative with investors due to the prevalence of petty corruption and local small−scale barriers. These local barriers include both administrative barriers, for example in obtaining approvals and licenses at time of entry and start−up, and operational barriers concerning tax, foreign exchange, import/export procedures, labor and social security.

The conditions sought by foreign enterprises are largely equivalent to those that constitute a healthy business environment more generally. However, internationally mobile investors may be more rapidly responsive to changes in business conditions. It is up to the countries seeking the investment to put in place transparent and non−discriminatory policies and appropriate regulatory and institutional frameworks so as to create an environment conducive to investment. It is no longer sufficient for a country simply to liberalize its restrictions on FDI−most have already done so. Nor is offering tax benefits and other incentives the key to success.

Foreign enterprises, like domestic ones, pursue the good business environment rather than the special favors offered to induce the foreign enterprises to locate in the incentive offering regions. (3) Special and thus transitory incentives for FDI might fail to give foreign investors long lasting interests in the host regions and would be at the risk of various types of ensuing negative side effects. It is important to enshrine the principle of non−discrimination in national legislation and implement procedures at enforcing it at all levels of government and public administration. (4) In some circumstances, incentives may serve either as a supplement to an already attractive enabling environment for investment or as a compensation for proven market imperfections that cannot be otherwise addressed. However, authorities engaging in incentives−based strategies face the important task of assessing these measures' relevance, appropriateness and economic benefits against their budgetary and other costs, as well as long−term impacts on domestic allocative efficiency.

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Host and home governments need to move beyond these and embrace a broader set of policies to create an enabling environment for investment: respect for workers and environmental rights, competition, taxation, financial markets, trade, corporate governance, public administration, and other public policy goals. In developing an enabling environment that will enhance the location's attractiveness to foreign investors, a country should at the same time be adopting those policies and creating those institutions that will help it maximize the net benefits of FDI and of domestic investment as well. These benefits do not, however, accrue automatically. Countries with better policies attract the largest increases in FDI. Better policies and governance structures not only bring in more FDI, but also tend to strengthen the foreign capital–domestic investment relationship. Such linkages bring about a "win–win–win" situation, because they have potential benefits for foreign affiliates, local firms and host countries.

Best Practice Guidelines for Investment Promotion Strategies

Multinationals have to choose carefully from a multitude of alternative locations and investment promotion agencies (IPAs) can help to build a country's image, attract the attention of prospective investors and strategically target certain types of foreign investors. IPAs are encouraged to centralize decisions on FDI regulations and promotion, co–ordinate other key government departments involved in FDI process and provide a focal contact point with private investors. Prerequisite characteristics of a successful IPA are political support and access to senior government leader, independence from other government departments and agencies, and inter–governmental co–operation and co–ordination. It is important to reinforce their policy advocacy functions vis–à–vis government so that they can be a genuine bridge between private investors and their governments.

Best practice guidelines on investment promotion strategies, developed on the basis of the OECD member and non–member experiences, include the following:

- ***Establish government policy on foreign direct investment and the vision for its role and contribution to the national economic development framework.***

The government should first decide on the aims and role of foreign investment in the overall development of the national economy. Successful practice builds on the vision (i.e., the 2023 Turkey vision) and the effective presentation of this vision to society. This action needs to be underpinned with legislation and institutional structures to give proper effect to policy. The attraction of foreign investment requires the mobilization of different interest groups across government and society (for example, central and local governments, unions and labor, employer representatives, civil society organizations). Unless government as a whole is convinced of and committed to an FDI policy, it is unlikely to maximize the opportunities for FDI or succeed with such policies in the longer term.

Continuity and predictability of overall economic policy are important to maintain foreign investor confidence. Predictability demonstrates political and economic stability, which is a fundamental issue for all investors and especially with regard to large–scale long–term investments. Continuity of FDI policy is similarly very important to investors. This is a primary task for government – it does not imply no change in policy but progressive change that is managed and coordinated with other policies and that involves effective communication with social partners, including investors. Hence the government should try to secure the society understanding and support of wider

society for the stated objectives and role of FDI in the economy, and thereby gradually remove fundamental objections to such broad policies was an issue in adversarial political debate.

The government should ideally have a clear vision of the actual and expected benefits of FDI (such as capital investment, increased tax revenues, exports and foreign exchange earnings, employment and skills, regional development, technology) and the role of FDI in the overall economic development strategy, including its contribution to balanced regional development. Periodic evaluation of FDI policy is key to long−term success in attracting FDI and maximizing benefits from investment.

- ***Articulate and advocate national policy on FDI among social partners and civil society as well as investors in order to create a better awareness and consensus on the aims of policy.***

Having established the vision for FDI policy within the overall economic development and the competitiveness strategy for the country, it is important that governments play a proactive role in articulating that policy and promulgating it to all social partners as well as investors. This task should not be underestimated or left to the IPA alone – it requires the active, continuing and committed support of the government to achieve public understanding and support for the Investment Promotion Agency (IPA).

The national plan to meet worldwide competition for FDI and achieve higher levels of international investment needs to be well presented and explained. It is equally important that governments avoid mixed messages about the merits and desirability of attracting FDI, as this may detract from the image of the country as an attractive investment location and send negative signals to potential investors. A key feature of many countries in attracting FDI is their highly professional approach to announcing new FDI projects and explaining the expected results from such investment. It also demands effective management of communication later on, as inevitably some projects may not meet expectations. The full benefits of FDI are further enhanced when local groups and especially local industry, including component and service sub−suppliers, are well informed about new investment. This needs to be done in close cooperation with new investors.

The process of reviewing performance should be inclusive and objective. The active involvement of investors in that process and in the dialogue on needed policy changes will lead to better policy development and implementation.

- ***Establish an Investment Promotion Agency and determine the objectives and the legislative and governance structures of the agency.***

Successful practice points to the need to establish institutional structures, which can be effective and competitive. This is the primary reason why many countries have established dedicated IPAs and endeavored to ensure that such institutions have the capacity and resources to deliver results. By having an institution that is non−political and non−governmental, these countries have achieved better stability and continuity in the institutional structure and programmes (less affected by periodic changes in government and less restricted by formal procedures that apply within ministries). It is not uncommon for countries to move through stages in establishing an IPA – initially having a dedicated unit within a ministry and gradually moving to a more independent organization, which can develop

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long–term strategies and service cultures that improve innovative practice and competitiveness.

Economic development, including promotion of foreign investment, is a long–term process. The IPA has to be organized and run professionally if it is to perform effectively and efficiently in the highly competitive world of attracting mobile investment, while at the same time maintaining responsibility for expenditure of public funds on operations or incentives. The institutional framework should ideally be protected from short–term political pressures that inhibit the efficiency of its operations.

Setting up and operating a modern investment promotion agency, with a head office and overseas and regional offices, is expensive in terms of facilities and staff. Most developed economies and many transition economies have set the standard in terms of the resources and activities required to be successful.

One method, which has proved effective in a number of countries, is to maintain full public control and accountability in the responsible minister's hands, while ensuring day–to–day operational independence by creating a board structure with strong representation of the private sector by senior business people who are free of conflict of interest and who contribute their time for a nominal fee. Some of the most successful IPAs have a majority of private sector representatives on their boards. This also ensures expert insights into industry sectors and trends. Clear lines of authority and reporting to the minister on performance and budget ensure consistency with government policy and with strong financial controls in an entrepreneurial organization. These policy issues and structures, and how they are decided, can determine the level of success or failure of the IPA.

- ***Inculcate within the IPA a professional management and service culture, result–oriented ethos and innovative marketing approach in order to compete successfully in attracting new investment and to ensure satisfactory continuity of the organization culture.***

Implementing the empowering legislation and establishing an IPA will not in themselves ensure a successful FDI programme. The IPA itself must be a professionally run organization staffed by people who understand the mentality and business strategies of foreign investors and are prepared to go the extra distance in terms of helping investors to become established and run their businesses.

Countries can create a competitive advantage by ensuring that their agencies are better than those of competitors. The professionalism and dedication to client service of IPAs in, for example, Singapore, Costa Rica and Ireland have been major factors in the success of FDI policy and promotion programmes in those countries.

The key to establishing a culture of direct relationships with potential investors and making things happen lies in the first instance in the selection of the governing board structure and the chief executive of the IPA. The board and chief executive will set the tone and direction for shaping the culture of the new organization. Very careful selection of board appointees and of the chief executive is clearly essential.

The most successful IPAs today act like top class service companies and often apply similar service systems and quality methods. Their approach is highly professional and efficient. They act as development agencies, proactively

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seeking not just to undertake promotion but to provide business solutions to potential investors and to improve the wider environment for investors by liaising with relevant government and other bodies on changes needed. They are innovative in seeking investment in new and emerging sectors. They have the mandate and resources to undertake their work and are perceived as central to national development policy.

- ***Define strategic policy options and set out the corporate strategy and marketing plan for the IPA to build competitive strength and achieve selected policy options.***

The globalization of business and growth of the knowledge economy have introduced new dimensions into investment decisions for both countries and companies. New and changing sectors (e.g. information and computer technology, biotechnology, media services and financial services) have opened new opportunities and challenges in attracting investment. Many small and medium–sized companies are international investors, and this trend is increasing. A key issue therefore is to recognize that not all FDI is the same. The IPA needs to carefully and realistically select strategic policy options based on the potential of certain sectors but also on a clear understanding of how FDI decisions are made. The IPA needs to understand what investors are seeking, their view of the country as an investment location, the needs of their particular sector and company, the country's competitive advantages for attraction of FDI and how it compares with other countries. This should form the basis of strategy.

Typically, the investor motivation for FDI is to acquire:

(a) Better access to markets – nationally, regionally and globally;
(b) Competitive labor costs and productivity as well as skills and availability;
(c) Access to raw materials at competitive cost;
(d) Acceptable risk, linked to a supportive policy environment and with essential infrastructure (utilities, telecommunications and transport).

Addressing investor motivations is a central element of the strategic approach of successful IPAs. Similarly, establishing an objective view on the competitiveness of the country is a key part of the strategy for many countries and IPAs. Showing that the business environment rates well with other locations may be one of the most powerful messages to send to investors.

- ***Decide on incentives policy and ensure objective and regular evaluation of the costs and benefits.***

The government should take a hard and objective look at the use of incentives and, before introducing any incentive, confirm that it is needed in order to compete. Numerous surveys of investor determinants have highlighted that incentives rank lower in importance than, for example, political and economic stability, market access, competitive cost structures and an attractive environment for doing business. If the location is fundamentally uncompetitive or insecure, or if the commercial reasoning for the investment is faulty, incentives will not rectify the situation.

Incentives need to be properly justified and need to be reviewed regularly and adapted or phased out when they have achieved their purpose. At the same time, peremptory or retrospective changes to existing incentives, that may

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damage the location as an investment destination in the eyes of international investors, should preferably be avoided.

Corporation tax incentives backed by appropriate taxation agreements between the host and FDI home country can be attractive for smaller transition economies. The trend in international agreements is towards similar tax treatment for all corporate participants in an economy, making it more difficult to target tax incentives towards foreign as opposed to domestic investors.

Incentives in the form of direct cash grants or the provision of free or subsidized buildings are often used to differentiate locations within the country itself. For example, differential incentives may be used to promote regional dispersion of foreign investment, to attract investment to employment black spots, or as incentives to the private or academic sectors to build technology parks or incubators. These incentives draw directly on government revenues, and the costs need to be balanced against anticipated advantages in regional, SME and technology development.

- ***Undertake a comprehensive review of skills available versus skills required by investors. Develop and implement policies to address identified gaps and thereby facilitate new investment, jobs and skills.***

One of the key areas in which countries (or regions within countries) can develop a competitive advantage is in the area of human skills. This is a broad area that affects wide sections of society, and the role of the IPA should be primarily as interpreter of investor needs and future trends as well as instigator of actions to implement policies and programmes to meet those needs.

It is important to emphasize that investment in training brings benefits to international and domestic investors and to the individual in society. In the modern information age, skills acquisition and development are crucial to the competitive status of a country. Many studies have shown that the return on investment in training and education is very high, provided that the skills acquired can be used within the country or region concerned. As high–level skills, in particular, have a fairly long lead time (three to six years for university level), careful planning of the country's future needs is required.

Future needs may differ from current needs. This is particularly the case for countries whose economies are in a state of transition. Forecasting the future skills needs of an economy is a complex and difficult task, but it must be attempted if wasteful investment in education and training is to be avoided. To be productive, such investment must be congruent with, and supportive of, investment in other areas of the economy, particularly in the area of industrial development.

This matching of the needs of industry, particularly FDI, has to be done on a continuous basis so as to ensure that the evolving needs of investors in the skills area are continuously matched by the outputs of training and educational institutes. The only way to achieve this match is to have a formal structure bringing together representatives of educational and training institutions, industry, the IPA, specialists in the area, and the government.

Countries that succeed in continuously fulfilling the evolving skills needs of industry will have a very strong

competitive advantage in attracting new investment.

- ***Ensure the provision of essential infrastructure needed by industry – industrial estates, modern factory and office buildings, utilities (electricity, gas, water), effluent treatment, drainage, telecommunications (including access to broadband networks) and different modes of transport.***

What constitutes basic infrastructure varies from sector to sector. Most businesses will need road access and electricity. Some (but not all) will also need gas or railway access. Broadband telecommunications is more and more in demand by modern business, especially service business. Specialist effluent treatment facilities will be required by the paper, chemical and agribusiness sectors. As well as "quantity" of infrastructure (e.g. available generating capacity in the case of electricity), investors are very concerned about the "quality" of infrastructure (e.g. voltage stability, frequency stability, numbers of outages in a year). Finally, the cost of infrastructure may be an issue for some industries.

As in the area of skills, the planning of infrastructure must take account of the likely future needs of the industrial sectors being targeted by the FDI programme. Prioritization on sectoral and regional bases will be required. The government should carefully assess the advantages and disadvantages of public–private partnerships (PPPs) for the provision of infrastructure.

IPAs may not be directly involved in the provision of any of the essential infrastructure. However, they again have a vital role to play in interpreting investors' needs and serving as a proactive intermediary, where necessary, to ensure the provision of such infrastructure.

- ***Promote FDI by undertaking a comprehensive and professional marketing programme aimed at new and existing investors and by building the IPA as a credible and competent partner for investors.***

Image–building is particularly important for countries which are new to investment attraction, are undergoing rapid political and/or economic reform, have been faced with violence or terrorist acts (directed either to themselves or to neighboring states), or are small and therefore receive little international media coverage.

Image–building is a foundation block in the process of attracting FDI. Its role is primarily that of focusing investor interest on the location and overcoming negative perceptions rather than directly persuading a multinational company to invest.

Image–building may require considerable and well–targeted expenditure over time, but in itself is not sufficient to make an investor decide on a particular country or location.

- ***Facilitate investment and service investors at all stages of the investment cycle, from start–up through to post–investment and new expansion stages***

Once the potential investor displays real interest, the process of country visits, negotiations, advice, legal and

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regulatory matters, visits with existing investors, financing, location choice, property, recruitment, training, and post–investment facilitation all must be provided in a professional way to the investor.

Each investor is different, as is the amount of support required. Whatever the demand, within reason, the IPA must be able to respond from own or private resources. This is the critical first step in introducing the investor to the local community. An investor will not visit a location unless the country is being given serious consideration. Impressions count, even if the objective location determinants are of paramount importance. It is also important to remember that the investor is likely to be visiting other shortlisted locations on the same trip. These locations will also be competing strongly for the same investment.

Potential investors will always be interested in visiting existing foreign investors in the country, especially those from the same country or the same sector. The unsolicited recommendation of a fellow foreign investor can be a major advantage for a location.

The servicing of investors includes not only the visit, but also the management of the post–visit, and follow–up and aftercare processes. The post–visit activities involve putting together a development package for the investor comprising, for instance, property, training and fiscal and/or financial incentives. Follow–up and aftercare concern the handling of requests for assistance on matters such as taxation, work and residency permits, company registration, tariffs, building permits, utilities' connections and many other items. The links with investors should be ongoing after start–up, with the objective of embedding the affiliate in the host economy and maximizing the benefits associated with its presence, to the mutual benefit of the country and the investor.

- ***Encourage greater integration of foreign businesses into the economy and rooting of foreign investment in the country***

Aside from the direct benefits of FDI, foreign investment can also act as a key driver of local enterprise development. It can do this by developing management and technical skills, improving quality and service standards, encouraging links with technical research institutions, developing suppliers of goods and services, and influencing education policy on a national level.

Linking foreign investment to the local economy can strengthen the security of the investment itself, while also contributing to the development of an entrepreneurial indigenous sector. There will always be some level of contact between the foreign investor and the local economy, even if only limited to basic infrastructure and labor supply. The objective of the government and the IPA is to deepen these contacts in order to both secure the initial investment itself and develop the capacity of the local economy to meet international standards of quality, service and price, and hence become internationally competitive in its own right.

- This process requires a two–pronged strategic approach:
  motivating foreign investors to increase the direct benefits of the investment to the local economy;
- developing an internationally competitive domestic sector (which will be assisted by promoting linkages between foreign investors and the local economy).

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FDI in Redressing Turkey's Regional Imbalances

This is an area where there is enormous potential to be harnessed because FDI in Turkey is concentrated in a few highly developed regions and several vibrant regions are yet to be connected to the world of multinationals for expanding investment and trade links. Rapid technological change, extended markets and a greater demand for knowledge are offering new opportunities for regional development. Globalization is increasingly testing the ability of sub−national economic areas to adapt in order to maintain their competitive edge. Performance gaps and comparative advantages vary from one region to another (5).

The new paradigm in regional development includes actions away from subsidies towards regional competitiveness−enhancing policies and from traditional sectoral towards place−based policies complemented by multi−sectoral actions. This requires innovative solutions in the governance of regional development policies, namely in institutional partnerships among different levels of government and partnerships involving social partners and civil society. Advanced regions can help underdeveloped regions stand on the better position for development. Any political promotion activities or incentives, which would be necessary to jump start to attract FDI, should be terminated once the targeted development threshold has been reached and market forces can take over.

To begin with, FDI's role in enhancing Turkey's regional development efforts has been generally negligible because even the country's more advanced regions have failed to attract sufficiently much−needed investment. The only realistic hope for the relatively backward eastern and southeastern regions of Turkey is the gigantic GAP project, which is likely to produce a booming effect on private capital accumulation and entrepreneurship. The GAP, (6) initially formulated as individual irrigation and hydropower projects on the Euphrates and the Tigris Rivers in the 1970s, is the most comprehensive integrated regional development project ever attempted in Turkey to address the wide disparities in the south−east, and in recognition that strengthening this region socially and economically will benefit all of Turkey.

As an integrated project, in addition to dams, hydroelectric power plants, irrigation systems, it also contains industries and investments for the development of agricultural, industry, urban and rural infrastructure, communication, education, health, culture, tourism and other social services in a coordinated way. (7) GAP's focus on sustainable human development builds upon the concept of integrated regional development of the GAP Master Plan of 1989, which mandated the creation of a Regional Development Administration to co−ordinate the implementation, management, monitoring, and evaluation of development related activities. The subsequent Social Action Plan of 1995 was a major step toward a greater integration of sustainable development with socio−economic and infrastructure projects. (8)

The poorest cities are all located in eastern and southeastern region. About 15 per cent of all families in Turkey live in the region, which in turn uses only 10.2 per cent of national income. In the region, the average income per family is $3,851, 30 per cent below the national average (9). The difference in prosperity and income between Western and Eastern−South−eastern Turkey continues to cause the flight of manpower and capital, which hurt the development process. Internal migration data on manpower potential is truly striking. According to the 1990 census, the region's population was 9,365,000. The same data show that there were about 12,000,000 people born in eastern cities. This

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means that 30 per cent of the region's population (that is 3,607,000) have migrated to the west and live there. Due to both economic and political reasons, this ratio may have increased by 2 to 3 percentage points by 2000. Hence, 1 out of every 3 easterners lives outside the region (10).

Since most industries are established in the west, power generated in these regions is transmitted and consumed in the west, thus leaving little room for fostering linkages with local economy. According to Turkish Electricity Authority data, whereas the average power consumption per person in Turkey is 625 kW/h annually, this figure is 349 kW/h in the east. A speedy industrialization related to cotton spinning and weaving has recently been taking place in the GAP region and its neighboring cities. If this development continues power consumption may increase, but an immediate radical change is not expected to occur in this picture.

It is still difficult to say that investments related to GAP in manufacturing, electrical power, and mining undertaken by the state have so far produced positive effects that spread to the entirety of the region. Government incentives for underdeveloped regions too have not secured the necessary flow of investments. In this region, where population growth is much higher than the national average, production and income per capita are low. Agriculture and husbandry are on decline, and unemployment is the primary problem especially for the youth. Such an unproductive economy mainly dependent on government spending, while providing nothing more than limited sustenance of daily life for a part of the population, has also contributed to the demise of the productive activity in the region.

More lasting positive effects to the GAP region could come from investments in irrigation. However the south−easterners will not fully benefit from the rents generated by these state investments. Because the southeast has the most unequal land distribution in Turkey. Despite having been targeted by successive governments for land reform programmes that were invariably undermined by local power holders, there are still entire villages owned by individuals or families. The new patterns of land use and investments in agriculture are likely to transform the region as a whole. When production for the market begins to predominate, and large lands turn into capitalist farms by better irrigation, the capitalist farmer−agricultural laborer differentiation process will speed up. If the agro−businesses are established in cities with the help of productivity increase in agriculture, then the population that has migrated from rural areas will be used as manpower in factories. In short, as GAP investments raise the value added in agriculture, the region's ranking on the development scale within Turkey will move up considerably.

Although GAP investments appear to be just regional projects, their sheer volume has ramifications for the national economy. The business volume generated by GAP investments in construction, for example, was important for large contractors based in Istanbul and Ankara. These companies that built their businesses in the Middle East and North Africa in the beginning of the 1980s had a difficult time when these countries reduced their investments due to their declining oil income. The acceleration of investments in GAP was a big boost for these contractors. Activities at GAP continued even when the economy was in a general slump, and sustained the firms that supplied the construction sector as well as the contractors.

In the final analysis, the realization of GAP's promise for the region will largely depend on finding foreign markets, finance, technology and investment. The surplus generated by increased production will have to be exported. This requires the use of agricultural technologies that are on par with the world as well as the diplomatic skill not to

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alienate the neighboring countries with potential markets. The GAP is truly exciting both as a utopia for regional development and as a process, but its cost for Turkey's economy has not been insignificant over the past two decades. This project, which swallowed enormous government resources, has put a great strain on public finances. Out of the total project cost of $32 billion, $14.8 billion have already been invested. The international component is rather small – only $2.1 billion from foreign sources including the World Bank and several European governments, with little private foreign investment. Unless these investments are complemented and supplemented by productive private sector investments the full benefits cannot be realized. Another possibility will be to develop cross–border investments and partnerships with countries bordering this region.

Turkey: a "Miracle–in–the–Waiting"?

Turkey already has many top multinationals and can interest even more from several perspectives, specifically as a manufacturing or service provision base from which to supply European, Central Asian and Middle Eastern markets, as a source of raw or processed materials, as a pool of talent and innovation to be deployed in a Turkish "Silicon Valley" that is readily transferred abroad, as a market for both imports and domestic goods and services, and as a potential joint venture partner anywhere in the world. These all suggest that it should be performing better. One should also add to these advantages the dynamism of Turkey's entrepreneurs, the quality of management and the discipline of workers, which are no less important factors in attracting FDI.

It is still difficult to claim in fairness that today's Turkey is a friendly place to invest. There are many reasons for the existing unfavorable investment climate. If domestic investors are not willing to invest in their own country why foreigners should consider doing so. The only exception is those foreign investors who look for very high rate of return in the short term for being exposed to high risks. This type of FDI is not what Turkey should be interested. Turkey needs long–term commitment from FDI.

Perceived obstacles to investment in Turkey include complex administrative procedures, local government interference and corruption. According to a World Bank survey, investors in Turkey spend 20 percent of their time dealing with bureaucracy, compared with 8 percent for investors in Central Europe. Turkish firms themselves are increasingly investing elsewhere. While Turkey has taken significant strides in simplifying foreign investment procedures, it continues to screen foreign investment. Although its screening mechanism is routine and nondiscriminatory, it can also be an impediment to the free flow of capital.

For perhaps the first time, the Turkish authorities are taking a systematic approach. They enjoy the support not only of existing foreign investors but also of a substantial section of the local business community. Turkey is overhauling both its legislation and its administrative procedures over the past few months in a bid to improve dramatically its investment climate. If all goes according to plan, the time and effort needed to set up a business, to acquire land and planning permission and to obtain the licenses needed to operate in the various sectors of the economy will be reduced from years to a matter of few months. Taxes, incentives and the protection of international property rights are also all up for review. The Foreign Capital Law of 1954 will be replaced, and an Investment Promotion Agency will be set up to service and target international companies.

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In sum, to attract FDI of a magnitude similar to that in other emerging markets depends largely on Turkey's ability to complete long–overdue structural reforms in areas ranging from banking to agriculture and creating a truly investor–friendly environment for domestic and foreign enterprises.

The Way Ahead

Foreign direct investment is absolutely essential if Turkey will be able to move rapidly towards realizing its 2023 vision. Therefore, the new measures and institutional set–up aimed at improving the business environment for investors should not be a redressing of the old configuration. Turkey needs a comprehensive long–term vision of how FDI could fuel its growth and modernize some of its antiquated industries. It also needs to have an integrated approach towards investment across the often–disconnected central government departments, the regions, and the municipalities in order to ensure that investors would operate in an enabling environment without arbitrary government hindrance and on the basis of market–based incentives. What matters most is the effective implementation and enforcement.

Together with its IMF standby agreement, the anticipated EU membership is expected to provide Turkey with the chance of becoming a major recipient of FDI, rivaling Greece, Spain, Portugal and new accession countries in Central and Eastern Europe. For this to happen, Turkey has to harmonize his investment policies in accordance with those of other EU members and institute the Union's trade and competition rules into his economy. This would require Turkey to compete for FDI on equal terms with other members in the EU, which will in turn give rise to increased productivity, improved infrastructure, and macroeconomic stability including price and exchange rate stability.

Going forward, the FDI figures will depend not only on efforts to transform the investment climate, but also on the global FDI conjuncture, the pace of privatization, the new mergers and acquisitions – domestically and cross–border alike –, the resolution of the legal/policy impasse in the energy and telecommunications sector, the success of the IMF programme in achieving stabilization, and the launch of Turkey's accession negotiations with the EU (11).

The problems faced in Turkey are in large part as relevant to most domestic investors as they are to foreign investors in the Turkish economy. However, the basic difference between the two is that the domestic entrepreneur is condemned to cope with local conditions while the foreign investor is free to choose from among competing host countries and to decide which one offers the most attractive balance of risk and opportunity for its investment. So, as and when positive change occurs – not only on paper but also in deeds, FDI could dramatically increase and indeed become a motor for Turkey's 2023 priority projects in the coming years.

1. This paper was presented at Forum Istanbul, 8–10 May 2003, Istanbul, Turkey. The paper builds on the author's earlier work and draws on the ongoing work in the OECD Committee on International Investment and Multinational Enterprises. However, the views expressed in this paper are his personal and do not reflect those of any

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organization he is associated with.

2. The stock of FDI in Turkey was only $300 million in 1971, and up until 1980 the average annual inflow of FDI was only $90 million. This was far less than other comparable countries, and FDI did not increase significantly for most of the 1980s. It was only with a shift in Turkey from a protectionist trade regime to export−oriented economic liberalization in the mid−1980s that FDI increased significantly. Annual FDI flows in Turkey grew rapidly from the mid−1980s, reaching $1 billion in 1990. However, there has not been any meaningful increase for the decade since then. In other words, during the 1990s when global FDI flows boomed − exceeding the growth in world trade since 1989 − FDI in Turkey remained static.

3. A sensible approach for host countries is to presume that subsidies to FDI are not warranted, and so avoid preferential treatment of FDI relative to foreign portfolio investment or domestic investment. Deviations from such a policy would be justified only where there is clear and direct evidence of substantial positive spillovers associated with multinational production and where multinationals are unlikely to choose the optimal level of production (from the host country's perspective) without a subsidy or other inducement.

4. This implies that no special treatment would be granted to domestic enterprises under pressure from foreign entrants. However, the approach should be even−handed: efforts at attracting FDI through inducements not offered to domestic companies should equally be considered as discriminatory − except where aimed at compensating for manifest deficiencies (e.g. an "un−level playing field") in the host country business environment.

5. Some regions that have limited access to capital accumulation and national/regional markets are disadvantaged. Those lagging behind in infrastructure investment are finding it difficult to keep up with the general trends. All regions find it more difficult to stay competitive without foreign direct investment (FDI), which sustains growth and brings at least four things of value−financial capital, management skills, technology, and access to export markets−and therefore enhances a country's and its regions' competitiveness in the global marketplace.

6. The project area includes the watersheds of the lower Euphrates and Tigris Rivers and the upper Mesopotamian plains. It covers the nine provinces of Adiyaman, Batman, Diyarbakir, Gaziantep, Kilis, Mardin, Siirt, Sanliurfa and Sirnak.

7. Sometimes the GAP is compared with the Cerrado Plain, a savannah area of central Brazil reaching into parts of Colombia. The area is huge, covering an area larger than all of Western Europe. Brazil is already an agricultural powerhouse, the world's largest producer of rice outside Asia, among the top three producers worldwide of corn and soybeans and a leading producer of beef, tobacco and of course coffee, sugar and citrus. Credible Brazilian estimates say the area under cultivation could be expanded by up to 60 million hectares, an area equivalent to the entire plantings in corn and soybeans in the United States.

8. Within the scope of a macro economic and social development programme, the GAP Master Plan defined small and medium scale investment and socio−economic development projects ranging from educational and health infrastructure to environmental protection, irrigation systems, management development, and transportation.

9. There are various historical and social reasons for the disparity in income and development between the East and the West of the country. When choosing the place or sector to make an investment, the alternative with the lowest costs and the highest return is preferred. This is the universal and constant rule of economic behavior. The same rule was applicable to Turkey in the second half of the 19th century as the country was integrating with western capitalism. The Ottoman Empire's process of integration with the world markets began at that time in those areas most accessible to western capitalism, that had better transportation and market followed suit. Some sections of Central Anatolia and the Black Sea regions, and all of Eastern−South−Eastern Anatolia were left behind in this

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capitalist expansion.

10. Private View, autumn 1998, TUSIAD Publication.

11. The absence of a large European FDI base in Turkey deprived it of a powerful business lobby to intervene on its behalf in the accession discussions. Remember how effective was the lobbying of US Congress by US multinationals invested in Mexico during the debate on NAFTA.

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