THE INVESTMENT ENVIRONMENT

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A GENERAL ASSESSMENT ON FOREIGN DIRECT INVESTMENT

Annual foreign direct investments (FDI) to Turkey remained below 1 billion US Dollars during 1980-2004 period except for the year 2001. Attractiveness of Turkey for foreign investors, however, seems to increase after the new FDI law came into force in 2003 on the one hand and a start-date for EU accession negotiations was set on December, 17 2004 followed by the actual start of negotiations on October, 3 2005 on the other hand. Following 2003, the only structural change in FDI is not only real estate purchases exceeding the total FDI inflow of previous years, but also the change in distribution of FDI among sectors. The share of manufacturing, which was 42% of FDI stock as of the date the new FDI law came into force, falls to 13% in 2005, largely as a result of the increasing interest of foreign investors towards financial intermediaries and acquisitions in telecommunications due to privatization. However, the decrease in the share of manufacturing in total FDI does not imply that FDI towards this sector has declined in absolute terms: foreign investment amount directed to manufacturing increased from 110 in 2002 to 789 million US Dollars in 2005. Among manufacturing Food, Transport equipment, Chemicals and Textiles appear as the most attractive sectors.

EU NEGOTIATIONS AND THE INVESTMENT ENVIRONMENT

As it is the case in international trade, the major partners of Turkey in FDI are EU members. France is the country with the highest share of 20% in FDI stock followed by Netherlands and Italy with 9% each; and Germany and United Kingdom with 6% and 4%, respectively. Taking into account the other members, FDI stock of EU-15 countries sums up to 63%. EU, called European Economic Community then, has triggered the FDI since it was founded. The first direct investment wave originated from US at the end of 1950s towards the six founder states continued throughout 1960s; and afterwards, above world average foreign investments have

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1 This paper is abridged version in English of Chapter 2 in the Global Competitiveness Report Turkey 2006 published by REF in Turkish in November 2006.
directed to countries in EU accession negotiations almost every year. Even some countries such as Spain, Portugal, which were members since 20 years and the ones that became members in the last two enlargements, have been receiving above world average FDI per GNP.

One of the important advantages of EU accession negotiations is the potential for improvement of investment environment of negotiating country. Figure 2 gives pillars of the Global Competitiveness Index, published by World Economic Forum, for Turkey and for 2004 accession member states with respect to EU-15, whose score is taken as 100%, in 1996 and 2005, comparatively.

![Figure 2 Global Competitiveness Index Pillars of Turkey and New EU Members for 1996 and 2005](image)

*Source: WEF, 1997  
Source: WEF, 2005-2006*

Figure 2 reveals that, while Turkey performs better than the average of Czech Republic, Poland, Hungary and Slovak Republic in all pillars except for Finance and Government Efficiency in 1996, the comparison with respect to 2005 data shows that Turkey falls behind of these countries in all but the Business Sophistication pillar. This analysis implies that there is a significant improvement in investment environment of the four countries along with EU accession negotiations. Another result that can be inferred from Figure 2 is that pillars of Global Competitiveness Index converge to EU average at the end of the accession negotiations. This convergence should not totally be associated with legal regulations to fulfill “Acquis Communitaire”; because Global Competitiveness Index captures a complex set of
considerations, including size of the market, skills of the work force, tax rates, wages and the extent of corruption. These factors are among the determinants of FDI as well. Indeed, the information in World Economic Forum’s 1997 Executive Survey states that countries that are more competitive -as judged by the overall Competitiveness Index- are also looked upon by investors as better prospects for direct investment. There is a specific correlation between FDI and especially **Basic Requirements** sub-index of Global Competitiveness Index, which comprises Institutions, Infrastructure, Macroeconomy and Health and primary education pillars, such that the higher is the score of a country’s **Basic Requirements** sub-index; the higher is the ratio of FDI to GDP for that country. Consequently, EU-membership, even the process accession negotiations, is accompanied by improvement of the investment environment for a country. Therefore, EU-membership should be considered not as the goal by itself, but as the last stage of a process towards enhancing the global competitiveness, and thus increasing the welfare of nations.

**INTERNATIONAL BENCHMARKING TO SET STRATEGIC PRIORITIES**

International benchmarking of Turkey’s investment environment can be helpful in determining strategic priorities with the aim of improving it. Among various benchmarking studies, three of them stand out with their comprehensiveness. The first one is the World Economic Forum’s Global Competitiveness Report, the second is the Competitiveness Yearbook prepared by International Institute for Management Development-IMD and the last one is Doing Business series published annually by World Bank since 2004.

Turkey moves up 12 positions to 59th out of 125 countries in the World Economic Forum’s Global Competitiveness Index Rankings for 2006-07. With this big step forward compared to the previous year, Turkey has surpassed Romania and Bulgaria, ranked 68th and 72nd, respectively, among the new members of EU such as Czech Republic, Hungary, Slovak Republic, Poland, Bulgaria, Romania as well as the other negotiating country, namely Croatia, which are the potential rivals of Turkey in attracting FDI originating from EU-15, the major source of it. It is, therefore, possible to deduct that Turkey is beginning to reap the benefits of policy reforms introduced in the context of an intensified relationship with the EU.

Although the overall ranking of a country gives an idea, what matters more is which areas deserve particular attention for intervention. The Global Competitiveness Index is a weighted
average of three sub-indices that covers nine different pillars, each of which is critical to driving productivity and competitiveness in national economies, where weights are determined according to the stage of development of countries. The first sub-index, called **Basic Requirements**, groups data regarding *Institutions, Infrastructure, Macroeconomy* and *Health and Basic Education* pillars, which are most critical for countries in the factor-driven stage (income of less than US$ 2000). The second sub-index, **Efficiency Enhancers**, on the other hand, includes those pillars critical for countries in the efficiency-driven stage (income between US $3000 and US $17000), namely *Higher Education and Training, Market Efficiency*, and *Technological Readiness*. Finally, the last one, **Innovation and Sophistication Factor** sub-index comprises *Business Sophistication* and *Innovation* pillars, which are especially important for countries in the innovation-driven stage (with income more than US$ 17000). Figure 3 presents Turkey’s performance in each of these nine pillars in comparison to the average performance of countries acceded to EU membership in 2004 enlargement with population over 4 million, namely Czech Republic, Hungary, Slovak Republic, Poland. The performance of the latter is taken as 100% as a standard to gauge the relative strength and weaknesses of the Turkish economy.

**Figure 3** Turkey’s Performance in the Pillars of Global Competitiveness Index (In comparison to the average performance of Czech Republic, Hungary, Slovak Republic and Poland taken as 100%)

*Source: WEF (2005-2006, 2006-2007), REF Calculations*
- The unique pillar in which Turkey’s score is better, both in 2004 and 2005, than the average score of countries acceded to EU membership in 2004 enlargement with population over 4 million, is Business Sophistication. Business Sophistication concerns the quality of a country’s overall business networks, as well as the quality of individual firms’ operations and strategies.

- With respect to Innovation pillar, Turkey’s performance is close to the average of that of the 2004 accession member states. Furthermore, there is, though slight, an improvement in Turkey’s relative performance in 2005 compared to 2004.

- Among all pillars, Turkey performs worst still in Macroeconomy, though there is a marked improvement with respect to the previous year.

- Following Macroeconomy, the next area that deserves particular attention for intervention is Infrastructure, which groups data related to the quality of railroads, ports, and air transport; as well as electricity supplies that are free of interruptions and shortages; and finally a solid and extensive telecommunications network.

Figure 4 Turkey’s Performance in the Pillars of Global Competitiveness Index (In comparison to the average performance of Bulgaria, Croatia and Romania taken as 100%)


- In general, Turkey performs better with respect to the average of new members of EU, i.e. Bulgaria and Romania as well as Croatia -the other negotiating country besides Turkey- in
comparison to the average of 2004 accession member states, namely Czech Republic, Hungary, Slovak Republic, Poland (Figure 4). Among the nine pillars of Global Competitiveness Index, Macroeconomy is the only area in which Turkey performs significantly worse than the average performance of Bulgaria, Croatia and Romania. With respect to Health and Basic Education, Infrastructure, Higher Education and Training, Market Efficiency and Technological Readiness, however, Turkey’s performance is more or less similar to the average of that of Bulgaria, Croatia and Romania, while in case of Business Sophistication and Institutions and, to some extent, in Innovation pillars, Turkey surpasses the average of these three countries considerably.

- The evidence that Turkey performs better in pillars such as Business Sophistication and Innovation that are more conducive for developed countries in innovation-driven stage, where the private sector’s capacity in producing new and different goods using the most sophisticated processes is evaluated while fails in Basic Requirements sub-index comprising data related to Macroeconomy, Health and Basic Education, and Infrastructure, in which mainly governments’ performance is measured, implies how poorly governed Turkey in recent decades.

The evidence found for Turkey by the second international benchmarking used in this study, namely Competitiveness Yearbook prepared by IMD supports that of WEF’s Global Competitiveness Report not only in case of most competitive areas (Foreign Trade, Attitudes and Values, Domestic Economy, International Investment, Business Legislation, Productivity and Efficiency), but also for the least competitive ones (Public Finance, Prices, Basic-, Technological-, Scientific-Infrastructure, Education, and Employment). The weakest areas, which deserve particular attention for intervention in order to improve Turkey’s competitiveness are microeconomic criteria, such as Education, Health, and Infrastructure besides all aspects of Macroeconomic environment.

- The efforts towards reducing government budget deficit and consumer price inflation should be maintained.

- All types of Infrastructure should be improved, especially Internet usage should be broadened by promoting investment in Information and Communications Technologies; Education should be emphasized, especially illiteracy rate as a percentage of adult (over 15
years) population measured as 13.5% should be decreased; and Employment, especially woman employment should be increased.

- Besides these, the most important criterion that undermine the competitiveness of Turkey appears as the tendency towards higher unit labor costs in the manufacturing sector: Turkey is ranked 6th in average personal income tax and social security contribution rates on gross labor income, also called as total tax wedge, among the group of countries comprising EU-25, USA and Japan.

The last cross-country study employed to make comparative analysis of Turkey’s investment environment, is Doing Business series published annually by World Bank since 2004. According to the last Ease of Doing Business Index, Turkey ranks 91st out of 175 countries, falling behind all countries benchmarked in this section, but Croatia. The index is calculated as the ranking on the simple average of country percentile rankings on each of the 10 topics covered in Doing Business in 2006. The analysis of these 10 topics for Turkey reveals that there is no consistency between them: Turkey performs quite well in some topics while can not reach even 30% of the average of new EU members in some others. The reason for this inconsistency is that in spite of improvement in topics such as Starting a Business and Paying Taxes following the reforms, the lack of reforms, e.g. in Closing a Business. In four out of ten topics, namely, Paying Taxes, Starting a Business, Protecting Investors and Registering Property, in order of success, Turkey’s performance is best among the countries benchmarked in this study. While Turkey performs on a par with them in case of Trading Across Borders, has weak performance in the rest of the topics: Employing Workers, Closing a Business, Dealing with Licenses, Getting Credit, and Enforcing Contracts.

- Turkey performs worst in Employing Workers topic. The evidence on the difficulties confronted in the process of Employing Workers may shed light on the high informal economy rate prevailing in Turkey.

- Another criterion in which Turkey is considerably unsuccessful is Closing a Business. The time required to resolve bankruptcies is over four times of that of OECD average; and furthermore, the recovery rate, expressed in terms of how many cents on the dollar claimants recover from the insolvent firm, is only 9.77. The OECD average of the latter is as high as 74 cents. Taking into account that Turkey’s performance is outstanding in Starting a Business
topic, the failure in *Closing a Business* indicates the lack of consistency in reforms, in other words, diverse aspects of the same phenomenon are not handled in entirety.

- A further obstacle to Doing Business in Turkey is the difficulty in *Dealing with Licenses*. A reform similar to the one realized in components of *Starting a Business* seems to be needed in this topic.

- A comparative analysis of World Bank’s 2006 and 2007 Doing Business Reports, in which Turkey’s rank fell from 84th to 91st, reveal the importance of continuity in reform process. While it is possible to move up in rankings of topics in which reforms take place, it is inevitable to lose ground in topics that are merely not handled, even when no anti-reform is in question, due to the reforms realized in other countries.

To sum up, in order to help improve competitiveness, thus sustainability of growth, it is inevitable to continue reforms, both in macro- and micro-level. Furthermore, it is necessary to ensure consistency as well as continuity of reforms, i.e., reforms should not be considered as a one-time affair, but as a process. Otherwise, it won’t be possible to foster competitiveness, even to maintain the current position.