



Foreign Investment in Turkey



FOREIGN DIRECT INVESTMENTS IN TURKEY

A Global Outlook to FDI Flows

In respect of global investment flows, a significant slowdown can be observed between 2000-2003. Global foreign direct investment flows declined sharply in 2001. Inflows fell by 45 percent and outflows by 50 percent. This reversal -after a steady growth since 1991 and large rises in 1999 and 2000- reflects two factors: the slowing of economic activity in major industrial economies and the sharp decrease in their stock market activity. These combined to slow down new international investments, particularly new cross-border mergers and acquisitions (M&As).

FDI inflows fell by 45% in 2001, and by a further 20,5% in 2002. FDI inflows declined for the third consecutive year in 2003. No previous FDI downturn in recent decades extended two years. Global FDI inflows fell by 12% in US\$ terms in 2003, to an estimated US\$ 575 bn. The global slowdown, political risks, stock market collapse and corporate scandal have all taken their toll on global foreign direct investment. The run-up to the war in Iraq, and the ensuing uncertainty, contributed to the overall decline in FDI in 2002. The high oil risk premium and the impact on overall confidence shaved about half a percentage point off world growth over the past year. It also reinforced the already existing investor caution around the globe. The impact of recent geopolitical uncertainty on FDI is in strong contrast to the negligible economic impact of the September 11th 2001 attacks on the US and subsequent fears of terrorism. The steep decline in

global FDI in 2001 and the sharp global slowdown predated the events of September 11th.

However, despite the likelihood of continuing international political tensions, FDI will recover strongly over the next five years, according to World Investment Prospects, annual analysis of global investment trends, published by the Economist Intelligence Unit. Over the longer term, international production seems set to raise its share of global economic activity. The trend towards better business environments; regional integration; technological change; industrial consolidation; sharper global competition; and opportunities in emerging markets will all underpin renewed strong expansion in FDI. A recovery will begin during 2004, and accelerate from 2005. The growth in global FDI in 2004- 08 will be much stronger than the growth in world trade or GDP.

In today's challenging economic environment all of the countries try to utilize domestic and international resources to maintain a sustainable growth. Since the developing countries can be identified as more capital-scarce compared to developed countries, they need more external resources to expand their productive capacity and maintain a sustainable growth.

FDI is the most stable external resource among the other forms of capital flows. Unlike portfolio investments, investment in stock market and loans to the private sector, FDI involves direct equity ownership plus significant ownership control. FDI is more integrated with domestic economy as direct-

ly being a part of it and does not easily flee in a down turn of domestic market.

The impact of FDI on development and growth is not confined with the simply expansion of the production base and requires a more detailed look to understand its gains to the domestic economy. Briefly we can specify the contribution of FDI to domestic economy as follows:

- Technology transfer
- Creation of new jobs
- Management know- how
- Skilled labour
- Access to international production networks
- Access to major markets
- Modernization of the national economy
- Expansion of capital stock
- Raise the investment rate
- Increased productivity
- Improved R&D activity
- Intensified domestic market competition
- Improving exports in both volume and composition

One of the important aspects of the FDI is the export orientation. Export oriented FDI contributes to the domestic economy more than the domestic market oriented FDI by not only increasing the export volume but also establishing a more value added production base and transforming the export good composition. Technology diffusion and increase in the productivity will be enhanced by horizontal and vertical spill over effects. FDI contributes to the domestic economy by both increasing the competition among the domestic firms and transferring technology and/or know-how to the domestic firms by backward and forward linkages.

Policy Reforms to Increase the FDI Inflows to Turkey

Strengthening private sector activity in the



Turkish economy is an integral part of the Government's overall macroeconomic stabilization program. The aim of the program is to achieve a sustainable growth level with a vibrant private sector and a smaller but more effective public sector. Key structural reforms in major markets such as agriculture, pensions, banking, telecommunications and energy and accelerated privatisation program have been adopted, which will pave the way for a more dynamic private sector.

Turkey has one of the largest economies in the World and with GDP of over US\$ 299,5 billion; it's the largest economy in Eastern Europe, the Balkans and the Middle East.

Well-known with its skilled and flexible workforce, huge domestic market and sizeable nearby external markets, Turkey is located in the heart of a region with more than one billion population and almost one quarter of world output and offering

investors a potential to reach that market potential with the listed features:

- A huge and growing local market (approx. 70 million)
- High-income European markets (approx. 600 million)
- Emerging Russia, Caucasian and Central Asia markets (approx. 250 million)
- Diverse and expanding Middle East and North Africa markets (approx. 160 million)

Despite its competitive advantages and diverse market opportunities, FDI inflows have not lived up to the potential of an economy of that size. Recognizing the importance of this issue, the Government placed efforts for improving the investment climate at the top of the political agenda.

The feedback received from the international investment circles were mainly focusing on cumbersome, unclear, informal and time - consuming administrative procedures which were creating an opaque and uncertain business environment, raising initial and operational costs for investors. First signals was indicating that Turkey should replace its cumbersome, cost creating administrative procedures with a cost-effective structure that is competitive with other countries where investors might alternatively locate.

The Government of Turkey has therefore initiated a comprehensive reform program to streamline all investment-related procedures and to attract more private direct domestic and foreign investment. The Government has established a Co-ordination Board for Improving the Investment Climate (YOIKK). The Board assigned specialized technical committees to work on developing concrete proposals and strategies in order to overcome all main obstacles. Productive collaboration between the public and the private sector is the key in this process. To ensure that policy reforms truly reflect and address private sector concerns, intensive and direct involvement of companies and investors in this process is critical. Each technical committee therefore consists of private sector and government agencies' representatives. The Board's mandate is to make specific recommendations to the Council of Ministers who will take the required political decisions to remove the obstacles impeding the improvement of the investment climate.

The key reform areas have been determined after a comprehensive study conducted by the Undersecretariat of Treasury of the Prime Ministry in cooperation with Foreign Investment Advisory Services, a joint service of the International Finance Corporation and The World Bank. Technical Committees are responsible for the following topics:

Technical Committee I	: Company establishment
Technical Committee II	: Employment
Technical Committee III	: Sectoral Licenses
Technical Committee IV	: Location of Investment
Technical Committee V	: Taxes and Incentives
Technical Committee VI	: Customs and Standards
Technical Committee VII	: Intellectual Property Rights
Technical Committee VIII	: Small and Medium Sized Enterprises
Technical Committee A	: Promotion of Investment
Technical Committee B	: Foreign Direct Investment Regulation

This comprehensive reform program has begun to give its fruitful results recently. The laws enacted by the national assembly and draft laws submitted to prime ministry can be summarized as follows:

Enacted laws as a direct result of the YOIKK process to-date include:

- law on employment of foreign personnel;
- the law on the investment allowance system which enables a shift to an automatic state aid system in line with EU requirements;
- and the new up-to-date FDI law that serves as a declaration to foreign investors of their rights and will enable a shift from an "investment permission system" to an "investment monitoring system" in conformity with international best practices.

The law that redesigns company registration process which diminishes the prior 19 required steps to 3 steps and reducing turnaround from two and a half months to one day. The company registration procedures which previously were taking almost two and a half months and requiring excessive documentation and approvals from several authorities have been simplified and streamlined. Now the registration can be done in a day. All that is required is to fill out a standard form at one point without applying to several different authorities for necessary approvals;

One of the key issues in the reform agenda of the Government of Turkey is attributing great importance to the role of collaboration between public and private sector. Therefore necessary platforms have been created where the representatives of public and private sectors come together to discuss and provide solutions on key issues facing Turkey's business climate. While achieving quite positive results in improving the environment for business by means of national platforms like the Coordination Council for the

Improvement of Investment Climate, an other structure with an international perspective, named Investment Advisory Council (IAC) for Turkey was established in 2004 with a view to raise the competitive position of Turkey in the world economy as an investment location. The high - level IAC meetings in 2004 and 2005 brought together the top echelons of leading multinational companies, international organizations and heads of Turkish private sector associations and both were entirely chaired by the Prime Minister Recep Tayyip Erdoğan.

The inaugural meeting of the Investment Advisory Council for Turkey was held on March 15th, 2004 in Istanbul. Council members identified 13 priority areas on which the government should focus attention, advising that strengthened implementation of measures in these areas would lead to improvements of the investment climate and scaling up of private investment in Turkey. As decided by the Council, an interim progress report which was also published on the web page of the Undersecretariat of Treasury was prepared and submitted to the IAC Members before the 2005 meeting and informed them about the improvements made in Turkey's investment climate. Thereby the valuable proposals generated in the IAC platform have been successfully transferred to the reform program on improvement of the investment environment. The second meeting of the Investment Advisory Council was held on April 29, 2005 in Istanbul. According to the official statement, which was declared to the public by the Council Members after the meeting, Turkey has made remarkable achievements in one short year since the first meeting of this Council. It was emphasized that major determinants in an investment environment, such as economic and political stability, have been broadly addressed in Turkey.

During these meetings, IAC Members made valuable contributions in developing many proposals that will help attract FDI in Turkey. The Undersecretariat of Treasury as the Council's Secretariat informed the heads of technical committees of the Coordination Council for the Improvement of the Investment Environment (YOIKK) and relevant Ministries about the priorities for Turkey to improve its investment climate listed in the statement of outcomes of the IAC meetings' and requested them to take possible quick actions in these fields.

Given the importance of a strong legal framework for foreign direct investment, the existing relevant legislation was reviewed to assess the needs for as well as the content of new investment legislation. A new foreign direct investment law has been drafted taking into consideration international best practices and recommendations of the FIAS study assessing the foreign direct investment legislation. The objective was to have a legal framework in conformity with the most up-to-date international standards.

The new FDI law has been enacted and published on June 17, 2003. With the new FDI legislation notification based system instead of screening and approval system will be in effect. Also this law defines investment and investor in line with the international standards and abolishes minimum capital requirement of US\$ 50,000 per real or legal person for foreign investors.

The new law is aiming to provide a broader view point to foreign direct investment. Precise definition of the rules and regulations and abolition of some requirements causing delays in the entry, transfer of shares and increase of capital processes further liberalized the already liberal FDI legislation. Some of the important features of the new law are as follows:

- Broader Definition of Investor

- Foreign Nationals
- Turkish Nationals Resident Abroad
- Foreign Legal Entities
- International Organizations
- Freedom to Invest
- Internationally-accepted FDI Definition- (All

Kinds of Assets)

- National Treatment
- Guarantee to Transfer Proceeds
- Key Expatriate Personnel
- Protection Against Expropriation
- Access to Real Estate
- International Dispute Settlement

In addition to these legislative features, Turkey is a member of several international organizations and is a party to many bilateral and multilateral agreements, to provide a more secure investment environment for foreign investors:

- Turkey is a member of the leading economic and trade organizations of the world, such as IMF, World Bank, OECD, and WTO.

- Furthermore, in order to create a secure and predictable investment environment for foreign investors, Turkey has signed Promotion of Investment Agreements with 73 countries, and 54 of which have entered into force. Turkey is also a member of ICSID (International Centre for the Settlement of Investment Disputes and MIGA (Multilateral Investment Guarantee Agency) of the World Bank, and WAIPA (World Association of Investment Promotion Agencies).

- Avoidance of Double Taxation Agreements with 60 countries have been signed and entered into force.

Foreign Investment Figures

Despite its strong potential, Turkey has not benefited greatly from increased FDI flows brought by globalisation. However, thanks

to remarkable performance of economy and pro-business government policies in recent years, FDI inflows have gathered pace. Taking into consideration,

new steps to improve investment environment, the positive macroeconomic developments, and the EU perspective, the government expects that Turkey will attract more than USD 15 billion of FDI between 2005 and 2007.

According to the balance of payment statistics published by the Central Bank of the Republic of Turkey, the capital (inflow) of US \$ 1.753 million in 2003 has increased by 55,9 % in 2004 and reached to US \$ 2.733 million. In 2000, 2001 and 2002 total direct foreign capital (inflow) are US \$ 982 million, US \$ 3.266 million and US \$ 1.063 million respectively.

Table : Foreign Direct Investment (Inflow)

In 2004, 24,52% of the capital inflows are in manufacturing sector,

69,07% in services sector and 6,04% in other sectors. In year 2004, 81,13% of the inflows was from the EU countries. This ratio realized as 78% in 2003.

The foreign investment regime of Turkey is governed by the Foreign Direct Investment Law No. 4875/2003, which is based on the principle of equal treatment of domestic and foreign investors. The objective of this Law is to encourage foreign direct investments; to protect the rights of foreign investors; to define investment and investor in line with international standards; to establish a notification-based system for foreign direct investments rather than screening and approval.

As of July 2005, there are 11.084 companies with foreign capital in Turkey.

Out of these, 9.325 are of new company and branch establishment and 1.759 are

of foreign capital participations into existing companies. In 2001, 2002, 2003 and 2004 the number of companies with foreign capital are 507, 517, 1114 and 2162 respectively.

In terms of accumulated foreign capital commitment up to today; the leading investors are Germany, USA, the Netherlands, Greece, United Kingdom, Switzerland, Belgium and Russian Federation.

In year 2004, 247 incentive certificates were issued for investments to be carried out by companies with foreign capital, and the estimated total value of these investments within these certificates amount to US\$ 3.882,1 million, of which 41,2% will be undertaken by foreign shareholders.

Within the manufacturing industries, the leading sectors are;

- Automotive and transportation equipment
- Food, beverage and tobacco industries
- Chemical and petroleum products
- Electrical machinery and electronics

Within services sector, the leading sectors are;

- Banking
- Trade & retail chain stores
- Telecommunications
- Tourism

As of the end of 2004, 9.446 foreign capital companies operate in Turkey. The foreign partners of these companies include 149 of the 500 companies which are listed in the Top 500 companies list of the Fortune magazine.

Incentives Tax Incentives

General Incentive Regime:

The general incentive regime is applied varying to the location, scale and subject of investments. In terms of application of general incentives, Turkey is divided into three types of regions:

- **Developed Regions :** The city boundaries of Istanbul and Kocaeli; and the municipality boundaries of Ankara, Izmir, Bursa, Adana and Antalya)

- **First priority regions :** 50 cities determined by the Council of Ministers

- **Normal Regions :** The remaining cities

To be eligible for these incentive measures, the minimum amount of fixed investment must be 200 billion TL for the first priority regions and 400 billion TL for the developed and the normal regions.

The main incentive tools granted to investors by the current legislation are;

- Exemption from customs duties and fund levies

- Investment allowance,

- VAT (Value Added Tax) exemption for imported and locally purchased machinery and equipment,

- Exemption from taxes, duties and fees.

Exemption from customs duties and fund levies: This incentive measure ensures that the imported machinery and equipment for the investment can be brought to the country with the exemption of customs duties and fund levies. The machinery and equipment, which are to be imported under this measure, must be included in the imported machinery and equipment list to be approved by General Directorate of Foreign Investment. Within this context, raw materials and intermediate goods cannot be imported.

Investment allowance: Investment allowance is a corporate tax exemption applied to taxpayers. The expenses incurred within the scope of their investment, those relating to buildings, machinery

and equipment are entitled to benefit from the investment allowance. With the latest amendment in the income tax law all the investments which amounted above 5 billion TL are entitled to benefit from the investment allowance. Investment allowance rate is fixed at 40% for all types of investments regardless of region or value. The withholding tax which has been levied up on the taxable income before deduction of the investment allowance prior to the amendment is abolished in order to provide more effective rate of 40% with a net value. There is no need to obtain a prior approval or permission like an investment incentive certificate for the investment to be eligible for investment allowance incentive. The corresponding percentage amount of the fixed investment cost can be deducted from the future taxable profits starting with the year the cost realized. Investment allowance amount can also be readjusted for inflation.

VAT exemption for imported and locally purchased machinery and equipment: The Value Added Tax, which is due to be paid for both the imported and locally purchased machinery and equipment, shall be exempted by this incentive measure. The imported machinery and equipment, which are included in the imported machinery list approved by GDFI, can be brought to Turkey without paying Value Added Tax. The locally purchased machinery and equipment should also be included in the locally purchased machinery list to be approved by GDFI. With this approved machinery list, the investor can purchase the local machinery without paying the VAT to the seller.