



TURKISH INDUSTRIALISTS'S AND BUSINESSMEN'S ASSOCIATION

**INVESTMENT ENVIRONMENT
AND
FOREIGN DIRECT INVESTMENTS
IN TURKEY**

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EXECUTIVE SUMMARY

GENERAL SETTING FOR THE ATTRACTIVENESS OF TURKEY

1. GLOBAL SITUATION: RECENT TRENDS IN FOREIGN DIRECT INVESTMENT

Potentially, Turkey is an appealing country for global investors.

Despite her numerous advantages, Turkey has not received considerable FDI inflows in the last decade.

With the changing economic setting in Turkey, there is now more room for global entrepreneurs and the corporate sector to take initiative.

2. POLITICAL AND ECONOMIC STABILITY

Turkey accomplished the bulk of its rigorous structural reform program

The economic program offers a window of opportunity for growth and competitiveness.

Economy's resilience to shocks improved and vulnerability reduced.

Stabilization and structural reforms draw Turkey nearer to EU.

Economic and political stability is expected to continue.

The vigorous economic activity supported by the strong TL, low interest rates, and disinflation gives the fertile soil for a new high growth era.

3. GROWTH PROSPECTS

Sustained growth will come together with implementation of strict monetary and fiscal policies.

Favorable economic climate will be supported by continued structural reforms.

2004: the first year of a new sustained growth process in Turkey.

4. EU ACCESSION PROCESS

EU membership makes a country more attractive for FDI.

Starting of negotiations with EU will stimulate FDI inflows to Turkey.

LEGAL AND REGULATORY FRAMEWORK OF DOING BUSINESS IN TURKEY

Further to achievements towards macroeconomic stability, the focus now is shifted to improve the investment environment in Turkey.

However, sustained high economic growth will come through by removing obstacles of doing business.

1. LEGAL SYSTEM AND ENFORCEMENT OF LAWS

Although Turkey has made significant progress in modernizing its business legislation, a stable legal framework for investment decisions cannot be established.

Poor implementation of existing legislation seems to be the main problem. The application of legislation is often inconsistent and therefore unpredictable.

Frequent changes in legislations produce an unstable platform of enforcement of laws.



Lack of a political culture whereby decisions and commitments made by previous authorities honoured reinforces unpredictability.

Insufficient administrative capacity heavily adds to weak and unreliable judicial enforcement.

2. TAXES AND INCENTIVES

The tax to GDP ratio has trended up in Turkey until recently.

The need for the establishment of a viable tax system and effective incentives in Turkey is felt more than ever.

For an efficient and “attractive” tax system, a harmony should be ensured among the amendments to be introduced in the law and the tax strategy.

Turkey has to take immediate action and specify concrete measures to attract more FDI to the country.

3. UNREGISTERED ECONOMY

In order to improve the investment environment, priority should be given to the struggle against the unrecorded economy.

4. PRIVATISATION

Although privatisations are important means of generating FDI in the world, Turkey failed to generate FDI by privatisations.

Privatization should be understood as a means of increasing efficiency not as a source of generating income.

5. LABOR RELATIONS

Labor force is an important contributor of Turkey’s competitiveness.

In terms of the availability of skilled labor force, Turkey performs higher when compared with its competitors.

Turkey has to compensate its increasing labor cost either with another impressive advantage or by improving the investment environment.

Turkish private sector has managed to adjust its cost structure and the excess labor supply.

The rise in labor productivity points to a higher potential growth rate.

Both by the provisions of new Labor Law adopted by the Parliament in May 2003 and other measures taken it is aimed to improve the conditions of the labor market:

6. INTELLECTUAL PROPERTY RIGHTS

Effective protection of intellectual property rights is essential for attracting FDI

Concerning legislation, intellectual property rights protection is in place.

However, concerning implementation, there are serious concerns.

Furthermore, some of the laws are not yet up to the international standard particularly in view of EU harmonization.

The problems encountered in the area of effective protection of IPR in Turkey create obstacles to FDI inflows.

The priority should be given to effective implementation and enforcement of protected rights.

7. SECTORAL LICENSES AND OPERATING PERMITS

Sectoral licenses impose the problem of barrier for market entry.

Overlapping laws and institutions exist today to govern the implementation of environmental protection.

Lack of coordination among different ministries and agencies causes a major problem for effective operation.

8. LAND AND REAL ESTATE



There is a shortage of appropriate land for investment although Turkey is a land-rich country. However, there is no discrimination between domestic and foreign investors concerning land ownership.

The country suffers from a lack of proper space planning.

9. INFRASTRUCTURE

Turkey should enhance its basic and technological infrastructure in order to attract more FDI. Infrastructure is costly and quality is a concern.

Infrastructure investments will total around 56 Billion USD per year between 2001-2005.

The lack of infrastructure should not hinder FDI but turn into potential new investments and FDI in the future.

Liberalizing the infrastructure sectors properly will help to solve the problems and stimulate FDI.

ACHIEVEMENTS IN BUSINESS ENVIRONMENT

1. IMPROVEMENT OF THE INVESTMENT ENVIRONMENT COORDINATION COUNCIL (IECC)

A Reform Program was launched for the Improvement of the Investment Climate in Turkey

There have been improvements that have a direct, significant and immediate impact on foreign investors.

2. FDI LAW

A liberal foreign investment environment was introduced with the new Foreign Direct Investment Law.

3. ACCOUNTING STANDARDS

There have been significant improvements in the accounting framework in Turkey in the last year.

Further to International Financial Reporting Standards, Hyperinflationary Accounting has also become effective.

4. COMPANY ESTABLISHMENT

Foreign investors are now entitled to establish any form of company included in the Turkish Commercial Code.

Cumbersome company establishment procedures notably simplified.

The new law decreases the number of steps for establishing a company from 19 to 3.

WHAT NEEDS TO BE DONE?

Although Turkey has adopted numerous legal changes in order to improve her investment environment, these changes have not produced the desired outcomes in FDI inflows yet.

1. A CLEAR STRATEGY

In order to make a breakthrough Turkey has to clearly define its FDI strategy and improve its reform management process.

FDI incentives hardly offer to be a substitute of an enabling investment environment.

Some of the significant steps to be rapidly taken are as follows

- Sustain political and economic stability
- Change the vicious circle of bureaucratic envy and struggle for power to a virtuous circle of mutual understanding and cooperation



- Make the importance of the private sector in Turkey's development well understood by state officials
- Give the reform process to the care of those who have faith in market economy
- Simplify the currently complicated tax system, decrease the taxes on various transactions and eliminate volatility of the tax environment
- Provide a stable and non-discriminatory environment
- Simplify and streamline the bureaucratic processes
- Safeguard public sector transparency, including an impartial system of courts and law enforcement
- Reduce Social Security Premiums that constitute a major factor in Labor costs
- Increase transparency in the incentive legislation and develop and implement incentive mechanisms used by countries successful in attracting FDI such as providing free land, tax holiday for a certain start-up period and so on
- Establish an appropriate regulatory framework in order to introduce fair competition in all sectors and especially in the infrastructure sectors
- Foster privatization
- Fight against corruption
- Avoid unrecorded economic practice

2. NEED FOR RESTRUCTURING IIECC (IMPROVEMENT OF THE INVESTMENT ENVIRONMENT COORDINATION COUNCIL)

An ongoing reform program, aiming at attracting foreign investments to Turkey and improving the investments conditions of foreign and domestic investors, is in place since 2002.

IIECC should be reorganized through private sector know-how to produce better results.

3. INVESTMENT PROMOTION

After putting in place a clear strategy to promote FDI, Turkey needs to explain its attractiveness for foreign investors through an Investment Promotion Agency.



GENERAL SETTING FOR THE ATTRACTIVENESS OF TURKEY

1. GLOBAL SITUATION: RECENT TRENDS IN FOREIGN DIRECT INVESTMENT

Potentially, Turkey is an appealing country for global investors.

Potentially, Turkey is an attractive country for global investors. Turkey has a large and dynamic market with a relatively high quality labor force and economic location advantages with easy access to regional markets. Despite these advantages Turkey could only attract USD 1 billion foreign investment on the average per year since 1990. According to generally accepted international standards, the minimum annual FDI attraction potential of Turkey is USD 35 billion (UNCTAD, 2002), which means that Turkey faces an investment loss of minimum USD 34 billion every year. In order to catch this potential Turkey has to build confidence to its economy by ensuring stability of rules and regulations, transparency and political stability.

Besides the improving economic setting with liberalized regulations and radically cut red-tapes, below discussed advantages offers further attraction for foreign direct investments into Turkey.

- ***Export and domestic market oriented investment:*** Turkey is one of the few privileged countries that have the potential to attract investment both for export and as well as for domestic market. With a population of 68 million, Turkey has a huge domestic market and among the biggest emerging markets. Moreover, Turkey enjoys a very special location at the crossroads between East and West, overlapping Europe and Asia geographically. The proxy to the new emerging markets in Middle East and Central Asia creates unique business opportunities. As a leading investor in Caucasian and Central Asian Turkic Republics and having strong cultural and historic ties with the region, Turkey offers an exclusive opportunity to develop business with these countries.
- ***The gateway of energy resources:*** Turkey is located at the gateway of Middle East and Caspian petroleum and Central Asian natural gas to the west, which are regarded as the future energy reserves of the world. The construction of oil and natural gas pipelines has become a national policy for Turkey, in its quest to harbor different points of connection. In the domestic market, network industries and natural monopolies are being introduced to market competition by the removal of sectoral entry barriers. Therefore, the energy production and distribution business opportunities are appealing. Major legislative changes in the Electricity Market Law, Natural Gas Market Law and Petroleum Market Law make the sector more attractive both for domestic and foreign investors.
- ***Demographic window of opportunity:*** The size of the adult population, in other words, “the potential active labor force” will continue to increase at a constant rate over the next two decades on contrary to the developed countries. In line with the Southeast Asian experience, in period of stabilized population growth and increasing households and labor supply, per capita income and welfare improves significantly.



- ***Business skills and high-skilled, competitive labor:*** Turkish economy is characterized by rather high number of market entries and exits, accounting for about 10% of the number of existing enterprises. This points not only to the high flexibility of Turkish entrepreneurs but also to a liberal regime of market access. The Turkish labor force is well known with its skills and learning capacity, and competitive labor rates offer cutting edge for industries. Entrepreneurial activity is flexible, open to foreign ideas and globalization. Turkey's communication and transportation infrastructures are also highly supportive when compared with its competitors.

Despite her numerous advantages, Turkey has not received considerable FDI inflows in the last decade.

As of 2002, Turkey's foreign direct investment stock amounts to USD 15.6 billions, one third of which has been collected in the last three years. The UNCTAD's investment report ranks Turkey 123rd with 0.1 value, which indicates the ratio of country's share in global FDI flows to its share in global GDP. Comparatively, one step below there is Haiti, a country that has 460 \$ GNP per capita and 60 % unemployment rate, and one step below rests Bangladesh with 292 \$ per capita GNP. On the other hand, EU acceding countries such as Poland, Czech Republic and Hungary enjoy high FDI inflows in parallel to the Spanish and Portuguese experiences. These three acceding countries' FDI stock has reached USD 43 billions, USD 27 billions and USD 24 billions respectively. The amount of total FDI with respect to GDP increases as high as 47% for these countries, while it's only 8.5% for Turkey. The EU accounts for 67% of foreign capital companies operating in Turkey. Netherlands is by far the leader investing country and the followers are Germany, United Kingdom and the United States.

With the changing economic setting in Turkey, there is now more room for global entrepreneurs and the corporate sector to take initiative.

The improvement in the underlying trends of the Turkish economy should be appreciated on the base for the attractiveness of direct investments in Turkey. With the shifting economic setting in Turkey, not only the public sector but also the corporate sector is facing a need to adapt itself to a more competitive environment. The privatization efforts, tax reform, abolishing the barriers to enter for network industries and natural monopolies, constructing regulatory authorities, adapting adequate laws etc. are all processes that change the face of Turkish economy. While these reform efforts aim to structure and strengthen the fundamentals of the market economy, there will be more room for entrepreneurs and the corporate sector to take initiative. However, this new environment will be a more competitive and though one to survive for the firms ignoring efficiency and technologic development. Considering that the Turkish economy proved its capacity next to the global competitiveness, it would be fair to claim that the new environment will bring more pros than cons for the foreign investments. Actually, Turkey has significantly improved the functioning of its market economy, while further decisive steps towards macroeconomic stability and structural reforms are also enhancing the attractiveness of foreign investments. The achievement of the market economy with its rules and institutions not only offers a window of opportunity from medium to long term, but also brings Turkey ready for a more convenient investment environment.



2. POLITICAL AND ECONOMIC STABILITY

Turkey accomplished the bulk of its rigorous structural reform program

Under the IMF Stand-by Agreements and the World Bank assistance, Turkey accomplished the bulk of its rigorous structural reform program since 1999, supplementing the remaining elements of a well functioning market economy. The pace of the reforms had progressed in leaps and bounds, partially due to the twin crises of 2000 and 2001. However, in the general public eye, the main culprit behind the economic turbulence and the reluctance in the reforms was the politics. The nature of a three-party coalition government gave birth to a political struggle among the ruling parties and this curbed the pace of the structural reforms. Not surprisingly, the landslide election of November 2002 turned into a clean-sweep of AKP, leaving all the ex-government coalition parties and the opposition parties out of the parliament. This supported the view that, the public at large thinks that there was not a single viable policy to put the economy on a new growth path other than realizing the structural and the political reforms that would sustain stability.

The economic program offers a window of opportunity for growth and competitiveness.

The essence of the structural reforms is the establishment of a market economy with its rules and institutions, while removing the political rent distribution mechanisms to achieve more efficient resource allocation and improve the economy's resilience to shocks. This resolute macroeconomic policy backed by IMF program offers a window of opportunity from medium to long term for Turkey to improve its potential output level and competitiveness. The aim of the IMF supported economic program is two folds: (I) Improving the economy's resilience to shocks and reduce its vulnerability in the short run (II) Achieving sustainable growth via fundamental structural reforms from the medium to long run. Therefore, the achievement of the program not only offers a window of opportunity from medium to long term but also brings Turkey closer to the EU.

Economy's resilience to shocks improved and vulnerability reduced.

In the short-run, the costly but comprehensive banking sector restructuring, the floating exchange rate system, the implicit inflation targeting and ensuring viable public finances via high primary surpluses have been the major short term tools to heal macroeconomic imbalances. However, one another important issue is the management of the expectations. The Turkish economy has suffered so far from displaying multiple-equilibrium, in which expectations may carry the economy from a "good equilibrium" to a "bad" one or vice versa. However, the structural change since 1999 became fruitful in both improving the economy's resilience and paving the way for sustainable growth. Also, there is a structural break in the inflation pattern and the single digit annual rates will probably be seen in the first half of 2004. The real interest rates are declining with the fiscal discipline and the corporate sector gains competitiveness with its increasing productivity.



Stabilization and structural reforms draw Turkey nearer to EU.

In its 2003 Regular Report the Commission found that:

“Turkey has significantly improved the functioning of its market economy, while macroeconomic imbalances remain. Further decisive steps towards macroeconomic stability and structural reforms will also enhance the Turkish capacity to cope with competitive pressure and market forces within the Union.”

The 2003 Regular Report evaluates the developments in the Turkish Economy on the base of the Copenhagen economic criteria, covering the period of 1997-2003. The report emphasizes a continuous improvement in the functioning of the market economy and in the capacity to cope with competitive pressure. The report also points out the considerable progress in the economic environment, stressing that the current reform process should be maintained.

Besides the improvements in the economy, the medium term outlook is closely related with Turkey’s accession process to EU. Therefore, the Commission’s attitude in 2004 towards the developments in Turkish economy will be at the utmost importance. In light of the indicators regarding the economic criteria, Turkey is not an outlier when compared with Bulgaria and Romania. Opening of negotiations and clearance on the EU membership will serve as the ultimate anchor for the Turkish economy,

Economic and political stability is expected to continue.

In the aftermath of the war in Iraq, it’s confirmed that the Turkish economy had become more resilient to the external shocks. The tight fiscal and monetary policies and the implemented structural reforms have an essential role in this remedy. However, the main factors that could move the Turkish economy to a “bad equilibrium” with a devaluated exchange rate and higher inflation and interest rates have often been political. In the election period, the major political risks regarding the AKP were based on the assumption that the Party would create inertia in the EU membership, the IMF-backed economic programme and secular-democratic Turkey perspectives. However, contrary to the expectations, the government has displayed a successful performance in these three essential areas. Considering that the way of doing politics has changed in Turkey with the last landslide elections, the rational thing to expect is that the AKP will not create tension and become more supportive in these issues in 2004. Since the success of the economic program will create a welfare increase for the households –or one might say the voters-, the government should not to diverge from low inflation-high growth path achieved by the fiscal discipline. Therefore, in order to obtain permanent improvement in the public finance in medium-term, the government has to expand the tax base, constitute the transparent and rational public fiscal governance principals and provide the expenditure reform.

The vigorous economic activity supported by the strong TL, low interest rates, and disinflation gives the fertile soil for a new high growth era.

Although the Turkish economy has been growing fast for the last two years, it is still below the potential output level. Besides, the proportion of the gross fixed capital investments to GDP, the historical average of which had been about at 27%, is still down at 19% as of end-2002. Starting with 2003, there is an opportunity for an increase in both the domestic and foreign direct



investments. With the continuing public sector reform based implementation of the economic program, it's likely to have single-digit inflation and a significant increase in the per capita GDP until 2005. Consequently, a huge domestic market that resolved its structural problems and increased its purchasing power, will be more attractive for the investments. In a macroeconomic environment with welfare gains arising from invigorating economic growth and declining inflation and interest rates, progress on structural reforms by the government –apart from being conditions for the IMF reviews, constitutes the premise for sustainable growth on medium and long term.

3. GROWTH PROSPECTS

Sustained growth will come together with implementation of strict monetary and fiscal policies.

Recently, Turkish economy has encountered important problems such as high inflation, high public debt stock and growth rates lower than the potential. With the contribution of structural reforms to be implemented in the period 2004-2006, macroeconomic policies will focus on the solution of these problems and implementation of strict monetary and fiscal policies will continue. The positive effects such as securing confidence in the economy, reducing risk premium and inflationary expectations will be more pronounced, and therefore will have a supportive effect on growth. In the period of 2004-2006 it is targeted to increase competition and secure more efficient resource utilization in the economy through continuous implementation of the structural reforms. It is foreseen that the expected rise in savings due to policies being implemented and the regulations aimed at improving the investment environment will lead to an increase in private investments. Moreover, the expected decrease in interest rates, as a consequence of raising confidence, will create a positive effect on investments. In an environment of low inflation, the decrease in real interest rates and the reduction of the cost of keeping required reserves will have a positive effect on the cost of bank resources. As a result, the loan volume of banks is expected to rise. The reduction of public deficit and the resulting decrease in the pressure caused by public finances in financial markets will also be supportive (Pre-accession Economic Program 2003).

Favorable economic climate will be supported by continued structural reforms.

Although Turkey has reverted to the growth path, following the recessions, potential output still hasn't been obtained. The ratio of investment to output, which has a historical average of 27%, is presently around 18%. Beginning with 2004, there is in the coming periods a very positive climate for both foreign and domestic investment. Provided that the emphasis on public sector does not wane and the economic program continues unflinchingly, it is highly possible that from 2005 onwards inflation can take a single-digit form and real income per head in Dollar terms can rise rapidly. This process will be accentuated by a favorable outcome in the EU-membership negotiations in 2004. In a macroeconomic environment in which growth is accelerated, inflation and interest rates are dropping, the cost and difficulty of undertaking structural reforms is relatively diminished. The feasibility of these reforms will make it easier for the government to stick to them, thereby laying a better foundation for sustainable growth. These three basic variables shape the expectations for 2004. Moreover, depending on the foreseen increases in



growth and investments, it is expected that nearly 2 million new employments will be created in the period 2004-2006 and thereby a reduction will be achieved in the unemployment rate.

Public sector reform constitutes the most important leg of structural reform program. What lies in the heart of this reform is the strengthening of the free market's legal and institutional framework; a more effective resource allocation mechanism by limiting political intervention and influence in the economy; and, contraction of the operational field of the public sector and its restructuring according to the principle of efficiency. The noteworthy stances made in 2003 in this area should continue just as resolutely in 2004. Decisiveness on reform steps turns out to be only relevant policy options for better budget performance.

2004: the first year of a new sustained growth process in Turkey.

After increasing by 5% in 2003, GDP may decelerate slightly in 2004 as a result of adjustments in stockbuilding, but should rebound in 2005 provided that positive expectations are maintained. The authorities should stick rigorously to the fiscal stabilization and structural reform programme, pursuing the primary budget surplus target and implementing the new policies regarding social security, banking, privatization and foreign direct investment. A firm policy stance in the face pressures emanating from the local elections in spring 2004 would help to preserve the crucial momentum of positive expectations.

Having overcome the two major obstacles of sustained growth, namely, political and macroeconomic instability, 2004 now should be regarded as the year of igniting growth and the years to come as the process of sustaining growth. In terms of accelerating growth, the per capita income growth rate should increase by 2.5 percentage points. This figure leads to a 5% yearly growth rate. The level of unemployment and the need to liquidate the labor force in the agricultural sector, necessitates that Turkey cannot tolerate a growth rate which is less than 5% in the following 5-6 years. This will allow for an increase of 2.4% in the employment rate and approximately 12% of unemployment rate. In order to sustain this growth rate, the investment rate should be around 24% of GDP.

A robust growth perspective necessitates the removal of barriers to investment and entrepreneurship. Elimination of market failures and making the market economy perspective prevail among the politicians and the bureaucracy with accomplishing the public sector reform, are the main prerequisites of igniting growth.

OECD claims that a virtuous cycle of fiscal stabilization, interest rate declines and increasing confidence should help maintain GDP growth on a strong path.

4. EU ACCESSION PROCESS

EU membership makes a country more attractive for FDI.

The EU membership will bring Turkey access to big EU market, increased growth prospects and access to structural funds. But more importantly Turkey's EU membership boost confidence by removing uncertainty in political and economic stability.



In fact, the EU membership and even the membership process itself produces substantial positive effects for the economies of the member and candidate countries from growth rate to GNP per capita and FDI inflows.

According to Eurostat (1997: 39) “European companies have a tendency to respond to globalization pressure by enhancing the division of labor through FDI within the EU rather than to third countries.” This means that the EU membership makes a country more attractive for FDI from other EU countries. On the other hand with the EU membership a country also attains the opportunity to get a share from the FDI inflows to the EU from third countries. In Spain and Portugal, after full membership foreign investment increased 10 times in five years. Between 1986-1994 Spain attracted a total of USD 60.3 billion FDI, while Portugal attracted USD 11.2 billion. These figures reveal the real force behind the rapid economic development of these countries.

Starting of negotiations with EU will stimulate FDI inflows to Turkey.

For the candidate countries these positive effects could be observed with the opening of accession negotiations. As soon as the candidacy is declared foreign investment inflows increase significantly in countries that have lower GNP per capita than the EU average. For instance the amount of foreign investment that entered the candidate countries doubled between 1997-1999.

Among candidate countries, the size of Polish economy is comparable to Turkish economy. FDI flow in Poland has been increasing steadily since the political and economic reforms started in 1989. More than USD 60 billion of foreign capital has been invested in Poland since then. Bigger inflow of foreign investment started in the second half of 1990s as a result of successful transformation and privatization.

However, the candidate countries will lose some of their advantages like skilled and cost-effective labor force, incentives offered to foreign investors, derogations from the EU acquis, when they become full members. Subsequently, foreign investment will move to other candidate countries. Turkey can use this advantage if she starts accession negotiation and settles the road to full membership. This will be an opportunity for Turkey to catch its potential in FDI inflows.



LEGAL AND REGULATORY FRAMEWORK OF DOING BUSINESS IN TURKEY

Further to achievements towards macroeconomic stability, the focus now is shifted to improve the investment environment in Turkey.

After years of struggle with high inflation and high volatility in the interest rates and the exchange rate, the economy now has moved to a better stage. Although macroeconomic balances and especially, public balances are still important and in need of further improvement, Turkey now is in a position to devote efforts to microeconomic issues, that had not got the chance of being on the agenda up to now. Having overcome the two major obstacles of sustained growth, namely, political and macroeconomic instability, 2004 now should be regarded as the year of igniting growth and the years to come as the process of sustaining growth.

However, sustained high economic growth will come through by removing obstacles of doing business.

Although the top priority now shifts from stabilization to growth, sustained high growth will not come automatically. The locomotive of growth will be obviously private sector, both domestic and foreign. A robust growth perspective necessitates the removal of barriers to investment and entrepreneurship. Elimination of market failures and making the market economy perspective prevail among the politicians and the bureaucracy with accomplishing the public sector reform, we see as the main prerequisites of igniting growth.

1. LEGAL SYSTEM AND ENFORCEMENT OF LAWS

The privileged movement area of the state concerning the law system should be limited with “legal certainty” which necessitates the Courts’ decisions not to be questioned after their finalization.

In Turkey,

a) An administrative transaction produces all the legal consequences, the rights and the responsibilities, concerning that the administration established the transaction and the drawees benefits from the transaction, if it is established in a suitable manner within the certain legal system and general principles of law.

b) If the administrative transaction has been established contrary to the legislation and the general principles of law, this transaction can be abolished by the state in 60 days. But the state always has the authority of abolishing this kind of transactions concerning its consequences regarding future that are contrary to legislation without prejudicing the acquired rights of the third parties.

c) If the administrative transaction has been established in line with the legislation and the general principles of law, but it became contrary in a time period because of some amendments



in the legislation, this transaction cannot be abolished by the state in any way. But again without any prejudice to acquired rights of the third parties, these transactions can be abolished concerning their consequences regarding future. The decisions of Danıştay -Supreme Court for Administrative Law- also confirm the points mentioned above.

Although Turkey has made significant progress in modernizing its business legislation, a stable legal framework for investment decisions cannot be established.

In the last 20 years, Turkey has made significant progress in modernizing its business legislation. The ongoing reform efforts are closely correlated to the objective of Turkey to accede to the European Union. Pushing on with the ongoing reforms is crucial to the country's economic future. These improvements, many of which were achieved in the last few years, were necessary but not sufficient to create an attractive legal framework for foreign investors. A stable legal framework for investment decisions should be established in order to solve the legislative, executive, and regulatory problems which are significant impediments on FDI.

Poor implementation of existing legislation seems to be the main problem. The application of legislation is often inconsistent and therefore unpredictable.

While there are some gaps in laws and regulations, poor implementation of existing legislation still seems to be the main problem. Foreign and domestic investors complain about missing implementing rules and administrative guidelines, inconsistent application of laws, incompetent bureaucrats and lack of judicial enforcement.

The main difficulty regarding the poor implementation of existing laws is that time-consuming procedures and decision-making processes appear that the application of legislation is often inconsistent and therefore unpredictable.

Frequent changes in legislations produce an unstable platform of enforcement of laws.

It is a problem that adopted laws are often not implemented on time and legislation is repeatedly amended right after its adoption or even withdrawn which produce an unstable platform of enforcement of laws. Rules seem to change overnight without prior warning or consultation. Law-making procedures often lack participation of the people subject to it like the business community, who is mostly the practitioners dealing with the legislation and the transactions on a daily basis, feels left out in the democratic process of discussing changes in the legislation and are often taken by surprise when legal changes are adopted.

Lack of a political culture whereby decisions and commitments made by previous authorities honoured reinforces unpredictability.

Local politicians may cause problems delay the implementation of signed agreements or the issuance of necessary permissions for personal reasons because of the lack of political culture. The inconsistent behaviour of the administration often stems partly from the instability of tenure of officials at operating levels.



Promoting a political culture whereby the state, the public administration and the judiciary honour decisions and commitments made by previous authorities can be accepted as a long term project that requires a fundamental change in the bureaucratic mindset and needs to be taught right from the beginning when new officials enter the service.

Insufficient administrative capacity heavily adds to weak and unreliable judicial enforcement.

Weak and unreliable judicial enforcement mainly arises from the high workload of judges. Another problem is that the courts are often not computerized or linked with each other. The Ministry of Justice is aware of this problem and initiated a reform program that envisages the computerization. This project –UYAP- will be realized in 2005.

Corruption and bribery hinder to embody the enforcement of laws. A fundamental state reform should be generated to ensure the state's regulating duty.

Lack of defined public regulations and standardisation in public service causes corruption and partisanship in the public sector, misuse of public resources as a result of political pressure, lack of objectivity in recruiting civil servants, out of proportioned allocation of authorities and accountabilities, corruption in personnel management and misapplication of promotion and punishment mechanisms. Turkish business environment diverges from those in the home country of foreign investors due to existence of corruption and bribery. Foreign investors find it difficult to understand the governing rules of business life and cope with them. Sustaining fair competition in this area also, making the rules of the game clear and impartial to every player will be an important step in this direction. State reform should be initially handled to prevent corruption and bribery and answer the varying and changing requests and deepening the integration to EU and process of developing into a democratic phase.

Recommendations

- Increasing the salaries of judges budget permitting and decreasing the workload of judges to a level where the duration of cases becomes acceptable can also be a solution for qualified workforce and independent and impartial trial.
- The laws might have a deadline in which implementing legislation like regulations and decrees should be adopted and all relevant interest groups, including business associations should be invited to comment on draft legislation before laws, law decrees, or regulations adopted. This will increase the quality and predictability of the legislation.
- Standards of behaviour for public service should be legislated in order to prevent corruption and bribery. The real value of public personnel wages should be maintained.
- A fundamental state reform should be generated to ensure the state's regulating duty.



2. TAXES AND INCENTIVES

The tax to GDP ratio has trended up in Turkey until recently.

There has been a persistent upward trend in the ratio of tax to national income since 1965 across most of the OECD area. Meanwhile, the deteriorated public balances in preceding years has revealed an imperative increase in tax burden in Turkey. Correspondingly, the proportion of the tax burden to the national income in Turkey has increased by 10 points within the last decade, bringing that Turkey has the fastest swell in tax to GDP ratio, ending up with 33%. However, recent developments across transition economies suggest that the upward trend in tax burden may be ending. Considering the high rate for Turkey –though under the OECD average, a healthier tax design is to be shaped by the considerations of efficiency, equity, and enforceability. Meanwhile, the tax in question is levied from a very small number of taxpayers. Among approximately 550,000 corporations operating in Turkey, 1,500 are currently paying 83% of the total corporation tax. This situation is also indicative of the fact that measures are required to be taken and to be implemented immediately.

The need for the establishment of a viable tax system and effective incentives in Turkey is felt more than ever.

There are numerous issues that need to be considered individually such as tax administration, the tax judiciary system, auditing, the tax procedural code, direct and indirect taxation. Some of these issues can be regulated through the publication of communiqués and passing of decrees, while certain other issues can be resolved through the enactment of new laws. Although the regulations that are required to be introduced within this scope have already been initiated, the relevant solutions should be achieved as early as possible. The appropriate amendments within the tax system should be accomplished in a transparent environment, with a specific attention to the acquired rights.

For an efficient and “attractive” tax system, a harmony should be ensured among the amendments to be introduced in the law and the tax strategy.

The current situation in Turkey reveals that a strong tax administration is needed in order to struggle against tax losses and tax evasion, and a comprehensive project should be started in order to strengthen the tax administration. The shift to the inflation accounting system may be considered to be a constructive step for the taxation of the actual earnings. Similarly, efforts exerted to ensure that the profits calculated in compliance with the international accounting standards are accepted as the assessment base in the calculation of the tax burden. Yet, it is still necessary that the tax rates be reduced within a scheduled time frame. It is also beneficial that the government should exchange information and opinion with the taxpayers, while determining its tax strategy. In the meantime, taking into consideration the damages caused on the economy by firms operating out of record, the issue of unrecorded economy should be treated as a top priority issue.

Turkey has to take immediate action and specify concrete measures to attract more FDI to the country.



While the amount of FDI in the world is decreasing, the competition among countries to attract FDI is increasing. Turkey, which is ranked as number 122 among 137 countries in FDI attractiveness¹, should take immediate measures to improve its situation. One of the fields through which a fast improvement can be achieved is the incentives regime. Currently, Turkey is facing high competition from other countries like Hungary, Poland, Czech Republic, but also from countries like Ireland and India in attracting FDI. These countries offer competitive incentives and very actively work on inviting government officials, chairmen of big companies to invest in their country. Statesmen of these countries visit employers associations to present them the concrete offers of their country. Not every country has the best practices in incentives, still, in order to urgently compete with these countries, Turkey has to take up short term and longer term concrete measures, otherwise the amount of money spend for investments is decreasing.

An investor who wants to invest in Turkey, wants stable, permanent and reliable laws and regulations, attractive facts and conditions.

To be able to compete with other countries, the measures that Turkey has to take up may well be run through the short and long term actions. For the meantime, incentives should be also provided in the form of land, lower energy and infrastructure costs. Also, the incentives granted should not be modified with the changes made in the legislation if the new legislation has disadvantageous conditions to the prior one. The short and longer term measures can be summarized as follows:

Recommendations

Short term

- The Withholding Tax applied on companies with incentives should be eliminated, if not reduced to 10%.
- The more workers you employ the more you should be exempt from taxes and social obligations.
- VAT re-payments to the exporters should be faster.
- Application of lower statutory tax rates.
- Incentives should be given to companies, which comply with the EU-regulations about waste treatment.
- Free Trade Zone regulation should be made clear.
- Increase transparency in the incentive legislation by making clear and detailed definitions.
- Limit frequent changes to the rules.
- Simplify the application procedure.

¹ World Investment Report, 2001, Promoting Linkages, United Nations: New York and Geneva, 2001 pp.254-255



- A sole authority should be responsible for incentives policy.
- Establishment of an agency (IPA) to inform investors about the attractive incentive conditions of Turkey.

Long term

- Cost-benefit analysis of the incentives regime (effect on the government revenues, lower corporate tax rates might be advantageous than giving tax allowances, incentives, check whether the crucial sectors are promoted or not).
- Automation of the incentive system, operation as part of the normal tax system.
- Focus on sectors and regions in which development is necessary.

3. UNREGISTERED ECONOMY

In order to improve the investment environment, priority should be given to the struggle against the unrecorded economy.

An imperative issue that needs a special emphasis for Turkey is that the tax in question is levied from a very small number of taxpayers. Among approximately 550,000 corporations operating in Turkey, 1,500 are currently paying 83% of the total corporation tax. In the meantime, bulk of the unrecorded economy is estimated to exceed 60% of the total economic testimony. This situation is indicative of the fact that the required measures need to be implemented immediately. Considering the edgy tax base, this issue should be treated as a top priority concern and that the unrecorded economy should be reduced to a minimum level through a separate regulation. Within this scope, a number of measures need to be implemented, such as the termination of the bearer system in economy and shift to registered economy, the mandatory employment of the banking system in certain types of payments (for example, the disbursement of payments over a certain amount through banks, the deposit of salaries/wages in bank accounts and basing on these accounts the calculation of the employees' legal rights etc.) and the widespread use of the personal tax account numbers. Strengthening the enforcement of tax laws can potentially enhance the perceived fairness of the system and thus compliance. In other words, a "*recorded*" economy in Turkey is needed in order to prove the fair competition and to cover the disadvantage born by the firms, which are operating in the records.

4. PRIVATISATION

Although privatisations are important means of generating FDI in the world, Turkey failed to generate FDI by privatisations.



After economic liberalism started to govern the global economy in the 1980's, privatization became one of the most essential reforms on the economic strategy of many nations. As being one of the fundamental tools of the free market economy and attracting foreign direct investment, privatization has been on Turkey's agenda since 1984.

In the 1980's, Turkey, is one of the first countries to initiate privatization in the framework of opening its markets and economic restructuring. Although Turkey had made a fast head start in privatization, it has not been able to maintain this speed due to political and economic instability as well as opposition from public opinion and bureaucracy, and has even remained behind Eastern European countries that have undertaken privatization as late as the early 90's. Furthermore, privatization has accounted for a large part of the increased FDI flows to developing and transition countries during the 1990s. However, in Turkey only about 30 % of privatizations have been in FDI. Turkey has spent the past twenty years working on laying the legal groundwork of privatization rather than actual implementation. During this period, the Privatization Law no. 4046 was enacted along with the related amendment in the constitution.

In Turkey, privatization implementations have started in 1984 with the transfer of incomplete plants of the SEE's to the private sector for completion. Since 1985, total proceed from the privatization implementations is recorded as US\$8.1 billion. Total revenue generated from entities within the privatization program between 1985-2003, together with US\$2.1 billion dividend income and US\$1.9 billion other income, has amounted to US\$11.2 billion. In the same period, total privatization expenditures were US\$11 billion.

The fundamental transformation in Turkish economy, EU membership candidacy, and the East-West expansion of the world's geopolitical horizons has opened up a new era for Turkey with many promising opportunities, including privatization, for international investors in Turkey. While actual privatization in 2003 has been less than perfect, total privatization revenues of US\$140 million against US\$2.1 billion of privatization target, lessons can be learned from accumulated experience and privatization can be done in a highly beneficial way.

Privatization should be understood as a means of increasing efficiency not as a source of generating income.

Since, the 2004 privatization program that was announced by government comprise many different sub-sector of the economy, including power generation, telecommunications, transport, petroleum, agriculture, foreign direct investment may prove to be an important component of privatization in Turkey for the near future. Energy sector alone would require US\$3 billion per year investment. Within this perspective, the ability of Turkey to attract foreign investment in these sectors will determine the success of privatization in these areas.

Current priority privatization projects include Türk Telekom, Turkish Airlines, Tüpraş, Petkim, Tekel, Halkbank, and a number of energy enterprises. These are extremely important and noticeable projects, and challenges lie ahead. Parallel to this endeavors, foreign direct investment participation is prerequisite for successful implementation for the 2004 privatization program.



During the last twenty years, it was proved that the most important issue is to get a stable government formation that is committed to privatization. The privatization initiatives would succeed if the government would last long enough to make the necessary action. Turkey's privatization record has not been satisfactory because recent governments have not pursued a long-term strategy, instead they chose to pursue short-term budgetary gratification.

Being a single party government, the ruling government has the majority of the parliament, has removed the biggest barrier that thwarted the way in the country's development, which was political instability. As a result, this has made it possible for political and economic policies, including privatization, could be carried out without internal conflict within the government. In this context, privatization, with the support derived from political backing, should proceed in collaboration with public institutions and independent regulatory bodies in an accelerating manner.

5. LABOR RELATIONS

Labor force is an important contributor of Turkey's competitiveness.

Turkey, with 70 millions population and labor force amounted to 23 millions, stands strongly on numerical values when the current workforce rate against the population figure is taken into consideration in order to enable a cross-country comparison and is placed favorably where other Eastern and Central European countries that have a workforce around 5-6 million at most.

The male-female distribution of labor force is approximately 72% and 28% with the women participation rates on increase and employable women population is growing. After the length of compulsory elementary education raised from 5 to 8 years in 1997, there is a considerable progress in women's attainment. As their educational level rises, their wages and income increase, which is a very powerful incentive to participate in the labor force.

Although the share of agricultural labor force has declined constantly from 50% in 1988 to 33% in 2002, it still constitutes a relatively big stake in total. Half of the agricultural labor force, or more precisely, 80% of women in the agricultural sector are in the form of unpaid family labor. Agricultural subsidies helped so far to keep this population in the rural areas, although urbanization is steadily on the rise. The sectors that are to absorb the supply coming from the agricultural sector and increasing women participation rates are manufacturing and services. Since the share of industrial sector seems to be crawling towards 20%, the services sector's absorption accounts for the most labor supply. Through the process of urbanization, an increase in the women participation rates is crucial for Turkish economy not only to absorb excess-agricultural labor supply but also for social transformation.

In terms of the availability of skilled labor force, Turkey performs higher when compared with its competitors.



According to a recent survey by FIAS², Turkey scores higher in availability of skilled labor than its Eastern European competitors and even higher than Ireland, a country that has been highly successful in attracting FDI on that basis. Turkey ranks 13th in the IMD World Competitiveness Yearbook, 2003 in terms of skilled labor and 8th in terms of the availability of competent senior managers.

Turkey has to compensate its increasing labor cost either with another impressive advantage or by improving the investment environment.

Many countries have made use of low wage structures in order to increase their competitiveness. However, Turkey were not able to replace its increasing labor cost with another impressive advantage. In early 1980's Turkey has build its strategy of integrating to the world economy, on labor cost advantage. However, during 1990s this advantage has eroded as real wages started to rise as a consequence of the populist policies applied by every government in office.

Average hourly wages in the private sector rose to 2.14 in the year 2000, but decreased to 1.6\$ after the crisis. Turkey ranks 18th in the IMD World Competitiveness Yearbook, 2003, in terms of compensation levels among 30 countries. High tax burden on wages and salaries increases labor costs in Turkey. However, not being a country of cheap labor, does not impair a country's overall competitiveness. Rather it should be taken as the importance of improvements in other areas for competitiveness of Turkey.

Turkish private sector has managed to adjust its cost structure and the excess labor supply.

Since 1999, the dispersion between the real wages in public and private sectors is evident. Through the subsequent contractions due to crises and earthquakes, private sector managed to adjust its cost structure and the excess labor supply helped to tame real wages. However, the public sector could only reacted to changing macroeconomic environment with an almost two years lag due to collective bargains and intensive backward indexation. Under the current macroeconomic program, one of the core issues is the rationalization and contraction of state intervention to the economy and introducing better governance and higher productivity to the public sector. In the private sector, productivity increases were one of the major drives that took the industry out of the through with an increased competitiveness and better terms of trade. For the following period, the total factor productivity increase is expected to be the main drive of increasing potential output. In a labor market view, new legislation passed from the parliament introduces more flexibility for entrepreneurs to control their cost structure. Flexible working schemes also give the advantage to react more promptly to the changing economic environment and reduces informal sector that creates unfair competition.

The rise in labor productivity points to a higher potential growth rate.

A marked improvement in the rate of productivity growth has been an important factor in the strength and duration of the current economic expansion. Labor productivity in the

² FIAS, "A Diagnostic Study of the Foreign Direct Investment Environment", 2001.



manufacturing sector rose by 8.0% in the third quarter of 2003, up from an average of 3.9% in the first half. On a seasonally adjusted basis, the underlying growth of labor productivity increased to an annualized rate of 13.5% in the third quarter, from 9.4% in the first half of 2003. Although Turkey's private sector has the lead in improving productivity, restructuring measures have also increased labor productivity in the public sector by 23.4% in the last two and a half years. As a result, the rate of overall productivity growth accelerated from less than 4% per annum in the 1990s to 8.4% in the aftermath of the 2001 crisis. Higher total factor productivity growth in the business sector and the upcoming capital deepening should help to maintain an above-trend labor productivity growth in the future.

Both by the provisions of new Labor Law adopted by the Parliament in May 2003 and other measures taken it is aimed to improve the conditions of the labor market:

- The major modifications brought with new Labor Law are provisions regarding part time employment contracts and work on call has been brought, a fund has been established to secure the salary of the employees against the bankruptcy of the employer, new principles has been determined for overtime work, working for a shorter period due to economic reasons and force majeure has been accepted, the rate to employ handicapped and ex-convicted employee is regulated at 6%, maternity leave is extended to 16 weeks, obligation to employ an office doctor in the offices with more than 50 employees has been accepted.
- The draft law covering the establishment of the National Occupational Standards Authority will be legislated as soon as possible.
- The Law on Foreign Employees' Work Permits is legislated.
- Necessary amendments are made in the current legislation and a modern Employment Authority (İŞKUR) set up is finished.
- All the documents, information and official formalities is reduced and simplified.
- Formalities are carried out through a single office, by the Ministry of Employment and Social Security.

Recommendations

For improvement of the investment environment reform program:

- The law, which was adopted in February 2003 concerning work permits for foreign citizens is an important development but it is needed to review several laws and the role of professional organizations to eliminate restrictions on free movement of foreign workers.
- The labor and social security system under one authority should be assembled. Amendments to the current legislation are still needed in order to ensure the proper



functioning of the social security system and to ensure its fiscal sustainability. Inefficiencies and cases of irregularities in the pension system and social security institutions are partly due to legal defects and partly to insufficient administrative capacity.

As a result, when the burden on the domestic and foreign investors regarding legal deductions on salaries and wages reduced, Turkey will be a much more attractive investment location from the labor perspective.

6. INTELLECTUAL PROPERTY RIGHTS

Effective protection of intellectual property rights is essential for attracting FDI

Effective patent protection is essential for attracting modern manufacturers of goods and services. Most companies would be reluctant to invest in research and development of products in a country where the patent protection is not considered as sufficient. Further, they would be reluctant to introduce proprietary technology developed elsewhere, for fear of infringements.

Like patent protection, an effective trademark protection is vital for foreign, as well as domestic, companies to market their products. Investments in the development of a brand name and a logo and its introduction on the market are usually very costly. These efforts are worthless when trademarks are not sufficiently protected and imitators can exploit these investments without paying for them. Therefore, foreign investors will closely examine the state of trademark protection before introducing their products into the Turkish market.

Finally, all producers of artistic works like music tapes and CD's, videos, films, software etc., are dependent on the legal protection of their products. These companies will produce and distribute their products only if they do not face competition from product pirates, which can offer unlicensed products for a fraction of the originals based on their illegal business. Therefore, effective copyright protection is key to attract the entertainment industry and related businesses.

Concerning legislation, intellectual property rights protection is in place.

Many standards in the field of industrial property rights are set by international conventions and agreements. Therefore, it is important that Turkey is member of the leading international organizations and has signed all of the important international conventions and agreements in the area of industrial property.

Turkey fully harmonized its legislation on industrial property rights, prior to its Customs Union Agreement with EU countries. It has enacted important laws on protection of trademarks, industrial designs, patents/utility models and geographic indications. The Turkish Patent Institute has been established in 1994 for the purpose of registration and protection of such industrial property rights. The main system concerning the protection of industrial rights is based on the registration, which is similar to that of the European Union and the other countries that are party to Paris Convention.



Meanwhile, Turkey has established specialized courts to deal solely with intellectual property cases. However, no new specialised courts have been established in addition to the two existing ones (in Istanbul and Ankara). Administrative capacity has continued to develop during the period but the enforcement and monitoring capacity of the competent authorities in the field of intellectual property rights, custom authorities, police and judiciary is still in need of strengthening. A project on intellectual property rights aiming to train judges and providing equipment and the setting up of a database is in the process of being executed. Border controls and the fight to combat piracy and counterfeiting have been improved. The copyright law is by and large in line with international best practice.

However, concerning implementation, there are serious concerns.

It must be stressed that in Turkey, the protection of patents, trademarks and copyrights is not sufficiently effective. Piracy and counterfeiting remains a serious problem. The level of book piracy is estimated to be as much as 90%. Other common forms of piracy concern optical discs with copyright content (movies, music, software, reference materials, etc.) The fight against piracy is still not effective as suggested by the high level of infringements and the low number of court cases and sanctions applied to offenders.

Police and customs appear to lack awareness of the gravity of IPR violations. In addition, the level of professional knowledge in administration, courts, legal profession and police is often not up to date and makes the enforcement of granted rights difficult and sometimes impossible.

In the area of pharmaceuticals, IPR problems remained unresolved. Turkey claimed the transitional periods provided in the TRIPS Agreement for pharmaceutical products. After revision of the transitional period, patent protection for pharmaceutical products and production processes for human and animal health has been delayed until January 1, 1999 according to Art. 4 of the Patent Law. No progress can be made concerning the effective protection of industrial property rights and the commitment of Turkey to grant full protection for pharmaceutical products is never realized.

Furthermore, some of the laws are not yet up to the international standard particularly in view of EU harmonization.

On intellectual property rights, the Law on Intellectual and Artistic Works needs further amendment with respect to copyright in the information society, *sui generis* database protection, public lending, artists' resale rights and rental rights. Concerning industrial property rights, the laws adopted in 1995 need to be amended to comply with EC directives. Turkish law on designs should be amended to comply with the *acquis* on the legal protection of designs. As regards patents, Turkey ratified the European Patent Convention (EPC) in 2000 and has become a party to the EPC. However, Turkey should further align its legislation with the EU and international requirements and ensure effective implementation.

The process of accession to the several international agreements are still pending



The problems encountered in the area of effective protection of IPR in Turkey create obstacles to FDI inflows.

Unfortunately, lack of progress in the implementation of IPR, exacerbates Turkey's problems concerning FDI flow.

European Commission had been closely monitoring Turkey in terms of IPR applications due to the complaints concerning severe violations of IPRs in the country. It had emphasized both in the 2002 and 2003 Progress Reports that no concrete step had been taken towards enforcement of "data protection" and that Turkey has also not taken any measures to fulfill its obligations arising from Customs Union.

Finally, in response to the complaint lodged by EFPIA (European Federation of Pharmaceutical Industries and Associations) European Commission launched an examination procedure concerning obstacles to trade within the meaning of Council Regulation (RC) No 3286/94, consisting of measures imposed and practices followed by Turkey affecting pharmaceutical products³. The complaints concerned obstacles to trade allegedly caused by Turkish practices and measures involving lack of transparency, discriminatory application of the pharmaceutical import, sales and marketing system, including discrimination in pricing and pharmaceutical marketing approvals procedures and distribution channels. Also a lack of protection of commercially sensitive data submitted as part of the marketing approval procedure is identified as an important drawback.

Effective protection of the IPR should not impair the country's investment environment. Thus, it is crucial to find lasting solutions that would minimize the adverse effects of the process and probable negative measures to be taken by the Commission while protecting the country's own interests.

Recommendations

The priority should be given to effective implementation and enforcement of protected rights.

To build up confidence in private sector that their rights are effectively protected more has to be done. Apart from a continuous updating of the existing legislation to meet the international standards and in addition to speed up the procedure for trademark registration, the government's main focus should be on the implementation and enforcement of protected rights.

- The effectiveness of the fight against piracy should be increased and the administrative capacity should be strengthened with training and more inter-institutional cooperation between the police, customs offices and the judiciary.
- All forces involved in the protection of industrial and intellectual property rights should be trained to detect pirated products and to deal with these violations according to the law.

³ Official Journal of the European Union, 20.12.2003



- The authorities need to build awareness in the population that violation of IPRs is a crime and has a harmful effect on other parties. Such an awareness program should also be launched by the police and in customs.
- In the long run, administrators and judges should receive the appropriate training in the field of IPRs protection. The law faculties should offer a reasonable training to law students in the field of IPR. In addition, intensive exchange programs with patent institutes, special forces, bar associations, culture ministries in other countries may be considered to improve the professional knowledge of the experts.
- Apart from two specialised courts in Istanbul and Ankara, criminal and civil courts are dealing with IPR cases and excessive delays are encountered in reaching verdicts. Also, Turkey has to ensure the application of appropriate remedies and sanctions in cases of infringement of copyright and related rights.

Despite the measures taken in previous years, overall alignment in the field of intellectual and industrial property rights remains very limited. Both legislative and enforcement measures are needed to tackle piracy and infringements of intellectual and industrial property rights more effectively.

7. SECTORAL LICENSES AND OPERATING PERMITS

Sectoral licenses impose the problem of barrier for market entry.

Approval procedures for company establishment in Turkey are lengthy and overly bureaucratic and needs to be simplified and streamlined. Business entry is a critical mechanism in market economies to assure competition and allow new investment. Barriers to entry from slow, expensive or arbitrary administrative procedures limit competition deter investment and may discourage innovation. The result will be a less dynamic and smaller economy with less consumer choice. Compared to other countries, many of the administrative steps necessary to establish a company appear to be superfluous, the excessive documentation in the various steps do not seem to fulfill a justified purpose, the inspections conducted at many stages of the procedures are excessive and the lack of coordination between involved administrative bodies give rise to lengthy procedures for construction of plants and a significant burden for businesses.

For a typical investment project that is “unhealthy” or “environmentally sensitive”, there are 6 major steps of permitting process: site selection permit, facility permit, building permit, occupancy permit, trial permit, unhealthy establishment opening permit. Many of the difficulties encountered by investors at the various stages of project approvals are related to the existing systems of government land development planning and environment protection. Investment projects may be subject to a Preliminary Environmental Impact Assessment (PEIA) or an Environmental Impact Assessment (EIA) depending on their field of activity. Obtaining a PEIA approval reportedly took from 6 months to a year, depending on each individual case. EIA report approvals reportedly took from 8 months to 2 years, depending on the complexity of the project. With the new regulation, while the duration it takes for the EIA report approvals has shortened



and the need for a report of PEIA has annulled, there is now a new step instead, “the method of selecting and eliminating the investment projects”.

Overlapping laws and institutions exist today to govern the implementation of environmental protection.

Up to the 1980s, environmental protection had been mainly a concern of the Law on Public Health, under the responsibility of the Ministry of Public Health (MOPH). In 1983, the government stipulated the Law on Environment, to provide a more focused approach to protect the environment. The Ministry of Environment (MOE)⁴ was created in 1991 as a specialized authority to implement the new law. In the meantime, however, the government did not revise the Law on Public Health and many of the institutional functions of MOPH in the light of the new legislation. Thus, two main sets of laws and institutions exist today to govern the implementation of environmental protection.

Lack of coordination among different ministries and agencies causes a major problem for effective operation.

The overlap of assumed responsibilities between the two laws and between The Ministry of Environment and Forestry (MOEF) and MOPH are obvious. For instance, both laws have schedules and annexes that list the same types of activities that are regarded “unhealthy” or “sensitive to the public environment,” and both subject those activities to special permitting requirements with almost identical aims.⁵ This means that the same industrial establishment has to fulfill two sets of legal obligations, obtain two sets of permits and licenses in establishing the projects, and be inspected and monitored by two different authorities at the operational stage – all for the same or similar purposes. An investor needs to find out how his planned activity is classified under each law and what specific regulatory requirements he has to fulfill. One often heard excuse for the existing overlap is that, as a relatively new ministry, MOEF does not have a strong enough institutional capacity. While the MOPH, on the contrary, is a long-existing ministry with relatively strong capacity, the lack of coordination among these ministries and agencies causes a major problem for effective operation.

Apart from the MOPH, there are several other ministries and authorities that have also been traditionally involved in environment-related decision-making processes based on different laws and regulations. These include, among others, the Ministry of Energy and Natural Resources, Ministry of Agriculture and Rural Affairs, General Directorate of State Hydraulic Works, and General Directorate of Bank of Provinces. Each ministry or authority may have some legitimate reason to be involved in some aspects of environmental protection, but overall, the lack of coordination among these ministries and agencies cause a major problem for effective operation. One of the intentions to create the MOEF was to enable a more synthesized approach to address

⁴ Ministry of Environment and Forestry since 2003 with merging the two Ministries of Environment and Forestry

⁵ For instance, both would aim to diminish or minimize the harmful impacts of unhealthy establishments that endanger the protection of the environment and public health, to control operations of these establishments in order to protect natural resources and environment.



the environmental issues. But this has not yet happened either at the legislative or the institutional level.

On the other hand the positive developments and accomplishments in the last two years regarding the improvement of the investment environment should not be disregarded. A series of measures are taken within the related reform program. Representatives of the public and private sector have worked together during these works for the improvement of the investment environment in order to determine the problematic areas. Joint works to resolve the existing difficulties in these areas are ongoing. Under the Improvement of the Investment Environment Coordination Board, Technical Committee of Sectoral Permits handled with many subjects under different sub-committees (mining, tourism, foodstuff, medicine, chemistry). The measures developed under this committee should be put into effect urgently.

Recommendations

Speed up the implementation process. Although some progress on improvements have been realized within the framework of the Improvement of the Investment Environment Coordination Council works, adequate results have not been obtained in the implementation. Numerous governmental bodies involved in the process makes the discussions too lengthy and the hesitations among these bodies to give up their right of approval, makes it almost impossible to reach at a satisfactory solution.

Enable a more coordinated procedure. Through a central coordinating mechanism, companies should have access to public authorities at all levels when completing the registration requirements. It apparently makes a decisive difference which authority the investor has to deal with if he needs to obtain permits or registrations for his business.

Enhance clear, transparent rules and regulations. Considering the public benefit, it is necessary to avoid delays in all fields of decision-making process, to avoid arbitrariness and sustain the decision making process on the grounds of objectiveness.

8. LAND AND REAL ESTATE

There is a shortage of appropriate land for investment although Turkey is a land-rich country.

With a territory of 780,576 square kilometers, Turkey is larger than many European countries. Moreover, the country has a variety of geographic features, and much of its land is suitable for agricultural, tourism and industrial development. About 45%⁶ of the land in the country is privately owned and the rest is in the hands of the State, often referred to as the “treasury land.”

Since the 1980s, the government has made a conscientious effort to transfer state land to the hands of the private sector to encourage investments. In doing so, it has given priorities to the

⁶ Estimate of General Directorate of National Property (*Milli Emlak*)



sectors of tourism, manufacturing industries and SMEs, and resorted to a variety of mechanisms, such as long-term leases, sales and free allocations under set conditions. Despite these positive experiences, there are general difficulties encountered by investors in accessing state land. The overall process is lengthy and procedures involved are not always clear, especially if the land under application is outside the “organized zones.”

However, there is no discrimination between domestic and foreign investors concerning land ownership.

In Turkey, acquisition of land by foreign individuals is determined based on the principle of reciprocity between Turkey and the country of origin of the foreigner. However, foreign companies that are registered in Turkey are regarded as the legal persons of the country and, thus, can acquire land.

The country suffers from a lack of proper space planning.

A national land development strategy and plan does not exist at the present. As a result, there is no coherent and consistent land use guidance given to the local governments. The absence of the national plans limits the initiatives of modern land use planning at the local levels and causes a number of approvals and permits, to remain in effect which would otherwise be irrelevant. Moreover, all municipalities responsible for local land development planning suffer from budgetary constraints and weak institutional capacity, and most of them have not completed or updated their plans of 1/5000 and 1/1000 scales. Incomplete land development plans cause serious difficulties for individual investors to “comply with” such plans, as required by the law. When proposing their individual projects, they often have to start with the preparation of a City Plan, an Implementation Plan and a Parcellation Plan, all subject to difficult and time-consuming approvals. The lack of a proactive land use planning is also reflected in the slow updating of the “agricultural” land at the national level.

Recommendations

It is crucial to recognize that, unless more state land suitable for modern development is made available to private investors, investment growth will continue to face a bottleneck due to shortage of land supply in the private land market.

Improve the process to allocate state land to private investors. Turkey already has the basic principle and system supporting the transfer of state land to the private sector, but the process needs improvement. The problems encountered so far in the process cannot be just attributable to procedures but also has roots in legislative ethics. The improvement of the procedures, therefore, will take a lot more effort related to privatization and civil service reform than simply removing administrative barriers.

Further develop industrial zones. More industrial zones are needed because of the general lack of industrial land in the country. Outside the organized industrial zones, indeed, land available for new investment projects is very hard to find. In most cases re-zoning would be required to convert the agricultural land to commercial uses, which is a very lengthy and difficult process.



Industrial zones can also help the country use limited resources on concentrated development of industrial infrastructure and encourage industrial clustering – an approach that could be sensible for the long-term development of the economy.

Rehabilitation of the Organized Industrial Zones (OIZ) Budget allocations should be made for completing the insufficient and incomplete infrastructure on most of the Organized Industrial Zones, to promote the investment the incentives and subsidies should be rearranged and an action plan should be implemented to convince investors to establish their facilities in existing OIZs.

Finally, necessary steps should be taken to realize the amendments to be made in Land Development Law in line with the private sector demands and necessary regulations should be made so that Regulatory Partnership Share (DOP) could be performed only at the stage of preparing the development plans and all land requirements in the planned territories should be made only by expropriation.

9. INFRASTRUCTURE

Turkey should enhance its basic and technological infrastructure in order to attract more FDI.

Basic and technological infrastructure is one of the basic determinants of attractiveness and competitiveness of a country. According to IMD World Competitiveness Yearbook 2003, Turkey ranks 25th among 30 countries in terms of basic infrastructure. The performance with respect to technological and scientific infrastructure is not also promising.

Infrastructure is costly and quality is a concern.

Turkey should develop its infrastructure to attract FDI. Where does Turkey stand with respect to its competitors⁷?

- There are 28 main and 30 mobile telephone lines per 100 people in Turkey. Whereas the figure for Ireland and Spain is almost the double. The e-government project and additional FDI will necessitate further capacity for fixed and GSM lines.
- The electricity consumption per capita of Turkey (1468 kw/h) is well below the world average (2176 kwH). Electricity costs for industrial clients (0.095\$ per kwH) are the highest in OECD. Yet, the potential demand for electricity will be a driving force for future investment. (Currently expensive and short in supply.)
- The percentage of paved roads is around 34% of the total roads. The figure for Ireland is around 94%, for Poland it is around 68%.

⁷ World Development Indicators, 2003



The need to improve infrastructure points out potential infrastructure investments for the coming years.

FDI may prove to be an important component of infrastructure development and privatization in Turkey. Foreign investors consider the privatization of infrastructure even more important and infrastructure privatizations among all have the strongest impact on attracting additional FDI into a country. Not only do they attract investment to power, telecommunications, transport, and water sectors, but also improve the condition of infrastructure services, which is an important component of FDI attraction and productivity increase. Establishment of an appropriate regulatory framework will introduce real competition in the infrastructure sectors.

The lack of infrastructure should not hinder FDI but turn into potential new investments and FDI in the future.

In order to make an opportunity out of a challenge Turkey needs greater persistence in creating the necessary regulatory bodies for infrastructure. The establishment of an appropriate regulatory framework to introduce real competition in the infrastructure sectors is needed.

Liberalizing the infrastructure sectors properly will help to solve the problems and stimulate FDI.

Turkey performs almost the worst after Mexico among the OECD countries in infrastructure capacity, pricing and quality in energy and telecommunications. The prices when compared in terms of purchasing power parity became even higher. Furthermore, the prices applied to the industry for electricity and natural gas are the highest amongst the OECD countries. The high tax rates contribute to the level of prices. The differentiated price structure between industry and households indicate that the industry subsidizes the prices for the households. This off course hinders the competitiveness of the industry.

Studies show that liberalizing the natural monopoly sectors such as telecommunications, transport and energy, increases productivity, investments in that sector, product differentiation and product quality as well as reduce prices. However, having a proper regulation, which prevents dominant positions in the markets, is crucial for yielding the expected positive results of liberalization. In this sense, Turkey should continue its reform program in these sectors. The regulatory environment should be designed to attract FDI to these sectors, which will result in enhanced competition, and as a result of it better quality at lower costs.



ACHIEVEMENTS IN BUSINESS ENVIRONMENT

1. IMPROVEMENT OF THE INVESTMENT ENVIRONMENT COORDINATION COUNCIL (IIECC)

A Reform Program was launched for the Improvement of the Investment Climate in Turkey

In 2001, an initiative has been started to make Turkey a more attractive location for foreign investment. Since the unnecessary, time consuming and complex administrative procedures are among major setbacks to foreign investments, and can discourage the investors despite other attractive features that a country may offer, a reform process to improve administrative cumbersome procedures has been launched.

At the request of the Undersecretary of Treasury, the Foreign Investment Advisory Service (FIAS) has conducted a study on administrative barriers to investment. Taking into account the findings and recommendations of this diagnostic study, the Government of Turkey has enacted a "Principle Decision on the Reform Program for Improving the Investment Climate in Turkey" on December 11, 2001.

Immediately after the decision, a coordination body - Improvement of the Investment Environment Coordination Council (IIECC) has been established with the participation of Government officials and private sector organizations. The mission of the Council is to identify and then to remove regulatory and administrative barriers that impede both foreign and local investments. In this context, 9 technical subcommittees, in line with the findings and recommendations on FIAS report, are formed on the problematic areas in need of improvement. Their scope was:

- Foreign Direct Investment legislation,
- Promotion of Investment,
- Company Registration and Reporting,
- Employment,
- Sectoral Licenses,
- Land Acquisition and Site Development,
- Taxes and Incentives,
- Customs and Standards,
- Intellectual Property Rights,

In addition to the bureaucrats, representatives of the four most important Non Governmental Organizations – Turkish Union of Chambers and Stock Exchanges (TOBB), Turkish Industrialists' and Businessmen's Association (TUSIAD), Foreign Investors Association (YASED) and Turkish Exporters' Assembly (TIM) – have also worked within these committees. Works of the Technical Committees are being evaluated at the IIECC which is a Supreme



Council chaired by State Minister Ali Babacan. Chairmen of TOBB, TÜSİAD, YASED and TİM are natural members of the IIECC.

There have been improvements that have a direct, significant and immediate impact on foreign investors.

Major improvements on the basis of the recommendations of the IIECC committees are the following;

- *Enactment of Foreign Direct Investment Law*, which removed the screening and pre-approval procedures, simplified the procedures and bureaucratic formalities and reemphasized the principle of equal treatment.
- Enactment of a Law concerning the revision of Commercial Law and various other relevant laws, which redesigns and simplifies *company registration process* through eliminating complex and long administrative procedures for both local and foreign investors.
- Enactment of the Law concerning the *Employment of Foreigners in Turkey*, which has simplified and accelerated the process of obtaining a work permit.
- Enactment of the *Law Amending the Public Procurement Law*, which broadens the definition of “domestic tenderer” to include foreign capital companies established in Turkey. Through this change, foreign capital companies established in Turkey have the same rights and subject to the same conditions with local companies with respect to the public procurements.
- Enactment of Law no 4916 **amending the Registry of Title Deed Law** granting the foreign real persons and foreign companies established abroad to acquire a real estate in Turkey on the principle of reciprocity. The reciprocity shall mean that the rights granted by the other country to its own citizens and companies should be granted to the Turkish citizens and companies, as with the same conditions. The principle of reciprocity is not applied in establishing restricted in kind rights on the real estate in favor of the foreign real persons and foreign companies established abroad.

However, the achievements under IIECC have been limited because of the lack of determination of the bureaucrats.

The technical committees are presently working on their own technical areas and formulating solutions and legislative amendments to the predefined hindrances, problematic issues and regulations impeding the investment. Meanwhile, the Government declares and shows its commitment to take the necessary steps to enact laws on the basis of the recommendations of the technical committees. However, the progress is slow and the achievements under IIECC have been limited. Main reason of this drawback is the hesitation on the part of the different representatives of the state bureaucracy to give up their responsibilities.



2. FDI LAW

A liberal foreign investment environment was introduced with the new Foreign Direct Investment Law.

Having been in effect since 1954, the Foreign Capital Incentives Law number 6224 has been abolished with the new Foreign Direct Investment Law, which entered into force on 17 June 2003. This represents a significant initial step towards the removal of the disparity between domestic and foreign investors and the reduction of bureaucratic procedures into one-stop. The investment environment would improve dramatically by the removal of bureaucratic procedures, by the improvement in the procedures to establish companies and by making it possible for foreign investors to obtain real estates. It is expected that these improvements would contribute to the extension of foreign direct investments the stock of which amounts to \$15.6 billions as of 2002.

The Law describes Foreign Investors as real persons who are foreign nationals and Turkish nationals residing in foreign countries as well as legal entities and international organizations established under foreign laws who effect direct foreign investments in Turkey. It also describes the liberal foreign investment environment regarding:

- Freedom to investment: Unless otherwise required by the international agreements and special statutory provisions, foreign investors are free to make direct investments in Turkey.
- Freedom of profit transfers through banks and private financial institutions
- Acquisition of real estate: Foreign capitalized companies would be able to acquire real estates.
- Settlement of disputes, international arbitration: The law assures foreign investors of the right to apply either to the authorized local courts, or to national and international arbitration or other means of dispute settlement.
- Assessment of the value of non-cash capital: The non-cash capital valuation of foreign investors would be accepted as it is in home countries. So, it is expected that the foreign direct investments would accelerate.
- Employment of foreign personnel: Previously, the General Directorate of Foreign Investment issued working permits for foreign personnel. With this new law, it will be issued by the Ministry of Labor and Social Security. So, it is expected that the regulation to determine the concrete procedures and rules would be issued promptly. Moreover, the Ministry should allocate the duties of issuing working permits to its officials who have foreign languages skills, i.e. English.



3. ACCOUNTING STANDARDS

There have been significant improvements in the accounting framework in Turkey in the last year.

In a world of continuous change, global companies need to present their performance in a way that is easily understood by the competitive global markets in order to benefit from the gifts of the economic globalization. Financial reporting reaches a wider audience than ever before, an audience that demands relevance, transparency and credibility in financial reporting. Hence, internationally acknowledged standards gain great importance in the face of global economic trends. Within this framework, IAS compatible accounting standards in a country create room for enhanced investor confidence and finance raising capabilities, improved comparability with the peers and consistent financial information to effectively manage the business.

Considering these global trends and changes, it can be concluded that there have been significant improvements in the accounting framework in Turkey in the last year. The Turkish Capital Markets Board (CMB) initiated a project at the beginning of year 2003 for the adoption of International Financial Reporting Standards (IFRS/formerly IAS). The project was finalized towards the end of the year and the new CMB communiqué No: XI / 25 has been published. This new communiqué dictates new CMB standards that are almost identical with IFRS with the exception of a few points/aspects, and will be applicable for the financial statements of all companies quoted on the Istanbul Stock Exchange (ISE) for the financial period beginning on or after 1 January 2005. XI / 25 encourages early adoption (for financial statements as at 31 December 2003 and onwards) and also gives the option to companies in Turkey to use IFRS financial statements as their main reporting sets of accounts. It is thus expected that many Turkish publicly quoted companies will be publishing IFRS accounts in early 2004.

Further to International Financial Reporting Standards, Hyperinflationary Accounting has also become effective.

The new CMB communiqué No: XI / 25 can be considered as a great step towards providing the Turkish firms with effective financial reporting. It will provide Turkish firms with easy access to capital and a strong competitive power in the global markets; will increase the FDI flows to the country and will lead to improvement of capital markets in Turkey.

In addition to the release of this new communiqué, that will be effective from 1 January 2005, two individual new standards of the CMB, namely, XI / 20 “Hyperinflationary Accounting” and XI/21 “Consolidation Accounting”, has already become effective for all quoted companies as of 31 December 2003. This represents a significant step forward in the accounting profession in Turkey.

All the financial statements that will be publicly announced during 2004 will be adjusted for inflation and requirements for reporting for group companies will be adopted. These two new standards are in line with the relevant IFRS.



Apart from the new developments introduced by the CMB, Ministry of Finance has promulgated the new tax law numbered 5024; “Application of Inflation Adjustment”, which comes into force on 1 January 2004. In this context, all companies are required to restate their financial statements and calculate the tax base taking the inflation adjustments in to account. This new law is important for the corporate sector, as there has been a strong lobby for inflation accounting to be applied in the tax laws, for many years in Turkey.

4. COMPANY ESTABLISHMENT

Foreign investors are now entitled to establish any form of company included in the Turkish Commercial Code.

The new FDI Law brought about some positive developments concerning the establishment of foreign companies. Under the stipulation of the new law, foreign investors will be able to form a partnership in Turkey. In the old regime, foreign investors were only allowed to form a joint stock company or a limited company, under the present regime, they are entitled to establish any form of company included in the Turkish Commercial Code.

The new Law has retained the permission requirement for Liaison Offices. Liaison offices are special type of offices whose main activity is to conduct market research and feasibility studies and to accumulate investment opportunities in the Turkish market on behalf of their head offices. They are not allowed to carry on any commercial activity. Foreign investors are required to obtain permission from General Directorate of Foreign Investment to open a liaison office in Turkey. The initial permission is given for 3 years, which can be extended at depending on the activities performed in the last 3 years and future plans of the head office.

Cumbersome company establishment procedures notably simplified.

Time-consuming and complex company establishment procedure of Turkey has been the cause of the frequent complaints of both local and foreign investors; however, the problem could not be solved due to various reasons. Finally, the issue was designated as one of the activity fields of the IIECC established in accordance with the Reform Program for the Improvement of the Investment Environment in Turkey. Subsequently, the special technical committee established under IIECC “for company establishment” worked on the issue.

A draft law prepared by the Government that takes the results of these works into consideration and that projects amendments in (5) different laws (Turkish Commercial Code, Stamp Duty Law, Procedural Tax Law, Labor Law and Social Security Law), has been legislated at the Turkish Parliament as Law No: 4884 and has come into effect as of 17 June 2003 by its publication in the Official Gazette on the same day. The Law avoids unnecessary and recurring transactions encountered at company establishment and enables the completion of the establishment transaction at a single authority within the same day.

Thus, as pointed out in the reasoning statement of Law No: 4884, commerce, commercial entrepreneurship and local and foreign investors shall be encouraged; effort and time losses of



the entrepreneurs shall be prevented by efficient, productive and rapid fulfillment of public services through reduction of red tape.

The new law decreases the number of steps for establishing a company from 19 to 3.

The major changes introduced by this law to be effective as of 17 June 2003 briefly are;

- 1) Permit requirement from the Ministry of Industry and Commerce for joint stock companies and limited liability companies prior to establishment and in the amendments to the articles of associations thereof has been repealed,
- 2) The option to have the books certified by the commercial registry offices, as alternative to notary publics at the establishment stage of the companies has been facilitated,
- 3) It is provisioned that the notifications for initiation of operation, employment of personnel and number of personnel employed which until today were being served separately tax offices and Social Security Authority, will be served exclusively to the commercial registry offices at the stage of company establishment,
- 4) It has been facilitated for real persons to serve the notification of initiation of operation obligatory in accordance with tax laws, within (10) days following the initiation of operation.



WHAT NEEDS TO BE DONE?

Although Turkey has adopted numerous legal changes in order to improve her investment environment, these changes have not produced the desired outcomes in FDI inflows yet.

In fact, since 2002 Turkey has adopted numerous legal changes in order to improve her investment environment. Formation of the Improvement of the Investment Environment Coordination Council (IIECC)⁸ was a crucial step because it represents a significant change in mentality towards foreign investment on the part of bureaucrats and politicians. With the new FDI law, approved in June 2003, equal treatment principle was adopted, so that foreign investors acquire same rights and obligations with that of domestic investors.

However, new arrangements in investment environment have not produced the desired outcomes in FDI inflows yet. This underperformance is closely related to still required improvements notwithstanding the increased competition between countries to attract more FDI.

In 1990s while worldwide FDI have increased substantially and developing countries classified as Turkey's competitors received substantial shares of this growth; supporting their country's development; Turkey could not sustain her favorable position it reached in the early 90's and lingered in attracting foreign investments. Fast declines in global FDI movements in the last years have introduced fierce competition between countries. This competition is yet more noticeable among developing countries, which require foreign investments even more. Competition between Turkey and the neighboring countries have gained particular significance, following the entry of countries in the Central and Eastern Europe into the market after the 90s. Some countries attract much more than USD 17 billion FDI value in one year, which is the amount that Turkey attracted in 50 years.

Within this picture, in order to reach its potential in attracting foreign investment, Turkey urgently has to solve the problems that hinder foreign investors' decisions in choosing Turkey as an investment location and has to promote the country more actively and effectively in the international arena.

There are a number of specific policy actions that the government may want to consider to improve the FDI environment. However, it should be noted again that only if political and economic stability were sustained, more specific efforts targeted at improving the investment environment would succeed.

1. A CLEAR STRATEGY

In order to make a breakthrough Turkey has to clearly define its FDI strategy and improve its reform management process.

⁸ See Annex I for more information about IIECB



Apart from flaws in its business environment, Turkey has obviously failed to define a clear cut strategy for FDI. Turkey should first define its objective: FDI for compensating for low level of domestic savings, or creating positive externalities for host country such as technology transfer, best management practices, increased labor quality, export promotion, increased competition environment. If the aim is to increase the overall attractiveness of the country, the appropriate strategy would be to improve the investment environment. However, if FDI is wanted for particular sector or regions, than a targeted strategy will be needed. The strategy and policy options and tools should be defined after reaching a clarity on the objectives. Otherwise, it is highly probable that FDI incentives may not produce the desired outcome or that the same outcome might have been produced with less cost. For the appropriateness and effectiveness of the incentive policies, there should be clarity on what these incentives are meant to achieve and how. Furthermore, the linkages between FDI attraction and other policy objectives should be clearly defined.⁹

FDI incentives hardly offer to be a substitute of an enabling investment environment.

Creating an enabling investment environment is often less costly when compared with generous incentive schemes for FDI, the efficiency and effectiveness of which is not for sure. Henceforth, the priority for Turkey should be to improve the business environment.

Some of the significant steps to be rapidly taken are as follows

⁹ OECD, Checklist for Foreign Direct Investment Incentive Policies



- Sustain political and economic stability
- Change the vicious circle of bureaucratic envy and struggle for power to a virtuous circle of mutual understanding and cooperation
- Make the importance of the private sector in Turkey's development well understood by state officials
- Give the reform process to the care of those who have faith in market economy
- Simplify the currently complicated tax system, decrease the taxes on various transactions and eliminate volatility of the tax environment
- Provide a stable and non-discriminatory environment
- Simplify and streamline the bureaucratic processes
- Safeguard public sector transparency, including an impartial system of courts and law enforcement
- Reduce Social Security Premiums that constitute a major factor in Labor costs
- Increase transparency in the incentive legislation and develop and implement incentive mechanisms used by countries successful in attracting FDI such as providing free land, tax holiday for a certain start-up period and so on
- Establish an appropriate regulatory framework in order to introduce fair competition in all sectors and especially in the infrastructure sectors
- Foster privatization
- Fight against corruption
- Avoid unrecorded economic practice

2. NEED FOR RESTRUCTURING IIECC (IMPROVEMENT OF THE INVESTMENT ENVIRONMENT COORDINATION COUNCIL)

An ongoing reform program, aiming at attracting foreign investments to Turkey and improving the investments conditions of foreign and domestic investors, is in place since 2002.

Governments in Turkey are carrying out a series of reform works since 2002 aiming at attracting foreign investments to Turkey and improving the investments conditions of foreign and domestic investors. Subjects handled within the reform framework include Company Establishment, Employment, Sectoral Permits, Investment Location, Taxes and Incentives, Customs and Standards, Intellectual Property Rights, Investment Regulation, Investment Promotion and Small



and Medium Size Enterprises. Works have been carried out through committees and sub committees established for each of these subjects.

However, the results achieved so far, falls below expectations.

The objective of the IIECC works is to create a platform to understand the difficulties encountered by the investors, to have an open discussion on these issues between the private sector and the public sector representatives and to explore solution alternatives. The private sector representatives are working in harmony to highlight the problem areas and formulate solutions and discuss these with the public sector representatives. However, most of the IIECC meetings do not produce concrete and satisfactory results.

In order to transform Turkey into an attractive place for foreign investors, result oriented works have to be carried out rapidly at IIECC and the required regulation amendments should rapidly be realized. Besides the realization of regulation amendments the most important criteria here is to score progress in the implementation as well. Although some progress on improvements have been realized within the framework of the IIECC works, adequate results have not been obtained in the implementation. The approach and determination of the 59th Government is very encouraging. Although there is political will to resolve the issues that investors face, the same understanding should also be adopted by bureaucrats who are in charge of regulation and implementation.

IIECC should be reorganized through private sector know-how to produce better results.

Working principles of IIECC should be made similar to those of the private sector. Several important changes should be made to increase the efficiency and effectiveness of these committees such as:

- Ultimate outcomes, responsibilities and time schedules should be determined.
- Those who bear the responsibilities should be accountable for not meeting the targets.
- There should be a transparent knowledge sharing among the governmental bodies and private sector representatives.
- The Council should also be accountable to AIC.
- There should be periodic assessments of the progress to the Council of Ministers and the public.
- The Council itself should set the strategy and monitor and evaluate the outcome.
- The technical committees should be co-chaired by the private sector.
- The technical committees should meet with a preset time schedule, agenda, appropriate documentation and background work.



- The secretariat should be fortified to carry the massive workload of minutes, on-line information sharing, reporting, conducting research for strategy development and impact assessment studies.

3. INVESTMENT PROMOTION

After putting in place a clear strategy to promote FDI, Turkey needs to explain its attractiveness for foreign investors through an Investment Promotion Agency.

The ideas developed to promote more FDI through an Investment Promotion Agency (IPA) are highly welcomed. But promoting FDI makes only sense if the rules for FDI inflow are defined, attractive for foreign investors and overall wanted by the government. The most essential thing to increase FDI is the mindset of the inviting country. The IPA in this sense should have a marketing function to promote what is set-up in a well-defined FDI-law. Such an agency may execute a long-term promotion program especially to correct the prejudice and disinformation about Turkey in the EU countries as well as the US and to develop a better image in the eyes of international investors by establishing a focused and pro-active promotion institution according to international best practice that best suits Turkish promotional needs. The institution would also be a focal point to advocate improvements in the FDI environment.

The investment promotion agency that is expected to be established in the first half of 2004, will carry on investor servicing, investment generation, image building and policy advocacy functions by means of various programs



ANNEXES

A.1 FAIR COMPETITION

A. Competition Law

Turkish Competition Law has been fully harmonized with European Union regulations. The Law on the Protection of Competition dated 1994 is the main legislation governing the competition rules in Turkey, which also established the Competition Authority in 1997. After its establishment, the Competition Authority has issued a series of communiqués that ensured a considerable harmonization with the EU in terms of competition policies, by means of closely following the EU practices. Competition Authority has targeted the task of surveillance and supervision of the economy as well as spreading the competition culture in the society. Competition policy focuses on three main areas of intervention directed at the realization of all these objectives:

- Prevention of agreements restricting competition and abuse of dominant position
- Control of mergers and acquisitions, prevention of attempts for mergers and acquisitions which would create a dominant position in the market and adversely affect competition
- Monitoring of state aids, prohibition of state aids contrary to efficiency and competition

Competition Authority, while implementing its task, tends to follow a similar approach with European Commission. Therefore a foreign investor may easily grasp the legal system in Turkey and find itself in familiar legal environment, which is quite similar with its origin country. Therefore, one can easily say that a foreign investor may adapt the similar principles of its origin country, from competition law perspective, for the operation and running of the business to be established in Turkey.

B. Anti-dumping Regulations

Following the adoption of the import liberalization policies after 1980, the need to protect the domestic industries from unfair trade practices emerged. Consequently, Turkey enacted its first anti-dumping code in 1989, namely, the Legislation on Prevention of Unfair Competition in Importation, which covers the provisions on the protection from dumped imports. After Turkey signed the Final Act of the Uruguay Round and the Marrakech Agreement Establishing the World Trade Organization, WTO Anti-Dumping Agreement became the main reference for the Turkish anti-dumping authority.

A further step was taken with the signing of Turkey-European Community Council Resolution, regulating the Customs Union. According to the provisions of the Resolution, the procedure relating to execution of measures will continue to be applied and consequently there will be no adverse effect on foreign investors due to aforementioned measures since the related procedures of anti dumping measures ensures that while protecting the domestic industries, the exporter



countries will not bear any damages. The harmonization of measures by means of international treaties constitutes another guarantee for foreign investors since the related regulations are accessible and predictable.

Turkey being a party to WTO Anti-Dumping Agreement and European Community Council Resolution undertook to follow certain procedures with regards to measures that are applied for the protection of domestic industry and harmonized its legislation with aforementioned international documents by issuing The Code Concerning Prevention Of Unfair Competition.

Turkish anti-dumping system has a commercial understanding as to preventing unfair competition in international commerce and competition as well as protecting the domestic industry of its own. Thus, Turkey, certainly fulfills the requirements of free trade, fair competition and meets the criteria set by EU and WTO.



A.2 ISSUES UNDER SECTORAL PERMITS

Under the Improvement of the Investment Environment Coordination Council, Technical Committee of Sectoral Permits handled with many subjects under different sub-committees (mining, tourism, foodstuff, medicine, chemistry). The decisions taken should be put into effect urgently.

- To ensure coherence between NHB Regulation and EIA
- To remove preliminary permit for emissions for the investment projects obtained EIA approval
- To lay down a time limit for the sectoral permits and to arrange legislation in the way of giving permission to the applicant if there is no response within this period.
- To make arrangements in the relevant legislation in order to obtain a single certificate for the site selection permit in the EIA process from the General Directorate of Health of Province and facility permit from the Ministry of Labor and Social Security in accordance with the Labor Law No: 1475
- To make arrangements in the relevant legislation in order to obtain a single certificate for the operating permit from the Ministry of Labor and Social Security in accordance with the Labor Law No: 1475 and unhealthy establishment opening permit from the MOPH
- To ensure competence between the Law No: 3572 on the amendment of the decree regarding the opening and operation permit with the Law No: 3030 on the Metropolitan Municipalities
- To ensure coherence between the definitions of facility and operation permits in the legislation of the food industry and to set up a General Directorate of Foodstuff under the Ministry of Agriculture and Rural Affairs concerning food production, consumption and control
- To bring the Mining Law No: 3213 on the agenda of Grand National Assembly of Turkey after the necessary amendments.
- To include the issues determined by the Sectoral Permits Committee in the Environment Law
- To make necessary amendments in the Water Pollution Regulation
- To make amendments in order to consider the necessary operations in the Law and Regulations of pastures under the EIA process



- To ensure the certification of Tourism Facilities and to reduce the relevant formalities

A.3 HARMONIZATION OF TURKISH LAW WITH INTERNATIONAL TREATIES AND LEGISLATION ON INTELLECTUAL AND INDUSTRIAL PROPERTY RIGHTS

1. International Agreements and Applicable Laws

The Republic of Turkey is a member of the World Intellectual Property Organization (WIPO) and signed the Agreement on Trade Relating Aspects of Intellectual Property Rights (TRIPS) of the World Trade Organization (WTO) since 1995. In addition, Turkey signed the following multilateral agreements in the field of industrial property:

- Paris Convention for the Protection of Industrial Property of 20 March 1883.
- Vienna Agreement Concerning the International Deposit of the Industrial Designs.
- Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of Registration of Marks of 15 June 1957.
- Locarno Agreement Establishing an International Patent Classification for Industrial Designs of 8 October 1968.
- Patent Cooperation Treaty of 17 June 1970.
- Strasbourg Agreement Concerning the International Patent Classification of 24 March 1971.
- Budapest Treaty on the International Recognition of the Deposit of Microorganisms for the Purposes of Patent Procedure of 18 April 1977.
- Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks of 17 June 1989.
- European Patent Convention (Munich) on Granting European Patents (effective: November 2000).
- International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations done at Rome on October 26. 1961 (Rome Convention)
- Berne Convention for the Protection of Literary and Artistic Works, Paris Act of July 24, 1971, as amended on September 28, 1979.

2. Several International Agreements are signed but not ratified yet:

- The Hague Agreement Concerning the International Deposit of Industrial Designs.
- Trademark Law Treaty of 27 October 1994.
- Patent Law Treaty.



- Act Revising the Convention on the Grant of European Patents.

3. The following laws protect intellectual property rights in Turkey:

- Law numbered 5000 on Establishment, Organization and Functioning of the Turkish Patent Institute
- Law numbered 5846 on the Protection of Intellectual and Artistic Works, as amended.
- Law numbered 3257 on Cinematography, Videos and Musical Artwork
- Decree Law No. 551 on the Protection of Patent Rights of 1995, as amended.
- Decree Law No. 554 on the protection of Industrial Designs of 1995, as amended.
- Decree Law No. 555 on the Protection of Geographical Signs of 1995, as amended.
- Decree Law No. 556 on the Protection of Trademarks of 1995, as amended.

A draft law on the protection of topographies of semiconductor products is on the agenda of the Parliament



A.4 INFRASTRUCTURE

Transport:

Highways account for a stunning 95% of passenger and 92% of goods transportation. Apart from the high potential for railways, bounded by seas on three sides, most analysts agree that Turkey has yet to exploit the huge potential presented by maritime transport. The percentage of paved roads in Turkey is around 25% of the total roads. The figure for Ireland is around 90%, for Poland it is around 65%. With air travel in a worldwide lull, airport projects, with the exception of new terminals in Dalaman and Antalya, have been suspended.

Significantly different conditions are still applied to international and domestic transport operations. Legislative arrangements, which are effective for international transport operations, should be extended to cover the domestic part of transport operations.

Turkey's most urgent infrastructure needs can be listed as follows:

- Improvement of the existing road infrastructure
- Extension of the road network towards East-Turkey
- Further investment in motorways as “metropol connections” is crucial.
- Improvement of poor rail conditions and inefficient operations
- Creation of opportunities for private involvement
- Expansion and improvement of railway lines around the ports
- Extension and the modernization of container terminals
- Elimination of bureaucratic procedures in the ports for in loading and unloading goods.

Telecommunication:

The players in the telecommunication market in Turkey are state-owned Türk Telekom and the four mobile operators, with a market size of approximately 7 billion USD. More than a decade of heavy investment since 1980's, Türk Telekom is highly modernized, the transmission network is expanded, the number of subscribers is significantly increased.

Telecommunications market has become competitive except voice transmission and infrastructure. The existing legal regulations envisage liberalizing the market completely by repealing the monopoly in above mentioned areas.



The law (Law no. 4673) stipulates that the monopoly of the incumbent operator will be repealed as soon as the publicly owned shares decrease to less than 50 per cent. This will lead to liberalization of telecommunications in the first half of 2004 in Turkey. The beginning of 2004 is the most important period for the development of Telecommunication infrastructure. The competent authorities are studying on necessary measures and legal arrangements in order to improve competition after the monopoly has been repealed. After the monopoly of telecommunication services will be removed in 2004, the means provided to one operator will be balanced with those of others in order to form positive competition relationships. For this reason, the players of the new environment and their roles, as well as the rules of the game should be carefully determined by the Telecommunications Authority.

The expected improvements are:

- Decreasing costs of international calls
- Decreasing costs of internet access

Which will take Turkey to a higher level among other comparative countries.

As stated in the Turkey's National Program prepared for the EU, many regulations that need to be prepared in a short time stand before the Telecommunications Authority.

The necessary steps to remove the monopoly on telecommunication services and the cancellation of the Turkish Telecom being mainly government owned structure are:

- Removal of the monopoly must be realized before the targeted date in 2004.
- In order for the Telecommunications Authority to prepare the necessary regulations in the shortest time, additional support to the Telecommunications Authority should be provided. Necessary precautions must be taken to avoid political pressure on Telecommunications Authority.
- Mainly government owned capital structure of Turkish Telecom must be cancelled in order for it to compete in equal conditions with the new operators.
- Telecommunications Authority should take the effective precautions to avoid dominant operators' usage of their dominant position for aims other than positive competition. For this reason, transparency based, cost oriented price practice should be provided.
- Rather than being preventive, the regulations should be paving way, and providing outcomes that result in the benefit of the society.
- For topics under the responsibility of other ministries that are out of the Telecommunications Authority's regulation area, coordination is required and the necessary regulations to fill the missing parts should be prepared with the contribution of sector representatives.



- In order to be effective and rapid, this work should be coordinated by a fully authorized undersecretariat connected to a ministry. Coordination of the regulatory bodies close to the telecommunications field should be provided.
- In order for local and foreign capital to invest in this relatively low profit sector, a consistent and permanent market, shaped by regulations without uncovered parts and uncertainties, is required.
- Removal of tax on communication expenses, limitation of taxation to only the tax paid by the firms, and the increase of usage as a result of the decrease in prices will lead to market growth.
- In order for the operator's investment to provide local value add and higher employment, encouraging measures should be taken. Local production, which is based on R&D, should be supported.
- Regulation on the unbundling of the local loop should be prepared.
- In order for Turkish Telecom to adapt to the competitive environment, it is important that it acts as rapid as private firms. For public adjudication in telecommunication sector, the system of the European Union comprises a special regulation. This regulation should be rapidly prepared.
- Any delay on the preparation of the regulation on VoIP, empowers the illegal applications, and makes it harder for legal VoIP to take place. Regulations on VoIP should be prepared without delay.

Energy:

Turkey's energy policy has switched from a government controlled to a competitive market focus approach. In the last 20 years, private sector share in power generation has increased from 0 to 40%. The sector is living through the below listed pains of transformation to a "free" market due to missing national energy policies:

- ◆ No clear cut policies and approaches regarding the transformation
- Chaos caused by the cancellation of licenses regarding distribution of energy
- Changing rules and regulations, and problems faced in privatization
- High energy prices set by public authorities for industrial usage compared to the EU countries
- Discussions about possible transfer of Build/Operate/Transfer (BOT) to public authorities
- Expected excess in supply until 2007-2010
- High loss and leakage rates



- Expectations from the government for a guarantee of additional investment in high voltage networks (transmission) as it is a state owned function of the sector. The need for a reliable and financially strong “wholesale” market

After the foundation of Energy Market Regulatory Authority (EMRA), Turkey has given high hopes in liberalization and deregulation. Below is a list of on-going and new measures:

- The Ministry of Energy and Natural Resources will focus on development of national energy policy with the support of to-be-founded “National Energy Institute”,
- The Ministry of Energy and Natural Resources has announced its will to decrease energy prices via taking necessary actions,
- EMRA will focus on market control, regulation and monitoring,
- Energy Corridor Project: Turkey aims to become the second largest economical energy bridge after Russia

In the coming two to three years, the electricity market will be able to constitute its own exchange. The transformation phase is expected to last until 2010.



A.5 STATUS REPORT OF THE LEGISLATIVE REFORMS UNDERTAKEN IN THE CONTEXT OF IMPROVEMENT OF THE INVESTMENT ENVIRONMENT COORDINATION COUNCIL (İIECC)

ENACTED LAWS	Law No	Date
1 Law for the Recruitment of Expatriates	4817	27.02.2003
2 Foreign Direct Investment Law	4875	05.06.2003
3 Law on Amending Various Laws Concerning Company Establishment	4884	11.06.2003
4 Labor Law	4857	22.05.2003
5 Law on Amending Public Procurement Law	4734	04.01.2002
	4735	04.01.2002
	4964	30.07.2003
6 Social Security Organization (SSK) Law	4784	08.01.2003
7 Law on Social Security Organization for the self-employed (Bağ-Kur)		
8 Law on Turkish Employment Institutions	4904	24.06.2003
9 Law on Amending State Pension Fund	4919	08.07.2003
10 Law on Establishment of the Social Security Organization	4947	16.07.2003
11 Law on Amending the Registry of Title Deed Law	4916	03.07.2003
12 Law Amending Tourism Incentives Law No: 4957	4957	24.07.2003
13 Law on Prohibition and Prosecution of Smuggling	4818	27.02.2003
14 Law Amending Decree Law 544 stipulating the Establishment, Organization and Functioning of the Patent Institute	5000	06.11.2003
15 Law Amending Various Tax Laws	5024	17.12.2003
16 Utilization of State Owned Land as an Investment Incentive: Law on Disposition of Immovable Assets by Foreigners		
17 Amendments to be made in Land Development Law No: 3194	5006	03.12.2003
18 Law on Inflationary Accounting	5024	17.12.2003

Communiqué accepted



1 Communiqué on transactions regarding the amendment of articles of association and establishment of joint stock companies and limited liability companies

LAWS IN LEGISLATIVE PROCESS

- 1 Draft Law concerning amendments in Decree Law No: 485 stipulating the Organization and Duties of the Undersecretariat of Customs and Draft Law on Customs Brokers
- 2 Draft Law Amending Mining Law and some articles of related laws
- 3 The new Draft Law on Environment
- 4 Draft Law Amending the Free Zones Law
- 5 Amendment in Law No: 3257 on Cinematography, Videos and Musical Artworks and its harmonization with Law No: 5486 on Intellectual and Artistic Works
- 6 Draft Law on Patents and Trademark Attorneys
- 7 Establishment of an Institute on Industrial and Intellectual Property Rights
- 8 Draft Law on Protection of Integrated Circuits
- 9 Draft Law on Investment Promotion Agency
- 10 Draft Law on National Vocational Standards
- 11 Harmonization of the “Facility” and “Activity” definitions in the Food Sector Legislation
- 12 Amendments in Laws and Decree Laws concerning Tourism and draft law on Tourism Sector Professional Unions
- 13 Framework Law for State Subsidies in Investments
- 14 Regulations on establishment of Self-Governing Incentive Mechanisms in Investments
- 15 Legal arrangements necessary for the enforcement of the Inward Processing Regime under the umbrella of the Undersecretariat of Customs
- 16 Harmonization of the Free Zones Law No: 3218 and Customs Law No: 4458
- 17 Amendments in Meadows Law No: 4342 and Organized Industrial Zones Law No: 4562



18 Amendments in Organized Industrial Zones Law No: 4562



A.6 STATISTICAL ANNEX