

POTENTIAL EFFECTS OF EU MEMBERSHIP ON TURKISH FOREIGN
DIRECT INVESTMENT INFLOWS: IMPLICATIONS OF EXPERIENCES OF
IRELAND, SPAIN AND POLAND

A THESIS SUBMITTED TO
THE GRADUATE SCHOOL OF SOCIAL SCIENCES
OF
MIDDLE EAST TECHNICAL UNIVERSITY

BY

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IN PARTIAL FULFILMENT OF THE REQUIREMENTS
FOR
THE DEGREE OF MASTER OF SCIENCE
IN
EUROPEAN STUDIES

MAY 2006

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ABSTRACT

POTENTIAL EFFECTS OF EU MEMBERSHIP ON TURKISH FDI INFLOWS: IMPLICATIONS OF EXPERIENCES OF IRELAND, SPAIN AND POLAND

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M.S., European Studies

Supervisor: Assoc. Prof. Dr. Aylin Ege

May 2006, 152 pages

This thesis aims to analyse the implications of European Union (EU) membership on Foreign Direct Investment (FDI) inflows to Turkey by applying a comparative methodology. The effects of EU accession on FDI inflows to three present member states, Ireland, Spain and Poland, is investigated in order to draw conclusions for Turkish case. The attractiveness of each country in terms of locational determinants of FDI are evaluated. Application of our findings in Ireland, Spain and Poland on Turkish case signifies implications of these determinants on attractiveness of Turkey in terms of FDI inflows. The results of the comparative analysis indicated that “distance” and “market size” are going to be essential determinants together with the other four determinants, namely “infrastructure and human resources”, “macroeconomic stability”, “openness and business environment” and “incentive schemes”, which will have positive consequences on FDI inflows on the condition that appropriate policies are implemented. EU membership is found to have positive implications on FDI inflows by indirectly affecting the other determinants. In general, it is concluded that sustainability of FDI inflows in the long-term is again related to the improvements in the other determinants of FDI rather than EU membership.

General Keywords: FDI, Determinants, Turkey, Ireland, Spain, Poland, European Union

ÖZ

AB ÜYELİĞİNİN TÜRKİYE'YE DOĞRUDAN YABANCI SERMAYE GİRİŞLERİ ÜZERİNDEKİ MUHTEMEL ETKİLERİ: İRLANDA, İSPANYA VE POLONYA'NIN DENEYİMLERİNİN SONUÇLARI

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Yüksek Lisans, Avrupa Çalışmaları

Tez Yöneticisi: Doç. Dr. Aylin Ege

Mayıs 2006, 152 sayfa

Bu tez Avrupa Birliği(AB) üyeliğinin Türkiye'ye Doğrudan Yabancı Sermaye (DYS) girişleri üzerindeki etkilerini kıyaslama yöntemiyle incelemeyi amaçlamaktadır. Bu amaçla, halen AB üyesi İrlanda, İspanya ve Polonya'nın deneyimlerinden Türkiye için çıkarılabilecek sonuçlar araştırılmaktadır. Her ülkenin yabancı sermaye belirleyicilerinin o ülkenin DYS çekebilme gücü üzerindeki etkileri değerlendirilmektedir. İrlanda, İspanya ve Polonya örneklerindeki bulguların Türkiye örneği üzerine uygulanması aynı belirleyicilerin Türkiye'yi DYS girişi açısından ne kadar cazip hale getirdiğini ortaya çıkarmıştır. Bu kıyaslamalı analiz, "uzaklık" ve "pazar büyüklüğü" gibi belirleyicilerin Türkiye'nin DYS çekebilmesi üzerinde doğrudan etkisi olacağını, "altyapı ve insan kaynakları", "makroekonomik istikrar", "açıklık ve iş ortamı" ve "teşvik sistemi" belirleyicinin ise uygun politikaların uygulanması halinde DYS girişleri üzerinde olumlu etki yapacağını ortaya çıkarmıştır. "AB üyeliği" belirleyicisinin ise diğer belirleyicileri etkileyerek DYS girişleri üzerinde dolaylı olarak olumlu etki yaptığı sonucuna varılmıştır. Sonuç olarak, uzun dönemde sürekli DYS girişi sağlanabilmesi için diğer belirleyicilerde ilerleme sağlanmasının AB üyeliğinden daha önemli olduğu belirlenmiştir.

Anahtar Kelimeler: DYS, Belirleyiciler, Türkiye, İrlanda, İspanya, Polonya, Avrupa Birliği

To My Parents

ACKNOWLEDGMENTS

I wish to express my deepest gratitude to my supervisor Assoc. Prof. Dr. Aylin Ege for her guidance, advice, criticism and insight throughout the research.

I would also like to thank Assoc. Prof. Dr. Cem Somel and Assist. Prof. Dr. Galip Yalman for their valuable suggestions and comments on this thesis.

I am grateful to my mother and father who always supported and encouraged me and done everything to help me to finish my thesis. I wish to thank my friends who motivated me in most difficult times.

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LIST OF ABBREVIATIONS

CEECs	Central and Eastern European Countries
CET	Common External Tariff
EAs	Europe Agreements
EU	European Union
EFTA	European Free Trade Area
EMU	European Monetary Union
FDI	Foreign Direct Investment
FTZs	Free Trade Zones
GDP	Gross Domestic Product
IDP	Investment Development Path
IDA	Investment Development Agency
IMP	Internal Market Programme
M&As	Mergers and Acquisitions
NTB	Non-Tariff Barriers
OECD	Organisation for Economic Cooperation and Development
OLI Paradigm	Ownership, Location and Internalisation
PAIZ	Polish Agency for Foreign Investment
SEZs	Special Export Zones
TNC	Transnational Corporations
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States
USD	United States Dollar
VAT	Value Added Tax
WTO	World Trade Organisation

CHAPTER I

INTRODUCTION

Turkey began accession negotiations with EU in 2005 more than forty years after signing of the Ankara Agreement in 1963. EU is the most advanced form of regional economic integration and after 1985 Turkey desired to be a member of this integration process. Main benefit to be obtained from membership has been perceived as economic gains which are expected to have positive implications on welfare. One of the positive consequences of membership is expected to be on FDI inflows. These expectations arise from experiences of some present member states. It is expected that EU accession will bring an influx of FDI to Turkey similar to the other countries that joined the EU in the past. In this framework, this study aims to check the validity of the argument that EU membership will give a boost to FDI inflows for the case of Turkey in the light of experiences of three present member states, namely Ireland, Spain and Poland.

These countries joined EU in the last three decades. They are all located in the periphery of Europe and prior to accession their economic development level had been below EU average. Thus, in general they all have been referred as "peripheral" which is the most suitable category to be compared with the Turkish case. The evidence to be obtained from the experiences of these three peripheral member states sheds light on our analysis of implications of EU accession on FDI inflows to Turkey. Thus, a comparative methodology is adopted throughout this study which is based on locational determinants of these three countries and Turkey.

The “determinants” of FDI can be defined as factors that determine the attractiveness of a country for foreign investors. In this study, the strengths and weaknesses of each of country in terms of these determinants are evaluated separately. The findings of these separate investigations are later compared with Turkish case. Thus, in general determinants provide us the necessary framework for our comparative analysis on implications of EU membership on FDI inflows. The comparative analysis based on FDI determinants of these three countries and Turkey, also indicates implications of membership on other aspects of FDI such as potential sources and sectoral destinations of FDI. Furthermore, the comparative analysis also provides evidences on the motivations of foreign investors.

As a starting point, the second chapter of the thesis presents FDI in a conceptual, historical and theoretical framework. Since FDI is a comprehensive concept involving a variety of actors and the complex nature of transactions among these actors, it is not possible to make a simple and comprehensive definition of FDI. However, the illustrative definitions suggested by several scholars and international institutions offer a general conceptual framework.

FDI evolved historically taking on new forms in new geographies. Global developments that took place since World War II provided diversifying motivations for potential investors. In some periods, investors were attracted by abundant resources while in later periods reaching larger markets gained more significance. Today FDI became a key concept in the globalization process.

The second chapter also provides a spectrum of theories in order to answer the question of why some firms are involved in FDI. Especially after the acceleration of globalization, several studies tried to provide theoretical explanations to this question. Some of them point to the market imperfections or oligopolistic advantages, some of them put forward theories like international production or product cycle. However, Dunning (1981, 1993) combined all these explanations in an eclectic fashion in his OLI (Ownership, Location, and

Internalization) paradigm. OLI Paradigm basically links Ownership advantages of firms with Location bound advantages to Internalize international activities.

In order to transform their primary motivations into actual investment, firms seek appropriate determinants in the targeted locations which make them more attractive for foreign investors. Some of these determinants, market size, natural resources and geographical location (distance) are already given assets. They do not necessitate any administrative or policy choices. However, the rest of determinants depend on definite policy choices. There are several determinants that can be grouped under this category. However, most commonly referred ones are infrastructure and human resources, labour costs, macroeconomic stability, openness and business environment, incentive schemes and regional integration schemes. In general, the determinants that have been identified in this chapter provide the framework of the comparative analysis applied to the case studies in the next section.

With this motive in mind, the third chapter of the study covers an analysis of the past experience regarding FDI inflows of three peripheral countries which became EU members in different dates, namely Ireland, Spain and Poland. In this part, the implications of locational determinants on the attractiveness of each country are investigated separately in order to reach conclusions for Turkish case. Consequences of EU membership of FDI inflows into these countries are investigated in terms of its implications on the other locational determinants.

These countries symbolise three different enlargements of EU in the last 33 years. All of these countries which are located at the periphery of EU have economic problems prior to membership and hence their stock of inward FDI was very low especially in comparison with the EU members at those times. Among these three countries, Ireland represents a small economy unlike Turkey. However, Irish economy shared similar characteristic with Turkey before EU accession. Ireland is a success story in terms of convergence with the EU and especially in attracting FDI although success did not come right after

membership. After the huge influx of FDI in 1990's owing to the right mixture of given advantages with effective policy choices, Ireland's FDI stock per capita is now among the top five in the world. Ireland, in this study represents a best practice model.

The other two countries, Spain and Poland, share similar characteristics with Turkey. They are larger markets with respect to their population and land size. Although there was an economic recovery in line with the democratisation process in 1980s, Spain was an underperforming economy prior to EU membership in 1986. After the accession, Spain received an influx of FDI which especially originated from EU. This surge of inflowing FDI to Spain lost its pace in 1990s, despite the economic convergence taking place. Poland represents the biggest market among the new members of EU. Passing through a transition stage to market economy, Poland is in the group of Visegrad countries which have the best performance among the Central and Eastern European Countries. Although opening of economy to foreign investments in early 1990's has given a boost to FDI inflows, the real surge of FDI inflows immediately took place in late 1990s after the EU accession process has been intensified. Thus Polish case provides the opportunity to observe the implication of pre-accession process on the prospective members of EU such as Turkey.

Fourth chapter initially provides a historical analysis of Turkish FDI inflows. Despite the boom of FDI inflows in 2005, stemming mainly from large scale privatisations, Turkey is an underperforming economy in terms of FDI inflows. Turkish case shows great resemblance with the above mentioned cases prior to accession. In order to speculate on what may change within the pre-accession process and after membership, FDI determinants of Turkey need to be analysed. The determinants are analysed comparatively with previous case studies, in order to evaluate the impact of EU membership on FDI inflows.

The final part concludes our comparative analysis with special emphasis on the implications of the experiences of Ireland, Spain and Poland for FDI inflows to Turkey after EU membership.

CHAPTER II

CONCEPTUAL, HISTORICAL AND THEORETICAL FRAMEWORK OF FDI

The second chapter of this study locates FDI in a conceptual, historical and theoretical framework. The definition of the concept arises from the set of relations among the actors in the world economy. The definitions proposed by the scholars and international institutions try to cover complexity of this relation. Thus this chapter provides a detailed illustration of this set of relations in which TNCs play the major role. In this sense, an analytical analysis of the characteristics of the TNCs and their organizational restructuring reveals the hints for their expanding role in the world economy. Furthermore, expanding role of TNCs is more evident when the historical evolution of FDI is examined. Statistical evidence illustrates the dominance of FDI over trade and TNCs strength as well. Statistical evidence further provides a general understanding about the ongoing trends in the world economy in terms of geographical and sectoral destination of FDI.

The striking statistical evidence clearly illustrates the dominance of FDI in the global economic transactions. However, underlying reasons of this trend is based on increasing propensity of some firms to involve in cross-border activities. Thus, most of the theories on FDI are generally aim to explain why some firms are involved in FDI. On the other hand, the motives of firms are not independent from the location bound factors which are referred as “determinants” in the literature.

2.1 Conceptual Framework of FDI

2.1.1 Definition of FDI

Globalisation changed the scope of world business by fostering the role of foreign companies in national economies. Firms are engaging in cross-border operations across the whole process of production, supply, marketing and financing activities. They are mainly aiming at expanding and achieving efficiency in their operations in order to increase their profitability. Internationalisation of the economic activities is realized on two channels: Trade and capital movements. Statistical evidence clearly indicates that capital movements have surpassed trade in the last two decades. However, among the capital movements it is necessary to make a distinction between portfolio investment and direct investment.

Portfolio investments represent passive holdings of securities such as foreign stocks, bonds, or other financial assets, none of which entails active management or control of the securities' issuer by the investor.¹ On the other hand, FDI establishes active long-term relationship between the investor and invested enterprise. Thus FDI require a longer-term commitment on the part of the investor. While portfolio investments provide no managerial control to the investor, FDI is associated with control, usually identified by ownership of a certain fraction of equity of a company. Thus FDI is defined as any foreign investment that results in a controlling stake of foreigners in a domestic production unit. According to WTO (1996), FDI occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset . It is the acquisition or establishment by a firm in one country of control over business activity in second

¹ Some examples of Portfolio investment are:

- purchase of shares in a foreign company.
- purchase of bonds issued by a foreign government.
- acquisition of assets in a foreign country. (OECD, 1996:3)

country. In this vein, Knight (1998) defines FDI as “establishment or purchase of plant and equipment or net inflows of controlling equity”. On the other hand, formal benchmark definition of OECD (1996) states that FDI is the objective of obtaining a lasting interest by a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor (direct investment enterprise).

Involvement in FDI gives the authority to the investor² who is operating in another country to exert a lasting and significant degree of influence in the management over another enterprise or to establish a new enterprise. This authority implies the existence of a long-term relationship between the direct investor and the invested enterprise. Existence of some other factors is also considered to be essential as an indication of direct investment relationship such as representation in the board of directors and involvement in the policy making process of direct investment enterprise. FDI also reveals the opportunity to realize inter-company transaction, interchange of managerial personnel, rendering of technical information, and offering of long-term loans at lower than existing market rates between direct investor and direct invested enterprise.³

Direct investors may have direct investment enterprises, which have subsidiaries, associates and branches in one country or in several countries. In subsidiaries, foreign investor owns more than half of the shares which bring certain rights to the foreign investor like the right to appoint or remove a majority of the members of the administrative, management or supervisory body. On the other hand in associates, foreign investor just owns 10 percent to 50 percent of shares while in branches even less than 10 percent. Holding more than 10 percent of share and voting power is considered to be a threshold to claim the

² Investor can be either an individual, a public or private enterprise, a government, a group of related individuals, a group of related enterprises which has a direct investment enterprise.

³ According to OECD (1996) FDI comprises three components:
a) new equity from the parent company in the home country to the subsidiary in the host country;
b) reinvested profits of the subsidiary;
c) Long and short term net loans from the parent to the subsidiary.

control of assets for the foreign investors. In general, the control of voting power in associates and branches are weaker.⁴

In order to cover the above mentioned features of FDI a simple comprehensive definition can be formulated. Taking into consideration the significance of the essential components such as “control”, “authority” and “lasting interest”, we can define FDI as a certain form of business relation that stems from a lasting commitment of an investor which provides an authority over an enterprise resident in another economy either acquired or established by the investor.

2.1.2 Actors of FDI: Transnational Corporations (TNCs)

The engines of the internationalisation of economies are TNCs who are comprised of parent enterprises and their foreign affiliates. Essential feature of FDI is that, a TNC maintains control over productive actions outside its boundaries. The parent enterprises hold the control of assets of other entities in countries other than its home country, usually by owning equity (OECD, 1996: 10).

TNCs organise themselves vertically and horizontally in order to reap market specific advantages. In general terms, horizontal TNCs carry out FDI in order to improve access to some host country market, while vertical FDI is undertaken in order to reap benefits from international factor price differences.

Vertical TNCs are firms that geographically fragment production into stages typically on the basis of factor intensities, locating skilled labour intensive activities in skilled labour abundant countries and unskilled labour intensive activities in labour abundant countries (Markusen and Maskus, 2002: 694). Headquarter services are intensive in physical and human capital, while production is intensive in manual labour. When factor prices differ across

⁴ In order to avoid confusion during this study, subsidiary enterprises, associate enterprises and branches will all be referred to as foreign affiliates.

countries, firms become multinational by locating production in countries where manual-labour costs are relatively low and headquarters in countries where skilled-labour costs are relatively low. Thus, vertical FDI is observed in countries abundant in low-skilled labour (Braconier, Norbäck and Urban, 2002: 5).

Horizontal TNCs are multiplant firms that approximately replicate the same activities in many locations. They produce abroad the same line of goods that are produced at home. The organizational structure is designed such that firms have high fixed cost headquarters and one or more production plants. When trade costs are low, a firm produces all output in domestic plants and serves foreign consumers through exports. When trade costs are high, a firm becomes multinational by building production plants both at home and abroad, each serving only local consumers. Most horizontally integrated TNCs are concentrated in advanced industrial economies (Slaughter, 2002:12).

In the literature about vertical and horizontal FDI, there are diverging views on the significance of these two models in terms of global FDI flows. Markusen and Maskus (2002), Blonigen and Brainard (1993) through empirical research across several cases of FDI, found out that horizontal model has dominance over the vertical one. These studies mostly support the hypothesis that FDI is generally flowing between developed countries. Thus horizontal investment is much more dominant in the world economy.

On the other hand Braconier, Norbäck and Urban (2002) found sufficient support for vertical FDI in the sense that TNCs' affiliate activities are affected by relative wage costs. Similarly, Helpman (1984) found that relative factor costs are important for explaining patterns of FDI. Dunning (1998) also underlined the fact that recent developments in the world economies especially brought up by technological advances strongly provided the surge of vertical type of FDI. TNCs have taken the advantage of speedier, more efficient and less costly

transportation and communication networks supported by a highly integrated and sophisticated financial system.⁵

Integrating these propositions, Yeaple (2003) suggested that low transport costs encourage vertical FDI by making use of low cost labour while high transport costs encourage horizontal FDI by making international trade expensive. When transport costs lie between these extremes, neither vertical nor horizontal motive is by itself sufficient to encourage firms to invest abroad so that FDI is only feasible when firms take advantage of the complementarity between developed and developing countries by investing in both locations.

2.1.3 Forms of FDI

FDI takes the form of (i) greenfield investment (ii) mergers and acquisitions (M&As) sometimes called “Brownfield investment”.

Greenfield direct investments represent long-term, carefully selected investment projects, which cannot be liquidated at short notice. In this type of investment, direct investor builds or establishes new plant and brings new equipment. In other words, greenfield type of FDI involves a contribution to the host countries capital formation, which makes this form of investment more attractive for host countries. Host regions eagerly seek greenfield investments because they are perceived to provide a net increase in capital stock, with corresponding implications for trade and employment. In particular, these types of investments are assumed to expand output of the domestic industry, thus leading to reduced imports or increased exports. All of these possible developments will increase the prospects for creation of new jobs.

⁵ Dunning (1998) cites the example of contemporary textile and clothing industry sector which is among the leading cross-border organizational arrangements. According to Dunning, the success of the textile sector rests on the application of the latest technological advances in computer-aided design, manufacturing techniques, near instantaneous transfer of information through the production and marketing process.

M&As involve by definition the take-over of existing locally owned firms by foreign firms and the surrender of control over operations (depending on the equity acquired by investor) by the former to the latter. In the context of globalisation, mergers and acquisitions became the most important medium for the expansion of FDI flows. Investors in many sectors commonly prefer to invest abroad through acquisitions rather than greenfield sites because local firm provides a ready to use distribution network, an established brand and market share, as well as intimate knowledge of local customs and regulations. In this sense, mergers are used frequently as a means of rapid access to the foreign market. It is often argued that M&As, as opposed to greenfield investments, result in very little new investments, only a transfer of ownership of existing assets from locally owned firms to foreign owned firms. Although M&As are a phenomenon of significance in the developed countries, around one third of FDI flows to developing countries in recent years is composed of acquisitions (UNCTAD, 2004: 9).

2. 2 FDI in Historical Framework

FDI evolved throughout the historical process depending on the dynamics presented by vertically or horizontally organized TNCs. Not only the host or home of the investments changed but also forms and characteristics of FDI have been altered. The evolution of FDI can be traced from the Table 2.1.

Prior to World War II, FDI was more resource oriented. Later this type of FDI was classified by Dunning (1993) as resource seeking FDI. TNCs seek endowments in natural resources, energy or abundant labour. This type of investment aims to exploit a country's comparative advantage. Most commonly seen type of resource seeking FDI is found in the labour abundant countries providing cheap labour. Today, the investments of developed countries in the Southeast Asia can be categorized as resource seeking FDI.

After the World War II, TNCs began to seek opportunities to exploit larger markets. These types of investments, which are attracted to host countries because of the size of markets, are known as market seeking FDI (Dunning, 1993). Market seeking FDI provides access to larger markets. Either the target market is the host country or it provides a link to larger markets.⁶ (MIGA, 2000: 3) In the post World War period, the target markets were Canada, Europe and USA although the source of the FDI were the same countries. There was an internal circulation of FDI among developed countries while TNCs were expanding their cross-border activities.

After 1960's, FDI began to mature and became a serious alternative option to trade. The formation of new organisational forms such as strategic alliances, networks and other equity arrangements initiated the rationalisation of FDI. The rationalisation of FDI brought new motives for FDI which can be classified as efficiency seeking FDI and strategic asset seeking FDI. Low wages coupled with relatively high productivity attract efficiency seeking FDI (Dunning, 1993). Such investments consolidates and rationalises market seeking and resource seeking investments which companies may have undertaken in the past and occur consequently. These sequential investments are frequently aimed at increasing the efficiency of the regional or global activities of the TNCs through integration of its own assets with existing market conditions. Most efficiency-seeking FDI in developing countries tends to be vertically integrated, with investors seeking locations, which offer an adequate supply of cost-effective semi-skilled or skilled labour, a good physical infrastructure, government policies that are market friendly, and minimal distance-related transaction costs. (MIGA, 2000:3) Thus efficiency-seeking investments aim to exploit several locational endowments. This form of FDI is common in regionally integrated markets, most notably in Europe or North America.

⁶ For example, Turkey provides by itself a large market which could be seen as a target market for the investors. On the other hand, Ireland is a small market providing access to a larger market.

Table 2.1 Evolution of FDI

PERIOD	FORMS AND MOTIVES OF FDI	MAIN HOME COUNTRIES	MAIN HOST COUNTRIES	REASON
Pre-World War II	Mostly resource seeking FDI but also expansion of market seeking FDI	UK and USA dominance with the emergence of diversified and integrated TNCs	2/3 stocks in developing countries, principally Latin America and Asia	Investment patterns are affected by the context of intra-war years
Early post-war 1945 to late 1960s	Rapid growth in especially in market-seeking manufacturing activities	Canada, Europe (especially UK), USA	Canada, Europe (especially UK)USA, developing countries represent 1/3 of stock	Worldwide expansion of TNCs, intensified relations among the developed economies, deepening relations
Late 1960s to early 1980s	Shift to efficiency and asset seeking FDI	Growing role of continental European countries followed by Japanese and newly industrialized countries	USA is largest host country	Expansion of new organizational forms such as strategic alliances, networks, other equity arrangements
Mid 1980s to present	Services overtake manufacturing as principal FDI sector; increase in mergers and acquisitions	USA and Japan continue to invest overseas	China became a major host country in terms of FDI flows, EU's share continues to rise	Globalization of business; technology begins to play a role as form of FDI change, widespread liberalization in economies in 1990's, as part of market reform and privatizations

Source: Derived from Dunning (2003: 110)

Strategic asset seeking FDI is attracted by more sophisticated determinants like the presence of high-quality physical and human infrastructure and a favourable political and commercial understanding towards M&As and alliances. The main purpose is to acquire strategic assets. These strategic assets comprise innovatory capabilities, managerial expertise and organizational capabilities which provides access to foreign distribution channels and an advanced level of knowledge about the needs of consumers in unfamiliar markets. Owing such assets will sustain or expand the competences of the TNC in targeted regional or global markets. Between 1960 and 1980's, most active source for these more rationality oriented FDI were continental Europe in where efforts to form a Common Market began to speed up after the effective realisation of Customs Union. Similarly, the emergence of the international Japanese firms provided a major role as an outward investor for Japan. The main target of these FDI flows was US market, which still preserves its attractiveness for foreign investors.

In the last two decades, globalisation of business and production activities and globally integrated strategies of TNCs pushed FDI upwards. After 1980's, FDI began to take the form of M&As due to expanding privatisations in the global scale. Japanese and United States TNCs continued their investments in overseas while the completion of the Common Market made the EU one of the most attractive location of FDI. On the other hand, especially since mid-1990, China began to attract huge FDI inflows.

Throughout all the periods concerned since pre-World War II period, FDI has grown over time in all three economic sectors – primary, manufacturing and services. However in the last two decades, FDI in services has largely taken the lead. The statistical evidence on the breakdown of World inward FDI stock according to sectors in Table 2.2 illustrates the fact that service sector is still continuing to attract more FDI than manufacturing and primary sectors. In 1990, service sector FDI comprised 46 percent of total world FDI stock while manufacturing sector FDI stock was 33 percent and primary products sector was

6 percent. In 2003, the share of manufacturing sector and primary products sectors FDI stock declined to 33 percent and 6 percent respectively, whereas service sector FDI stock began to constitute 3/5 of global FDI stock.

Table 2.2 Sectoral Breakdown of World Inward FDI Stock (Million dollars and %), 1990- 2003

Sectors	1990			2003		
	Developed Countries (Million USD)	Developing Countries (Million USD)	World Million USD and (% share)	Developed Countries (Million USD)	Developing Countries (Million USD)	World (Million USD and % share)
Primary Products	145.404	24.727	170.301 (10 %)	428.831	165.591	594.321 (6 %)
Manufacturing	595.142	150.410	745.552 (40 %)	2.081.645	784.457	2.876.102 (33 %)
Service	717.147	157.950	875.097 (46 %)	4.015.555	1.238. 271	5.153.826 (59 %)

Source: Own calculations based on UNCTAD (2004: 260)

FDI became the main mechanism to deliver goods and services to other markets even surpassing the traditional method of trade. Table 2.3 compares FDI and trade and illustrates the role played by TNCs in world economy. As Table 2.3 shows, global sales by TNCs, including sales to the host country, home country and other markets, reached 18 trillion dollars. Moreover, approximately 1/3 of global exports are realized by TNCs. The difference is evident when we look at the growth rates of FDI flows and exports. While annual growth of FDI inflows has been approximately 17 percent in the last two decades, world exports growth stayed about 10 percent. The rapid increase in

the FDI, despite the recession between 2001 and 2003, brought world inward FDI stock from 692 billion dollars in 1980 to 8.902 billion dollars in 2004. This is approximately 1/5 of the world GDP in 2004 (IMF, 2005:13).

TNCs have expanded their role in international economy especially in the last decade. There were 17.000 estimated TNCs in the world controlling approximately 37.000 affiliates in 1990. In 2004, the number of TNCs reached 70.000 which control approximately 690,000 affiliates (UNCTAD, 2005: 13). In parallel to this, number of people employed by TNCs has risen from 24 million to 57 million in the last decade.

Most of the TNC are controlled by developed countries. Almost 90 percent of the top 100 TNCs are headquartered in the Triad (the EU, Japan, the United States). EU leads owning more than half of the top 100 TNCs. United States accounts for slightly more than a quarter, while Japan's share has decreased over the years to fewer than ten (UNCTAD, 2005:11).

Although above mentioned statistical evidence prove that FDI have become a major component of globalisation, regional distribution of the flows demonstrated in Table 2.4 indicate that it is not equally felt all over the globe. The major share of the FDI is flowing to the developed countries and the position of developing countries is not improving significantly despite a slight increase. Developed economies had 56 percent of world inward FDI stock in 1980, while after 1990's their share reached above 70 percent. On the other hand, despite the accelerating globalisation, the share of inward FDI stock of developing countries has fallen from 43 percent in 1980 to below 30 percent level in 1990 and later. Within developing countries, "Asia and Oceania", to which Turkey belongs according to UNCTAD's classification, is loosing its share together with other developing economies despite the enormous FDI flows to China. Among the developed countries category, EU's success in attracting FDI is striking. Before the completion of common market and the enlargements, EU's share of FDI inward stock was 31 percent. However, after deeper and widening integration took place especially in 1990's EU's share reached above 40

percent. In 2004, inward FDI stock of EU was 4 billion USD, which is almost double of all developing countries.

Table 2.3 FDI and International Production (billion dollars and %), 1980-2004

	Value at current prices (billions of dollars)			Annual growth rate (%)				
	1980	1990	2004	1986- 1990	1996- 2000	2001	2002	2004
FDI inflows	55	209	648	22,8	39,7	-39,7	-13,3	2,5
FDI inward stock	692	1.950	8.902	16,9	17,3	7,1	8,2	11,5
Sales of foreign affiliates	2.717	5.660	18.677	15,9	8,7	-3,0	14,6	10,1
Exports of foreign affiliates	717	1.194	3.690	22,1	4,8	-3,3	4,9	20,1
World Exports of goods and services	2.247	4.761	11.269	12,7	3,6	-33,3	4,9	20,1
Employment of foreign affiliates (thousands)	19.232	24.197	57.394	5,4	9,4	-3,1	10,8	7,9

Source: Derived from UNCTAD (2005:32)

Table 2.4 FDI Inward Stock by Host Regions and Economies (billion dollars and %), 1980-2004

Host Region	FDI Stock (billion dollars)			Share (%)		
	1980	2000	2004	1980	2000	2004
Developed Economies	390.740	4.140.271	6.469.832	56	67	73
European Union	216.296	2. 257.701	4.023.935	31	39	45
North America	137.209	1.566.340	1.777.678	20	24	20
Other developed countries	21.988	206.445	433.608	3	3	4
Developing Economies	301.974	1.939.926	2.225.994	43	32	26
Asia and Oceania	219.516	1.286.585	1.282.964	31	20	15
Latin America and the Caribbean	50.412	512.455	723.752	7	8	8
Africa	32.045	140.886	219.277	4	2	2
World	692 714	6 089 884	8.895.279	100	100	100

Source: Derived from UNCTAD (2005:308-312)

2. 3 Theoretical Framework

2. 3.1 Theories of FDI

Theories of FDI are inspired by the rise of TNCs around the 1960s and 1970s. Many studies tried to explain the reasons behind some firms' decision to invest in foreign lands outside their domestic markets.

The major emphasis of FDI theory prior to the mid-1970s was focused on explaining the extension of the business activities of a firm of one nationality into

the territory of another country. Early explanations of FDI were not institutionally based. Ray Vernon (1966), in his product cycle model was concerned with the changing location of business activities of a firm as its products moved through the various phases of their life cycles. The “product cycle” explanation of firms, describe direct investment as a means of transferring technologies that have been developed and exploited first in more advanced countries to developing countries. Caves (1971) related FDI theory to industrial structure of the home country. He argued that firms in oligopolistic industries tend to become transnationals because they obtain intangible assets such as skilled management capacity or organizational know-how from their investments at home which also provides superiority over the other competitors in the host country. In other words, oligopolistic industrial structure yields intangible assets for TNCs that may also be utilised in other markets.

Likewise, Hymer (1976) suggested that firms undertaking FDI are not perfect competitors. The market imperfections theory of Hymer states that firms constantly seek market opportunities and their decision to invest overseas is in line with this motive. Firms choose FDI as a strategy to utilize their capabilities to control products and factors of production. Direct investments provide means of differentiating their products in order to compete with other firms. The firms by integrating its local and international operations aim to establish their own oligopolistic advantages in the host country and try to create and capture economies of scale advantages.

However, these theories did not provide a comprehensive explanation of FDI phenomenon. The basic question of why foreign production is considered the most efficient means of utilizing the firm’s advantage is left unanswered. Fayerweather (1982) analysed this issue and developed what can be described as international production theory. International production theory suggests that the propensity of a firm to involve in foreign production will be determined by a comparative analysis. The firm involve in FDI taking the specific attractions of its home country and resource implications and advantages of locating in another

country (potential host country) into consideration. This theory makes it clear that not only resource differentials and the superiority of the firm play a part in determining overseas investment activities, but also foreign government actions may significantly influence the attractiveness and entry conditions for firms.

Dunning has brought a new understanding in this field with the comprehensive outlook that he has provided. According to Dunning (1981), to explain fully the extent and pattern of the foreign investment, it is necessary to explain why TNCs prefer to generate and/or exploit their advantages and rights like franchising or licensing internally, rather than to acquire or sell these through the open market. Theories from economics, sociology, political science, and the business disciplines may each have something substantial to contribute to his eclectic approach. Dunning's eclectic theory, also referred as OLI paradigm, provides a combination of Ownership, Location and Internationalisation (OLI) advantages each of which is identified by the early works of the scholars in the field.

- *ownership advantages(O-type advantages)*: These are the firm specific advantages that a firm possess which helps to be more competitive against its rivals. These competitive advantages comprise such capabilities like productivity, superior technology and managerial skills, ability to upgrade qualities of work force.

Regarding the advantages firms possess prior to FDI, Hymer (1960) claim that such advantages arise from firm's ability to harness economies of scale and their capability to control intangible assets such as skilled management capacity or organizational know-how which may also be exploited by investing abroad. On the other hand, Kogut (1983) made a distinction between the O-type advantages that are essential for initial engagement to invest abroad and those arise as a direct consequence of foreign production. These latter advantages include specialization and intra-firm trade, spreading of political and environmental risks, improvement of bargaining power in relations with national governments or other economic agents such as trade unions or media and the

learning and overall experience gains which stem from operating in different markets.

- *locational advantages(L-type advantages)*: L-type advantages comprises some of the location bound endowments such as domestic factor costs, market-size and growth, transport costs and tariff or other economic and social barriers, human resources, infrastructure government-imposed incentives and/or obstacles to FDI, a market facilitating macroeconomic environment offered by host governments, stable political and economic regime.⁷ All the L variables like labour costs, tariff barriers, and the presence of competitors rest on the assumption that firms will seek to locate their activities at the most profitable location.

- *internalisation advantages (I-type advantages)*: The eclectic FDI theory of Dunning (1981) maintained that, once a firm possesses net ownership advantages, it utilizes these advantages in connection with some locational advantages existing in the foreign country. If the firm perceives it to be in its interest to add value to its O advantages rather than to sell them, internalisation (I) advantages exist. In other words, internalization advantages are those factors which make foreign production the best way of exploiting a firm-specific asset (O- type advantage) in a foreign market better than for example licensing a foreign firm to do it. The basic idea here is that there are transactions costs of various kinds involved in international trade. When such costs of international trade are greater than those arising from carrying out activities within the firm, internalisation, that is, establishing an overseas subsidiary, will be preferred. Thus, internalization involves a form of integration bringing new operations and activities under the ownership and administration of the firm. Internalization may also be associated with scale economies that seem to emerge in activities such as R&D and advertising, which allow for the generation of advantages in intangible assets (Markusen and Maskus, 2002:22). By internalizing their operations in abroad, firms who have above mentioned O-type advantages gain

⁷ These factors will be separately dealt with in the next section covering determinants of FDI.

privileged access to host country-specific intangible assets such as technology, trademarks, managerial expertise, entrepreneurship and access to factor, intermediate product or final goods markets (Dunning, 2001: 176).

2. 3. 2 Determinants of FDI

Above mentioned theories, try to explain why firms engage in cross-border activities. They try to explain why some firms move their capital and assets abroad instead of investing them in home market. From a country's perspective the question is more complicated because once a TNC decide invest abroad there are several alternative locations. So the main question is why Firm X should invest in Country A but not in Country B? What are the factors that distinguish country A from B? What are the factors that may urge or motivate Firm X to invest in Country A? Will resource seeking, market seeking, efficiency seeking or strategic asset seeking FDI flow, or a combination of these motives?

All these questions can only be answered by investigating specific location bound factors. These features are classified as "locational determinants". Determinants are useful instruments especially to formulate empirical models in order to explain FDI flows to a specific location. The most commonly referred determinants in the literature are natural resources, size of markets, infrastructure and human resources, labour costs, macroeconomic stability, openness and business environment, incentive schemes, distance and regional integration schemes.

2.3.2.1 Natural Resources

A country may possess a significant comparative advantage or an absolute advantage in primary supplies meaning natural resources like energy, water supply etc. If such a country has an absolute advantage in terms of

natural resources, the country is likely be the recipient of inward investment from TNCs that wish to internalize supply of primary supplies to their activities located in other countries (Narula, 1996: 43). The extent of this resource seeking inward investment will rise as other L advantages associated with the host country develop.

2.3.2.2 Distance

Firms generally tend to prefer FDI to exports because trade costs mounts as distance increases. More distant markets tend to be served by affiliates rather than by exporting. Nevertheless this variable may also have a negative effect, since the costs of operating affiliates is likely to rise the further they are from the headquarters stemming from the facts such as higher costs of placing personal abroad or communication costs. Egger (2004) found that vertical FDI declines with distance due to rising trade costs while horizontal FDI for the same reason rises with distance. The logical explanation is that vertical FDI necessitates transactions between the plants spread over different geographies which push up the costs of production. On the other hand, horizontal FDI becomes a viable option as it provides opportunity to serve distant markets with no inter-company transaction costs.

Apart from geography, “distance” as a determinant also covers other aspects such as cultural or historical proximity. The cultural bonds, common language or historical background all have positive implications on FDI inflows.

2.3.2.3 Labour Costs

There are several costs involved in the production or distribution process. However, labour cost is signified as an important determinant in the literature. Especially those TNCs which are involved in low-tech production are primarily attracted by low labour costs. Today, still ongoing huge influx of FDI to

Southeast Asia or to developing countries mainly stems from lower labour costs. However on the contrary, as it is mentioned in section 2.2, most of FDI in the world today transacted between Triad (Japan, USA and EU) who has very high wage rates.

2.3.2.4 Infrastructure and Human Resources

A foreign investor would prefer a host country with a good infrastructure, which facilitates communication, transportation and distribution. Infrastructure facilities include not only transportation, local services and communication network but also favourable environment for work and leisure. Wheeler and Mody (1992) found that infrastructure quality clearly determines the flow of FDI to mainly developing countries.

Human capital measured by education enrolment rates is correlated with FDI implying that countries with more human capital are associated with more FDI. This association has become stronger over time. TNCs are able to locate complex and skill-intensive affiliates only in countries that have a well-educated workforce (Te Velde, 1992:22). Offering of a good quality and appropriately educated and trainable workforce will raise the relative supply of skills. This can attract skill intensive FDI, especially when combined with appropriate FDI policy, and hence raise the relative demand for skills as well. Abundance of developed infrastructure and human resources will attract efficiency-seeking FDI.

2.3.2.5 Market Size

National market size, in absolute terms or relative to the size and income of the population, has been another important traditional determinant, leading to market-seeking investment. Size of the market is determined by the extent of population and GDP. The higher amount of GDP stimulating a greater demand

attracts foreign investors. Large markets can accommodate more firms and allow each of them to reap the benefits of scale economies.

The firms generally try to maximise returns to their investments. Since firms necessitate sizeable markets both at home and abroad, they prioritise the existence of large market in their investment decisions. Thus, mostly size of the local market becomes a pre-condition of a firm's ability to exploit its O-type advantages in the host country.

Although large markets abroad can be serviced through exports, trade restrictions may constitute a barrier to exporting. By investing in the target market, TNCs climb over the barriers. They acquire the opportunity to serve to a larger market and they further utilize host country's links to deliver goods and services to third markets. In the literature, empirical studies mostly signify market size as a significant determinant. Empirical research by Wheeler and Mody (1992) and Devereux and Griffith (1998) both reached to the conclusion that market size is more important than labour costs or tax rates. Dunning(1993) also found that the market size in parallel with the anticipation of growth prospects of the market are significant determinants and positively related to the level of FDI flows.

2.3.2.6 Macroeconomic Stability

It is generally accepted that healthy macroeconomic indicators are pre-requisites for attracting foreign as well as domestic investment. Especially low inflation, budget deficit and public debt and stable exchange rates are essential indicators because they indicate stability and strength of the economy. They provide a degree of certainty for the future path of the economy. Weak economies with high levels of domestic borrowing and debt are often forced to institute exchange controls and controls on the capital account items of the balance of payments (Megygyery and Sader, 1996: 10). Foreign investors try to avoid such unanticipated risks. The feeling of uncertainty raises fears among

investors for the potential loss of their profits. A positive outlook in these features provides necessary confidence in the ability of firms to repatriate their profits and dividends.

2.3.2.7 Openness and Business Environment

The orientation and openness of an economy will substantially affect the extent and pattern of FDI. The orientation of an economy may either be outward looking export oriented or inward looking import substituting. Ozawa (1996) argues that export oriented regime is necessary condition for FDI facilitated development. Buch, Kokta and Pialzola (2003) also found that degree of openness has a positive impact on inflowing FDI in their research covering FDI outflows from EU countries, US and Japan. Incentives offered by the import substitution regime are related to lack of location specific advantages and their continuation is subject to the discretion of the policy makers. Thus, foreign firms worrying about unexpected policy changes are unlikely to bring large volumes of FDI. TNCs may try to exploit this artificial location advantages. However, FDI that is attracted by restrictions on imports is likely to be short-lived, lasting as long as the artificial policy incentives endure (Balasubramanyam, Sapsford and Griffiths, 2002: 463). On the other hand, in an open economy, it is easier to import raw materials or some capital goods, which are necessary for the investment and also to export the finished goods.

The core framework for FDI consists of rules and regulations governing entry and operations of foreign investors, standards of treatment of foreign affiliates and the functioning of markets. Complementing core FDI policies are other policies that affect foreign investors' locational decisions directly or indirectly, by influencing the effectiveness of FDI policies. Transparency and stability of policies towards FDI are crucial factors. Frequent changes in policies related to business world like fiscal and exchange rate policies discourage foreign firms about the stability of the host economies.

2.3.2.8 Incentive Schemes

Incentive schemes are among the largely debated determinants of FDI in the literature. Apart from trade policies, most countries in the contest of attracting FDI offer a variety of subsidies to foreign firms. There are three broad categories of investment incentives which can be distinguished as tax incentives, financial incentives and other non-financial measures. Examples of tax incentives include preferential tax rates. Even if production costs are equalized across locations, international differences in corporate taxes may be a factor in the final decision to invest in a specific area. Financial incentives include factors such as government grants and subsidies, loan guarantees, preferential loans and government equity participation in high-risk investments. These measures are often discretionary, with the size of payment depending upon the scale of investment and the activities that the inward investor plans to undertake. The third category, other non-financial measures, includes the provision of subsidized infrastructure, such as prepared industrial sites, free-trade zones, export processing zones, employment subsidies, infrastructure improvements, cheap land prices, use of preferential government contracts etc.

There is contrasting evidence for whether or not fiscal incentives attract more TNCs. It is doubtful if these incentives weigh heavily in the investment decision process of foreign firms. For example, in a study of determinants of US FDI abroad for 42 countries in manufacturing and in electronics in particular, Wheeler and Mody (1992) found that tax incentives were not a significant factor. By contrast, Hines (1996) found that tax incentives significantly influence FDI because they also affect other critical components of FDI such as, profit repatriation, dividend and royalty payments, R&D activity and exports. Similarly, Görg and Ruane (1999) argued that taxes and grants have been significant in attracting FDI to Ireland in 1980's. However, there were no signs that after corporate taxes was raised from zero to 10 per cent in 1990 TNCs run away. Instead a real boom in FDI inflows took place.

There is some evidence that FDI promotion policy works. Wells and Wint (1990) argue that developing countries with a promotional body in the US attracted 30 per cent more FDI than countries that are not represented in US. However, this does not mean that all investment promotion agencies are effective in their FDI strategies. The success of promotion agencies generally depends on the organizational structure of the investment promotion agencies, the method of implementation, and the financial resources available. TNCs prefer single and simple services to lengthy entry procedures involving many agencies. According to UNCTAD (2003), the information for basing investment decisions is not perfect and subjective perceptions matter.

Good marketing can make a difference of course, only if other conditions are available. General promotion methods such as missions, seminars and websites are widely applied throughout the range of services. Some countries (Ireland, Singapore, Malaysia, Costa Rica, etc.) tried to attract high-tech and skill-intensive electronic TNCs by creating investment promotion agencies. Some of these agencies (Ireland's IDA, Singapore's EDB) use specific promotion methods (phone calls, mailings, visits to headquarters, on-site visits, etc.) to attract TNCs.

In the literature these determinants have been utilized to provide empirical explanations of FDI inflows to a specific location. The effectiveness of determinants generally depends on the specific conditions of the host country as well as the preferences of TNCs. The results are quite mixed demonstrating the uniqueness of each case. Thus it is possible to obtain diverging results from different case studies. However ambiguity in the effectiveness of them does not diminish their indicativeness. In this vein UNCTAD concluded that:

With more and more TNC intermediate products and functions becoming open to FDI, TNCs strategies are evolving from simple to complex integration. Complex integration strategies can involve, where profitable, splitting up the production process into specific activities or functions and carrying out each of them in the most suitable, cost competitive location.

To attract such competitiveness-enhancing FDI, it is no longer sufficient for host countries to possess a single locational determinant. The challenge is precisely to develop a well-calibrated and preferably unique combination of determinants of FDI location, and to seek to match those determinants with the strategies pursued by competitiveness enhancing TNCs. (UNCTAD, 1998: 5)

2.3.3 Regional Integration

Among the policy measures that can have a direct effect on FDI, membership in regional integration schemes is a crucial one since this can have implications on the determinants of FDI such as market size.

Regional integration frameworks may cover a wide scale of integration measures, ranging from tariff reduction among members to policy harmonization in many realms. In conventional terms, the process of economic integration is usually accompanied by a reduction in tariff and non-tariff barriers, the adoption of a common external tariff on imports from the rest of the world, free movement of capital and labour, and harmonization of taxation and regulations.

Effects of regional integration on FDI are not only related to trade rules or tariff barriers. A reasonable generalization is that regional integration should enhance the attractiveness of the region as a whole by creating a larger common market and contributing to overall efficiency and higher income levels in that market. Concerning developing countries, membership in a regional integration scheme usually requires at least some degree of policy harmonization for attracting FDI inflows. Nonetheless, it provides increased predictability of the investment climate by locking in general reforms such as regulation, competition policies, property rights, contract enforcement, guaranteed access to members' markets and stable trade policies in order to harmonize the investment regime in a wider context. From the investor's perspective, Neary (2002) argued that foreign direct investment is a strategic move of TNCs in order to cope with the changes in relative competitiveness and

locational advantages brought about by the formation of regional integration. The perception of the investor is generally positively influenced by the fact that national policies are tied in regional treaties (Blomström and Kokko, 1997: 17). This provides an additional provision against the policy reversals.

Market enhancement effect of regional integration is also considerable. Market enhancement should not only be interpreted to mean the geographical size of markets but also their economic size in the sense of generating income growth and effective demand for goods and services (Balasubramanyam, Sapsford and Griffiths, 2002:476). An enhanced market may simply allow some firms to grow larger and stronger than what would have been possible in individual national markets. As firms become larger, they may be able to invest more in R&D and marketing, which may lead to the creation of new intangible assets that stimulate new FDI, within as well as outside their own region. Within this perspective, many⁸ argue that crucial effects of economic integration on FDI are dynamic, with competition creating a more efficient industry and growth, which in turn can affect FDI. FDI can actually be an instrument itself through spillovers in terms of technology transfer and other linkages with local firms. There can thus be long-lasting effects on growth and productivity as opposed to static effects based on a more efficient allocation of resources.

Nevertheless, according to several scholars in the field, integration schemes can not by itself induce increased flows of FDI. Blomström and Kokko (1997) argued that the effect of a regional integration depends on two factors—the attractiveness of a country and the quality of that country's liberalization of trade and investment policies. Countries with the strongest locational advantages will receive most of the FDI oriented toward serving the regional market. Countries with weak locational advantages will see little change in their level of inflowing FDI as a result of the regional integration. In fact, they may experience FDI outflows as firms relocate production to the most competitive country in the regional agreement.

⁸ For details see Dunning (1997), Blomström and Kokko (1997) and Neary (2002)

There are many dimensions that should be dealt separately concerning the effectiveness of regional integration as a determinant of FDI. However it is also necessary to make a distinction between intra-regional and extra-regional FDI flows since regional integration might have diverging effects on external members who are still subject to regional tariff and outsider of the existing integration framework and on existing members who might benefit from positive spill over effects of the integration. The impact of this process on FDI depends on the motive of FDI, but also on the origin and destination of foreign investments (intra or extra-regional).

2.3.3.1. Intra-regional FDI

FDI is mostly established in order to take advantage of some host country characteristics such as low wages or market size. Main objective is to sell products and services in the home country, or export to a third country or re-export it to the home country. In such cases, the elimination of trade barriers and formation of an economic integration between the host and home countries will increase the attractiveness of the partners vis a vis other potential hosts. Countries and industries that are already closely linked to their regional partners before the formal agreements - due to geography, historical conditions, or other reasons - are likely to face smaller revisions than countries and industries with limited familiarity with the other participants in the region. (Blomström and Kokko, 1997:13)

Direct effects of integration like the elimination of tariffs can be completed by indirect forces when the process of integration allows the removal of non-tariff barriers, capital flow liberalization, free mobility of workers etc. (Dunning, 1997:34). In this case, economic integration could reinforce firm's competitiveness in the host market by better allocation of resources. This provides the opportunity to expand sales and the size of the market, which could contribute in increasing attractiveness for "market-seeking" FDI. According to

Stein and Daude's (2001) empirical analysis, impact of common membership in a regional integration agreement is quite important in FDI inflows. A host country that is a partner with a home country will receive 70 percent more FDI than a non-partner *ceteris paribus*.

Another argument goes in the opposite direction. If production is intended for the host country market, the bilateral elimination of trade barriers may reduce FDI, since it becomes cheaper to serve this market through trade. If foreign investments are considered as an alternative to exports for a horizontally organized TNC, intending to supply a foreign market, the reduction in transaction costs following the set up of an economic union could reduce intra-regional FDI.

2.3.3.2 Extra-regional FDI

The problem is quite different when considering extra-regional FDI. Firms from non-member countries will be induced to invest in a member country to get lower tariffs within the area. In the case of horizontal FDI, a foreign producer will “jump” the common external tariff to have access to a larger market, while in the case of vertical FDI, foreign firms will locate the different stages of production in various member countries at a lower cost (Yeyati, 2002: 13). As internal tariffs fall within the integrating region, extra-regional TNCs would prefer establishing a single plant and serve the region from this plant. TNCs which face restraints on their exports to the region following regional integration agreement may invest in one of the member countries within the region. Thus, TNC utilize the country as an export platform.

The main impact of benefits of integration is to make the integrating region a more attractive investment location, which should both stimulate intra-regional as well as extra-regional FDI flows. In general in the short run, integration is expected to stimulate intra-regional trade and investment; in the longer run the combination of larger markets, tougher competition, more efficient

resource allocation, and various positive externalities in the form of dynamic effects is expected to raise the growth rates of region's economy which lead to more extra-regional FDI.

2.3.3.3 FDI Inflows from Core to Periphery

Regional economic or trade integrations today cover the core and peripheral countries. The creation and functioning of regional blocs do not have identical effects on the core and periphery⁹ of the region. General assumption is that the relatively less developed peripherals would attract FDI from the core.

In order to illustrate the effects of regional integration on intra-regional FDI flows from core to the periphery, the equation formulated by Görg and Ruane (2000) may be useful. According to this equation, before economic integration unit costs due to trade barriers (b) are high. Also it is assumed that unit wage costs in the core are (wc) higher than those in the periphery (wp), since the periphery is less developed than the core. There are further transportation costs (t) for the goods produced in the periphery.

$$wc < wp + b + t$$

As the equation illustrates despite these lower unit wage costs, TNCs do not produce in the periphery trying to avoid the high trade barriers. Production, therefore, of any product for which there is only demand at the core will be concentrated in the core. As the integration takes place trade barriers are removed (b=0) between the periphery and the core.

The equation turns out to be as follows:

$$wc > wp + t$$

⁹ The periphery in this context refers to countries which are geographically distant from the centre or core of the region and also having a low level of development. In terms of EU core countries refer to Germany, France, Belgium, Netherlands and Luxembourg.

While there are only transportation costs (t) for shipping goods from the periphery to the core market, a TNC will find it profitable to locate in the periphery and send goods to the core if the unit wage cost in the core exceeds the unit wage cost in the periphery plus the unit transportation cost for shipping goods to the core market. As equation above suggests, this is more likely to occur in the case where (t) is low which one might expect for goods with high value to weight costs such as high-technology products.

On the other hand even ahead of economic integration, some products may face lower non-tariff barriers than others and may therefore, be more easily traded between the core and periphery countries. In this case, a multinational may decide to locate in the periphery even without economic integration. Any reduction of trade barriers will increase the likelihood of TNCs, especially those producing high technology goods, investing in the periphery relative to the core. Firms already located in the core, however, may not find it profitable to re-locate their plants because of the fixed costs involved in setting up a plant.

However, this relative attractiveness of the periphery over the core in terms of inflowing investment would not be expected to continue indefinitely, as the location of multinationals in the periphery may lead to surge of the wage rate over time which will gradually decrease the attractiveness of the periphery as a location.

The equation may turn out to be as follows:

$$(wc < wp+t)$$

Thus FDI inflows to periphery may increase the similarity of periphery industrial structure to that of the core. This fact might limit FDI flows from core to periphery in the long-term especially in labour intensive sectors.

2. 3.3.4 Extra-regional FDI Flows to the Periphery

Regarding the extra-regional FDI inflows to the periphery, implications of other determinants are crucial. In this sense, market size is a significant determinant for periphery, potentially indicating market-oriented FDI activities undertaken in this territory. The economic welfare, which represents the purchasing power of consumers and the transition of medium income countries to high-income countries, seems to attract foreign investors. Extra-regional foreign investors seek primarily to exploit cheap resources in the periphery providing a large share of their production domestically (Kottaridi, 2005: 109). Furthermore, other factors like the size or level of income of the host and the home country may be determining (Balasubramanyam Sapsford and Griffiths, 2002: 468).

On the other hand, Krugman's (1991) geography and trade theory suggest that a reduction in transport cost does not necessarily shift production away from the centre to periphery. According to Krugman, the two considerations behind direct investment in an integrated region are where to invest and how many plants to operate. The number of plants is related to the potential for economies of scale in particular industry. The decision on when to invest is a function of the costs of production in various locations together with the costs incurred in exporting from these locations. These are referred as distance costs. If the concerned location cannot provide enough potential to exploit in terms of economies of scale in a particular industry, distance costs will outweigh gains from investing in the periphery. Thus, TNCs would seek for closer locations for establishing their affiliates unless costs of exporting from the periphery are reduced.

In this vein, Te Velde (1992) found out that distance is still an important determinant within the integrated market as well. Countries that are further away in distance from the largest economy in the region attract less FDI. This is consistent with the above mentioned hypothesis that core countries would

attract more FDI than periphery countries through regionalisation if not reversed by other factors like direct policy initiatives.

Furthermore it is a crucial point that the deepening of the integration will reinforce the tendency for increasing geographical concentration within region (Pain and Hubert, 1996: 339). This argument is supported by Brülhart and Torstensson (1996) and tested on the EU model. They conclude that increasing return industries tend to be concentrated in core countries that have good access to large markets, whereas traditional, small-scale industries are dispersed and a locational shift of these is more likely to benefit periphery countries. The conclusion that one might draw from these observations is that the core of the integrated market retains a strong appeal for investors, even when they are looking for export platforms to supply the whole market, but that the more peripheral countries with lower unit labour costs can attract gradually more FDI over time.

Furthermore considering controversial views about the core-periphery pattern of FDI, it seems reasonable to argue that economic integration may be one of a number of necessary conditions for a peripheral country to be able to attract foreign investment but it is certainly not in itself a sufficient condition.

2.3.3.5 EU Case

The above mentioned theoretical explanations for the effects of integrations are based on the knowledge and experience observed in several economic integration endeavours which is increasingly taking place in the second half of the twentieth century. The most complex and sophisticated example of these integrations is the EU. EU transformed a group of fragmented markets into a single integrated market, and its size is still growing with the recent addition of several countries and more in the future.

The theory of FDI is primarily interested in the impact of regional integration on FDI, either into or out of the member states. FDI theory examines

the impact of integration on the competitive advantages of firms of different nationalities, the location of activities associated with these advantages, and the way in which these activities are organized jointly with the resource capabilities of the host countries.

Since the beginning of the European integration, economists have argued about its effects on FDI flows. Most of the studies have found positive correlation between completion of Single Market in 1980's and FDI flows. The abolition of non-tariff barriers, the simplification of administrative formalities, the prospect of a large and growing market demand and the scope of economies of scale seem to have provided strong incentives to invest in EU. For example CEPS (1996) study found stronger significance of Single Market factor in 1987-1992 period in which Internal Market Program (IMP) is completed in a comparison with 1982-1987 period. Similarly, Baldwin, Francoise and Portes (1997) argued that the creation of the Single Market in the EU led to investment diversion in the economies of the European Free Trade Association (EFTA) and investment creation in the EU economies after the inclusion of Spain and Portugal. Aristoteles and Fountas (1996) with a time series analysis of US and Japanese FDI in EU, found strong correlation between FDI inflows and completion of IMP. In a similar analysis, Hein and Vörk (2002) concluded that completion of IMP has positive influence on FDI inflows depending on other country specific variables like market size, GDP level or distance.

Some also argue that the effects of IMP have been sector specific. Among these, Dunning's (1997) analysis on the effects of IMP worth mentioning. He found that the main dynamic impact of the FDI is through the effects on other determinants of FDI, such as market size and income levels. IMP as an independent variable raised extra- and to a lesser extent intra-regional FDI but not by as much as other variables. IMP is more likely to lead a dispersed production of labour intensive goods in low-income countries, while the production of capital intensive goods is more likely to be concentrated within high-income countries.

These empirical results are in line with the theoretical hypotheses regarding the general effects of regional integrations on FDI flows and core-periphery duality discussed above. However in general terms, economic integration is likely to make the region a more attractive investment location for outside investors. The stronger the macroeconomic stability sustained in connection with regional integration and the stronger the locational advantages of the individual country or industry are, the more likely it is that integration will lead to inflows of FDI from the outside as well as from the rest of the integrating region.

The studies mentioned above are generally are trying to explain the effects of European Integration for the member states already in the Union. However, when we consider the subject that is to be surveyed in this study, we have to take into account the effects of EU membership for the accessing peripheral countries. Accession to the EU affects both factors, i.e. potential market size and political stability. TNCs investing in the region will receive the access to the developed market of the united Europe while still benefiting from lower input and labour costs. Nevertheless, this advantage will erode in due time as wage rates converge across the member states. The perceived risk of doing business in the accession countries is somehow reduced, although the overall impact has not been as large as the one caused by the market expansion. The market size effect is more significant, as new member-countries obtain access to the entire EU market.

Several scholars analysed the observed and expected effects of EU accession on FDI inflows. Brenton, Di Mauro and Lücke (2004) suggested that joining a regional economic integration scheme can provide an impetus to inward FDI. De Sousa and Lochard (2004:22) found that joining EU could generate an increase in intra-EU FDI of 34 percent, both for intra-EU relationships and for investment stocks from third countries. When compared to investments between two non-EU countries, this additional stock rises to 100

percent. Moreover, they found that after joining EU, investments from non-EU countries would increase by more than 70 percent.

Similarly investigating the 1995 enlargement (Austria, Sweden and Finland) Egger and Pffafermeyer (2004: 108) found that real FDI volume between the three new member countries and the EU12 has grown by 26 percent faster than intra-EU FDI itself between this and the previous integration phase. The increase in FDI was 24 percent stronger than the increase in FDI within the EU12 and within the new members together. Interestingly they found that this surge in the volume of FDI is valid only before the enlargement took place. Their estimates suggest that anticipation effects on FDI typically take place between the announcement and the formal establishment of an integration event. FDI does not increase before the official announcement of an integration step and the integration effects seem to be exhausted with the finalization of the accession.

Such anticipation effects are also observed in recent enlargements. Bevan, Estrin and Grabbe (2001) examine FDI flows from 18 market economies to the ten Central and Eastern European (CEE) accession countries over the period 1994 to 1998. The research examined the impact of two public statements on accession made by the EU. The 1994 Essen Council in which EU announced its commitment to enlarging eastwards in 1994, led to a significant increase in the level of FDI received by all the CEECs. On the other hand, the Agenda 2000 announcement in 1997 to open negotiations with five of the CEE candidates (Czech Republic, Estonia, Hungary, Poland and Slovenia) but not with the others (Bulgaria, Latvia, Lithuania, Romania and Slovakia) led to a significant increase in the growth rate of FDI flows to the five CEE candidate countries invited to enter negotiations. The other five CEE candidate countries faced a steady or declining trend of FDI inflows. In short, two European Union announcements regarding the enlargement process had a statistically significant effect on FDI inflows. Their results show that the European Union announcements have substantially influenced the amount of foreign direct

investment received by the CEE countries, a finding that is consistent with theoretical predictions.

The descriptive, theoretical and empirical explanations presented in the previous chapters provided a framework to move forward in this study. This framework will be used in the next chapter, in order to analyse the effects of previous enlargements on FDI inflows of accession states. Furthermore, they will constitute criteria for comparing these cases with Turkish case in order to reach meaningful conclusions.

CHAPTER III

EXPERIENCES OF IRELAND, SPAIN AND POLAND: FDI INFLOWS AND IMPLICATIONS OF FDI DETERMINANTS

In this chapter, experiences of three present member states of EU, Ireland, Spain and Poland, are investigated in order to understand the underlying reasons behind their FDI trends before and after EU accession. A comparative methodology is used based on the locational determinants of FDI which have been identified in the previous chapter. For each country, these determinants have different significance and mostly it is difficult to measure their implications on FDI inflows. In order to make a reliable comparison among three countries, some comparable indicators are used such as telephone mainlines for infrastructural quality or tertiary level education attainment for quality of human resources. The data is mostly derived from UNCTAD, OECD and World Bank databases.

3.1 Ireland: FDI since EU Membership

Ireland became an EU member in 1973 together with the UK and Denmark. Prior to accession, Ireland was considered to be one of the least developed countries of Western Europe. Irish economy underperformed even after EU accession until the upturn in 1990. Since then, Irish economy has shown a miraculous performance. The economic success realized in 1990s almost in all indicators of economy later earned the name “Celtic Tiger”¹⁰ for Ireland. FDI has been a key factor in this achievement.

¹⁰ Ireland’s performance during this period resembles the performance of the “Far Eastern Tigers” like Singapore or Korea indicated by high growth rates boosted by increasing exports.

3.1.1 FDI Inflows and Inward Stock

FDI inflows to Ireland were minimal in the beginning of 1970s as shown in Figure 3.1.1. After Ireland joined EU in 1973, FDI inflows drastically increased to 180 million dollars between 1974 and 1978 which stayed steady in the next decade. Then a steep increase in annual FDI flows took place in late 1990s. FDI inflows boomed in the second half of 1990's and reached its maximum level in 2002 with 28 billion dollars.

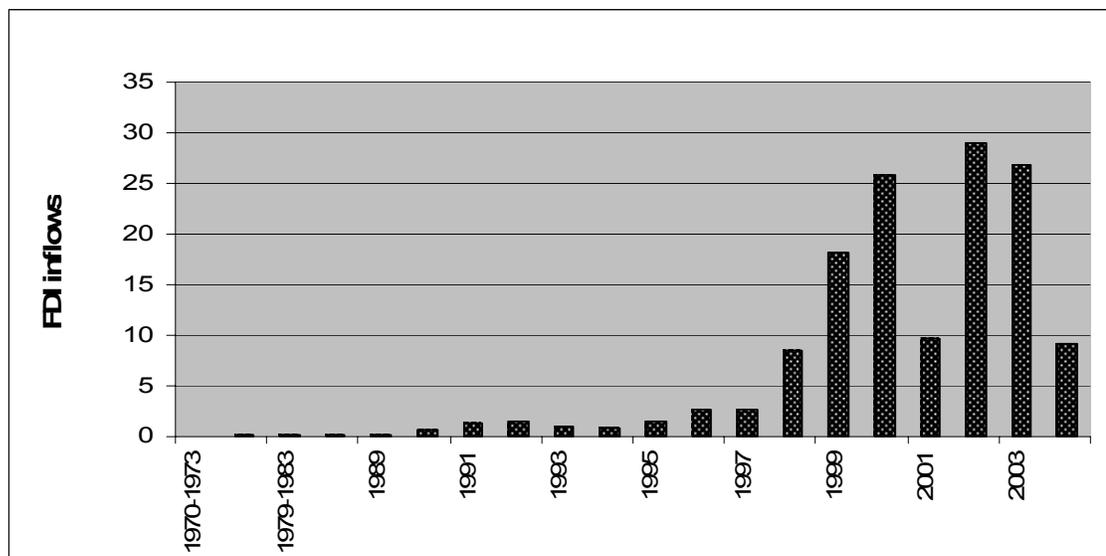


Figure 3.1.1 Net Inflows of FDI in Ireland (billion dollars), 1970-2004

Source: Own calculations based on World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

FDI inflows in terms of annual Gross Fixed Capital Formation (GFCF) evidently demonstrate the scale of incoming FDI to Ireland. As shown in Figure 3.1.2, net inflows of FDI comprised just 6 percent of Irish GDP in 1970s and 1980s. It has even retreated below 1 percent in late 1980's. After FDI boomed in late 1990's, inflows reached 70 per cent of GFCF.

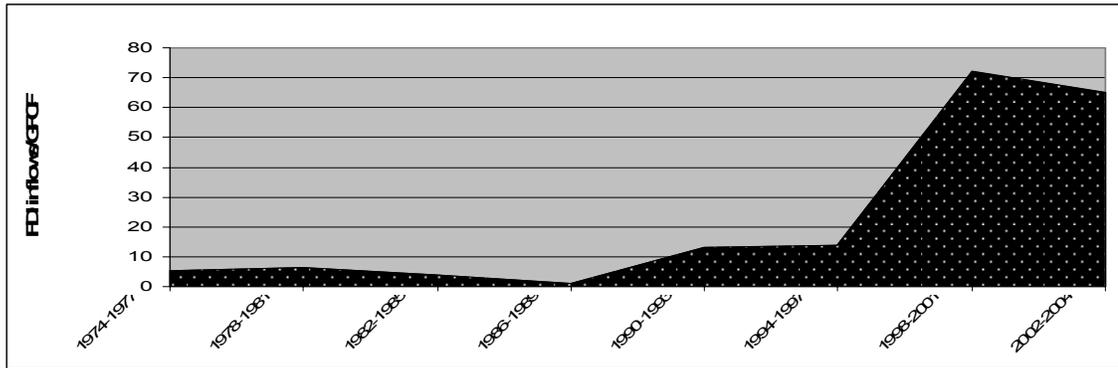


Figure 3.1.2 FDI inflows/GFCF in Ireland (%), 1974-2004

Source: Own calculations based on data retrieved from World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

Ireland's FDI inward stock has been generally high when compared with her GDP. The percentage of FDI inward stock in the economy clearly illustrates the high presence of foreign investments in the economy which makes Ireland one of the most open economies of the world. As shown in Figure 3.1.3, inward FDI stock covered above 150 percent of GDP in early 1980s. After mid 1980's inward stock decreased gradually in terms of GDP until the end of 1990s. FDI boom between 1999 and 2003 led inward stocks reach the level of mid-1980s.

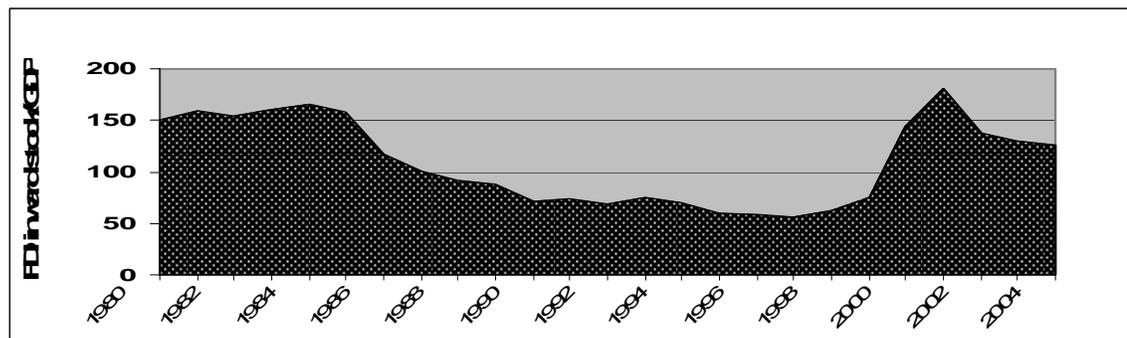


Figure 4.1.3 FDI Inward Stock/GDP in Ireland (%), 1980-2004

Source: Own calculations based on data retrieved from World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

3.1.2 Sectoral Destination of FDI

In parallel to global trends mentioned in Section 2.2, FDI began to shift its destination from manufacturing to services sector in Ireland. Figure 3.1.4 demonstrates the fact that until 1997, over 90 percent of FDI was flowing to the manufacturing sector. However, after 1996 services began to dominate as FDI destined to services comprise over 60 percent of total inflows.

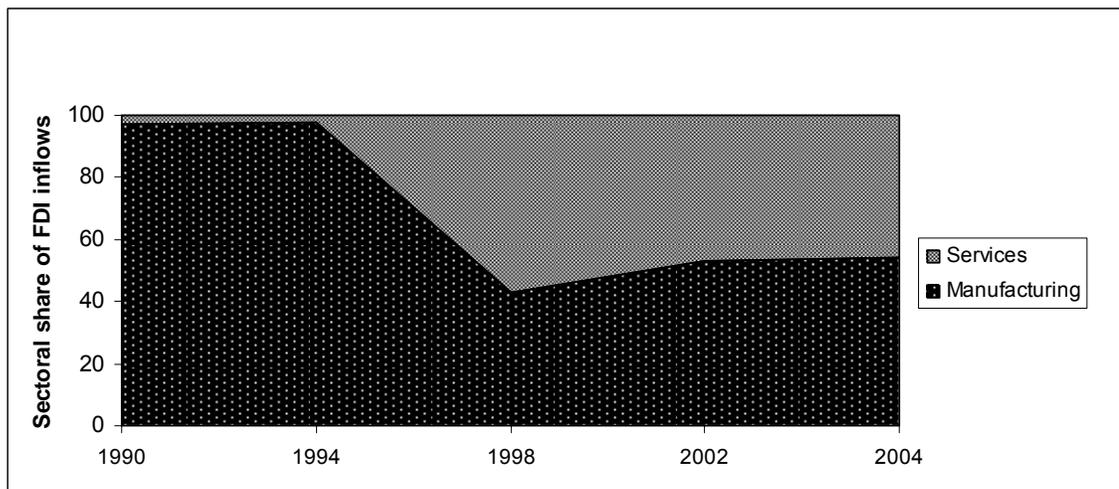


Figure 3.1.4 Sectoral destination of FDI inflows in Ireland(%), 1990-2004

Source: Central Statistics Office of Ireland: Balance of International Payment Service (www.cso.ie) (Cited on 30.1.2006)

As Figure 3.1.5 shows, FDI flows to the manufacturing sectors have been generally destined to increasing return sectors such as chemicals and chemical products, electrical and electronic equipment and precision instruments. In 1990, when FDI inflows boomed, the share of electrical and electronic equipments in FDI inflows was around 27 percent and other major sectors attracting FDI were food and beverages, textiles, clothing and leather. However, in 1995 these sectors' share began to shrink while high-technology sectors like chemicals and chemical products attract gradually increasing amounts of FDI. In 2000, electrical and electronic equipment production sector was still leading by attracting 45 percent of all incoming FDI. On the other hand, share of food products and textiles reduce to 10 percent and 2 percent respectively. Chemical

products and precision instruments sector tend to attract higher amount of FDI each year.

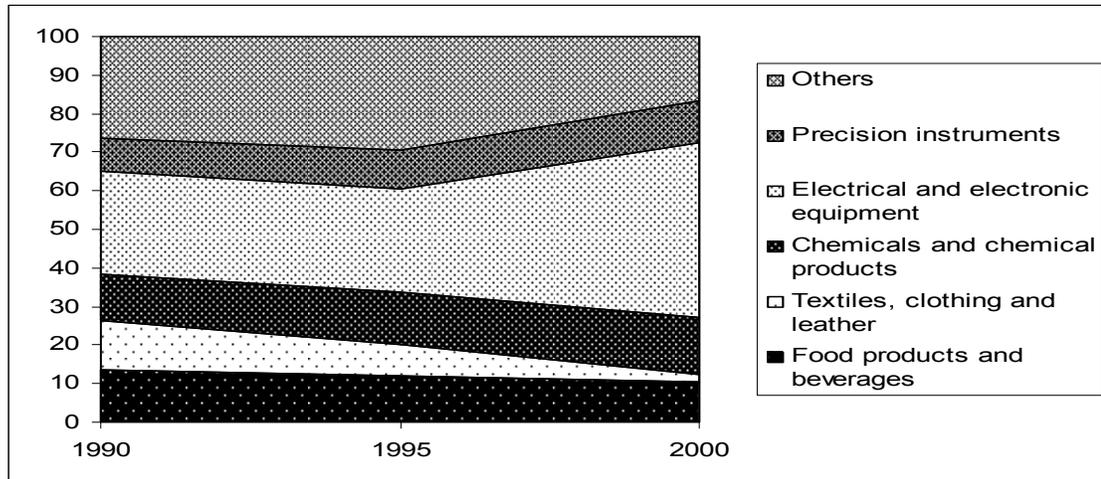


Figure 3.1.5 Shares of manufacturing sub-sectors in total FDI inflows to manufacturing sector in Ireland (%), in 1990, 1995 and 2000

Source: Own calculations based on data retrieved from Industrial Development Agency of Ireland (www.idaireland.com) (Cited on 30.1.2006)

3.1.3 Origins of FDI

Figure 3.1.6 shows the geographical origin of FDI inflows to Ireland. Before Ireland became a member of EU, UK was the major investor. In 1973, 42 percent of Irish FDI inward stock consisted of UK investments. The other continental European countries were also among the major investors in Ireland. After EU accession, US share in Irish FDI inward stocks rapidly increased and reached 63 percent in 2000. On the other hand, EU's share began to fall up to 20 per cent in 2000. Although Ireland joined EU together with UK, the latter's FDI stock in Ireland has decreased below 10 percent in 2000.

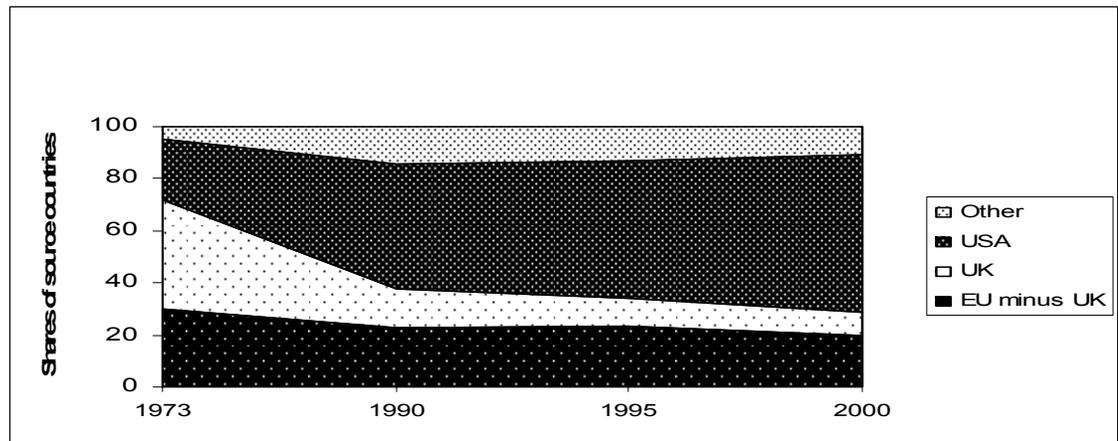


Figure 3.1.6 Origins of FDI inward stock in Ireland (%), 1973-2003

Source: Own calculations based on data retrieved from Industrial Development Agency of Ireland (www.idaireland.com) (Cited on 30.1.2006)

3.1.4 Determinants of FDI in Ireland

It is evident from annual inflow trends that EU accession did not result directly in a concrete increase in FDI until late 1980's and 1990's. However, a careful analysis of determinants of FDI indicates indirect effects of accession on attractiveness of country for foreign investors in the long-term.

Ireland's success in attracting FDI has been attributed to many factors. Studies in the literature by Barry (2000, 2003), Doherty (1999), Barry, Bradley, and O'Malley (1999), Ruane and Görg (2001) has identified low corporate tax rate, investment grants, an English-speaking environment, a plentiful supply of low cost educated workers, sound public finances and sensible economic policies, generous industrial incentives as the basic factors that increased the attractiveness of Ireland for foreign investors. The Irish Development Agency's role as an investment promotion agency is also emphasized. In the literature studies by Ruane and Uğur (2004) and Doherty (1999) also give a special emphasis on coherent, consistent and efficiently implemented FDI-led strategy followed by Irish government which has been complemented by EU membership.

This FDI-led strategy allowed Ireland to offer US firms the possibility of using its market as an export platform to the rest of Europe since Ireland is positioned as an access point to the EU. In the studies of Barry and Bradley (1997), Barry, Bradley, and O'Malley (1999) Kennedy (2001) EU membership has been also identified as a significant factor since Structural Funds and Cohesion Funds provided by EU has been used in financing infrastructural and educational programs which later paid in terms of inflowing FDI.

The effectiveness of these factors differs from each other thus a comparative study of these determinants helps us to measure their significance in explaining the success of Ireland in attracting FDI.

3.1.4.1 Natural Resources

Ireland is not a natural resource abundant country. The country is a net importer of energy resources. This is evident from the fact that those sectors necessitating abundance of natural resources did not attract foreign investors. As Table 3.1.1 indicates, in the major sectors like electronic equipment, chemicals and pharmaceuticals, office and data processing or communication, share of foreign affiliates in total sectoral employment is over 60 percent. In these sectors natural resources are not significant inputs. On the other hand in sectors like non-metallic mineral products, metal products or wood and wood products sectors which necessitate a substantial amount of natural resource inputs, share of foreign affiliates in total sectoral employment is less than 25 percent.

Table 3.1.1 Sector share and employment of foreign affiliates in manufacturing sectors in Ireland(%), 2002

	Sector Share in Total Employment	Employment of foreign affiliates in sector total
Food, drink and tobacco	18,8	27,4
Textiles, clothing and foot wear	4,3	33,7
Wood and wood products	2,4	17,8
Paper and printing	9,3	31,3
Chemicals and pharmaceuticals	9,1	77,0
Rubber and plastics	4,2	36,4
Non-metallic minerals	4,4	14,2
Metal products	6,6	21,0
Machinery and equipment	5,6	44,7
Office and data processing	8,1	88,3
Electrical machinery and apparatus	5,9	62,3
Radio, TV and communications	5,9	85,3
Medical and optical equipment	5,9	84,7
Transport equipment	7,1	55,8

Source: Own calculations based on data retrieved from Industrial Development Agency of Ireland (www.idaireland.com) (Cited on 30.1.2006)

3.1.4.2 Distance

Ireland is situated in north-eastern part of Europe. The country is located between US, UK and continental Europe. Considering the distance with continental Europe, Ireland can be classified as a peripheral country. On the other hand, the location of Ireland as one of the closest country to US is an advantage, since US TNCs consider Ireland as a bridge to access EU markets. Furthermore, cultural proximity, common language and a very big population of immigrants living in US brings Ireland and US even closer. The dominance of EU, US and UK investments in terms of inward FDI stock, shown in Figure 3.1.6, can be related to the proximity of these regions or countries. Geographical breakdown of foreign affiliates operating in

the country in Figure 3.1.7 further indicates the importance of distance factor. As seen in Figure 3.1.7, 53 percent of the affiliates are US originated ahead of EU TNCs consisting 31 percent. UK affiliates consisted a considerable 13 percent of total affiliates.

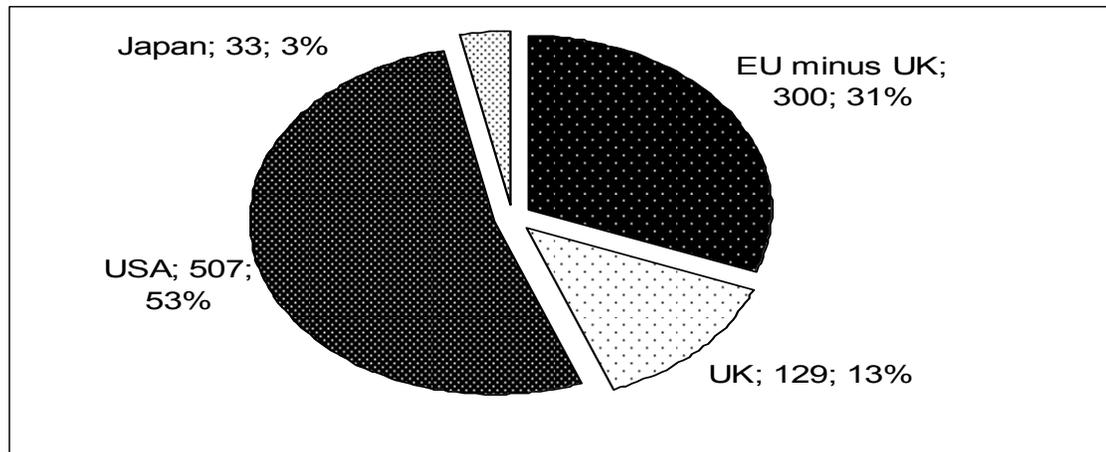


Figure 3.1.7 Geographical breakdown of foreign affiliates in Ireland (number and %), 2004

Source: Own calculations based on data retrieved from Central Statistics Office of Ireland (www.cso.ie) (Cited on 30.1.2006)

3.1.4.3 Labour Costs

Ireland's high skilled labour force is generally classified as cheap. As shown in Figure 3.1.8, in 1975 while EU average for hourly labour compensation was around 4 dollars, and US average was above 6 dollars, Ireland's corresponding amount was 3,1 dollars. During the period between 1975 and 2000, labour costs have all risen in the developed world. However, labour costs in Ireland always stayed below EU average and US despite the increasing welfare and economic growth. Especially during the period of economic and foreign investment boom beginning from mid-1990s, labour costs stayed below of EU average. However, combination of wage inflation and strength of euro

have brought about a convergence after 2000. Substantial labour cost differential with the USA and EU has also been narrowed.

Although low labour costs have been identified as a significant determinant in literature, it has not attracted substantial FDI to Ireland until necessary improvements in skill level of Irish workforce have been made as steady trend of FDI inflows during 1980s and early 1990's indicate. Moreover, Ireland attracted most of FDI to high technology sectors which pays higher wages to its workers. Thus, in general labour cost is not considered a significant determinant of FDI in Ireland.

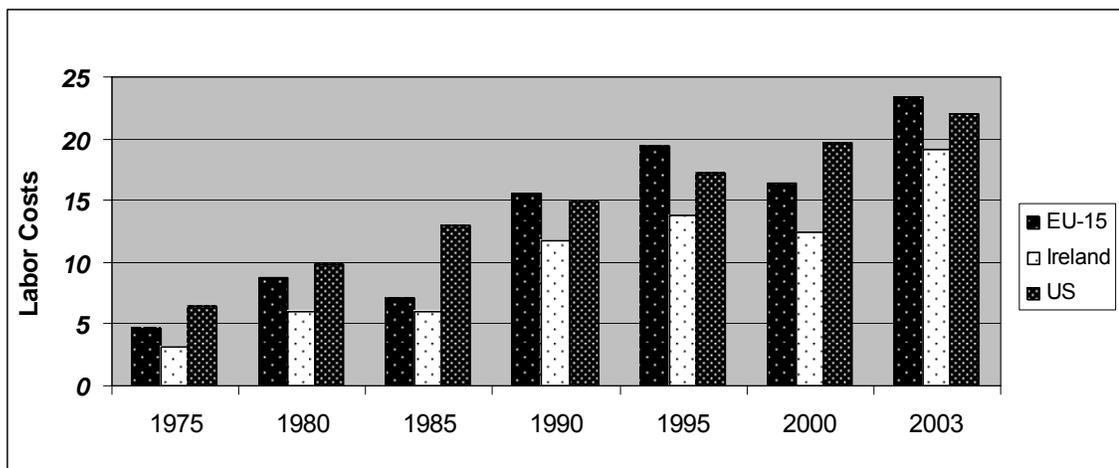


Figure 3.1.8 Hourly Labour Compensation for Manufacturing Workers in Ireland (dollars), 1975-2003

Source: U.S. Bureau of Labour Statistics and National Competitiveness Council (2005) (Cited on 30.1.2006)

3.1.4.4 Infrastructure and Human Resources

Ireland's success in attracting FDI is largely related to her achievement in developing a well designed infrastructure meeting the requirements of investors. Before Ireland joined EU in 1973, the country was lagging far behind the other members of the EU. There was not even a motorway in the country.

Ireland began receiving subsidies after joining the European community in 1973. Net receipts from the EU were approximately 4 percent of GDP from

1973 through 1986 which reflects a low growth period. The doubling of EU Structural Funds in 1989 and their subsequent further increase in 1995 improved infrastructure levels. The Structural Funds included support for investments in motorways and urban bypasses, upgrading of the rail network, national airports and ports (O'Neill, 2000:7). During the period of rapid growth, from 1995 through 2000, they averaged 3 percent of GDP (Barry, Bradley, and O'Malley (1999:42)). Nonetheless, EU funding has been particularly important in terms of the long-term contribution to the economy in terms of infrastructure development.

Ireland's public infrastructure has improved particularly in the telecommunications field. Figure 3.1.9 is a clear illustration of this improvement in the conditions. In 1975, average number of telephone mainlines per 1000 people was around 100. During 1980's this figure did not change despite a gradual increase in telephone mainlines. However, in late 1980s, largely owing to EU structural funds, the amount of mainlines constantly and rapidly increased. In 1999-2003 period, the number of telephone mainlines reached to 500 per 1000 people.

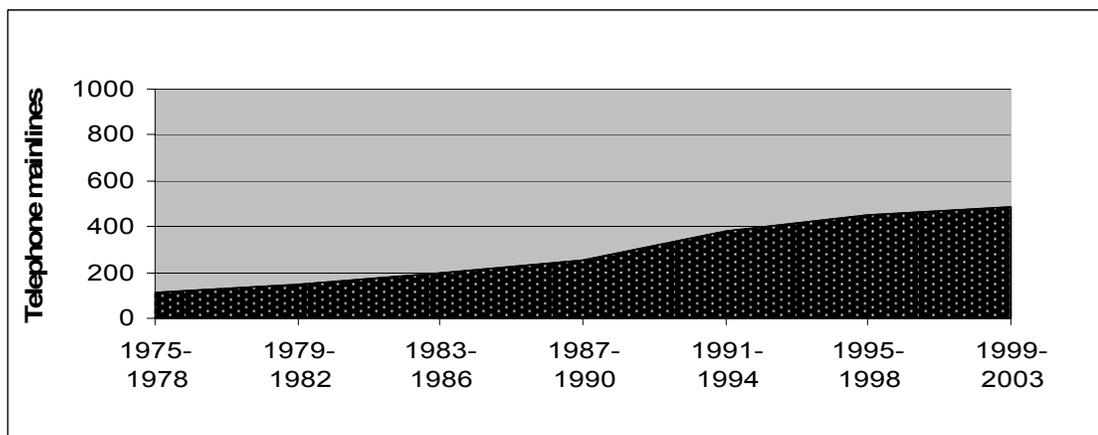


Figure 3.1.9 Average number of telephone mainlines per 1000 people in Ireland, 1975-2003

Source: Own calculations based on data retrieved from World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

Ireland's greater success is in her attainment of improving the human resources. The labour market in Ireland offers inward investors young, well-

educated and qualified workers. The structure of the Irish population is such that the availability of a young workforce is likely to continue. Approximately 38 per cent of people in Ireland are under 25 years of age being above the European average of approximately 30 per cent (Price Water House Coopers, 2003:26). Furthermore, English speaking population further increases Ireland's attractiveness for TNCs which seek comfortable working conditions. These features have been a significant factor in attracting the large number of multinationals that have located operations in Ireland.

Government investment in education has been vital in the human capital accumulation that has contributed to Ireland's recovery. Since the 1960s education has been treated as a 'major priority' by successive governments. In the 1980s, when many other sectors suffered severe problems, the education system improved. The value that the Irish government places on the role of education is reflected in its public expenditures on education. In 1990-2002 average Ireland spend 4,5 percent of its GDP to education. EU Regional Funds also contributed to Irelands continuous efforts to build a skilled labour force. Expenditure on training and improvements of education infrastructure absorbed 42 percent of Cohesion and Structural Funds allocated to Ireland (Paliginis, 2002:6).

With such financial support, Ireland improved in terms of educational attainment. Ireland ranks fourth in the OECD in terms of tertiary education¹¹ attainments since 1995. As shown in Figure 3.1.10, tertiary education attainment in 1991 was 15 per cent. Continuing investment in education led tertiary education attainment to reach 25 per cent in 2002, which is among the best figures in EU and OECD.

Over 60 percent of new entrants to tertiary level education in Ireland undertake business, engineering, computer science or science courses (Enterprise Ireland, 2003:10). More specifically, OECD (2002) data reveal that 40 percent of Irish tertiary graduates are in natural sciences, agriculture and

¹¹ University or equivalent

engineering – which compares to an EU average of only 28 percent. The above achievements in advancement of human resources together with English speaking population have been a very significant factor that attracted especially efficiency seeking FDI to high technology sectors such as software, electronics or pharmaceuticals especially after early 1990's as shown in Figure 3.1.5.

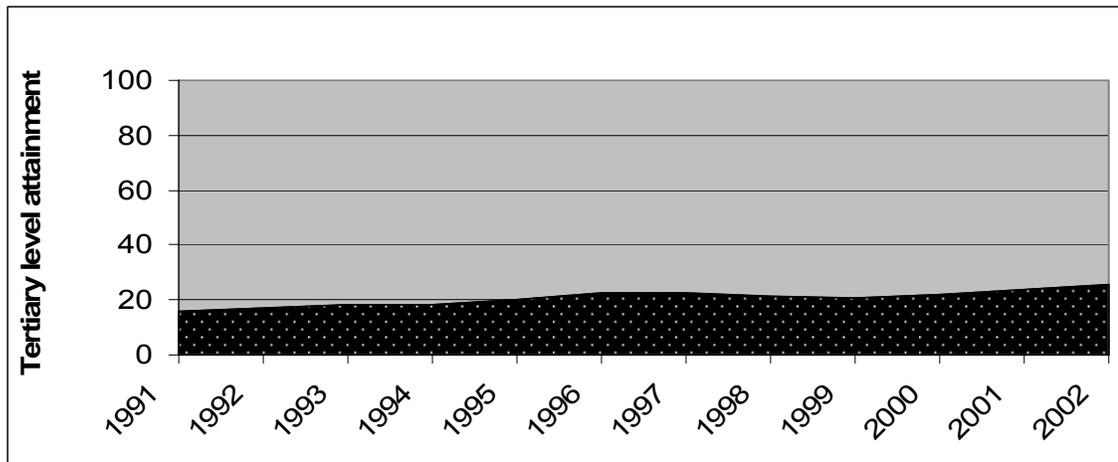


Figure 3.1.10 Tertiary level educational attainment of working population in Ireland (%), 1991-2002

Source: OECD (2005) (<http://lysander.sourceoecd.org/vl=7208621/cl=11/nw=1/rpsv/fact2005/>) (Cited on: 10.2.2006)

3.1.4.5 Market Size

Ireland is a small country in terms of land size and population. Despite the 1,3 percent annual growth which is the highest in the EU, population is still around 4,1 million according to 2005 estimations. This comprises only 1 percent of total EU-25 population (Economist Intelligence Unit, 2004: 11).

Due to the relatively small size of the Irish market, foreign companies locate Ireland primarily to serve foreign markets, since sales solely to the Irish market would not be profitable enough to justify the location of foreign-owned plants. The domestic market is of little significance to the foreign plants since mainly they locate in Ireland to produce for export to EU (Barry, 1999: 6).

Export performance of the foreign firms in the major FDI receiving sectors demonstrated in Figure 3.1.11 indicate that TNCs operating in Ireland mainly aim to use the country as an export platform to serve the enhanced market after EU accession. In the food and beverages sector which receives a decreasing share from inflowing FDI, foreign owned firms exported 72 percent of their output while domestic firms exported 38 percent. In the textiles sector while Irish owned firms' export performance is 46 percent, foreign firms export 90 percent of their output. Most export oriented foreign affiliates operate in chemicals and pharmaceuticals sector, in which almost all of the output in 2004 is exported. On the other hand, Irish firms are more domestic market oriented. They export just 26 percent of their products. Similarly, 90 percent of production is exported by foreign affiliates in electrical and electronic equipment sector which attracts most of FDI. In manufacturing sector in general, foreign affiliates export 90 percent of their production while Irish firms serve mostly to the domestic market.

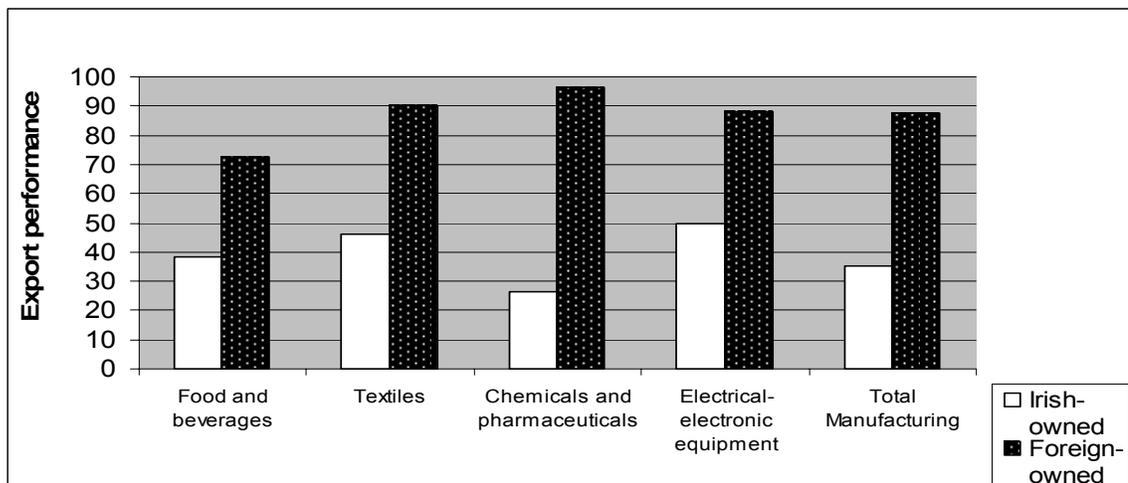


Figure 3.1.11 Export performance of selected manufacturing sectors in Ireland (%), 2004

Source: Data retrieved from Industrial Development Agency of Ireland (www.idaireland.com) (Cited on 30.1.2006)

For Ireland, EU accession was an important step which enhanced the market size of the country beyond domestic and UK market. As Table 3.1.2

indicates, since 1973, the proportion of exports to non-UK destinations increased from 45 percent to 74 percent. In 1975, Ireland was exporting 54 percent of its exports to UK. After EU membership, UK began to lose its share as an export destination, despite the significant surge in exports to EU. Europe as a whole became the major trading partner, with over two-thirds of Irish exports now going to other member states rather than UK. Similarly the share of US and other countries significantly expanded.

Table 3.1.2 Destination of Irish exports (%), 1975-2000

	1975	1985	1990	1995	2000
EU minus UK	27,9	39,6	44,2	46,8	39,9
UK	54,2	33	33,7	25,4	21,8
US	6,3	10,1	11,7	14,5	17,2
Other	12,6	17,3	10,4	13,3	21,1

Source: Retrieved from UN Trade Statistics Database

<http://unstats.un.org/unsd/comtrade/dqBasicQueryResults.aspx?y=2004&px=BE&r=372> (Cited on 4.2.2006)

Table 3.1.3 on the export destinations of Irish and foreign companies indicates that Irish companies mainly aim to export UK and EU market. On the other hand, EU originated investors try to export their products to EU market. US investors have a greater tendency to export to EU market.¹² They are exporting 52 percent of their products to EU market. US affiliates also try to export to the UK market and other markets through Ireland. This tendency of US affiliates in exports to EU proves the fact that market seeking motive has been a dominant factor in especially US investments to Ireland.

¹² In the information technology sector for example, most of the computers produced by Dell and the packaged software products produced by Microsoft at their Irish plants are exported to markets in Europe, the Middle East and Africa. In the case of electronic components however, produced in Ireland by Intel and a number of other firms, the United States is as important an export destination as the EU. (Barry,1999: 7)

Table 3.1.3 Export destinations Irish firms and foreign affiliates, 2004

	UK	EU minus UK	USA	Other
Irish	42,1	32,2	7,3	18,4
EU	32,9	50,6	6,5	10
USA	20,9	52,4	10,4	16,2
Total Foreign	26	47,6	10,2	16,2

Source: Data retrieved from Industrial Development Agency of Ireland (www.idaireland.com)
(Cited on 30.1.2006)

3.1.4.6 Macroeconomic Stability

Ireland was not able to sustain macroeconomic stability shortly after joining EU since Ireland's accession to the EU in 1973 coincided with the first of the major oil shocks of the 1970s and with the slowdown in world productivity growth. The Irish debt crisis, like the broader world debt crisis, happened due to the oil shocks of 1973 and 1979 (Barry, 2003: 900). High levels of government debt, interest payments, and expenditures put Irish government in an insecure fiscal position. The government reacted, in the early 1980s, by increasing taxes on labour and consumption to reduce the budget deficit. Fiscal stabilization sustained through a rapid cutback in government expenditures and by an anti-inflationary policy, while a decline in government borrowing reduced the debt burden. The deficit was eliminated in 1987, and the debt-to-GDP ratio started falling sharply. In 1990's, Ireland managed to sustain macroeconomic stability. The government in order to comply with Maastricht Criteria got inflation under control. EMU membership also brought a strict fiscal discipline which strengthened long-term macroeconomic stability. Irish pound followed a stable track during 1990s. Owing to the stability sustained in terms exchange rate in this period, the transition to actual use of the euro at the start of 2002 was exceptionally smooth, and Ireland was among the first of the 12-euro zone members to complete the process (Economist Intelligence Unit, 2004: 23). In

the long run, more important than any other economic feature of EU membership, have been the access to the Single Market. The single market reforms were brought significant benefits to Ireland.

Membership in the EU had positive implications on sustaining long-term political stability by building a buffer for Ireland to avoid political turmoil in the northern part of the island. Thus, despite the slowdown in the economy during EU accession in 1973 due to global recession, political stability could be sustained. In 1980's and 1990's deeper integration within EU presented Ireland, who has a favourable attitude towards integration since her accession, a stable domestic political ground.

In general, macro-economic stability sustained in 1990's which led Ireland to become a member of Euro area has also been a significant factor in the boom of FDI in the same period.

3.1.4.7 Openness and Business Environment

One of the main factors behind Ireland's earlier poor performance is that it retained its protectionist barriers for about a decade longer than European countries. Ireland followed an import-substitution industrialization policy from the 1920s to the end of the 1950s. Irish government deliberately tried to open up the economy around 1960. The Control of Manufacturers Act which limited foreign ownership of Irish industry to minority holdings had been abolished. The outward orientation of foreign trade and the abandonment of the protectionist import-substitution strategy have been accompanied by a policy that encouraged the development of export-oriented manufacturing industries through tax and financial incentives. While protectionism did lead to an expansion in the share of industry at the expense of agriculture, outward-orientation turned Ireland into an export oriented country after joining EU.

The gradual opening up of the economy lead to a surge in degree of openness basically related to the high level of exports mentioned above. Degree

of Ireland's openness is shown in Figure 3.1.12. In 1974 trade intensity (ratio of exports and imports to GDP) of the country was 43 percent while FDI intensity (ratio of inward FDI to GDP) was only 0,6 percent. Since then both of the measures of openness gradually improved especially in 1990's. In 1990 trade intensity was 45 percent and in 2000 reached to 81 percent. The boom in late 1990's led FDI intensity over 25 percent.

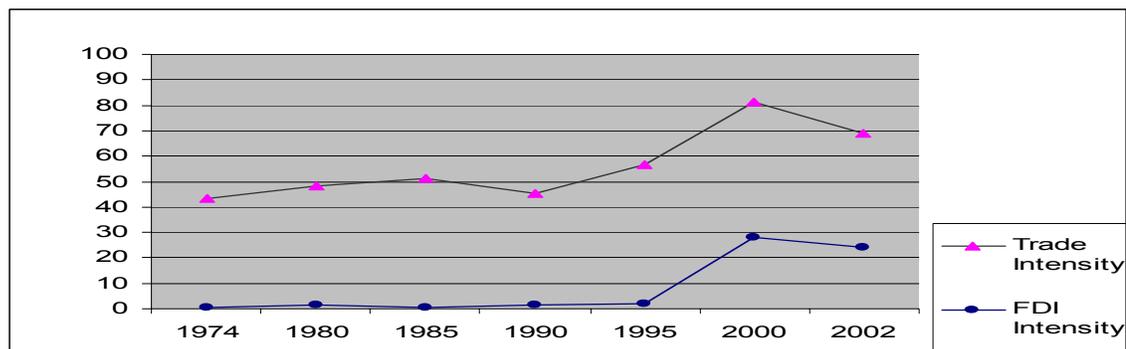


Figure 3.1.12 Trade and FDI intensity in Ireland (%), 1974-2002

Source: Data retrieved from World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

The business environment in Ireland has been generally liberally oriented especially since joining EU. As mentioned above, after the protectionist regime has been abandoned in 1960's, government applied a business friendly regime. Economic policies are designed to foster a climate conducive to business and economic development and to attract foreign investment that will expand employment opportunities. Global Entrepreneurship Monitor rated Ireland as one of the best countries in the world in which to start a business together with USA, and ahead of Britain, France and Germany (Enterprise Ireland, 2003:8).

Business environment is also very favourable for foreign and domestic companies. Table 3.1.4 illustrates some of the indicators of business environment in comparison with OECD average. In Ireland, number of procedures that should be fulfilled to establish a company is 6 procedures equal

to OECD average. It is possible to start business in 24 days to fulfil these procedures in Ireland while OECD average is 25 days. Furthermore, legal system in Ireland makes it easier to enforce business contracts. Through 16 procedures contracts can be enforced in 217 days in Ireland while corresponding levels for OECD average is 19 procedures in 219 days. This level of convergence with OECD in terms of general business environment indicators has been a motivating factor for investors, since it signals confidence and limited bureaucracy.

Table 3.1.4 Business Environment Indicators in Ireland, 2005

	Ireland	OECD
Starting a business: no of procedures	6	6
Starting a business: duration (days)	24	25
Enforcing contracts: no of procedures	16	19
Enforcing contracts: duration (days)	217	219

Source: Data retrieved from World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 30.1.2006)

One such factor, facilitating a business friendly environment has been Ireland's industrial strategy, involving a series of national agreements since 1988 between the government and key economic and social interest groups. A key element of this has been wage bargaining, which is seem to have contributed to increase in FDI inflows by maintaining the competitive level of industrial costs. Successive governments have used the process to purchase wage moderation via the promise of future tax cuts (O'Neill, 2000:7). Beginning in 1987, a series of national wage pacts has been agreed between the 'social partners'¹³. The social partnership approach brings partners every three years to agree a general path for wages and working conditions over the course of the agreement (Barry, 2001:14). Thus, labour costs and industrial relations have

¹³ Initially, partners are composed of government, private sector employers, and trade unions but, in late 1990s, this has increased to four as representatives of the unemployed and of community groups have joined the partnership. (O'Neill, 2000:7)

become moderate for foreign investors which contributed to the attractiveness of the country for FDI.

3.1.4.8 Incentive Schemes

Incentives have been one of the basic elements of Ireland's FDI oriented policy. These incentives are applied in the form of low taxes and grants.

Ireland used tax measures for many years as a means of facilitating the establishment and expansion of local and overseas companies. Introduced in 1957, tax holiday¹⁴ was given initially for ten years. However, this was later subsequently extended to twenty five years with a further five years of partial relief (Ruane and Görg 1999:42). But, in spite of a zero corporate tax rate that dates back to 1957; FDI flows boomed in the late 1980s and the 1990s. From 1982 to 2003, new firms in the manufacturing sector have been entitled to a rather low standard corporate tax rate of 10 per cent. Then Ireland was forced by the European Commission to alter the policy for new firms and raised corporate tax rate to 12,5 percent in 2003. Despite this rise in the rate, Ireland's corporate tax rates are lowest in EU and OECD.¹⁵ Low corporate taxes have been seen as one of the basic factor that increased the attractiveness of country for foreign investors.

The second branch of Ireland's incentive policies composed of financial supports. Grants are available for both manufacturing and services in the form of capital and employment grants. Capital grants are available to subsidise expenditure on the purchase of land and new plant and equipment. Employment grants are available where permanent full-time positions are created and are the most commonly used type of grant. Grants are also available towards investment in R&D facilities and major training initiatives. Recognising the negative effects of uncertainty on investment, Irish governments attempted to

¹⁴ Tax holiday refers to exemption of some pre-determined transactions from tax with a limited time span.

¹⁵ Average tax rates in EU and OECD are 31 percent and 30 percent respectively.

give as much certainty as possible to the incoming and established investor through policy continuity especially in terms of financial incentives. Grants are essentially independent of the annual budgetary process and of changes in government. Uncertainty on the part of firms has been minimised by the payment of the cash grant in advance with repayment required if the firm fails to meet its agreed employment objectives (Ruane and Görg, 1999:38). This gives certainty and security to both investor and government.

Besides the low corporate tax regime and financial grants, another decisive factor in attracting FDI has been Irish Development Agency (IDA) which administers active investment promotion and aftercare services. IDA has offices in abroad especially to promote investment opportunities in Ireland. These offices establish and run intimate connections with potential investors. Established in 1969, IDA followed a pro-active, market-led, interventionist policy. IDA's strategies since the 1980s targeted high-technology activities including electronics, pharmaceuticals, health care, international traded services, financial services, software, and office activities.¹⁶ A second IDA priority is the rising of the quality and strengthening of the sustainability of these companies to enhance their strategic value and locate them more securely in the Irish economy. IDA offers grants for investors which also encompasses other forms of assistance such as training or R&D.

In general, incentive schemes in Ireland have been very successful in terms of attracting FDI to high technology sectors. The higher share of foreign investments in sectors such as chemicals and pharmaceuticals or electrical and electronic equipments as shown in Figure 3.1.5, stems from targeted incentives to these sectors. Furthermore, these incentives succeeded in transforming

¹⁶ Particular examples were the identification and early exploitation of software in the 1980's, call centres and shared service centres in the early 1990's, and e-business in 1999.

export portfolio of Ireland from one dominated by low technology goods into one dominated by high technology goods.¹⁷

3.2 Spain: FDI since EU Membership

Spain had been one of the least developed countries in European geography until EU membership. Franco regime led to the isolation of the country from the enlarging and deepening EU market. Industrial development lagged behind the other core European countries, while trade and FDI relations were very limited. However, after the end of Franco regime in mid 1970's, country has gone through a major transformation process fuelled by rapid democratisation. Although this process had been intervened by attempts to reverse democratisation, in the beginning of 1980 a certain degree of stabilisation was sustained. EU membership in 1986 further consolidated the regime and opened Spanish market to foreign investors.

The Spanish experience can thus provide an interesting case to evaluate the impact of EU Membership on FDI flows. The combined effect of the development of her internal market and the increasing external opening of her economy, which concluded by her integration into the EU, have led to a continuous rise in her trade flows as well as a impressive increase in foreign direct investment. The massive increase in FDI inflows following the Spain's integration with EU in 1986, coupled with the prospects about the completion of the Single European Market by 1992, has been one of the most important features shaping the behaviour of the Spanish economy in the last twenty years.

¹⁷ High technology goods have a 50% share in total exports of Ireland since 2000, while EU-15 average is just over 20 percent. (OECD, 2002:4)

3.2.1 FDI Inflows and Inward Stock

FDI Inflows of Spain were negligible throughout 1970's and in the first half of the 1980s as shown in Figure 3.2.1. FDI inflows grew especially rapidly in the second half of the 1980s and early in the 1990s which also coincided with a boom in global FDI. Beginning from the 1986, the year that Spain became an EU member, annual FDI inflows increased in impressive amounts. In 1986, FDI inflows reached 3,5 billion dollars which then doubled in 1988 to 7 billion dollars. During this period, besides the United Kingdom, Spain was the country within the EU which attracted the highest level of FDI. Starting from 1992, FDI inflows lost pace until the next surge in 1998. After 1998 FDI inflows steadily increased and finally reached its maximum amount being 43 billion dollars in 2002.

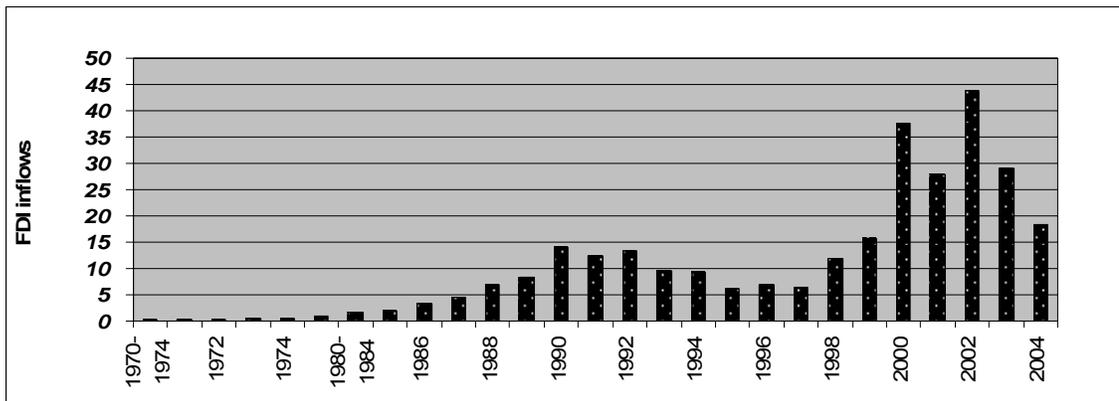


Figure 3.2.1 Net FDI Inflows in Spain (Billion dollars), 1970-2004

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

As demonstrated in Figure 3.2.2, FDI inflows have been even more impressive considering its share in terms of GFCF after EU accession. Reluctant growth in terms of inward FDI have led to a very small FDI contribution to the GFCF in Spain until 1980. However since then, FDI began to comprise an increasing share in GFCF. In 1985-1989 period, FDI inflows comprised about 8

percent of GFCF. After the slowdown in mid 1990s, stronger surge in FDI inflows increased the share of FDI inflows in GFCF to 16 percent in 2000-2004.

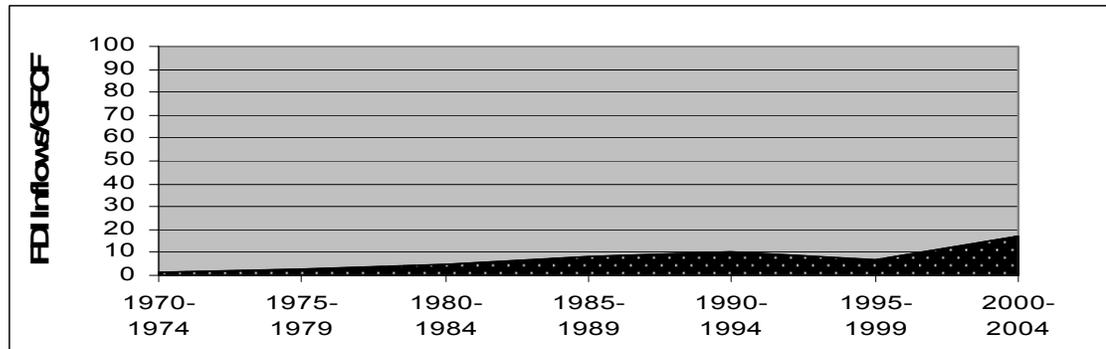


Figure 3.2.2 FDI Inflows/ GFCF in Spain (%), 1970-2004

Source: Own calculations based on data retrieved from World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

The increasing FDI inflows led to a striking climb up in FDI inward stock. The rise in FDI stock as a percent of GDP is demonstrated in Figure 3.2.3. Until 1986, although there was a slight increase in FDI inward stock, it comprised just below 5 percent of GDP. However, in the second half of 1980's this ratio gradually increased reaching 10 percent in 1990. During 1990's the figure stayed steady while second surge that began in late in 1999 led inward FDI stock/GDP ratio to reach 35 percent.

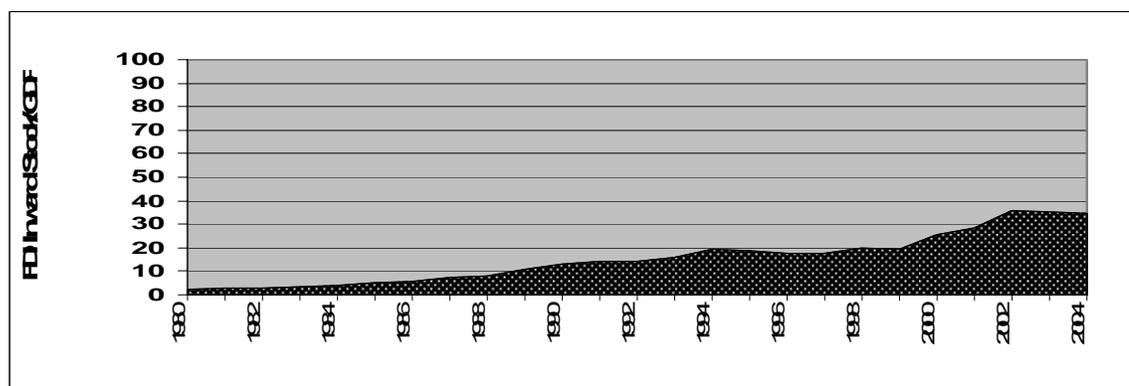


Figure 3.2.3 FDI Inward Stock/GDP in Spain (%), 1980-2004

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

3.2.2. Sectoral Destination of FDI

Manufacturing activities have been the traditional major recipients of FDI inflows to Spain accounting for 65 percent of total inflows in the first half of 1980's as represented in Figure 3.2.4. However, its share decreased steadily over the last decade and especially after 1986. 80 per cent of FDI is attracted by services sector in recent years. Increasing inflows to services are mainly explained by the rise of FDI in real estate, finance and insurance activities in parallel with the global trends.

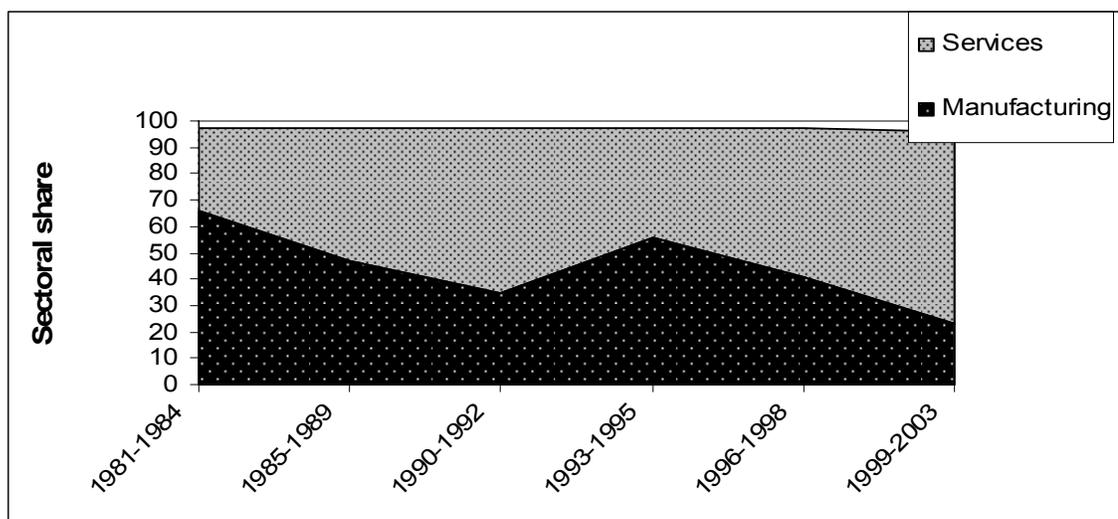


Figure 3.2.4 Sectoral Destination of FDI Inflows in Spain (%), 1981-2003

Source: Own calculations based on data retrieved from Banco de Espana, International Investment Position <http://www.bde.es/infoest/e0706e.pdf> (Cited on 10.2.2006)

As listed in Table 3.2.1, investments are distributed across all industrial sub-sectors of manufacturing in Spain. However, FDI is mostly concentrated in low technology sectors. In this category, most attractive sectors for foreign investments were food, beverages and tobacco together with minerals and non

metallic minerals which are basically related to natural resources that the country possesses. In the medium technology category, FDI destined to motor vehicles and transport equipment sectors. Similarly share of high-technology sectors have increased throughout late 1980's and 1990's. Chemical industry continued to receive a considerable amount of FDI, followed by electrical machinery sector.

Table 3.2.1 Shares of sub-sectors in total FDI inflows to manufacturing sectors (%), 1988-1997

	1988-1990	1991-1997
High Technology	26,2	27,7
- Chemicals	17,4	18,5
- Office Machinery	4,0	0,6
-Electrical Mach., precision and medical instruments	4,8	8,6
Medium Technology	26,4	27,2
- Rubber and plastics	5,6	3,8
- Machinery and equipment	2,2	2,5
- Motor vehicles, transport equipment	18,3	20,2
Low Technology	47,4	45,1
- Food, beverages, tobacco	10,9	16,3
- Textiles	2,2	1,7
- Wood, paper, printing	13,6	7,1
- Minerals and non-metallic minerals	14,6	16,6
- Basic and fabricated metals	4,6	2,4

Source: Ministry of Industry, Tourism and Trade, Foreign Investment Registry of Spain <http://www.investinspain.org/defaultin.htm> (Cited on 10.2.2006)

Data on foreign penetration (share of FDI) in manufacturing sectors in Table 3.2.2 shows that foreign companies have larger shares in high and medium technology sectors while Spanish companies dominate low-technology sectors. Among the manufacturing sectors, chemical products sector is mostly owned by foreign companies and textile sector is the one with the lowest foreign ownership. In general, among top five foreign penetrated sectors, there are two high technology (chemical products and electrical machinery) and three medium

technology sectors (motor vehicles, non-electrical machinery, rubber and plastics).

Table 3.2.2 Foreign penetration (share of FDI) levels in manufacturing sub-sectors of Spain (%), 2003

Chemical Products	65
Rubber & Plastic	54
Electrical Machinery	57
Motor Vehicles	60
Non-Electrical Machinery	41
Non-Metal Mineral Products	32
Paper, Printing & Publishing	30
Metal processing	30
Food Beverages & Tobacco	27
Textiles Apparel & Leather	18

Source: Ministry of Industry, Tourism and Trade, Foreign Investment Registry of Spain
<http://www.investinspain.org/defaultin.htm> (Cited on 10.2.2006)

3.2.3 Origins of FDI Inflows

Even though developed countries remained as the almost exclusive source of FDI inflows in Spain, there has been a redistribution in their origin during the eighties and especially since 1986. However, in the first half of 1980's, EU FDI began to prevail over US FDI. After Spain's EU accession, EU FDI boomed comprising 80 percent of inflowing FDI to Spain. The share of the United States decreased dramatically. While between 1960-1979 US FDI in Spain represented on average 33 percent of total FDI inflows, this has decreased to 5 percent between 1986-1992. In the 1999-2004 period however, EU FDI saturated and US share in total FDI inflows has risen to 25 percent again. The most outstanding development in 1999-2004 has been Latin

American countries increasing penetration in the Spanish economy which corresponded to 10 percent of total inflows.

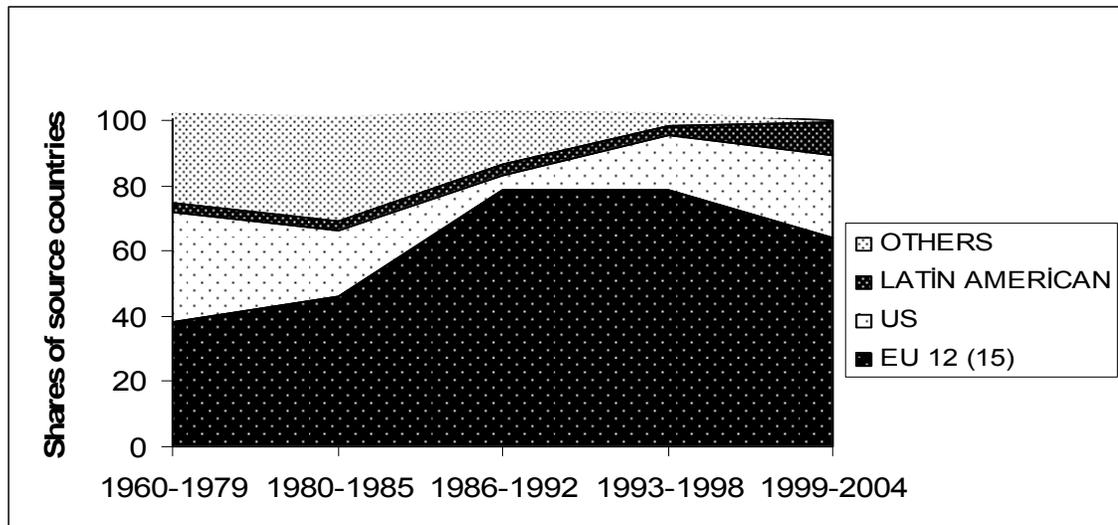


Figure 3.2.5 Geographical breakdown of FDI inflows in Spain (%), 1960-2004

Source: Ministry of Industry, Tourism and Trade, Foreign Investment Registry of Spain <http://www.investinspain.org/defaultin.htm> (Cited on 10.2.2006)

3.2.4 Determinants of FDI in Spain

There are several studies on determinants of FDI to Spain. According to the survey of Buesa-Molero, Casado (1995), which was made among German and Dutch investors in Spain, the size and characteristics of the domestic market were ranked by far the most important attractive factors for the German investors. Dutch investors appreciated cost-related factors, fiscal incentives, and legal framework more. The studies of several other scholars Bajo-Rubio (1991), Bajo-Rubio and Torres (1996), Bajo-Rubio, Sosvila-Rivero (2001), Diaz de Sarralde-Martinez (1996) identified market size, macroeconomic stability and openness as common significant determinants of FDI. In all these works, contrary to the general belief, it was found out that labour costs were not significant determinants, not even in the manufacturing sector. EU integration was found to be an important determining factor in the studies of Bajo (1991),

Bajo-Sosvilla (1992), Diaz de Sarralde-Martinez (1996), Bajo-Rubio and Torres (2001) and Aristoteles and Fountas (1992). Common finding in all of these studies is that EU membership has been a significant factor in Spanish case since it had several implications on the other locational determinants.

3.2.4.1 Natural Resources

Spain has considerable reserves of some natural resources such as metals and non-metallic minerals. Basic and fabricated metals constitute 6 percent, of all Spanish exports while fuels and non-metallic minerals comprise 3 percent of Spain's exports in 1990-2000 period. On the other hand, Spain is a net energy importer since almost 70 percent of its energy is imported.

Especially throughout late 1980's and 1990's non-metallic minerals and metal processing sectors attracted a considerable amount of FDI. In general, natural resources have not been one of the fundamental determinants attracting foreign investor which is evident from the low level of foreign penetration in natural resource based sectors such as metal processing or non-metallic minerals sub-sectors as shown in Table 3.2.2.

3.2.4.2 Distance

Spain is situated in the southern periphery of Europe. As mentioned in section 3.2.3, major foreign investors in the Spanish economy have been EU countries and USA, although the latter lost its share after Spain became a member of EU. Nevertheless, it is possible to argue that distance has not been an important factor in the decline in US FDI. Rather, Spain's integration with the European economies has been a more influential factor in this trend.

On the other hand, considering the major investor countries in the EU, core European countries comprise 45 percent of total foreign affiliates in Spain. According to data on number of foreign affiliates in Spain listed in Table 3.2.3,

among this core group, eastern neighbour of Spain, France, has the major share. Netherlands also has a considerable share corresponding to 14,4 percent. Among the core European countries Germany has slightly less FDI in Spain than the others, while UK which is more distant than these core European countries also has a significant share of about 13 percent.

Spain also attracted considerable amount of Latin American FDI since late 1990s. As it is widely known, Spain is the major investor in Latin American countries especially in 1990's. Together with the intensifying trade relations stemmed from ongoing flow of Spanish FDI in the region, Latin American companies led by Mexican companies began to establish foreign affiliates in Spain. In 2004, Latin American investments in Spain correspond to 18 per cent of all FDI inflows. This development rather proves the fact that in Spanish case, cultural proximity has been a more significant factor than geographical distance.

Table 3.2.3 Share of foreign affiliates of some EU members in total number of foreign affiliates in Spain (%), 1980-2004

	1980-2004
France	14,7
Netherlands	14,4
Germany	10,3
UK	12,5

Source: Ministry of Industry, Tourism and Trade, Foreign Investment Registry of Spain <http://www.investinspain.org/defaultin.htm> (Cited on 10.2.2006)

3.2.4.3 Labour Costs

Statistical data indicate that nominal costs in Spain are lower than most EU countries. Figure 3.2.6 evidently demonstrates this fact by comparing hourly compensation of manufacturing workers in Spain, EU and US. As the figure

indicates, Spanish labour costs have always been well below the EU and US average in last three decades. In 1985, while EU average labour cost was 7 dollars and US labour costs were 13 dollars, Spanish workers earned 4,7 dollars. Labour costs are constantly increasing as the skill level and general welfare increases in Spain. In line with this trend, labour costs in Spain reached to 15 dollars in 2003. However, labour costs are still lower than EU and US. In general, as mentioned earlier, foreign investors are more interested in medium and high-technology sectors in Spain in recent years as shown in Table 3.2.2.

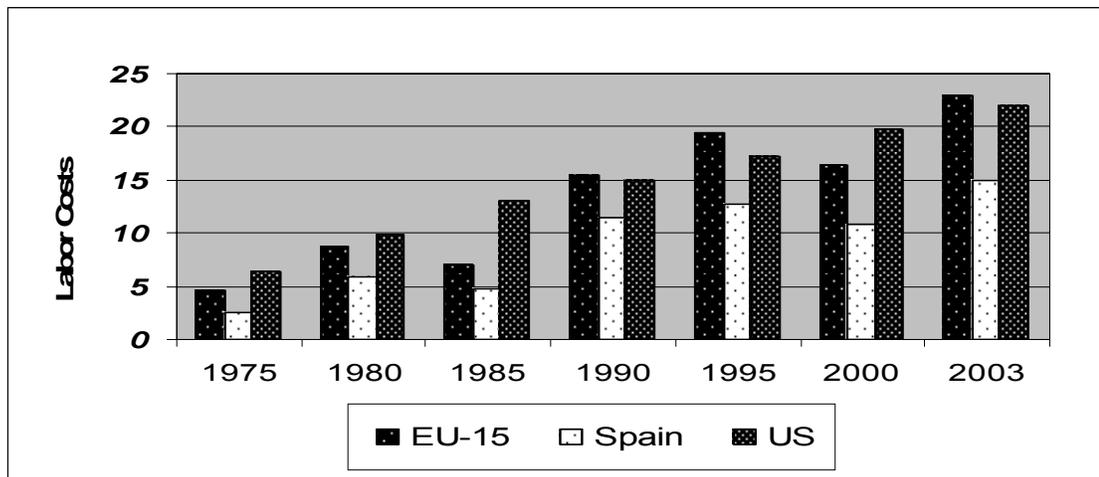


Figure 3.2.6 Hourly Compensation Costs for Manufacturing Workers in Spain (dollars), 1975-2003

Source: US Bureau of Labour Statistics Database <http://data.bls.gov/cgi-bin/surveymost?ec> (Cited on 11.2.2006)

3.2.4.4 Infrastructure and Human Resources

The development of modern transportation and telecommunication infrastructures has been one of the priorities of Spain's economic policy since the mid-1980s. Major infrastructural shortcomings have been addressed and road and telecommunication networks improved considerably both in quantity and quality. After accession to the EU, community financial support contributed to the development of Spanish infrastructure. 80 percent of the means of the structural funds and a major part of the Cohesion Fund were directed towards

infrastructure (Royo, 2004:3). The percentage of public investment financed by EU funds has been rising since 1985, and reached average values of 15 percent for Spain between 1989-1999. Spanish government also made efforts in this respect. From the mid-eighties public spending on infrastructure increased significantly. The most spectacular development is observed in public roads in Spain. The length of the roads more than doubled. Improvement in the endowment of transport infrastructure is well illustrated by the fact that in 1986 the length of public roads was 71 percent of the EU average, but in 2004 it was 95 percent (Economist Intelligence Unit, 2004:23). In general according to OECD (2005), Spain's infrastructural level measured by public capital stock (including roads, railways, ports, schools and hospitals) comprises 47 percent of its GDP. This ratio is very close to the OECD average which is 50 per cent.

In the field of telecommunication, several million new phone lines were installed and the process of digitalization advanced. As Figure 3.2.7 demonstrates, while only 200 telephone mainlines were available for 1000 people in 1980, because of the increasing investment in the telecommunication network this number rise to 315 in 1990 and 506 in 2002.

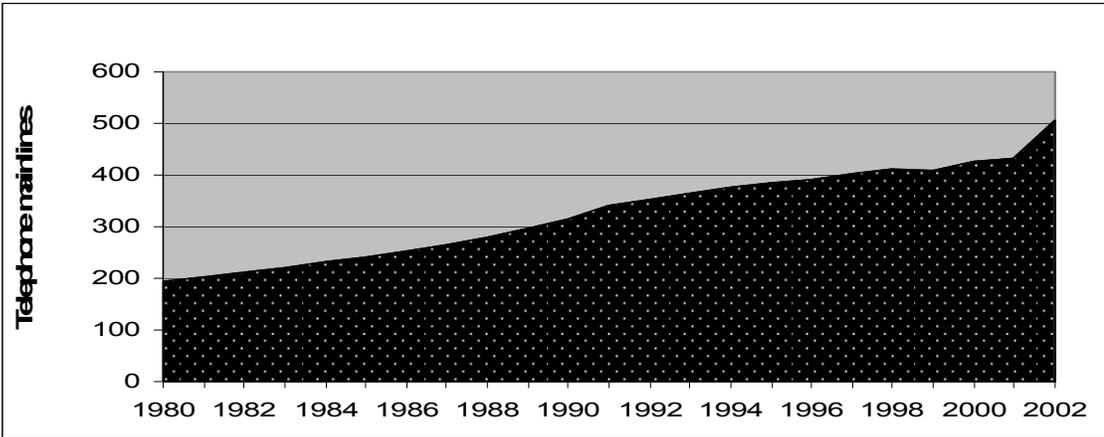


Figure 3.2.7 Telephone mainlines per 1,000 people in Spain, 1980-2002

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

Before EU accession Spain was among the laggards of European countries in terms of education and training. At the end of the 1970s, over two-thirds of the population in the middle age-group (25-44 years) completed no more than the compulsory period of primary schooling (Larre-Torres, 1991:180). However successive Spanish governments began to increase their educational spending since mid-eighties. Today Spanish governments spend 5 percent of GDP to education which is still less than OECD average.

Furthermore EU structural funds contributed to finance education and training programs to upgrade skill level of Spanish population and as Figure 3.2.8 demonstrates, Spain levelled with OECD and EU average in terms of tertiary level education attainment of working population. While just 10 percent of working population accessed to tertiary education in the beginning of 1990's, as the educational spending increased, Spain reached EU and OECD levels of 25 percent. According to latest figures in 2002, 24 percent of Spanish working population attained tertiary level education. Spain is the second country in the EU in number of students attaining university education as a percentage of total population (Molero, 2001: 48).

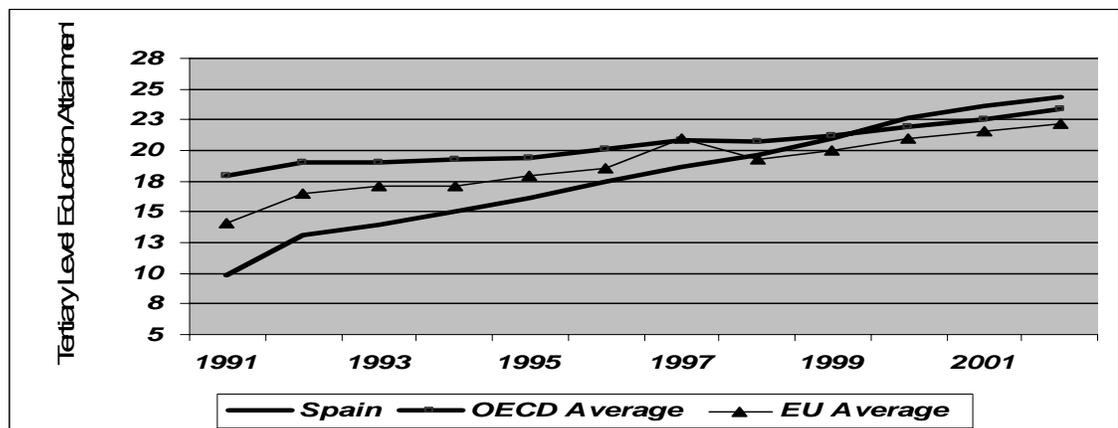


Figure 3.2.8 Tertiary Level Education Attainment of Working Population in Spain (%), 1991- 2002

Source: OECD(2005)(<http://lysander.sourceoecd.org/vl=7208621/cl=11/nw=1/rpsv/fact2005/>)
(Cited on: 10.2.2006)

Although, Spanish government did not implement a foreign investment oriented education strategy like we see in Irish case, skill level of Spanish population has been improved which may be an important factor in explaining higher foreign penetration of FDI in medium and high technology sectors. EU funds have played a prominent role in developing the factors that improve competitiveness and have upgraded the location bound advantages of Spain. Thus in general, it can be concluded that efficiency-seeking investments to medium and high technology sectors began to dominate FDI inflows to Spain in recent years as shown Table 3.2.2.

3.2.4.5. Market Size

Spain is among the largest markets in European Union. The population amounting to 41 million in 2004 is the fourth biggest in EU after Germany, France and UK. The population has a steady growth unlike Ireland. GDP per capita also gradually increased especially after EU accession. In 1985, GDP per capita was 9.000 dollars and Spain was lagging behind other members of EU in this category. However, after the EU accession Spanish GDP per capita reached to 15.079 US dollars in 2004 and total GDP reached to 991 billion dollars. With this amount, Spain consists fourth biggest economy of Europe.

Taking into consideration the scale of her GDP and population, Spanish market had been a prospective market for TNCs. Domestic sales have been an important consideration of TNCs. The studies of Bajo-Rubio (1991), Bajo-Rubio and Torres (1992), Bajo-Sosvilla (1992) found that market size have been an important determinant of the success of Spain in attracting FDI in the initial years of EU accession.

On the other hand, Spanish market has been expanded due to integration with EU, since trade relations between the two have been intensified. As the Table 3.2.4 indicates EU's share in total Spanish exports reached to 74 per cent

while it was 50,5 per cent in 1977-1985 period. Markets like US and Latin America have been other major export destinations.

Table 3.2.4 Shares of major markets in Spanish exports, 1977-2004

	1977-1985	1986-1992	1993-1998	1999-2004
EU-12 (15)	50,5	67,5	68,5	74
United States	8,2	6,6	4,4	4,0
Latin America	4,6	2,4	3,8	4,3
Others	36,7	24,8	23,1	17,7

Source: Own calculations based on data retrieved from UN Trade Statistics Database, <http://unstats.un.org/unsd/comtrade/dqBasicQueryResults.aspx?y=2004&px=BE&r=372> (Cited on 4.2.2006)

In parallel, several empirical studies found that those manufacturing sectors receiving higher FDI inflows record higher export propensities. According to Martin-Velazquez (1993) and Baja-Rubio and Lopez (1996), enterprises with foreign capital realise a larger ratio of exports to total sales than domestic ones. Their results are further confirmed by Moreno-Rodriguez (1998) who found a significant effect of foreign participation on propensity to export¹⁸. Thus, a great number of multinationals with a presence in Spain based their strategies of using the country as an export platform (Molero, 2001:41). The adoption of such strategies can be confirmed by the improvement in export performance of Spain and the composition of goods that began to be exported after foreign penetration increased.

These developments prove the fact that market size has been an important determinant in attracting FDI to especially medium technology sectors. Size of Spanish market and possibility to serve whole EU market from Spain triggered market seeking investments. This can be a plausible explanation for drastic increase in FDI inflows after EU accession in 1986.

¹⁸ Export propensity is much higher in the medium and high technology sectors which attracted more FDI than the others. (Molero,2001:42)

3.2.4.6 Macroeconomic Stability

Between 1975 and 1985, Spanish economy was in a deep recession related to global oil crisis. Until 1982, political uncertainty reigned which was characterised by conflicts among parties and the attempt of military coup. From 1982 on, the socialist party overcame the crisis and prepare the country to integration (Molero, 2001: 30). From political perspective, EU integration has been an important step for Spain in order to consolidate newly established democratic regime and institutions throughout the process. Spanish leaders used the fragile and unstable situation of their country as a leverage to move forward the accession process. In addition, financial contributions from the EC budget as well as the FDI inflows contributed to improve economic conditions and lessened some of the negative effects of liberalization. In turn, improved economic conditions and better prospects for social and political stability influenced public opinion and helped to legitimize the new system and to strengthen support for democracy (Royo, 2004: 7). Political stability sustained during this period further consolidated macroeconomic stability.

Before EU accession, Spanish economy used to suffer from some macroeconomic problems such as high inflation, high public and foreign trade deficit. At the end of the eighties, the deficits of public companies and the state investments contributed to the increase of the public deficit. As an achievement of the National Convergence Plan, public deficit decreased constantly from 1995. The deficit of the Social Security system was reduced. Also, the social and health system was reformed. Subsidies to certain state companies were abolished, wages of the public sector were fixed, and some public investment projects were cancelled. Revenues from privatisation were increased (Elteto, 2000: 35).

Restrictive measures were acceptable for the public, because EMU membership was perceived as a common goal. Macroeconomic programs like monetary and exchange rate policies, reform of the tax system and the fiscal

consolidation process have been completed successfully and especially EU investors looking for long-term stability have been satisfied. Indeed, EU membership has led to anchoring of Spanish economy to EU economies after accession. EU began to play a larger role in Spanish economy which led to high levels of EU investment in medium and high technology sectors.

In 1998, budget deficit was only 1.5 per cent which led Spain to be among the 11 founding members of the EMU.¹⁹ During the first years after the accession the peseta depreciated substantially but when in 1989 Spain became a member of the European Monetary System, the strengthening of the inflow of capital led to appreciation of the peseta (Elteto, 2000: 33). Then, Spanish currency stayed stable and has remained close to the central parity until EU membership.

Inflation has been another chronic problem of the Spanish economy. Thus, one important aim of the monetary policy implemented after EU accession has been to curb inflationary tendencies. Inflation in Spain has fallen steadily since the late 1980's. The rate of inflation was kept under 5 percent for the first time in 1993. Inflation has followed a stable trend since 1993.

In general, macroeconomic stability has been a significant factor in FDI inflows to Spain. Inability of Spanish economy to alleviate macroeconomic problems in the beginning of 1990s had been a major factor in the slowdown of FDI inflows during the same period. Consequently, achievement of stability in late 1990's led to the second surge of FDI in the same period.

3.2.4.7 Openness and Business Environment

Spain was relatively excluded from foreign competition since mid-1980s. The trade policy was protectionist based on high levels of import tariffs. Foreign investment was conditioned and had to fulfil strict authorization procedures.

¹⁹ The impressive reduction in Spain's long term interest rates from 10 percent in 1993 to 2,2 percent in 1998 is also a remarkable indicator of macroeconomic stability sustained in this period. (Molero,2001: 42)

After the 1970s, asymmetrical conditions prevailed in which tariff barriers were maintained even though the other European countries had dismantled their tariff barriers on a wide range of exports from Spain (Larre-Torres, 1991: 78). When Spain applied for accession in 1977, protectionist institutions which were incompatible with EC rules were still in force.²⁰ This situation provided a considerable advantage for Spanish manufacturers, which were highly protected from foreign competition

EU accession in 1986 led to the progressive opening of the Spanish economy. In parallel, EU membership triggered a wave of domestic liberalization. The combined implications of lowering trade barriers, the introduction of VAT and the increasing mobility of goods and factors of production that comes with integration, have boosted trade and enhanced the openness of the Spanish economy (Elteto, 2000:35). The speed of liberalisation was reflected in growing propensity to export.

On the other hand, the fast growth of the economy in the second half of the 1980s led to a massive trade deficit, which needed to be balanced. FDI inflows were seen as crucial to close this gap. FDI policy was increasingly liberalized by adopting EU legislation on foreign investments.²¹ In 1992, Spain eliminated remaining restrictions on capital movements (Molero, 2001: 40). As a result of the liberalization and integration with EU, Spain became a more open economy in terms of trade and FDI as Figure 4.2.11 indicates. Trade intensity in 1980 was 32 per cent in 1980 while FDI inflows comprised 3 per cent of GDP. In 2003, trade intensity has reached to 60 percent and FDI intensity surpassed 13 percent.

²⁰ Spanish government controlled through the I.N.I (National Institute of Industry) a considerable size of the economy, and subsidized public enterprises such as the auto making companies (SEAT, ENASA), as well as the metallurgic, chemical, ship construction and electronic sectors. (Molero, 2001: 10)

²¹ The only restrictions remained towards non-EU investors in sectors with special regulation i.e. gambling, television, radio, defence sectors and air transport. Investments in these sectors are regulated by separate legislation in which prior authorization is necessary. (Duce, 1995:22)

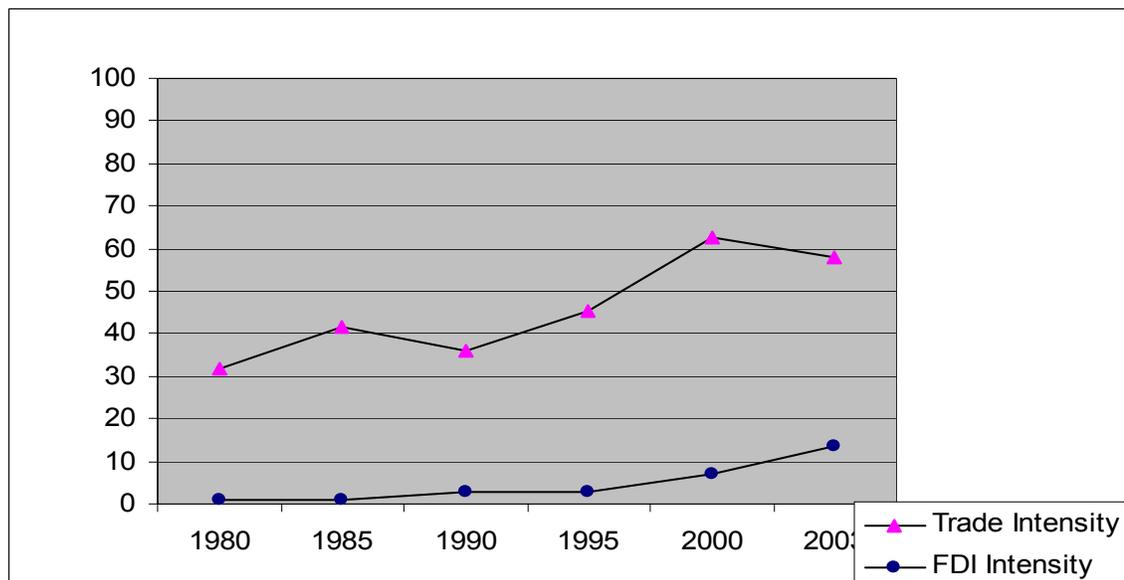


Figure 3.2.9 Trade and FDI Intensity in Spain (%), 1980-2003

Source: Own calculations based on World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

Despite these moves towards liberalization, business environment in Spain is impeded by bureaucratic restrictions. It is a long lasting task to start business in Spain since it takes 108s day to complete 6 procedures while the corresponding figures are 25 days and 6 procedures in OECD average as seen in Table 4.2.5. On the other hand, the period of enforcing contracts are shorter compared to OECD which indicates existence of an effective legal system.

Table 3.2.5. Business Environment Indicators in Spain, 2004

	Spain	OECD
Starting a business: no of procedures	6	6
Starting a business: duration (days)	108	25
Enforcing contracts: no of procedures	16	19
Enforcing contracts: duration (days)	169	219

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

Business environment in Spain is generally considered to be more regulated. According to World Economic Forum (2004), general level of regulation on enterprises is scaled as high and labour market regulations are evaluated as stricter in comparison with EU average. Major handicap of the business environment of Spain is the rigidity of employment. When Spain joined the EU, costs and bureaucratic procedure of hiring and firing employees were extremely high for the companies (Molero, 2001:17). Thus, mobility among branches and among regions was very low. The 1994 labour market reform introduced new forms of temporary contracts and eased firing for the firms. The monopoly of the employment agency was dissolved. With these efforts, rigidity has been considerably eased in the past decade; Spanish labour market is still considered to be among the rigid and strictly regulated markets of OECD area according to OECD (2002).

3.2.4.8 Incentive Schemes

Unlike Ireland, Spain did not implement a low corporate tax policy as a part of her incentive schemes. Standard corporate tax rate implemented for foreign as well as local companies is 35 percent. This rate is even above some of the EU countries like UK, Netherlands and Sweden. Thus, Spain does not provide any tax advantages for foreign investors. Besides that, Spain did not establish an IDA like active investment promotion agency. Investment promotion is held under the aegis of the central government and regional governments in Spain. The responsible authority in the central government is General Directorate of Finance and Trade under the Ministry of Industry, Tourism and Trade.

On the other hand Spain provides grants and special incentives for investors which are implemented in a non-discriminatory basis. Foreign investors, equally like national ones, can benefit from general types of incentives. First type of incentives is the general state incentives in the tax

system consisting of specific tax deductions. Another type is the regional incentives in specific economic zones. These are called Economic Promotion Zones (regions with the lowest amount of economic activity and income) where a certain part of the investments can be subsidized by the state (General Directorate of Finance and Trade, 2005:34).²²

All aids and incentives offered by the state and the regional governments are administered according to the regional policy of EU.²³ This assistance is based on non-refundable cash subsidies for a percentage of eligible investment expenditure to be located in determined regions²⁴. Central and local government also provide training and employment grants for investments²⁵.

In general, it is possible to say that incentives offered by Spanish government and regional governments are in parallel with EU policies. Thus, incentive schemes in Spanish case have not been a factor in diverting FDI to Spain from other EU members. Thus, unlike Ireland, incentive schemes have not been a significant determinant of FDI in Spain.

3.3 Poland: FDI Inflows during EU Pre-accession Process and after Accession

Poland is the largest country among the countries that have been classified as Central and Eastern European Countries (CEECs). These countries abandoned their socialist regimes in the end of 1980's and began to transform their economy into free market economies. Among these countries,

²² Local authorities and regional governments can also provide incentives.

²³ The European Commission only permits aid and incentives in those regions in which GDP is below 75 per cent of the Community average and where it is necessary to revitalize areas facing structural difficulties, whether industrial, rural, urban or dependent on fisheries.

²⁴ Subsidies are generally allocated to land purchases; installation of services such as gas and electricity; civil engineering for plants, offices or warehouses; capital goods and other fixed assets; planning and design of the projects; R&D; training.

²⁵ For details see General Directorate of Finance and Trade (2005).

“Visegrad” group, consisting of Slovakia, Czech Republic, Hungary and Poland, have been the leaders in terms of transition to market economy. The liberalization in these countries resulted in a rapid growth in trade and FDI flows. As the Figure 3.3.1 indicates these countries attracted most of the FDI flowing to CEECs. Poland while following Hungary in the first half of 1990’s began to attract a major share of FDI in late 1990’s. However, while Hungary and Czech Republic lost their share Poland attracted 46 percent of total FDI inflows in 2000, and 37 percent in 2003 in the region.

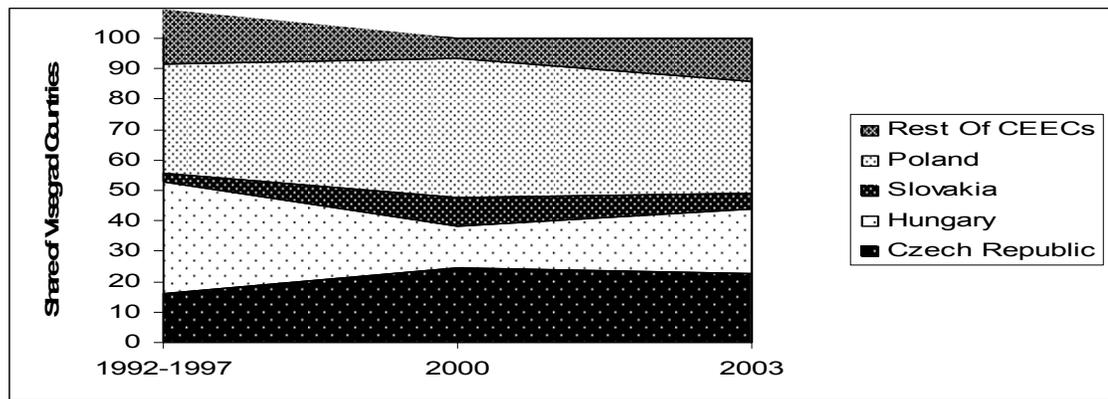


Figure 3.3.1 Share of Visegrad Countries in Total FDI Inflows to CEECs (%), 1992-2003

Source: Own calculations based on World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

3.3.1. FDI Inflows and Inward Stock

The upward trend in Polish FDI inflows is demonstrated in Figure 3.3.2. After the collapse of the communist regime foreign capital began to penetrate in Polish economy. However, the pace of reform in Poland was not enough to attract a major share in total foreign investment influx to the region in the early 1990’s. FDI inflows just exceeded 1 billion dollar level in 1993 and stayed steady

until 1995. After 1995 FDI inflows began to increase steadily and in 2000 exceeded 9 billion dollars.

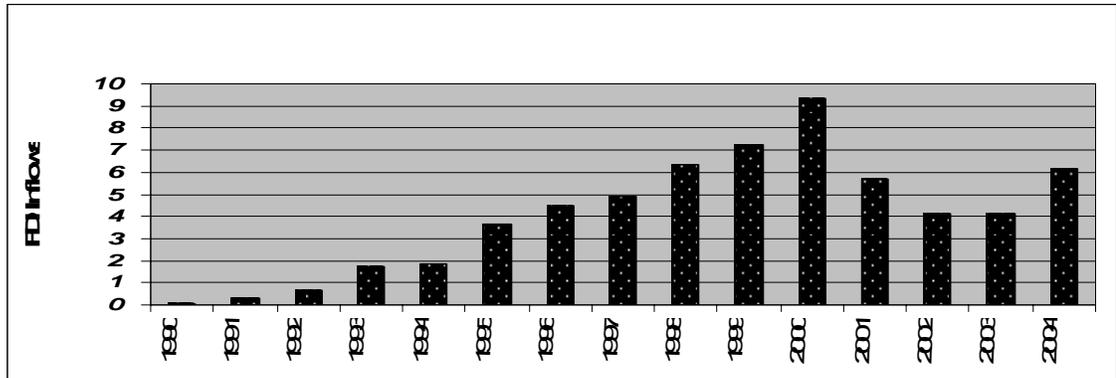


Figure 3.3.2 FDI inflows in Poland (billion dollars), 1990-2004

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

The increasing share of FDI in GFCF is demonstrated in Figure 3.3.3. FDI was contributing approximately 8 percent of capital formation in the first half of 1990's. However, in parallel to upward trend in terms of inflows, FDI began to comprise more than 15 percent of GFCF between 1998 and 2001.

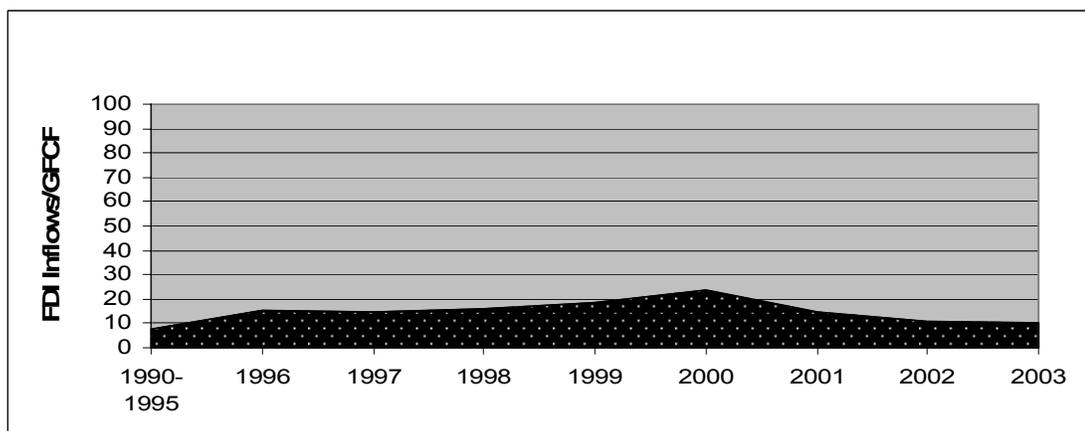


Figure 3.3.3 FDI inflows/GFCF in Poland (%), 1990-2003

Source: Own calculations based on World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

The increase in the FDI flows led to a parallel increase in FDI inward stock as shown in Figure 3.3.4. While inward FDI stock was negligible in the beginning of 1990's, it reached 25 percent of GDP in 2003.

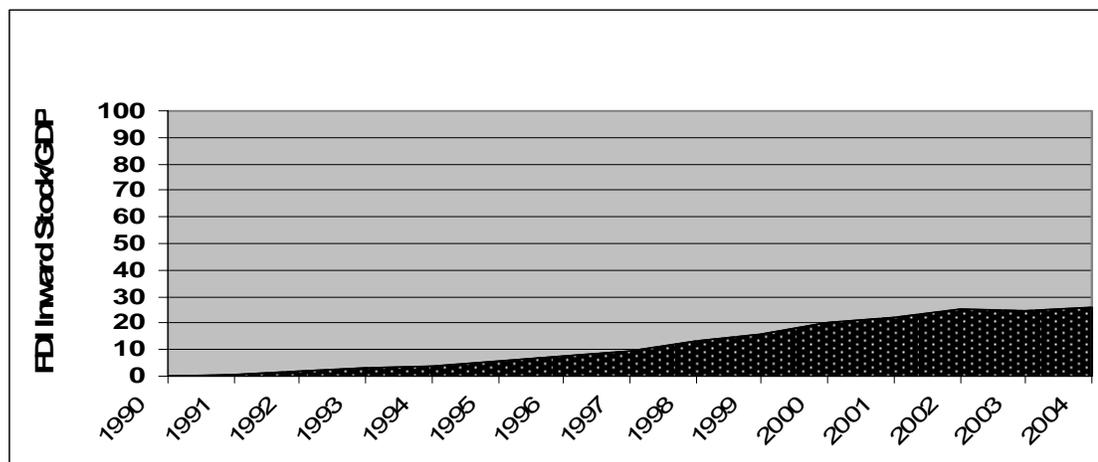


Figure 3.3.4 FDI Inward Stock/GDP in Poland (%), 1990-2004

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

3.3.2. Sectoral Destination of FDI

In the initial years of transition, FDI was mainly oriented to manufacturing activities. However, as Poland improved in the transition process, share of manufacturing activities declined in FDI inflows. As shown in Figure 3.3.5 due to the ongoing integration of Poland with EU and global financial networks, services began to level with manufacturing activities and even exceeded 60 percent in 2004.

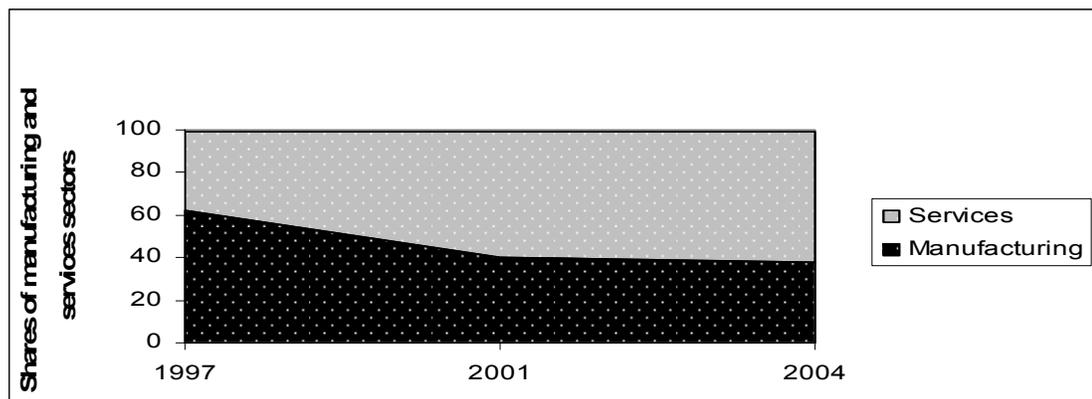


Figure 3.3.5 Sectoral Destination of FDI Inflows in Poland(%), 1997-2004

Source: Polish Agency for Foreign Investment (<http://www.paiz.org.pl>) (Cited on 12.2.2006)

In manufacturing, food, beverages and tobacco is the leading sub-sector despite the noticeable increase in the transport equipments in recent years as indicated in Table 3.3.1. Contrary to Ireland and Spain, chemicals and chemical products and electrical machinery have a smaller share in Poland while natural-resource based non-metallic minerals attract a considerable amount of FDI. In service sector, financial services especially outweigh the others with 23,4 percent share in overall inward FDI stock. Trade and repairs sector also attracted a considerable amount of FDI.

Table 3.3.1 Share of manufacturing and services sub-sectors in total FDI inflows in selected years in Poland (%), 1996-2004

	1996	2004
Food beverages and tobacco	11	8,2
Motor vehicles and other transport equipment	7,2	8,3
Chemicals and pharmaceuticals	4,4	2
Electrical Machinery	2	4
Non Metallic Minerals	6	7
Wood and wood products	4,6	2,1
Trade and repairs	11,6	11,8
Financial services	11,1	23,4

Source: Polish Agency for Foreign Investment (<http://www.paiz.org.pl>) (Cited on 12.2.2006)

Foreign investors are mainly penetrated in the medium to high technology sectors such as transport equipment, electrical machinery or chemicals as indicated in Table 3.3.2. Foreign penetration in these sectors is 58 percent in 2003. On the other hand, low technology labour intensive sectors like textiles and food and natural resource intensive sectors like minerals or mining are less penetrated by foreign investors.

Table 3.3.2 Foreign penetration levels according to technology in Poland (%), 2003

Low Technology Labour Intensive	47
Natural Resource Intensive	52
Medium to High Technology	58

Source: Polish Agency for Foreign Investment (<http://www.paiz.org.pl>) (Cited on 12.2.2006)

3.3.3 Origins of FDI inflows

Since Polish market was opened for foreign investors, European companies have been very active. As shown in Figure 3.3.6, EU has been the major investor in the country ahead of United States. The role of EU investors even expanded in recent years. According to 2001 statistics, EU investors comprise 68 percent of all inward FDI stock in Poland. On the other hand, share of US investors declined. Third investor country in Poland is Republic of Korea despite the fact that Korean investments also began to loose their share. The major investor which can be identified in the others group is Russia which began to boost her investments gradually since late 1990s.

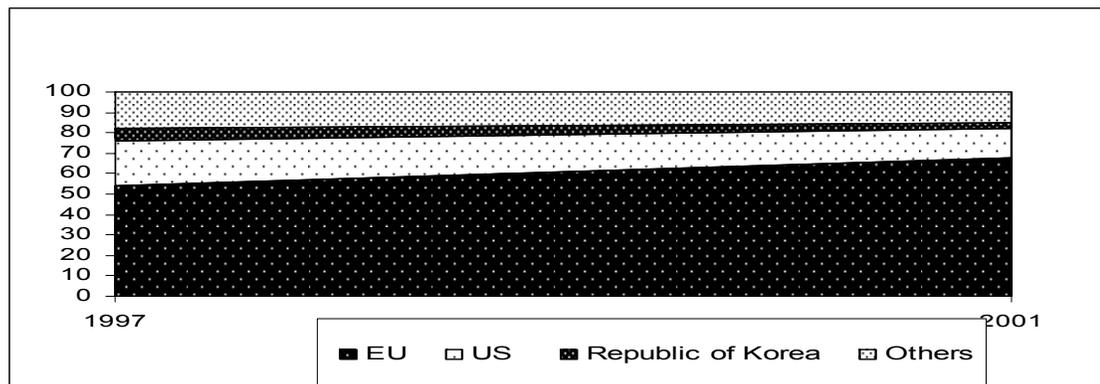


Figure 3.3.6 Origins of FDI in Poland (%), 1997-2001

Source: Polish Agency for Foreign Investment (<http://www.paiz.org.pl>) (Cited on 12.2.2006)

3.3.4 Determinants of FDI in Poland

There are several studies on the determinants of FDI inflows in CEECs which have implications on Poland as well. Meyer (1995) and Deichmann (2004) found that market size is the primary determinant of foreign direct investment in the CEE region and that labour costs play a statistically insignificant role. Lankes and Venables (1996) reinforce Meyer's findings, but also emphasize the importance of political and economic stability, in attracting foreign investors to Central and Eastern Europe. On the other hand, Campos and Kinoshita (2001) and Resmini (2000) found out that quality of the labour force, business environment and abundant natural resources are also significant determinants. Moreover, they argued that countries with good institutions, greater trade openness, and fewer restrictions on FDI flows are likely to receive more FDI. Lansbury (1996), Holland and Pain (1998), Woodward (2000), Carstensen and Toubal (2003) and Brada (2003) found evidence to support the hypothesis that transition specific factors, such as the process of privatization and the reduction in perceived level of risk, influence the amount of foreign direct investment received by the CEE countries. Smarzynska (2002) found out that corporate tax rate and several transition related factors affect all foreign

investment projects, while the existence of well-established intellectual property rights affects FDI mainly in high-tech sectors in CEECs. Finally, Bevan, Estrin and Grabbe (2001), Clausing and Dorobantu(2003), Brenton, Di Mauro and Lücke (1999) emphasised the EU accession process as an essential factor.

3.3.4.1 Natural Resources

Poland has abundant resources in some metals and minerals.²⁶ Under the communist regime, coal, was the main energy source and supported heavy industries such as iron and steel. The collapse in industrial production in the early 1990s had a shock effect on coal output. As Poland reduced its coal production for economic and environmental reasons, the country has become more reliant on hydrocarbons, especially gas. Natural gas imports met 76 percent of domestic needs of the country while most of these gases are imported from Russia (Economist Intelligence Unit, 2004: 23).

Coal and copper, non-metallic minerals and agricultural products are comprising 6,5 per cent of Polish exports. Apart from non-metallic minerals sector, inward FDI stock in other primary sectors are comparably low covering less than 1 percent of all inward FDI stocks (see Table 3.3.2) On the other hand, although primary sector have not attracted much FDI in the past, natural resources such as coal and other metals have been a significant input in other industrial sectors such as transport equipments. Abundance of natural resources has positive implications on FDI inflows to especially low technology manufacturing sectors.

3.3.4.2 Distance

EU investments comprise 70 percent of FDI inflows in Poland followed by US and Korean investments. As illustrated in Figure 3.3.7, among the EU

²⁶ 1/4 of coal and 1/3 of copper reserves of Europe are owned by Poland. Poland also have considerable silver reserves (Economist Intelligence Unit, 2004: 23).

countries, main investors have been core European countries led by France, Germany and Netherlands. Half of the inward FDI stock and foreign affiliates established in Poland is owned by these core European countries.

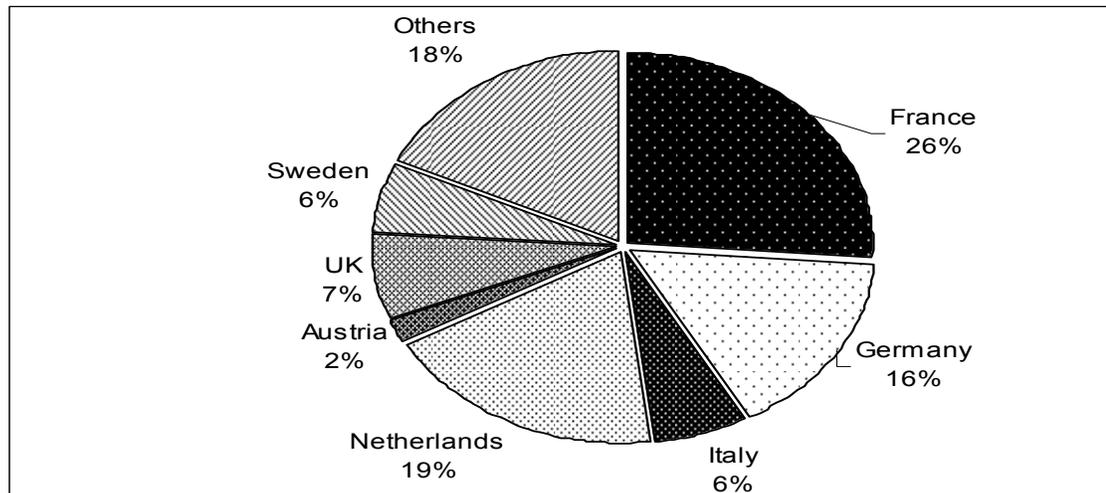


Figure 3.3.7 Geographical breakdown of foreign affiliates of EU member states in Poland (%), 2004

Source: Polish Agency for Foreign Investment (<http://www.paiz.org.pl>) (Cited on 12.2.2006)

In parallel, in empirical studies by Walkenhorst (2004), Bevan, Estrin and Grabbe (2001) Pain, Landsbury and Smidkova (1996), Gobermann and Shapiro (2003) geographical proximity is found to be a significant determinant with respect to FDI flows in almost all industries of Poland. One possible explanation for the almost manufacturing-wide importance of proximity for FDI in Poland could be that the costs of controlling foreign affiliates might increase with geographical distance thus foreign investors choose adjacent countries like Poland as a location to invest (Walkenhorst, 2004: 32).

3.3.4.3 Labour Costs

Several studies such as Janicki and Wunnawa (2004), Bevan, Estrin and Grabbe (2001) on the consequences of labour costs in Polish FDI inflows found

that labour costs play an important role in determining FDI flows into almost all of Poland's manufacturing industries. Especially, resource-seeking investments in the low and medium-technology sectors are attracted by these low labour costs.

When compared with other Visegrad countries as the major competitors of Poland, labour costs were lower in the beginning of 1990's as shown Figure 3.3.8. While monthly wages were 82 Euro for Polish workers, Hungarian workers were earning 145 Euro. Throughout 1990's wages have increased gradually reaching to 215 Euro in 1995 and 370 Euro in 2000. The rise in Polish workers earnings have been more rapid than the other Visegrad countries, thus labour costs have become higher in 2000.

Despite the fact that labour costs are higher in Poland in comparison with other Visegrad countries, Poland attracted comparatively higher amounts of FDI as demonstrated in Figure 3.3.1 in recent years. Thus labour costs could not be considered a major determinant that diverted FDI from other Visegrad countries to Poland. Rather the market size had been influential this trend.

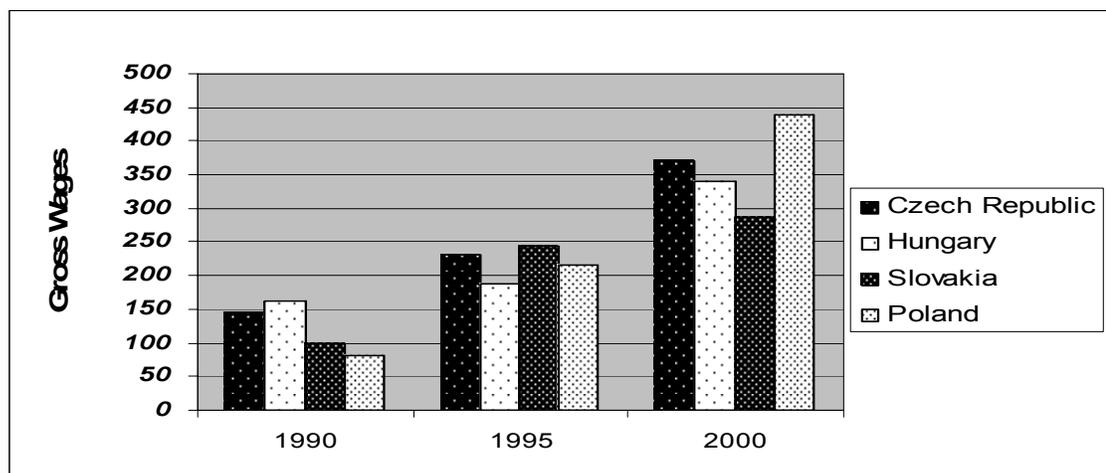


Figure 3.3.8 Average monthly gross wages in Visegrad countries (Euros), 1990-2000

Source: EUROSTAT (2005)

http://epp.eurostat.ec.eu.int/portal/page?_pageid=1334,49092079,1334_49092794&_dad=portal&_schema=PORTAL (Cited on 10.2.2006)

3.3.4.4 Infrastructure and Human Resources

Although some improvements have been made in the infrastructure of Poland, the country lags behind EU levels. One of the impediments to FDI especially in 1990's has been the lack of infrastructure concerning roads, railways and telecommunications.

The poor state of the road network is one of the weakest aspects of Poland's infrastructure and a major handicap to business and economic development. On the other hand, although Poland's communications infrastructure has improved immensely since 1989, progress has been uneven, with use of cellular phones rising dramatically, but the development of the landline network progressing only slowly (Economist Intelligence Unit, 2004: 22). EU accession process contributed to Poland's development by pre-accession funds under the "PHARE programme". These funds amounted to 4.2 billion euros during the years 1990-1994. The amount rose to 6.7 billion euros for the period 1995-1999. Poland received financial assistance in the form of credits and grants from the European Investment Bank to finance developmental expenditure. The funds of the PHARE programme are utilized to develop infrastructure (Picciotto, 2003: 14).

As an indication of development in infrastructural developments, Figure 3.3.9 demonstrates the telephone mainlines per 1000 people. While, telephone mainlines were less than 100 in 1990, due to abovementioned spending in infrastructure, mainlines per head reached to 319 in 2003. However this level is still far below the EU average. According to World Competitiveness Report 2004, Poland's infrastructural quality score is 2,6 over 7, which is considered as insufficient.

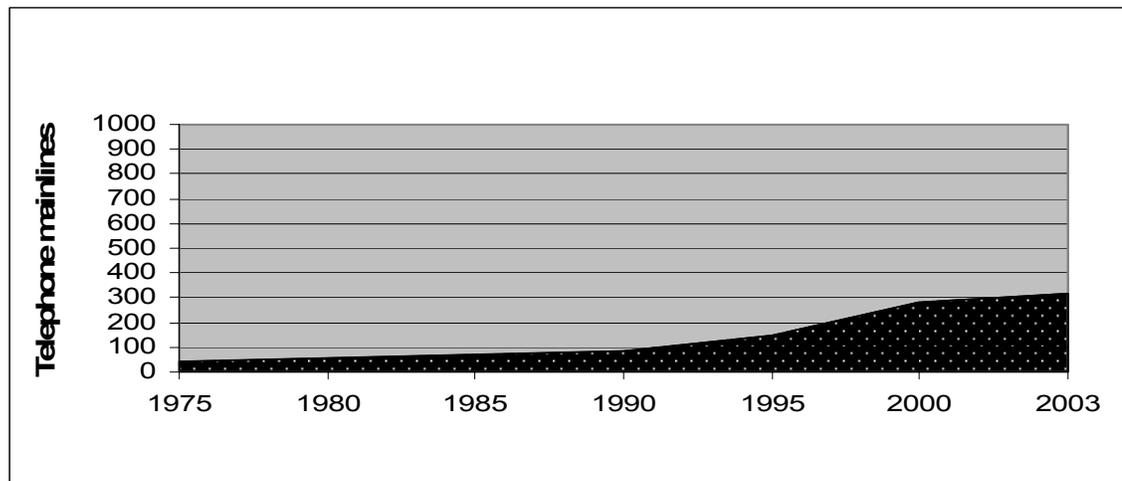


Figure 3.3.9 Telephone mainlines per 1000 people in Poland, 1975-2003

Source: World Bank World Development Indicators Database
<http://www.worldbank.org/data/wdi2005/index.html> (Cited on 10.2.2006)

In the communist regime, education was a priority area, thus Poland like other CEECs achieved high rates of literacy.²⁷ Average years of schooling per adult are 11 years. Like other public services, the education sector suffered from a sharp fall in pay and status relative to other parts of the economy in the 1990s, although there have been moves to improve the system. Polish government spent 5,5 percent of GDP to education investments between 1998-2002 (OECD, 2005:22). However, the education system was oriented to the needs of a centrally planned economy, in particular, to heavy industry at the beginning of the transition process. Thus, it was unable to provide much training in areas, such as finance and information technology (IT) that is important for an emerging market economy.

Since 1989 the Polish system of higher education has done much to catch up and broaden its curriculum in order to meet demands of emerging market economy in the country. Much of this increase has been driven by the recent surge in the number of young people attaining tertiary level education. The participation rate in tertiary education increased from around 10 percent in the communist era to 14 percent in 2003 as demonstrated in Figure 3.3.9.

²⁷ Over 70 percent have a medium level of education. (Picciotto, 2003: 7)

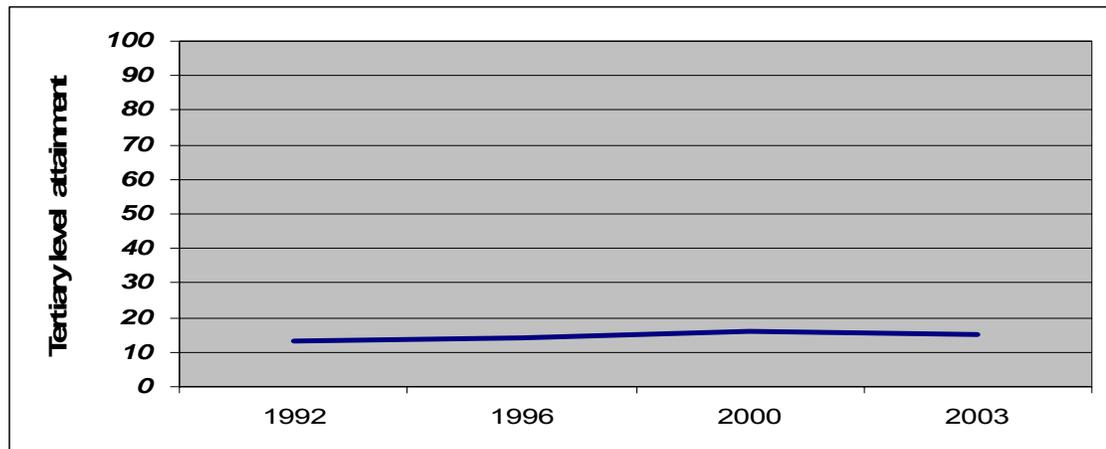


Figure 3.3.10 Tertiary level educational attainment of working population in Poland (%), 1992-2003

Source: OECD (2005) (<http://lysander.sourceoecd.org/vl=7208621/cl=11/nw=1/rpsv/fact2005/>)
(Cited on: 10.2.2006)

Despite this improvement in educational attainment, Poland is still behind its competitors in terms of human capital development. According to European Bank for Reconstruction and Development (2003), Poland's score in terms of quality of mathematics and science education and management schools are below Slovakia, Czech Republic and Hungary. Furthermore the country has the lowest share of population with tertiary education among Visegrad countries.

This underdevelopment in terms of infrastructure and human resources can be considered as the basic reason for low foreign penetration in medium and high technology sectors of Poland unlike Ireland and Spain.

3.3.4.5 Market Size

Poland has the biggest population among CEECs. Almost forty million consumers with a growing market is a factor which is worth consideration for foreign investors. Total GDP of the country has grown steadily despite some temporary slowdowns since 1991. Poland's GDP reached from 76 billion in 1991

to 241 billion in 2004 which puts Poland on the top of the economies among CEECs in terms of market size.

In this vein, market seeking strategy of foreign firms especially prevailed in the beginning of 1990's. Foreign affiliates aimed to meet local demand for consumer goods. The main investment motive was to supply domestic markets and exploit markets with limited competition. The underdevelopment of the Polish service sector also presented a huge market opportunity for foreign investors, and a large number of foreign enterprises have been attracted into trade, retail and consumer services. According to a study carried out by Boer and Brücker (2000), nearly half of FDI flows in Poland are directed to previously underdeveloped non-tradable sectors²⁸ and manufacturing of consumption goods²⁹. Poland's trade with the EU has grown substantially since Europe Agreements(EAs) signed in 1991 with EU. Foreign firms seem to have been contributed to the shift in Poland's exports to the EU which also expanded the market size of the economy.³⁰ During the transition process, FDI in Poland began to flow to the other sectors of economy which are generally export oriented. In 2004, in comparison to 1995, companies with foreign affiliates strengthened their position in Polish exports, what can be confirmed by an increase in their share in total exports from 24 percent to 56 percent (Ünsal and Atanasova, 2005: 7).

Access to local market motive began to be replaced with access to regional market. Export-orientated investments began to dominate in order to serve other markets within Eastern Europe. For instance, in 1995 the share of foreign-owned firms in CEEC-oriented exports was 19 per cent. In 2003, the share of foreign-owned firms in CEEC-oriented exports corresponding shares have risen to 45 percent. This proves the fact that foreign owned firms increased their propensity to export CEECs markets from Poland.

²⁸ Such as utilities, transport and communications, trade, financial intermediation and other services.

²⁹ Such as food, beverage, tobacco, soap and publishing industries

³⁰ From the beginning of 1999, a free-trade area with the EU has existed in most industrial goods.

In conclusion, market size has been a significant determinant of FDI inflows to Poland. While in early years of transition the target of the investors was the domestic market, in later periods market size of Poland began to extend to other CEECs and EU market.

3.3.4.6 Macroeconomic Stability

Following the deepest and most severe recession of the post communism period in 1989-91, in which real GDP collapsed by 18 percent, Polish economy began to recover from 1992 and the annual growth rate of real GDP peaked at 7 percent in 1995. Poland was the first transition economy to regain the level of output of 1989 in 1996 (Economist Intelligence Unit, 2004: 12).

Budget problems were particularly serious in Polish economic transformation since slow economic growth and poor spending control produced high budget deficits and a sharp increase in government debt. Inflation has been a serious problem of Poland during the transition period. In 1991, consumer price index has shown a 60 percent inflation rate. However, shock therapy that has been applied during the period led to a considerable decrease in inflation. Inflation rate fell down to 12 percent in 1998 and further to a record low level of 0,7 percent in 2003.

Poland's exchange-rate system evolved considerably since the early 1990s. Fixed exchange rate was an anti-inflationary anchor at the beginning of the economic transition in 1990. However, later in 1990's a free floating exchange rate system has been adopted (Economist Intelligence Unit, 2004: 14). The zloty has been volatile with long periods of strength periodically interrupted by sharp short-term declines.

The inability to sustain macroeconomic stability has been one of the factors that delayed inflows of FDI to Poland in the beginning of transition. Poland began to re-establish macroeconomic stability in late 1990s and FDI

inflows began to increase rapidly in this period as illustrated in Figure 3.3.2. In sum, macroeconomic stability has been one of the essential locational determinants of FDI in Polish case.

3.3.4.7 Openness and Business Environment

The acceleration of investment into Poland has been widely attributed to the reversal of its government's anti-foreign policies toward FDI and Poland's radical shock therapy reform program, featuring privatization, stabilization, liberalization, and the promotion of inward investment (Deichmann, 2004 :18). Poland in the transition period fully opened her capital market for FDI, portfolio investment flows and short term capital flows. The country also gradually opened its market for foreign trade especially after EAs. EAs removed tariff and non-tariff barriers on most manufactured products. In 2003, Poland joined the customs union with the EU meaning a further reduction of customs duties (Ünsal and Atanasova, 2005: 7).

Foreign investment legislation has become progressively more liberal, opening more sectors of the economy to foreign investors and giving the investor more control over the enterprises. This process of liberalization of FDI legislation finalised in 1994 which abolished the former requirement of minimum investment and minimum stock ownership requirement. Foreign companies became subject to the same taxation as Polish firms. EAs which led Poland to become an EU member in 2004 also guaranteed the right of establishment to EU firms and also served as a credibility-enhancing mechanism (Kaminski and Smarzynska, 2001: 268).

EU accession process led to the opening up of market to full foreign competition of services sectors such as telecommunications, fuel, energy and banking. Privatization has been an important component of Poland's transition to market economy which also contributed to the increase of FDI inflows. Privatization programme was not rapid and far-reaching in initial years of

transition which has been speeded up in late 1990's. On the other hand, foreign participation in capital privatisation has been substantial, generating more than 50 percent of revenue from sales. Foreign companies accessed Polish market by acquiring state enterprises which already have established networks of distribution. Between 1993 and 1998, foreign investors acquired approximately 70 percent of privatised enterprises. These acquisitions pave the way for further direct investments in Polish economy (Schöllmann, 2001:373).

The results of these measures to open Polish economy can also be traced from Table 3.3.11. As shown in the figure, although there were some slight increases in FDI and trade intensity such as in late 1990's and 2000, there is not much improvement in terms of trade intensity unlike the previous case studies.

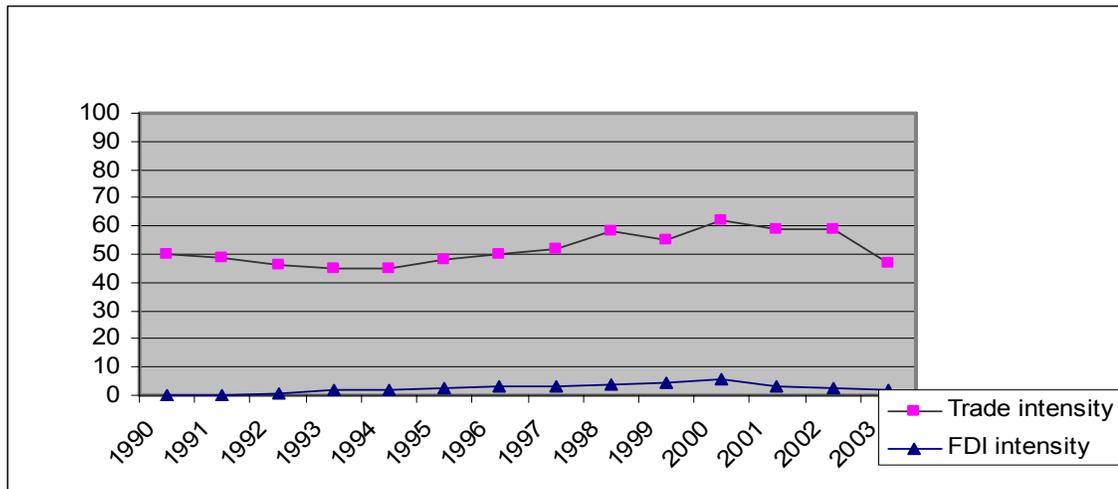


Figure 3.3.11 Trade and FDI Intensity in Poland (%), 1990-2003

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

In terms of business environment, Poland has a comparatively poor record on transparency. The country was ranked 67th out of 146 in Transparency International's Corruption Perceptions Index (2004), and was below Western European average of 7.9. Poland compares relatively poorly

with other CEECs. As illustrated in Table 3.3.3, it takes 41 separate procedures to enforce a business contract, which takes an average of 1,000 days. This figure signifies an ineffective legal system. World Bank data also indicate that procedures of company establishment are time consuming in Poland. It takes 10 procedures and 31 days to start a business in Poland, compared to OECD average of six days and 25 procedures.

Table 3.3.3 Business Environment Indicators, 2004

	Poland	OECD
Starting a business: no of procedures	10	6
Starting a business: duration (days)	31	25
Enforcing contracts: no of procedures	41	19
Enforcing contracts: duration (days)	1000	219

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

Prospective membership had positive consequences on foreign investment in the Poland, as it signals an improved risk environment and promised barrier-free access to the European common market. The perception of not-so-distant EU membership helped to reduce the level of risk in Poland relative to other countries in the region and this, too, has encouraged investment. In parallel, empirical studies by Bevan, Estrin and Grabbe (2001), Clausing and Dorobantu (2003) also found that the EU announcements regarding enlargement to the east have substantially influenced the amount of foreign direct investment received by the CEECs including Poland. In 1993, the level of risk associated with investing in Central and Eastern Europe was high, as all of the countries including Poland in the region were in the beginning stages of their transition process. The 1994 Essen Council announcement which EU declared its commitment to enlarge to the East was found to be associated with a significant increase in the level of FDI received by the Visegrad countries. EUs announcement lowered the perceived level of risk associated with investing

in Poland as well as other Visegrad countries. Moreover, their findings indicate that the EU's decision in 1997 to open negotiations with five CEE applicant countries led to an increase in the growth rate of FDI to the leading applicants including Poland (Bevan, Estrin and Grabbe, 2001:13). The prospect of joining the EU might have been seen as guaranteeing governance improvements. The gradual adoption of the *acquis* has contributed to the improvement in business climate and made Poland more attractive to foreign and domestic investors. Institutional alignment with the requirements of the *acquis* served as a basis for domestic transition towards a market based economy.

The tax system in Poland is very often viewed as unstable. The frequent amendments in the tax law in the past decade made investors unable to foresee the future tax burden. Uncertainty over the tax consequences of FDI increases the perception of risk and thus discourages capital flow. This factor is particularly important for capital-intensive direct investments.

In general, the level of openness and business environment in Poland is below Ireland and Spain. Furthermore, especially in comparison with Poland's major competitors among Visegrad countries, business environment is not favourable for foreign investment despite several measures that have been undertaken in recent years.

3.3.4.8 Incentive Schemes

Poland applies an incentive scheme policy based on low corporate tax, offering of incentives and grants and implementation of an active investment promotion policy.

Prior to 2000, Poland had 34 percent of corporate tax rates equal to most EU members. According to the Tax Reform legislated in 2000, corporate tax rate decreased gradually within 5 years (from 2000 until 2004) by 16 percentage points. This brought Poland in equal rate with Hungary applying 18 percent corporate tax rate. Such a significant reduction of the tax rate tends to have a

great impact on the location competitiveness of the country and is expected to stimulate the level of the foreign direct investment.

Poland offered generous tax holidays and other general types of incentives in the initial years of transition. As incentive measures based upon tax relief unable to attract FDI to areas where the infrastructure was underdeveloped, more sophisticated measures have been introduced in order to address regional and sectoral disparities (Heimann, 2001: 24). In this new regime, a company can be granted up to three years tax holiday depending on some requirements.³¹ Enterprises that invest in the production of medical equipment or medicines, R&D, patents and licences, implementation of quality control systems or newly established ones are also eligible for certain investment allowances. The maximum investment allowance is provided for investment in areas with high unemployment rates.

Poland also established Special Economic Zones (SEZs) as an added incentive to promote economic activity by attracting capital inflow through tax holidays and improved infrastructure. There are various tax incentives ranging from complete exemption, exemption from real estate tax rates or 50 percent tax exemptions, to be claimed by enterprises located in SEZs (Mah and Tamulaitis 2000:120). SEZs appeared to be a successful³² instrument to attract foreign direct investment and stimulating economic activity within regions and improving the situation in local labour markets. In order to adapt the rules for public assistance to meet EU regulations, in 2001 Poland amended the privileges granted to companies investing in SEZs.³³

³¹ The capital invested has to exceed 2 million Euros and the activity of the company has to be conducted in regions of high unemployment. Additionally, the new investment should ensure the introduction of new technologies and enable sales of goods and services for export equalling at least 20 percent of total sales value.

³² The zones attracted 81.25% of all foreign capital invested in Poland in 2000(Economic Country Profile, 2004:45).

In order to administer investment promotion policy, Polish Agency for Foreign Investment (PAIZ) was established in 1994 following a similar route with Ireland's IDA. PAIZ as a politically independent semi-private joint stock company aims to promote Poland as an FDI location and assist potential investors. It operates at three levels: nationally by facilitating economic growth through attracting foreign direct investment, sectorally by encouraging selective promotion of targeted economic sectors (especially high-technology firms) and promoting regionally targeted investments.

³³ According to the new regulations, the value of public assistance for an investor must not exceed 50 per cent of the value of the investment (Halkier, Helinka-Hughes and Hughes, 2003:5).

CHAPTER IV

TURKISH FDI INFLOWS: CURRENT TRENDS AND PROSPECTS FOR EU ACCESSION

In the previous chapter, we analysed experiences of three EU member countries which had a significant amount of increase in FDI inflows. Despite the common upward trend in their FDI inflows, they all have different development and abundance levels in terms of locational determinants. Different characteristics of locational determinants of these three countries led to differing trends in terms of FDI inflows. For example, while Spain experienced a sudden increase in FDI inflows, the Irish miracle occurred twenty years after joining EU. Similarly, abundance in qualified human resources has attracted higher levels of FDI to high technology sectors in Ireland, while Poland still attracts most of FDI to low and medium technology sectors.

The comparison of these diverging trends with Turkey in terms of locational determinants provides a concrete framework to make eligible forecasts for future trend of FDI inflow to Turkey during EU accession process. In order to make a comparative analysis, in parallel to previous case studies a general description of Turkish FDI position is provided with time series data as well as sectoral and geographical data.

4.1. Current Trends

4.1.1. FDI Inflows and Inward Stock

FDI inflows in Turkey have been generally very low as demonstrated in Figure 4.1. Accession of Turkey to Customs Union did not lead to any difference

in terms of inflows. Until 2001, annual FDI inflows did not exceed 1 billion Dollars. In 2001, due to the Italian Telecom's investment in the telecommunication sector, inflows reached 3,3 billion dollars. However, after 2001 inflows remained below 3 billion dollars. In 2005, FDI inflows reached 9,6 billion dollars which is the record high amount for Turkey. This amount is more than the accumulated FDI inflows of last ten years. Major reason behind this performance has been the large scale privatisation finalised during 2005 which led to acquisition of State Owned Enterprises and also acquisition of some banks by foreign firms.

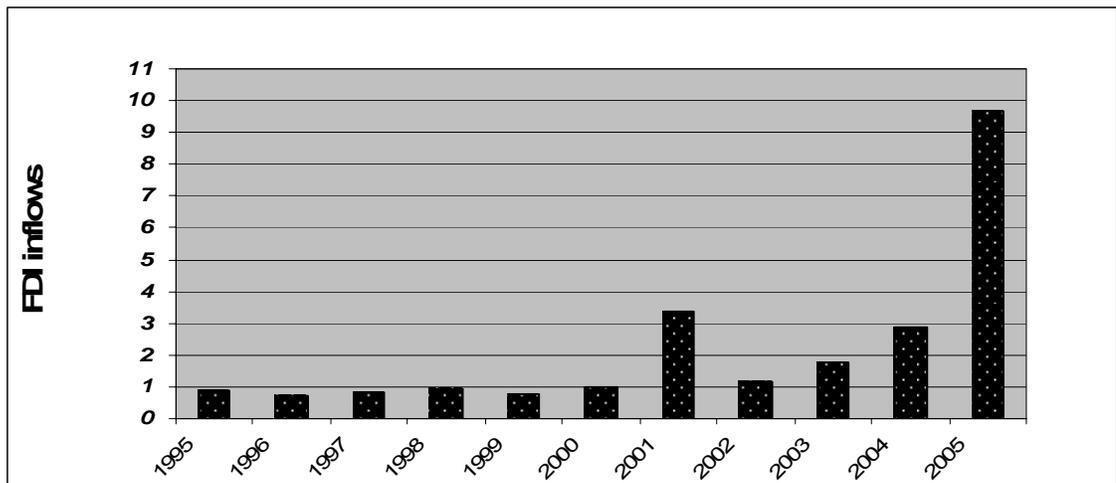


Figure 4.1 FDI inflows in Turkey (billion Dollars), 1995-2005

Source: Undersecretariat of Treasury Foreign Investment Report 2005(<http://www.hazine.gov.tr/stat/yabser/ybsrapor2005.xls>) (Cited on 20.3.2006)

In parallel the share of FDI inflows in terms of GFCF has been very low. As shown in Figure 4.2 FDI inflows have not comprised even 2 percent of the GFCF except 13 percent in 2001. Although there is no statistical data for 2005, FDI inflows is expected to exceed 2001 levels.

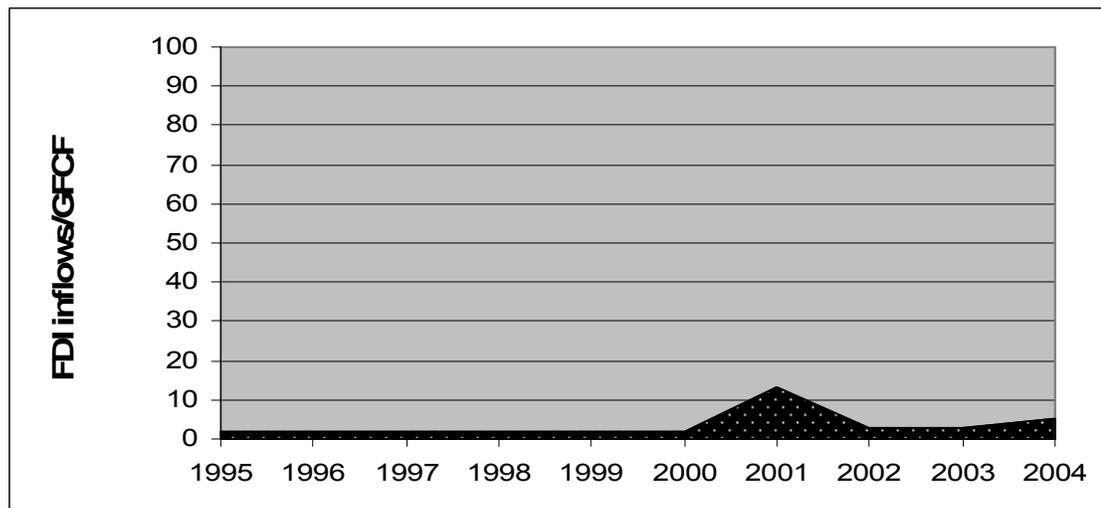


Figure 4.2 FDI Inflows/GFCF (%), 1995-2004

Source: Own calculations based on data retrieved from World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) on 10.2.2006

Turkey's inward FDI stock has also been very low as demonstrated in Figure 4.3. It stayed between 8 to 12 percent of GDP with the exceptional surge in 2001. However, due to surge in FDI inflows in 2005, it can be expected that 12 percent in 2001 is exceeded.

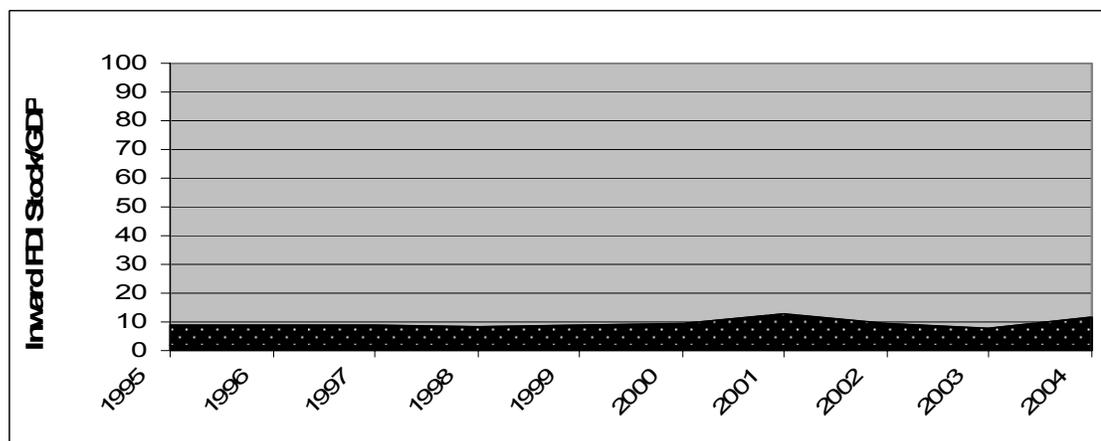


Figure 4.3 Inward FDI Stock/GDP in Turkey (%), 1995-2004

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) and UNCTAD World Investment Report, 2005 (http://www.unctad.org/en/docs/wir2005_en.pdf) (Cited on 10.2.2006)

4.1.2 Sectoral Destination of FDI Inflows

The sectoral breakdown of FDI inflows in Figure 4.4 shows that the services sector began to attract more FDI inflows than the manufacturing sector since mid 1990's. In the first half of 1990s manufacturing sector attracted 70 percent of inflowing FDI while services had a 29 percent share. However in the second half of 1990's this trend was reversed and after 2000 service sector began to attract higher amount of FDI compared to manufacturing. In 2005, service sector even attracted more than 90 percent of inflowing FDI.

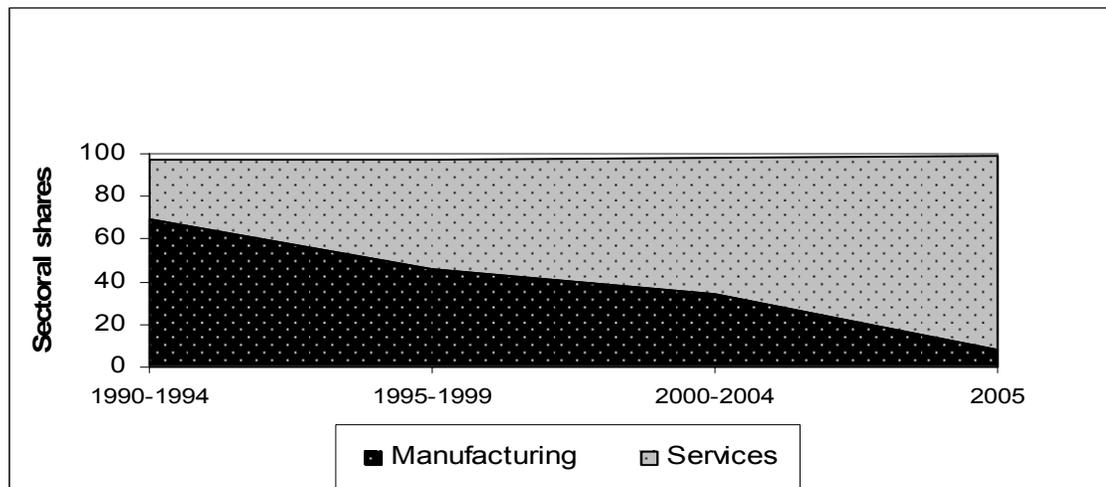


Figure 4.4 Sectoral destination of FDI inflows in Turkey (%), 1995-2005

Source: Own calculations based on data retrieved from Undersecretariat of Treasury Foreign Investment Report 2004(<http://www.hazine.gov.tr/stat/yabser/ybsrapor2004.xls>) and 2005 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2005.xls>) (Cited on 20.3.2006)

Leading sub-sectors in attracting FDI and their share in total FDI inflows are shown in Table 4.1. The increasing share of services sectors is evident, while some manufacturing sectors like food and beverages or motor vehicles are also among leading sub-sectors. On the other hand, medium and high technology manufacturing sectors such as electrical machinery and electronics and chemicals attract a small share of total inflows. Financial services and telecommunication sectors are gradually attracting higher amounts of FDI. The

most recent statistical data strikingly indicates that these two sectors comprise almost all of the inflowing FDI in 2005 with 47 and 40 percent share respectively.

Table 4.1 Leading sub-sectors in attracting FDI and their share in annual FDI inflows in Turkey (%), 1980-2005

	1980-2000	2001-2004	2005
Food and Beverages	5,0	8,5	1,0
Chemicals	8,0	2,1	2,0
Textiles	2,2	1,0	2,0
Motor Vehicles	8,0	8,5	0,5
Electrical Machinery and Electronics	3,6	1,0	0,1
Financial Services	18,2	16,5	47
Trade Services	9,0	7,5	0,5
Communication	1,7	21	40

Source: Own calculations based on data retrieved from Undersecretariat of Treasury Foreign Investment Report 2004(<http://www.hazine.gov.tr/stat/yabser/ybsrapor2004.xls>) and 2005 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2005.xls>) (Cited on 20.3.2006)

4.1.3 Origins of FDI Inflows

Like Spain and Poland, FDI inflows to Turkey have been largely dominated by EU countries as indicated in Figure 4.5. Share of EU countries has been 60 percent in 1995-1999 period. The dominance of EU originated FDI further strengthened in 2000-2004 reaching 72 percent while other OECD countries (including USA, Japan and Canada) lost their share as EU investment increased. In 2005, other OECD countries group reached the level of EU owing to an increase in US investments. Other countries including Middle Eastern capital increased their share in 2005.

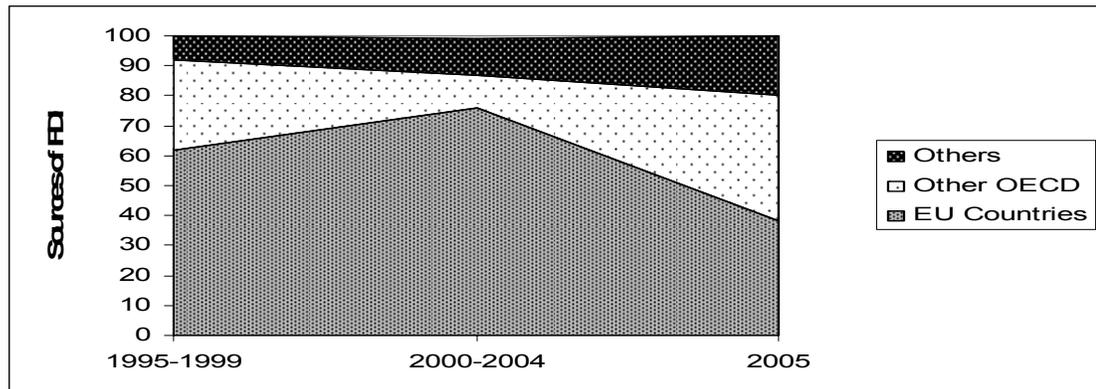


Figure 4.5 Origins of FDI inflows according to country groups (%), 1995-2005

Source: Own calculations based on data retrieved from Undersecretariat of Treasury Foreign Investment Report 2005 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2005.xls>) (Cited on 20.3.2006)

Among the EU countries, France Netherlands and Germany have been traditionally main investors as shown in Table 4.2, UK also had a significant amount of investment. However, after 2001 these EU members began to lose their share while US investment increased. In parallel, the other countries which did not have significant investments in earlier periods increased their share. For example, Middle Eastern countries investments constitute 18 percent of FDI inflows in 2005.

Table 4.2 Geographical breakdown of FDI stocks in Turkey (%), 1980-2005

	1980-1995	1996-2001	2002-2005
France	15	15	4
Netherlands	11	16	9
Germany	11	12	6
UK	8	6	4
US	12	8	17

Source: Own calculations based on data from Undersecretariat of Treasury Foreign Investment Report 2005 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2005.xls>) (Cited on 20.3.2006)

4.2 Comparative Analysis of FDI Determinants of Turkey with Ireland, Spain and Poland

4.2.1. Natural Resources

We have seen that in Ireland, Poland and Spain, resource seeking FDI attracted by abundant natural resources had been very low before and after accession. In Irish case natural resource based product sectors were least foreign penetrated sectors. Similarly, in Spanish case these sectors have not been the leading sectors in terms of penetration. However, Spain attracted a considerable amount of FDI to especially metallic and non-metallic mineral sectors. Although Poland has considerable natural reserves like coal and some metals, FDI inflows had been very small in the mining or other primary sectors leaving non-metallic minerals sector aside.

In Turkish case also we see that FDI inflows to the primary sector have been very low in comparison with manufacturing and services sector. As shown in Table 4.3, FDI inflows to the mining sector have been insignificant. Furthermore, metallic products and non-metallic minerals which are also based on natural resources received very small amount of FDI.

Table 4.3 Share of some natural resource based sub-sectors in total inward FDI stocks in Turkey (%), 1954-2003

	1954-2003
Agriculture	3,6
Mining	0,5
Metallic Products	0,1
Non-Metallic Minerals	0,1
Coal and Oil Products	0,8

Source: Own calculations based on data retrieved from Undersecretariat of Treasury Foreign Investment Report 2003 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2003.xls>) (Cited on 20.3.2006)

The data that can be compiled from the Turkish case and the previous case studies lead to the conclusion that natural resources will not be a major factor in attracting FDI to Turkey. However, effective utilisation of some potential natural resources like alternative energy resources and metals like boron may lead to an increase in FDI inflows. Similarly an improvement in the level of energy abundance in Turkey may attract more FDI to some energy dependent manufacturing sectors.

4.2.2. Distance

As mentioned earlier, “distance” as a determinant of FDI indicates cultural or historical as well as geographical distance. The previous case studies illustrate the fact that distance, in this sense, is a significant determinant of FDI. Hence, FDI inflows have been mainly originated from US and UK in Ireland, both of which have geographical and cultural proximity with the country. In Spanish case, EU member countries which are culturally and geographically closer to Spain established more foreign affiliates in the country. Moreover, Latin American countries made remarkable amount of investments in Spain. One of the leading investor in Poland has been Germany which is geographically and historically closer to the country.

Similar to the case studies analysed in Chapter 3, Turkey is situated in the periphery of Europe. As Figure 4.6 demonstrates, core EU countries and US have been the leading countries in establishing affiliates in Turkey. Among the EU members, Germany which Turkey has closer cultural ties compared to other EU members, owns the highest number of foreign affiliates in Turkey. German companies comprise 18 percent of all of foreign affiliates established in Turkey. UK and Netherlands also have remarkable amount of affiliates. Beside the other EU members, US originated TNCs also established a considerable number of affiliates. However, US share in number of affiliates are smaller when compared with US affiliates in Ireland, Spain and Poland. On the other hand,

eastern neighbour of Turkey, Iran, has 6 percent share in number of all affiliates established in Turkey. The share of Russian Federation originated firms is also noticeable with 4 percent.

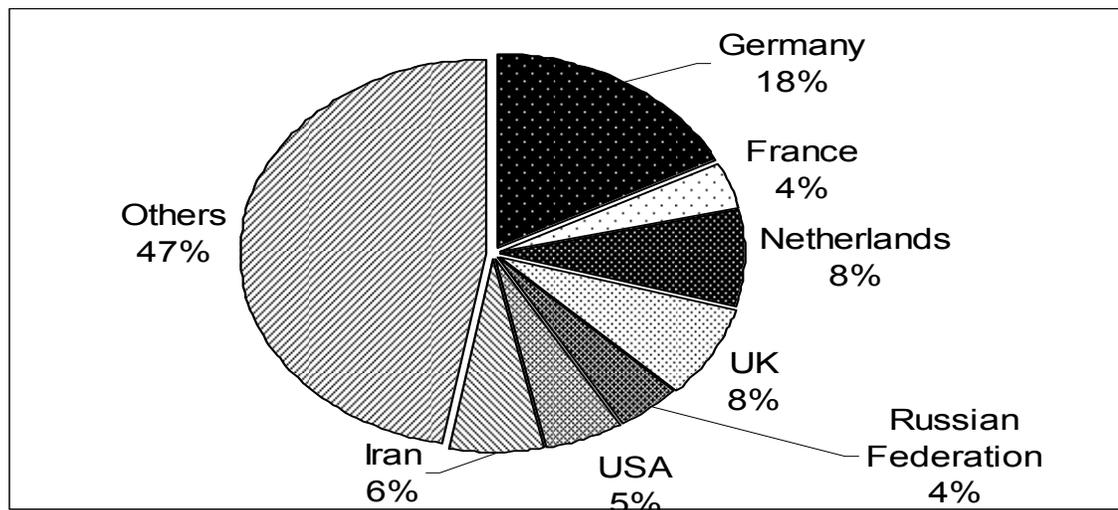


Figure 4.6 Origins of foreign affiliates in Turkey (%), 2005

Source: Undersecretariat of Treasury Foreign Investment Report 2005 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2005.xls>) (Cited on 20.3.2006)

Another important development observed in recent years is the increasing interest of Middle Eastern countries in Turkish economy they do not have a significant number of affiliates in the country. The EU membership prospects have boosted the flow of Arabic capital in Turkey in 2005. The geographical and cultural proximity of Turkey to the region have been a motivating factor for the Middle Eastern companies.

In short, distance has been a significant determinant of FDI inflows to Turkey in parallel to previous case studies. This similarity leads us to the conclusion that distance will be a crucial factor in determining future FDI inflows to Turkey. It can be expected that, culturally and geographically more proximate countries will increase their investments in Turkey considering the prospect of EU membership. Russian or Middle Eastern affiliates may prefer Turkey as a base to serve EU market.

4.2.3. Labour Costs

Labour costs are considered as a fundamental determinant of FDI. In all the previous case studies labour costs have been a crucial factor in attracting FDI. Ireland and Spain had lowest labour costs in the EU. Poland also had very low labour costs compared to EU and even compared to its major competitors among Visegrad countries. However, in Irish and Spanish cases there is also evidence of convergence with EU in terms of labour costs. Thus, especially in Ireland and Spain, FDI began to shift from labour-intensive sectors to capital or technology intensive sectors.³⁴ Trends in previous case studies show that FDI began to flow to a country independent from labour costs.

As a peripheral country Turkey also has very low labour costs compared to EU and US. As demonstrated in Figure 4.7, while average labour costs were 24 dollars in EU and 23 dollars in US in 2004, manufacturing workers earn 3,5 dollars per hour in Turkey.

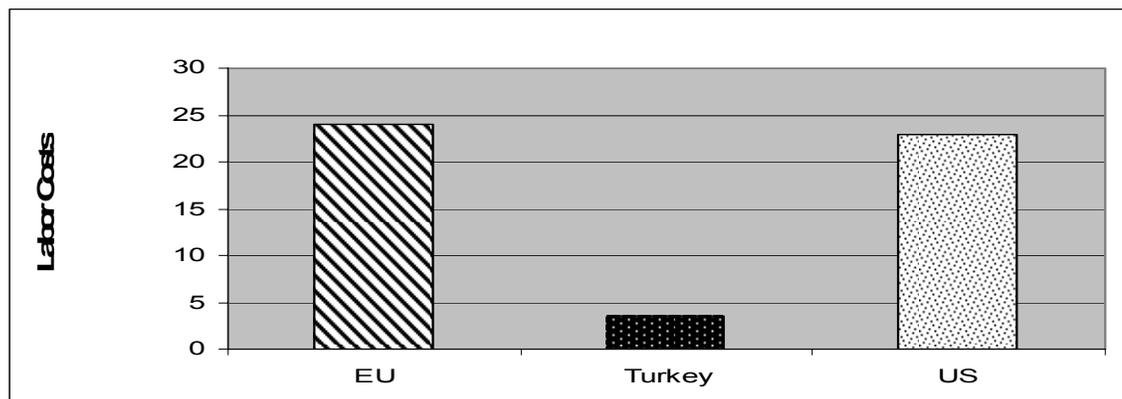


Figure 4.7 Hourly Compensation Costs for Manufacturing Workers (Dollars), 2004

Source: US Bureau of Labour Statistics and Turkish Statistical Institute Labour force Database (http://lmisnt.pub.die.gov.tr/die/plsql/lmwebeng.lmwebform_eng) (Cited on 20.3.2006)

³⁴ Also improvements in other determinants such as infrastructure and human resources have played a crucial role in this change.

Considering sectoral distribution of FDI, in Turkish case, FDI is generally attracted by manufacturing sectors which have higher labour costs. As Table 4.4 shows, manufacturing sectors with higher labour costs such as motor vehicles or chemicals have recorder higher amount of FDI inflows between 1980 and 2005. On the other hand, low labour cost sectors such as textiles or food and beverages attracted less FDI.

Table 4.4 Leading manufacturing sectors in attracting FDI and corresponding labour costs in Turkey

	Hourly Costs for workers in 2005 (Dollars)	Sectoral share in total annual FDI Inflows, 1980-2005 (%)
Food and Beverages	5,0	5,4
Motor Vehicles	5,6	7,8
Chemicals	7,8	6,8
Electrical Machinery and Electronics	6,3	3,0
Textiles	3,0	2,0

Source: Own calculations based on data retrieved from Turkish Statistical Institute Labour force Database (http://lmisnt.pub.die.gov.tr/die/plsql/lmwebeng.lmwebform_eng) and Undersecretariat of Treasury Foreign Investment Report 2005 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2005.xls>) (Cited on 20.3.2006)

Considering the CEECs countries which provide even cheaper labour supply as competitors in terms of attracting FDI, labour costs might not be an essential locational determinant of FDI inflows to Turkey in the future. Labour cost oriented FDI will continue to flow to CEEC countries or other low cost labour locations like China.

4.2.4 Infrastructure and Human Resources

Infrastructure and human resources are significant determinants of FDI since, quality of both have ramifications on the amount and as well as sectoral

destination of FDI. Abundant and high quality infrastructure and human resources guarantee higher and high technology oriented investment.

In terms of infrastructural quality, all three countries had unsatisfactory level of FDI before accession process. Ireland and Spain have long been considered as laggard countries of EU in terms of infrastructural development even after their accession. However, in both countries structural funds and cohesion funds provided by EU met the required infrastructure. Similarly, in Poland EU accession process has led to an improvement in infrastructural quality. Furthermore, Poland is looking forward to more EU funds in order to upgrade her infrastructure.

When compared with these three countries, regarding traditional basic infrastructure measures Turkey is lagging behind. Despite the high potential for railways, bounded by seas on three sides and maritime transport, highways account for 95 percent of passenger and 92 percent of merchandise transportation (Economist Intelligence Unit: 2005:25). In terms of paved roads as Figure 4.8 indicates, Turkey is considered to be the least developed country with 42 percent of roads paved in 2002.

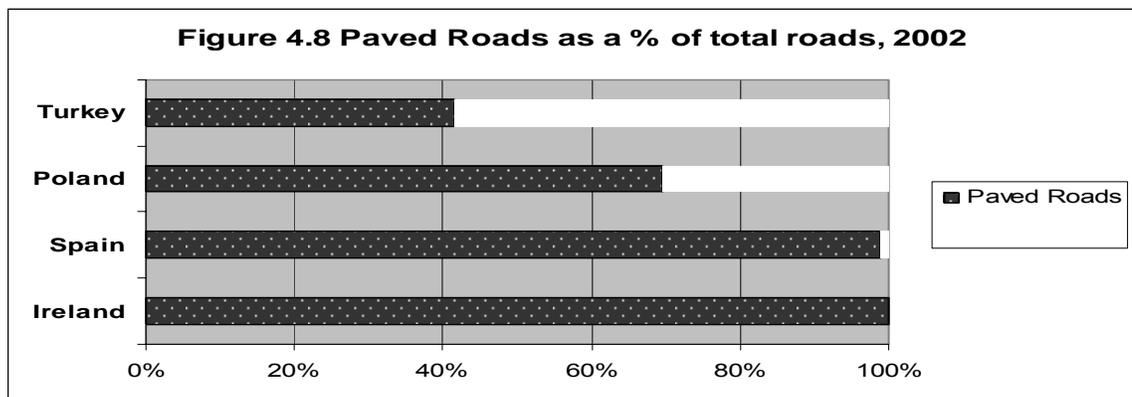


Figure 4.8 Paved Roads as a % of total roads, 2002

Source: OECD (2005) (<http://lysander.sourceoecd.org/vl=7208621/cl=11/nw=1/rpsv/fact2005/>) (Cited on: 10.2.2006)

On the other hand, telecommunications network was improved and expanded rapidly in the 1980s and early 1990s. With a substantial growth during the last decade, there is a technologically efficient and well functioning telecommunication system. There is a very wide range of internet access and a sufficient number of internet service providers. Digitalisation is almost complete, but today infrastructure is again failing to keep up with demand, particularly for Internet and data services (Hadjit and Moxon-Browne, 2005:324). Comparison between four countries in number of telephone mainlines per 1000 people in Figure 4.9 demonstrate that despite the recent improvement of telecommunication network in Turkey is still below even that of Poland.

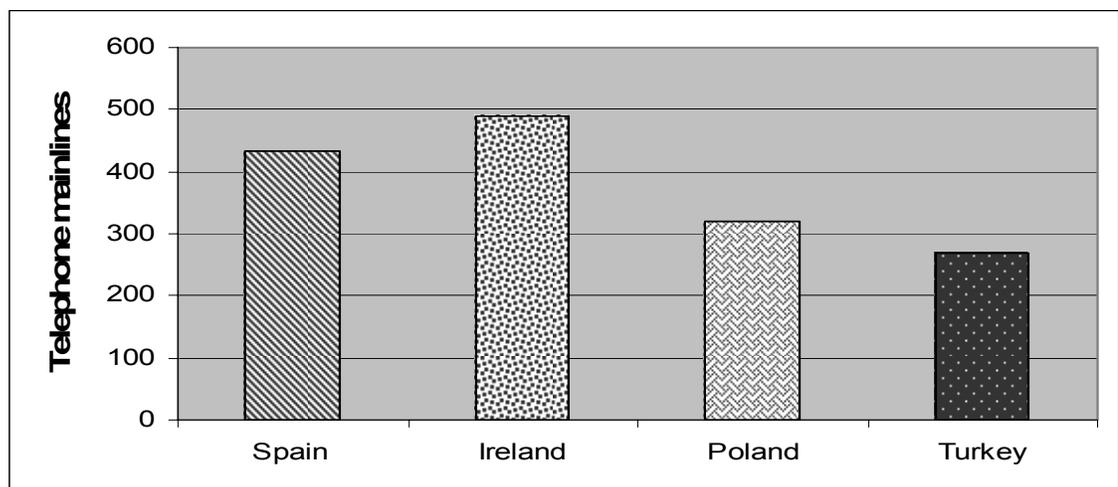


Figure 4.9 Telephone mainlines per 1000 people, 2003

Source: World Bank World Development Indicators Database
 (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

In terms of human resources development, Ireland achieved a great success after EU membership. Continuous spending in education and vocational training upgraded human capital endowments. EU funds have been mostly used to finance education programs. In result, Ireland's human capital level has caught and even exceeded EU levels. Similarly, throughout the accession process Spain also upgraded her human capital endowments.

However, Spanish government did allocate larger share of EU receipts in infrastructure projects. In Poland, educational spending decreased in early years of transition process at the beginning of 1990's. Since then, governments began to invest in human resources. Although, communist regime provided a high level of educational attainment, the challenge for Poland has been reforming the education system to comply with the needs of market economy. Thus, especially engineering education and vocational training have been encouraged.

The quality and level of education in Turkey is modest compared to other emerging markets. However, Turkey has made sizeable progress in recent years, especially as regards basic and intermediary skills. The minimum period of schooling was raised from eight to twelve years in 2004. Primary enrolment has reached 95-100 percent in most parts of the country. In order to compare Ireland, Spain and Poland with Turkey, tertiary level educational attainment level of working population is demonstrated in Figure 4.10. As the figure indicates, tertiary level education attainment is comparably very low in Turkey since only 10 per cent of working age population can complete tertiary level education. On the other hand, the ratio for Spain is 25 and Ireland is 26. Overall, Turkey's human capital endowment still compares unfavourably to other emerging markets but continues to improve gradually.

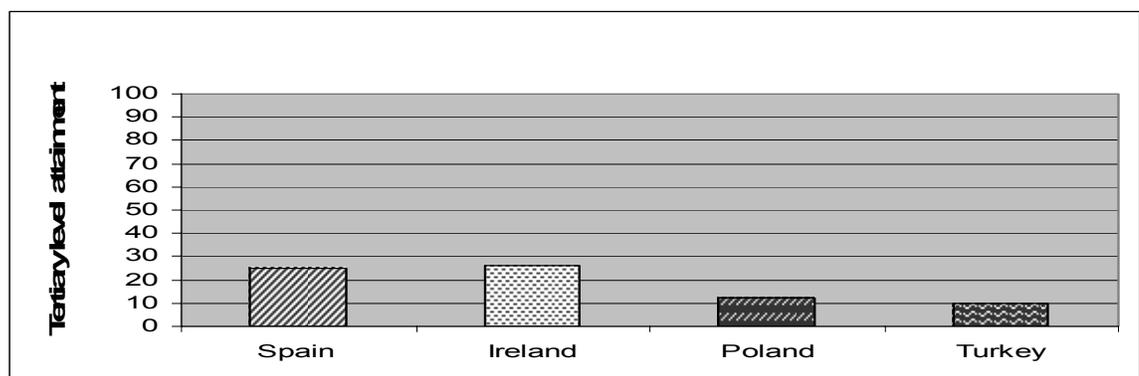


Figure 4.10 Tertiary level educational attainment of working age population (%), 2003

Source: OECD (2005) (<http://lysander.sourceoecd.org/vl=7208621/cl=11/nw=1/rpsv/fact2005/>) (Cited on: 10.2.2006)

In general, Turkish infrastructure and human resources has not yet reached a level capable of attracting especially efficiency seeking FDI. However, in terms of human resources, young and dynamic demographic structure of Turkey has a potential to improve in terms of overall human capital level in order to attract FDI to medium and high technology sectors like Ireland. In this sense, accession process and EU membership may have positive implications on infrastructure and human capital development like in Ireland or Spain. If Turkey were a member country today, it could count on structural funds allocations to develop the infrastructure and human capital capabilities. Moreover, all of Turkey's regions currently have a per capita GDP way below 75 percent of the EU average and the country would also be eligible for assistance under the Cohesion Fund. More or less, through accession process and after a potential membership, Turkey will be provided with some amount of EU funds. On the condition that these funds are utilised efficiently like Ireland, a sustainable flow of FDI may be attained in long term.

4.2.5 Market Size

The theoretical explanations and empirical studies commonly found that existence of a target market for selling their goods and services is a primary prerequisite for TNCs to involve in foreign investment.

Similarly in the previous case studies common determinant which had a crucial significance in attracting FDI inflows has been market size. However, each country has different market characteristics. As shown in Table 4.5, Ireland is a very small country with approximately 4 million citizens while Spain and

Poland have populations over 40 million. Turkey on the other hand is a more populous country with 71 million citizens.³⁵ In terms of GDP, Ireland is the smallest country with 183 billion dollars in 2004. Spain has the biggest GDP with 991 billion Dollars. In this category, Turkey's GDP is close but higher than Poland. Although in terms of GDP or population, she has the smallest values; Ireland is the leading country in terms of per capita GDP in Purchasing Power Parity (PPP) followed by Spain. Purchasing power of Turkish citizens is less than Irish and Spanish, but higher than Polish citizens. In general, when compared with the other three countries current size of Turkish economy is displaying similarities with Poland. However, if the current trend of growth realized in recent years³⁶ could be sustained Turkish economy may converge to Spanish economy. Thus, the scale of population and growth expectations of the economy is setting necessary the conditions for market seeking FDI. Thus market size is considered to be the most significant determinant in Turkish case.

In parallel, empirical studies by (Loewendahl and Loewendahl (2001), Tatoğlu and Gleister (1998), also found that market size have been the major asset of Turkey in terms of attracting FDI. Michalet's (1997) survey, comparing Turkey with CEECs countries revealed that 53 percent of foreign investors rank Turkey in first place in terms of market potential.

Table 4.5 Market Size Indicators, 2004

	Population	GDP (Dollars)	Per capita GDP in PPP (Dollars)
Ireland	4.019.000	183.559.618.560	16.099
Spain	41.286.400	991.441.649.664	10.462
Poland	38.160.000	241.832.542.208	4.915
Turkey	71.727.100	301.949.845.504	5.529

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

³⁵ Turkey has the third-largest population in Europe, after Russia and Germany. (Economist Intelligence Unit: 2005:20)

³⁶ 8% in 2002, 6 % in 2003, 9,5 % in 2004 and 7,5% in 2005. Last four years average growth rate is 7.75%.

On the other hand, another dimension of market size as a determinant of FDI has been the potential of the host economy to provide access to other markets. This had been the major factor in attracting US FDI to the small Irish economy since Ireland provided access to EU market. Poland also provides access to other CEECs markets for especially EU and US investors. Similarly, empirical study by Erden (1997) found that multinational firms in Turkey view Turkey as a market base that provides access to several markets such as European Union, Middle East and Central Asian Republic since Turkey is situated in a critical location as an export base.

Turkey is the only non-EU member to have a customs union with the EU. With the entry into force of the customs union between the EU and Turkey, many of the features attributable to potential EU membership and the improved market access related thereto have already materialized. Customs union provided the opportunity to the foreign firms that want to access EU market to use Turkey as an export base to the rest of the EU. In parallel Tatoglu and Gleister (2000: 4) in their study argued that customs union with the EU will spur the flow of European FDI to Turkey. However, this potential have not been realised after the establishment of Customs Union.

As shown in Figure 4.11, the EU has regularly accounted for one-half of Turkey's exports. In 2004, with the expansion of the EU to 25 countries, the share of EU rose to 55 percent. US take 8 percent of Turkey's exports. The remainder of Turkey's exports go mainly to the neighbouring regions of central and south-east Europe, the Middle East and the former Soviet Union.

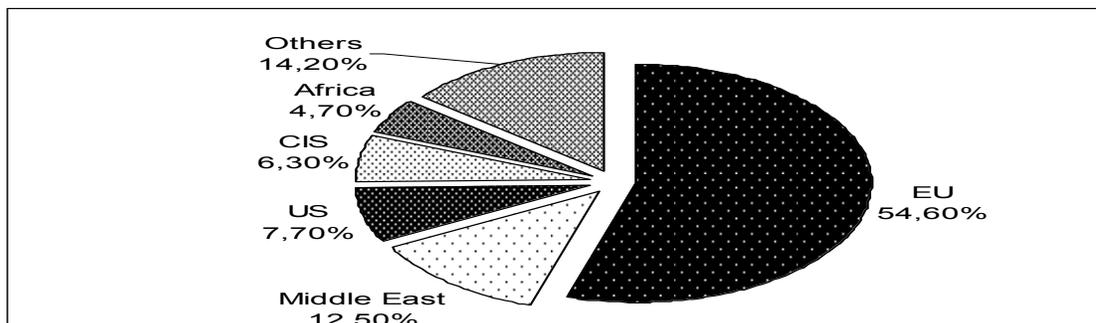


Figure 4.11 Export destinations of Turkish goods and services (%), 2004

Source: Own calculations based on data retrieved from Turkish Statistical Institute Foreign Trade Indices (http://www.die.gov.tr/ENGLISH7SONIST7DISTICIST7K_310306.xls) (Cited on 23.3.2006)

However, statistical data in Figure 4.12 indicate that foreign affiliates in Turkey have not been traditionally export oriented. Foreign affiliates did not have a major share in total exports contrary to the Irish case where foreign affiliates realized 90 percent of the total exports of Ireland. Foreign affiliates share in exports were steady between 1996 and 2002, although there is a slight increase in foreign affiliates share from 18 percent in 1996 to 24 percent in 2002.

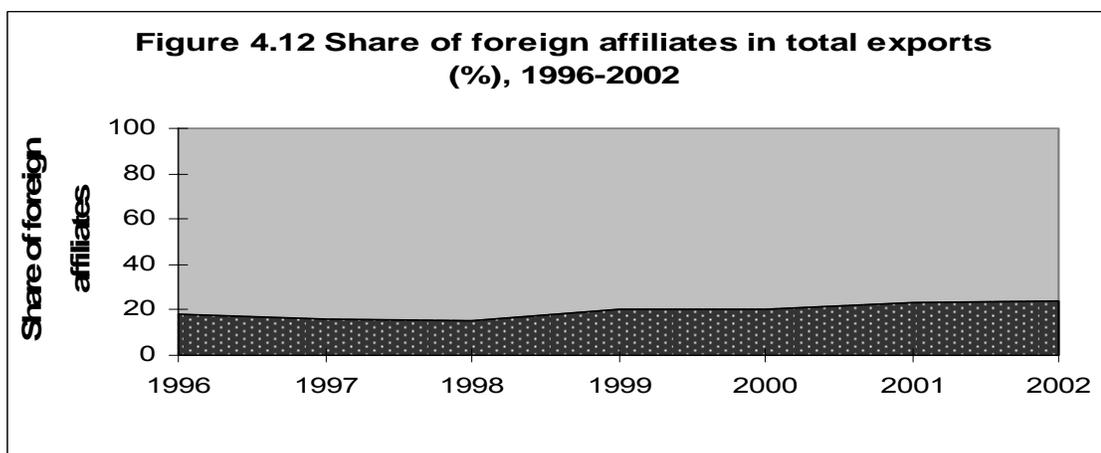


Figure 4.12 Share of foreign affiliates in total exports (%), 1996-2002

Source: Own calculations based on data retrieved from Undersecretariat of Treasury Foreign Investment Report 2003 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2003.xls>) on 20.3.2006

Concerning the top 6 export destinations between 1996-2002, foreign affiliates share in exports is shown in Table 4.6. As Table 4.6 indicates, foreign affiliate's exports basically directed to EU countries such as Germany, France and Italy. In parallel, exports to these three countries comprise 38,5 percent of total exports of foreign affiliates in Turkey in the same period. On the other hand UK as a more distant member of EU to Turkey is less preferred to be served by foreign affiliates. Foreign affiliates share in total exports to non-EU members such as USA and Russia is lower. Their share in total exports of foreign affiliates is also very small, with 5 per cent and 4,2 percent respectively.

Table 4.6 Share of foreign affiliates in Turkish exports to major export destinations (%), 1996-2002 average

	Share of foreign affiliates in Turkish exports to the country	Share of country in total exports of foreign affiliates in Turkey
Germany	21,6	21,6
USA	10,8	5,0
UK	13,0	4,0
Italy	28,5	7,8
France	31,0	9,1
Russia	16,0	4,2

Source: Own calculations based on data retrieved from Undersecretariat of Treasury Foreign Investment Report 2003 (<http://www.hazine.gov.tr/stat/yabser/ybsrapor2003.xls>) (Cited on 20.3.2006)

These data prove the fact that Turkey still does not constitute an export base for foreign investors since the role of foreign affiliates are comparably low.³⁷ However, EU accession may be a motivating factor for especially non EU investments in order to serve EU market since positive developments in other determinants may attract EU and non-EU investors who aim at exporting to neighbouring eastern regions of Turkey. In conclusion, market size is an

³⁷ Although in some sectors such as automotive industry, investments of France, Italy or Japan are mainly export oriented. For details see Göver (2003).

important FDI determinant in Turkish case and there is still more potential for market seeking investments to be largely motivated by the prospect of EU membership.

4.2.6 Macroeconomic Stability

General macroeconomic condition of a country usually has a priority among the criteria that influence the decision to invest of a foreign investor. Macroeconomic fluctuations deter domestic investors from investing because of the uncertainties about the future.

In all the previous case studies, macroeconomic stability has been a common determinant, since in all three countries FDI inflows began to increase after a certain level of stability have been sustained. In Ireland, public debt, budget deficits and inflation problems have been significant factors that delayed the influx of FDI. Successful fiscal policy that has been implemented in late 1980's alleviated most of these problems. As stability maintained in the beginning of 1990's, FDI inflows began to materialize. The Spain's route was different, since just after the accession FDI inflows began to increase although there were still imbalances in macroeconomic indicators like volatile currency, budget deficit and inflation. Due to these problems, Spain could not sustain a steadily increasing FDI. However, as effective macroeconomic policies implemented in 1990's in order to comply with Maastricht Criteria and EMU accession, macroeconomic indicators turned out to be positive. This improvement in the economy has been a crucial factor in the second surge of FDI inflows in the beginning of 2000's. The high level of inflation, exchange rate volatility and severe public debt problem has also been a significant factor in Poland's relatively limited achievement in attracting FDI in comparison to other transition economies. However, as the public debt problem has been alleviated and inflation rates fell down, Poland began to materialise her real potential in attracting FDI.

Similar to these three countries, Turkey also had suffered from severe macroeconomic problems. In Turkey, political instability has had a major impact on macroeconomic instability, with the lack of structural economic reform leading to sustained inflation and exchange rate instability (Loewendahl and Loewendahl-Ertugal, 1998:24). According to Derviş, Öztrak, Yılmaz, Bayar and Işık (2004), the main factor that has deterred foreign investment in Turkey has been the lack of political and macroeconomic stability.

Growth, which had always been volatile, became even more so in the 1990s and in the beginning 2000's. After 2002, with the implementation of the stabilisation programme Turkey realized a gradual but steady improvement in its economic conditions. Economic activity bounced back again in 2002-2005 period. GDP growth has recorded over 5 percent in this period³⁸ and inflation rates are decreased to 6 percent.

For over two decades the Turkish economy recorded persistently high levels of inflation. High inflation in Turkey has gone hand in hand with a persistently large fiscal deficit, financed generally by domestic and foreign borrowing. Successive governments were unable to bring budget deficits and hence inflation under control. As shown in Figure 4.13, inflation is comparably high and very volatile in comparison with Ireland and Spain. However, like Poland policies to reduce inflation have been successful bringing inflation to single digits in recent years.

³⁸ 7,9 per cent in 2002, 5,8 per cent 2003, 9,5 per cent in 2004 and 7,5 per cent in 2005.

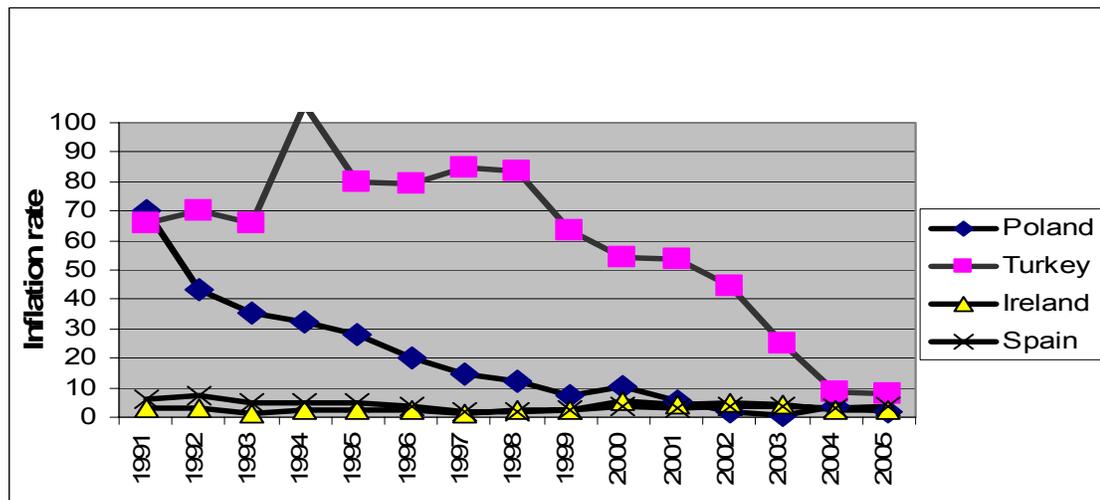


Figure 4.13 Inflation, Annual Changes (%), 1991-2005

Source: OECD (2005) (<http://lysander.sourceoecd.org/vl=7208621/cl=11/nw=1/rpsv/fact2005/>)
 (Cited on: 10.2.2006)

Over the past ten years, Turkey changed its exchange rate regime several times. The policy adopted in November 1995 linked the devaluation of the Turkish Lira systematically to the development of the Wholesale Price Index. In 2000, a crawling peg regime was introduced. After February 2001 crisis, there has been a switch to a free floating regime. As a result of macroeconomic imbalances and instability in currency regime exchange rate of Turkey has been very volatile.

In general, positive developments in terms of interest rates, inflation and exchange rates sustained by lowering public debt and budget deficit have been the key factors in all three countries analysed previously. Thus, similar achievements in attaining long-term macroeconomic stability are a prerequisite for an effective investment environment.

According to Dutz, Us and Yilmaz (2003), even the signalling effect of the opening of accession negotiations will be strong since such a decision will assure foreign investors that the Turkish economy will move through a stable growth path. For Turkey, the benefit of stability will convince foreign investors to invest in Turkey for domestic as well as export market-oriented projects. In this

vein, as macroeconomic problems have been impediments to FDI inflows until today in Turkey, achievement of stability is expected to boost FDI and further retain the continuation of the inflows.

4.2.7 Openness and Business Environment

Openness and an investment-friendly business environment have been common features of the economies that attracted more FDI than the others. In this vein, in Ireland, Spain and Poland efforts to open up the economy and create a more liberal business environment have been a common characteristic. Prior to EU membership, Ireland was implementing a protectionist regime. FDI was restricted and import substitution policy was followed. After EU accession, FDI legislations and trade regime have been liberalised. Ireland became one of the most open economies of the world. Similarly, until EU accession in 1986, Spain was applying high tariff barriers and implementing a protectionist regime in general. Foreign investment was regulated very strictly. However, EU accession led to the opening up of the market through lowering tariffs and also liberalising FDI legislations. Openness of the economy in the early years of accession led to an increase in imports which tried to be balanced by increasing FDI inflows. In the end, especially after 2000 Spain became a very open economy. Although coming from a very different historical background, Poland also followed a similar path with Ireland and Spain. After abandoning the communist regime, Poland applied a “shock therapy” programme aiming to realise a rapid transition to market economy. After signing EAs with EU, Poland removed tariff and non-tariff barriers. Furthermore, FDI regime have been liberalised and foreign investors penetrated in the economy through large scale privatizations. In general, although FDI inflows to GDP ratios improved since 1990, foreign trade to GDP ratio has remained steady.

The openness indicators of Turkish economy are demonstrated in Figure 4.14. As Figure 4.14 shows, trade intensity of the economy increased after

Customs Union with EU and stayed between 50 and 60 percent. This level is above Poland's trade intensity in the same period while being below that of Spain and Ireland. On the other hand, despite a sudden increase in 2001, FDI intensity in the same period had been very low when especially compared with all the other three countries.

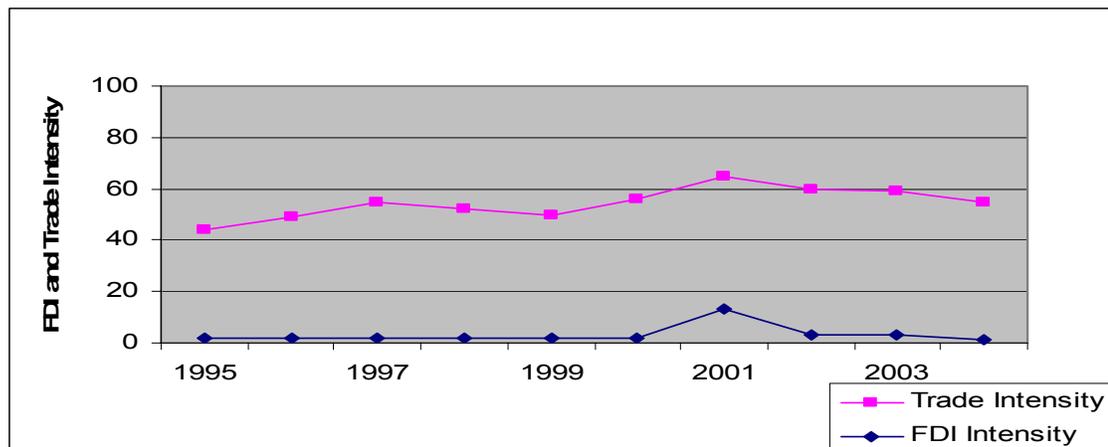


Figure 4.14 Trade and FDI Intensity (%), 1995-2004

Source: World Bank World Development Indicators Database
(<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

Although staying below these three countries in terms of openness criteria, Turkey also passed through the same phases with these three countries in which Customs Union has been a turning point. In early 1960s to 1980, Turkey followed a strategy of industrialization through inward-oriented import substitution policies. Accordingly, the economic policies were mainly designed to protect the domestic industry from the foreign competition and to increase the government's controls over the allocation of resources and production of goods (Elveren and Kar,2005:6). The policy package put into effect in 1980 and developed in the following years marked a shift in development strategy from inward orientation to outward orientation. Turkey liberalized its foreign trade regime, removed price controls and other distortions in product markets, and deregulated its financial sector. This enabled the formation of the Customs Union between Turkey and the EU in 1995, with the removal of tariff and non-

tariff barriers on industrial goods and forced with respect to the EU and the adoption of the Common External Tariff (CET) against third country imports and all preferential agreements between the EU and third countries by the year 2001. The customs union with the EU contributed to opening up of Turkey's economy, bringing about major increases in the volume of foreign trade. On the other hand, owing to an asymmetric abolition of trade barriers³⁹ the customs union initially had a greater impact on the country's imports than on its exports and trade deficit increased.

The foreign investment law of Turkey in 1954 was in compliance with the rather protectionist regime. This law brought some limitations on foreign ownership in some sectors. The foreign investors had to get authorisation from the Undersecretariat of Treasury and they were obliged to provide 50.000 dollars to establish a company or open a branch in Turkey. In 2003, a new Foreign Investment Law has been adopted. This law liberalized direct investment regime by eliminating authorization obligation of foreign investors and replacing it with a notification system, providing national treatment in acquisition of real estate to foreign-owned entities registered under Turkish law, and abolishing the specific minimum capital requirement for foreign investments. Foreign investors are subject to restrictions on establishment in certain sectors.⁴⁰(PRS Group, 2004:3, YASED, 2005:12)

In terms of establishment of company, recent legislation simplified the procedures. As seen in Table 4.7 it takes only 9 days to open a company while it takes longer than 24 in Ireland, Spain, and Poland. Turkey has become, at least in terms of legislation, one of the countries with the shortest and simplest process to set up a business. On the other hand, enforcing contracts are more

³⁹ EU abolished tariffs on most industrial goods from Turkey in the early 1970s whereas Turkey only lifted tariffs on after entering the customs union.

⁴⁰ The equity participation ratio of foreign shareholders is restricted to 20 percent in broadcasting, and 49 percent in aviation, value-added telecommunication services, and maritime transportation. However, companies receive full national treatment once they are established..

difficult in Turkey since number of procedures and duration is higher compared to Ireland and Spain.

Table 4.7 Business Environment Indicators in comparison, 2004

	Ireland	Spain	Turkey	Poland	OECD
Starting a business: no of procedures	6	6	8	10	6
Starting a business: duration (days)	24	108	9	31	25
Enforcing contracts: no of procedures	16	16	22	41	19
Enforcing contracts: duration (days)	217	169	330	1000	219

Source: World Bank World Development Indicators Database (<http://www.worldbank.org/data/wdi2005/index.html>) (Cited on 10.2.2006)

The business environment in Turkey is generally considered to be hindering investments. According to Hughes (2004) the main impediments include, bureaucratic barriers, lack of competition, corruption, the judicial and court systems, and problems in land acquisition. Global Competitiveness Report (2003) of World Economic Forum ranked bureaucratic 'red tape' as a leading competitive disadvantage for Turkey. This is supported by Loewendahl and Loewendahl-Ertugal (2001)'s study which results with over 50 percent of respondents among foreign investors citing legislation, regulation and bureaucracy and nearly 30 percent citing the slow pace of reform and political resistance as the major factors explaining Turkey's under-performance in attracting FDI. Dutz, Us and Yılmaz (2003) related Turkey's poor performance in attracting FDI to legal and judicial constraints related to insufficient clarity and respect for the rule of law, and existence of competition constraints. Furthermore Erdilek (2001), Dutz, Us and Yılmaz (2003) emphasised inadequate protection of intellectual property rights such as patents, trademarks and copyrights as obstacles to inward FDI.

In general, as seen in previous case studies lack of openness and unstable business environment have been one of the major reasons behind under-performance of Turkish economy in attracting FDI. Attainment of a more open economy is an ongoing task for Turkey reflected in the increasing imports as well as exports recorded in last years. However, improvement in business environment in terms of institutional quality, governance and competition will significantly contribute to general business environment in the country.

4.2.8 Incentive Schemes

Although most governments try to provide incentives for (domestic or foreign) investors, their form and extent reflects the reigning business policy in the country. As dealt in the previous case studies, incentive schemes are generally evaluated as a significant determinant of FDI implemented in terms of advantageous taxes, grants and active investment promotion policies administered by Investment Promotion Agencies.

In terms of tax policy, Ireland evidently opted for low corporate tax policy. While, Spain and Poland applied higher tax rates (over 30 per cent) in compliance with EU standards. However, in 2000 Poland also began to decrease the tax rates reaching 18 per cent in 2005. Among these group of countries, Turkey applies a higher corporate tax with 30 per cent as shown in Table 4.8.⁴¹ This rate is, on the other hand, equal to EU average. In general, Turkey is not implementing a competitive corporate tax rate like Spain. Furthermore, frequent changes in tax regime and rates are increasing uncertainty. On the other hand, as mentioned in Section 3.1.8, success of Ireland largely depends on implementation of an explicit tax regime.

⁴¹ A new law reducing corporate tax rates to 20 percent has been proposed to Parliament but not yet finalised.

Table 4.8 Effective Corporate tax rates 2005 in Ireland, Spain, Poland and Turkey (%), 2005

	Ireland	Spain	Poland	Turkey
Corporate Tax Rate	12,5	35	18	30

Source: OECD (2005)
<http://lysander.sourceoecd.org/vl=7208621/cl=11/nw=1/rpsv/fact2005/> (Cited on 10.2.2006)

In Ireland, Spain and Poland, governments provided extensive incentives for the investors. They are generally applied both for foreign investors and domestic investors. Among three countries that have been analysed, most comprehensive and extensive level of incentives have been provided by the Irish government. Ireland also established Special Export Zones which attracted a remarkable amount of especially US high-technology investment. In Spain, grants and incentives were applied generally in compliance with EU legislations. However, special incentives applied by regional governments aimed to sustain regional development. In Poland, incentives have also been largely applied in the form of employment and capital grants. Similar to Ireland, Poland also created Special Export Zones which attracted a significant amount of FDI. In general Poland's and Ireland's incentive policies have been more pro-active.

Turkey also applies non-discriminatory incentives for investors since 2003. According to Turkish incentive system, the investors may qualify for general incentives⁴² based on the location, scale, and other qualifications of the

⁴² These are:

- Investment allowance
- Exemptions from customs duties and fund levies
- VAT exemption for machinery and equipment
- Exemption from certain taxes, duties and fees
- Grant of subsidized credits

investment.⁴³ There is a special emphasis, on the development of backward regions, small and medium-sized enterprises and high-technology industries. New incentives for investment in low-income regions including subsidies for energy costs and new employment and the possibility of free state land were provided (YASED, 2005:34). Research and development promotion open to both advanced technology firms and firms applying technological inventions to the development of new products. Earnings from such activities are exempt from income tax for five to ten years (Pöschl, Vidovic, Wörz and Astrov, 2005:12). Furthermore, there are some special sectors of importance⁴⁴ for which incentives are granted regardless of the location of the investment.

Similar to Poland and Ireland Turkey also established Free Trade Zones (FTZs). Turkey's legislation treats FTZs as being outside the Turkish customs territory. Sales from FTZs to Turkey count as Turkish imports. Companies operating in the FTZs are subject to VAT as well as to customs duties. They do not pay corporate income tax and salaries they pay are exempt from tax. However, in the EU accession process FTZs will be abolished through a transition process. Thus, legislation regulating FTZs amended reducing the attractiveness of these zones.⁴⁵

Another dimension of facilitating FDI is investment promotion. As mentioned in Chapter IV, investment promotion agency of Ireland, IDA has been a driving force of Ireland's FDI oriented policy. Active promotion of Ireland's investment opportunities to foreign investors and well-established aftercare

⁴³ In order to qualify for the above incentives, it is necessary to obtain an incentive certificate before the investment is initiated. An investment must meet a minimum equity ratio of 20% and minimum value of 600.000 YTL for the developed regions⁴³ and 400 billion YTL for the normal regions and 200.000 TL for priority development regions.

⁴⁴ Research and development, software development, environmental protection, rehabilitation centres, infrastructure (including energy), ship and yacht building, education, shipyard, health, tourism, electronics industry, mining, priority technological investments, Information technology

⁴⁵ Depending on their field of activity, at least some of the companies with FTZ licences issued after February 2004 will have to pay corporate income tax. Companies with licences dating further back will remain exempt from that tax – up to the expiry of the licence or, in the event of Turkey joining the EU, up to the date of accession. The salaries they pay will be exempt from income tax up to 2008.

services have been the major policies of FDI. Furthermore, industrial targeting policy of IDA, favouring high technology sectors has given its fruits in late 1990's. Spain implemented a low profile policy mostly depending on government institutions while Poland followed the track of Ireland by establishing PAIZ as an investment promotion agency. Similar to IDA, PAIZ also plays a very active role in providing and implementing incentives for foreign investors.

In Turkish case, FDI promotion policies are showing similar weakness with Spain. Turkey at present does not have an agency with a clear set-up and budget to carry out effective investment promotion like Ireland and Poland. However, since 2004 there are initiatives to establish an investment promotion agency which will have an autonomous structure and an independent budget similar to IDA or PAIZ.⁴⁶

In general, incentive schemes as a determinant played a significant role in attracting FDI to Ireland and to some extent Poland. However, Turkish incentive and investment promotion policies were not very significant in terms of attracting FDI although the recent government is working on the reform process. The success of Ireland especially indicates the fact that well designed and rational incentive policies may result in more FDI inflows to high technology and increasing return sectors. Thus, adoption of the policies formulated by taking the unique characteristics of Turkish economy into account may result in increasing amount of FDI inflows.

⁴⁶ This law is expected to be finalised in 2006.

CHAPTER V

CONCLUSION

This study mainly aimed to investigate potential effects of EU membership on FDI inflows to Turkey. The experiences of the present member states created expectations for a similar boost of FDI inflows during the negotiation process of Turkey and after her membership. In order to draw reliable conclusions on future trend of FDI inflows to Turkey, the experiences of three peripheral countries, namely Ireland, Spain and Poland, that acceded to the EU in the last three decades, had been investigated with a comparative methodology. The comparison of each country in terms of their determinants provided evidences for our analysis on implications of EU membership on FDI inflows to Turkey.

The second chapter of the thesis provided a historical, conceptual and theoretical framework for FDI. Basing on the main components inferred from conventional definitions of the concept, FDI has been defined as a certain form of business relation that stems from a lasting commitment of an investor which provides authority over an enterprise resident in another economy either established or acquired by the investor. The main actors in this business relation are TNCs, which involve in FDI by adopting their organizational form according to their motives and locational determinants. While they horizontally organize themselves to serve a specific market, they prefer a vertical model to exploit some locational endowments such as natural resources and low labour costs.

FDI concept also found to be evolved throughout the historical process depending on the dynamics presented by vertically or horizontally organized TNCs. Resource seeking and market seeking have been identified as dominant motives of TNCs before 1960's which spurred FDI inflows to labour or resource intensive low technology. Later with the advancement of technology and

increasing role of TNCs, other motives such as efficiency seeking began to dominate. These kinds of investments necessitate more qualified locational endowments such as productivity or efficient infrastructure. Thus, they are mainly destined to high technology sectors and to developed countries.

As FDI evolved, it became the main driving force of the global economy. The statistical evidence in the second chapter clearly illustrated the fact that FDI has surpassed trade in terms of international economic activity and TNCs became the major actors in global economy. The statistical evidence also showed that although FDI flows rapidly increased in the last two decades, it has not flown equally to whole globe since developed countries attracted a major percent of FDI inflows while developing countries lagged behind. The major group that attracted most of FDI among the developed countries is identified as EU especially after the completion of the Single Market.

The second chapter also located FDI concept in a theoretical framework which helped us to understand why firms are involved in FDI. Among several alternative theoretical explanations of the concept, most extensive one has been identified as Dunning's OLI paradigm. According to this paradigm, Ownership advantages stimulate firms to invest in other markets. The coordinates of this investment is mainly determined by Location bound advantages of the host countries which are indeed in a harsh competition to attract as much FDI as possible. These locational factors of the host economies are fundamental for firms, since they could only exploit Internalization advantages by combining their Ownership advantages with locational endowments.

As the study mainly aims to research FDI inflows to a specific location, our analysis have been focused on locational determinants of OLI paradigm. In the literature, several determinants have been utilised in empirical models that aim to estimate FDI inflows to a specific location. Among these, we have identified nine common determinants, namely "natural resources", "distance", "labour costs", "infrastructure and human resources", "market size", "macroeconomic stability", "openness and business environment", "incentive

schemes” and “regional integration schemes”. Each of these determinants has varying implications on FDI inflows to each country. However, in general they had been instrumental in order to make a comparative analysis among the case studies that have been considered in the next chapter. Thus, they constituted the basis of the framework of our competitive methodology.

In the third chapter, an analysis of Ireland, Spain and Poland’s accession experience have been provided with reference to implications of locational determinants on the attractiveness of these countries. In each of the three countries FDI inflows follow a different path considering the timing of membership and increase in FDI inflows. While, FDI inflows stayed steady even two decades after EU membership in Ireland, Spain experienced a very sudden surge. Poland, which had to pass through a long accession process to become an EU member, experienced a gradual increase even before accession. In terms of foreign involvement in the economies, Ireland largely took the leading position owing to historical openness of the country even before EU accession. Sectoral destinations of FDI inflows indicated that, FDI is mainly oriented in high technology manufacturing and services sectors in Ireland, while a similar path is observed in Spain. However, in Spanish case medium technology sectors still have a higher share in terms of FDI inflows. Polish case differs from these two cases since low and medium technology sectors still attract most of FDI. In terms of origins of FDI, while EU dominates FDI inflows to Spain and Poland, Ireland is preferred mostly by US affiliates.

In Irish case, it is found out that market size embracing both domestic and EU market have been an important factor that attracted such high amounts of FDI. Distance factor referring to geographical as well as cultural proximity found to determine the origin of FDI inflows which led to US dominance in Irish case. The most crucial determinant in Ireland had been infrastructure and human resources. Policies supported by EU funds improved existing infrastructure conditions and upgraded human capital level. This contributed to rise in efficiency-seeking FDI flows especially destined to high technology sectors such

as software, pharmaceuticals or medical technology. Offering of high technology oriented incentives with an active promotion policy further strengthened this trend. Although accession itself did not lead to an evident increase in FDI inflows statistically, it had very positive implications on other determinants such as market size or openness and business environment.

In Spain, major determinant that led to the initial surge in FDI inflows is found to be market size of the country. The second surge in FDI in late 1990's has been more sustainable since other determinants began to contribute to Spain's attractiveness for foreign investors. Improvement in terms of infrastructure and human resources and sustainability of macroeconomic stability in 1990's created a feasible environment for efficiency seeking foreign investments. Geographical and cultural proximity attracted more European and Latin American investments in the country. EU membership in general led to a gradual improvement in overall locational determinants of FDI.

In Poland, in the initial years of transition, market size had been a dominant factor since there were several unexploited market opportunities for foreign investors. However, market size did not lead to an influx of FDI. Later, Poland began to attract higher levels of FDI which can be explained by her ability to sustain macroeconomic stability in the second half of 1990's. Gradual improvement in the business environment and adoption of an effective incentive policy encouraged efficiency seeking FDI to medium and high-technology sectors. Increasing prospect of EU membership has been perceived as a provision for locking in and integration of Polish economy to European market. It enhanced market size of Poland by integrating EU and CEEC market which especially spurred export-oriented foreign investments.

The fourth chapter is devoted to application of our findings in the previous chapter to Turkish case. Turkey is found to have low levels of FDI inflows prior to her accession like Ireland, Spain and Poland. However, characteristics of Turkish economy provided diverging evidences that has implications on locational determinants of FDI. Thus, the chapter provided a comparative

analysis of locational determinants that have been tested in Irish, Spanish and Polish case studies with the locational determinants of Turkey.

The comparative analysis indicated that some determinants will have a more substantial role in attracting FDI to Turkey than others. The analysis also showed that some determinants are expected to have a critical role on the condition that required policy decisions are taken.

The determinants that are expected to be less essential in attractiveness of Turkey consisted of “labour cost” and “natural resources”. These determinants mainly motivate resource seeking FDI. However, our study verified that neither of these determinants has been vital in Ireland, Spain and Poland. Although Turkey has very rich natural resources and comparably low labour costs, FDI inflows in the past have not been destined to low labour cost sectors or natural resource based sectors. Thus, in accession process we do not expect a reversal in this trend since the experience of Spain, Poland and Ireland has shown that these determinants even lose their significance as other determinants improve and FDI began to shift from labour-intensive or natural resource-intensive low technology sectors to medium and high technology sectors. FDI inflows to Turkey are not expected to target primary sector in general.

The determinants that will be more influential in the attractiveness of Turkey have been identified as market size and distance. These determinants have implications on both the amount and origins of FDI inflows to Turkey. The market size has been a crucial factor in all the case studies. Larger EU market or neighbouring markets have been targeted by extra and intra-EU foreign investors as higher export propensity of foreign affiliates in these countries indicate. Turkey provides a bigger market which has a potential to further expand in comparison with these three economies. Thus, market seeking is expected to be the main motive of foreign investors in initial years of pre-accession period which may be strengthened by the prospect of membership that signals a further improvement in market conditions.

Similarly, distance will be a decisive factor in determining origins of FDI. In all the case studies, geographical and cultural proximity led some countries to become the major investors. USA and UK in Ireland, France and Latin American countries in Spain and Germany in Poland have been the leading investors. Thus, in Turkish case we expect that distance both in terms of cultural and geographical proximity might attract more EU investments in the long term. Moreover, geographical and cultural proximity may boost increasing FDI flows from other neighbouring markets such as Middle East and Russia.

The other group of determinants are also found to have a very critical role in attracting FDI to Turkey although these necessitate determined policy decisions to improve existing conditions. This group of determinants consists of “infrastructure and human resources”, “macroeconomic stability”, “openness and business environment” and “incentive schemes”.

The analysis of three case studies provided in the fourth chapter indicated that policy decisions that aim to improve infrastructure and upgrade skill levels have attracted efficiency-seeking FDI in the long term. Technical skill development programs have been functional to meet the requirements of high technology oriented investments as seen Irish case. In other words, adoption of similar policies to improve infrastructure and human resource quality is expected to attract efficiency-seeking investments to capital and technology intensive medium and high technology sectors in Turkey.

The attainment of a stable macroeconomic environment has been a very decisive factor in FDI inflows to Spain, Poland and Ireland, since investors mostly care about certainty. All these countries experienced severe inflation rates, public debt, budget deficit and volatile currencies in the past. Such indicators of macroeconomic instability deterred or delayed expected FDI inflows. For Turkey, which suffered from more severe economic crises in the last decade, attainment of macroeconomic stability is even more critical. Concerning the interrelation between political and macro-economic stability, EU negotiation

process will be a crucial dynamic in this sense which may have positive or negative consequences depending on the progress of negotiations.

Similar to macroeconomic stability, an open economy with proper business environment are essential conditions for foreign investors. In all of these case studies, most evidently represented by Ireland, level of openness and improvement in business environment has been followed by increasing FDI inflows. In this sense, Turkey is trying to improve its business environment in recent years and adopted one of the most liberal FDI regimes in terms of establishing companies. However, there are still complaints from bureaucracy, corruption, inefficiency of judiciary and difficulty of enforcing contracts. Thus, improvements in business environment by upgrading legal and administrative infrastructure is expected to have a fundamental role in attracting FDI to Turkey.

Although there is controversial evidence for the effectiveness of the incentives in the literature, in this study we found that incentives have been a vital factor in especially attracting FDI to Ireland and Poland, since they provide comparative advantages. Low taxes, effective and well designed incentives administered by a development policy targeting high technology sectors have been the fundamentals of success in establishing an efficient incentive framework in these countries. This approach has been further supported by very pro-active investment promotion policies in Ireland and Poland. Lowering corporate taxes may be a challenging task for Turkey considering existing fiscal constraints and inefficiency of the tax system. However, increasing incentives for research and development activities and targeting sectors that will spur technological capabilities of Turkey might be preferable options. Furthermore, establishing a clear mandated, well designed investment promotion agency like IDA in Ireland or PAIZ in Poland is expected to attract more FDI in targeted regions and sectors.

The past experiences of the Ireland, Spain and Poland and the other accession countries prove that FDI inflows tend to increase with the accession. The trends of FDI inflows of the three countries analysed previously also

indicate that being a member of a regional economic integration have positive implications on FDI flows either directly or indirectly. In Ireland, EU membership enhanced the market size of the economy uniting all EU market as an export destination. Membership also helped to open up the economy and liberalise the business environment. Furthermore, EU funds which have been utilised very effectively in building an advanced level of human capital have become a major attraction of the country for foreign investors. In parallel to Ireland, membership has brought integration of Spanish economy with the EU market and alleviated the problem of isolation. Membership also contributed to the democratization of the country bringing political stability and a proper business environment. Spain also benefited from EU funds in order to upgrade the infrastructure of the country. In Poland, accession process have supported the integration of the economy with the Western Europe and accelerated the transition process. Like Spain and Ireland, accession enhanced the market size of the economy and led to the liberalisation of the economy. In all of these three countries, EU membership had certain implications on the other determinants which became effective mostly by determined policy choices of the governments in order to attract more FDI. In other words, EU membership prepared required set-up for policy makers to create a FDI friendly business environment.

In the light of the experiences of Ireland, Spain and Poland, we can conclude that FDI inflows are expected to increase with EU accession. However, sustainability of such trend depends on the other determinants of FDI. On the condition that EU allocates funds to Turkey comparable with Ireland and Spain, these funds are expected to finance some of the infrastructure projects aiming to develop transport and energy network. These funds may also be used to finance education and vocational training programs for improvement of human capital level. The Spanish and Irish models are clear examples in this context. Prospect of EU membership may help Turkey to stabilize domestic politics and economy depending on the success and smoothness of negotiation process. Furthermore, compliance with the Maastricht Criteria and efforts to enter into EMU is expected

to sustain stability in some macroeconomic indicators such as currency, inflation and budget deficits. In parallel, the process of adoption of EU *acquis communautaire* will boost attempts to improve business environment. The locking of administrative system with EU is expected to provide guarantees for foreign investors and lessen the uncertainty for the future. The furthering integration of the economy with the European economies will open up Turkish economy irreversibly.

In conclusion, in this study a comprehensive comparative analysis of the locational endowments of three present EU member states and Turkey is made, which provided substantial evidence for the implications of EU accession on FDI inflows to Turkey. Conclusion that can be drawn from this comparative analysis is that EU membership will not be a key determinant in terms of attracting FDI inflows to Turkey. Rather, other determinants will determine the trend and destination of FDI inflows. Membership will be effective to the extent that it supports improvements in the other locational determinants.

This study provided an overview of investment environment of Turkey in case of EU membership in comparison with three present member states. The findings in this study prepared the ground for further research that will empirically explain the significance of locational determinants on FDI inflows to Turkey. It is hoped that this study will lead to building of empirical models based on these locational determinants which will further enable projections for FDI inflows to Turkey after EU accession.

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