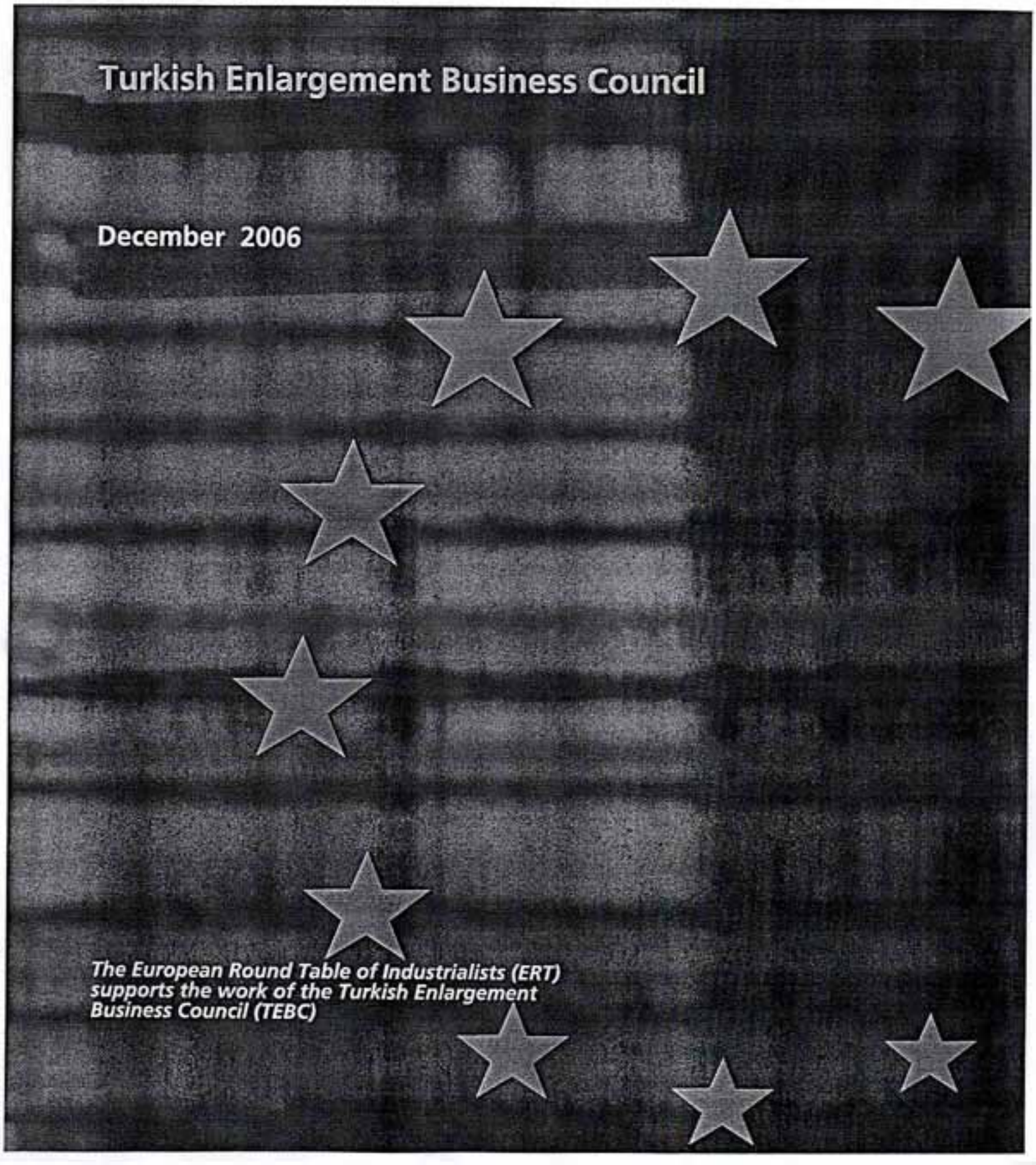
Chairman
Jorma Ollila - Nokia

Vice-Chairmen
Alain Joly - Air Liquide
Peter Sutherland - BP

Paul Adams - British American Tobacco
César Alierta Izuel - Telefónica
Nils S. Andersen - Carlsberg
Belmiro de Azevedo - SONAE, SGPS
Jean-Louis Beffa - Saint-Gobain
Wulf Bernotat - E.ON
Carlo Bozotti - STMicroelectronics
Peter Brabeck-Letmathe - Nestlé
Martin Broughton - British Airways
Antonio Brufau - Repsol YPF
Antony Burgmans - Unilever
Bertrand Collomb - Lafarge
Gerhard Cromme - ThyssenKrupp
Dimitris Daskalopoulos - Vivartia
Rodolfo De Benedetti - CIR
Thierry Desmarest - TOTAL
Bülent Eczacibaşi - Eczacibaşi Group
John Elkann - Fiat
Jukka Härmälä - StoraEnso
Zsolt Hernádi - MOL
Leif Johansson - Volvo
Henning Kagermann - SAP
Klaus Kleinfeld - Siemens
Gerard Kleisterlee - Royal Philips
Thomas Leysen - Umicore
Gary McGann - Smurfit Kappa Group
Gérard Mestrallet - Suez
Aloïs Michielsen - Solvay
Manuel Pizarro - Endesa
Eivind Reiten - Norsk Hydro
John Rose - Rolls-Royce
Wolfgang Ruttenstorfer - OMV
Paolo Scaroni - Eni
Manfred Schneider - Bayer
Louis Schweitzer - Renault
Paul Skinner - Rio Tinto
Jean-François van Boxmeer - Heineken
Jeroen van der Veer - Royal Dutch Shell
Ben Verwaayen - BT
Jacob Wallenberg - Investor AB

28/01/2007

Policy Recommendations for Turkey's Industrial Competitiveness



Annual Meeting of the Turkish Enlargement Business Council (TEBC) with the Prime Minister of Turkey

5 December 2006

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Evaluation of Progress on Issues Discussed on 29 November 2004

The issues raised with the Prime Minister on 29 November 2004 are grouped below under six headings, each with a summary of TEBC company views on the progress made in each category as of 15 November 2006.

1. TEBC members responded very positively to the reduction in the corporate tax rate to 20% and to the government's efforts to widen the tax base, which they felt would result in a fairer tax regime and ensure that the benefits were sustainable.

On the other hand, respondents said that high indirect taxes and the heavy tax burden on employment continued to influence negatively the competitiveness and entrepreneurship of Turkish industry, discourage investments, and fuel the unregistered economy. **Unfortunately no progress has been made in this area.**

2. **The judiciary continues to be of concern to most TEBC companies,** and some even believe there has been a deterioration in this area over the last two years. We were anticipating a new commercial code, which would also have involved a retraining of the judiciary; we continue to hope that it will be enacted by the present parliament before the next general elections.

3. Trade policies continue to create problems. **Non-tariff barriers** to trade seem to have become a popular instrument for discouraging imports and protecting domestic production. TEBC believes that this is against the interests of Turkish industry as it reintroduces protection and encourages industries that are not competitive, while penalizing technology transfer and weakening competition in the marketplace.

4. **No progress has been made in the field of intellectual property rights.** This penalizes Turkish innovators first and foremost and thereby technological progress in the country.

5. It is essential that incentives are transparent and treat all market players equally. Investors want to be free of obstacles that hinder their operations and of policies that discriminate against them. Our main priority is that everyone competes on a level playing field. At the same time, **it would be wise to facilitate better operating conditions for industries that contribute to employment, value added, technology transfer and the trade balance and to ensure that industries do not relocate because other countries offer easier conditions and better infrastructure.**

6. **The quality of markets and competition** is of utmost importance. The European Union has made achievement of the "single market" a top priority because it foresees that this goal will enhance the efficiency and productivity of its economy and enterprises. Accurate investment decisions can only be made in this kind of environment.

Turkey's large unregistered sector is a burden for its economy and an important disadvantage for its enterprises. Not only is unregistered activity bad for public finances, it also reduces the effectiveness of macroeconomic policy and generates unfair competition. A country with such a sizeable unregistered economy cannot be an effective partner of the European Union, so it is essential that all the steps are taken to eliminate it.

How can Industrial Competitiveness be Increased?

Interviews were conducted with 28 executives to conduct a value chain analysis of their companies. The list of interviewees is in Appendix 1.

The key findings of the value chain analysis are:

- Research activities are minimal and development activities are limited.
- High value-added raw materials and intermediary goods are imported.
- Companies see Turkey as a potential hub for reaching neighbouring regions.

In the interviews, industrialists were asked what policies they required to strengthen their competitiveness in Turkey and thus encourage them to increase their added value.

Policy recommendations can be grouped into "fundamental policies" and "growth-drivers":

Fundamental Policies

- o Regulatory (bureaucracy, tax, judiciary)
- o Infrastructure (energy, telecom, land)
- o Non-market (stability)

Growth Drivers

- o Strategic (innovation)
- o Human Capital (education, labour market flexibility, trade union relations)
- o Finance (sovereign risk, inflation, cost of capital)
- o Trade/Markets (imperfect markets, liberalisation/deregulation, trade policy)

Fundamental policy recommendations overlap significantly with the list of issues brought to the attention of the government by TEBC in 2004. Although some progress has been made in this area, problems remain that need to be resolved immediately in order to become "non-issues".

Growth drivers are what will carry industry from its current state and make it a world contender alongside the leading economies, such as the European Union, United States and fast growing Asian economies. Moving forward in these areas will differentiate Turkey and increase the competitiveness of Turkish industry.

The list of issues, policy recommendations and expected impact of recommended policies are summarised in the "Policy Recommendations for Industrial Competitiveness" table.

This report has been prepared by Prof. Dr. Çelik Kurtoğlu and Gaye E. Özerkan (MBA).

Position of TEBC Members' Value Chain in Turkey

The current position of TEBC Members' Value Chain in Turkey is summarised in the table below.

This chart is not based on a quantitative analysis. It is a qualitative chart, based on the information obtained in interviews and submitted to local executives for their review.

	R&D		INBOUND LOGISTICS/ PROCUREMENT		OPERATIONS/ MANUFACTURING			OUTBOUND LOGISTICS			MARKETING AND SALES			AFTER SALES SERVICES	
	Research	Development	Local	Import	Labour intensive	Know-how intensive	Automated	Local	Regional	Global	Local	Regional	Global	Call center	Service network/ support
AKZO NOBEL		++	+	++		++	+++	++	++		++	++		+	++
BAT			+	++			+++	++	+*		++	+*		+	
BAYER			+	+++			++	++	+*		++	+*		+	
BP			++	++			+	++			+++			+	++
BT ISTANBUL TELEKOM											+				
ECZACIBAŞI VitrA		++	+++	++	++		++	++	++	+	++	++	+	+	+
FİAT TOFAŞ		++*	++	++			++	++	++*		++	+*		+	++
NESTLE		+	++	+++	+		++	++	+		+++	+		+	
SHELL			+	+++			+	++			+++			+	++
SIEMENS	+	++	++	++	++	+++	+	++	++	+	+++	++	+	+	+++
PHILIPS			+	+++			+	++	++		+++	++		+	+++
PIRELLI		++*	++	++	++	++	+	++	++		+++	+*	+	+++	+++
TOTAL			+	+++			+	++			+++			+	++
TÜRK TUBORG		+	++	++			++	++	*		++	*		+	
UNİLEVER		++	++	++	++		+++	++	++		+++	++		+	

Legend:

	None
+	Limited/Some
++	Significant
+++	Intensive
*	Potential for higher value add in the near future

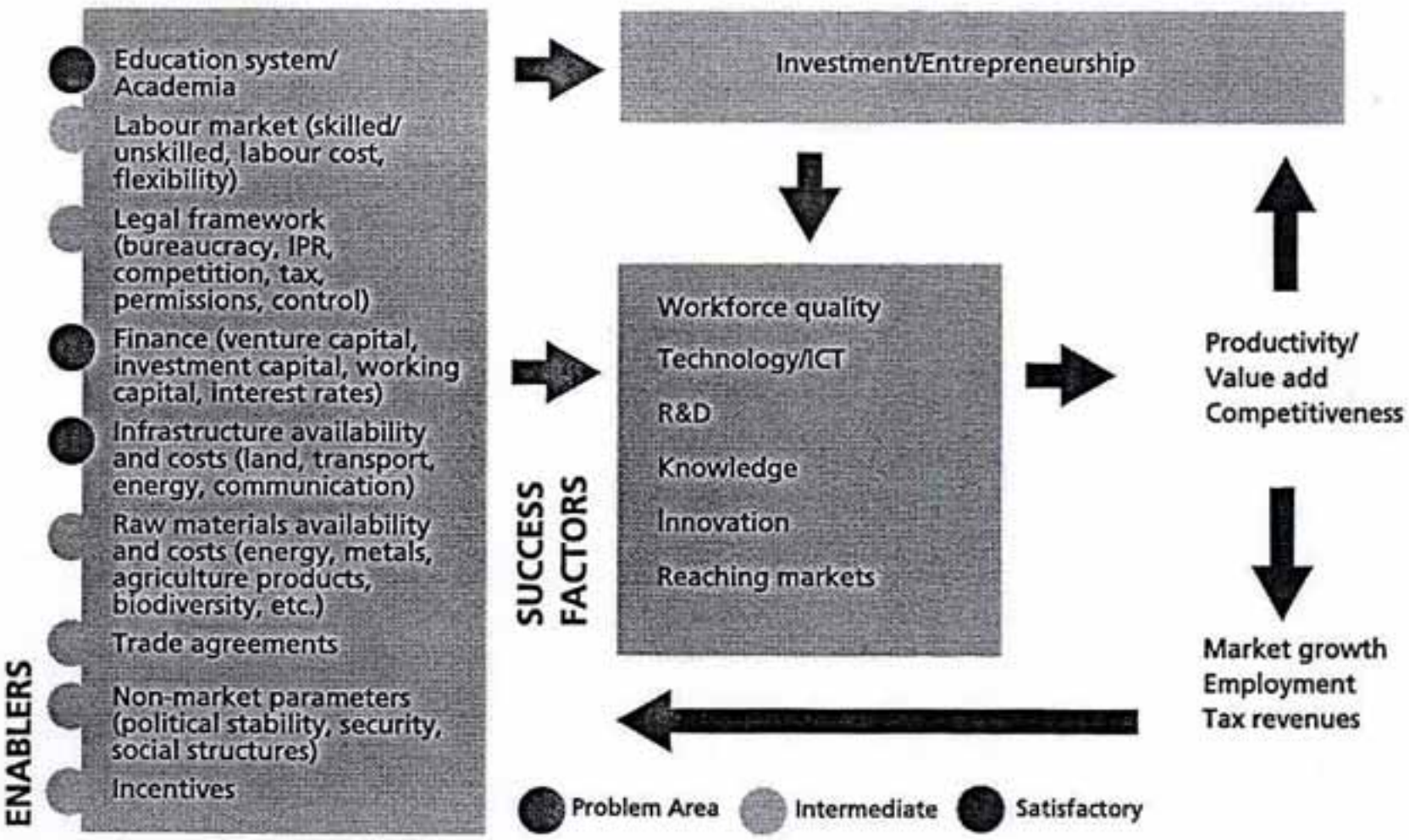
Findings from the value chain analysis:

- Research activities are minimal. Development activities are limited.
- High value-added raw materials and intermediary goods are imported.
- Companies see Turkey as a potential hub for reaching neighbouring regions.

Causality System Influencing Industrial Competitiveness

Factors identified during the interviews as affecting the competitiveness of industry have been explained in the Causality System Influencing Industrial Competitiveness-Detailed Chart. The relationship among the factors is summarised in the chart below.

Macro factors called "enablers" influence investment/entrepreneurship. Both the level of investment/entrepreneurship and macro enablers influence "success factors" at the micro/company level, which in turn influence the productivity, value add creation, competitiveness and growth of the company. These results have a direct positive effect on investment/entrepreneurship, macro market growth, employment and tax collection, which in turn become the input for new macro policies.



Interviewees were asked to classify every factor in Turkish industry as "problem area", "intermediate" or "satisfactory."

Areas identified as problematic were:

- The education system/academia
- Finance (start-up capital, investment capital, operating capital, interest rates)
- Infrastructure availability and costs (land, transport, energy, communication).

Policy Recommendations for Industrial Competitiveness

	ISSUES	POLICY RECOMMENDATIONS	EXPECTED IMPACT
FUNDAMENTALS			
REGULATORY	Red tape Ineffective controls and implementation Lack of transparency High indirect taxes Gaps regarding EU standards Slow judicial process Insufficient environmental controls	Redesign bureaucratic procedures and use e-government for higher efficiency and transparency Ensure clarity, transparency and accountability in policy making and implementation Assess and improve the effectiveness and efficiency of public/ local administration Improve the effectiveness of the judiciary Reduce indirect taxes Enhance dialogue between policy makers-industry-university and civil society and their counterparts in the EU Improve environmental management	Higher business efficiency Higher market growth => higher levels of production => higher employment => higher welfare Better and faster alignment with EU regulation Prevention of smuggling
INFRASTRUCTURE	High transportation costs High energy costs, low reliability High communication costs High land costs Insufficient waste treatment infrastructure	Establish fast and efficient freight transport infrastructure for high volumes that combines rail-sea-road transportation Increase energy efficiency Improve ICT infrastructure, including broadband Land planning and production of land for investment (industrial, logistics, tourism, environmental)	Global competitiveness Ability to continue exporting to EU countries Become a distribution base for neighbouring regions: Caucasus, Russia, Middle East, North Africa Attract greenfield investments Secure environmental sustainability
NON-MARKET	Political and macro-economic instability Corruption	Pursue EU negotiations with a win-win strategy and use the process as a means for anchoring political and macroeconomic stability Adopt international practice when appointing senior civil servants Increase transparency to reduce corruption	Political and macroeconomic stability Higher FDI
GROWTH DRIVERS			
STRATEGIC	Lack of industrial vision and strategy Lack of an information-based policy-making process Insufficient innovation Insufficient brand creation	Implement EU Lisbon goals as government policy; define and implement science, innovation and research policies Provide incentives for research centres as centres of excellence for pre-competitive collaboration to lead to innovation Provide incentives for R&D and technology development in SMEs Provide low cost-high quality infrastructure for the establishment of complementary industrial clusters Provide incentives for R&D to promote environment-friendly energy and material consumption	Efficiency and effectiveness in R&D investments Efficiency and economies of scale in manufacturing investments Competence in bio, nano, information technologies, renewable energies and other emerging technologies Higher innovation and value add
HUMAN CAPITAL	Lack of people with medium to advanced technology skills Lack of skilled people to support industrial growth Tendency to resist rule-based management High indirect labour costs Rigid labour markets	Education and training system to close technical skill gaps, promote innovation and entrepreneurship Attract talent from neighbouring regions and reverse the brain drain Employment policy for specialist labour requirements Improve technological capability of public administration Secure labour market flexibility Reduce tax wedge and social security burden	Become the centre of excellence for the Eurasian continent: Europe + Caucasus + M. East + North Africa Efficient, effective and productive workforce Registered workforce, working within the social welfare system
FINANCE	High inflation, high sovereign risk, high cost of capital Shortage of working capital Shallow financial sector Weak support for new business development	Continue anti-inflationary measures – reduce interest rates and investment costs Prevent policy and implementation that will disrupt stability and cause higher interest rates Provide local investment incentives, support innovation investments Provide investment and working capital support, especially for SMEs	Higher entrepreneurship and investments Higher innovation potential, competitiveness Attract greenfield investments
TRADE/MARKETS	Unfair competition due to insufficient implementation of regulation Insufficient information about markets Non-performing markets Insufficient product range and quality of material inputs Non-tariff barriers	Eliminate / reduce unregistered economy Increase efficiency of customs Privatisation / liberalisation and deregulation of markets and industries to secure competitive markets Determine and publish data on industrial production capability Provide incentives to manufacturing investments that complement existing supply chains	Growth in registered economy => larger tax base => higher tax revenue Less smuggling of illegal products Better decision making Competitive input prices Effective and efficient markets

Appendix 1- List of Interviewees

TEBC members interviewed

Institution	Names
Akzo Nobel	Feridun Uzunyol
Bayer	Axel Steiger
BP	Tahir Uysal
British American Tobacco Turkey	Tuna Turagay/David Wilson
BT İstanbul Telekom	Tayfun Uğur
Eczacıbaşı Group	Toker Alban
Fiat	Alfredo Altavilla/Emre Akın Sait/Özgür Özel
Nestle	Serhat Oran
Philips	Fridus Vest
Pirelli	Andrea Pirondini
Shell	Ayşe Canan Ediboğlu
Siemens	Alper Alsan
Total	Muammer Ekim
Türk Tuborg	Jesper Joergensen
Unilever	İzzet Karaca

Non-TEBC industrialists interviewed

Institution	Names
Coşkunöz	Ali İhsan İlkbahar
ARFESAN	Ahmet Arkan
NOVA Reklamcılık	İskender Atakan/Aydın Başyurt
Vestel	Cengiz Ultav
Kalebodur	Zeynep Bodur Okyay
ENEL	Guiseppe Farina

Representatives of academia/think tank/sectoral organisations interviewed

Institution	Names
Sabancı University Research and Post-Graduate Program	Cemil Arıkan
İnovent	Serhat Görgün/Ömer Hızıroğlu
İstanbul Ekonomi Danışmanlık	Sinan Ülgen
Automotive Manufacturers' Association	Ercan Tezel

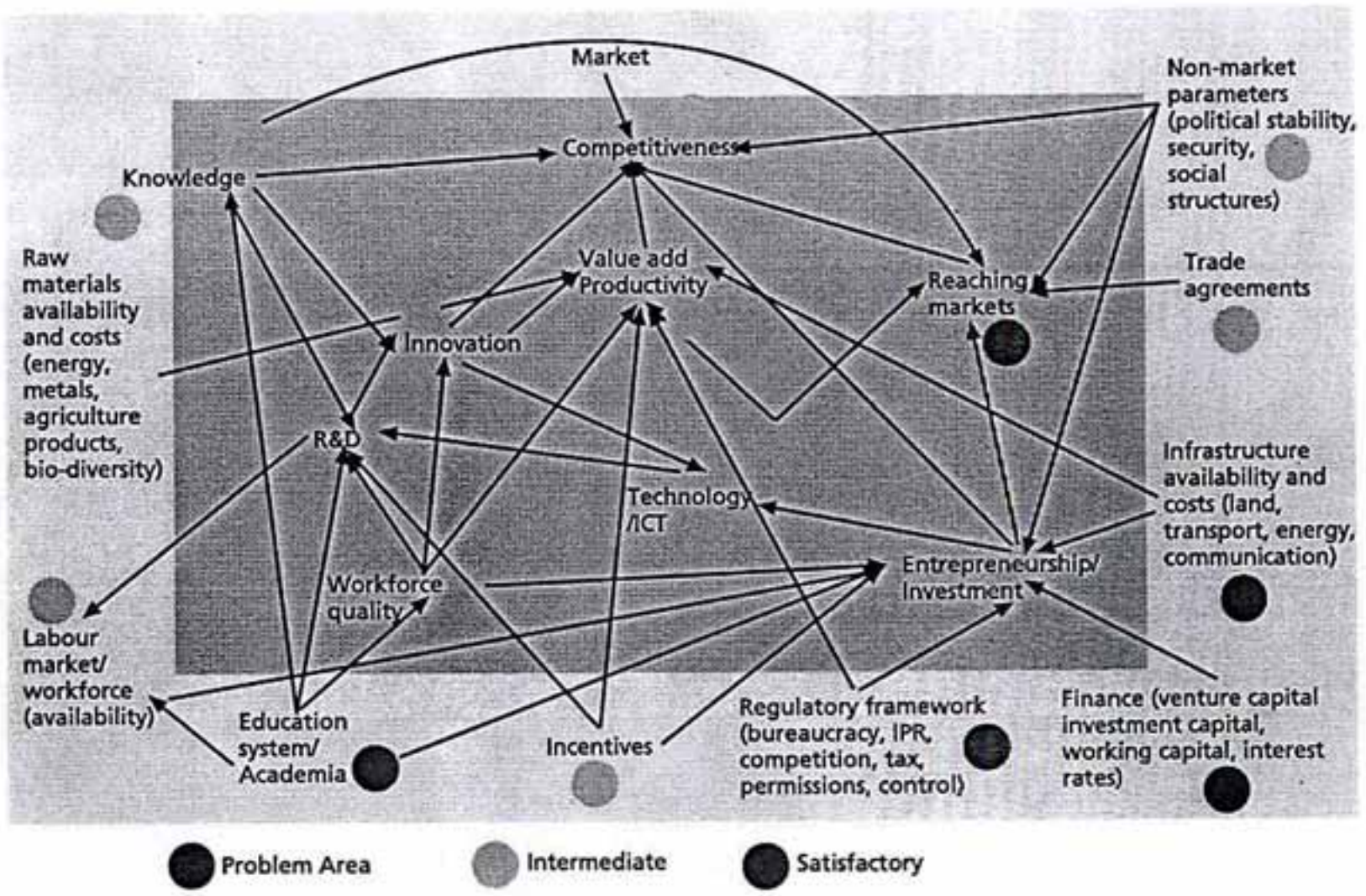
Government agency representatives interviewed

Institution	Names
State Planning Organisation	Ahmet Tıktık
Turkey Investment Support and Promotion Agency	Alpaslan Korkmaz

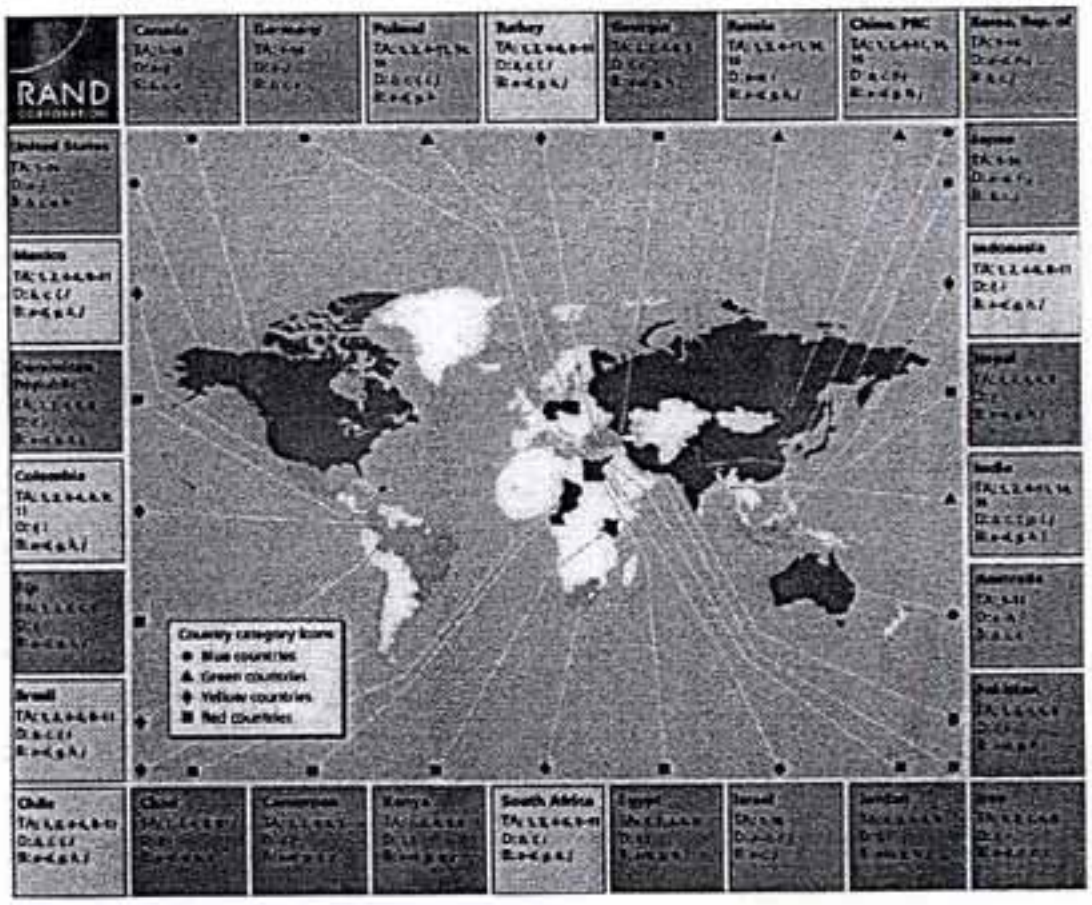
Appendix 2- Causality System Influencing Industrial Competitiveness-Detailed Chart

Factors in the yellow box are "enablers" and factors in the blue box are "success factors".

The decomposition analysis reflects the views of ERT member companies about the factors contributing to the competitiveness of industry in Turkey. This analysis was facilitated by in-depth interviews with the local CEOs of said companies. Policy instruments which might support and enhance the effectiveness of enablers and success factors are determined from this interaction analysis.



Appendix 3- Capacity to Acquire Top Technology Applications



Scientifically advanced		US, Canada, Germany, Japan, S. Korea, Australia, Israel
Scientifically proficient		Russia, China, India, Poland
Scientifically developing		**Turkey,** Brazil, Chile, Colombia, Mexico, Indonesia
Scientifically lagging		Chad, Cameroon, Kenya, Egypt, Jordan, Iran, Pakistan, Nepal, Dominican Republic, Georgia

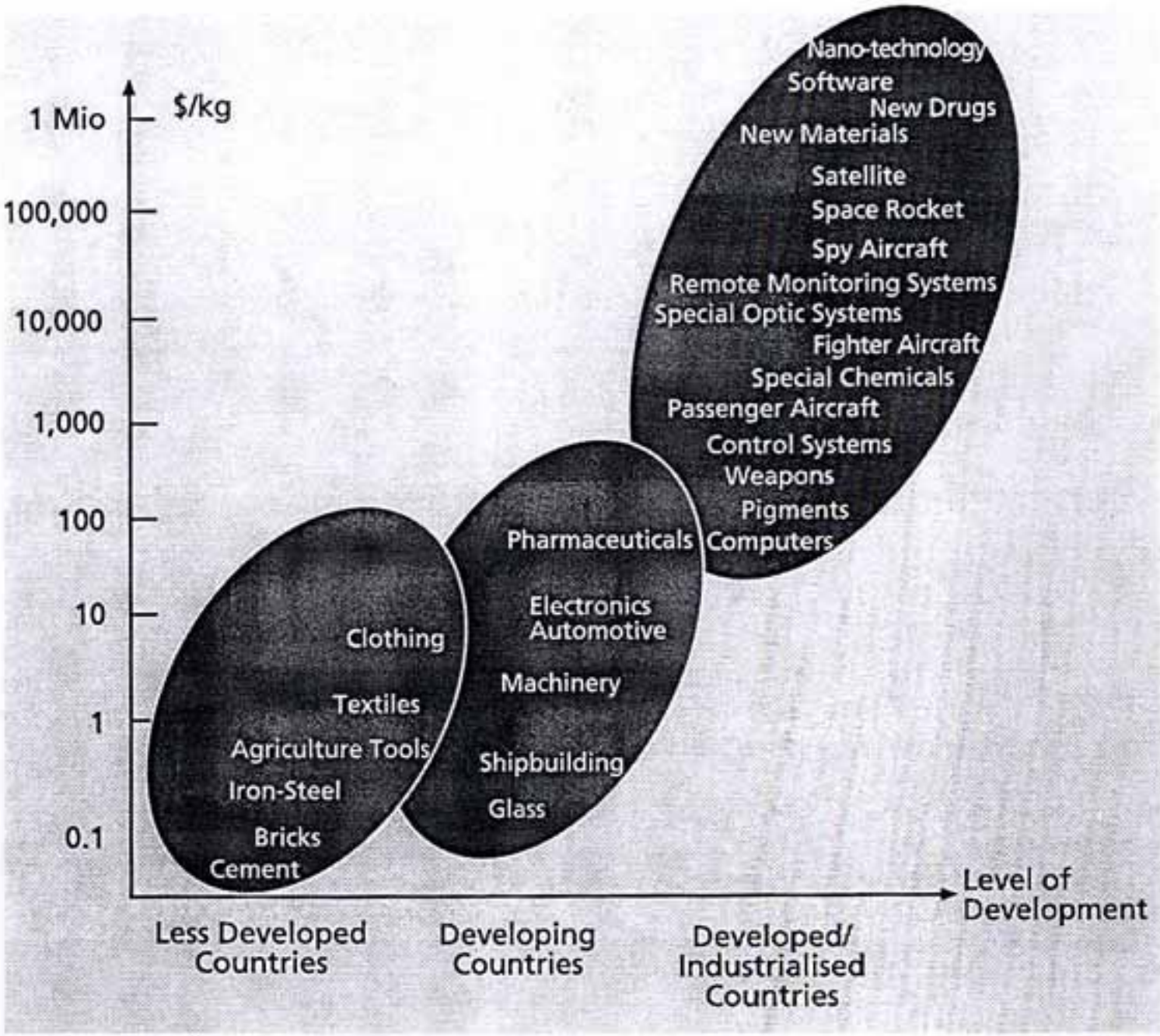
Turkey risks falling behind in the race to develop and acquire new technologies.

For a study conducted by the RAND Corporation in the US, 29 countries representative of countries across the globe were compared according to their ability to acquire 16 top technology applications in medicine, genetics, pharmaceuticals, nano-technology, biotechnology, RFID, etc.

The assessment was based on such factors as GDP per capita, number of scientists per million people, number of publications on science and technology, percentage of R&D spending in GDP, number of research institutions and universities per million people, number of patents; as well as on countries' governance structures and political stability, population and demographics, and human development indicators like education and literacy.

Source: The Global Technology Revolution 2020, In-Depth Analyses Bio / Nano / Materials / Information - Trends, Drivers, Barriers, and Social Implications; National Security Research Division, RAND Corporation, 2006

Appendix 4- Value is Concentrated in Information-Intensive Industries



Source: ARGE Consulting

In the medium to long term, Turkey needs to invest in information-intensive industries.

Appendix 5- Alternative Definitions of Industrial Policy

Selective interventions

-"Efforts by a government to alter the sectoral structure of production towards sectors it believes offer greater prospects for accelerated growth than would be generated by a typical process of industrial evolution according to comparative advantage." Noland and Pack (2003)

-"Comprise a variety of actions designed to target specific sectors to increase their productivity and their relative importance within the manufacturing sector." Pack (2000)

-"A policy aimed at particular industries (and firms as their components) to achieve the outcomes that are perceived by the state to be efficient for the economy as a whole." Chang (1994).

-"Industrial policies, as distinct to trade policies, are government efforts to alter industrial structures to promote productivity-based growth." World Bank (1993)

Deviation from market forces

-"Interventions to skew market outcomes in a nation's favour." World Economic Forum (2002)

-"Industrial policy essentially comprises all actions taken to promote industrial development beyond that permitted by free market forces." Lall (1996)

A catalogue of interventions

-"...a summary term for the activities of governments that are intended to develop or retrench various industries in a national economy in order to maintain global competitiveness." He also includes 'micro' policy or 'industrial targeting', and 'government incentives for private saving, investment, research and development, cost-cutting, quality control, maintenance of competition, and improvements in labor-management relations'." Johnson (1984), cited by Chang (1994)

-"...favoring promising industries; creating skilled workforces; developing infrastructure; regional policy." Reich (1982), cited by Chang (1994)

-"...general industrial support policies such as manpower policy; fiscal and financial incentives for investment; public investment programmes; public procurement policies; fiscal incentives for R&D; firm-level policies such as specific R&D support; antitrust policy; merger policies to create 'national champions'; support for small firms; regional policies such as the development of physical and social infrastructure and the establishment of industrial complexes; generalised trade protection; sectoral policies such as the organization of recession cartels in depressed industries; product upgrading in labour-intensive industries." Pinder (1982), cited by Chang (1994)

Any measure that affects industry

-"Industrial policy embraces all government actions which affect industry." Donges (1980), cited by Chang (1994)

Source: Background paper prepared for the World Development Report 2005: A Better Investment Climate for Everyone - INDUSTRIAL POLICY IN EAST ASIA: IN SEARCH FOR LESSONS Zenaida Hernandez, Revised draft, September 24, 2004

Appendix 6- Members of TEBC

AKZO NOBEL
BAYER
BP
BRITISH AMERICAN TOBACCO TURKEY
BT İSTANBUL TELEKOM
DIAGEO
ECZACIBAŞI GROUP
FIAT
LAFARGE
NESTLE
PHILIPS
PIRELLI
RENAULT
ROCHE
SHELL
SIEMENS
TOTAL
TÜRK TUBORG
UNILEVER