An Evaluation of Tax Reform in Turkey in the Context of Turkey's Long Term Goals

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In all of the days that have passed since Turkey started its journey to the West nearly two hundred years ago, the days we are living in now certainly will be remembered as some of the most remarkable. Turkey is currently closer to EU membership than ever and the government seems to be determined in this goal. Turkey's EU membership should not be considered just a political movement, it is rather a declaration of Turkey's commitment to becoming a country administered in a transparent, democratic and modern way. From this perspective, amendments made to Laws in recent years with regard to public sector revenue and spending policies are encouraging. A taxation system, which conforms to EU standards, is a must for a healthy economic environment.

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General Outlook

When Turkey's recent economic structure is examined, it is obvious that Turkey's economy as gone through a very volatile period, characterized by chronic high inflation, business cycle crises every three to four years and an economic growth rate that is low in comparison with its potential. As stated in the World Bank's latest memorandum about Turkey, a number of factors have contributed to this situation and the opinion formed by most experts is that macroeconomic instability has been the main cause of the volatility. The main reason for the economic instability is the fiscal imbalance and indebtedness of the government sector, which is the result of unsustainable fiscal policies Turkey has implemented for quite some time. The budget deficit was due mainly to "black holes", such as the loosely regulated banking system, inefficient social security institutions and a political system allowing politically oriented decisions which left the Turkish economy very vulnerable to ups and downs in the global economy.

In accordance with the implementation of the disinflation and structural program agreed upon with the IMF and the World Bank, the government has tried to control the public expenditures on the one hand while trying to steadily increase tax revenues on the other. The basic goal of the medium-term tax strategy announced in January 2002 was the broadening of the tax base, recovery of unrecorded earnings, simplicity in both direct and indirect taxation, and equality regarding the tax burden on different classes of people, all of which helps the stability and transparency of the whole economy. From our present vantage point we see that some of these goals have been reached, while some of them need more action supported by the determined political will of the government.

In this respect, the main problems of the Turkish taxation system must be carefully examined. One of the characteristics of the system is the relatively high proportion of indirect taxes in total tax revenues. Revenue statistics of OECD member countries show that, in 1999, indirect taxes made up 47% total tax revenues, while the OECD average rate was 33 %. Again in 1999, Turkey was the 28th out of 30 regarding the ratio of direct taxes to total GDP with a rate of 16 %. This situation indicates that Turkey has been somewhat unsuccessful in collecting direct taxes, and has, therefore, turned to indirect taxes, which are easy to collect and do not depend on the declaration of taxpayers. We should remember that, in taxation theory, a taxation system is commonly dependent on mostly indirect taxes.

A historically narrow tax base is another on-going problem of the Turkish taxation system. As a consequence of the underground economy's size, the narrow tax base has forced Turkish governments to collect higher taxes in order to increase the tax revenues, which in turn caused more tax evasion and injustice. Unfortunately, taxation has become a competitive disadvantage for the honest taxpayers.

The complexity of the taxation system makes it difficult to understand for most of the taxpayers. Some applications are not clearly explained in the text of Laws and Communiqués, creating ambiguity on these subjects. Our opinion is that the Ministry of Finance should take a proactive approach in problematic areas by adopting the regulations necessary for clarity in the system. As a last remark, the lack of adequate tax audits, combined with high tax rates, is the primary reason for the epidemic tax evasion.

Basic Developments and Suggestions Concerning the Turkish Taxation System

The new tax laws introduced in Turkey were influenced not only by the macroeconomic adjustment and structural reforms that the Turkish authorities have maintained but also by the stand-by program established by the IMF and the Turkish government for 2002 and 2003. In this regard, the Ministry of Finance aimed to improve the Turkish tax system with the following practices:

- The introduction of the Special Consumption Tax greatly simplified the indirect taxation system, by eliminating 18 different indirect taxes and grouping them into one type of tax. This application increased tax collections and reduced tax distortions and complexities.

- The implementation of the personal tax identification number was widened in 2002. This application facilitated the cross-checking of income and expenditures of individual taxpayers and in the long run it will also facilitate efficient tax administration.

- Lack of transparency is a widely known disadvantage of the Turkish business environment. The amendment to the Money Laundering Code made in 2002 was an attempt to put an end to corruption. Identity verification was made obligatory for banking and insurance transactions and it became mandatory for banks and financial institutions to employ an official who reports the suspect transactions to a manager.

- As stated in previous paragraphs, one consequence of economic developments was that local Turkish capital groups lacked the financial stability and power to invest. To strengthen the financial structure of the companies in Turkey, Law No. 4761 was introduced, through which companies were given incentives to increase their capital. Assets to be contributed as kind or in cash to the capital of the companies established or to be established by 31 December 2002, are not subject to any tax inspection or any direct assessment with regard to the capital owner.

- After the elections on November 3, 2002, AK Party took over the government and introduced a three level tax reform. The first step of this plan was finalized by the ratification of Law No. 4775 in last days of 2002. With this law, taxable income has been redefined and income components were re-determined parallel to this definition.

- The second step in the tax reform was the “Tax Amnesty Law”, which provided easy payment opportunities for the tax debts, which had accrued. The terms were 9 installments over a period of 18 months. The main goal of the Law was making a peace between the Ministry of Finance and those with outstanding taxes, who were not able to pay their tax debts because of the economic crisis. The law also aimed to settle conflicts in the tax courts, in which a predicted 180.000 tax cases were to be tried. With the “tax base increase” introduced through this law, those with outstanding taxes were exempted from tax inspections and tax levies by the Ministry of Finance with regard to the years they increased their tax bases. To put it another way, the ministry of Finance would do no inspection for the tax types and tax years, on which the taxpayers increased their tax bases. This law gave many taxpayers an opportunity to pay their tax debts without penalties, and make a new start in their activities without the fear of a tax audit from the Ministry of Finance. However, it should be kept in mind that in case such an amnesty practice is applied more than once, most of the taxpayers would not feel obliged to fulfill their obligations on time, always living with

the expectation that a new tax amnesty will be forthcoming. So, we believe that this practice is useful only as a one-time practice and repetitions do more harm than good.

- The third cornerstone of the tax reform was ratification of Law No. 4842. This law included:
    - Redefining the basics of application for the investment tax allowance, by fixing the allowance rate at 40 % and abolishing withholding tax,
    - Improvements in harmonization of personal income tax and corporate tax by introducing % 50-dividend deduction at the personal level to offset taxes paid at the corporate level,
    - Equity shares of domestic companies held more than 12 months were exempted from capital gains, as well as equity shares held more than 3 months and traded on the Turkish stock exchange.
    - The replacement of the special deduction and expenditure system with an integrated income tax credit system, effective as of 2004.

These new laws and amendments have made the Turkish tax legislation closer to OECD standards and internationally accepted practice. The complexity of the system, which is considered its most important weakness, has been somewhat alleviated by these changes. However, there is still more action needed to be taken in order to further simplify the system.

In our opinion, new practices introduced for covering the underground economy are among the most important ones. After expanding the usage of the tax identification number, a new requirement was made that all payments and collections exceeding TL 10 Billion be done through banks or special finance institutions starting on 01 August 2003. These achievements will certainly help to reduce the size of the underground economy, and also strengthen the banking system weakened by the 2001 crisis.

Turkey's Path to European Union

Business cycle crises have hit small and medium scale industrial and commercial activities in Turkey very hard. Big industrial groups have also gone through difficult times because of fluctuating currency and interest rates due to contractual periods in the economy. As a conclusion, it is nearly impossible to claim that Turkey possesses strong capital groups that can stimulate economic growth in both the medium and long term. Turkey has to attract global funds in order to achieve the investment level the economy needs. The high real interest rates offered by the Turkish treasury, has, in the past, always attracted short-term funds to Turkey. However, the large interest spreads were damaging the Turkish economy and leading to big profit margins for the lenders, and this situation created an unsustainable economic environment. This is the main reason Turkey needs foreign investment, specifically long-term direct investments, to increase the power of private sector and employment rates.

In addition to the tax strategy stated above, Turkey has also taken steps to increase the flow of foreign cash into the country. The main emphasis is on increasing direct foreign investment, which is very small when compared to the size of the country's economy. The last section of this report will cover an evaluation and suggestions regarding Turkey's FDI policies.

Turkey's application for European Union membership is not a mere economic and political movement, it should rather be thought of as Turkey's commitment to join the modern countries and become united with the modern world. This movement requires not only that

we conform to the financial and macroeconomic norms of the EU, but also change the way we administer ourselves, a dedicated will to be a country of law and democracy.

In this context, Turkey will have to go on liberalizing its economy, decreasing the size of the government's economic activities, and opening its doors to foreign investors. The Government has opted to accelerate the harmonization of various laws in order to fulfill the political criteria, the prerequisite to the opening of accession negotiations, through "harmonization legislation packages".

From an economic perspective, EU membership will bring change world perception of Turkey. It will be considered a secure, stable, fair and dynamic economic market with all its financial institutions operating smoothly, which in return will contribute to macro economic welfare by increasing trade, investment and financial unity.

The government should be given credit for attempts to improve our relations with the European Union and our neighbors, cooperating with civil society organizations and a positive approach to foreign investment. The new Foreign Investment Law abolished the requirement to bring in a minimum USD 50.000 foreign capital and freed the companies found by foreign investors to buy real estate. The new Law does not contain any specific provisions regarding tax laws, however, the "non-discrimination" rule that is included in the Law, which states that foreign investors will be treated on equal terms with local investors, can be applied to tax applications. We can interpret from this provision that foreign investors will be subject to the same procedures and treatments as local investors in tax applications.

It should also be stated that the "inflation accounting" principle, which will be put into practice starting as of 2004, is another encouraging sign for both foreign investors and domestic investors. Although it will decrease overall corporate tax revenues, it will prevent taxation of unearned income arising from high inflation. It is also positive for domestic investors since the financial tables of companies will be more reliable and harmonious with EU directives.

Conclusion

It is obvious that there are still much that needs to be accomplished with regard to the integration of Turkey into the EU. Harmonization legislation packages ratified by the Turkish parliament are giving hope for the future; however, it is more important to realize that foreigners will pay more attention to the application of the laws than to their ratification. If the laws stay only on the paper and are not applied in real life, foreigners will continue thinking of Turkey as a place where the law is not enforced, a country well-known for its inflation and budget deficits and the poor service and performance of governmental bodies in general - from administration to juridical procedures, from its slow bureaucracy to its rampant corruption.