OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Tax Policy Reforms in Turkey

CTPA

CENTRE FOR TAX POLICY AND ADMINISTRATION

4. TAX REFORM IN TURKEY

4.1 Tax structure and trends

The tax burden, measured by total tax revenue as a percentage of GDP, has increased considerably in Turkey during the last decades, as can be seen from table 4.1. After 2000 the tax burden seems to have stabilized just above 30 per cent. This level is still below the OECD-average.

Table 4.1: Total tax revenue as a per cent of GDP 2000 -2004. Figures for 2004 are provisional.

	1975	1985	1995	2000	2003	2004 (prov)
Turkey	16.0	15.4	22.6	32.3	31.1	31.1
OECD-average (unweighted)	30.3	33.5	35.7	37.1	36.4	-
EU15-average (unweighted)	33.1	38.6	40.1	41.7	40.6	-

Source: OECD Revenue Statistics 1965-2004.

Table 4.2 shows the breakdown of Turkey's total tax revenue into its main components. Turkey relies relatively more on taxation of goods and services compared to the OECD-average as this generates almost half of the country's total tax revenue. The tax burden on personal income is relatively low compared to the OECD-average. The level of taxation of personal income is, however, close to the level of its neighbouring country Greece.

Table 4.2 Tax structure in Turkey compared to some other OECD countries and the average OECD and EU15 (unweighted). Revenue of major taxes as a percentage of total tax revenue 2003

	Germany	Greece	Italy	Turkey	OECD (2003)	EU15 (2003)
Personal income taxes	23.9	13.7	25.1	15.7	24.9	25
Corporate income taxes	3.5	9.2	6.6	8.0	9.3	8.1
Social sec. and other payroll	40.5	36.1	29.5	20.8	27.0	29.8
Property taxes	2.4	4.5	8.0	3.2	5.6	5.2
Goods and services taxes	29.4	35.8	25.7	49.5	32.1	30.4

Source: OECD Revenue Statistics 1965-2004.

4.2 Recent tax reform initiatives

The Turkish tax system has generally been exposed to some concerns about its complexity. The IMF and the World Bank and the investment environment by FIAS (Foreign Investment Advisory Service) have signalled concerns about the complexity of Turkey's tax system. This complexity has been exacerbated by tax policy instability coupled with high and unstable inflation rates. The proliferation of special and additional taxes and surcharges, as a result of urgent pressures to reduce the fiscal deficit, contributed to the complexity and instability. Partial inflation indexation in combination with different nominal tax rates and various investment incentives distorted real effective tax rates across financial instruments and real business investments.

A medium-term tax reform strategy was put in place based on a review carried out jointly with the World Bank in 2002. The main objective of the strategy was to improve the stability, transparency and equity of the tax system through measures that minimize tax distortions, broaden the tax base and improve the efficiency of the tax administration.

The strategy had three main elements.

- Rationalization of indirect taxation by replacing several taxes by one tax (Special Consumption Tax).
- Rationalization of personal and corporate income taxes
- Reorganization of the tax administration.

4.3 Tax reforms in detail

4.3.1 Reform related to the personal and the corporate income tax

In line with the tax strategy, a legislative package under the direct tax reform was implemented as of January 2004. The package aimed at harmonizing the system of investment incentives and tax rates on income from financial investments, at reforming the system of income tax credits and at simplifying the taxation of corporate earnings and dividends. This aim was to bring Turkey's personal and corporate income tax regimes closer to OECD standards and international best practices.

Investment Tax Allowance

The complicated and bureaucratic investment tax allowance system was first simplified in 2003. The new system replaced allowance rates of 100 and 200 per cent by a uniform 40 per cent investment tax allowance. The former allowance depended on an investment certificate being issued. The new allowance represented a simplification since it is provided automatically. The new allowance is simpler and more transparent and implies lower compliance costs. As of 1 January 2006, however, this new regime is also revised. Since the CIT rate is reduced from 30 per cent to 20 per cent with an aim of broadening the tax base, the content of the exemptions and allowances in CIT are narrowed and, accordingly, the Investment Tax Allowance (ITA) is removed. On the other hand, a transition period is envisaged so as to protect the vested interests of the investors acquired before the enforcement of this new regime.

Integration of PIT and CIT

At the end of 2004, the marginal PIT rate was reduced from 40 per cent to 35 per cent for wage and from 45 per cent to 40 per cent for non-wage income to be earned in 2005. With an amendment in the PIT Law in April 2006, the structure of the PIT schedule was rearranged by both reducing the tax rates and the number of tax brackets. The new PIT schedule now consists of four tax brackets instead of five brackets and the new tax rates are 15, 20, 27 and 35 per cent, respectively. In addition to this, the different tariff schedules for wage and non-wage income are unified. Therefore, the new tax rates and unified tariff schedule will be applied to both wage and non-wage income to be earned from 1 January 2006.

A surcharge (Fund levy) equal to 10 per cent of corporate income tax was abolished. Thus, with a corporate tax rate of 30 per cent, the tax burden on corporate profits was reduced by 3 per cent. On the other hand, the CIT rate is recently reduced from 30 per cent to 20 per cent, with a competitiveness consideration in parallel with the developments and the trends in the European Union and OECD countries. The withholding tax system was simplified and withholding taxes are deferred until the profit is distributed. A new partial inclusion system was introduced in 2003 where only half of the dividends have to be included in the personal income tax base in order to compensate or corporate taxes already paid. The final tax burden on corporate profit is reduced gradually to 44 per cent in 2005 compared to 65 per cent in 2000. This can be seen from figure 4.1, which compares top statutory rates on dividend income of OECD-countries in 2000 and 2005. After the recent reduction of the CIT rate from 30 to 20, the total tax burden

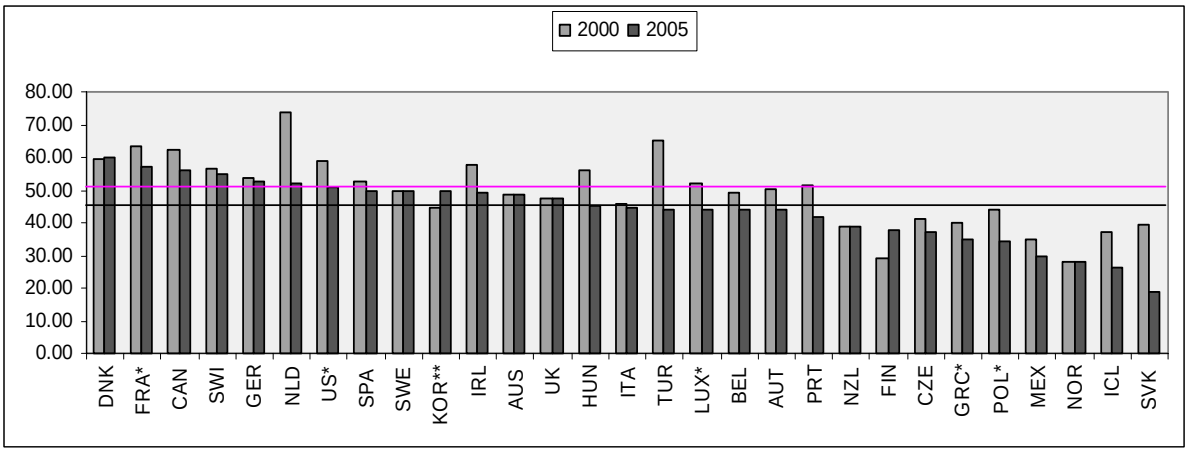
on corporate profit is calculated as 34 per cent. Turkey is one of the countries with the largest tax rate reduction and the rate is now slightly below the OECD-average.

The reductions in the effective tax rate on dividends reflect the reduction of corporate income tax rates, personal income tax rates on dividend income, or both. A recent trend in some OECD-countries is the move away from full imputation systems to systems where dividends are taxed at a lower rate at the personal level. Also other European countries have introduced or are in the process of introducing a similar system.

Effective from 1 January 2006, the foreign-source profits (including profits from funding, financial leasing, insurance services or security investments) derived by the resident companies from their participations, permanent establishments and representatives in foreign countries were exempted from CIT with some conditions to qualify for the exemption.

The provisions related to thin capitalization and transfer pricing in the CIT law were rewritten by introducing more objective criteria and more clear definitions in order to cope with aggressive tax planning, tax avoidance and evasion issues.

Figure 4.1 Top Statutory Marginal Tax Rates on Dividend Income [1,2]
2000 and 2005



1) This tax rate is the overall (corporate plus personal) top marginal tax rate on distributions of domestic source profits to a resident individual shareholder, taking account of imputation systems, dividend tax credits etc.
2) 2004 figures for countries marked * (US sub-central rates in 2005 are set equal to 2004 rates), 2003 for countries marked **. The Germany rate will fall from 52.4 to 48.3 per cent if the proposed reduction in federal CIT rate to 19 per cent is implemented.

Source: OECD Tax Database

Free trade zones and regional tax incentives

Several tax incentives and exemptions have been rationalized. Tax incentives for the activities in the free trade zones are rationalized. Tax holidays in selected regions have been removed, but have been replaced with job creation incentives in low income regions.

4.3.2 Indirect tax reform

In order to simplify the indirect tax system and to align it EU rules, a unified Special Consumption Tax (SCT) was introduced in August 2002. This tax replaced a range of selective taxes on oil products, vehicles, alcohol and tobacco products and a range of luxury consumer goods into a one single tax. The SCT is structured as a single stage tax charged on importation and domestic production of certain goods.

The VAT is charged on top of the SCT. Revenue from the SCT represented 25 per cent of total tax revenues (excluding social security contributions) in 2003.

The SCT made it possible to abolish 16 different taxes, fees, charges and two VAT rates. However, the VAT still has three rates (18, 8 and 1).

The revenue from indirect taxes in Turkey has increased considerably in recent years. In the period between 1999 and 2003 the indirect tax revenue has increased from 15.2 per cent of GDP to 19 per cent of GDP in 2003 according to OECD Revenue Statistics. In the same period revenue from direct taxes has decreased from 10.2 per cent of GDP to 8.5 per cent of GDP. This indicates a significant change in the tax burden from direct to indirect taxation.

4.3.3 Reform of tax administration

The tax strategy has also included tax administration issues encompassing institutional improvements, automation, transparency, compliance, taxpayer services and tax audit. In order to realize the reform on these matters, on 16 May 2005, the new law on the organization and duties of the Presidency of Revenue Administration was enacted (PRA).

The objective of the Law is to lay down the necessary legal basis to ensure that PRA will operate on the principles of transparency, accountability, participation, efficiency and effectiveness with a taxpayer-oriented approach in an effort to implement the revenue policy in a fair and impartial fashion to collect taxes in the most cost-efficient way possible, to ensure voluntary compliance, to take necessary measures so as to help taxpayers easily meet their liabilities by providing high-quality services with a consideration of taxpayer rights. The main institutional and organizational change that the Law brought about is the establishment of a semi-autonomous tax administration operating on a functional basis. The Presidency of Revenue Administration plans to carry out their tax responsibilities by simplifying the system and by providing necessary assistance to the taxpayers in order to minimize the burden on Turkish citizens.

In order to achieve its mission; including increasing the level of voluntary compliance with tax laws and combating against the unregistered economy, the administration has established the following strategic objectives for improvement during the years 2004–2006:

- Improve the efficiency and effectiveness of tax administration
- Establish a modern integrated information technology support system
- Rationalize and simplify the tax system.

This process also implies a functional reorganization of GDR from 2004. The tax policy department of the Ministry of Finance is upgraded and the tax audit management capacity is strengthened. A strategy for taxpayer service is also developed as well as for improvements in relations between taxpayers and the General Directorate of revenue. With regard to the main organizational change, some entirely new functions were assigned to PRA as a part of the restructuring process on a functional basis. For the first time, the functions such as taxpayer services, audit, and strategic planning were introduced and organized both at the headquarters and the local level. As a complementary component of the strategic planning function, a performance management system is also being established based on the international best practices. This system will be supported by the use of IT and management information system in performance measurement.

The tax policy function, on the other hand, has shifted to the General Directorate of Revenue Policies, which is separately established under the Ministry of Finance in February 2006 as one of the main service units of the Ministry.