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Ozan ACAR[1]
Analyst, Economic Studies
Esen ÇAĞLAR[2]
Analyst, Economic Studies

AN ASSESSMENT ON THE NEW INCENTIVE PACKAGE

Introduced on 5 April 2012 by Prime Minister Recep Tayyip Erdoğan and explained in detail the next day by the Minister of Economy Zafer Caglayan, the new incentive package has substantial importance as it will shape the future of Turkey and affect the investment decisions. It is expected that this new incentive package will be finalized and take affect subsequent to the introduction of the required legal regulations in the following days. In this short note, we will evaluate the package in four sections on the basis of what we have been able to understand from the information shared with the public. First, we will compare the new incentive package with the previous incentive regulations and evaluate the points that we deem different. Second, we will discuss the challenges to reaching the specified targets through this new incentive package alone. Third, we will give some examples of the policies that we think should be implemented alongside the proposed package. Finally, we will discuss the questions that arise regarding the difficulties that might occur during the implementation of this new incentive package, and we will conclude with a brief assessment.

[1] *http://www.tepav.org.tr/tr/ekibimiz/s/1213/Ozan+Acar*

[2] http://www.tepav.org.tr/tr/ekibimiz/s/25/Esen+Caglar

I. How is the New Incentive Package Different from Previous Schemes?

1. **The framework of the public support provided in Turkey for investments has been amended and improved four times in the last decade with the introduction of new packages.** The first amendment was realized through Law No. 5084, introduced in 2004. This was later amended in 2006 by Law No. 5035. The third amendment was realized in 2009 with a completely new incentive system. Subsequent to the introduction of this new system in 2009, the Ministry of Economy devised the latest package in 2012.

2. **The change in the objectives of the different incentive implementations in the last 10 years has been remarkable.** Frequent changes have been introduced taking the demands of the private sector into consideration in order to eliminate the flaws in the system. Scrutinizing the incentive mechanisms that have been applied in Turkey during the last decades, we see that what has been targeted through the incentives has been changed continuously.

    a. **The objective of Law No. 5084 and Law No. 5035** was stated as "...in some provinces, by way of the application of the tax and insurance premium incentives, providing energy support and supplying free-of-charge land and area for investments to increase the investments as well as employment opportunities (Law No. 5084, article 1.)

    b. **The objective of the incentive system in 2009** was stated as "...in compliance with the Development Plans and the objectives stipulated in the Annual Programs as well as the international agreements, to direct the savings toward the investments with high added value, to increase the production and employment, to ensure the sustainability of the investment tendency and sustainable development, to encourage large-scale investments with high content of technology and research and development, to increase direct foreign investments, to overcome regional development differences, and to support research and development activities regarding the conservation of the environment" (Resolution No. 2009/15199, article 1.)

    c. **The objective of the system to be implemented in 2012:** As far as we understand from the presentation by the Minister of Economy, Zafer Caglayan, the objective is to reduce the current account deficit, increase the added value of production, ensure development in the least developed regions, increase the efficiency of support instruments, overcome regional disparities, and support clustering and high technology investments to improve global competitiveness (Ministry Presentation, 6 April 2012.)

3. **We can say that in order to fulfill the multiple number of objectives, the incentive instruments and the scope of the incentives have been expanded in each revision (Table 1).** Laws No. 5084 and 5035 used only three kinds of instruments, while the number of instruments was five in 2009, and is eight in 2012. Within the scope of Laws No. 5084 and 5035, 49 provinces in which the income per capita was less than $1,500 were supported. Since the amount of support did not vary among provinces, the relatively more developed areas within the 49 were able to attract much more investment compared to the others. With the system adopted in 2009 to overcome this outcome contradicting with the objective to eliminate regional disparities, the provinces of Turkey were divided into four

different groups according to their socio-economic development levels using the 2001 data of the State Planning Organization. Support instruments and amounts were differentiated among regional groups. Yet, this arrangement did not solve the problem. The new system to be enacted in 2012 increases the number of regions from four to six and differentiates the incentive amounts so that the least developed regions benefit to the highest degree.

4. **Sector-specific incentive schemes gain prevalence with the new incentive systems.** In all the incentive systems applied in Turkey before 2009, regional supports were distributed regardless of sector priorities. Subsequent to 2009, the sectors to benefit from the incentive system were specified. This way, activities in sectors other than the selected could no longer benefit from the incentive system. Sector prioritization continues in the new system that will be adopted in 2012 with the exception of Region 6, socioeconomically the least developed region. In this region, all investments will qualify for incentives. The list of the sectors to be supported in the regions will be announced in the upcoming days.

5. **The minimum amount for large-scale investment, first instituted in 2009, was lowered.** Within this framework, the activities in the sectors including the manufacture of chemical products, refinery, and mining, which exceeded the minimum investment amount as per the 2009 regulation, were made eligible for the special incentives. The aim of this amendment in 2012 is to enhance the number of large-scale investments by reducing the minimum limits for activities considered to be large-scale economic activities. Large-scale investments to be made in eastern and southeastern will benefit from Turkey's income tax withholding and insurance payment discounts as well as regional investment incentives.

6. **Supporting horizontal areas like education and transportation in each region as strategic investments that have the potential to affect all sectors positively is prioritized for the first time in the scope of the new incentive package.** Another critical change in the new incentive package is the classification of some investments as "prioritized." In prioritizing investments on transportation, test centers, and education, the aim is to provide development in areas expected to increase Turkey's competitiveness permanently. School investments by the private sector can contribute to the increase of the physical capacity in the education sector and to the solution of the skills gap problem. Incentivizing investments in the transportation sector can increase the connectivity of particular regions, thus reducing logistics costs.

7. **The incentives tailored to develop the technology content of Turkey's production structure, which were included within the scope of the 2009 scheme, gain greater importance in the new incentive package.** In Laws No. 5084 and 5035, there was no positive discrimination towards the production of high-technology products. In the system launched as of 2009, large-scale investments with high technology and R&D content started to be granted incentives. This practice is maintained in the new incentive system. In addition, the new system provides additional incentives to the manufacturing of products developed with the support of TUBITAK. The new to package also considers rest and wind tunnel centers that are critical for the development of technology as priority areas, which is harmonious with the objective of increasing the share of advanced technology in the economy.

8. **Another distinguishing feature of the new incentive package is the positive discrimination regarding Organized Industry Zones.** Free land assignment from the OIZs for incentive-beneficiary investors, which were implemented during the last decade, was maintained in the new package, too. Different from the previous ones, the new package, provides more generous incentives to promote OIZ investments, where OIZ investments will benefit from the rates applicable for the region, one rank higher than the one where the OIZ province is located. For investments made in Region 6, the incentive period for investments in OIZs will be longer than that for investments out of OIZs. Advantageous schemes for OIZ investments not only will help strengthen Anatolian clusters, but also can ensure a more regular and environment-friendly industrialization around the city.

9. **Finally, different from the previous incentive systems, the new system allows tax rebates at the investment stage rather than during the operation stage and calculates the proportion of public contribution on the basis of all of the economic activities of the investors, which significantly eases the finance burden on investors.** In all of the previous incentive systems, incentives were granted during the operation stage, at the end of the investment stage. This practice, which reduced the effectiveness of the incentives, was criticized harshly by the private sector. The 2012 package allows the private sector to benefit from public support at the investment stage. As the level of development of the investment region increases, the proportion of total support amount to be granted during the investment phase will increase. An investment in Region 5, for instance, can use 50 percent of the total during the investment stage while the rate for Region 6 is 80 percent. In addition, for investments in regions other than Region 1, the public contribution in investments can be calculated on the basis of all of the economic activities of the relevant investor. In other words, the scheme makes it more attractive to invest in the underdeveloped regions in order to decrease tax obligations resulting from the activities in more developed regions. These changes both take into account the criticisms of the private sector and build on the capacity to reduce regional disparities.

II. Can the New Package Remedy the Current Account Deficit and Regional Development Disparities?

10. **The fact that the new incentive system has multiple objectives raises the question of whether it is possible to reach them with a single policy instrument.** When evaluating the incentive package, it is necessary to first determine its objective. It can be said that the general objective of the incentives is to direct the private sector to areas where investments have not been made due to market failures. However, the new package presents a number of reasons among which are reducing the current deficit and overcoming the regional disparities. One chief point to regard when assessing an incentive policy is that in economics, the number of objectives equals the number of policy tools. Hitting two birds with one stone being unlikely in economics, it seems unrealistic to aim at five different targets with the incentive package. Given the design, which does not clarify which incentives are tailored to correct which market failure, it is uncertain whether incentives aim to promote new investments or to “compensate” the private sector for investments in

regions with an unfavorable investment climate.[3] Unfortunately, it is not possible to say whether or not financial incentives can contribute to the sustainable competitiveness of Turkey without overcoming market failures.

11. **One chief matter of debate about the new incentive package is whether it can help reduce the current account deficit.** When evaluated from an economic perspective, it is not easy to see the effects of the package on the current deficit. The package is targeted to solve the chronic current account deficit problem by promoting the domestic production of intermediate inputs that are heavily imported. However, at the base of Turkey's high current account deficit lie weak domestic savings that fail to meet domestic investments. Can a micro policy tool as incentives solve a macroeconomic problem like current account deficit? The answer to this question is not certain. There is no direct link between the domestic production of currently imported intermediate inputs and the rise of domestic savings and/or the fall of domestic investments required to lower the current account deficit. Indeed, it would be more reasonable to expect the new package not to decrease but to increase domestic investments, which is more likely to stimulate current account deficit unless savings rates change.[4]

12. **The potential effect of the new incentive package in reducing regional development disparities is another matter of debate.** From the perspective of regional development, it would be optimistic to expect a single package to completely overcome the imbalances in the distribution of the economic opportunities. At first glance, that the package defines six regions on the basis of socioeconomic development and provides advantageous schemes for less developed regions might lead us to the expectation that the new system will definitely help reduce regional disparities. But eliminating regional disparities about fundamental services and infrastructure quality are of greater importance than financial incentives. From this perspective, it is critical that the quality of education and health services in the underdeveloped regions of Turkey be upgraded to those in the developed ones. Another priority area should be to overcome the flaws in physical infrastructure in underdeveloped regions.[5] For any incentive system to prove more fruitful in the underdeveloped regions, it is necessary first to provide high-quality education and health services to the residents of such regions and then to strengthen the connectivity of such regions with the rest of Turkey and the world centers.

[3] For a detailed assessment regarding this issue, see Ersel, Hasan and Alpay Filiztekin, "Incentives or compensation? government support for private investments in Turkey, Industrial policy in the Middle East and North Africa: rethinking the role of the state, Galal, Ahmed (ed.), Cairo, Egypt: The American University in Cairo Press 2008, 35-50

[4] We would like to thank to Dani Rodrik, who shared his valuable views regarding the issue via e-mail.

[5] In a report entitled "World Development Report 2009: Reshaping Global Geography," it is shown that in the countries where the ethnical and cultural differences between regions are limited, like Turkey, the differences between the education, health, and infrastructure quality are critical for regions to overcome inequalities. It underlines that financial incentives and region-specific policies have secondary importance.

III. Examples for the Mechanisms that Will Contribute to the Success of the New Incentive Package

13. **The development of "private economic zones" can increase the effectiveness of the incentive package in reaching the regional development target.** During the public introduction of the incentive package, the Minister of Economy emphasized the "investment basin" concept, which adds another dimension to the new regulation. We do not know whether the investment basin refers to a concept different from and wider than OIZs as there is no report available on the new incentive regulation. When evaluated together with recent the statements of the Ministry of Economy regarding the "private economic zones,"[6] however, it can be said that investment basins can be transformed into a critical incentive instrument. In this context, the development of private economic regions that focus not only on industrial investments but also on all of the other factors that affect Turkey's industrial competitiveness can contribute to achieving the desired outcomes. For example, a pilot project for a new special economic zone could be carried out in Şanlıurfa, which with the new incentive package achieves an advantageous position for industrial investments in Region 6. Within the scope of such pilot project, a new and wide ranged "investment basin" that far transcends the conventional OIZs or free zones and that also harbors urban, logistics, and touristic factors as well as institutions regarding education and technology can be created. Such an implementation, which could be considered a "GAP 2.0 Project," might accelerate the results expected from the incentive package.

14. **It is important to handle the factors restricting the sectors addressed within the scope of strategic investment to contribute to Turkey's competitiveness through the sector reform packages.** The steps that must be taken in the pharmaceuticals sector can be an example of this case. In the new system, the facilities that will be established in one of the first four regions for the production of the biotechnological and oncologic medicines as well as blood products are to benefit from the incentives that are defined for Region 5 with the aim to increase Turkey's attraction as a center for pharmaceutical production. Financial incentives, however, are not enough to realize a leap in pharmaceutical production in Turkey. To carry out the manufacturing of critical pharmaceuticals in Turkey, R&D activities in this field also must be supported. From this perspective, Turkey needs to strengthen the scope of intellectual property rights, to train a qualified labor force that will conduct pharmaceutical research, to overcome the problems encountered in the licensing of products, to increase the predictability in health policies, and to realize the long-term pharmaceutical purchase agreements in the critical areas. Subsequent to these and with the contribution of financial incentives, Turkey can become a center where high value-added pharmaceuticals are produced.

15. **It is critical to take steps towards liberalization in the transportation sector in order for the cargo transportation investments supported through the new incentive package to be effective.** The new regulation incentivizes railway transportation investments, which in particular represents an interesting vision given that Turkish Railways is a monopoly in railway passenger and cargo transportation. When the European Union liberalized railway transportation, the draft law regarding the issue that was submitted to the

[6] http://www.hurriyet.com.tr/economy/19432632.asp

Parliament before the end of the previous legislative year was not enacted. In the current situation, it is not possible for private locomotives to carry cargo containers on Turkish rails. In a project we implemented at TEPAV, we were surprised when we learned that the legal regulations of Pakistan regarding this issue were more liberal. We hope that the fact that this issue was included in the incentive package marks a speed-up in the government's efforts towards liberalization in the railway transportation sector.

IV. Some questions on the possible challenges for implementation

16. **How will the balance between the rights earned through unfair competition between and within the provinces be ensured?** The prime factor among those that distinguish the zoning method of the new incentive package is that "the distribution of the provinces to the regions can be changed when necessary." Both the prime minister and the Minister of Economy stressed in their presentations that "the location of the provinces in the regional distribution can be re-evaluated on the basis of the data derived from studies by the Ministry of Development." The package, on the one hand offers 12-year, long-term incentives, and on the other, makes it possible to change the rank of investment regions and thus incentive degrees, which is prone to certain complications. For example, let's assume the case in which an investor (Mrs. Ayşe) made an investment in Şanlıurfa, currently in Region 6, and after a while the city was upgraded to Region 5, which can benefit from a smaller degree of incentives. Also, assume that subsequent to the changes, another investor operating in the same sector (Mrs. Fatma) also made an investment in the city. In that case, Mrs. Ayşe will benefit from a lower amount of incentives, which violates the principle of vested rights. In addition, Mrs. Ayşe and Mrs. Fatma benefiting from different degrees of incentives for the same economic activity creates the risk of unfair competition. Therefore, details about how such problems can be solved during the implementation process shall be carefully designed.

17. **Will the center have all the authority regarding the implementation? If so, will the capacity for project-based assessment be enhanced?** With the new incentive package being much more comprehensive than the previous ones, questions arise about the management of the process (the evaluation of the applications, the monitoring of the investments, etc.) To begin with, it is not certain how and according to which criteria the sectors to benefit from the incentive system will be selected, which means that the central authority will have a large degree of discretionary power. The second question is how the authority will be shared with local administrations that have more information than the central authority on local clusters. For example, it is yet to be said what roles development agencies, which have built an important capacity in terms of supporting the private sector during the recent years, will undertake. Moreover, that the scope of the package has been broadened much further than that of previous regulations might imply a need for a serious capacity building for the central authority. Finally among the questions to be answered is whether making investments in the sectors within the coverage in order to make use of the new arrangements would be sufficient; that is, whether a project-based evaluation oriented toward the qualities of the project and work plan will be conducted.

18. **Will protective measures be implemented to ensure the competitiveness of strategic investments to be incentives with the aim to lower the current account deficit?** Turkey has not targeted overcoming the current deficit through an incentive package for a long time. While the key question here is to what degree an incentive package can fulfill this objective (see article 12 of this note,) it is also critical to ascertain to what extent and for how long the incentivized investments will be protected via non-tariff barriers or other foreign trade policies. Given that Turkey's experience in this field is not marked with success stories, it becomes of higher importance to cast away the questions with this regard. For example, within the scope of the Incentive Law No. 5084 that entered into force in 2004, several investments were made in thread manufacturing. Right after the investments, however, the domestic production regime was loosened and the importation of thread was authorized, which harmed the competitiveness in the sector, even for the investments that used the state-of-art technology.[7] Turkey's obligations toward the European Union and World Trade Organization on one hand and the desire to fight the current account deficit through the investment incentive package on the other might bring about highly difficult policy preferences. Therefore, it is necessary to decide how to minimize the disruption to the domestic market and prevent the waste of public and private resources when making these policy preferences.

Conclusion: Can we reach the 2023 Targets with the Incentive Package?

19. **When compared to the previous incentive packages, it is possible to say that the new regulation will make a large contribution to the increase of the amount of manufacturing industry investments in different regions, underdeveloped ones to begin with.** From this perspective, the new incentive package is extremely successful. The package seems to satisfy the wide array of demands and views from as many sectors successfully with a regulation that will contribute to industrialization. In terms of responding to the demands, the new incentive package can be considered as the most comprehensive and technically-correct incentive regulation so far.

20. **On the other hand, it would be unfair to the incentive package and those who prepared and are to implement it to expect it to sustain industrialization, reduce regional development disparities, enhance global competitiveness, and lower the current account deficit, which are ambitions objectives that require a wide array of policy interventions.** What role the new incentive package can play to make Turkey one of the top ten economies by 2023, with per capita income over $25,000 and export volume at $500 billion, can be analyzed. It must be kept in mind that the success of an incentive system that is not supported by an assertive structural reform agenda will be limited as well. In other words, the new incentive system can contribute only partially to Turkey's targets for 2023. Today, Turkey is the 17th largest economy in terms of GDP but 56th in the competiveness index by the World Economic Forum. Japan, Germany, France, England, Italy, and Canada, countries with similar population structure and larger economies compared to Turkey, perform much more successfully in the competitiveness index (Table

[7] For a study regarding this issue, see Ozan Acar, "A Story of Wasting: State Incentives and the Competition Power of the Thread Producers in Kahramanmaraş Tied to a Cotton Thread," September 2008, TEPAV Bulten #3.

2.) Therefore, without reforming the components of the competitiveness index among which are labor force and skills, institutional and physical infrastructure and governance, it would be unrealistic to expect the new incentive package to make Turkey one of the top ten economies in the world. The new incentive system can encourage a high number of new investments by 2013, as stressed in the introduction meetings. Yet, the need for a structural reform agenda for 2023 continues. And our time is running out.

Annex. Table 1: Comparison of incentive policies Turkey has implemented over the last decade

	Regional Scope	Incentive Instruments	Are support degrees differentiated by region?	Sector selection	Horizontal areas	Large-scale investments	Support for clusters
Incentive Law No 5084[8]	36 provinces where income per capita is below 1500 US dollars	• Tax and insurance premium discounts • Energy support • Free land assignment	○	○	○	○	○
Incentive Law No 5350 that updated Law No 5084[9]	13 provinces added to the 36 covered by Law No 5084	• Tax and insurance premium discounts • Energy support • Free land assignment	○	○	○	○	○
The system adopted in 2009[10]	Entire Turkey (26 NUTS-2 Regions divided into 4 regions by the level of socioeconomic development)	• Tax and insurance premium discounts • Free investment area • Customs tax exemption • VAT exemption • Interest rate incentives	●	●	○	●	○
The new incentive system drafted and announced on 5 April 2012	Entire Turkey (Turkey is divided into six regions on the basis of the latest socioeconomic development index announced by the Ministry of Economy)	• VAT exemption • Customs tax exemption • Tax discount • Insurance premium discount • (on minimum wage) • Interest rate incentives • Free investment area • Income tax withholding incentive • VAT rebate	●	●	●	●	●

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[8] Law No 5084 on Employment and Investment Incentives published in the Official Gazette on 6 February 2004
[9] Law No 5350 Amending the Law No 5084 on Employment and Investment Incentives published in the Official Gazette on 12 May 2005
[10] No 2009/15199 Decree on State Support for Investments published in the official Gazette dated 16 July 2009

Annex. Table 2: Output per worker and competitiveness index rank of top 20 economies

		Nominal GDP (2010, $ million)	Output per worker (2010, $1000)	Rank in the competitiveness index (2011)
1	USA	14,582,400	104.9	5
2	China	5,878,629	7.9	26
3	Japan	5,497,813	87.9	9
4	Germany	3,309,669	85.4	6
5	France	2,560,002	99.5	18
6	United Kingdom	2,246,079	77.6	10
7	Brazil	2,087,890	94.8	53
8	Italy	2,051,412	89.7	43
9	India	1,729,010	4.1	56
10	Canada	1,574,052	92.4	12
11	Russia	1,479,819	21.2	66
12	Spain	1,407,405	76.3	36
13	Mexico	1,039,662	23.7	58
14	South Korea	1,014,483	42.6	24
15	Australia	924,843	82.2	20
16	Holland	783,413	91.1	7
17	**Turkey**	**735,264**	**32.5**	**59**
18	Indonesia	706,558	6.5	46
19	Switzerland	523,772	113.4	1
20	Poland	468,585	31.3	41