

**THE STRUCTURE AND THE
EFFECTIVENESS OF TURKISH
INVESTMENT INCENTIVE SYSTEM**

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DENİZ TOPRAK

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Approval of the Graduate School of Social Sciences

Prof. Dr. Sencer Ayata
Director

I certify that this thesis satisfies all the requirements as a thesis for the degree of Master of Science.

Prof. Dr. Erol akmak
Head of Department

This is to certify that we have read this thesis and that in our opinion it is fully adequate, in scope and quality, as a thesis for the degree of Master of Science.

Assoc. Prof. Dr. Cem Somel
Supervisor

Examining Committee Members

Assoc. Prof. Dr. Aylin Ege (METU, ECON) _____
Assoc. Prof. Dr. Cem Somel (METU, ECON) _____
Assoc. Prof. Dr. Ahmet Hařim Kse (AU, ECON) _____

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Name, Last name : Deniz Toprak

Signature :

ABSTRACT

THE STRUCTURE AND THE EFFECTIVENESS OF TURKISH INVESTMENT INCENTIVE SYSTEM

Toprak, Deniz

M.S., Department of Economics

Supervisor: Assoc. Prof. Dr. Cem Somel

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The aim of this thesis is to investigate the structure and the effectiveness of the investment incentive system in Turkey. The theoretical definition and the economic and social targets of incentives, and the direction, problems and the effectiveness of the investment incentive system are investigated. This study finds that the most prominent target of investment incentives is to alleviate the unemployment problem in Turkey. The regional investment incentives seem to be successful in the western part of the country to some extent. The investment incentive system does not seem to be successful in directing the investment to underdeveloped regions of the country. The investment incentive system has no strong effects on directing the sectoral distribution of investments.

Key Words: Investment Incentives, Government Intervention.

ÖZ

TÜRKİYE'DE YATIRIM TEŞVİK SİSTEMİNİN YAPISI VE ETKİNLİĞİ

Toprak, Deniz

Yüksek Lisans, İktisat Bölümü

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Bu çalışmanın amacı Türkiye'deki yatırım teşvik sisteminin yapısını ve etkinliğini araştırmaktır. Teşviklerin tanımı, ekonomik ve sosyal hedefleri, ve yatırım teşvik sisteminin sorunları ve etkinliği araştırılmıştır. Çalışmanın sonuçlarına göre, yatırım teşviklerinin en öne çıkan hedefi Türkiye'deki işsizlik sorununa çözüm bulmaktır. Bölgesel yatırım teşvikleri ülkenin batı bölgelerinde bir ölçüde başarı sağlarken, yatırımları ülkenin az gelişmiş bölgelerine yöneltmekte başarılı görünmemektedir. Yatırım teşvik sisteminin yatırımların sektörel dağılımı üzerinde güçlü etkileri bulunmamaktadır.

Anahtar Kelimeler: Yatırım Teşvikleri, Devlet Müdahalesi.

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LIST OF ABBREVIATIONS:

EAR	: Extraordinary Administration Regions
EU	: European Union
CBRT	: Central Bank of the Republic of Turkey
DGPI	: Directorate General of Press and Information
DPR	: Development Priority Regions
FDI	: Foreign Direct Investment
FIAS	: Foreign Investment Advisory Service
FSC	: Fund Subsidized Credits
GAP	: Güneydoğu Anadolu Projesi
GNAT	: Grand National Assembly of Turkey
ICC	: İstanbul Chamber of Commerce
IAs	: International Investment Agreements
ISI	: Import Substituted Industrialisation
İTB	: İzmir Ticaret Borsası
JDP	: Justice and Development Party
METU	: Middle East Technical University
MFN	: Most-Favoured-Nation
R&D	: Research and Development
RPP	: Republican People's Party
SIS	: State Institute of Statistics
SMSEs	: Small and Medium Sized Enterprises
SPFT	: Supporting Premium of Fund Transfer
SPO	: State Planning Office
TEC	: Treaty Establishing the European Community
TRIMs	: Trade Related Investment Measures
UT	: Undersecretariat of Treasury
UN	: United Nations
UNCTAD	: United Nations Conference on Trade and Development
VAT	: Value Added Tax
WPI	: Wholesale Price Index
WTO	: World Trade Organization

CHAPTER 1

INTRODUCTION

Many developing countries that are considered successful in upgrading their industries have applied a development strategy based on planned government intervention. Although there are many debates on the failures of government intervention, as being price distorting and rent creating activities¹, when the emphasis is put on technological change and industrialization, there is empirical evidence that government intervention can have an economic rationale (Wade, 1988). “National comparative advantage is not simply the result of given endowments of capital, labour and natural resources, but it is also the result of government promotion”, as comparative advantage rests on *accumulated* capital and skills, which can be achieved by a long term national strategy (Wade, 1988, p.153). A non-market force is needed to induce firms to take the risks of the new productive economic activities.

At international prices, the low wage rates of developing countries have been insufficient to compete against the higher productivity levels of developed countries (Amsden, 1990, p.16). For the developing countries to be protected from international competition, to increase their productivity and industrialize, governments may use several economic tools, such as tariff protection of the home market, incentives to export, subsidies on inputs, and government investment to promote technical and economic linkages among industries (Amsden, 1990, p.16). Investment incentives are one of these tools, which help the firms to decrease their investment costs.

¹ Krueger, A. (1990).

Governments grant investment incentives to domestic and foreign firms for several reasons and for various targets. The aim of this study is to investigate the structure and the effectiveness of the investment incentive system in Turkey. The main research question of this paper is whether the Turkish incentive system is effective on the investment decisions and investment level. The second research question is about the direction of the policy. That is, whether the policy makers in Turkey grant incentives depending on some objective criteria related to industrialization and development, or whether they use this tool for some political targets. Another question investigated is, whether it is possible to direct private sector investment decisions.

The incentive system in Turkey does not discriminate among the domestic and foreign firms, with respect to incentive legislation. But the focus of this study, is on the effectiveness of the system on domestic investment decisions and domestic resource allocation.

In Chapter 2, the theoretical definition and the economic and social targets of incentives are summarized. In Chapter 3, the incentive instruments applied in Turkey are introduced, within the current context of investment and employment incentives legislation. Also brief information about the international institutions' legislation on investment incentives is given. In Chapter 4, the sectoral and regional directing power of Turkish incentive system is analyzed. In Chapter 5, the general problems and the effectiveness of the Turkish incentive system are investigated. In Chapter 6, the results of the study are summarized, with some policy implications.

CHAPTER 2:

THE DEFINITION AND TARGETS OF INCENTIVES

The definition of an ‘incentive’ can be very broad, covering virtually any assistance offered by a country to firms, or it can be narrower, covering only specific types of assistance to firms (UNCTAD, 2004, p.11). In this study I will mainly concentrate on the incentives granted to the domestic and foreign firms, intended to stimulate ‘fixed investments’. An ‘investment incentive’ means, the granting of a specific advantage arising from public expenditure, for example a financial contribution, in connection with the establishment, acquisition, expansion, management, operation, or conduct of an investment of a contracting party or a non-contracting party in its territory (UNCTAD,2004, p.15).

Incentives can be used to increase investment in the country or to make the firms undertake functions regarded as desirable such as training, local sourcing, research and development or exporting. Most incentives do not discriminate between domestic and foreign firms, but they sometimes target one of the two.

Investment incentives can involve financial aid, fiscal benefits or other incentives such as including the relaxation of regulatory standards (UNCTAD, 2004, p.3). Commonly used incentives are:

- **financial incentives**, such as outright grants and loans at concessionary rates;
- **fiscal incentives**, such as tax holidays and reduced tax rates;

- **other incentives**, including subsidized infrastructure or services, market preferences and regulatory concessions, including exemptions from labour or environmental standards² (UNCTAD, 2004, p.5).

A contribution by a government or any public body to investment projects could be a government practice involving a direct transfer of funds (e.g. grants, loans and equity infusion), or a potential direct transfer of funds or liabilities (e.g. loan guarantees); government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits); a government provides goods or services other than general infrastructure, or purchases goods; a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the types of the functions above (UNCTAD, 2004, p.13). Countries tend to use a mix of fiscal and financial incentives depending on their economic structure.

However World Trade Organization (WTO) and European Union (EU) have activated some rules in order to control the incentives, such as completely abolishing the public incentives on the tradable goods sector. In the near future, a new policy, limiting the incentives granted to direct investments, would seem to be in the agenda of these institutions (Duran, 2002, p.1).

Incentives may favour small firms over large, or vice versa. They are offered by national, regional and local governments (UNCTAD, 2003, p. 123). In 1967, the Bureau of Investment and Export Incentives was linked to the State Planning Organization (SPO). This situation led the Turkish planning organization to become politicized with respect to its fund transferring to private sector. In 1993, with the Law 511, the incentives were no more included in the duties of SPO (Sezen, 1999, pp.91, 93, 122, and 129). Later on, after 1998, granting incentives

² See also UNCTAD 1996a for theoretical definition of incentives.

again became one of the duties of SPO. Now, in Turkey, the public authority responsible for incentive grants is General Directorate of Incentives and Implementation within the Turkish Undersecretariat of Treasury.

Incentives can be a tool for countries to pursue their development strategies. If used properly, they can compensate for some deficiencies in the business environment that cannot easily be remedied. They can also help correct the failure of markets to capture wider benefits from externalities of production. At the same time, incentives may result in competition between countries and divert financial resources that could otherwise be more effectively used for development purposes (UNCTAD, 2004, p.2). Administrators might also use incentives as a social policy tool, such as investment projects to decrease unemployment, etc.

In Turkey, there is much discussion about the targets, application, and the tools of incentive policy and the general effectiveness of the system. The incentive tools have always had an application area in the general economic policy as a tool for directing the private sector investments (Duran, 2002, p.4).

The aim of the incentive policies may vary according to the economic structure of the countries. Randomly applied incentives would bring no real benefit to the country. Even though there should be no discrimination on some respects like nationality, a strong incentive system should make the correct choices about how the resources of the country would be allocated. The main long-term target of investment incentives should depend on the overall development objectives of the country both in domestic and international areas. The specific and strategic regions and sectors should be selected to activate a healthy working development period in order to economize in the use of *limited investment promotion budgets* (UNCTAD, 1997, p.6). The scarcity of available resources is maybe the most important problem of the developing countries with respect to investment promotion.

So the aim of the administrators must be to economize on their limited budgets, in order to avoid wasting public resources. Critics argue that, the tax burden would result in crowding out of the private investment and working. Efficient resource allocation can only be realized by the market system. In addition, government operations are often carried out inefficiently, and the regulatory process imposes excessive burdens and costs on the economic system. However, empirical studies draw *different conclusions* on the impact of government expenditures on economic growth particularly depending on the level of development (Güenalp and Gür, 2002, p.312). So particularly for developing countries, there is no consensus on incentive policy.

On the issue of foreign direct investments (FDI), the targets are more or less similar, with a little more expectation from those investments.

The developing countries generally grant incentives in order to attract foreign capital, to promote technology transfer and technology production, and to direct private sector investments to some critical sectors.

The developed countries mainly grant incentives to prevent reallocation of production to low production cost countries; and to retain their competitiveness in the world. However they sometimes use them for the same reasons as developing countries. Such as the regional development programs like Silicone Valley in United States of America, and the one in Germany after the unification with East Germany (Duran, 2002, p.1).

For a more detailed analysis of incentive targets of Turkey, the important historical turning points should be considered. The aim of the incentive policies might be grouped in five main historical stages in Turkey (Duran, 2002, p.5):

First stage: During the first years of the Turkish Republic, several incentives have been granted with priority to the private sector to stimulate industrialisation and development.

Second stage: In 1930s the main industrial sectors were established by the public sector. The incentives were granted for development of the private sector, in order to create profitable tradable sectors.

Third stage: During 1950s, with liberal economic policy perspective, the aim of the incentives was to support the domestic enterprises, and also to attract foreign capital.

Fourth stage: During the planned economy period, the incentives were granted in order to support the import substituted industrialisation (ISI) targets.

Fifth stage: After 1980, with the shift to liberal economic policy, the incentives were granted to private sector for them to succeed in increasing their competitiveness in the world; make technology transfer; and increase their production capacity. Supported by favourable exchange rates and massive incentives in the form of tax rebates, manufacturing exports boomed in the early 1980s and the average GDP growth rate stayed above 6 per cent per annum during 1983-1987 (Öğüt, and Barbaros, 2005, p.8).

Key Policy Issues:

In order to establish a good operating incentive system in an economy, the administrators should be careful on some important issues. There must be some objec-

tive criteria to select the firms and projects, such as the business sector, or the size, or the location of a company.

When the topic is investment incentives, **the principle of non-discrimination** mainly applies for foreign firms in a country. For foreign firms, the principle of non-discrimination, in the form of the national treatment and the most-favoured-nation (MFN) treatment, might be employed, in the context of International Investment Agreements (IIAs), to prohibit countries from differentiating in their incentives programmes on the basis of the nationality of an investor or an investment. But this principle does not preclude the selection of firms eligible for incentives on the basis of other objective criteria, such as the business sector or the size or location of a company (UNCTAD 2004 pp.8-9)³. In practice, by making use of the exceptional cases, the principle of non-discrimination is either inapplicable or applies only to a limited extent (UNCTAD, 2004, p.22).

Investment incentives might be conditional on the fulfillment of certain **performance requirements**. “All governments know that subsidies are most effective when they are based on performance standards. Nevertheless, state power to impose such standards, and bureaucratic capability to implement them, vary from country to country” (Amsden, 1990, p.24). The aim behind such requirements is to ensure the fullest economic utility of an investment to a country and, in particular, to its development objectives. However, such measures could be regarded as having negative effects on economic efficiency, by imposing unwanted additional burdens upon firms (UNCTAD, 2004, pp.8-9)⁴. This issue is also linked to the common debate on bureaucracy in Turkey. The more the burdens put on firms, the harder it is to make them invest.

³ See also UNCTAD 2003, pp 119-120.

⁴ See also UNCTAD 2003, pp 119-120.

Another important policy issue is, about the **choice of the sector**. According to some people, the private sector always predicts the profitable sector better than the public sector, and incentive programs supporting other sectors than the choice of the firms, have little chance to succeed (Duran, 2003, p.65). However, if a sector could be made profitable enough, there would be no reason for private sector to evade from investing in that sector. The choice of the sector is important, since the studies on the international terms of trade trends confirm the Prebisch-Singer hypothesis that the terms of trade between primary products and manufactures is deteriorating for primary products (Ram, 2002, pp.241-242). Moreover, even if the developing countries could export manufacturing goods, the terms of trade between their imported manufactures and exported manufactures also deteriorate for their exported manufactures. The developing countries' gain from trade declines (Ram, 2002, pp.248, 250).

Another policy issue related to incentives is **transparency**. Transparency is related to the openness and impartiality of the decision-making process in the design, introduction and administration of incentives (UNCTAD, 2004, p.9). It also helps to reveal covert positive or negative discrimination.

Transparency is important because arbitrary administrative or political decisions may lead to severe short term and long-term inefficiencies in the economy, and also lack of confidence among the forthcoming firms. "A lack of transparency may be the single greatest cost of incentive programmes, because it creates significant possibilities for corruption and other types of rent seeking behaviour" and this can be detrimental to the development of competitive markets and to development itself (Oman, 2000, pp. 5, 73, 101 quoted in UNCTAD, 2004, p.9).

For FDI, during the examination of an project the related government entity generally takes into consideration the following criteria: Importance of the investment; participation in the implementation of the economic and social plans;

creation of employment and vocational training; participation of the concerned sides in the formation of capital; use of technically guaranteed equipment; priority use of local raw materials and, in general, local products; etc (UNCTAD, 2004, p.42).

When an investment incentive is in question for foreign direct investments (FDI), the other important key issues might be the technical assistance, and technology transfer requirements of a project. “Technical assistance, technology transfer requirements, financial and fiscal incentives and investment insurance provided by the country, are recognized as positive instruments to encourage and promote FDI flows to developing countries”⁵ (UNCTAD, 2004, p.43).

One of the most prominent objectives of incentive policy in Turkey is to increase the employment level. It is also a constitutional obligation of the national assembly to sustain the necessary conditions to prevent unemployment. According to the latest employment report of State Institute of Statistics (SIS), now the unemployment rate is % 9.2 in Turkey. That is, there are 2.294.000 unemployed people in Turkey according to official records (SIS, 2005). Also according to the data announced by (SIS), 10.179.000 over 20.815.000 employees, that is, almost half of the working population, are not recorded in any social security institution (Oyan, 2005). Another aim of the incentives is to incorporate this unrecorded part into the economy.

In the latest legislation of investment incentives, for a province to be justified for incentives, the per capita income of the province should be under \$2000; and social and economic development index calculated by SPO in 2003 should be negative (GNAT, 2005a). There is also minimum 30 personnel employment requirement for the individual firms. This would prevent the SMSEs from benefiting from incentives. Furthermore, it might result in corruption that, in order

⁵ See also UNCTAD 2001 and 2003.

to reach 30 personnel, firms might find some voluntary people for a little fee, and show them as their workers to the authorities. These issues will be discussed more detailed in the succeeding chapters.

According to the present incentive policy of Turkish authorities, incentives should not be granted generally and widespread. They must be limited to special areas, and supported with strong tools. The whole process should be planned, should not harm the market's operation, and also should obey the rules of the international organizations (Duran, 2002, p.2) like WTO (World Trade Organisation), and IIAs (International Investment Agreements). But it is not clear how it would be possible to prevent harming the market's operation when some specific areas are chosen to support. This problem becomes very clear on the regional distribution of incentives as will be seen in Chapter 4.

CHAPTER 3:

THE INSTRUMENTS OF INCENTIVES AND THE LEGISLATION IN TURKEY

The tools of incentives used in different countries are more or less similar to each other. They may differ a little according to the economic and social characteristics of the countries, and the different levels of development.

Developing countries often prefer fiscal instruments, such as tax holidays (mainly for FDI), concessionary tax rates, accelerated depreciation allowances, duty drawbacks and exemptions; whereas developed countries mainly use financial incentives, including cash grants (exceeding sometimes 50% of the investment costs) and interest-free or subsidized loans. In general, developed countries grant financial incentives more than fiscal incentives, partly because the latter involve parliamentary decision⁶; while developing countries rely more on fiscal incentives, mainly because they lack the resources to provide financial incentives (UNCTAD, 1997, p.15).

This might be seen as reflecting the differences in wealth, as developed countries can afford to use cash and credit incentives for domestic investment, whereas developing countries can, at best, afford to ease the tax burden *ex post* (UNCTAD, 2004, p.5).

For an ideal climate for FDI, in addition to certain fiscal and financial incentives, the government may grant guarantees as to the financial, legal and economic

⁶ Karier (1994).

stability and stable conditions for financial transfers and the marketing of goods; guarantees for the entry and movement of labour; freedom of employment; and the free choice of suppliers and services; and guarantees as to the renewal of certain permits if necessary (UNCTAD, 2004, p.43).

In Turkey, during the decision making process of an investment, the investment period, and the first years of an enterprise, the incentive tools used are summarized in Table 3.1:

TABLE 3.1: Incentive Instruments Used in Turkey (1980-2004)

Financial Instruments	Application
1. Fund Subsidized Credit	It is granted at minimal levels for Small and Medium Sized Enterprises (SMSEs), regional targets, and some sectors.
2. Grants	It has not been granted since 1991.
Fiscal Instruments	Application
1. Investment Allowances	It is granted with four different ratio as % 40, %60, %100 and %200 depending on the region and the sector.
2. Exemption from Customs Tax	It is granted generally, with %100
3. VAT Support	It is granted generally for domestic and imported capital goods.
4. Taxes duties and fees exemption	It is granted depending on a commitment to make exporting.
5. Reductions in Social Security Contribution of Employees	It is granted partially for Development Priority Regions, and fully to EAR provinces.
6. Tax Reduction in Some Expenditures	It is applied automatically in the tax system.
7. Postponement of Losses, Re-evaluation, Accelerated Depreciation Allowances	It is granted automatically in the tax legislation.
Other Instruments	Application
1. Land Assignment	It is granted to the Priority Development Regions
2. Energy Support	It is granted partially for emergency cases and Extraordinary Administration Regions (EAR) (%50 reduction rate for EAR-Serdengeçti, 2000, p.22)

Source: Duran, 2002, p.6

Some of these instruments are no longer in use. As stated on the official web site of Turkish Treasury (UT, 2005c), one of the duties of the Undersecretariat of Treasury, which is written in the related Law dated December 9, 1994 and numbered 4059 is, to perform regulations on investment incentives for domestic and foreign capital. In this respect, Treasury,

aims to encourage, support and orient investments, in-line with international commitments and in conformity with the objectives of Development Plans and annual Programs, reduce regional imbalances, diffuse the capital to a wider base, create new development opportunities, take advantage of advanced and appropriate technologies with greater added value and to realize international competitiveness (UT, 2005c).

According to the present legislation in Turkey, **the appropriate State Encouragements are: customs tax exemption, investment allowance, Value Added Tax (VAT) support for the purchase of machinery and equipment, taxes duties and fees exemption, energy support, land allocation, and credit allocation from the fund** (UT, 2005c).

Exemption from customs tax and VAT support are generally granted. Fund subsidized credit, land assignment, and energy subsidies are granted according to the region, sector, or some other criterion. Some of the instruments are applied automatically with no requirement of certificate, such as tax reduction in some expenditures, and accelerated depreciation. Since the manufacturing sector uses more fixed capital than any other sector, it is more sensitive to accelerated depreciation (Duran, 2003, p.95).

3.1 FINANCIAL INCENTIVES:

Investment grants could be direct transfer of funds to cover all or some part of the capital, production, or marketing costs of the investment project. (UNCTAD, 2004, pp.6-7). Financial incentives in developing countries are mainly subsidized loans, loan guarantees and government grants. Although financial incentives are very effective on domestic firms; for foreign firms, the market size, production costs, and political and economic stability are more important than monetary incentives (UNCTAD, 1997, p.15).

In Turkey, direct fund transfers are Supporting Premium of Fund Transfer (SPFT) which is called grants; and after 1991, Fund Subsidized Credits (FSC). These are the most easily measurable investment grants. SPFT is an unrequited transfer of funds to the firms, and it was one of the most attractive incentive tools between 1985 and 1991 (Duran, 2002, p.11). The share of SPTF in an investment project positively depends on whether the project is for a privileged sector such as high-technology sectors, or a priority has given to development in that region.

Between 1980 and 2002, the Turkish government has assigned 61.158 investment incentive certificates. 15.908 (in other words, %26) of them were financial incentive certificates. According to Turkish Treasury records, during 1985-1991, between %10 to %65 of fixed investment cost was funded by SPFT, parallel with the realisation of the investment (Duran, 2002, pp.11-12). This ratio has been diminishing in time because of the debates about the financial incentives, and also because of the scarce resources of Treasury. The realisation of an investment is recorded with the *ex-ante* invoices of the project. In case of an inflated invoice, the real value of incentive would be different. Therefore, in Turkey, the amount of the support of SPFT for investment projects might be higher than the official numbers in reality, since this was the case in some projects (Duran, 2002, p.107).

A very important problem in measuring the net effect of fund subsidized credits on the investment level is that, firms repay their debt after a period. In order to measure the net effect, the cost-difference (i.e. subsidy ratio) between the market credit rates and the public credit rates should be calculated. But as the estimation is difficult, the aggregate effect of subsidized credit can only be measured on the basis of firms' own financial accounts (Duran, 2002, p.13).

Other financial incentive tools are **subsidized credits** and **credit guarantees**. A *subsidized credit* means that the government (or a government directed private body) provides funds for an investment project at a discounted interest rate, and for a longer period of maturity than the market. In Turkey, in 1991, SPFTs has been converted to Fund Subsidized Credits (FSC). After 1995 its scope has been narrowed that, it is granted only for exceptional investment projects on SMSEs, regional targets, and R&D studies (Duran, 2002, p.6; and also in Serdengeçti 2000).

During 1980-2002 period, 3.642 over 15.908 of the investment incentive certificates were in form of FSCs (Duran, 2002, p.12). This means % 22.9 of financial incentives; and % 5.9 of all incentive certificates were low cost credit certificates granted to the firms. Since the donation period is completely over, the only financial incentive tool is fund subsidized credits since 1991.

According to a Treasury official, there is an excessive demand for financial investment incentives, because market channels to obtain funds are scarce and expensive (Duran, 2002, p.12). This is an understandable situation. The (financial) market rules are simple: Get maximum profit with minimum risk. Since almost all investment projects are long term projects and even after that period there is no guarantee to succeed (to make profit), there is a high risk in financing it. Hence the importance of a credit guarantee, which means a risk insurance to the lenders.

A **credit guarantee** means that the government gives guarantee to the lender (a private bank, a financier, etc.) that the investor will repay his/her debt in a determined period. “Investment guarantees are an increasingly important tool for development finance as they contribute to reducing project risks and inducing private capital flows” (UNCTAD, 2004, p.46).

Another financial incentive instrument is **government insurance**, *which* is granted to publicly funded venture capital participating investments involving high commercial risks. “Government insurance at preferential rates, is usually available to cover certain types of risks such as exchange rate volatility, currency devaluation, or non-commercial risks such as expropriation and political turmoil” (UNCTAD, 2004, p.6). These instruments are more likely to be applied for FDI projects in order to attract them into the country.

For now, in Turkey, the financial incentives are at minimal levels. The problem with these incentives is that, for many years the real interest rate on these credits are negative because of the high inflation rate in Turkey. According to the officials in Turkish Treasury, the financial incentives had great promoting effect on investment in targeted sectors in Turkish economic history (Duran, 2002, pp.12-13).

These type of credits should be granted with real positive rates of interest, in order to prevent the inefficient investment projects and to obtain a sustainable investment finance process. Otherwise they could turn out to be just discretionary credits⁷. Credit subsidies with negative real interest rates can also be interpreted as a redistribution policy that is unfair to taxpayers. So the administrations should be careful about the repayments and the interest rates of these subsidized credits. For example, during 1992-1994, the market interest rate was around %125, however, Fund Subsidized Credit's rate was between %20-%40 (Çiloğlu, 1997, p.11). This

⁷ GNAT 2005b.

means that the incentive scheme involved large transfers to the private sector. (Duran, 2002, p.11). As a matter of fact, the private sector representatives also do not expect financial incentives anymore. They mainly demand that, the structural reforms to be made in employment and export issues, and the obligations like high taxes and bureaucracy to be decreased (Dünya, 2001).

3.2 FISCAL INCENTIVES

Among fiscal incentives, in general, developed countries frequently apply accelerated depreciation and specific deductions from corporate income-tax purposes. In developing countries, mainly for FDI projects, tax holidays, exemptions from import duties and duty drawbacks are more prominent. Tax holidays are typically available for up to 5 years after an investment, but they can go up to 10 years and, occasionally, 25 years. Tariff concessions are granted for periods usually lasting 5 to 10 years, but sometimes as long as 15 to 25 years for major projects (UNCTAD, 1997, p.15).

In Turkey, most of the investment incentive instruments are fiscal incentives as seen in Table 3.1. These are, investment allowances; exemption from customs tax; VAT support; taxes duties and fees exemption; reductions in social security contribution of employees; tax reduction in some expenditures; and postponement of losses, re-evaluation, and accelerated depreciation allowances. Fiscal incentive instruments mostly consist of tax reductions. The effectiveness of tax incentives on investments differs according to the sector, the type of the investment, and the cost of the project. Tax incentives could be both very effective, as well as nearly zero, depending on these characteristics of investment (Duran, 2002, p.26).

According to UNCTAD'S and WTO's classification (UNCTAD 2004, pp.6-7 and UNCTAD 2000, p.20; based on UNCTAD, 1996a, 1996b, and WTO, 1998), fiscal incentives are:

Profit-based incentives which means the reduction of the standard corporate and income tax rate, and the profit tax rate, and tax holiday. In Turkey, the legislation for tax incentives is determined in the Act on Encouragement of Foreign Capital, and Act on New Taxes for Economic Stabilization (UNCTAD, 2000, p.111).

Capital-investment-based incentives, which are, accelerated depreciation, and investment and reinvestment allowances. In Turkey, most of the fiscal incentives are capital-investment based.

Labour-based incentives, which means a reduction in social security contribution and deduction from taxable earnings based on the number of employees or on other labour related expenditure. In Turkey, most of the investment incentives seem to aim to increase the employment level in Turkey. This issue will be discussed more detailed in succeeding chapters.

Sales-based incentives, which are corporate income tax reductions based on total sales.

Import-based incentives like duty exemptions on capital goods, equipment or raw materials, and parts and inputs related to the production process; and also tax credits for duties paid on imported materials or supplies.

Export-based incentives which are export tax exemptions; duty drawback; preferential tax treatment of income from exports, income-tax reduction for special foreign-exchange-earning activities or for manufactured exports; tax credits on domestic sales in return for export performance; income-tax credits on

net local content of exports; deduction of overseas expenditures and capital allowance for export industries.

Value-added-based incentives are, corporate income tax reductions; or credits based on the net local content of outputs; and granting income-tax credits based on net value earned.

Incentives based on other particular expenses, which are corporate income tax deduction, based on, for example, expenditures relating to marketing and promotional activities.

The most important and widely used fiscal instruments in Turkey are:

Investment allowances:

Investment allowances are the most effective tax incentives among the fiscal incentives in force. In theory, the contribution of investment allowance to investment cost would be between minimum % 5.4, and maximum %26.4. (This ratios are calculated after the stoppage.) This means that a 100 unit cost investment project would be subsidized for 5.4-26.4 units (Duran, 2002, p.14).

For many years, investment allowances of 100 percent have been granted. “As from 1 January 1999, Turkey provides investment allowances ranging from 40 per cent to 200 per cent for industrial investments exceeding US\$250 million, depending on location and type of investment” (UNCTAD, 2000, p.110). For 1980- 2002 period, %60 of the investment allowance certificates was granted as 100 percent ones. (This ratio could be maximum %200 as an exceptional case). However, when a 100 percent investment allowance has been granted, a minimum 19.8 percent of stoppage (tax) burden is put on the firms, which means a reduction in the effect of the incentive. This rate is close to the no-incentive tax rate of competing countries (Duran, 2002, pp.15-16).

A ratio as low as %5.4 for investment allowances may not be effective in stimulating investment. The stoppage ratio is too high, and should be diminished to %5 according to Duran (Duran, 2002, p.17). Furthermore, the number of bureaucratic steps and time cost would also discourage the demand for investment allowances. However, according to Treasury officers, there is still demand for investment allowances. The possible reason for this situation, is the positive expectations of the firms with respect to future expansion of incentives to certificate holders (Duran, 2002, p.16).

Customs Exemption:

This instrument was more important when there were high tariff rates among the world. But the globalisation and regional integrations, decrease of customs tax, etc. have diminished its importance.

VAT Support:

It is granted as VAT exception for imported or domestic machinery inputs, which helps the firms to decrease their cost. A cash repayment of the VAT paid is available for machines purchased or produced in Turkey, and additional payments may be applied for from the Fund of Encouragement of Investments.

In order to VAT support to be a more effective incentive tool, the content might be enlarged via including the building-construction expenditures of the firms (Duran, 2002, p.18).

One of the instruments of these incentives in Turkey is the **Renewal Fund**. It gives firms the opportunity to defer corporate tax for three years without any indexation. Any profits stemmed from the sale of the assets are kept under an equity account for a maximum period of three years. “This fund will be offset

against the depreciation amount of the newly purchased asset, and in the event of a balance remaining after a three-year period, it must be transferred to the profit and loss account at the end of this period and will be subject to full corporation tax” (PWC, 2005, p.5).

Another one is the **Financing Fund**, which provides firms with the ability to defer corporate tax for one year. This applies only to earnings gained before 1 January 1999. And last but not the least important is the **re-evaluation and cost increase** incentive which protects companies from seeming to have huge inflationary profits, causing high tax payments (UNCTAD, 2000, p.111).

3.3 OTHER INCENTIVES

These instruments are also consistent with the international incentive definitions (classified in UNCTAD 2004, pp.6-7 and UNCTAD 2000, p.20; based on UNCTAD, 1996a, 1996b and WTO, 1998), but these are applied less frequently than the financial and fiscal incentives:

Regulatory incentives, which are lowering of environmental, health, safety or labour standards; temporary or permanent exemption from compliance with applicable standards; and stabilization clauses guaranteeing that existing regulations will not be amended to the detriment of firms.

Subsidized services, which are subsidized dedicated infrastructure such as electricity, water, telecommunication, transportation; designated infrastructure at less than commercial price; and subsidized services, including assistance in identifying sources of finance, implementing and managing projects, carrying out pre-investment studies, information on markets, availability of raw materials and supply of infrastructure, advice on production processes and marketing techniques

assistance with training and retraining, technical facilities for developing know-how or improving quality control.

In Turkey, the most commonly used subsidized services is, **land assignment** and **energy support**. And these two instruments are not granted generally and widely as seen from Table 3.1.

Market privileges, such as preferential government contracts; closing the market to further entry or the granting of monopoly rights; and protection from import competition.

Foreign exchange privileges, like special treatment with respect to foreign exchange, including special exchange rates, special foreign debt-to-equity conversion rates, elimination of exchange risks on foreign loans, concessions of foreign exchange credits for export earnings, and special concessions on the repatriation of earnings and capital.

Market privileges and foreign exchange privileges were used extensively in the periods when protectionism was applied, like the ISI period in Turkey.

If an incentive has been granted to a project, the conditions are determined in detail by the law. A general summary of the legislation for incentives in 2000 in Turkey is in Table 3.3.1.

Of the requirements for the incentive certificates, one is that, an investment incentive could be granted only if the fixed investment cost of the project is more than 200.000 YTL in Priority Development Regions; and 400.000 YTL in normal regions (UT, 2005a, p.2). If the investment will be realized through a financial leasing company, %25 of these figures is required (UT, 2005a, p.2, and also Serdengeçti, 2000, p.10). As mentioned before, VAT support is generally granted in the tax system.

The breakdown of investment incentive certificates according to the types of investment is:

New Investment, Expansion, Completion, Renewal, Quality Improvement, Elimination of Bottlenecks, Modernization, Integration of Facilities, Removal, Leasing, Transfer, Restoration, Research & Development (R&D), Environmental Protection, Build Operate Transfer, Infrastructure, Product Diversification.

It is not easy to determine the share of each incentive type, since comprehensive data is not available. here is not very regular data on this issue. However, it is reported that the share of new investment incentives is inclined to decrease (Kepek, Yentürk, 2000, p.324). In the early 1980s, a very great portion of these incentives was granted as **new investment**; and in the early 2000s, as **expansion**, according to the statistics of Undersecretariat of Treasury (UT-2005b- Incentive Statistics 1980-2005, and also Serdengeçti, 2000, p.33).

In 2000, the share of new investment incentives in YTL value was % 75, the share of the expansion % 15, the share of renewal was % 5, and the share of completion was %2 out of the total. In that year, for SMSEs, the biggest share was expansion's, and second was renewal (Üzümcü, Doğan, 2001, p.304). In 2004 the share of new investment incentives YTL value was % 68; the share of expansion was %20, the share of renewal was % 2; and share of completion was % 5 (UT, 2005b).

TABLE 3.3.1: Incentive System In Turkey (2000)

Incentive System	Developed Regions	Normal Regions	Development Priority Regions	Urgent Support Regions	EAR Regions
A) General Legislation (Act No. 98/10755)					
1.Investment Allowances*	40%	60%	100%	100%	100%
2.Customs Exemption	100%	100%	100%	100%	100%
3.VAT Support	Amount of VAT	Amount of VAT	Amount of VAT	Amount of VAT	Amount of VAT
4.Taxes duties and fees exemption	Yes	Yes	yes	yes	yes
5.Fund Subsidized Credit	No	No	no	no	yes
B) SMSE Legislation (Act No. 99/12474)					
1.Investment Allowances	100%	100%	100%	100%	100%
2.Customs Exemption	100%	100%	100%	100%	100%
3.VAT Support	Amount of VAT	Amount of VAT	Amount of VAT	Amount of VAT	Amount of VAT
4.Taxes duties and fees exemption	Yes	yes	yes	yes	yes
5.Fund Subsidized Credit	Yes	yes	yes	yes	yes
a.Credit Limit (YTL)	50.000	50.000	60.000	75.000	75.000
b.Credit rate	30%	30%	20%	20%	20%
c.Repayment	4 Years	4 Years	4 Years	4 Years	4 Years
C) Urgent Support (Act No.99/12477)					
1.Investment Credit	No	No	no	yes	yes
a.Credit Limit (YTL) (Inv.+Operation)	No	No	no	300.000	300.000
b.Credit rate	No	No	no	20%	20%
c.Repayment	No	No	no	2 Years	2 Years
2.Operation Credit	No	No	no	yes	yes
a.Credit Limit (YTL) (Inv.+Operation)	No	No	no	300.000	300.000
b.Credit rate	No	No	no	30%	30%
c.Repayment	No	No	no	1 Year	1 Year
D) According to Code 4325					
1.Income and Corporation Tax Reductions**	No	No	partially	partially	yes
2.Two Years Postponement of Social Security Contributions of the Employees	No	No	partially	partially	yes
3.Taxes duties and fees exemption	No	No	partially	partially	yes
4.Land Assignment to Priority Development Regions	No	No	yes	yes	yes
E) Energy Support to Investment incentive Certificate Owners for Three Operational Periods (Act No.99/12478)	No	No	no	yes	yes

* Before 2005, this ratio was %100 for all the regions.** For five years after the code enacted.

Source: Serdengeçti, 2000, p.38; and UT (2005a).

3.4 ACCOMODATION WITH EUROPEAN UNION AND INTERNATIONAL INSTITUTIONS

3.4.1 EUROPEAN UNION

Under the Treaty of Rome, the European Commission operates controls over market-distorting, anti-competitive State aids to investment. State aid includes grants, loans and guarantees, tax exemptions and infrastructure projects benefiting identifiable users. According to Article 87:

any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market (TEC, 1997, p. 73).

Investment incentives are allowed, if there is no specificity in terms of sector, region or category; if the eligibility of the aid is based on objective criteria (will be discussed below), without any discretionary power of the authorities; or the measure is in principle not limited in time or by a predetermined budget. Also, the Commission may let aid to promote economic development in *poor regions*; aid to promote *an important project of common European interest* or aid to promote *regional economic development*, if it does not negatively impact other regions' trading positions; if they remedy serious economic disturbance; aid to promote cultural and heritage conservation; and other categories of aid as may be determined by the Council. "Many of the above criteria are development related criteria, or emergency criteria that may well apply to the economic and social realities of the developing countries" (UNCTAD, 2004, p.35-36), that is, they might be of relevance to Turkey.

However, it is not easy to say that Turkey has accommodated her current policy completely to European Union criteria. For example, the regional incentives damage the other regions' trading and production positions, and create disturbances as will be seen in Chapter 5. Also, there is sign of discretionary applications in most of the acts in the history of incentive legislation, such as, the frequent changing of the authority responsible for the incentives.

The factors which would stimulate foreign investment are, the market size, political and social stability, production cost, availability of funds, rates of tariffs and quotas, transportation costs, foreign exchange rate, and the institutional structure⁸ (Pershin, 2003, p.186).

Among the other factors, which would effect the investment decisions, for Turkey, the integration with European Union might also be of importance. It is reported that, many foreign firms wishing to invest in Turkey are waiting for the beginning of the negotiations between European Union and Turkey to start up their projects (Milliyet, 2004a).

3.4.2 INTERNATIONAL TREATIES

Turkey has been a member of World Trade Organization (WTO) since 26 March 1995 (WTO 2005). As a member of WTO, Turkey has to comply with the rules of the institution. The limitations of the WTO are mostly about the extent of protection in a country, and therefore the market and trade distorting actions of the member countries. The international arrangements organizing foreign investment rules are called International Investment Agreements (IIAs).

⁸ Export-oriented FDI are driven largely by low costs in host countries, while import-substituting FDI seek large or quickly growing domestic markets, Pershin (2003).

The multilateral agreement to control certain incentives is the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement). It covers **trade-related** subsidies, and **trade-distorting investment subsidies** including investment incentives (UNCTAD, 2004, p.1)⁹. There are also bilateral investment agreements signed among countries, and these agreements only cover the post-establishment phase of an investment project (UNCTAD, 2004, p.18). Incentives for the pre-establishment period of a project would not be subject to the non-discrimination principle, as long as these incentives are consistent with SCM Agreement.

The general trend in national laws and policies is one of liberalisation and convergence in the treatment of foreign firms, including with respect to, right of establishment; national treatment; protection against nationalization; international dispute settlement; and assurances for the repatriation of earnings and capital. This general trend is complemented by the increase in bilateral investment agreements. There is a growing number of agreements between countries which exempt foreign firms from double-taxation (UNCTAD, 1997, p.3), and Turkey also provides this kind of tax incentives such as, tax holiday and tax exemption, investment allowance, tax credit, duty and VAT exemption/reduction, and R&D allowances (UNCTAD, 2000, p.69) via these agreements. With respect to bilateral tax agreements concerning foreign direct investment, Turkey has one tax agreement signed with Egypt in Africa, ten tax agreements signed with European Union countries, and total 40 tax agreements with the countries in the world (UNCTAD, 2000, pp.38, 69 and 121).

Two very important international agreements with regard to incentive policy that Turkey has signed are, first, the one in World Trade Organization (WTO), which is the Agreement on the Subsidies and Countervailing Measures. And the second is the one with European Union, which is Customs Union Agreement signed on

⁹ WTO (2005), TRIMs (Trade Related Investment Measures).

March 6, 1995, numbered 1/95. According to these agreements, the trade performance related incentives, and specific sector incentives are prohibited. These articles only permit incentives for the SMSE, R&D, and environmental incentives (Serdengeçti, 2000, p.6).

These international agreements do not prohibit the countries to demand of the foreign firms the fulfillment of performance requirements such as minimum number of job creation, region choice, and transfer of a certain technology (UNCTAD, 2004, p.24). In Turkey, especially in the last decades, no such requirements were in force. The only requirements were the condition of establishing a joint-stock or a limited company, and the condition of realizing minimum \$ 50000 of investment (Foreign Direct Investment Law, N. 6224, Undersecretariat of Treasury, UT, 2005). Also the foreign firms were required to obtain a permit from Treasury. But the ratio of the permitted FDI to the realized FDI has never exceeded %60, between 1980-1997; except for 1983 (%84.5) (Kepenek, Yentürk, 2000, p.321). Now all the requirements and permits are abolished with the new Foreign Direct Investment Law, N. 4875, enacted on June 17, 2003 (UT, 2005c), in order to attract FDI. Since then, the same rules are valid for the foreign firms, as the domestic firms.

CHAPTER 4:

THE DIRECTION OF THE INCENTIVE POLICY

4.1 INCENTIVES IN PRIVATE AND PUBLIC SECTOR

Many developing countries, including Turkey, used to have extensive government direction and regulation in the allocation of investment resources between sectors (Amsden, 1990; and Chang, and Grabel, 2004). These interventions included direct allocation of resources into particular sectors through public sector investment decisions, and through some restrictions on or stimulations of some country-specific sectors.

In Turkey, the public investment figures are declining both because of the neo-liberal economic policies in practice in the last few decades, and because of the scarcity of financing resources resulting from economic bottlenecks in the history. Moreover, there is no evidence that the Turkish incentive system has a persistent sectoral vision, which would direct the resources effectively for the development purposes. Judging by their statements, the most prominent aim of the policy makers in the implementation of the incentive system seems to be employment related.

In any case, according to the official policy statement of Undersecretariat of Treasury, there is no sectoral directing of investments in the general incentive system, not to distort the market and trade system; and also because of the interna-

tional agreements signed. However, specially in the last decades, on a sectoral basis, the highest numbers of investment incentive certificates are granted to services sector in public investments and to the manufacturing sector in private investments (UT, 2005b; and also, Serdengeçti, 2000). And in manufacturing, the textile sub-sector gets most of the incentive certificates. Similarly in the services sector, tourism, and transportation sub-sectors get most of the incentive certificates (UT, 2005b, and also Serdengeçti, 2000, p.27). This means that, to some extent, the demand of the firms is determining the direction of the incentives.

This is the case in the other countries too. According to one of UNCTAD's report on investment incentives, firms frequently ask for discretionary incentives and governments often oblige. There is the question whether it is more effective to offer a general incentives package or to negotiate deals responding to the particular conditions of individual investments (UNCTAD, 1997, p.16). This is a valid question, since a general investment incentive scheme may not be equally effective on investment projects whose profitability is affected by many different factors. In Turkey, most of the debates on the new law on incentives were about the regional demands of the deputies for their provinces, rather than a general debate on the future production and development prospects of the country¹⁰.

According to the director of the Undersecretariat of Treasury General Directorate of Incentives and Implementation, approximately %35 of the total fixed investment projects was realized with fiscal investment incentive certificates per year. This ratio was approximately %50-55 before the abolishment of financial incentive instruments (Serdengeçti, 2000, p.27).

¹⁰ GNAT 2005a and 2005b.

An empirical investigation has been done to see whether there is a direct linear relationship between the amount of realized investment level and the incentives granted.

According to Table 4.1.1, the changes in the constant price realized investment level and the constant price investment incentives do not show much coincidence. Between 1996 and 2000 the investment level rises, but the incentive figures are inclined to fall. After 2000, the real value of incentives fell below even its 1994 crisis year level, but the gross investment level does not decrease to its 1994 level.

TABLE 4.1.1: Gross Fixed Investment Level and Gross Fixed Investment Incentives at constant prices*, (1987-2002)

	Gross Fixed Investment (At Constant Prices, 1000 YTL) (1)	Gross Fixed Investment Incentives (At Constant Prices, 1000 YTL) (2)
1987	109	95
1988	124	134
1989	116	176
1990	134	98
1991	147	88
1992	151	140
1993	198	285
1994	164	79
1995	171	427
1996	199	183
1997	229	161
1998	228	86
1999	212	91
2000	226	75
2001	169	60
2002	164	55

Source: Calculated from (1) SPO (2004b); (2) UT (2005b).

* WPI, ICC 1968=100, CBRT (2005).

The investment figures are inclined to fall during the crisis periods such as 1994 and 2000. The incentive values do not show much regularity. One year after the 1994 crisis, in 1995, the real value of investment incentives rose from 79000 YTL to 427000 YTL. The incentive scheme does not show much stability in real values. The level of investment incentives constantly fell after 1999.

According to the Pearson correlation coefficient, the correlation between the gross fixed investment level and gross fixed investment incentives level at constant prices is 0,05 between 1987-2002. It is hard to suggest that investment incentives have a strong stimulating effect on investment.

For the private sector realized investments and investment incentives, the values are on Table 4.1.2:

TABLE 4.1.2: Private Sector Fixed Investment and Investment Incentive Figures (1980-2002)

	Private Sector Gross Fixed Investment (At Current Prices, 1000 YTL) (1)	Private Sector Fixed Investment Incentives (At Current Prices, 1000 YTL) (2)	% Share of Incentives with r. to Investment (3)
1980	694	285	41,1
1981	865	865	100,0
1982	1.165	652	55,9
1983	1.586	939	59,2
1984	2.507	958	38,2
1985	3.879	3.220	83,0
1986	6.449	5.874	91,1
1987	11.017	12.727	115,5
1988	22.324	30.261	135,6
1989	34.276	59.986	175,0
1990	62.208	65.553	105,4
1991	102.571	65.581	63,9
1992	177.111	188.223	106,3
1993	381.529	618.779	162,2
1994	760.270	407.981	53,7
1995	1.553.648	4.223.140	271,8
1996	2.994.391	3.289.347	109,9
1997	5.945.673	4.670.454	78,6
1998	9.662.778	4.353.465	45,1
1999	12.156.009	5.760.070	47,4
2000	19.971.790	6.772.209	33,9
2001	22.170.344	10.102.355	45,6
2002	30.150.416	13.437.982	44,6

Source: (1) SPO, (2004b); (2) UT (2005b) .

The meaning of the share of investment incentives with respect to investment is that, the incentive figures show the amount of investment, which is expected to be realized with supporting incentive certificates by the firms. Column (1) includes

the non-supported investment figures too. Whenever this ratio is more than 1, it would mean that there are problems in the establishment phase of the investment projects in that year. It appears that, even the supported investment projects are not completed between 1987-1990, 1992-1993 and 1995-1996.

It is impossible to calculate an incentive multiplier, measuring the net effect of incentives on investments. For example, in 1987-1990 period, and in 1992, 1993, 1995, and 1996, the level of investment incentives was more than the total (supported and non-supported) realized investment level. Even if we think that the effect of the incentives would be realized within a time lag of one or two years¹¹, the 1987-1990 period would refute this idea, since this situation should not keep on going for four succeeding years.

After 1998, the share of investment incentives with respect to the realized investment decreased to a large extent. This was probably not because of the self-booming of the private investment. Those years were the financial crisis period for Turkey, and the government budget were so restricted that, the Treasury had difficulty even in managing its debt. Also the demand of firms would diminish as a result of instability in the financial markets and high real interest rate.

The Pearson correlation coefficient, which shows the linear relationship among the observations, is as high as 0,96 (r-squared: 0,93) for private sector. However, the instability of the individual year observations causes suspicion about the one-to-one correspondence of the figures. So the high correlation ratio of the two observation sets might be because of the increase in the price level in Turkey during those years. To see this fact better, it would be meaningful to look at the percentage change of investments and the investment incentives with respect to their previous year levels (Table 4.1.3).

¹¹ The time lag considered here is, the establishment period of the firms after they gathered the incentive certificate.

TABLE 4.1.3: The Percentage Change in Private Investment and Incentive Figures, (1980-2002)

Years	Private Sector Investment (% Change)	Private Sector Investment Incentives (% Change)
1980		
1981	24,7	203,8
1982	34,7	-24,7
1983	36,1	44,1
1984	58,1	2,0
1985	54,8	236,3
1986	66,2	82,4
1987	70,8	116,7
1988	102,6	137,8
1989	53,5	98,2
1990	81,5	9,3
1991	64,9	0,04
1992	72,7	187,0
1993	115,4	228,7
1994	99,3	-34,1
1995	104,4	935,1
1996	92,7	-22,1
1997	98,6	42,0
1998	62,5	-6,8
1999	25,8	32,3
2000	64,3	17,6
2001	11,0	49,2
2002	36,0	33,0

Source: Calculated from Table 4.1.2.

We cannot talk about linearity between the movement of private investment incentives and investment level. The instability that Kepenek and Yentürk suggested about the Turkish incentive policy, is again clearly observed from these figures (Kepenek, Yentürk, p.312).

These figures are not free of inflation rate, but as inflation affects the investment and incentive value figures roughly equally each year, they can be compared on a year-to-year basis.

The direction of upward and downward movement of investment and investment incentive levels might coincide for some years. However, the differences between the amount of change could be very high as seen in 1993 and 1995. In 1993, the hike was due to the textiles and apparel sub-sector in manufacturing sector, and tourism sub-sector incentives in services sector. In 1995, it was due to the textiles and apparel sub-sector in manufacturing sector, and transportation sub-sector in services sector (UT, 2005b). Even if those extremes are missing, the rest of the figures also do not show much coincidence. While the level of investment shows some growth regularity, the same could not be said for the incentive certificates.

Furthermore, even if these problems do not exist, these figures are about the certificated investment projects. But, the firms would also be effected by the non-certificate incentives, (such as automatic tax incentives, and accelerated depreciation in specified provinces, etc.). So calculating the net real effect of incentives becomes harder.

In 1991, donation type of investment incentives, and in 1994, all the financial incentives were abolished with some exceptional few cases. These changes are also reflected in the Table 4.1.3.

Table 4.1.4 shows the figures for public sector investment and investment incentives. There are large variations of the value of incentives for the public sector.

TABLE 4.1.4: Public Sector Fixed Investment and Investment Incentive Figures (1980-2002)

Years	Public Sector Gross Fixed Investment (At Current Prices, 1000 YTL) (1)	Public Sector Fixed Investment Incentives (At Current Prices, 1000 YTL) (2)	% Share of Incentives in Investment
1980	462	42	9,1
1981	723	193	26,6
1982	869	81	9,3
1983	1.213	203	16,8
1984	1.777	134	7,6
1985	3.236	17.438	538,9
1986	5.222	3.071	58,8
1987	7.480	3.402	45,5
1988	11.451	6.162	53,8
1989	17.346	18.618	107,3
1990	27.684	167	0,6
1991	47.585	23.969	50,4
1992	81.295	51.101	62,9
1993	143.977	136.569	94,9
1994	192.052	49.311	25,7
1995	328.577	465.312	141,6
1996	763.421	172.557	22,6
1997	1.782.699	759.655	42,6
1998	3.359.435	577.323	17,2
1999	5.172.830	1.712.358	33,1
2000	8.602.103	2.627.861	30,5
2001	11.300.047	1.710.781	15,1
2002	17.320.079	2.517.012	14,5

Source: (1) SPO (2004); (2) UT (2005b).

In 1985, on boom in incentive values, the most prominent reason was the extraordinary increase in the level of public energy sector investment incentives (UT, 2005b). Conversely, in 1990, the level of investment incentives fell from

18.618 YTL in 1989, to 167 YTL. Two probable reasons for this odd situation might be that, first, already the 1989 level was very high compared to the previous years, because of the booming of incentives granted to transportation vehicles sub-sector in manufacturing sector (UT 2005b). Second, there is still a great decline in the 1990 public sector incentive level. As seen from Table 4, the incentives in 1990 granted to private sector has a % 10 percent increase over the previous year. However the public sector incentives decreased by almost %100 compared to the previous year level. Since this data set is directly obtained from Undersecretariat of Treasury, there is a very little possibility that there is inaccuracy in the data. So the reason of this decline should be a politic decision of the administrators in that year.

The Pearson correlation coefficient, which shows the linear relationship among the observations, is as high as 0,92 (r-squared: 0,84) for public sector investment and incentive figures between 1980-2002. But it seems that this high correlation ratio is due to the inflation factor, as for 1987-2002, the correlation between the aggregate in constant price figures is as low as 0,05. And also, as seen in Table 4.1.4 and Table 4.1.5, just like for the private sector, there is no regularity in the public sector incentive figures.

TABLE 4.1.5: The Percentage Change of Public Investment and Incentive Figures (1980-2002)

Years	Public Sector Investments (% Change)	Public Sector Investment Incentives (% Change)
1980		
1981	56,5	356,1
1982	20,1	-58,0
1983	39,6	151,8
1984	46,5	-34,0
1985	82,1	12894,8
1986	61,4	-82,4
1987	43,2	10,8
1988	53,1	81,1
1989	51,5	202,1
1990	59,6	-99,1
1991	71,9	14217,9
1992	70,8	113,2
1993	77,1	167,3
1994	33,4	-63,9
1995	71,1	843,6
1996	132,3	-62,9
1997	133,5	340,2
1998	88,4	-24,0
1999	54,0	196,6
2000	66,3	53,5
2001	31,4	-34,9
2002	53,3	47,1

Source: Calculated from Table 4.1.4.

Devaluation might affect the YTL value of the incentives granted. Because, the investment incentive figures are calculated as follows¹²:

Fixed Investment Incentives = Land Assignment + Building/Construction + Imported Machinery/Tools + Domestic Machinery/Tools + Other Expenses.

Total Investment Incentives = Fixed Investment Incentives + Customs Tax + Operational Capital.

Customs tax and operational capital are no more included in the fixed investment incentives in the current incentive legislation.

In order to calculate them in YTL prices:

Imported Machinery/Tools : YTL amount of FOB \$ cost of machinery.

Domestic Machinery/Tools: YTL amount..

Land Assignment: Market price that the firm declared.

Building/Construction: Annual price index of The Ministry of Public Works and Settlement

Other Expenses: YTL amount.

R&D, environment protection, priority technology investments, and investments in technology regions have been granted credits amounting %50 of their machinery/tools expenditures. The maximum amount of this credit could be 400.000 YTL (Information from Özlem Ünal, UT Official).

¹² Information from Özlem Ünal, UT official.

4.2 REGIONAL DISTRIBUTION OF INCENTIVES

The provinces in Turkey are grouped into classes according to their per capita income and the unemployment rates. In the latest legislation on incentives, an economic and social index calculated by SPO is also employed. More generous incentives are to be given for investments made in regions with first or second degree priority, where the degrees are determined by the research of SPO. First degree provinces are Adıyaman, Ağrı, Batman, Bayburt, Bingöl, Bitlis, Diyarbakır, Gümüşhane, Hakkari, Kars, Mardin, Siirt, Şırnak, Tunceli and Van. Second degree provinces are Amasya, Artvin, Çankırı, Çorum, Elazığ, Erzincan, Erzurum, Kastamonu, Kahramanmaraş, Malatya, Sinop, Sivas, Şanlıurfa, Tokat, Yozgat and Zonguldak (UNCTAD, 2000, p.110). The enterprises in these provinces would be granted land assignment, reductions in social security contributions, and fund subsidized credits for SMSEs; additional to the other generally granted incentives (Table 3.3.1).

A type of locational incentives are site incentives, seeking to influence the choice of a site within an economy, for instance, inducing firms to locate in a backward area or away from a congested area (UNCTAD, 2004, p.10). In Turkey, in 2000, according to the classification of UT, the share of developed regions and normal regions in the investment incentive certificates granted was %85; whereas it was %15 for the Development Priority Regions (DPRs) (Serdengeçti, 2000, p.27), despite the fact that the DPRs are in greater need and more sensitive. This is mostly because of the attraction of the industrialized regions such as Marmara Region, with lower transportation and infrastructure costs, and some risk factors like social and political instability compared to other regions.

Also there are provinces in the same class with respect to the incentive legislation, but which in fact have many advantages or disadvantages relative to the each other. For example, both Çanakkale and Siirt are under the same classification in the incentive legislation, that is, they are DPRs (UT, 2005a; also Serdengeçti, p.46). But Çanakkale has many advantages for investment in general compared to Siirt. Because, Çanakkale is much closer to the output and input markets and big harbours. Moreover, the social risk level is much lower in the Marmara region than the South-East region. There are numerous examples of this kind of regional inequalities in the Turkish incentive system. The incentive system does not seem to direct the investments in a balanced manner among regions¹³.

The fixed investment incentive certificates granted to the geographical regions Turkey between 1997-1999, and their per capita real income in 1996 were distributed as follows:

TABLE 4.2.1: The Distribution of Investment Incentives Certificates and per capita GNP Shares According to Geographical Regions

	Investment Incentive Certificates (%) (1997-1999) (1)	Per capita GNP, at 1987 Prices (%) (1996) (2)
Marmara	41,2	23,6
Central Anatolia	13,0	14,9
Aegean	14,6	20,2
Mediterranean	11,3	14,9
Black Sea	5,6	11,7
East Anatolia	2,2	6,2
South-east Anatolia	7,5	8,5

Source: (1) Serdengeçti, 2000, p.14, (2) SPO (1997).

¹³ See also Türkoğlu (2005) on this problem.

Although there are much more number of provinces which have been granted special incentives in the Black Sea, East and Southeast Anatolia regions, these figures suggest that there are problems in the regional distribution of incentives and national income. The incentive investment certificates have a direct effect on investments in a region according to Kepenek, and Yentürk (2000, p.317). However, even if this were so, this is just an absolute effect, i. e., the regional imbalances of investment, per capita income and development are still unaffected. An outstanding regional policy to reduce regional disparities is the implementation of “special development projects” such as Southeastern Anatolia Regional Development Project (GAP) and Eastern Anatolia Development Project (DAP), does not seem to be successful according to some writers (Öğüt, and Barbaros, 2005, p.11)

In 2000’s legislation, for **SMSEs** investment projects, the provinces which are on the **urgent support** list are Adıyaman, Ağrı, Ardahan, Batman, Bayburt, Bingöl, Bitlis, Diyarbakır, Elazığ, Erzincan, Gaziantep, Giresun, Gümüşhane, Hakkari, Hatay, Iğdır, Kahramanmaraş, Kars, Kilis, Malatya, Mardin, Muş, Ordu, Rize, Siirt, Sinop, Sivas, Şanlıurfa, Şırnak, Tunceli, Van, Yozgat (Serdengeçti, 2000, pp.45-46).

In 2000’s legislation, for **DPRs and EAR** investment projects, the provinces on the **investment and employment incentive** list are Adıyaman, Ağrı, Ardahan, Batman, Bayburt, Bingöl, Bitlis, Diyarbakır, Erzurum, Gümüşhane, Hakkari, Iğdır, Kars, Mardin, Muş, Ordu, Siirt, Şanlıurfa, Şırnak, Tunceli, Van, Yozgat. In 2004, the number of provinces rose to 36, and in 2005 to 49 (UT, 2005a).

In 2000’s legislation, the **Development Priority provinces** are Adıyaman, Ağrı, Aksaray, Amasya, Ardahan, Artvin, Bartın, Batman, Bayburt, Bingöl, Bitlis, Çanakkale, Çankırı, Çorum, Diyarbakır, Elazığ, Erzincan, Erzurum, Giresun, Gümüşhane, Hakkari, Iğdır, Kahramanmaraş, Karabük, Karaman, Kars, Kastamo-

nu, Kırıkkale, Kırşehir, Kilis, Malatya, Mardin, Muş, Nevşehir, Niğde, Ordu, Osmaniye, Rize, Samsun, Siirt, Sinop, Sivas, Şanlıurfa, Şırnak, Tokat, Trabzon, Tunceli, Van, Yozgat, Zonguldak¹⁴.

As it is easily seen, some of the provinces, which have priority in development targets, are not included in the incentive legislation. This shows an inconsistency of the incentive system¹⁵. Either all DPRs should be included in incentive legislation, or they should be excluded from the DPR list. For the moment, Kırıkkale, Samsun, Karabük, Çanakkale –except Bozcaada and Gökçeada- and Zonguldak are DPR provinces, but they are not included in the incentive legislation (GNAT 2005b).

In 2000's legislation, the EAR provinces are Adıyaman, Hakkari, Siirt, Şırnak, Tunceli, Van.

In 2000's legislation, the provinces, which have less than \$1 500 per capita GDP, are Adıyaman, Ağrı, Ardahan, Bayburt, Erzurum, Gümüşhane, Iğdır, Kars, Ordu, Şanlıurfa, Yozgat (Serdengeçti, 2000, pp.45-46).

The distribution of SMSE incentives with respect to provinces, as well, do not show a different picture. The first five provinces in investment certificates granted are İstanbul, Ankara, İzmir, Bursa and Kahramanmaraş. The share of incentives granted to these five cities constitutes %40 of all SMSE incentives. Then follows Gaziantep, Çorum, Elazığ, Adana and Kayseri. The share of the first ten cities is almost %60 of all incentives among 81 provinces. So even the small and medium sized firms are concentrating in the already industrialized regions of the country (Dilik and Duran, 1998, p.74).

¹⁴ Samsun and Zonguldak have been added later.

¹⁵ GNAT 2005b.

As a consequence, the question is, what should be done to obtain a more balanced development among the regions. It is obvious that, it would not be enough just diminishing the investment costs in order to achieve regional development. In order to those investment projects to survive in the market conditions, a general favourable economic climate is also necessary (Duran, 2003, p. 69). Turkey has been pursuing policies that are aimed at alleviating the regional imbalances and disparities that has been widening for 40 years. The five year development plans placed critical emphasis on fostering national development and economic growth and yet the distribution of the overall wealth between regions is still imbalanced (Öğüt, and Barbaros, 2005, p.11).

4.3 SECTORAL DISTRIBUTION OF INCENTIVES

The choice of the sector when granting incentives is very important, for the resources to be allocated efficiently and effectively for the development objectives of the country. There are many studies and theories¹⁶ which argue that the market actors tend to underestimate the *long-term* gains of particular activities such as R&D. “Thus it is often necessary to offer government support for activities that both take a long time to bear the fruit and are of national importance” (Chang, Gabel, 2004, p.74). Also the high value added, high quality commodity groups would have higher terms of trade in the international markets and contribute more to the development objectives of the economy¹⁷. So some criteria should be operated during the decision process.

¹⁶ Chang, and Gabel 2004.

¹⁷ Ram (2002) made an econometric analysis on terms of trade trends for the last 30 years.

Employment shares according to sectors in Turkey, in 2001, are as follows: Agriculture %48.7, manufacturing %20.4, services %30.9 (Arioğlu, Yılmaz, 2001 p.14). Most of the working population is in agriculture sector. The incentives were mainly granted to manufacturing and services sectors for many years, as will be seen below¹⁸.

The main important technical criteria are, the contribution of the project to the GNP with value added gained during the production process; the ratio of domestic and foreign resource usage; the foreign exchange earning and saving levels; the level of employment creation; and the share of the national enterprises in the project (Duran, 2003, p.68). Also the potential of new investments and the backward linkages spread of the investments would be some positive points for the investment projects. The importance level of these criteria might depend on the country, and its level of development. The level of value added of a sector depends on the technology it requires. According to some writers, if the required technology is domestically produced, than a sector's net value added might be higher than the high-tech sector's, if its technology comes from abroad (Çiloğlu, 2000, pp.40-41).

For foreign direct investments in a developing country, the most favourable sector is the manufacturing sector (though some governments continue to target other sectors like agriculture, fisheries, mining and oil exploration and extraction, hotels and tourism). Increasingly, countries target investment in industries involving technology and high value-added (such as electronics, robotics, computer software) and in infrastructure projects (UNCTAD, 1997, p.14).

International treaties restrict sectoral incentives. But they are not fully prohibited. In general, incentives for technology, R&D, environment, SMSEs, regional devel-

¹⁸ However, the Prime Minister Recep Tayyip Erdoğan stated that the manufacturing investments do not contribute to employment, and they will promote agriculture sector (Yılmaz, 2005).

opment, and crisis sectors are allowed (Duran, 2003, p.67). So in Turkish legislation, investments in the following areas will qualify for incentives in *developed regions*: electricity production, those within the framework of Build-Operate-Transfer, R&D or design and modeling, environmental protection, yacht building and shipbuilding, education, health and tourism, the electronics industry and other sectors approved by the Undersecretariat of Treasury and Foreign Trade (UNCTAD, 2000, p.110).

There are many factors, which affect the investment decisions of the firms in a period. The opportunity cost of other alternatives, the cost of finance, capital accumulation, the stability of the economical and social environment, the traditional motives, etc., all can effect this decision. This chapter aims to find the effect of incentives on the sectoral distribution of investments.

As mentioned previously, in Turkey, the economic development policy mostly aims to support the private sector and export-led economic development after 1980s. And the incentive policy was one of the instruments of this strategy¹⁹. However, in the views of some writers, the incentive policy of Turkey has not been coherent, and did not have a long run policy perspective, with respect to the incentive types, and the opportunities supplied to the firms (Kepenek, Yentürk, 2000, p.315).

The instability of the figures support this idea. For example, in 1985, the share of energy sector rises from %2.3 to %42.8, as a result of the % 538.9 increase in the incentive granted to public energy sector (Table 4.3.1).

¹⁹ Along with investment incentives, there were also export promoting incentives, which resulted in corruption among the supported firms in Turkish economic history.

TABLE 4.3.1: Investment Incentive Certificates by Economic Sector (%) (1979-1999)

	Agriculture	Mining	Manufacturing	Energy	Services	Total (%)	Total (1000 YTL with current prices)
1979	3,2	1,8	90,2	n/a	4,8	100	114
1980	13,3	1,8	78,0	n/a	6,6	100	2.070
1981	4,4	2,9	48,1	n/a	43,5	100	1.046
1982	4,7	2,7	41,0	1,9	50,1	100	513
1983	3,8	5,4	47,4	0,5	42,9	100	571
1984	2,0	19,4	50,4	2,3	21,4	100	1.105
1985	1,1	3,9	26,0	42,8	26,2	100	3.531
1986	0,7	6,0	38,7	4,0	50,6	100	5.130
1987	2,3	7,6	37,5	9,4	43,2	100	5.830
1988	1,1	2,0	49,2	9,3	38,4	100	11.653
1989	2,6	2,7	48,3	1,9	44,4	100	19.376
1990	10,5	2,7	48,3	1,9	44,4	100	22.684
1991	1,5	1,6	62,6	4,3	28,1	100	38.131
1992	1,2	2,9	66,3	2,2	27,3	100	51.393
1993	1,0	2,9	69,8	6,3	20,0	100	247.054
1994	1,1	2,1	59,9	5,0	32,0	100	208.862
1995	0,4	0,6	87,6	2,3	9,1	100	2.232.828
1996	1,7	1,2	73,1	3,2	20,8	100	2.110.691
1997	0,8	1,6	61,0	6,7	29,8	100	3.476.611
1998	3,4	3,2	57,6	1,1	34,8	100	4.715.883
1999	3,0	2,3	53,6	1,0	40,0	100	7.258.059

Source: 1980-1997, Kepenek, Yentürk (2000) p.316 (1980-1988, SPO (1990), p.34; 1989-1997, MF (1990), p.13; MF (1994), p.17; MF (1997), p.31; MF (1998), p.31). **1998-1999**, Çiloğlu, (2000) p.43.

Another example is that, the share of manufacturing incentive certificates diminish almost by half in two years from 1979 to 1981 (from %90 to %48). At the same time the share of service sector incentives rise from %4.8 to %43.5 (from 1979 to 1981).

The level of real manufacturing private investment fell by % 13.6 between 1977-1980 economic crisis period, and rose by % 4.8 during 1981-1982; where the level of real energy and services sector private investment fell by % 10.6 during 1977-1980 period and rose by % 27.3 between 1981-1982 stabilization period. Also during 1981-1982, public sector real manufacturing investment fell by % 11.2, where services and energy sector real investment rose by % 9.5 (Yeldan, 2001, p.46). This may be an indicator of the policy shift during the early 1980s, from a production-biased viewpoint to a services-biased viewpoint in the development strategy. Turkish economy had an export oriented perspective after 1981, but without an industrialization supporting it (Yeldan, 2001, p.47).

Although there was some increase in real manufacturing investment in 1983-1988 export led growth period (Yeldan, 2001, p.46), the share of manufacturing investment incentives continued to fall until 1990 (Table 4.3.1).

As seen in Table 4.3.1, after 1987, the share of manufacturing investment incentives began to rise, but never reached the pre-1980s level. Also the level of real manufacturing investment increased during 1988-1993 financial liberalization period, but not as much as the increase during 1972-1976 ISI period (Yeldan, 2001, p.46).

The share of the manufacturing investment is approximately one fifth of all investments between 1980 and 2002 (Table 4.3.2). The public and private sector decreased their real investments to minimal levels for the last decades, and so the manufacturing investments (SPO, Economic and Social Indicators, 1950-2003). However, even though the share of manufacturing investment incentives are significantly greater than other sectors during 1990-2002 (Table 4.3.1), the share of manufacturing investment does not increase (Table 4.3.2).

TABLE 4.3.2: Gross Fixed Investments by Sectors, Total (At Current Prices, % Share) (1980-2002)

Years	Agriculture	Mining	Manufacturing	Energy	Services	Total
1980	7,6	3,3	28,5	8,7	51,8	100
1981	10,5	4,7	28,6	10,3	45,9	100
1982	10,8	4,0	27,3	10,8	47,0	100
1983	10,7	4,4	25,5	11,2	48,1	100
1984	9,9	4,4	25,0	10,2	50,4	100
1985	7,4	5,1	23,1	10,2	54,2	100
1986	6,2	3,6	22,0	11,3	56,9	100
1987	6,9	2,4	17,6	9,7	63,4	100
1988	6,0	2,4	16,1	9,7	65,9	100
1989	5,5	1,9	14,8	10,8	67,1	100
1990	5,4	1,8	19,5	7,3	66,0	100
1991	5,7	1,9	18,9	6,1	67,3	100
1992	4,9	1,7	18,4	5,0	70,0	100
1993	5,0	1,4	18,0	3,6	72,0	100
1994	4,1	1,5	19,6	2,8	72,0	100
1995	5,4	1,3	22,6	2,7	68,0	100
1996	5,8	1,2	21,6	4,1	67,4	100
1997	5,8	1,2	18,2	5,9	68,9	100
1998	5,7	1,4	18,0	6,8	68,1	100
1999	4,6	1,6	17,5	6,6	69,9	100
2000	4,9	1,1	19,4	6,3	68,5	100
2001	4,8	1,6	17,8	8,7	67,3	100
2002	4,6	1,4	20,1	9,6	64,4	100

Source: SPO (2004b), Economic and Social Indicators, 1950-2003.

Similarly, the share of mining and agriculture investments are declining too. Their shares in the incentive figures are also low. Then is it possible for Turkey to economically and socially develop just with transportation/ communication and housing investments?²⁰

According to Table 4.3.2 and Table 4.3.3, the share of manufacturing investments are more or less stable around % 20-% 25, but the share of manufacturing investment incentives are not that stable. As seen from Table 4.3.1 and Table 4.3.2, the manufacturing sector does not seem to respond to the investment incentives .

The manufacturing sub-sectoral incentive distribution varies. Investment incentives in the manufacturing sector were relatively concentrated in textiles and apparel, and metal products at the early 1980s; in textiles and apparel, food and beverages, and metal products in the mid-80s; textiles and apparel, cement, chemicals and motor vehicles industries in the late 1980s and 1990s (UT, 2005b). The share of investment incentives to textile and apparel industry reaches its peak at mid-1990s, with a very high difference compared to the other sectors. No other sub-sector has been granted incentives as high as textile and apparel industry ever between 1980-2004 except for 2001²¹.

In the last two decades, except for the years 1985 and 1987-1989 and 1999, the highest amount of incentives were granted to manufacturing sector (Table 4.3.3). For late 1980s, the most favoured sector was services sector, except 1985, where energy sector was granted %77.6 of all incentives (and it was public sector enterprises which have taken the great portion, see UT 2005b).

²⁰The highest levels of investment are made on these sub-sectors of services sector in the last decade. SPO Economic and Social Indicators 1950-2003.

²¹ In 2001, the iron and steel industry had greater amount of incentives than textiles, but not much greater (UT, 2005b).

TABLE 4.3.3: Total Investment Incentives, Current YTL, Percentage Shares (1980-2002)

Years	Agriculture	Mining	Manufacturing	Energy	Services	Total
1980	17,5	1,4	74,9	0,2	6,0	100
1981	2,9	11,1	46,0	0,1	39,9	100
1982	2,6	1,7	69,0	0,01	26,7	100
1983	2,3	4,0	53,2	0,3	40,3	100
1984	3,0	15,4	58,3	3,7	19,6	100
1985	0,2	0,7	6,9	77,6	14,5	100
1986	0,4	2,8	49,8	0,2	46,8	100
1987	1,7	2,3	28,8	16,4	50,8	100
1988	0,4	0,7	23,0	6,1	69,8	100
1989	0,7	1,3	38,6	0,5	58,9	100
1990	4,6	1,8	64,7	10,6	18,2	100
1991	0,9	1,4	53,8	2,4	41,6	100
1992	0,4	1,5	51,8	3,4	42,8	100
1993	1,5	1,9	61,4	3,9	31,3	100
1994	1,5	1,3	67,8	4,5	24,8	100
1995	0,2	0,4	70,4	8,5	20,4	100
1996	1,5	0,8	68,3	4,0	25,5	100
1997	0,6	1,0	53,6	17,2	27,6	100
1998	2,2	2,1	48,7	5,9	41,1	100
1999	1,7	0,7	35,0	5,7	56,8	100
2000	1,5	0,9	41,8	24,0	31,8	100
2001	0,9	0,8	51,0	16,1	31,2	100
2002	1,1	4,2	57,8	3,2	33,7	100

Source: Calculated from UT (2005b).

4.3.1 MANUFACTURING SECTOR

For manufacturing sector industry incentives first had a legal perspective with Temporary Act of Stimulation of Industries (1913) (Duran, 2002, p.4). In 1876, there were some legislative arrangements for duty tax exemptions in capital goods importation²².

In Turkey, from the foundation of Republic of Turkey in 1923, to the end of 1970s, the prevalent economic development policy was the import substituting industrialisation (ISI) approach (Tezel, 2002, p.285). During this period, manufacturing sector was seen as the driving force of development, since the economy was dependent on the importation of manufactured consumption and capital goods. Manufacturing sector was to be strengthened in order to reduce this dependence.

Although, in the early stages of this long period (1923-1970s), most of the investments were realized by public sector, there were investment incentives granted to the private sector. Until a new code enacted in 1927, a few hundreds of enterprises had already been granted some incentives via 1913 Code on Industry Incentives (Tezel, 2002, p.289). But of course, the use of the investment incentives granted to private sector as a tool for economic development increased with the move away from etatism in the five year plans.

Whatever the development strategy, the manufacturing investment would be very important since manufacturing sector is the most productive and high value added sector. As mentioned before, these criteria on the commodity groups is very important for the trade performance of a country in the world markets. In order to become more productive and more competitive in the world markets, a country

²² Toprak, Z. (1982).

should be capable of producing high value added, enhanced quality commodities requiring high technology, and/or innovative design. Manufacturing incentives would be more important in this respect, since all these improvements means high costs for the enterprises. As one of the most important problems of investment, and, therefore growth is, the cost, investment incentives might be a very useful instrument if applied rationally.

As seen from Table 4.3.3, the share of manufacturing investment incentive certificates are not very regular between 1980-2002. Specially, the downward movement of this share in the late 1990s may indicate the diminishing importance of manufacturing sector in the economy. As a matter of fact, the incentives granted to manufacturing sector are mostly directed to labor-intensive sectors, such as textile and apparel, and food and beverages sub-sectors²³. These figures, are determined by the choices of the firms, as well as the political choices favouring employment creation, all of which affect the composition of Turkish manufacturing sector.

The share of the number of certificates, rather than the share of currency values of incentives are shown here; because, this would better reflect the quantity of individual incentive demands of the firms. As the recent Turkish incentive policy mostly differentiates among the regions and provinces, rather than the critical sectors for development; the incentive distribution among each sector's sub-sectors would be determined according to the demand of the firms in those regions; and the number of certificates is a better way of tracking it.

²³ UT (2005b).

TABLE 4.3.4: Percentage of Manufacturing Sub-sectors' Incentive Certificates among Manufacturing Investment Incentive Certificates (1980-2000)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
01-Food and Beverages	22,1	30,3	18,4	16,9	18,8	20,8	14,3	14,2	12,4	17,6	28,8
02-Textiles and Apparel	8,5	12,4	21,2	25,0	28,4	31,0	26,4	23,7	22,3	31,8	26,6
03-Wood Products	7,2	2,6	1,8	2,5	1,4	1,7	2,2	4,0	4,2	4,6	4,6
04-Paper	2,1	0,8	2,6	1,0	0,5	1,2	0,8	0,9	1,7	0,9	1,0
05-Leather Products	1,6	2,1	2,2	2,2	2,7	2,7	2,7	3,9	4,0	2,0	1,9
06-Rubber and Plastics	1,3	0,9	1,2	1,2	1,5	2,6	2,0	2,6	3,8	4,8	4,8
07-Chemicals	4,3	4,6	4,4	7,6	7,5	4,9	3,9	3,6	3,0	3,6	3,4
08-Glass	0,3	0,5	0,8	1,0	0,9	1,2	0,7	1,2	1,6	1,2	0,6
09-Iron and Steel	2,4	0,7	1,8	4,2	2,9	1,7	2,4	1,7	1,7	1,8	1,6
10-Non-metallic Prod.	0,5	0,5	1,2	1,0	1,9	1,2	1,0	1,0	1,0	0,9	0,5
11-Vehicles	21,3	21,6	21,2	10,0	8,2	3,0	5,3	4,2	6,4	8,4	5,7
12-Metal Products	2,7	3,8	5,4	5,9	4,6	6,1	5,0	4,4	5,2	3,4	5,0
13-Job Training	0,5	0,9	3,0	2,7	1,7	0,8	1,0	1,2	1,5	1,5	0,6
14-Machinery	5,6	3,1	3,2	3,2	1,7	3,0	2,7	2,2	2,5	3,9	1,7
15-Electrical Machinery	4,8	1,8	1,8	1,7	1,9	1,6	1,4	1,3	2,0	1,9	1,4
16-Electronics	0,8	0,9	0,8	2,0	1,5	1,2	1,9	1,2	0,8	1,0	1,2
17-Cement	1,3	2,1	1,4	2,5	1,7	3,9	7,9	8,4	6,8	1,9	2,1
18-Clay and Cement Pr.	9,0	6,0	4,2	4,2	3,9	4,4	9,5	10,3	11,1	3,5	4,0
19-Construction	0,0	0,1	0,0	0,7	0,3	1,7	4,7	6,2	3,2	0,6	0,3
20-Ceramics	0,8	0,7	0,6	0,5	0,9	0,7	0,6	0,4	0,8	0,5	0,9
21-Other	2,9	3,8	2,8	4,2	6,8	4,5	3,4	3,4	4,0	4,2	3,2
TOTAL	100	100	100	100	100	100	100	100	100	100	100

TABLE 4.3.4: Percentage of Manufacturing Sub-sectors' Incentive Certificates among Manufacturing Investment Incentive Certificates (1980-2000) (continued)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
01-Food and Beverages	17,1	11,9	10,9	11,9	10,0	19,3	14,9	16,6	16,7	18,0
02-Textiles and Apparel	24,9	33,9	35,7	39,2	63,0	34,0	38,1	32,2	15,1	24,6
03-Wood Products	4,0	2,0	2,8	3,0	1,2	2,8	3,3	4,0	4,1	4,1
04-Paper	1,2	0,7	1,0	1,5	0,9	1,3	1,6	1,1	1,6	1,2
05-Leather Products	2,9	2,2	3,6	4,0	2,3	2,2	2,5	2,2	0,6	1,5
06-Rubber and Plastics	4,8	3,8	2,5	1,6	2,3	4,2	4,4	6,1	6,7	6,4
07-Chemicals	5,3	3,7	3,8	4,8	2,3	2,6	3,6	3,2	4,6	3,8
08-Glass	0,9	1,9	1,3	2,1	0,6	1,2	0,8	0,9	1,4	0,7
09-Iron and Steel	2,2	2,6	1,8	1,3	0,9	1,5	2,2	2,2	2,6	2,3
10-Non-metallic Prod.	1,6	1,2	1,1	0,9	0,6	1,0	1,4	1,4	1,6	1,1
11-Vehicles	7,4	7,8	10,1	7,8	3,6	7,2	5,2	6,5	8,0	8,6
12-Metal Products	5,9	5,3	5,3	4,6	2,1	4,8	5,3	5,3	11,4	7,3
13-Job Training	0,8	0,9	1,1	0,7	0,6	0,6	0,6	0,9	1,3	0,3
14-Machinery	3,6	2,8	2,8	1,9	1,5	4,1	3,2	3,4	4,7	3,3
15-Electrical Machinery	2,4	2,4	2,1	1,6	1,0	1,7	1,3	1,7	2,1	1,9
16-Electronics	1,6	2,2	1,2	0,7	0,3	0,8	0,5	0,7	2,0	1,2
17-Cement	3,9	6,5	6,2	6,9	2,0	3,7	4,4	4,4	6,3	6,3
18-Clay and Cement Pr.	3,7	2,4	2,3	1,5	1,0	2,0	2,3	2,7	4,2	2,8
19-Construction	1,0	0,8	0,3	1,0	0,2	0,2	0,5	0,8	0,7	0,6
20-Ceramics	1,1	1,4	1,2	0,9	0,7	0,8	0,7	1,1	0,9	1,0
21-Other	3,7	3,7	2,9	2,1	2,8	4,1	3,0	2,8	3,2	3,1
TOTAL	100	100	100	100	100	100	100	100	100	100

Source: Calculated from UT (2005b).

It is generally textiles and apparel, food and beverages and vehicles sub-sectors where the firms benefit incentives. According to the industrialists, during the textiles and apparel sector investment boom periods, the investment incentives were granted to final goods producing firms. But the intermediate goods producing firms should also be granted investment incentives for the requirements of this sector. Another problem is the fact that, the incentives were granted to low value added, price-competing commodity groups rather than high value added, high quality commodity groups (ÍTB, 2004).

These sectors are labour intensive, low value added sectors, and reflecting the structure of Turkish economy. The labour intensity might be beneficial for employment in the short-run. But unless the investment generates high incomes and saving, investment in labour intensive sectors cannot contribute much to economic growth and employment creation in the long-run.

CHAPTER 5:

THE PROBLEMS AND THE EFFECTIVENESS OF THE INCENTIVE SYSTEM

5.1 PROBLEM OF FINANCING

One of the most important issues of the incentive system is the political problem of how much resources the government should allocate to incentives. The resources which the public sector reserved for private sector is at minimal levels. Investment incentives, are either taxpayers' money used to subsidize private firms (grants, subsidised loans, etc.); or forgone tax revenues by the government, either can be spent for other important purposes, such as investing in infrastructure, education, improving the business environment, and so on. Another issue related to incentives, is the question of whether or not this sort of spending is justified. This 'dilemma of incentives'²⁴ cannot be resolved, unless it is clear to what extent incentives are important in investment decisions. This subject will be discussed more detailed in Section 5.3.

Investment promotion can be costly and yield little immediate result. While failure is easily measured, success is less so. For example, "when FDI inflows increase, it is unclear how much inflow would have occurred in any event. In the case of extravagant incentive packages, it is also possible that the added cost outweighs the benefits" (UNCTAD, 1997, p.4). The enlargement of the incentive system would also result in serious problems with IMF for countries like Turkey,

²⁴ Pershnin 2003.

since Turkey tries to generate operational surpluses from its budget in order to reduce of its huge public debt.

Despite all the constraints, the Turkish government has decided to widen the incentive frame in 2004 with the law on Stimulating the Investment and Employment Act No. 5084, and in 2005 with the law about the changes in Act 5084. According to the latest incentive legislation, the number of provinces, which benefit from incentives, would rise from 36 to 49²⁵. The limit of \$ 1500 per capita income for a province to benefit from incentives would rise to \$ 2000 with the new law, with the same employment requirements. Also the investment allowance rates would be increased and differ according to the per capita income in the provinces.

In Turkey, until 1980, both private and public investments were realized mostly with domestic resources. After 1980, these investments started to use foreign resource-finance, via foreign debt. After 1990, again domestic resources are used for investment (Duran, 2002, p.22). These developments lead to increased debt stock of the public sector, and reduced the resources for fixed investments. After 1985, the government began to borrow to cover budget deficits, instead of monetizing them (Karakoç, 2003, pp.11-12). Since the public sector obtained most of the funds from the markets, the cost of funds increased for also the private sector. This situation led the private sector to try the short term, high return options like interest, foreign exchange, and stock exchange rents. In this situation, only the equity option is used for fixed investment financing by the firms (Duran, 2002, p.22).

After the abolishment of grants in 1991, and all general financial incentives after 1994, the general incentives became only fiscal based. In 1997, SMSE credits

²⁵ GNAT 2005a and 2005b.

were introduced as a financial incentive instrument, but its level remained limited (Duran, 2002). It would be great optimism to expect from the government to finance SMSEs in the short-run. Government should therefore help the SMSEs to access the cheap international credits and funds, as Dilik and Duran (1998) also suggested.

As financial credits are no more an option, and all credits have been reduced during 1998-2001 crisis period. And also after the August 1999 earthquake in the industry-congested region, the existing financing problems have been multiplied for the firms. The public sector has been in a saving period –and is still so– because of the requirements of IMF, such as operational surpluses from the budget expenditures. As a result of all these negative effects, the resources for investment incentives largely shrank.

Debated from very different angles, privatization as a tool for financing budget deficits has also been criticized from the incentive side. Because, among the privatized enterprises, ironically there are companies which need to be supported with incentives (GNAT, 2005a). This means that, the net financial resources obtained through privatization, are less than the proceeds from the sales of the assets.

5.2 PROBLEM OF UNFAIR COMPETITION

Another problem with the Turkish incentive system is the allegation of unfair competition it creates by affecting production costs in neighbouring regions. A few months ago a businessman in Adana sued the government with the charge that the incentives granted to the neighbouring province Osmaniye caused unfair competition, and caused his bankruptcy. Because, Osmaniye, the neighbouring of

Adana, is a DPR province and it is in the incentive legislation, and the companies in Adana began to make losses, as they lose their clients to Osmaniye.

There are many examples of this kind, and this problem also caused hot political debates among the deputies of several provinces in the Grand National Assembly of Turkey. There is a very harsh competition among the provinces for incentives. It is alleged that, this law discriminates among the provinces, and punishes and discourages the successful regions²⁶. Then there is the question, whether the incentives help to increase the value added in the country, or whether they merely result in reallocation of resources.

The social and economic indicators index value might differ among the districts of a province. Among 479 districts of 49 supported provinces, 101 of them have positive index number. And 167 districts of the non-supported provinces, have negative index values. An example for this situation is from Samsun: Two districts of Samsun wish to be integrated in neighbouring Amasya province (which has been granted incentives), with 15000 signatures collected. If the incentives are granted to all negative indexed districts of Turkey, all the provinces would benefit the spreading effect of the incentives, and the unfair competition would be eliminated to some extent (GNAT, 2005b).

The incentives granted to 49 provinces also do not take into account of the previous investment projects in these provinces. Reduced investment cost advantage of the new supported firms harm the existing firms. In order to prevent causing another form of unfair competition, whenever an incentive is granted to a province, it should cover all the investment projects.

²⁶ GNAT 2005a and 2005b.

5.3 THE EFFECTIVENESS OF THE INCENTIVE SYSTEM

The effectiveness of the incentive policy is the power of the incentive system to channel the resources into the targeted investment projects, and therefore to targeted sectors and regions.

There are numerous factors which could affect the investment decisions, such as the cost and the rate of return of the projects, the cost of other alternatives for their funds (depending on the real and the nominal interest rate, inflation), the tax rate, the general social and the political climate in the country/region, the level of entrepreneurship tradition in the country/region (for example, risk taking or risk averse behaviour), and the availability of investment incentives granted to their projects, and so on. In some studies, the enumerated factors run into dozens (Duran, 2003, p.92). So it is very hard to calculate the net effect of any of these factors on the investment decisions. A method to form an accurate idea in this respect might be face-to-face interviews with the firms. However, this kind of study would be very costly and time consuming. Furthermore, when it is incentives in question, most of the firms would not prefer to admit that they have been granted incentives. So the importance of the incentives might be underestimated for this reason.

In order to measure the net effect, the cost-difference between the market values of the subsidized entries and the public price of them could be compared. However, as the prices and interest rates are very volatile in Turkey, only company based calculations are possible, which is hard to aggregate.

There are a few main reasons that why the effectiveness, efficiency and usefulness analysis of incentives programs cannot be done in Turkey.

First; the data on the investment incentive amount is inadequate. Even though there are some figures in the records, the real value of the contributions of investment incentives cannot be calculated; only the current values and totals are known. Moreover, it is not clear whether incentive certificates are in use or not. That is, some of the projects not have even been started, might not be completed; or might be completed but not declared to the government institutions again. According to Duran, all these unknown figures are far more above than exceptional small figures, i.e. they are about one third of the whole incentive certificates (Duran, 2002, p.9). This in turn results in a lot of indeterminates in the database.

Second; even though the incentive system goes back to the years prior to the Republic, there is still no settled institution related to investment incentives (SPO, 2004a, p.127). Even during this study, the responsible authority changed from State Planning Organization to Undersecretariat of Treasury. In every new institution charged with the incentive policy, the system is renewed completely, which in turn caused problems related to the lack of institutional experience. Duran also points out to a very important problem that the responsible institute does not work to analyze the results, but just carries out the routine job (Duran, 2002, p.9). This problem also became very clear during the research period of this paper.

Third; there is no coordination among the numerous institutions implementing the incentive schemes (Duran, 2002, p.9). The system is also affected by the economic and social instability. From time to time, populist or austere politic attitudes have dominated. The public resources are not sufficient. Specially the tax incentives regime was so volatile, that the firms cannot foresee the future (SPO, 2004a, p.127). The same problems are valid for the foreign firms too. "If a country has a volatile political system, it is important that foreign investment be subject to non-partisan consensus. Governments may come and go, but policies should not" (UNCTAD, 1997, p.5).

If the investments are affected by the presence and amount of incentives, there would still be measurement problems of the positive effects, such as the level of transfer of technology, and employment creation; and negative effects such as increased potential of corruption (Duran, 2003, p.59) and the presence of unfair competition.

In Turkey, in the preparation process of an incentive program, the decisions regarding which sectors will be supported; how much those sectors/regions require incentives; the predicted time period of the project; the resources to fund incentives; the tools are not based on careful research; and the total costs of the programs are not well defined. The same is valid for the evaluation process of the results of the program (Duran, 2002, p.8).

Many governments offer incentives to firms, though their costs and benefits are not easily calculated, and evidence suggests that they are not of fundamental importance in influencing investment decisions. There further appears to be a tendency for public authorities to compete among themselves to attract large-sized investments by offering extravagant incentive packages (UNCTAD, 1997, p.2). But this may result in making the cost of the incentives outweigh the benefits. The benefits of an investment are not realized in the short term. And in a country like Turkey, which has a fragile economic structure, the long term investment projects are hardly realized in the planned period (Duran, 2003, p.79). This has been the case for many years in Turkey, where there are lots of incomplete investment projects worth billions of YTL.

According to a literature review study on the foreign direct investment (FDI) behaviour, none of the empirical studies concluded that the most crucial determinant of the foreign investment decisions is investment incentives (Duran, 2003, p.93). The same issue is pointed out by others too, that the incentives do not rank high among the many determinants of FDI cited by various theories and sur-

vey data generally confirm the theoretical expectation, that, incentives play only a limited role. So the majority of researchers have found that incentives do not have a significant impact on FDI, although the validity of such results is questionable (Pershin, 2003, p.185). But of course, whenever all the other factors are the same, the presence of incentives would probably affect the investment decisions positively.

Despite these problems, some positive progress might be achieved via investment incentives in a region. For example according to a news item in Milliyet (2004b), there has been an investment boom in Aksaray in one year: Aksaray province, which has achieved a push by making use of the Code on Stimulating the Investment and Employment, had its most powerful progress that year since 1989. 41 factories were activated, 68 factories began to be set up, the number of insured employees has increased %32 compared to the previous year²⁷.

Similarly, after the land assignment incentives granted in Batman, 60 firms demanded land and built dye and plaster factories in the province (Zaman, 2004).

In Turkey, R&D expenditures constitute a very low percentage of GNP, and universities are more active than private and public sector in R&D studies (Beyhan, 2001, pp.42-43). Still there are successful examples of investment incentives on R&D projects. A very successful example of the incentive effect is the METU –Technopolis that has been granted R&D incentives as income and corporate tax exemptions. METU-Technopolis is the first and the biggest science and technology park in Turkey. Opened in 2000, it hosts around 120 companies employing over 1000 researchers. The majority of the companies are technology based and develop software products and services. In five years, between 1999 and 2004, the number of companies has increased from 13 to 120.

²⁷ The governor of the province Hüseyin Avni Coş declared that, what could not be achieved in 15 years has been achieved in one year in Aksaray (Milliyet, 2004b).

The majority of existing companies are operating in ICT and software development sectors. Almost 75 percent of companies deal with the ICT and software industry. These companies supply much of the knowledge based products and services. In 2003, METU-TECH companies have exported 7,5 Million USD of technological products and services. “The export markets of the companies are countries like US, Singapore, Hong Kong, Dubai, Holland, Russia, Germany England, etc” (UN, 2005, p.18). Over 10 million USD upstream investments were developed. Turkish general incentive system supports the high technology projects to a great extent (Beyhan, 2001, p.47).

In specific cases where particular regions benefited from incentives, it seems as if there was an investment response (Duran, 2002, p.19). Such examples show us that there may also be some benefits from the use of the incentives. Because, although in the short term there are less earnings from the taxes on the government side (in this example), in the long term such industries grow, and the country benefits from its new role on the international market.

It is not clear whether an investment surge stimulated by other factors, made increasing use of incentives; or whether the incentives themselves caused the investment upswing. Even if the incentives may have some stimulating effect on the investment decisions, another important aspect is the ratio of the completed investment projects after the incentive has been granted. For example, when Uşak has been involved in the incentive regions, over 200 applications were made for land assignment. Whenever the authorities demanded \$ 1,50 per square meter of land for infrastructure expenses, %90 of the applications were withdrawn. And only four of the remaining enterprises began their projects (Karasu, 2004).

Kemal Unakitan, Minister of Finance, declared that, with the Act No. 5084²⁸, 136.000 people has been employed in 36 provinces, and this is a great success of

²⁸ First version in 2004.

government. However, 136.000 personnel employment in 36 provinces, over approximately 2.500.000; that is, % 5,4 of the unemployed people (SIS, 2005), does not seem to be a very successful ratio for two years. Moreover, according to Ali Kemal Deveciler, RPP Balıkesir Deputy, investments were realized in only 5²⁹, out of 36 provinces, with incentive certificates (GNAT, 2005b). These examples reflect that the effect of incentives on investment and unemployment is not very strong.

There is always a political aspect of the incentive decisions of the administrators. Whatever the results of the effectiveness analysis done, the policy makers might grant incentives as a tool to strengthen their political condition, and to keep their word to their voters. Whenever the new incentive legislation was on the agenda of the Justice and Development Party (JDP) in 2004, a very hot debate took place among the deputies of JDP about the excluded provinces by the law³⁰. The excluded provinces' deputies insisted for their provinces to be included. Just one year later, 13 new provinces were included in the new law on incentives, despite the oppositions of the IMF³¹ (GNAT, 2005b; and DGPI, 2005).

Any change in the tax legislation could be effective on the investment decisions, by either lowering or increasing the decision-making level of project cost. For foreign direct investments, nothing in the World Bank Guidelines on the Treatment of Foreign Direct Investment suggests that a State should provide foreign firms with tax exemptions or other fiscal incentives. In fact, "reasonable and stable tax rates are deemed to provide a better incentive than exemptions followed by uncertain or excessive rates" (UNCTAD, 2004, p.33).

²⁹ Uşak, Sivas, Afyon, Malatya, Düzce.

³⁰ The ones excluded from 36 provinces.

³¹ Tom Dawson , IMF Director of Foreign Relations, suggested that, the new law significantly increases the fiscal burden, and this situation worries IMF (DGPI, 2005).

CHAPTER 6:

CONCLUSION

According to the Special Experts Commission Report of SPO, the Turkish industry has the following problems on the whole: entrepreneurship problem because of its traditional character; technology gathering problems, informational problems; education and qualified worker problems; finance problems; marketing and exporting difficulties; political instability problems; and consultancy problems (SPO, 2004a, p.128). However, the most important problem of the incentive system is finance scarcity.

If a government uses the tax revenues inefficiently, eventually there would be a scarcity of funding resources. The debt burden on Turkish government for many years partially is a result of these kinds of inefficient and discretionary expenditures. So the targets of the incentive system should be well-defined, well-chosen, and transparent. Moreover, incentives should be subject to some additional rules such as, repayment of credits, and employment requirements. The criteria or conditions must be clearly spelled out in a law, regulation, or other official document, so as to be capable of verification.

A healthy and strong financing mechanism is necessary to stimulate new investments, exports and growth. Even though the financial instruments are problematic to use, and very limited for now, government should find financial resources to support the finance-sensitive areas like SMSEs, R&D, high-technology, and regional targets. Of course, it is important for those funds to be repaid with a positive real interest rate to avoid injudicious consequences for taxpayers. It would be great optimism to expect from the government to finance

SMSEs in the short-run. Government should therefore help the SMSEs to access the cheap international credits and funds. Also, the high value added sectors should be promoted, in order to sustain the investment-finance process.

In Turkey, the public expenditure figures are declining both because of the neo-liberal economic policies in practice for the last few decades, and because of the scarcity of financing resources resulted from economic bottlenecks in the history. The recent crisis period has also resulted in serious capital losses in the private financing markets. Moreover, it cannot easily be concluded that the Turkish incentive system has a persistent sectoral and regional vision which would direct the resources effectively for the development purposes.

The most prominent objective of incentive decisions of the government is to alleviate the unemployment problem in Turkey, and to direct resources to their voters' regions, rather than development and growth targets. This is motivated by political considerations rather than economic, because, in a country suffering from high unemployment, no political party can remain in power very long.

For 2004, the expected level of employment creation was 167.621 people³². As hundreds of thousands of young people join the work force each year, the effect of incentive system on the employment level seems to be insignificant³³.

It seems to be true that the governments often oblige the demand of the firms. In Turkey, most of the debates on the new law on incentives revolved around the regional demands of the deputies for their provinces, rather than centering on the future production and development prospects of the country.

³² UT 2005b.

³³ The total level of employment *expected* for 1980-2000 period is 3.811.926 people (Serdengeçti, 2000, p.28).

In Turkey, a province can benefit from incentives if its per capita income is less than \$ 2000, and the social and economic index calculated by SPO is negative. On the firm basis, there is a requirement of 30 people employment. On the sectoral basis, there is no such selective criteria.

Even if the net value effect of incentives is hard to calculate, (and for foreign investments, incentives are hardly effective), it is obvious that there is a great demand for incentives in Turkey from domestic firms. An important effect of incentives might be the confidence they create among the firms. For example, a firm would worry less about the future price shocks in the economy, when it has been granted with land assignment, or energy support, and so on. Furthermore, according to the recent common public debates about the new legislation, the locational effects of incentives have very strong economic and social consequences.

Particularly the regional parties consider incentives as an important investment issue, which requires a policy dialogue between the parties concerned. Individual effects may vary from region to region; and incentives might result in unfair competition among the firms.

The regional incentives are non-discriminating among each province's advantages and disadvantages in particular sectors. Same incentive instruments are applied at the same rates. There must be a grading system across the provinces and also their districts³⁴, according their industry infrastructure and available resources. Then the unfair competition the incentives created would be eliminated. Otherwise no firms would prefer, for example Hakkari, Şırnak, Ağrı, Siirt, Muş to Kütahya, Afyon, Trabzon, or Malatya .

³⁴ The social and economic indicators index value might differ among the districts of a province.

If we summarize the general conclusions about the Turkish incentive system:

The regional incentives seem to be successful in the western part of the country to some extent. But there are few indications that they are successful in the least developed eastern parts of the country. The incentive system does not seem to be successful in directing the investment to underdeveloped regions of the country. The regional economic and social balance could not be achieved for many years.

There is some stimulating effect of the incentives on investment. However, this stimulating effect causes the resources to move from one region to another, rather than contributing significantly to overall capital accumulation in the country.

The incentive system has no strong effects on directing the sectoral distribution of investments. Not only the selection of the critical sectors is a complex and controversial issue, but also, it is forbidden by the legislations of WTO and European Union, as being market distorting actions. Even for the exceptionally permitted cases; the firms, choose the sectors to invest, with scarcely any orientation by government for an industrialization strategy.

One of the most critical contributions of incentives might be, affecting the decisions of the firms at their break-even points in the cost of new investment. This effect might be calculated for individual firms on a micro basis, but making a comprehensive study for the whole economy seems to be unfeasible with the present incentive and industrial data.

As a general rule, for investments to be successful and beneficial for the economy, investment incentives should provide support for capacity building, institutional support and participation in the funding of national and regional initiatives to reduce the political, social and commercial risks and costs of the firms.

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