TAX EXPENDITURES IN THE EUROPEAN UNION AND TURKEY

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ABSTRACT

TAX EXPENDITURES IN EUROPEAN UNION AND TURKEY

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This thesis analyzes the tax incentives and protection measures in the European Union and Turkey. The definition and classification of these measures in the form of tax expenditures will be stated in this study. EU's tax provisions in sources of the Acquis Communautaire will be described followed by the practice in the EU's major policy fields. The legal background and major policy implications of these tax policy measures in the framework of Turkey's tax laws will be explained followed by an evaluation of to what extent Turkey's tax expenditures are harmonized to the EU.

Keywords: European Union, tax expenditures, tax legislation, tax incentives, tax protections

ÖZ

AVRUPA BİRLİĞİ VE TÜRKİYE'DEKİ VERGİ HARCAMALARI

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Bu çalışma Avrupa Birliği ve Türkiye'deki vergi teşvik ve korumalarını incelemektedir. Söz konusu teşvik ve koruma yöntemleri çalışmada vergi harcaması olarak ele alınmaktadır. Vergi harcamalarının teorik açıklaması yapıldıktan sonra Avrupa Birliği muktesebatında yer alan vergi ve vergi harcamaları ile ilgili hükümler irdelenip Avrupa Birliği'nin önemli politika alanlarında vergi harcamalarının etki ve kullanım alanları incelenecektir. Avrupa Birliği'ni takiben Türkiye'deki vergi harcamalarının incelenecek ve Türkiye'deki uygulamanın Avrupa Birliği entegrasyonu yönünde değerlendirmesi yapılacaktır.

Anahtar Kelimeler: Avrupa Birliği, vergi harcamaları, vergi kanunları, vergi teşvikleri, vergi korumları

To my beloved father Nejat Coşkun, mother Füsun Coşkun, and grandmother Nimet Ünüulu

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INTRODUCTION

Various definitions of tax have been made in public finance literature, most of these definitions seeking to identify the legal features of the tax. Among these features, the most important ones are the “compulsory” nature of tax and its payment “without consideration”.

In the OECD classification, the term “taxes” is confined to compulsory, unrequited payments to general government. Taxes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments.[1]

The primary purpose of the tax system is to raise the revenue needed to pay for government spending. The goal is to raise this revenue without distorting the decisions that individuals and firms would otherwise make for purely economic reasons. Taxes are also an important tool of fiscal policy in addition to meeting public expenditures.

Tax policy is not defined among the common EU principles. “Taxation is at the heart of national sovereignty and one of the most protected *“chasses gardées”*[2] of the EU Member States.”[3] However, regulation as per the tax policy takes place under the common policy measures, and Member States are able to enjoy their right to tax to the extent that Member State’s tax

[1] OECD, *Definition of Taxes*, DAFFE/MAI/EG2(96)3, 1996, p.3

[2] *“Private grounds”*

[3] P.Cattoir, *‘A History of the Tax Package The Principlesand Issues Underlying the Community Approach’*, European Commission, 2007, p.1

policies do not hamper the functioning of the free competition and the fundamental freedoms of the EU Acquis. [4]

The Treaty on Fuctioning of the European Union (hereinafter; TFEU)[5] prohibits any tax discrimination which would directly or indirectly, give an advantage to national products over products from other Member States. The TFEU requires harmonisation of turnover taxes, excise duties and other forms of indirect taxes.

During the economic conjucture and cross border trade terms of 1950s when the Rome Treaty was signed it was sufficient to ban discriminatory measures in indirect taxation in the event of cross border procurement of goods and services in the Community. The first harmonization step in indirect taxation was the harmonization of the capital duty, levied by Member States on increasing capital for companies. An even bigger accomplishment in harmonization of indirect taxes was the Sixth VAT Directive of 1977 which ensured that VAT was applied to the same transactions in all Member States. This suggested a common base for value added taxation all over the Community, with bigger influence as to open the way to abolish tax frontiers before cross border transactions.[6]

The achievements were not as glorious in the field of direct taxation for a couple of decades following the Rome Treaty. “Direct taxation is an area in which cooperation at EU level is notoriously difficult. Owing to the need for

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[4] European Commission, *'Tax Policy in the European Union'*, 2000, p.6

[5] Consolidated version of the Treaty on the Functioning of the European Union, 2008/C 115/01, OJ., 09.05.2008, C115

[6] European Commission, *'Tax Policy in the European Union'*, 2000, p.12

unanimity, it took, almost 30 years of discussions to produce the first European directives on business taxation, the 1990 Parent/Subsidiary and Merger Directives".[7]

In this respect another milestone in the EU's taxation policy scene manifested in 1996 Verona Council when Ecofin met informally to discuss the most pressing tax issues of direct taxation. Verona discussions were carried by the Commission together with a high-level working group which would later form the Taxation Policy Group in December 1996, and a "Tax Package" was adopted due to "the need for coordinated action at European level to tackle harmful tax competition in order to help achieve certain objectives such as reducing the continuing distortions in the single market, preventing excessive losses of tax revenue or getting tax structures to develop in a more employment friendly way"[8].

The Tax Package consists of a Code of Conduct for Business Taxation (hereinafter; the Code of Conduct, or the Code), the Directive on taxation of saving income and the Directive on taxation of interest and royalty payments.

The Code of Conduct lays down those measures which affect, or may affect, in a significant way the location of business in the Community. Code of Conduct suggest that "tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code."[9] Now, after more than

[7] P.Cattoir, *'A History of the Tax Package The Principles and Issues Underlying the Community Approach'*, European Commission, Doc. TAXUD/2007/2901, 2007, p.2
[8] Ibid.

[9] Council of the European Union, *'Code of Conduct (Business Taxation)'*, SN 4901/99, 1999, p.2

a decade of its publication in 1999, Code of Conduct is still a very powerful tool to reduce unfair tax competition in Member States.

The design of taxes as a tool for achieving wider policy goals brings forward the use of incentive and protection measures as a form of tax expenditure. “In all OECD member countries, governments collect revenues through taxes and redistribute this public money, often by obligatory spending on social programmes such as education or health care. Their tax systems usually include tax expenditures, provisions that allow certain groups of people, such as small businessmen, retired people or working mothers, or those who have undertaken certain activities, such as charitable donations, to pay less in taxes.”[10]

In the broadest terms tax expenditure refers to any deviation from tax norms or benchmark that would result in a decrease in the tax revenue otherwise due. Tax expenditures are pervasive instruments used in almost all OECD countries, where the EU Member States and Turkey are no exception as well. The common feature of tax incentives and protection measures is that they are used in both high and low income countries, however the difference stems from whether they are classified as tax expenditure or not in the budgetary processes. According to Swift, high income countries treat tax incentives and protection measures as tax expenditure and monitor them as government spending in the normal budgetary controls. Low-income countries do not regard and treat these measures as tax expenditures. Developing countries on the other hand also use tax incentives, but in most cases they have not taken sufficient steps to make tax incentives accountable.[11]

[10] OECD, *‘Tax Expenditure in the OECD Countries’*, 2010, p.3

[11] Z.L. Swift, *‘Managing the Effects of Tax Expenditures on National Budgets’*, World Bank, WPS3927, p.2

EU Member States commonly use tax measures with regard to policy areas such as supporting research and development activities, enhancing environment friendly measures, or fighting unemployment. Using tax policy, more specifically tax expenditures are at the discretion of the Member States, as long as the measures introduced do not hamper the functioning of the common market and free competition.

There are numerous incentives and protection measures (tax expenditures) introduced in Turkey. There has usually been a consensus among the tax theoricians and practioners with respect to the complicated and instable structure of the Turkish tax system, where these numerous tax expenditure measures do not help to simplify the system as well. However, the vision of the Turkish tax authority for some time has been defined so as to improve the country's tax structure with simplicity, efficiency and stability.

This thesis investigates whether Turkish tax system is harmonized with the EU in the field of tax expenditures. In order to be able to reply this question the level of harmonization required in the field of tax expenditures in the EU will be examined first by explaining the legal basis of the tax measures and secondly by concentrating on the use of tax instruments in major policy areas of the EU. Then the Turkish experience will be examined following the action points that will be required from Turkey in the event of accession to the EU.

In the first chapter of the thesis, a definition of tax expenditure will be given based on the World Bank, and OECD definitions. This will be accompanied by the country examples on how these tax expenditures are reported and how big the tax expenditures are in the budgets of the said countries.

The following chapter will highlight tax policy in the EU acquis, to what extent tax harmonization or approximation is required in taxation, and more specifically tax expenditure issues, and how the tax expenditures are related with the tax competition and the ban on State aids in the EU. The use of tax expenditures in major EU policy areas will be stated followed by an evaluation of the treatment of the tax expenditures in the EU level.

Last but not least, the third chapter will focus on the Turkey case, opening with the review of Turkey and the EU legal documents within the tax and more specifically tax expenditure perspective. This will be followed by the legal framework that is deemed to be related with the tax expenditure notion, how they are forecasted and reported in the budgetary process. The Turkey chapter will conclude with tax expenditures in major policy areas and with an overall evaluation as per the harmonization of measures in the field of tax expenditure.

CHAPTER I

INCENTIVE AND PROTECTION AS A FORM OF TAX EXPENDITURE

The fine tuning of the fiscal policy in a world of increasing speed of technology and information in the one hand, and the pressures to sustain the fair market competition on the other hand becomes even more challenging in these years that is marked by the infamous global economic crises.

The question of whether or not to provide incentives and protection measures through fiscal stimulus packages have been debated by even the most powerful world economies in the time of downturn. The threat of falling into discriminatory taxation trap is out there for all the EU Member States and Turkey; and the EU's Code of Conduct for Business Taxation requires the utmost attention throughout the debate to utilize the tax policy tool.

The need for fiscal stimulus to fight the crises also results in significant increase in government expenditure. Thus the clear defition and survellience of incentive and protection measures in the taxation area gains importance due to the foregone tax revenue they bring on.

Recent trends in the EU in taxation area such as endeavours to establish a common European consolidated corporate tax base, reduced VAT rates, and coordination of Member States tax systems require a coherent system of tax incentives and protection measures if not fully harmonized. [12]

[12] Eurostat, 'Taxation Trends in the European Union', European Commission, 2009, p.11

This chapter of the thesis will give the definition of tax incentives and protection measures as a form of tax expenditure. The term tax expenditures will be interchangeably used for tax incentives and protections throughout the thesis. The definitions will be followed by different country experiences as how they are defined as opposed to the normative tax system and how they are reported for transparent budgetary purposes.

1.1. Definition and Classification of Tax Expenditures

Tax system is an important fiscal policy tool for the states to make income distribution more equitable and to encourage total savings and therefore economic growth.

In addition to its obvious function of raising revenue, taxation also serves to extra fiscal goals of governments through tax expenditures. Where normative or benchmark tax structure acts as the revenue raising component of the tax system, deviation from the normal tax system manifests itself as tax expenditure.

Tax incentives and protections are forms of tax expenditures, which in broad terms, are tax provisions that deviate from a normative or a benchmark tax system. Tax expenditures may take a number of forms such as exclusions, exemptions, allowance, deductions, credits, preferential tax rates, or tax deferrals. Tax holidays and tax free zones are tax expenditures subject to specific time periods or geographical areas. [13]

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[13] Z.L. Swift, 'Managing the Effects of Tax Expenditures on National Budgets', World Bank, WPS3927, p.3

Although there are numerous definitions of tax expenditure, the OECD definition as also used by the World Bank suggests that tax expenditures are concessions that fall outside a tax norm or benchmark. Tax norms include the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration and those relating to international fiscal obligations.[14] This definition however, has not led to international comparability of tax expenditures, because of differences of opinion about the benchmark tax. There are difficult, probably intractable, issues in cross-country comparisons of tax expenditures. There is no way to make such comparisons unambiguously right.[15]

Tax expenditures are commonly used both by high and low income countries. The difference however stems from how these are handled by each country. Tax expenditures are recognized as government spending by high income countries. This treatment results in endeavours to introduce tax expenditure accounting and normal budgetary controls. Low-income countries do not regard tax incentives as government spending items, in the sense that the incentives are not subject to accounting and budgetary control. On the other hand, there are transition economies and developing nations that make use of the tax incentives but without sufficient measures to ensure accountability of tax expenditures. [16]

Tax expenditures can be divided in two main groups. First are those that reduce the tax base (i.e. taxable income), with deductibles reducing the tax

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[14] V. Bratic, 'Tax Expenditures: A Theoratical Review', in Financial Theory and Practice 30 (2), p. 113-127, 2006, p.114

[15] OECD, 'Tax Expenditure in the OECD Countries', 2010, p.38

[16] Z.L. Swift, *'Managing the Effects of Tax Expenditures on National Budgets'*, World Bank, WPS3927, p.2

burden of a taxpayer by the product of the marginal tax rate and the amount of the deduction. Then there are those incentives that reduce the tax due that is the product of marginal tax rate and taxable income.[17]

Tax expenditures are instruments used by governments to favour certain groups or categories of taxpayers such as sectors, firms, individuals and to provide incentives to given economic activities or branches.[18] Tax expenditures functionally provide governments' financial assistance by not collecting tax revenue otherwise due.

Based on policy documents, papers and discussions with industry representatives, five characteristics have been identified which any tax incentive program should possess:

i. Generous enough to influence investment decisions
ii. Predictable enough to enable long-term investment planning based on the incentives
iii. Simple enough to ensure that companies understand the programs
iv. Low administrative burden to encourage even small companies to claim the benefits
v. A clear targeting profile to concentrate resources to where they have the greatest effect[19]

[17] European Centre for the Development of Vocational Training, 'Using Tax Incentives to Promote Education and Training',2009, p.20
[18] V. Bratic, *'Tax Expenditures: A Theoratical Review'*, in Financial Theory and Practice 30 (2), p. 113-127, 2006, p.114

[19] European Commission, *'Promoting innovation by tax incentives, A review of strategies and their importance to biotech growth'*, 6th Framework Program Contract No. LSSB-CT-2005-018768, 2005, p. 9

As opposed to the general provisions of tax laws, it may sometimes be necessary to consider the special circumstances of certain taxpayers and to make provisions accordingly. To meet this necessity, allowances and exceptions may be provided in tax legislation. The purpose of such allowances and exceptions is not to encourage any particular subject but to ensure the protection of the taxpayer on various grounds by not applying the general tax provisions. An example of protection measures in the tax systems of various countries may be stated as the minimum living allowance which is intended to exempt from taxing the necessary minimum income for subsistence on grounds of social justice, and which is also put in effect in the Turkish tax system as of 01.01.2008. [20]

Most common examples of the protection measures in the tax laws include:

i. Cancelling the tax, suspending the periods, and not assessing a tax penalty, in the event of a natural disaster;
ii. Rescheduling the tax debts of taxpayers who are in a difficult economic condition;
iii. Disability allowance, which is intended to enhance the competitiveness of disabled persons in relation to other citizens;
iv. Exemption from taxation of artisans, craftsmen and small farmers who are barely able to maintain themselves with their incomes. [21]

[20] Law No. 5615, *'Gelir Vergisi Kanunu ve Bazı Kanunlarda Değişiklik Yapılmasına Dair Kanun'*, OG. 04.04.2007, 26483

[21] R.Bıyık, A.Kıratlı, *'Vergi Teşvikleri ve Korumaları'*, Maliye Hesap Uzmanları Derneği, 2001, p. 6

These measures basically remove taxpayers from the scope of general rules on social or economic grounds and are intended to protect them in economic terms, sometimes through tax allowances and exceptions and sometimes through the cancellation or rescheduling of taxes which have been assessed.

1.2. Pros and Cons of Tax Expenditures

Just as normal public expenditures, tax expenditures may or may not be justifiable economic policy objectives like income redistribution or the correction of market failures. However, tax expenditures differ from direct government expenditures in a number of ways. In particular, they are frequently less visible and less clearly integrated into the budgetary process.

For these reasons, there is widespread concern that tax expenditures are more difficult to control, more vulnerable to capture by lobby groups or even corruption and therefore more likely to lead to budget imbalances and governance problems than direct government expenditures. Since issues of fiscal transparency and political accountability are particularly pressing in developing countries, tax expenditures may be particularly problematic therein. Moreover, since tax expenditures lead to more complicated tax systems, there is a concern that tax expenditures might encourage tax avoidance and tax evasion as well.[22]

All this does not imply that tax expenditures are necessarily undesirable as policy instruments. Depending on the policy objectives pursued

[22] C. Fuest, N. Riedel, *'Tax evasion, tax avoidance and tax expenditures in developing countries:
A review of the literature'*, Oxford University Centre for Business Taxation, 2009, p. 47

and the institutional environment, tax expenditures may also have advantages. [23] For instance, if a malfunctioning of the tax administration deters foreign direct investment, simply exempting investors from paying domestic corporate income taxes for some time (tax holidays) may be more effective as a way of encouraging investment than expenditure policies.

The positive aspects of tax expenditures can be summarized as below;

i. Tax expenditures encourage private sector participation in economic and social programs where government plays a main role;

ii. Tax expenditures promoting private decision making rather than government decisionmaking;

iii. Tax expenditures reduce the need for close government supervision of such spending

The negative aspects of tax expenditures mostly discussed by theoricians are summarized as follows;

i. Tax expenditures bear the risk of being ineffective as some are insufficient to override underlying economic forces or are offset by other domestic or foreign tax provisions.

ii. Once introduced, tax expenditures are often not controlled and are seldom abolished. This is why tax expenditures need incorporating in the annual budget and should be subject to the same detailed analysis that direct government expenditures have to endure during the budgetary process.

iii. Tax expenditures provide open-ended government spending, making it more difficult to estimate tax revenues.

[23] Ibid.

iv. Tax expenditures add complexity to tax laws, and increase the cost of enforcing them, and enable lobbying of certain groups.[24]

Despite the theoritical dispute whether or not tax expenditures are efficient ways to subsidize the related sector or group of people they are addressed to, “tax expenditures remain a feature of all tax systems, and many are widely believed to be effective and efficient as well as politically unassailable”.[25]

1.3. Tax Expenditure Country Experiences

Although the concept of a normative, or benchmark tax structure was first introduced in the US in the 1960s, the concern about the issue now extends across countries. The definition of what is benchmark and what is not differs widely among countries, and stemming from the difference of approach the amount of tax expenditures across countries differ widely. A selection of country definition of tax expenditures is given below.

> Austria: “Government income forgone due to exceptions from the general tax norm to the advantage of other agents with a view to their private activities performed in the interest of the general public.”
> Canada, using a broad approach: “only the most fundamental structural elements of each tax system are considered part of the benchmark.” So that the deviations from tax benchmarks are tax expenditures

[24] V. Bratic, *‘Tax Expenditures: A Theoratical Review’*, in Financial Theory and Practice 30 (2), p. 113-127, 2006, p.114

[25] OECD, *‘Tax Expenditure in the OECD Countries’*, 2010, p.24

France: “Any legislative or administrative measure may be called a tax expenditures if its application entails a loss of revenue from the State, and hence a lessening of taxpayers’ burden in comparison to that which would have resulted under the “norm”, that is the general principles of French tax law.”

Germany: tax expenditures are those tax incentives that are special deviations from the central concept of a tax norm, which involve a shortfall of receipts.

Spain: “departures from the normal tax structure which represent tax incentives or tax subsidies”.

United States Federal Government: Tax expenditures are revenue losses resulting from federal tax provisions that grant special tax relief designed to encourage certain kind of behavior by taxpayers or to aid taxpayer in special circumstances. These provisions may, in effect, be viewed as spending programs channeled through the tax system.[26]

The below tables from OECD’s 2010 Tax Expenditure Report gives a cross country data as per the share of tax expenditures in GDP and relevant tax revenue. [27] The tables depict a wide range of magnitude of tax expenditures which is a result of the differences in approaches in defining the benchmark tax system and the derogations from it in the form of tax expenditures.

[26] Z.L. Swift, *‘Managing the Effects of Tax Expenditures on National Budgets’*, World Bank, WPS3927, p.5

[27] OECD, *‘Tax Expenditure in the OECD Countries’*, 2010, p.44

Table 1

International comparison of tax expenditures (% of GDP) † Latest actual year available							
	Canada	Germany	Korea	Netherlands	Spain	UK	US
	2004	2006	2006	2006	2008	2006	2008
Purpose of tax expenditure, income tax*							
General tax relief	0,00	0,00	0,05	0,00	0,00	0,00	0,00
Low-income non-work related	0,02	0,00	0,03	0,00	0,04	0,09	0,11
Retirement	1,68	0,00	0,02	0,06	0,17	2,32	1,02
Work related	0,39	0,03	0,03	0,06	0,01	0,15	0,07
Education	0,12	0,00	0,12	0,06	0,00	0,00	0,13
Health	0,27	0,00	0,29	0,00	0,00	0,00	1,05
Housing	0,20	0,18	0,05	0,05	0,41	1,20	1,05
General Business Incentives	0,41	0,00	0,68	0,48	0,52	0,77	0,41
R&D	0,24	0,00	0,15	0,07	0,03	0,04	0,09
Specific Industry Relief	0,05	0,01	0,18	0,18	0,04	0,11	0,23
Intergovernmental relations	1,55	0,03	0,00	0,00	0,00	0,00	0,63
Charity	0,21	0,00	0,13	0,09	0,02	0,09	0,33
Other	0,02	0,00	0,02	0,01	0,17	0,12	0,09
Total	**5,16**	**0,26**	**1,75**	**1,06**	**1,41**	**4,90**	**5,21**

† For every country except for Canada and Spain, fiscal years rather than calendar years are used,
For the United Kingdom, fiscal year 2006-07 is used (from 6 April 2006 to 5 April 2007), p.224

Source: Tax Expenditures in the OECD Countries, 2010, p.226, 227

Table 2

Tax Expenditures Integrated into Budget Process (Selected countries, preliminary data)	
Australia	A separate government document.
Austria	As an annex, part of "Subsidy Report" to budget documents
Belgium	An annex to budget
Canada	Not linked to budget process, but for pre-budget consultation.
France	Appended to budget bill.
Germany	As a part of budget, called "Subsidy Report"
Italy	Not linked to budget process, nor as annex to budget document but an independent document.
Netherlands	As an annex to the budget memorandum, not directly linked to the budget but severs as an additional background information for the Parliament
United Kingdom	Not linked to budget process, nor as annex to budget document, but as part of statistical supplement to Autumn Statement (revenue)
United States	As part of annual budget documents, but is not integrated into the budget process

Source: H.P. Brixi et al,. "Tax Expenditures-Shedding Light On Government Spending Through The Tax System," the World Bank, 2003~ Swift, p.17

Tax incentives are tax expenditures. Tax expenditures are conceptually and functionally distinct from those tax provisions that have the purpose of raising revenue. They are government spending programs. Therefore, to ensure fiscal accountability, they must be analyzed in spending terms and must be integrated into the budgetary process. Tax expenditures must be audited for performance, and their information must be published to achieve fiscal transparency.

CHAPTER II

TAX EXPENDITURES IN THE EU

The EU is founded on the common market principle, and has aimed to accelerate economic growth by removing obstacles to free trade. In the framework of the single market, the aim has been the removal of barriers to free movement of goods, capital, persons, and assurance of freedom of establishment and free competition. These fundamental freedoms are achieved through the Community Principles.

Tax policy is a symbol of national sovereignty and part of a country's overall ecomic policy helping finance public spending and redistribute income. In the EU the responsibility for tax policy mainly lies with the Member States, the EU has no power to create or levy taxes. [28]

The EU's role in the area of taxation is founded on the principle of subsidiarity. The aim is not to create standardized national tax systems but rather to eliminate any obstacle that would occur in the functioning of free market competition and realization of the fundamental treaty freedoms. The intervention level of the EU changes according to market conditions and how international trade and business is conducted.

In the economic and technological conjucture of the time of Rome Treaty, introducing restrictions on discriminatory indirect taxation in the event of cross border trade of goods and services in the Community would suffice to ensure free movements of goods and services. However, in the time of globalization and information technologies, these restrictions imposed in the

[28] European Commission, *'Tax Policy in the European Union'*, 2000, p.5

field of indirect taxation results in incompatible measures to avoid harmful tax competition. Following the Communications adopted in December 2006, the Commission continued discussions with Member States in the Council on a series of initiatives to promote better co-ordination of national tax systems in the EU. The aim is to ensure that national tax systems comply with Community law and interact coherently with each other. The main objectives of a coherent and coordinated tax approach are to remove discrimitation and double taxation, prevent unintended non- taxation and abuse, and reduce compliance costs associated with being subject to more than one tax system.

Economic and Monetary Union (hereinafter; EMU) strongly relies on the harmonisation or approximation of the Member State's laws that would form an obstacle in front of the functioning of the EMU. Any discrepancy that distort the neutrality in the decision making process regarding trade, employment, establishment, and investment decisions would jeopardize the common market.[29] As tax policy plays an important role on the business decisions; the EU also needs to eliminate the free market distortions stemming from different tax policy measures regulated in the Member States.

Tax incentives and protection measures are important aspects of a country's tax policy, and the case is not different for the EU Member States either. There are numerous tax incentive and protection regulations both in the field of direct and indirect taxation in the EU Member States. Different tax systems of Member States bring forward numerous tax norms together with derogations from the benchmark tax systems via incentives and protection measures.

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[29] F.Erkan, '*Avrupa Birliği'nde Dolaysız Vergilerin Uyumlaştırılması ve Avrupa Birliği Mahkemesi'nin Bu Konudaki Rolü'*, T.C. Maliye Bakanlığı Strateji Geliştirme Başkanlığı, 2009/399, 2009, p.2

On December 1997 the Code of Conduct for business taxation (hereinafter "Code of Conduct" or "Code") was adopted after the discussions took place in 1996's informal Council of Ministers meeting in Verona. The discussions were focused on the coordinated action need in order to combat harmful tax competiton within the EU. The Commission committed itself to publishing guidelines on the State Aid rules to measures relating to direct business taxation and produced the Commission notice on the application of the State Aid rules to measures relating to direct business taxation in 1998. As stated in this notice, "the Commission's undertakings regarding State aid in the form of tax measures forms part of the wider objective of clarifying and reinforcing the application of the State aid rules in order to reduce distortions of competition in the single market. The principle of incompatibility with the common market and the derogations from the principle apply to aid "in any form whatsoever", including certain tax measures." [30] The Commission's notice emphasizes the need to examine the particular effects of aid granted in the form of tax measures and define the consequences of the aid as per the compatibility with common market.

Its virtue as stated by the former EU Commissioner for Taxation and Customs Union, Laszlo Kovacs in the Brussels Tax Forum of 2009 is as follows, "Code of Conduct on business taxation has been a successful tool to reduce unfair tax competition. It identifies potentially harmful measures and requires Member States to rollback specific business taxation measures deemed to give rise to unfair tax competition. The Code is not a legally binding instrument but it clearly has a strong political value. EU Member States have committed themselves both to ensuring that the principles of abolishing harmful tax competition are applied also in Member States' dependent or

[30] European Commission, '*Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation'*, OJ., 10.12.1998, C389/3, p.1

associated territories and to promoting these principles among third countries. This has led to a reduction in harmful measures in recent years. The Code of Conduct Group is still monitoring the implementation of the rollback in the Member States."[31]

The TFEU empowers the Community to take measures to eliminate various types of distortion that harm the proper functioning of the common market. Thus the EU bodies regulate and monitor the tax policy measures of the Member States to the extent of authority conferred by the EU acquis.

2.1. Tax Provisions in the EU Law

There are three sources of the EU law namely, primary, secondary and supplementary sources. The founding treaties on establishing and the functioning of the EU; the major laws amending the founding treaties, accession treaties are defined as the sources of primary law. Substantive rules contained in the primary sources define the scope of policies and activities within each policy area.

Regulations, directives, decisions, recommendations, opinions of European Parliament as described in the TFEU are defined as secondary law, in addition to communications, green papers, white papers, international agreements contracted by the EU, or agreements between Member States.

Finally, supplementary sources are elements of law that are not provided for by the Treaties; such as international law, general principles of law and Court of Justice (hereinafter; ECJ) jurisprudence. ECJ is the main

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[31] L.Kovacs, *'Commissioner's Opennig Speech at the Brussels Tax Forum 2009'*, 30-31 March 2009, p.4

judicial body of the EU. Articles 250 to 281 of the TFEU contain provisions relating to the ECJ. Decisions of the ECJ, established in a sense to guarantee respect for Community legislation, are among the sources that are compulsory and binding for the entire Community.

Tax policy is not among the common principles stated in the TFEU. Tax provisions take place in Articles 110 to 115 Part Three of the TFEU on the Community policies. However, taxation is closely linked with most of the fundamental EU principles, thus the interaction of these principles to tax policy is obvious. [32]

Legal basis of EU's tax policy is firstly the main source of primary law; the TFEU. Reassuring in the Communication dated 23 May 2001 "Tax policy in the European Union – Priorities for the years ahead" that there is no need for the cross border harmonisation of Member State's tax systems; the Commission yet emphasized that compliance with the fundamental freedoms and accompanying Community rules is obligatory.[33]

Community's taxation policy is regulated in the TFEU mainly under Part Three "Policies and Internal Actions of the Union". Title VII of Part Three, namely "Common rules on competition, taxation, and approximation of laws" encompasses Articles 101 to 118 and will be elaborated below following the explanation of tax aspect of fundamental freedoms of the EU as stated in the TFEU.

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[32] F.Erkan, 'Avrupa Birliği'nde Dolaysız Vergilerin Uyumlaştırılması ve Avrupa Birliği Mahkemesi'nin Bu Konudaki Rolü', T.C. Maliye Bakanlığı Strateji Geliştirme Başkanlığı, 2009/399, 2009, p.2

[33] European Commission, *'Tax policy in the European Union – Priorities for the years ahead', 2001*, p.4

The framework of this section is determined as per the tax and related articles of the TFEU in the following order:

i. Provisions for the establishment of the Customs Union and the adoption of the common customs tariff (hereinafter; CCT); regulated under Articles 28, 29, 30 and 31, prohibition of quantitative restrictions; regulated in Articles 34 and 35

ii. Ban on state aids; regulated under Article 107

iii. Prevention of discriminatory taxation; regulated in Articles 110, 111 and 112, harmonisation of indirect taxes; regulated under Article 113, approximation of direct taxes; regulated under Article 114.

2.1.1. Customs Union and Prohibition of Quantitative Restrictions

The European Customs Union, which was provided for in the Treaty of Rome, was created on 1 July 1968. Its establishment eliminated tariffs between EU Member States and introduced a Common Customs Tariff that applies to the import of goods from outside the EU. The Customs Union prefigured the advent of the Single Market fifteen years later, which lifted customs barriers within Europe, and permitted the free circulation of goods, capital and people.

The EU is the largest trading zone in the world with a population of nearly 500 million, with the customs administration of its members implementing a community customs code.[34] The true aim in the EU's control in customs is not to generate revenue for the Community, but rather to regulate

[34] European Commission, *'Customs Blueprints, Pathways to Modern Customs'*, 2007, p.8

the cross border trade of Member States.[35] The legal grounds for regulating the international trade are established in Free Movement of Goods Title of the Community Policies of the TFEU. Articles 28 to 32 encompass the provisions for free movement of goods and the Customs Union, followed by the prohibition of quantitave restriction between Member States as stated in Articles 34 to 37. These provisions establish a customs union in trade of goods via prohibition of any customs duties and charges having equivalent effect in all import and export taking place in Member States, and determine the adoption of a common customs tariff in trade with third countries.

2.1.2. Ban on State Aids

Ban on State Aids is part of the common competition policy which aims at preventing unfair competition in the EU. Instruments of the EU's competition policy are anti-trust rules, rules on mergers and State aid. EU competition policy is founded on three principles:[36]

i. Preventing the formation of monopolies (cartels) through agreements (or company mergers or takeovers) between enterprises;
ii. Preventing one or several enterprises from acquiring a dominant position in the common market through irregular ways (e.g. by making a common price agreement); and
iii. Preventing discrimination in State aids and public enterprises.

[35] F.Erkan, *'Avrupa Birliği'nde Dolaysız Vergilerin Uyumlaştırılması ve Avrupa Birliği Mahkemesi'nin Bu Konudaki Rolü'*, T.C. Maliye Bakanlığı Strateji Geliştirme Başkanlığı, 2009/399, 2009, p.24
[36] European Commission, *'Report on Competition Policy 2008'*, SEC(2009) 10004, 2009, p. 1

Tax systems in Member States have to be in line with Community's State aid rules. Article 107 of the TFEU regulates Community's ban on State Aids. According to the article, State Aids, which can also have the character of taxes, are defined as aids, which are implemented by a Member State or through State resources under any form whatsoever and which distort or threaten to distort competition by favouring certain enterprises or products.

The Commission's notice on the application of the State Aid rules to measures relating to direct business taxation emphasizes the need to examine the particular effects of aid granted in the form of tax measures and define the consequences of the aid as per the compatibility with common market. The TFEU empowers the Community to take measures to eliminate various types of distortion that harm the proper functioning of the common market. Thus the EU bodies regulate and monitor the tax policy measures of the Member States to the extent of authority conferred by the EU acquis.[37]

The European Commission has the right to adopt a binding decision for such aids to be discontinued if it concludes that they adversely affect trade between member states or that the state intervention favours certain sectors or companies in the economy. Member States must notify the Commission of the state aid they intend to introduce. A unit created within the EU Commission examines the amount of State Aids granted by each Member State and its sectoral distribution. Such aids are published on the website of the EU under the principle of transparency.[38]

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[37] European Commission, *'Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation'*, OJ., 10.12.1998, C389/3, p.1
[38] (http://ec.europa.eu/competition/ state_aid/newsletter/index.html), 19.03.2010

According to the EU Commission practice and ECJ decisions, the concept of aid includes all types of aids and direct or indirect tax advantages, and consists of four groups:

i. Cash aids, equity participations, provision of goods and services on preferential terms;

ii. Loans on favourable terms, interest reductions;

iii. Debt guarantees; and

iv. Tax reliefs, tax deferrals[39]

2.1.2.1. State Aids Provided Through the Tax Instrument

Certain sectors or products are supported with incentives provided through the tax instruments such as tax rebates, exemptions, exceptions or tax reliefs. Such support can be implemented via indirect or direct taxes. Incentives provided via indirect taxes are usually implemented by keeping the amount of tax rebates for export products higher than the amount of indirect taxes applicable to the import of similar products. In the EU, this may lead to the violation of the ban on excessive tax rebate. Where a member country introduces such a practice, it is first investigated whether the action falls under the ban on excessive tax rebate, before the investigation concerning the ban on State Aids, because the former laid down in the TFEU Article 111, allows the investigation to be finalised more rapidly than the investigation procedure concerning the ban on State Aids, laid down in Article 108. In implementation through direct taxes, total or partial waiver of the tax levied on export income may be stated.

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[39] N. Bilici, '*Avrupa Birliği Türkiye İlişkileri Genel Bilgiler, İktisadi Mali Konular, Vergilendirme'*, Seçkin Yayıncılık, 2005, p.159,160

Among the common tax incentives implemented are VAT relief, income tax and corporate income tax relief, investment allowance, accelerated depreciation, local tax advantages.

2.1.2.2. Permitted State Aids

The ban on State Aids, laid down as the general rule by the first paragraph of Article 107, is relaxed by the provisions in the following paragraphs. Second paragraph of Article 107 enumerates the State Aids compatible with the common market, such as the individual aids with a social character that are implemented for consumers and the aids provided to areas stricken by natural disasters. Third paragraph of the same article regulates state aids that "may be" compatible with the common market. The examples include aids for underdeveloped regions or regions with high unemployment rate, and state aids for projects relating to the conservation of culture and cultural treasures or to the common interests of Europe.

In addition to Article 107, the ban on State Aids is relaxed in the EU's common incentives policy framework. State Aids that:

i. concern the establishment and development of SMEs
ii. are intended to support R&D activities of enterprises
iii. aim to ensure better protection of the environment
iv. support agriculture take place among the incentives permitted by the common incentives policy of the EU.

2.1.3. Taxation

Enhancement of Internal Market and EMU is closely related with Community's tax policy. Abolition of discriminatory taxes and charges having equivalent effect on movement of goods within the Community directly contributes to free movement of goods principle. However, Community's tax rules are not only limited with abolition of taxes on the exportation or importation. The basic principle of the tax provisions of the TFEU and additional sources of law is that, Member States do keep their national sovereignty in taxation matters, with the assurance that no national tax policy would hamper the functioning of the internal market and exercise of fundamental freedoms.

The TFEU provisions 110, 111 and 112 on ban on discriminatory taxation rules that discriminatory taxation and excessive tax rebates that are intended to prevent Member States from developing measures to discourage imports and encourage exports among themselves. The TFEU Article 110 clearly bans Member States taxing imported goods more than for similar domestic goods as, measures to discourage imports. Similarly, Article 111 prohibits measures to encourage exports through excessive tax rebates. According to the article, tax rebates for exports must not be greater than tax collected on the domestic sale of the similar products. These provisions actually imply that trade between Member States are no more treated as "exports" and "imports" and those goods crossing the border do no longer lead to a taxable event. [40]

Prohibitions regarding discrimination through indirect taxes were extended by Article 112 of the TFEU to direct taxes. Article 112 suggests that measures so as to protect exports and discourage imports through direct taxation are prohibited unless the measures therein are introduced for a limited time period and approved by the qualified majority upon the Commission's proposal.

[40] European Commission, *'Tax Policy in the European Union'*, 2000, p.14

Article 113 introduces harmonisation of turnover taxes, excise duties and other forms of indirect taxes. A form of indirect tax that was introduced in 1970 in EEC, with first and second directives, VAT was harmonised in 1977, with Sixth VAT Directive[41]. With the introduction of this Directive, it was ensured that all taxable transactions were harmonised, meaning that a common basis for VAT was founded across the Community. The importance attributed to Sixth VAT Directive is not only limited with the common VAT base determined; but also the first time manifestation of abolition of tax frontiers in the Community.

Direct taxes are covered under the TFEU Article 115, which provides for the "approximation" of national laws that have a direct impact on the proper functioning of the common market by a unanimous decision to be adopted by the Council upon a proposal of the Commission and also receiving the opinions of the European Parliament and the Economic and Social Committee. As direct taxes are not deemed to be directly affecting the freedom of goods and freedom to provide services, to the extent of indirect taxes, direct taxes are left to the discretion of the Member States.

The EU Acquis provides that the Member States shall work towards the prevention of double taxation among themselves. Concerning the prevention of double taxation, there are two agreement models designed by the OECD in 1963 and the UN in 1979. These model agreements are intended to prevent double taxation on income and wealth. The EU countries have generally taken the OECD model as a basis in their agreements. In practice, agreements for the prevention of double taxation have the effect of filling the gap that remains after tax harmonisation.

[41] Sixth Council Directive, 77/388/EEC, OJ., 17.05.1977, L.145

Tax harmonisation is intended to ensure that the tax instrument remains neutral in free movement of goods and capital. Differences in the tax legislation of member countries lead to different tax burdens which constitute an obstacle to proper competition.

Direct taxes are the elements of cost and directly affect the price of goods and services. Enterprises of the countries which have lower direct taxes are in a more advantageous position in international trade. Countries with lower direct taxes have a better chance of attracting foreign investment. In general, rebates of direct taxes in exports are prohibited. Contrary to direct taxes, high indirect taxes do not have a considerable impact as they are refunded in exports. (Obviously, countries with low indirect taxes may benefit in the event of shopping by people who live near the border or by passengers. For example, in Luxembourg, where indirect tax rates are low; petrol, tobacco and alcoholic beverages are sold to attractive prices compared with the neighbouring countries. Thus, people in the neighbouring countries as Belgium, Germany and France who live near the border prefer shopping in Luxembourg.)[42]

Member States should not be able to use taxes as an instrument to enjoy a competitive advantage. Tax neutrality results in efficient use of production factors and financial resources. "Generally the tax system should strive to be neutral so that decisions are made on their economic merits and not for tax reasons".[43] When this is achieved, capital movements and choice of location by companies will take place according to pure economic

[42] N. Bilici, *'Avrupa Birliği Türkiye İlişkileri Genel Bilgiler, İktisadi Mali Konular, Vergilendirme'*, Seçkin Yayıncılık, 2005, p.155

[43] J.Furman, *'The Concept of Neutrality in Tax Policy'*, in Testimony Before the U.S. Senate Committee on Finance Hearing on "Tax: Fundamentals in Advance of Reform," April 15, 2008, 2008, p.1

considerations such as raw materials and labour. Therefore, it is essential to eliminate externalities through tax harmonisation accordingly.

Nice Summit in the year 2000, adopted the principle of majority voting in many areas where formerly unanimity was required, however it was not possible to introduce the same in the area of taxation. As long as unanimity continues, it will be more and more difficult achieving progress in tax harmonisation within the enlarging EU.

Harmonisation and approximation of tax laws as per the taxation articles in the TFEU confers the Commission to examine the Member States' tax laws and make proposals to the Council for the elimination of incongruities that hinder the proper functioning of the single market. Harmonisation process starts first in the EU Commission, which prepares a proposal concerning the tax legislation to be harmonised. The proposal is submitted to the European Parliament and the Economic and Social Committee for their opinions to be received. The Commission makes the necessary revisions in line with these opinions and submits the proposal to the EU Council. The proposal is discussed in the relevant working group of the COREPER. It is then submitted to the ECOFIN Council for approval. If adopted there, the proposal is published in the Official Journal of the EU. Following the publication, it becomes necessary to implement the directive in all member countries with priority over domestic law.[44]

Directives adopted by the EU Council are transposed to domestic law in accordance with the determined schedule. The EU bodies have done a lot of

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[44] N. Bilici, *'Avrupa Birliği Türkiye İlişkileri Genel Bilgiler, İktisadi Mali Konular, Vergilendirme'*, Seçkin Yayıncılık, 2005, p.158

intensive work and achieved the harmonisation of certain taxes. Work completed in this area is referred to as Community tax law in effect, and work not yet completed as Community tax law at the stage of proposal.[45]

2.2. Tax Expenditures in the Major EU Policy Areas

The primary goal of taxes is to raise enough revenue for government activities. Tax expenditures are preferential provisions in the tax norms that result in a conscious reduction of tax revenue, usually intended by public authorities to provide incentives or encourage particular types of behaviour such as savings, research and development activities, etc.; or concrete groups as some specific sectors, back-up to families, support to individuals or enterprises for becoming involved in education/training activities, etc[46]. These tax incentives are often introduced as alternatives to direct government spending. As discussed above, these preferential provisions can be applied through very different means, such as allowances, exemptions, credits, reliefs or deferrals.

2.2.1 Research and Development

There is widespread agreement that research and development (hereinafter; R&D) investments are beneficial to society. It is also recognised that governments can catalyse a positive development by stimulating business R&D.

[45] F.Erkan, 'Avrupa Birliği'nde Dolaysız Vergilerin Uyumlaştırılması ve Avrupa Birliği Mahkemesi'nin Bu Konudaki Rolü', T.C. Maliye Bakanlığı Strateji Geliştirme Başkanlığı, 2009/399, 2009, p.2
[46] European Centre for the Development of Vocational Training, 'Using Tax Incentives to Promote Education and Training',2009, p.20

In the Lisbon strategy, Member States committed to making structural reforms to their economies. Within this context, the European Council called for R&D investment to approach 3% of GDP by the year 2010, of which 2% should come from the private sector. The Communication "Investing in research: an action plan for Europe" highlighted that R&D plays a key role in achieving productivity gains and economic growth, but the social return of the investment is often higher than the private return to the investing firm. This market failure can be addressed through a combination of different public support measures to increase private R&D investment, such as grants, tax incentives and risk-sharing mechanisms, taking into account the specific contexts and objectives of different Member States.[47]

In order to remain competitive in research and development area among its rivals the USA and Japan, the EU gives the utmost importance to research, development and innovation. The EU's emphasis on R&D manifests in the Seventh Framework Programme of 2007-2013, where a European budget of Euro 5.5 billion is spared for R&D activity all over Europe. [48]

In its Communication to the Council, the European Parliament and the European Economic and Social Committee, namely "Towards a more effective use of tax incentives in favour of R&D", the Commission highlights tax incentives to become one of the major instruments used in many Member States to promote R&D activities. On the one hand, the Commission favours Member States' tax treatment for enhancing R&D, but on the other hand, it draws the attention to complicated and dispersed applications which risks

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[47] European Commission, *'Towards a more effective use of tax incentives in favour of R&D'*, SEC(2006)1515, 2006, p. 3

[48] EU Seventh Research Framework Programme 2007-2013, MEMO/05/114 - Brussels, 7 April 2005

"further fragmenting the European corporate fiscal landscape" leading to their less than optimal cross-border use. [49] Hence a certain level of coordination is demanded in order to foster the effective use of R&D tax incentives across the EU.

Keeping in mind the Member State's sovereignty in taxation policy, the above stated intention of promoting a more consistent and favourable tax environment for R&D needs to be compatible with the fundamental freedoms of the EU. The Commission, taking into consideration of the ECJ jurisprudence, states that R&D tax incentives should be open to all firms irrespective of size, sector, or location, avoiding both explicit and implicit territorial restrictions.

Member States' argument so as to secure tax revenue and fiscal supervision have been declined as per proportionality principle, implying that the restrictions so as to guard countries' fiscal considerations may not be deemed as proportionate to the aims sought. [50]

Apart from the fundamental freedoms, the R&D tax incentives have to comply with the State Aid rules. In order to provide for specific guidance the Commission has adopted a "Framework for State Aid for research and development and innovation", where R&D tax incentives are assessed as per their compatibility with the EU Law.[51]

[49] European Commission, *'Towards a more effective use of tax incentives in favour of R&D'*, SEC(2006)1515, 2006, p. 12

[50] Ibid., p. 5

[51] Ibid., p. 7

Member States' R&D tax incentives must conform to the fundamental Treaty freedoms and the principle of non-discrimination. In particular, any R&D tax incentive imposing restrictions on where the R&D is performed has to be scrutinised to verify compatibility with the TFEU.

When analysing an R&D tax incentive, the Commission considers both explicit and implicit territorial restrictions to be compatible with the TFEU freedoms. An example of an explicit restriction is a legal provision which restricts the benefit of an R&D tax incentive to activities performed domestically. Territorial restrictions infringe upon the freedom of establishment by excluding companies from conducting or outsourcing their R&D elsewhere in the EU.[52]

Explicit territorial restriction was the central issue in the Laboratoires Fournier ECJ case (C39/04), in which the ECJ ruled against the legality of the French "Credit d'Impôt Recherche" in force at the time. Under the French tax code (Code Général des Impôts) industrial, commercial or agricultural undertakings received a tax credit only for expenditure on R&D activity in France. The ECJ ruled that legislation restricting the benefit of a tax credit to R&D carried out in national territory infringes the principle of freedom to provide services. According to the ruling, by introducing discrimination regarding the place of establishment of the service provider, this legislation was liable to restrict cross-border activities and was directly contrary to the objective of Community R&D policy, which is to fully exploit the potential of the internal market through the removal of legal and fiscal obstacles to cooperation between undertakings. The French tax incentive was rapidly modified to comply with the ruling.[53]

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[52] Ibid., p. 4
[53] Ibid., p. 4-5

A tax incentive covering R&D costs incurred anywhere in the EU, but that is subject to administrative approval favouring domestic R&D performers over non-residents wishing to provide R&D services, when such approval is needed only for R&D costs incurred abroad, or when the administrative burden is heavier for non-resident companies; a tax incentive covering the costs of subcontracted R&D, but limiting the proportion of R&D that can be subcontracted to non-resident entities are deemed to be implicit restrictions. However, a tax incentive limiting the proportion of R&D that can be subcontracted without making any distinction between resident and non-resident subcontractors would be acceptable.[54]

For the effective usage of tax incentives in favour of R&D, the Commission invites Member States to review their tax policy as per the promotion of below issues:

i. Supporting large-scale trans-national R&D projects
ii. Young Innovative Enterprises
iii. Promoting philanthropic funding of research
iv. Cross-border mobility of researchers
v. Facilitating cross-border outsourcing of R&D
vi. R&D and VAT
vii. R&D treatment in the common consolidated corporate tax base[55]

Giving tax incentives for R&D is one attractive strategy that can efficiently stimulate investment in R&D companies with a minimum of market

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[54] Ibid., p. 5
[55] Ibid.,p.9-12

distortion and bureaucracy. There are strong arguments in favour of supporting business R&D through tax incentives. These include; overcoming the market failure in early stage financing "Young Innovative Enterprises", promoting growth and creating high-quality jobs and promoting private investment in innovative life science companies for enhancing public health benefits in the long run. [56]

A key European concern is to improve the environment for young innovative companies to grow as emphasized in the Lisbon process. It is vital to secure early-stage funding, to provide small business grants and to offer an overall growth-friendly tax environment in which venture capitalists, business angels, and companies feel comfortable with investing.

Several European States have introduced fiscal incentives for R&D. In France, R&D tax credits have existed since the 1980s, but the Young Innovative Company system launched in 2004 meant a decisive shift in policy towards a much more friendly tax environment for the most innovative firms. The UK has implemented a different system which also concentrates mainly on SMEs. Belgium, the Netherlands, Ireland and Norway are other examples of countries that have implemented fiscal incentives for business R&D; these all have their own specific profile.[57]

Tax incentives for R&D are most often available in the form of an allowance, or a credit. Although R&D expenditure represents an investment for

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[56] European Commission, *'Promoting innovation by tax incentives, A review of strategies and their importance to biotech growth'*, 6th Framework Program Contract No. LSSB-CT-2005-018768, 2005, p. 7

[57] Ibid., p. 5

the future, almost all developed countries allow complete deduction of current R&D expenditure, such as costs of materials and salaries for researchers.

A number of Member States including Spain, Denmark and Ireland, allow immediate or accelerated write off of capital expenditure such as machinery. The UK provides accelerated write off for buildings associated with the R&D work.

Many countries provide tax allowances for R&D expendenditure. This reduces the taxable profit and lowers the cost of the R&D investment. Austria, Belgium, Denmark and the UK are examples of countries that provide tax allowances. The value of these allowances for the company will depend on the level of income tax that the company is facing.

A tax credit on the other hand, is applied directly to the tax that is being paid. It is specified as a percentage of the R&D and this credit reduces the tax payable. An important difference between credits and allowances is that credits do not depend on the level of corporate tax. France, Spain, Ireland and Norway are all countries that offer tax credits for R&D, and among the OECD countries, credits are generally used more often than tax allowances.[58]

Constructing incentives for unprofitable firms thus requires special solutions. One alternative is to allow companies to carry tax credits and allowances back or forward in time, to set against profits in better years. However, carrying a tax credit forward makes it less valuable since time erodes its value. It is important to realise that young R&D-intensive firms are more in need of immediate cash flow than of reduced tax bills in the future. To support these companies, some countries provide tax incentives through an immediate

[58] Ibid.

cash payment. This is current practice in, France, the UK and Norway, for example, with variations in implementation.

The common rationale behind fiscal incentives for R&D is to increase industrial investment in R&D by lowering the cost of such investments. However, different countries have chosen strikingly different strategies to achieve a common goal. It is important to gain an overview of the practices that function best in order to improve existing systems, and guide countries that have not yet put fiscal incentives into practice. [59]

In the longer term, it is desirable to seek an EU-wide tax definition of R&D and innovation and to give such expenditure favourable tax treatment in the common consolidated corporate tax base.

2.2.2. Small and Medium Sized Enterprises

In Eurostat's 2009 statistics publication, small and medium size enterprises (hereinafter; SMEs) are referred to as "the backbone of the European economy, providing a significant source of jobs and economic growth. They were indeed the main contributor to growth between 2004 and 2006". [60] Compared to large enterprises, SMEs grew faster in number of enterprises, number of persons employed, value added and labour productivity.

SMEs typically account for a significant percentage of total employment in the OECD countries as well. Governments are therefore understandably keen to ensure that their tax policies do not place SMEs at a significant competitive disadvantage relative to other firms, including large

[59] Ibid.

[60] Eurostat, *'Statistics in focus 71/2009'*, 2009, p.1

domestic and foreign-owned firms, operating in the same market. Also recognising that many if not most large companies are created as small or medium-sized companies where only some fraction of SMEs growing to be large; governments are encouraged to ensure that policies are contributing to the growth of SMEs.

Given the important role of SMEs and concerns in some cases that SMEs may be at a competitive disadvantage with SME creation and growth impeded by one or more factors including taxation, arguments are often made that special tax incentives targeted at SMEs should be introduced, maintained or enriched.[61] At the same time, discouraging experience with the use of tax incentives may caution against their use, with revenue loss and efficiency concerns being more pronounced in some cases than in others.

SMEs role in the European economic scene is remarkable. "European SMEs represent 99.8% of all European enterprises, 67.1% of private- sector jobs, and more than 80% of employment in some industrial sectors such as the manufacture of metal products, construction and furniture."[62]

The EU's prevailing SME definition was adopted in the year 2003 for the sake of simplicity and efficiency in addressing the SME issue. [63] According to the Communication that was adopted in May 2003, medium, small and micro-sized enterprises are determined by the number of employees, the turnover upper limit and/or the balance-sheet upper limit, as follows:

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[61] OECD, *'Taxation of SMEs Key Issues and Policy Considerations'*, 2009, p.84

[62] European Commission, *'Putting Small Businesses First'*, 2008, p.7

[63] *IP/03/652*, Brussels, *0*8.052003

Table 3

SME THRESHOLDS				
ENTERPRISE CATEGORY	**HEADCOUNT**	**TURNOVER**	**OR**	**BALANCE SHEET TOTAL**
Medium-sized	< 250	≤ 50 million Euro		≤ 43 million Euro
Small	< 50	≤ 10 million Euro		≤ 10 million Euro
Micro	< 10	≤ 2 million Euro		≤ 2 million Euro

Source: *IP/03/652, 8 May 2003*

As the result of acknowledgement from Europe's highest political level, a very important step has been taken in the Community so as to introduce the "Small Business Act (hereinafter; SBA), which expressed the strong support to strengthen SMEs' sustainable growth and competitiveness, in March 2008 European Council.[64]

The SBA emphasizes that the general climate in society should encourage entrepreneurship and introduces a new principle namely; "Think Small First". With this act the political willingness to recognise the central role of SMEs in the EU economy is underlined. For the enhancement of a SME friendly EU, a set of ten principles for the guidance on conception and implementation of policies at the EU and Member State level are stated as below:

i. Create an environment in which entrepreneurs and family businesses can thrive and entrepreneurship is rewarded

ii. Ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance

iii. Design rules according to the "Think Small First" principle

iv. Make public administrations responsive to SMEs' needs

[64] European Commission, *'Think Small First, A Small Business Act for Europe'*, 2008, p.3

v. Adapt public policy tools to SME needs: facilitate SMEs' participation in public procurement and better use State Aid possibilities for SMEs

vi. Facilitate SMEs' access to finance and develop a legal and business environment supportive to timely payments in commercial transactions

vii. Help SMEs to benefit more from the opportunities offered by the Single Market

viii. Promote the upgrading of skills in SMEs and all forms of innovation

ix. Enable SMEs to turn environmental challenges into opportunities

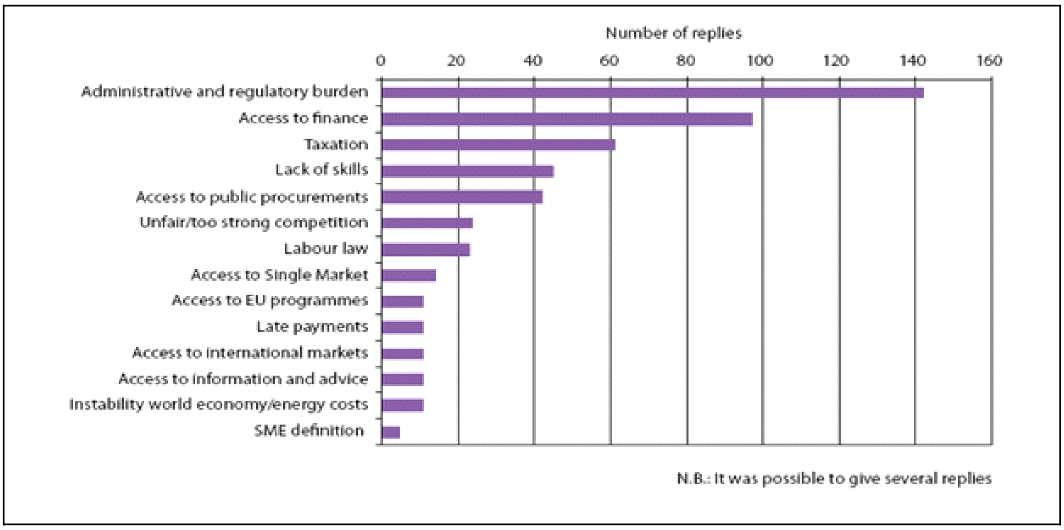
x. Encourage and support SMEs to benefit from the growth of markets

The figure below taken from Commission's report on the results of the open consultation on a Small Business Act for Europe, April 2008 shows the many challenges SMEs are faced with. [65]

[65] Ibid.

Figure 1

Most Important Problems EU SMEs are Facing



Source: *European Commission, Report on the results of the open consultation on a Small Business Act for Europe, April 2008*

Taxation is stated to be the third biggest challenge faced by SMEs. In order to achieve the goals of the Lisbon Strategy, Europe must improve European and national regulation. Better regulation has a significant positive impact on the framework conditions for economic growth, employment and productivity. This is important for the 23 million SMEs in Europe, which often have only limited resources and insufficient expertise to comply with complex rules and procedures.

Compliance with tax rules in particular can be challenging for small businesses. Tax legislation is in many cases rather complex. Tax laws are drafted in a way that allows their application to businesses of all sizes and to all types of economic transactions, even for operations that are only carried out by large corporations.

In relative terms, that is measured per employee or compared to turnover, small companies bear a disproportionate regulatory burden. On average, a company with fewer than ten employees has to face a regulatory burden that is roughly twice as high as the burden of a company with more than ten. For bigger companies, the burden per employee is only one fifth or one tenth of that of small enterprises.[66]

This effect of a disproportionate regulatory burden can also be observed in the tax area. The European Tax Survey of 2004 finds that European SMEs have a cost to tax revenue ratio (i.e. the ratio between total tax-related compliance costs and paid taxes) of 30.9%. Large companies on the other hand have a cost to tax revenue ratio of only 1.9%. Two factors are responsible for this major imbalance. First, compliance costs are to some extent fixed. Tax accounting and filing does not become more expensive just because larger figures have to be entered in the forms. Second, larger companies are more efficient in dealing with tax compliance. The higher absolute costs justify the employment of internal or external specialists and also the investment in systems to increase efficiency (e.g. software).

The main reasons for the high tax compliance costs of small businesses are stated as:

i. Frequent changes of tax laws
ii. Complexity of tax systems (tax systems are more geared to large enterprises)
iii. Existence of different tax administrations

[66] European Commission, 'Simplified Tax Compliance Procedures for SMEs', 2007, p.5

iv. Incomprehensible language of tax laws, including incomprehensible forms

v. Short and inflexible deadlines for tax payments (resulting in cash flow problems)

vi. Costs of tax consultants

vii. Registration procedures[67]

The experts have formulated best practices to be taken from experiences of the Member States.

i. A stable and predictable regulatory environment is one way to implement the "think small first" principle in taxation.

ii. The integration of registration for tax purposes within general business registration and one-stop shops can help to reduce information and compliance costs.

iii. Tailor-made information on taxation can reduce compliance costs for small businesses.

iv. Small businesses need information and assistance on changes in tax laws.

v. Binding interpretations of existing tax laws and rulings reduce uncertainty.

vi. Simplified methods for tax accounting and for establishing the tax base can reduce compliance costs for small businesses.

vii. Tax forms and reporting requirements can be adjusted to the business reality of small enterprises.

viii. The electronic filing of tax returns can speed up procedures and reduce compliance costs.

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[67] Ibid., p. 6

ix. Payment reminders and individual tax accounts can speed up payment and refund procedures.

x. Penalty procedures can be avoided or reduced by special information for young enterprises.[68]

The below set of new legislative proposals in taxation/ state aid field are introduced guided by the "Think Small First" principle.

In July 2008, the European Commission has adopted a Regulation giving automatic approval for a range of aid measures and so allowing Member States to grant such aid without first notifying the Commission, namely the General Block Exemption Regulation on State Aids (GBER). The Regulation authorises aid in favour of SMEs, research, innovation, regional development, training, employment and risk capital. The Regulation also authorises environmental protection aid, aid measures promoting entrepreneurship, such as aid for young innovative businesses, aid for newly created small businesses in assisted regions, and measures tackling problems, like difficulties in access to finance, faced by female entrepreneurs. With this regulation it is stated that "the Commission is therefore delivering on its commitments, in line with the State Aid Action Plan and the Small Business Act, to make it quicker and easier for Member States to give the right kinds of state aid." [69]

A Regulation regarding a Statute for a European Private Company (hereinafter; SPE) provides for a Statute for an SPE that could be created and operate according to the same uniform principles in all Member States. The Commission will also come forward with the necessary amending proposals to

[68] Ibid., p.40-43
[69] *IP/08/1110*, Brussels, 08.07.2008

ensure that this new company form can benefit from the existing corporate tax directives.

In the “Taxation of SMEs” report of OECD’s Tax Policy Studies, it is stated that the relative merits of tax concessions to SMEs are seen to outweigh their costs, income tax relief may be provided to SMEs in a number of ways. Alternatives of income tax incentive measures include: reductions in the statutory corporate income tax rate; accelerated depreciation allowances for capital expenditures; enhanced depreciation allowances for capital expenditures; general or targeted investment tax credits; and financing incentives.[70] In the said report the examples of tax incentives to encourage SMEs in the surveyed countries are expensing, accelerated depreciation and tax credits for investment by SMEs, special incentives for employment by SMEs, enhanced R&D tax incentives for SMEs.

EU’s new policy of “Think Small First” as introduced by the SBA, focuses on creating an SME friendly business environment and fair competition where “red carpets” replace “red tapes” for Europe’s 23 million SME’s.[71]

2.2.3. Energy and Environment

Environmental protection is one of Europe's key values. The EU has set clear policy objectives to achieve its environmental goals and has favoured market-based instruments (hereinafter; MBIs) to tackle the climate change problem. Fiscal instruments are deemed as cost effective means in which cases

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[70] OECD, ‘*Taxation of SMEs*’, No.18, 2009, p.99
[71] European Commission,‘*Putting Small Businesses First* ’, 2008, p.3

taxes and other types of fiscal instruments can usefully complement each other to achieve environmental targets.[72]

Environmental taxes can be divided into three broad categories as taxes on; energy; transport; and pollution and resource.

Energy taxes represent around three quarters of environmental tax receipts and around one twentieth of total taxes and social contributions. They correspond to 1.8% of GDP in the EU-27 in 2007. Energy taxes include taxes on energy products such as mineral oils, gas and electricity for both transport and stationary purposes.

In the EU-27, transport taxes correspond to, less than one quarter of total environmental tax revenues and 1.5% of total taxes and social contributions. The contribution of transport taxes in Ireland, Cyprus and Malta accounts for around half of environmental taxes. In Denmark, transport taxes raise revenue as energy taxes.

The pollution taxes and resource taxes raise together 4% of total environmental taxes. [73]

The introduction of environmental tax reforms gained increasing support during the 1990s. The basic idea was to shift the tax burden from the production factor of labour towards the use of natural resources and environmentally harmful goods and activities. With the publication of Jacques Delors' White Paper on Growth, Competitiveness and Employment in 1993 the idea to promote simultaneously growth, jobs and environmental protection, is

[72] European Commission, '*The role of fiscal instruments in environmental policy*', 2009, p.1
[73] Eurostat, '*Taxation trends in the European Union* ,2009, p.115

an achievement of 'double dividend'. At the same time, measures are needed to be taken to protect producers from increases in the cost of energy. Offsetting these costs increases through various tax reduction and refund schemes has been one of the main features of the 'green' tax reforms.[74]

In 1997, Commission presented a Proposal for a Council Directive for Restructuring the Community Framework for the Taxation of Energy Products. The policy context of the proposal was defined as "a single market framework enabling a revenue neutral restructuring of tax systems to sustain employment and the environment".[75] The Commission stated in the proposal that:

> The present proposal fits into an overall political context. It does not introduce a new tax, but aims to establish a new Community framework for the taxation of energy products which makes it possible to restructure national tax systems and to better attain national objectives of employment, environment, transport and energy policy, while respecting a key Community achievement: the Single Market.

It took five years to reach unanimous adoption of the Directive for restructuring the Community framework for the taxation of energy products and electricity widening the scope of the EU's minimum rate system, previously limited to mineral oils, to all energy products including coal, natural gas and electricity.[76] The Directive which was put in effect in January 2004 was designed so as to reduce the distortions of competition in the Member States due to divergent tax rates, reduce distortions of competition between mineral oils and the other energy products that were formerly untaxed, increase

[74] Ibid.

[75] European Commission, *'Restructuring the Community Framework for the Taxation of Energy Products'*, 1997, p. 4

[76] Council Directive 2003/96/EC of 27 October, 2003, p.1

the incentive to use energy more efficiently, and allow Member States to offer companies tax incentives in return for specific initiatives to reduce carbon dioxide emissions.[77]

Parallel to Jacques Delors' White Paper, debate on the Directive has encompassed labour taxation and environmental taxes simultaneously. The double dividend effect as often referred to in environment taxation policy suggests that resources attained from energy taxation would help combating unemployment via compensating for lower taxation of labour.

The EU has increasingly favoured MBI –such as indirect taxation, targeted subsidies or tradable emission rights – for such policy purposes. The more intensive use of MBI has also been advocated in the EU 6th Environment Action Programme and the renewed Sustainable Development Strategy as well as the renewed Lisbon Strategy for Growth and Jobs. The Green Paper on MIBs[78] explored further the options for a more intensive use of market-based instruments in different areas of environmental policy at both Community and national levels.[79]

Tax incentives have supported other public policies to stimulate the development of renewable energy markets and industries. Tax incentives are regarded as powerful and highly flexible policy tools that can be targeted to encourage specific renewable energy technologies to impact selected renewable energy market participants, especially when used in combination with other policy tools. Countries often combine "green" tax incentives with

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[77] http://ec.europa.eu/taxation_customs/taxation/excise_duties/energy_products/legislation/index_en.htm, 01.11.2009

[78] European Commission, 'Green Paper on market-based instruments for environment and related policy purposes', COM(2007), 2007

[79] European Commission, *'The role of fiscal instruments in environmental policy'*, 2009, p. 1

policy tools such as renewable energy quotas, goverment administered auctions for renewable energy, grants, low interest loans and funding for R&D and equipment rebates etc. Although they are generally not used alone, tax expenditures' design flexibility makes them particularly well-suited to meet needs not covered by other renewable energy policy tools.[80]

Tax deductions or tax credits are used as major tax expenditures in order to ensure the development and growth of renewable energy around the world by eliminating part or all of a tax. Tax expenditures directly reduce the cost to producers and consumers of renewable energy and the equipment used in its production. They are immediate in impact and straightforward to understand and administer. However, they can only be used to reduce the amount of taxes owed by a renewable energy company, investor, or consumer; since companies, investors, and consumers of renewable energy have varying degrees of tax liability. If the taxes owed are not sufficient to use all of the tax expenditures, their effectiveness as a policy tool to encourage investment in renewable energy will be reduced.

Thus the design of tax incentives deserves considerable attention. The flexibility of tax incentives allows them to be targeted to specific technologies and investor groups. For instance formerly strong tax incentives may be phased out as the domestic renewable industry matures and becomes self sustaining.

Most common international renewable energy tax incentives may be summarized as below.

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[80] Center for Resource Solutions, 'International Tax Incentives for Renewable Energy: Lessons for Public Policy', 2005, p.6

i. Investment tax incentives for large-scale applications provide income tax deductions or credits for some fraction of the capital investment made in renewable energy projects.

Table 4

Investment Tax Incentives: Large Scale Applications			
Country	**Tax Credit or Tax Deduction**	**Percent (%)**	**Renewable Technologies**
Belgium	Deduction	13.5	All
Canada	Deduction	100	Wind,hydro,photovoltaic
Czech Republic	Deduction	Na	All(hydrounder1MW)
Ireland	Deduction	18	Wind,hydro,solar,biomass
Korea	Credit	5	Energyefficiency
Netherlands	Deduction	13	All
Spain	Deduction	10	Solar,biomass
United States	Credit	10	Solar,geothermal

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

ii. Investment tax incentives for customer-sited applications provide tax deductions or credits are offered for some fraction of the costs of renewable energy systems or equipment installed on residences and businesses.

Table 5

Investment Tax Incentives: Customer-Sited Applications				
Country	**Sector**	**Incentive Type**	**Amount**	**Renewable Technologies**
Austria	Residential	Deduction	Up to 25%	Solar, biomass
Czech Republic	Residential, commercial	Deduction	Up to 100%	All
France	Residential	Credit	15%	All
Greece	Residential, commercial	Credit	Up to 75%	Solar
Portugal	Residential	Credit	Up to 30%	All
Spain	Residential, commercial	Credit	10%	Solar, biomass
United States	Residential, commercial, industrial	Credit	Up to 30%	All

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

iii. Production tax incentives provide income tax deductions or credits at a set rate per kilowatt-hour produced by renewable energy facilities.

Table 6

Production Tax Incentives fo Renewable Energy		
Country	**Amount per Kilowatt- hour**	**Renewable Technologies**
Finland	EURO 0.69	Wind, hydro, wood, biogas
Sweden	SEK 0.181	Wind
United States	USD 0.015	Solar, wind, biomass, waste

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

iv. Owners of land or real property used for renewable energy production facilities can have their property taxes reduced or eliminated.

Table 7

Property Tax Reductions			
Country	**Amount (%)**	**Limit (yrs.)**	**Renewable Technologies**
Czech Republic	100	5	Solar, wind, hydro, geothermal, biomass
Italy	36		Solar, wind, hydro, geothermal, biomass
Norway	100		Small hydro

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

v. VAT reductions exempt producers of renewable energy from taxes on up to 100 percent of the value added by an enterprise between purchase of inputs and sale of outputs.

Table 8

Value Added Tax Reductions		
Country	**VAT Reductions (%)**	**Renewable Technologies**
China	17 reduced to 6, 8.5, 13	Small hydro (6%), wind (8.5%), biogas (13%)
Czech Republic	22 reduced to 5	Solar, wind, hydro, biomass
Italy	20 reduced to 10	Parts for solar, wind, biomassi geothermal
United Kingdom	17.5 reduced to 5	Solar panels

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

vi. Excise (sales) tax reductions exempt renewable energy equipment purchasers from up to 100 percent of excise (sales) tax for the purchase of renewable energy or related equipment.

Table 9

Excise Tax Reductions for Renewable Energy		
Country	**Amount of Reduction**	**Renewable Technologies**
Czech Republic	100%	Bio- fuels
Italy	28%	Bio- fuels
United Kingdom	100%	Solar, wind equipment

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

vii. Import duty reductions reduce or eliminate import duties on imported equipment and materials used for renewable energy production facilities.

Table 10

Excise Tax Reductions for Renewable Energy		
Country	**Amount of Reduction (%)**	**Renewable Technologies**
Bangladesh	100%	Solar, wind
China	Wind: 82% parts, 65% turbines, PV: 30%	Wind, PV, biogas
Czech Republic	Up to 100%	All renewables
Finland	85% when duties exceed 3.7% of VAT	Bio- fuels
India	Varies	Wind turbine parts
Jamaica	83%	All renewables
Philippines	100%	Small hydro

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

viii. Accelerated depreciation allows investors in renewable energy facilities to depreciate plant and equipment at a faster rate than typically allowed, thereby reducing stated income for purposes of income taxes.

Table 11

Excise Tax Reductions for Renewable Energy			
Country	**Amount**	**Length**	**Technologies**
Belgium	10% / year	One- half of standard	All renewables
Canada	Up to 30% / year	Varies	All renewables
India	100%/ year	1 year	Wind
Luxembourg	Up to 60% / year	Varies	All renewables
Portugal	25% / year	4 years	Solar
United States	20% or money / year	5 years	Solar, wind, geothermal

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

ix. Research, development, demonstration, and equipment manufacturing tax credits are offered for up to 100 percent of the money invested by a corporation in renewable energy technology development, including the manufacturing processes.

Table 12

Tax Credits for RD&D		
Country	**Amount**	**Renewable Technologies**
RD & D Tax Credit to Renewable Energy		
Belgium	10%	Eleven renewable technologies
RD & D Tax Credit to All Industries		
Canada	35% up to C$2 million	All
France	50% of increase over 2 years average	All
Japan	20% of RD&D annual increase	All
United Kingdom	150% for small businesses	All
United States	20%	All

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

x. Tax holidays reduce or eliminate income, VAT, or property taxes for a temporary period of up to 10 years.

Table 13

Tax Holidays for Renewable Energy			
Country	**Amount**	**Length**	**Renewable Technologies**
Czech Republic	Income, property	5 years	Small hydro, heating systems
India	Income	5 years	Wind, biomass
Philippes	Income	7 years	Small hydro, others by application

Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

Additionally, tax incentives have often proven effective in encouraging private sector development of renewable energy resources. They can be designed to influence both investment decisions (supply) and consumption decisions (demand). Investment decisions of renewable energy investors and producers can be directly influenced by investment tax credits, production tax incentives, value-added tax reductions, property tax reductions, accelerated depreciation, import duty reductions, etc. All of these incentives – and others – can increase the after-tax cash flow and earnings of companies engaged in developing and operating renewable energy plants and facilities.

Residential and commercial consumption decisions for renewable energy can be directly influenced by consumer-focused investment tax incentives, sales or excise tax reductions, value-added tax reductions, import duty reductions for renewable energy equipment installed on residences and commercial buildings, taxes on conventional energy resources, etc.[81]

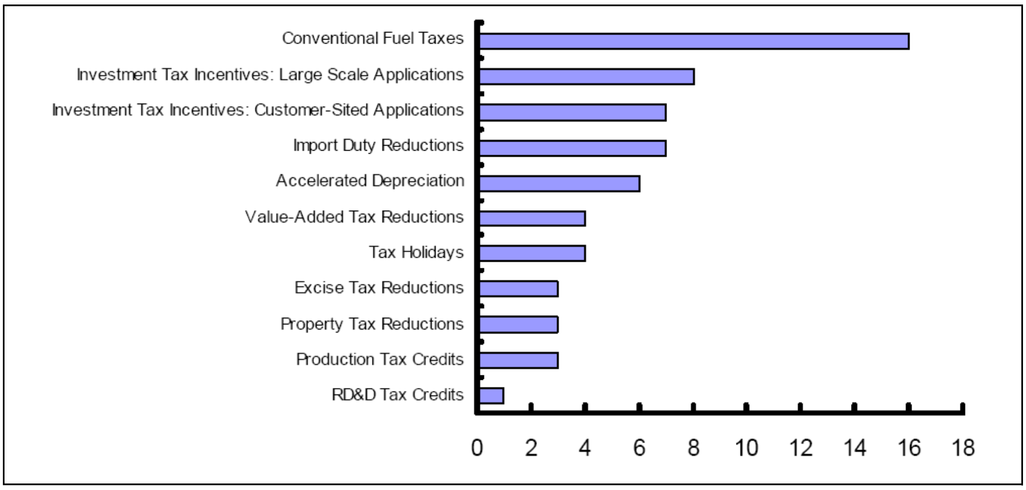
In addition, tax incentives can be specifically targeted to encourage local renewable energy manufacturing capability. Tax incentives are clearly highly flexible in regard to the types of technologies and the class of investors and consumers they can be awarded to. In fact, tax incentives observed internationally range from targeting single renewable technologies to targeting all technologies; and targeting only residential customers located in a particular geographic area to targeting all homes, businesses and corporations nationwide. [82]

[81] Ibid., p.5

[82] Ibid.

Figure 2

Number of Countries Using Each Type of Tax Incentive



Source: *International Tax Incentives for Renewable Energy: Lessons for Public Policy*

The idea of using environmental taxation to promote the EU's economic and environmental policy objectives has been endorsed also in many strategies and actions taken at the EU level. For instance, in Slovenia, a CO2 tax is applied to all energy products since 1997. In Estonia the increases of excise duties have been used to finance substantial cuts of personal income taxes in the last few years. The Czech Republic introduced an environmental tax reform in 2008, which would increase the tax rates of most energy products over the period 2008 to2012 and would use the tax revenues to support the state employment policy (i.e. double dividend effect). The lowest environmental tax revenues in relation to GDP are in Lithuania and Spain, both below 2 % in 2007.[83]

The relative homogeneity with respect to high transport fuel shares in energy taxation in the new Member States is explained by the fact that they

[83] Eurostat, *'Taxation trends in the European Union* ,2009, p.115

enjoy exemptions or at least considerably reduced rates from the minimum excise duty for the taxation of other products such as electricity and natural gas. As electricity and natural gas are hardly taxed their energy tax revenue from any other source but mineral oil taxes is very low. Poland represents the exemption with a tax rate exceeding the minimum excise duty on electricity by 10 times; it generates more than 10 % of its energy tax revenues on taxation of electricity 2007. In contrast to the new Member States, the relative importance of fuel taxes varies considerably across the old Member States. The UK levy more general taxes like a climate change levy, taxing ‘energy products for lighting, heating and power for the business and public sector’, also comprising the tax on electricity.[84]

A number of EU Member States already have some experience with using reduced VAT rates to promote environmentally preferred products. For example, from 1993 until 2004 the Czech Republic applied reduced VAT rates to a number of products including renewable energy equipment, biofuels and recycled paper. In Portugal, equipment necessary for the production and use of renewable energy resources is taxed at a 12% VAT rate (instead of 21%). Unfortunately, in both countries there is little evidence available that would allow determining the impact of VAT reduction separately from the influence of other policy instruments. However, the general impression is that the role of VAT differentiation has been minor. In the case of Portugal, one of the reasons mentioned is that natural gas and electricity are still taxed at an even lower (5%) VAT rate. In the UK a reduced VAT rate is applied to the (professional) installation of specific energy- saving materials. The uptake by paying customers (other than social housing and priority groups) has been low. One reason for this may be the fact that, since the installer buys the product for the

[84] Ibid., p.118, 119

final customer, the reduced VAT rate may not be clearly visible to the end consumer.[85]

Energy taxes were originally used purely as revenue raising instruments, without environmental purposes. Furthermore, the level of this indicator also says nothing about the achievement of environmental policy goals, as revenue increases could conceivably result from changes in the economy towards production and consumption patterns that are resource intensive and lead to even higher pollution.

In general, international experience has shown that successful renewable energy tax incentives:

i. Must be of sufficient size, scope, and length to be effective in influencing renewable energy investment and consumption decisions
ii. Should be tailored according to the stage of renewable energy industry development in a country
iii. Must be carefully designed to account for interactions with other government policies and energy market conditions
iv. May require other supportive policy initiatives to create and sustain a healthy renewable energy sector **[86]**

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[85] European Commission, *'The use of differential VAT rates to promote changes in consumption and innovation',* 2008, p. 5
[86] Center for Resource Solutions, *'International Tax Incentives for Renewable Energy: Lessons for Public Policy'*, 2005, p.31

2.2.4. Education

Europe is a knowledge society. The growing importance of lifelong learning and education issues in the EU's knowledge societies has increased public focus on the role played by tax policies in influencing and supporting enterprise and individual investment in education and training.

Investment in human resources and skills through education and training is widely recognised as one of the key engines for both economic growth and social cohesion. However, the available empirical evidence on lifelong learning shows that training opportunities are not evenly distributed and that there are multiple barriers and market failures that challenge the fulfilment of lifelong learning goal for all adults. European public policy-makers place special emphasis on lifelong learning for several reasons:

i. Raising the skills and the employability of workers at-risk can reduce social exclusion and income inequality caused by insufficient human capital;

ii. Lifelong learning sustaining policies can be a means of keeping older workers, who entered the labour force with low levels of schooling, active in the labour market, thereby sustaining European social protection;

iii. Policies targeted towards continuing vocational training and lifelong learning can be crucial to flexicurity, bringing flexibility and security by making internal labour markets more dynamic in the context of constant economic changes but at the same time offering more employment security;

iv. Lifelong learning policies are a key instrument for ensuring that workers acquire the skills necessary to learn and innovate in a new era characterised by rapid change and learning, also helping enterprises to become more competitive.[87]

The need to foster lifelong learning for all has led to the development of several joint financing schemes across Europe to stimulate investment in education and training, both for individuals and enterprises, including tax incentives. [88] Being primarily concerned with raising revenues for public sector, Member States' tax policies have been mostly not connected with education and training policies.

There are two ways which tax policy may influence investment in education and training activities; either through the tax treatment of revenue from the sale of learning services or through tax incentives on expenditure in education and training activities. The first concerns the tax treatment of revenues that education and training providers receive from those who pay for learning services. It takes the form of VAT as well as taxes on profits. The second approach to tax policy may influence investment in learning activities. [89]

Member States' tax systems reflect national preferences. This is especially true as far as direct taxes are concerned. In contrast, VAT has been harmonised since 1977, with the introduction of the Sixth VAT Directive. After a recast, the Sixth VAT Directive was replaced by the VAT Directive as from 1 January 2007. This is the major VAT legislation with the provisions of the common system of VAT in the EU, applying to all goods and services

[87] European Centre for the Development of Vocational Training, '*Using Tax Incentives to Promote Education and Training'*, 2009, p. 9

[88] Ibid.

[89] Ibid., p. 21

bought and sold for consumption within the EU. This implies that in all Member States, as part of the EU VAT system, the structure and scope that Member States apply VAT to goods and services is determined by the EU law, including education and training activities.

The VAT Directive states that certain activities of general interest linked to education and training are exempt from VAT, such as “the provision of children’s or young people’s education, school or university education, vocational training or retraining, including the supply of services and of goods closely related thereto, by bodies governed by public law having such as their aim or by other organisations recognised by the Member State concerned as having similar objects”[90]. This implies that the entities covered by the exemption can be different among the Member States as it is up to these Member States to lay down the rules on how to ‘recognise’ these organisations.

The below table depicts that education and training are usually exempt from VAT. In many countries, most education or training suppliers are exempted from VAT means that recipients benefit from lower costs. The same is true of certain culture products such as books, newspapers, and magazines, which benefit from lower VAT rates.[91]

[90] Article 131, Council Directive, 2006/112/EC, OJ.,11.12.2006, L347/1

[91] Ibid, p. 101

Table 14

Tax treatment of education and training providers in national VAT Legislation	
Member State	**Description**
Austria	Public education and training providers are exempted from VAT. Private schools and other providers of general or vocational education and training are exempted from VAT, provided that their programmes are comparable to those of public schools.
Finland	Public schools, higher education institutions and private organisations providing education by virtue of law are exempted from VAT. Education or training providers not organised by virtue of law are not allowed any exemptions and, therefore, they charge the standard VAT 22 % for their supply of services.
France	General education activities are exempted from VAT, whatever the legal status of providers. Vocational continuing training provided by public entities is exempted from VAT, with private providers of vocational continuing training exempted from VAT if they are certified by the public authority.
Denmark	Public education and training providers are exempted from VAT, and private education institutions are exempted from VAT if officially recognised; revenues are used to cover the costs and syllabus is in line with public requirements.
Ireland	The provision of education and training services in Ireland is exempted from VAT, irrespective of the public or private nature of providers.
Netherlands	Providers of education and training are exempted from VAT, irrespective of their legal status.

Source: *Ikei Research and Consultancy*

Tax incentives are considered as relevant and efficient instruments for reducing aggregate underinvestment in education and training, both by enterprises and individuals.[92]

Tax expenditures, accounted for a very small percentage of total public expenditure on education in 2003; figures range from less than 0.5% in Austria to 2% in Finland and 3% in the Netherlands.[93] Tax incentives can be regarded as helping to raise the overall involvement of enterprises and individuals in education and training, as they partly offset the disincentive of fees.[94]

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[92] Ibid.

[93] Ibid.

[94] Ibid.

In France, education incentives are designed primarily for other policy areas such as family policy or social policy. Tax incentives are considered more effective where they are used in concert with other policy measures rather than on their own.[95] The French tax credit on interest burden of loans incurred by students in higher education to finance their studies was rarely used since financial institutions were uneager to lend them money for lack of adequate guarantees. The French government has recently launched a new measure providing guarantees for students so that banks will be more inclined to grant loans.

A good practice is the Irish tax relief on tuition fees. This initiative is a complementary support measure operating alongside a much larger and better-known scheme, namely the free fees initiative, under which the government pays the cost of the tuition fees directly to the provider of eligible courses. Germany, the Netherlands and Austria have developed special tax incentives that favour not only training for current jobs but also activities preparing people for future occupational change, always from a long-term employability perspective. The aging population of these EU countries is an important motive for such measures.[96]

Tax incentives are particularly appreciated by employers and enterprises. The Austrian employers' organisations value highly the existing extra tax allowance/credit having proposed for several years increasing the allowance for small enterprises and individuals such as low-qualified workers, people returning to work after child leave, etc. Evidence from the Netherlands

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[95] Ibid., p. 13

[96] Ibid., p. 106

suggests that the Dutch payment reduction for education is widely appreciated by enterprises, with up to 80 % of eligible firms having made use of it.[97]

Cedefop's report on "Using Tax Incentives to Promote Education and Training" shows that education and training providers are treated differently in taxation according to their private/public status, which distorts the horizontal equity of the service providers.[98]

Table 17 depicts the EU Member States that provide tax incentives for expenses incurred for education and training activities. However it should be noted that deducting training expenses cannot be regarded as tax incentives as they are just one of many expense categories that an employer can claim as a deductible expense for corporate income tax purposes (i.e. benchmark/ tax norm).

Table 15

Member States where tax incentives for expenditure on education and training activities are available					
	Incentives for			Incentives for	
	Enterprises	Individuals		Enterprises	Individuals
BE			LU	X	X
BG	X		HU	X	X
CZ	X	X	MT		
DK			NL	X	X
DE		X	AT	X	X
EE	X	X	PL		
IE		X	PT		X
EL	X		RO		
ES	X		SI	X	X
FR	X	X	SK		X
IT	X		FI		X
CY	X		SE		
LV	X	X	UK		X
LT	X	X			

Source: *CEDEFOP; European Centre for the Development of Vocational Training Using tax incentives to promote education and training, 2009*

[97] Ibid., p. 101

[98] Ibid., p. 106

In countries with the highest tax rates, firms are also at a competitive disadvantage compared to providers in countries with the lowest rates. Table 14 provides an overview of the applicable rates of corporate tax income in the six analysed Member States, highlighting the differences. For example, an Irish provider will have to pay 12.5 % of profits, whereas this can be as high as 34.43 % for a French provider.[99]

Table 16

Tax rates in corporate income taxation in analysed Member States, 2008	
Member State	**Description**
Austria	Standard rate of 25 %
Finland	Standard rate of 26 %
France	15 % for enterprises with a turnover less than EUR 7,630,000, up to EUR 38,120 of profits and 33.33 % beyond this ceiling. For the remaining enterprises, between 33.33 and 34.43 %.
Denmark	15 % or 29.8 % if the trade tax and the solidarity charge are also included.
Ireland	12.5 %, although certain foreign companies have their profits taxed at 10 %.
Netherlands	20 % on the first EUR 25,000 of the total taxable profit, 23.0 % for profits in excess of EUR 25,000 but no more than EUR 60,000 and 25.5 % for profits in excess of EUR 60,000.

Source: *CEDEFOP; European Centre for the Development of Vocational Training Using tax incentives to promote education and training, 2009*

Table 17

General CIT treatment of training expenses carried out by enterprises	
Member State	**Description**
Austria	Training expenses carried out by the enterprise for employees and in the interest of the business are treated as any other professional/business expenses, reducing the profits and tax.
Finland	Employer supported training activities for maintaining/developing employees' skills in current employment position (supplementary or in-service training expenses) are fully deductible from profits. In contrast, enterprises' expenses on basic education or training for employees (degree/certificate-oriented studies) are not strictly deductible from the enterprise's profits, even if it is in the interest of the employer.
France	Enterprises can deduct education and training expenses from profits when these expenses are carried out for the purpose of the trade and they surpass the compulsory levy required by law. For the remaining enterprises, between 33.33 and 34.43 %.
Denmark	Training expenses of employers for their employees and for the interest of the employer are regarded as operating expenses, so they reduce the taxable income of the enterprise. Otherwise, the training expenses are regarded as a payment in kind for the employee and cannot be deducted by the enterprise.
Ireland	Training expenses for employees can be claimed as a deductible expense against company profits provided that the training is exclusively for the purposes of the trade. If the training is provided for the employee's own personal development, then the employer is not able to claim the cost of the training provision for tax purposes.
Netherlands	Education/training expenses carried out by the enterprise for employees can be deducted from earnings to arrive at the enterprise's profits when the purpose of these education and training activities are intended to obtain income from work, either in current or new job positions within the company.

[99] Ibid., p. 103

Source: *CEDEFOP; European Centre for the Development of Vocational Training Using tax incentives to promote education and training, 2009*

Best practice shows that tax incentives are considered more effective where they are used in concert with other policy measures rather than on their own. Tax expenditure in education and training is obviously not the backbone of the public education and training policy. Most Member States have opted for the public sector to be the most important direct funding source, as well as provider, of education and training services, usually free of direct charge or at low nominal cost. Therefore, it is agreed that tax policy should be regarded as a supplement rather than the main pillar of national education and training policies. [100]

2.2.5. Serious Economic Disturbances

Although the 2008 global financial crisis originated in the US, it spread quickly to the EU. The effects of the global economic and financial crisis have hit the EU hard with increasing force from the second half of 2008. Squeeze on credit, falls in house prices and tumbling stock markets has reinforced a decline in consumer confidence, consumption and investment. Households are under real pressure. Sectors dependent on consumer credit, like private construction and the automobile industry, have seen their markets sharply deteriorate in many Member States. The latest economic forecasts painted a pessimistic picture of close to zero growth and risks of contraction for the EU economy, with unemployment rising by 2.7 million in the next two years, on the assumption that no corrective action is taken.

[100] Ibid., p.100

Economic conditions have deteriorated further. Financial market conditions remain fragile, and are likely to be tighter for longer than expected; confidence amongst households and firms has fallen much lower than expected; the slowdown has spread to emerging economies with negative effects for European exports. [101]

The Maastricht Treaty and then the Stability and Growth Pact encouraged EU Member States to adopt a series of fiscal consolidation packages. In some Member States, the consolidation process relied primarily on restricting or scaling back primary public expenditures, in others the focus was rather on increasing taxes temporarily. [102] A number of countries took advantage of tax revenues to reduce the tax burden, through cuts in the personal income tax, social contributions, also in the corporate income tax.

The Commission took decisive and coordinated initiative to respond to the economic crisis. National governments work to address their own situations, they have been inspired by the common principles agreed for European action. Commission strengthens this platform for joint action with a Plan to contain the scale of the downturn and to stimulate demand and confidence, saving jobs and keeping large and small businesses at work while waiting for growth to return. In November 2008 the Commission presented its response to the economic situation: the European Economic Recovery Plan for Growth and Jobs calling for a timely, targeted and temporary fiscal stimulus of around Euro 200 billion to boost demand and restore confidence in the European economy.

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[101] European Commission, *'A European Economic Recovery Plan'*, 2008, p. 4
[102] Eurostat, *'Taxation trends in the European Union'* ,2009, p.5

The Plan contains a number of priority actions, grounded in the Lisbon Strategy and designed to adopt the EU economy to long-term challenges. The December European Council endorsed this Recovery plan which recommends among other things lowering the taxation of labour income to support the purchasing power, in particular for low wage earners, and the use of differentiated car taxes, to promote lower emission cars, within the context of a "European green cars initiative"[103]

Member States are encouraged to reduce the property tax for energy performing buildings and to increase private sector R&D by providing, among others, fiscal incentives.

Most of these measures are for the Member States to adopt and to implement. However, individual national measures alone are not sufficient. Coordinated efforts are needed in the EU so as to respond effectively to the challenges. This is no less true for taxation policy.

The European Economic Recovery Plan has two key pillars, and presents one underlying principle. The first pillar is a major injection of purchasing power into the economy, to boost demand and stimulate confidence. The Commission proposed, Member States and the EU agree to an immediate budgetary impulse amounting to € 200 billion (1.5% of GDP), to boost demand in full respect of the Stability and Growth Pact.[104]

The second pillar rests on the need to direct short-term action to reinforce Europe's competitiveness in the long term. “The Plan sets out a comprehensive programme to direct action to "smart" investment. Smart

[103] European Commission, ‘*European Recovery Plan’*, 2008, p.6
[104] Ibid., p.2

investment means investing in the right skills for tomorrow's needs; investing in energy efficiency to create jobs and save energy; investing in clean technologies to boost sectors like construction and automobiles in the low-carbon markets of the future; and investing in infrastructure and inter-connection to promote efficiency and innovation. At the same time, the ten Actions for Recovery included in the Plan will help Member States to put the right social and economic levers in place to meet today's challenge: to open up new finance for SMEs, cut administrative burdens and kick-start investment to modernise infrastructure. It will drive a competitive Europe ready for the low-carbon economy." [105]

The Recovery Plan puts emphasis on innovation and greening of EU investment. The EU level can act as a catalyst for such "smart action", combining EU policies and funds to help Member States maintain or pull forward investments which will create jobs, boost demand, and strengthen Europe's capacity to benefit from globalisation. In pursuing these aims, the European Economic Recovery Plan is designed to:

i. Exploit synergies and avoid negative spill-over effects through co-ordinated action;
ii. Draw on all available policy levers, fiscal policies, structural and financial market reforms and external action;
iii. Ensure full coherence between immediate actions and the EU's medium- to longer term objectives;
iv. Take full account of the global nature of the problem and shape the EU's contribution to international responses.[106]

[105] European Commission, 'European Recovery Plan', 2008, p.3
[106] Commission, *'European Recovery Plan'*, 2008, p.2

The Plan is anchored in the Stability and Growth Pact and the Lisbon Strategy for Growth and Jobs. The aim is to avoid a deep recession. The following measures of Lisbon Strategy apply as advices for Member States to combat the financial and economic crisis as well:

i. Supporting consumer purchasing power through improved market functioning
ii. Addressing immediate competitiveness problems
iii. Supporting employment and facilitating labour market transitions
iv. Reducing regulatory and administrative burdens on businesses[107]

In order to produce maximum benefits and achieve the Recovery Plan's aims of protecting people and preventing the crisis from deflecting attention from the EU's longer-term interests and the need to invest in its future, there should be a close connection between the fiscal stimulus and actions in the four priority areas of the Lisbon Strategy (people, business, infrastructure and energy, research and innovation).

a) People
1. Launch a major European employment support initiative
2. Create demand for labour

b) Business
3. Enhance access to financing for business
4. Reduce administrative burdens and promote entrepreneurship

c) Infrastructure and energy
5. Step up investments to modernise Europe's infrastructure
6. Improve energy efficiency in buildings

[107] Ibid., p.10

7. Promote the rapid take-up of "green products"

d) Research and Innovation
8. Increase investment in R&D, Innovation and Education
9. Developing clean technologies for cars and construction
10. High-speed Internet for all[108]

From the second half of 2008 onwards; governments have rushed to introduce measures to support the economy or to consolidate public finances. Member States introduce special tax measures to offset the effects of the global Financial Crisis.

The measures are quite diverse in form, scope, and budgetary impact, with some Member States introducing substantial reforms, others counting primarily on the automatic stabilizers to support economic activity although complementing this with some targeted actions. Although in the majority of cases the measures consist of discretionary tax cuts, some Member States have instead opted for revenue increasing measure owing to the lack of budgetary room for manoeuvre.

One of the most common types of measure was the direct support of household spending power by reductions in the personal income tax. This happened more often through increases in allowances than cuts in rates is expected to more directly boost private consumption. In a few cases, personal rates were even increased, but this was typically limited to higher incomes; some countries suffering from particularly pronounced drops in GDP decided to defer previously decided income tax rate cuts.Except for UK, Member States have generally not opted for temporary VAT rate cuts as a way to boost consumer spending in the short run, Finland decreased VAT on food, however. In contrast a number of Member States hiked VAT rates, curtailed the scope of

[108] Ibid., p.11-16

exemptions and reduced rates, or increased excise duties to help cover the budgetary shortfall generated by the slump. [109]

Similarly, measures to reduce the general corporate income tax rate were comparatively rare, as such a measure, while boosting confidence in the long run, has no short-term impact on loss-making companies. Nevertheless, many Member States attempted to support business investment through measures such as more generous depreciation allowances or investment tax credits; in a few cases, the cuts were targeted towards SMEs. Several Member States have opted for granting these incentives for a limited period of time only, in order to give an immediate boost to capital spending. In general, as world prices decreased with the start of the recession, Member States did not cut excise duties on energy products, although Italy cut excise duties on gas for industrial use and granted some tax and social contributions relief to road haulage operators.[110]

A wide variety of measures targeting individual sectors were introduced. In particular, several Member States tried to dampen the slump in the housing sector by granting tax reductions of various kinds; Malta took measures to reduce the tax burden on tourism; other measures aimed at supporting stock prices reducing inheritance taxes.

First sight exam of the measures introduced seems to point to a continuation of the recent trend towards greater reliance on consumption rather

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[109] Eurostat, *'Taxation trends in the European Union'* ,2009, p.11

[110] Ibid., p.18

than labour or capital taxes. This would be in line with the remarkable decline in corporate income tax rates observed since the end of the 1980s.[111]

Countries have implemented strong policy responses to the crisis. In particular, many countries have taken tax measures as part of broader fiscal stimulus packages.[112] Generally, measures have consisted in a lowering of existing taxes but the budgetary position of some countries -such as Latvia, Lithuania or Ireland (among others) - has forced those to increase taxes instead. The bulk of the measures have focused on a decrease in labour taxes, in particular by lowering personal income tax rates or increasing tax brackets. Another sizeable part of tax measures has focused on decreasing corporate income taxes, alternatively lowering the rate or the base. Interestingly, no country has acted to cut standard VAT

Table 18

Tax measures taken by EU-27 Member States		
	Lowering Taxes	**Increasing Taxes**
Labour Taxes		
Personal Income Tax	OE, DK, FI, FR, DE, HU, LV, LT, LU, MT, NL, PL, PT, SI, SK, SE	EL, IE, UK
SSC Employers	CZ, FI, HU, NL, SE	IE, RO, UK
SSC Employees	CZ, NL, SE, SK	LT, RO, UK
Withholding taxes	BE	
Deductions	OE, BG, DE, IT, PT, SK, ES, SE	
Capital Gains	RO	IE
Deferral of reform		CZ, EE
Corporate Income Tax		
CIT rate	EL, LU, PT, SE	IT, LT
Allowances	OE, BG, ES, IT, NL, DE, FR, LT, PL, PT, SI, SK	
Value-Added Tax		
Standard Rate	UK	HU, IE, LV, LT
Reduced Rates	BE, CY, CZ, FI, FR, MT, RO	HU, EE, IE, LV, LT
Property and inheritance taxes	EL, ES, IT, LU, PT	
Environmental taxes	DE, NL, RO	FI, IT, LV, LT, SI, UK

[111] Ibid., p.11
[112] European Commission's Directorate-General for Taxation and Customs Union, the 2008 Financial Crises and Taxation Policies, *2010, p. 39*

Source: *European Commission's Directorate-General for Taxation and Customs Union, the 2008 Financial Crises and Taxation Policies, 2010, p. 39*

The measures introduced varied considerably across Member States, but the substantial differences in the impact of the crisis and in Member States' budgetary and financial constraints justified a differentiated response. Nevertheless, the array of measures targeting individual sectors raises the question of whether industry-specific instruments represent an optimal response to an economy-wide slowdown. Additionally such a patchwork of incentives bears the risk of being incoherent at European level.[113]

[113] Eurostat, '*Taxation trends in the European Union'*,2009, p.11

CHAPTER III

TAX EXPENDITURES IN TURKEY

There are numerous incentive and protection measures introduced in Turkey, and it is way beyond this study's scope to encompass all of them. However this chapter focuses on the major tax incentives and protection measures in Turkey in the framework of the development axes that are stated in the Ninth Development Plan. Increasing competitiveness, employment, strengthening human development and social solidarity, ensuring regional development and increasing quality and effectiveness in public services have been determined as the development axes in order to attain country's vision. [114]

3.1. Tax (Expenditures) in Turkey and the EU Legal Documents

Following the enforcement of the Rome Treaty in January 1958, Turkey applied for association to the European Community in July 1959. With the Ankara Agreement (AA) signed in Septeber 1963, Turkey and European Economic Community (EEC) relations officially started. In 1970, the Association Council Decision (ACD) which determined the conditions, arrangements and timetables for implementing the transitional stage referred in Ankara Agreement was signed. Customs Union (CU) between Turkey and the EU started in 1 January 1996, and in the Helsinki Summit of 1999, Turkey's status as candidate country was recognized. In December 2004's Summit, it

[114] State Planning Organization, 'Ninth Development Plan 2007- 2010', OG., 01.07.2006, 26215, p. 12

was stated that Turkey has sufficiently implemented the political criteria and it could open the negotiations for the EU accession in October 2005. [115]

In June 2009, negotiations were opened in the taxation chapter. The following sections will focus on the tax provisions of the main legal documents of Turkey and the EU relations.

3.1.1. Ankara Agreement

Ankara Agreement between Turkey and the EC establishing an association for Turkey's full membership was signed in September 1963 and entered into force on 1 December 1964[116]. Ankara Agreement envisages Turkey's full membership to the EC in three stages, namely the preparatory stage, the transitional stage and the final stage.

In relation to the tax arrangements between Turkey and the EU, the general provision in Article 16 of the Ankara Agreement states that "Contracting Parties recognize that the principles laid down in the provisions on competition, taxation and the approximation of laws contained in Title I of Part III of the Treaty establishing the Community must be made applicable in their relations within the Association".

The provisions to be made applicable are those contained in the TFEU Articles 101 to 117 regarding competition; indirect taxes; and approximation of laws. More detailed provisions on taxation are introduced in Additional Protocol and Association Council Decision.

[115] Secretariat General for European Union Affairs, *'Chronology of Turkey- European Union Relations (1959 - 2009)'*, http://www.abgs.gov.tr/index.php?p=112&l=2, 20.03.2010

[116] Agreement Establishing an Association Between the European Economic Community and Turkey, 1 September 1963

3.1.2. Additional Protocol

The “preparatory stage” lasted for five years and Additional Protocol was signed in November 1970 to determine the principles for the implementation of the “transitional stage”[117]. Additional Protocol determines the conditions related to the completion of the Turkey and EU Customs Union.

Provisions which parallel those concerning taxation in the TFEU are included in various articles of the Additional Protocol which lays down the conditions for the implementation of the transitional stage.

Paragraph 2 of Article 43 of the Additional Protocol concerns state aid which is provided for in the TFEU Article 107.[118]

Paragraphs 1 and 2 of Article 44 of the Additional Protocol concern indirect taxes which contain provisions parallel to prohibition of discriminatory taxation, excessive tax rebates stipulated in the TFEU Articles 110 and 111 respectively. Article 45 of the Additional Protocol which parallels the TFEU Article 112, relates to direct taxes. Prohibition against discriminatory taxation is extended to direct taxes via this article.

On the other hand, the Additional Protocol does not include any provision corresponding to the TFEU Article 113, which concerns the harmonisation of indirect taxes. However, according to Article 48 of the Additional Protocol, which corresponds to Article 114, harmonisation will be

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[117] Additional Protocol, OJ., 31.12.1977, L361/1

[118] N. Bilici, *‘Avrupa Birliği Türkiye İlişkileri Temel Bilgiler, İktisadi Mali Konular’*, Seçkin Yayıncılık, 2007, p.166

possible upon a decision of the Association Council in matters which are not covered by the Protocol but which directly concern the functioning of the Association. [119]

In addition to the measures and prohibitions introduced concerning taxation, Additional Protocol also includes a safeguard provision (i.e. Article 60) for times of economic disturbances such that if serious disturbances occur in a sector of the Turkish economy or prejudice its external financial stabi1ity, or if difficulties arise which adversely affect the economic situation in a region of Turkey, Turkey may take the necessary protective measures. The Council of Association shall be notified immediately of those measures and of the rules for their application.

3.1.3. Association Council Decision

Customs Union negotiations that were started in 1993 resulted in the signing of the "Association Council Decision" dated 6 March 1995, effectively starting the Customs Union between Turkey and the EU as from 1 January 1996.

Tax-related provisions of the Association Council Decision are not different from the provisions contained in the Additional Protocol. The articles of the Association Council Decision that concern taxation are as follows. [120]

Article 4, provides for customs duties and charges having equivalent effect to be abolished and for no such duties and charges to be introduced in the future. It was envisaged that customs duties, charges having equivalent

[119] Ibid.

[120] N. Bilici, *'Avrupa Birliği Türkiye İlişkileri Temel Bilgiler, İktisadi Mali Konular'*, Seçkin Yayıncılık, 2007, p.167

effect, quantity restrictions, and all measures having equivalent effect intended for protection should be abolished between Turkey and the EU. (AA Art. 10/2, AP Art. 8 to 15, ACD Art. 4) In accordance with these provisions, Turkey reduced the customs duties to zero applicable to EU countries; and abolished the fund levies used to be applied as charges having equivalent effect (such as the Mass Housing Fund, the Stamp Duty, the Municipal Share, the Dock Dues, the Price Stabilisation and Support Fund, and the Mining Fund).

Articles 13 to 21 contain provisions concerning the establishment of the CCT. Turkey simultaneously adopted the CCT of the EU towards third countries (AA art. 10/2, AP art. 17 to 20, and ACD art. 13 to 21). However, for certain products as automobiles, furniture and footwear, referred to as "sensitive products" Turkey's alignment with the CCT, took place later. Turkey implemented the final reduction of customs duties for those products in the year 2000 and thus fulfilled its obligation of complete alignment with the EU CCT as from the beginning of the year 2001. In this way, Turkey and the EU Customs Union was fully achieved regarding industrial products. Turkey undertook the obligation to align with changes to be made by the EU in the CCT.

Article 49, states the freedom of the parties to make provisions in the area of direct taxation. Article 50, prohibits discriminatory indirect taxation and excessive tax rebates and stipulates the abolition of such provisions. Discriminatory taxation to imports; and excessive tax rebates in exports shall not be granted (AP Art. 44 and 45, ACD Art. 50).

Article 32 and the subsequent articles of the Association Council Decision include provisions concerning the ban on state aids. Finally, Article 51 (parallels Article 48 of the Additional Protocol) enables the alignment of legislation, regulations and administrative provisions in matters not covered by the Protocol but which directly concern the functioning of the Association. For such alignment, the Association Council will adopt decisions and make recommendations to the parties.

3.1.4. Taxation in Accession Negotiations- National Programme

At the Luxemburg Summit of December 1997, the guidelines and calendar of the latest enlargement were determined and it was decided that accession talks should be started with five Central and Eastern European countries and the Greek Cypriot Administration (under the name of the Republic of Cyprus). At the same Luxemburg Summit, Turkey was declared “eligible for full membership” but not included in the enlargement process.

As a matter of fact, while deciding at the Helsinki Summit of December 1999 to start accession talks with five other Central and Eastern European countries and Malta, the EU merely confirmed Turkey’s status as a “candidate country”. With the assignment of this status, Turkey was placed under the obligation to act in accordance with the acquis communautaire. The process of candidacy means the period during which the candidate country aligns itself with or converges to the common legislation of the EU. This process lasted for 6 to 8 years in the case of the last 10 countries.

Furthermore, the conclusions of the Copenhagen Summit held in December 2002 state: “If it is decided, upon the European Commission’s report and proposal, that Turkey fulfils the Copenhagen political criteria, the

European Council to be held in December 2004 shall without delay start negotiations between Turkey and the EU.” [121]

Following the endorsement of the Accession Partnership Document by the European Council, Turkey prepared a “national programme”, in which Turkey declared the period to which extent it would align itself with the Copenhagen criteria and the Community acquis comprising a total of 35 chapters. (The declared “national programme” was endorsed by the Council of Ministers decision dated 19 March 2001.) After Turkey prepared its legal programme, the EU redrafted the Accession Partnership Document at the Nice Summit of December 2000, and the new APD was adopted by the Council on 19 May 2003.

Following the process of candidacy that was started at the Helsinki Summit of December 1999, three Commission Reports were published in October 2004, namely the 2004 progress report, the impact report; studying the effects of Turkey’s full membership of the EU, and a recommendation.

In the “Recommendation”, the Commission stated that Turkey had fulfilled the necessary conditions, and recommended to the Council that accession negotiations should be started. Upon this report, at the Summit held in Brussels in December 2004, the Council decided to start negotiations with Turkey on 3 October 2005. [122]

[121] Council of European Union, *‘Copenhagen European Council 12 and 13 December 2002, Presidency Conclusions’*, 15917/02, 2003
[122] Secretariat General for European Union Affairs, ‘Chronology of Turkey- European Union Relations (1959 - 2009)’, http://www.abgs.gov.tr/index.php?p=112&l=2, 20.03.2010

Screening meetings on taxation chapter took place in June and July 2006. In the first series of meetings held in June 2006, the explanotary session took place with the presentation of the EU representatives on direct and indirect taxation and mutual assistance for prevention of tax evasion and avoidance, computerization of tax system and court cases regarding taxation. [123]

In the bilateral meetings that took place in July 2006, Turkey's tax representatives explained the tax administration and legal background of direct and indirect taxation in addition to the mutual assistance issues as presented by the EU representatives. Following the meetings a screening report was issued in January 2007, where it was stated that apart from the notable exception of the discriminatory elements of the taxation of alcoholic and tobacco products, Turkey had reached a satisfactory level of alignment in tax negotiations. [124]

In June 2009, negotiations are opened in the taxation chapter.

3.1.5. Progress Reports

In the 2009 Progress Report published on October 14, 2009 Commission presents detailed conclusions with respect to the political and economic developments taken place between October 2008 and September 2009. Turkey's political and economic situation analysis in terms of membership criteria is accompanied by "Turkey's capacity to assume the obligations of membership, that is, the acquis expressed in the Treaties, the secondary legislation, and the policies of the Union". [125]

[123] Screening Report Turkey, Chapter 16 Taxation, 2007, p.2

[124] Ibid., p.11

[125] European Commission, *'Turkey 2009 Progress Report'*, SEC (2009)1334, 2009, p. 9

Economic criteria as defined by the conclusions of European Council in Copenhagen summit of June 1993, requires a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union. Turkey’s evaluation as per the economic criteria takes into account the negative effects of the global economic crises, and the fiscal stimulus packages introduced between late 2008 to first half of 2009. The overall evaluation stated in the 2009 Progress Report is that despite the global economic crises challenge the economic policy essentials have been preserved however with a lack of public confidence in government’s fine tuned planning coordination and communication.

No progress is reported as per the state influence of competitiveness due to intransparent decision making process in state intervention which is reported to negatively affect the competiton and competitiveness of the whole economy especially with the increased size of state aid in certain sectors due to fiscal stimulus packages introduced to counterfeit the impacts of the global crises. [126]

Evaluation of the ability to assume the obligations of membership is structured under acquis chapters, where progress in taxation is evaluated under Chapter 16. The Report’s assessment in taxation field can be summarized as follows:

i. *Indirect taxation*: Uneven progress is reported. Partially aligned VAT legislation with the acquis. Further alignment needed for the structure, exemptions, special schemes and application of reduced rates.

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[126] Ibid., p.39

ii. *Excise duties*: Some progress is reported as per the action plan adopted in May 2009 to eliminate the discriminatory taxation on alcoholic beverages and imported tobacco. Turkey's ad volarem excise taxation does not comply with the Union's specific excise duties.

iii. *Direct taxation*: The tax burden on the minimum wage was reduced and the income tax brackets were increased. The Income Tax Law is being revised. Turkey will need to avoid introducing any measures contrary to the principles of the Code of Conduct for Business Taxation.

iv. *Administrative cooperation and mutual assistance:* The taxpayer call centre, taxpayer service centre and large taxpayer office established in the revenue administration are fully operational. Positive developments can be reported in the fight against the informal economy. An action plan for combating the unregistered economy was enacted, with action to be taken by 2010. It includes a VAT refund risk-analysis project and an e-customs system for cross-checks on people involved in VAT fraud. The revenue administration is responsible for monitoring and assessing the activities set out in this action plan.

v. *Operational capacity and computarasation:* Computerisation of the provincial tax offices was completed and the tax administration is developing IT systems with a view to interconnectivity between the Turkish IT systems and those of the EU and its Member States.

The evaluations of 2009 Progress Report are improved compared to the 2008 and 2007 Progress Reports in the same chapter, where 2008 and 2007 Reports conclude little progress for the alignment in taxation with acquis. [127]

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[127] European Commission, 'Turkey 2008 Progress Report', SEC (2008) 2699, 2008. European Commission, 'Turkey 2007 Progress Report', SEC(2007) 1436, 2007

3.2. Legal Framework in Turkey

In all contemporary constitutions, there are provisions that determine the fundamental principles of taxation. The main articles of the 1982 Turkish Constitution that regulate the principles of taxation are Articles 73 and 10. Article 73 of the Constition of the Republic of Turkey states that,

> Everyone is under obligation to pay taxes according to his financial resources, in order to meet public expenditure.
>
> An equitable and balanced distribution of the tax burden is the social objective of fiscal policy. Taxes, fees, duties, and other such financial impositions shall be imposed, amended, or revoked by law.
>
> The Council of Ministers may be empowered to amend the percentages of exemption, exceptions and reductions in taxes, fees, duties and other such financial impositions, within the minimum and maximum limits prescribed by law. [128]

Article 10 of the Constitution, states that "all individuals are equal without any discrimination before the law, irrespective of language, race, colour, sex, political opinion, philosophical belief, religion and sect, or any such considerations."[129] Hence, all individuals are equal before tax law. [130] In a way tax equity is under the protection of the Constitution.

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[128] Constitution of the Republic of Turkey; http://www.byegm.gov.tr/sayfa.aspx?Id=78; 21.03.2010

[129] Ibid.

[130] A. Baspinar, *'Tax Law and Turkish Tax System', T.C. Maliye Bakanlığı Strateji Geliştirme Başkanlığı,* 2009, p.5

3.2.1. Ninth Development Plan

Turkey's Ninth Development Plan covering the years 2007 and 2013 was approved in the Turkish Grand National Assembly in 28.06.2006[131]. The importance of the Ninth Development Plan stems from the fact that "the Plan forms the basis for the necessary documents in the EU accession process primarily the Medium Term Program and sectoral and institutional strategy documents. By ensuring coherence among these documents, which have different functions, the Plan will play an important role in directing all planning activities. Thus, it will help in establishing a common understanding and objective unity among institutions as well as constitute a basis for the highest level of utilization of the country's potential by realizing legal and institutional transformations and strengthening the plan-program budget connection". [132]

As per the economic and social developments in Turkey, it is stated in the Ninth Development Plan that "with the aim of making the tax system more efficient and simple, income and corporate tax rates were reduced, exceptions and exemptions were restricted, implementation of special consumption tax was initiated, differentiated taxation on investment instruments was abolished, an arrangement for entirely eliminating investment discounts at the end of a three year transition process was made, as an outcome of the improvement in public finance, reduction in the income tax and, in the value-added tax in some sectors was realized, and the intermediation costs on the financial sector was reduced. In addition, the revenue administration was restructured".[133]

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[131] State Planning Organization, 'Ninth Development Plan 2007- 2010', OG 01.07.2006, 26215, p.19
[132] Ibid.

[133] Ibid, p.28

However, it is also emphasized that “issues such as lack of efficient support instruments, complexity, repetition, lack of coordination and inadequacy of performance monitoring mechanisms in the incentive system maintain their importance” under the subtitle of improving the business environment.[134]

3.2.2. Medium Term Programmes

Medium Term Programmes, first of which covered the period of 2006-2008 are prepared with a view to formulate the public policies and to allocate the resources as per the country’s strategic objectives in conformity with the Law numbered 5018 on Public Financial Management and Financial Control. [135]

Tax sections of the Medium Term Programmes express the medium term agenda of Turkey’s tax authority. All of the five Medium Term Programmes starting from 2006 emphasized more or less the similar objectives of establishing an efficient and simple tax system that supports growth, investment, employment and reduce informal economy. Simplification is envisaged to be made by reassessing all tax exemptions, allowances, and deductions in the tax laws.

In 2010- 2012 Medium Term Programme under the public revenue policy objectives determination of tax expenditures’ fiscal amount is stated. In this framework in order to maintain economic growth, investment and employment and enhance the fight against informal economy, the objective of

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[134] Ibid, p.32
[135] Undersecretariat of State Planning Organization, Medium Term Programme (2006-2008), 2005/8873 dated 23/05/2005 and was published in OG., (2nd repeated) 31.05.2005, 25831, p.1

finalizing the determination of tax expenditure's fiscal amount is set among other tax measures.[136] The Public Revenue Policy section of the Plan states that;

> The main aim of the public revenue policies is to contribute to support growth, investment and employment and reduce informal economy. Encouragement of individual and institutional savings and capital accumulation has particular importance. Within this framework;
> i) Stability in implementing tax policies and foresight in taxation will be essential. Legal structure in tax legislation and implementations will be strengthened in order to maintain simplicity and stability.
> ii) The studies regarding the determination of fiscal amount of tax expenditures will be finalized.[137]

3.2.3. Tax Expenditure Budgeting

Following the 2001 financial crises in Turkey, the World Bank issued the "Turkey Public Expenditure and Institutional Review" report dated August 2001. With the contribution of representatives from Turkish Ministry of Finance, Undersecretariat of Treasury, World Bank, IMF among others, the findings of an analysis of budget and institutions of public expenditure management and public accountability were reported. For attaining fiscal transparency it is stated that,

> The use of tax exemptions will also need to be transparently disclosed. A review to estimate the size and allocation of tax expenditure should be initiated by the Ministry of Finance with a view to establishing the significance of this aspect of

[136] Undersecretariat of State Planning Organization, *'Medium Term Programme 2010- 2012'*, 2009, p. 26; Official Gazette No. 27351, 16.09.2009

[137] Ibid, p.26, 27

> fiscal support. Estimates of tax expenditure should be rationalized and transparently reported in the budget presentation.[138]

In year 2001, Turkish Ministry of Finance published the Tax Expenditure Year 2001 report, with an attempt to collect the all scattered measures that may be deemed as "tax expenditure".[139] The report was, as also stated in its foreword, a preliminary study that collects and lists the measures without presenting the nominal value of the costs associated with tax expenditures.

Tax expenditure term was introduced to the Turkish Legislation with Public Financial Management and Control Law No. 5018 which was adopted in December 2003.[140] Commission's 2004 Regular Progress Report of Turkey welcomed the adoption of the Law despite certain concerns with respect to its implementation.[141]

Nevertheless, the significance of the Law No. 5018 for this thesis mainly stems from its Article 15, where it is stated that tax expenditures due to tax exemptions, exceptions, allowances and etc would be forecasted in the budget law for the budget year and the following two years. [142]

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[138] World Bank, *'Turkey Public Expenditure and Institutional Review, Reforming Budgetary Institutions for Effective Government'*, 2001, p.51

[139] Maliye Bakanlığı Gelirler Genel Müdürlüğü, 'Vergi Harcamaları 2001 Yılı Raporu', 2001, p. 2

[140] Law No. 5018 'Kamu Mali Yönetimi ve Kontrol Kanunu', OG., 24.12.2003, 25326

[141] European Commission, *'2004 Regular Report on Turkey's progress towards accession'*, 06.10.2004, p. 156-157

[142] Law No. 5018 *'Kamu Mali Yönetimi ve Kontrol Kanunu'*, OG., 24.12.2003, 25326

In accordance with the Law No. 5018, with the Bugdet Law of 2006, a tax expenditure forecast has been prepared as part of the central government budget process. [143]

In October 2007, Ministry of Finance issued the 2007 version of the Tax Expenditure Report following the first version that was published in 2001. This report like the first report, made the definition of the tax expenditure, benchmark tax system and the methods used to forecast tax expenditures. However, what was new in the 2007 report was that, the report encompassed the tax expenditure forecast amounts as per the articles of the main tax laws in Turkey; namely Income Tax Law, Corporate Income Tax Law, VAT Law, Excise Tax Law and other laws.[144]

The 2007 Tax Expenditure Report of the Ministry of Finance forecasted a tax expenditure amount of TRY 11,952 million for the fiscal year 2007. The tax expenditure forecasts of the fiscal year 2007 annexed to Budget Laws of 2006 and 2007 however amounted to TRY 9,479 million and TRY 8,854 million respectively.

The below table summarizes the 2007 tax expenditure forecast as per the main tax laws as stated in the 2006 Budget Law[145], 2007 Budget Law[146] and 2007 Tax Expenditures Report of Ministry of Finance[147].

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[143] Law No. 5437 *'2006 Yılı Merkezi Yönetim Bütçe Kanunu'*, OG., 31.12.2005, 26040 (First Dublicate)

[144] T.C. Maliye Bakanlığı Gelir Politikaları Genel Müdürlüğü, *'Vergi Harcamaları Raporu'*; Sayı: B.07.0.GEP.10.10-2007

[145] Law No. 5437 *'2006 Yılı Merkezi Yönetim Bütçe Kanunu'*, OG., 31.12.2005, 26040 (Dublicate)

[146] Law No. 5565 *'2007 Yılı Merkezi Yönetim Bütçe Kanunu'*, OG., 29.12.2006 , 26391 (Dublicate)

Table 19

TAX EXPENDITURE FORECAST OF 2007 (TRY)			
LAW	**Budget Law 2006**	**Budget Law 2007**	**MoF Report 2007**
INCOME TAX LAW NUMBERED 193	2.845.216.075	2.798.977.169	7.107.631.294
CORPORATE INCOME TAX LAW NUMBERED 5520 FORMER LAW NUMBERED 5422)	5.918.000.000	5.318.937.183	3.173.053.321
VAT LAW NUMBERED 3065	479.017.000	482.399.905	401.807.590
EXCISE DUTY LAW NUMBERED 4760	236.900.000	254.150.000	199.588.615
OTHER	NA	NA	1.070.387.255
TOTAL	**9.479.133.075**	**8.854.464.257**	**11.952.468.075**

Source: *2006, Bugdet Law numbered 5437, OG. 31.12.2005 (dublicate), 26040*
2007 Bugdet Law numbered 5565, OG. 29.12.2006 (dublicate), 26391
2007 Tax Expenditures Report of MoF

The root cause of the differences in the figures is not known. Despite the ex-ante tax expenditure forecasts, the realized (ex-post) tax expenditures are not published.

The same broad definition of tax expenditure is made in the annexes of 2010 Budget Law presented to the Turkish Grand National Assembly[148]. According to this definition, tax expenditure stands for any concession, exception, and exemption that deviate from the standard tax system that result in a decrease in tax revenue. However, it also added that certain reductions, exceptions and exemptions may be components of this standard tax system and thus may not be evaluated as tax expenditure.

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[147] T.C. Maliye Bakanlığı Gelir Politikaları Genel Müdürlüğü, ‘Vergi Harcamaları Raporu’; Sayı: B.07.0.GEP.10.10-2007

[148] Law No. 5944 ‘2010 Yılı Merkezi Yönetim Bütçe Kanunu’, OG., 31.12.2009 , 27449 (Dublicate)

Table 20

TAX EXPENDITURE FORECAST AS PER TAX LAWS (TRY)				
LAW	2009	2010	2011	2012
INCOME TAX LAW NUMBERED 193	8.433.868.127	9.158.728.870	9.953.706.536	10.921.704.497
CORPORATE INCOME TAX LAW NUMBERED 5520	2.169.474.851	2.850.639.295	3.098.074.786	3.399.362.558
VAT LAW NUMBERED 3065	738.247.090	803.037.484	872.741.137	957.615.213
EXCISE DUTY LAW NUMBERED 4760	224.137.138	244.942.779	266.203.812	292.092.133
OTHER	2.410.032.866	1.306.317.174	1.419.705.504	1.557.771.865
TOTAL	**13.975.760.073**	**14.363.665.601**	**15.610.431.776**	**17.128.546.266**

Source: *2010 Bugdet Law numbered 5944, Official Gazette dated 31.12.2009, numbered 27449*

Following the broad explanation on what is to be called tax expenditure and not, the methodology is also explained. As per the law, the tax expenditure for years 2010, 2011, and 2012 are estimated according to the tax revenue foregone due to the existence of the measures deviated from standard tax system.

Table 21

TAX EXPENDITURES LISTED IN GENERAL BUGDET 2010	
LAW NAME AND NUMBER	NUMBER OF TAX EXPENDITURE
INCOME TAX LAW NUMBERED 193	47
CORPORATE INCOME TAX LAW NUMBERED 5520	24
VAT LAW NUMBERED 3065	11
EXCISE DUTY LAW NUMBERED 4760	10
OTHER	8
TOTAL	**100**

Source: *2010 Bugdet Law numbered 5944, Official Gazette dated 31.12.2009, numbered 27449*

The list of tax expenditure articles have been prepared in the annexes of the budget laws starting from 2006 in accordance with Law numbered 5018. Despite the long lists of tax expenditure articles of major tax laws, the forecasts are published on a summary basis. The lack of forecast made on the tax expenditures on article basis and the ex-post collection and publication of the tax expenditure figures are two drawbacks of the tax expenditure reporting affecting both the monitoring of the efficiency of tax expenditure measures and the budget transparency. However, these two drawbacks are not requirements as per the EU tax harmonization process.

3.3. Tax Expenditures in Major Policy Areas in Turkey

There are numerous tax expenditures in Turkish legislation. Looking merely at the tax laws, one cannot encompass all the tax incentives and protection measures, as a considerable number of tax expenditures are introduced in other laws as well. The lack of a comprehensive system of tax expenditures leads to complexity and ineffiecency of the overall tax system both for the taxpayers and the tax authority.

Tax expenditures are the tax measures that result in a decrease of the State's tax revenue otherwise due. As a requirement of the Competition Chapter of negotiations between the EU and Turkey, a law on the framework, monitoring, and inspection of State Aids is expected from Turkey to be enacted for alignment with the acquis.

In line with this requirement a Draft Law on the Monitoring and Inspection of State Aids (hereinafter; Draft Law) has been sent to the Turkish Grand National Assembly in February 2010. [149] The preamble of the Law states the draft has been been prepared as per the requirements stemming from Association Council Decision and Accession Partnership Document and the Competition Policy Chapter in accession negotiations.

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[149] http://www.tbmm.gov.tr/develop/owa/tasari_teklif_sd.onerge_bilgileri?kanunlar_sira_no=81453; 18.04.2010

The Draft Law determines the establishment of a State Aids Monitoring and Inspection Board and General Directorate of State Aids under the organisation of Undersecretariat of Treasury. With the powers conferred to the Board and General Directorate, the whole State Aids system of the country will be covered under a single framework that is compatible with the EU's State Aids acquis.

As stated above, the Draft Law envisages a new General Directorate of State Aids under the organisation of Undersecretariat of Treasury. This may lead to a criticism from the EU on the grounds of insufficient segregation of duties in the respect that the provider and the inspector of the State Aids is the same institution i.e. Undersecretariat of the Treasury.

Turkey's response to the global economic crises manifested in various measures including temporary VAT and Special Consumption Tax cuts for revitalisation of consumption and State's taking over certain portion of the employement burden to prevent further reduction in country's employment level.

The "Package Law" numbered 5838[150] introduced several tax measures in order to help boosting the economy among which are application of reduced corporate income tax rates on earnings to be derived from the investment made in specified sectors and regions, application of reduced corporate income tax rates in case of movement of certain types of investments to the regions specified, customs duty exemption, VAT exemption to be applicable from the Package Law's effective date of February 28, 2009.

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[150] Law No. 5838 'Bazı Kanunlarda Değişiklik Yapılması Hakkındaki Kanun', OG., 28.02.2009 , 27155 (Dublicate)

The most important amendment brought with the Law numbered 5838 is the new Article 32/A namely “Reduced Corporate Tax” annexed to Corporate Income Tax Law.[151] With the Article 32/A, the Council of Ministers is given the authority to introduce a reduced corporate income tax rate for the investments that are certified by the Undersecretariat of Treasury.

Following Law numbered 5838, a new Cabinet Decision numbered 2009/15199 on New Investment Incentive Regime is put in effect as of July 16, 2009. The decision is followed by two communiqués subsequently.

3.3.1. Investment Incentive Package of 2009

In June 2009 the long waited new incentive package was announced, then put in force with the “Council of Ministers Decree on Investment State Aids” numbered 2009/15199, in July 2009 (hereinafter; the Decree).[152]

The aim of the Decree is defined in its Article 1 as to provide incentives to direct the savings to the investments with high added value, increase production and employment, ensure continuous investment tendency and sustainable development, encourage large scale investments having high level of technology and R&D that can increase the international competitiveness, attract foreign direct investment, eliminate regional discrepencies, and support environment friendly investments and R&D activities in line with targets defined in Development Plans, Annual Plans and international agreements.[153]

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[151] Law No. 5520 *‘Kurumlar Vergisi Kanunu’* , OG., 21.06.2006, 26205
[152] Yatırımlarda Devlet YardımlarıHakkında Karar, 2009/ 15199, OG, 16.07.2009, 27290

[153] Ibid.

Six incentive elements are determined in the incentive package:

i. Reduced Corporate Income Tax Rate
ii. VAT exemption
iii. Customs Duty exemption
iv. Insurance premium employer's share support
v. Interest support
vi. Allocation of investment location

Under the incentive package, a regional classification and the definition of "big investment projects" (hereinafter; BIPs) are introduced. The six elements are attributed to the defined four regions of the country and BIPs as per the below table:

Table 22

Council of Ministers Decree on Investment State Aids	
Region	**Incentive Components**
	Customs Duty Exemption
	VAT Exemption
	Reduced Income/Corporate Tax Rate
	Social Security Premium Support (Employer's Portion)
Region I & II	Land Grant Subsidy
	Customs Duty Exemption
	VAT Exemption
	Reduced Income/Corporate Tax Rate
	Social Security Premium Support (Employer's Portion)
	Land Grant Subsidy
Region III & IV	Interest Support
	Customs Duty Exemption
	VAT Exemption
	Reduced Income/Corporate Tax Rate
	Social Security Premium Support (Employer's Portion)
Big Investment Projects	Land Grant Subsidy

Investments above TRY 50 million in twelve industries are classified as BIPs that are eligible to incentives regardless of the region the investments are made in.

BIP, regional investments and investments supported due to commonly available incentive regulations should also satisfy the minimum investment amount and minimum capacity conditions determined with regards to the industry of investment stated in the attached lists, if any.

The following section of the thesis will focus on the first three elements of the Decree that relate to tax expenditures.

3.3.1.1. Reduced Corporate Income Tax Rate

With the new Article 32/A of the Corporate Income Tax Law that is annexed to CIT Law, with Law numbered 5838, reduced corporate income tax rate mechanism is introduced for the revenues generated from the investments that are certified by the Undersecretariat of the Treasury.

As mentioned above, the reduced corporate income tax rate mechanism is provided to BIPs and industries and region specific investments. List 2 attached to the decision of the Council of Ministers states to which industries in the defined regions the relevant reduced rate incentive is provided.

The incentive amount that will be benefited related to the reduced corporateincome tax rate depends on the amount participated in investment, investment participation rate and reduced corporate income tax rate. The revenues generated trough these investments will be subject to the reduced income/corporate income tax rate until the forgone tax amount due to the applied reduced rate reaches the investment participation amount which is predetermined by the Cabinet. According to the decision numbered

2009/15199, the investment participation rates and reduced Corporate Income Tax rates by region can be summarized as below:

Table 23

Investments starting before 31 December 2010						
	Regional Investments			Big Project Investments		
Region	Investment Participation Rate (%)	Reduction Amount (%)	Reduced Corporate Income Tax rate (%)	Investment Participation Rate (%)	Reduction Amount (%)	Reduced Corporate Income Tax rate (%)
1	20	50	10	30	50	10
2	30	60	8	40	60	8
3	40	80	4	50	80	4
4	60	90	2	70	90	2

Table 24

Investments starting after 31 December 2010						
	Regional Investments			Big Project Investments		
Region	Investment Participation Rate	Reduction Amount (%)	Reduced Corporate Income Tax rate (%)	Investment Participation Rate (%)	Reduction Amount (%)	Reduced Corporate Income Tax rate (%)
1	10	25	15	25	25	15
2	15	40	12	30	40	12
3	20	60	8	40	60	8
4	25	80	4	45	80	4

According to the provisions of the recent amendment made in Article 32/A of the CIT Law, the reduced CIT rate application shall start in the accounting period when the investment starts operating, either partially or completely. The reduced rate shall be applied until the forgone tax amount due to the applied reduced rate reaches the determined investment participation amount.

The reduced corporate income tax rate shall only apply on the revenues generated through the new investment. Unlike the previous investment allowance practices, the new investment package is more restricting since the reduced rate will be applied merely to gains derived from the new investments. [154]

3.3.1.2. VAT Exemption

According to Article 3 of the Decree, VAT exemption is provided to all investments that exceed the minimum investment amounts, excluding investments made in industries that are not provided with the incentive and those that do not satisfy the required conditions set out in the decision.

3.3.1.4. Customs Duty Exemption

Article 6 of the Decree sets out the provisions related to customs duty exemption. Similar to the VAT exemption, customs duty exemption is provided to all the investments that exceed the minimum investment amounts excluding the investments made in the industries that are not provided with the incentive and the investments that do not satisfy the required conditions set out in the decision.

3.3.2. Supporting R&D Activities

The role of R&D activities in a country's development level is unassailable. Legal measures so as to enhance the R&D activities were first

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[154] Ernst & Young, New Incentive Package in 100 questions, 2009, p. 25, http://www.vergidegundem. com/Yayin.aspx?publication_id=565, 17.04.2010

introduced in Turkey, with the Law numbered 4691 on Technology Development Zones in the year 2001[155].

Technology development zones (hereinafter; TDZs) are defined as areas in which technology companies (the information sector) are located and carry out production. Universities or other research organizations are the essential elements of TDZs. The main purpose of the practice is to generate new advanced technologies with know-how of universities. Researchers and corporations are intended to collaborate in these zones. State support is also an important complement of this practice. Technology-intensive production, increased exports and accelerated foreign investment inflows, are aimed.

The provisions of Law 4691 were revised by Law 5035, adopted in 2004. Tax incentives related to TDZs as revised by Law 5035, can be grouped under three elements:

i. *Income and Corporate Income Tax Exemption:* Individuals or corporations that carry out R&D and software development activities within a TDZ are exempt from income and corporate income tax on the income derived from R&D activities until 31 December 2013. The exemption applies to TDZ Operating Companies as well. The relief is between the tax rate of 15- 35 % for income taxpayers, and 20% for corporate income taxpayers.

ii. *Income Tax Exemption of Salaries of the TDZ Personnel:* Salaries of the personnel employed in TDZ to carry out R&D and software development activities are exempt from all kinds of taxes

[155] Law No. 4691, *'Teknoloji Geliştirme Kanunu'*, OG., 06.07.2001, 24454

until 31 December 2013. As a result, these individuals are exempt from the obligation to pay income tax at the rates of 15 to 35 %; and salary stamp tax at the rate of 0.66 %.

iii. VAT Exemption: Deliveries of software (for system management, data management, internet, mobile and military command control applications etc.) developed as a result of the activities performed in TDZs is exempt from VAT until 31 December 2013.

On 1 April 2008, a new Law numbered 5746 on the Support of Research and Development Activities[156] was put in force in order to serve a broader vision and mission so as to support technological innovation and achieve a competetive economic environment with a target of reaching 2% of R&D share in GDP by the year 2023 compared to the current rate of 0.2%. [157]

According to Corporate Income Tax Law, companies that conduct R&D activities which are approved by the Council of Science and Technical Research (hereinafter; TUBITAK), universities and entities specialized in the subject of the research as “R&D activities” and fulfill the following conditions can benefit from an allowance equal to 100% of the R&D expenditures in addition to deduction of the expenditure itself.

Law numbered 5746 introduces the following tax incentives for R&D activities:

[156] Law No. 5746 *‘Araştırma Geliştirme Faaliyetlerinin Desteklenmesi Hakkında Kanun’*, OG., 12.03.2008, 26814

[157] S. Tuncer, *‘AR-GE Faaliyetlerinin Teşviki ile ilgili 5746 Sayılı Yasa’*, Yaklaşım Dergisi, 2009, p. 9

i. *R&D tax deduction:* All of the R&D expenditures incurred are deducted from the income or corporate income tax base. Additionally, for R&D centers that recruit 500 and more R&D personnel 50 percent of the increase in R&D expenditures compared to the previous year will ne deducted from corporate income tax base. The totals that were not deducted on the pertinent fiscal year due to the inadequacy of profits can be carried forward to the oncoming fiscal years.

ii. *Income Withholding Tax Incentive:* R&D and back-up personnel with PhD degrees shall be exempted from income tax at a rate of %90 of their income and %80 for the others who work at techno enterprises excluding the government officers, R&D centers, innovation and R&D projects supported by public institutes and foundations which are established by Law or international funds or executed by TUBITAK, enterprises which are using technology capital support and the ones who works on pre-competition cooperation projects.

iii. *Stamp Duty Exemption:* All documents drawn up in connection of all types of R&D and innovation activities pursuant to Law Numbered 5746 are exempt from stamp duty.

One of the major differences of the new arrangement from the TDZs practice is that, the incentives will be applicable to production activities in addition to R&D activities.

3.3.3. Temporary Tax Incentives in SME Mergers and Acquisitions

In the global turbulence of the economic and financial crises in order to boost up the local economy, Law numbered 5904 was enacted as of 3 July 2009. In the preamble of the Law, it is stated that tax systems have the flexibility to react swiftly to reach policy goals, under the changing economic, social and technological developments, and thus the law is prepared so as to support enhancement of economic activity through tax incentives.[158] Among other tax regulations, Law numbered 5904 introduced tax incentives in SME mergers and acquisitions in a period when SMEs all over the global economy are affected by the economic and financial crises and are under the threat of downsizing and bankruptcy.

As per the Temporary Article 5 of Corporate Income Tax Law as added with Law numbered 5904, the corporate income tax rate in SME mergers and acquisitions taking place until 31 December 2009, would be reduced to 5% instead of the normal rate of 20%. 5% corporate income tax rate would be applied to the earnings derived by the entity which is; annulled due to merger, in the fiscal period ending on the date of merger and, the merger is realized; in three fiscal periods including the fiscal period of the merger will be imposed.

The aim of the temporary amendment that was put into effect for the period of July and December 2009 was to help the SMEs reach economies of scale through merger and acquisitions, strengthening their financial position, and competitiveness of the SMEs. When attributing to the related article, the preamble of the Law states that, the majority of the enterpises in Turkey are categorized as family run SMEs, with little room for instutionalisation, and

[158] Law No. 5904, 'Gelir Vergisi Kanunu ve Bazi Kanunlarda Değişiklik Yapılması Hakkında Kanun', OG., 03.07.2009, 27277

poor governance due to lack of expertise and knowledge. Thus, tax incentives were introduced in order to promote merger of these SMEs so as to enhance the real sector and the competitiveness, to improve production, employment and exports with the strengthened and better managed SMEs where the income is also oriented to formal economy.

The enterprises that would benefit from the reduced corporate income tax rate are determined as follows:

i. SMEs should be established under the Turkish Commercial Code

ii. Number of employees should be between 10- 250 as stated in December 2008 declaration submitted to the Social Security Instition

iii. Turnover should not be more than TRY 25 million or company assets should be less than TRY 25 million as of 2008 fiscal year closing

Considering the enforcement and abolition dates of the amendment, the incentives measures are introduced for a very short period of barely six months which may be deemed as an inssufficiant period for realization of merger and acquisition activities to be conducted by the SMEs.

3.3.4. Free Trade Zones

Free Trade Zones (FTZ) are defined as areas outside the customs boundaries of the country with tax, duty and charge exceptions therein. The incentives provided by law are intended to enhance foreign investment and external trade, to contribute to the international competitiveness of local manufacturers by allowing them to procure inputs at the prices in world markets, to promote the development of export-oriented industries and increase exports, to increase foreign currency inflows, to create new jobs and assist in solving the problem of unemployment, and to raise economic standards through the transfer of advanced production and management techniques from abroad.

There are twenty-one FTZs in Turkey as of Febraury 2009, among which are; Istanbul Atatürk Airport, Istanbul Leather, Aegean, Mersin, Istanbul Thrace, Europe, and Bursa FTZs.

As of Decemer 2008 there are 3,620 FTZ operating licenses, with a total number of 50,641 employees in these zones. FTZ firms have reached a production and trade volume of 24 billion dollars for the year 2008. [159]

Under the FTZ Law numbered 3218, FTZs were defined as zones outside the customs line although they are within the political borders of the country.[160] A “Free Zones Implementing Regulation” has been issued to determine the implementation of the FTZ Law.

The generous tax advantages applicable in FTZs were to an important extent terminated by Law numbered 5084[161]. Tax exemptions and allowances formerly applied to all firms functioning in the FTZs were limited to production firms operating the FTZ with the Law numbered 5084.

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[159] http://www.dtm.gov.tr/dtmweb/index.cfm?action=detay&yayinID=132
&icerikID=242&dil=TR, 25.12.2009

[160] Law No. 3218, *‘Serbest Bölgeler Kanunu’* , OG., 15.06.1985, 18785

[161] Law No. 5084 *‘Yatırımların ve İstihdamın Teşviki ile Bazı Kanunlarda Değişiklik Yapılması Hakkında Kanun’*, OG., 06.02.2004, 25365

Each free zone is operated by an operating company, to which rent is paid by the businesses established there. The customs office located in the zone supervises the implementation of activities in accordance with legislation.

FTZ s are intended mainly for entry of foreign investment and technology; entry of cheap raw materials; and exports growth. Benefits include; tax advantages; good infrastructure; cheap energy; and 10-year ban on strikes and lockouts.

Operating in a FTZ provides important advantages, especially for enterprises that use imported inputs and marketing their products abroad; enterprises that operate in labour-intensive sectors; and enterprises carrying out transit trade, barter and re-exports.

Law 3218 was amended by Law 5084 and the tax advantages applicable in free zones were to an important extent terminated for enterprises to receive a licence after 06.02.2004; and the tax advantages for enterprises that received an operation licence before 06.02.2004 were limited to certain periods. Although the justification for the law stated that these amendments were being made as FTZ led to unfair competition, taxable income was transferred to FTZ (income shift) via transfer pricing (taking advantage of the absence of the direct tax liability in FTZs), and thus caused tax avoidance, and pressures from OECD, IMF and the EU were also effective in those amendments.

For all enterprises that received a licence before 06.02.2004, the income and corporation tax exceptions have been limited to the period stated in their licence as of 06.02.2004, the income tax exception for wages paid to personnel employed in the zone has been shortened to terminate on 31.12.2008, if the period stated in the licence as of 06.02.2004 expires before this date, the exception will terminate on that earlier date, the tax-duty-fee exception relating to activities undertaken in the zone terminated on 31.12.2008.

For enterprises receiving licence after 06.02.2004, the income and corporate tax exception will apply only to profits on sales of products manufactured in the FTZ. That is, tax advantages will be available only for enterprises with production licence and for their profits generated from production acitivies in the zone. Tax incentives of FTZs provided to production companies will be terminated with Turkey's accession to the EU. [162]

As per indirect taxation of entrance and exit of goods and services from and into the FTZ; no VAT and customs duties are payable on goods and services imported into the free zone from third countries. No VAT and customs duties are payable for imports from Turkey. Nor is the fund deduction made at the rate of 0.5%. Since the foreign trade regime is applicable, a VAT rebate is made in Turkey (Customs Regulation, article 518). For goods and services exports from the FTZs, the goods of EU or Turkish origin that are re- exported to the EU, Turkey or third countries, no customs duties are payable under the CCT since the free movement status of the goods does not change.

Export of goods of third county origin are to countries other than Turkey or EU member countries, again no customs duties are payable. Where these goods are shipped to Turkey or EU member countries, customs duties (compensatory taxes) are payable under the CCT. Deliveries of goods and services taking place within the FTZ are exempt from VAT and other indirect taxes.

[162] Deloitte, *'How to Do Business in, Investors' Guide Turkey'*, 2009, p.41

CONCLUSION

Starting from 1952 when the six founding countries have established the initial European Community, the EU was taken further with waves of enlargement taking place in almost every decade expanding the frontiers of the Union. Today with 27 Member States, the EU is a unique economic and political partnership aiming to create a more sustainable and innovative economy for its 500 million citizens and increase competitiveness through major policy goals of improved R&D, environment, employment, support of relatively under developed regions.

Taxation is a symbol of national sovereignity and the EU's approach has been to ensure that national tax systems do not undermine the achievement of the common market objectives.

The EU's role in conformity with the subsidiarity principle and with the legal powers conferred to the EU Institutions in the field of taxation calls for harmonization in indirect taxation measures in the event of cross border trade of goods and services. Harmonization in indirect taxation is clearly a requirement for all Member States, where any kind of tax discrimination is prohibited by virtue of the TFEU. There are no such strict prohibitions for direct taxation in the acquis. However, with the effects of globalization and development in information technologies taxation implications of international trade is far beyond the control of mere indirect tax measures. "Community activity in the direct tax area both in directives and in the case law has shown a desire to implement the Community objectives on the establishment and functioning of the common market which overcomes the reluctance to avoid entering the sphere of direct taxation, which is left to the Member States."[163]

Building on the laws enacted by the Council, rulings by the ECJ spell out in greater detail how the ban on tax discrimination the Treaty applies and define a number of important concepts inherent in tax directives. Both in the field of indirect and direct taxation, ECJ has been called upon to rule on the application of the Treaty articles covering the fundamental freedoms, all of which prohibit any discrimination, including tax discrimination on the basis of nationality. [164]

ECJ decisions are especially important in direct taxation as the acquis does not require harmonization in direct taxes. ECJ decisions have been thus playing a crucial role for Member States to act in conformity with the ECJ rulings despite the fact that the ECJ decisions are binding for the parties of the related case. ECJ's active role in direct taxation has also been referred to "negative harmonization" in the sense that the beneficiaries of the rulings are being limited to the parties of the court case and that the taxpayers who do not open a court case are not affected by the ECJ rulings. [165]

Code of Conduct for business taxation is an important reference for Member States to roll back and freeze their tax measures that would deem to result in harmful tax competition, thus undermining the free competition, the common market and distorting the fundamental freedoms.

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[163] J.Walters, 'The Role of EC Law in the UK Direct Tax', Speech at The Wyman Debate at the ICAEW, 07.07.1997

[164] European Commission, 'Tax Policy in the European Union', 2000, p.8

[165] F.Erkan, 'Avrupa Birliği'nde Dolaysız Vergilerin Uyumlaştırılması ve Avrupa Birliği Mahkemesi'nin Bu Konudaki Rolü', T.C. Maliye Bakanlığı Strateji Geliştirme Başkanlığı, 2009/399, 2009, p.186

Apart from the initial purpose of generating income for government spending, tax policy also serves as an important fiscal poliy tool to redistribute income and support or protect certain groups, sectors, regions in an economy.

Tax expenditures are utilized very commonly both in developed and developing economies. The pervasiveness of tax expenditures is also true for the EU Member States. Tax measures of Member States have to be in compliance with the Community's State aid measures; however this does not suggest that all tax expenditures are deemed to be unacceptable as per Community rules. On the contrary, the EU encourages Member States' tax systems to become more employment friendly, and suitable with the wider policy goals towards a greener and more innovative economy.

Tax expenditures have both weaknesses and strengths when it comes to their evaluation as a form of fiscal expenditures in the context of the whole tax system. Rigourous debates are made on tax expenditures concentrating on the concept of neutrality, simplicity, transparency and efficiency of the tax and budgetary systems. Many countries utilise tax expenditures, however the way these tax expenditures are treated and shown in budgetary processes differs widely.

Additionaly, tax policy played an important role in the considerations of many of the world economies when designing the options to stimulate economic growth in the time of the recent economic and financial crises. Subsidizing the financial sector and introducing fiscal stimulus packages in fighting the crises result in increase in government expenditures.

The Customs Union established in 1996 and recognition of Turkey's status as a candidate country for the EU membership in 1999 aims to establish free movement of goods, services and people together with the alignment of the acquis both in direct and indirect taxation areas. Turkey's tax incentives and protection measures must be aligned with Community's requirements accordingly.

With the start of the accession negotiations on October 2005, the EU and Turkey accepted the Negotiating Framework where taxation was one of the 35 chapters of accession negotiation. In this respect the screening and detailed screening meetings for taxation were held in June and July 2006. Three years later in June 2009, the negotiations were opened in taxation chapter. For the negotiations to be finalized, Turkey needs to adopt and implement the acquis in the field of taxation.

Turkey's tax incentives and protections measures need to be in line with the tax acquis as these measures are important tools that affect the economic decision making processes in competition, investment, employment policies. There are numerous tax expenditures in Turkey. Tax incentives and protections take place in direct and indirect tax laws and also many tax expenditures are introduced in other laws as well.

The list of tax expenditure articles have been prepared in the annexes of the budget laws starting from 2006 in accordance with Law numbered 5018. Despite the long lists of tax expenditure articles of major tax laws, the forecasts are published on a summary basis. The lack of forecast made on the tax expenditures on article basis and the ex-post collection and publication of the tax expenditure figures are two drawbacks of the tax expenditure reporting affecting both the monitoring of the efficiency of tax expenditure measures and the budget transparency. However, these two drawbacks are not requirements as per the EU tax harmonization process.

A Draft Law on the Monitoring and Inspection of State Aids has been sent to the Turkish Grand National Assembly in February 2010. The Draft Law determines the establishment of a State Aids Monitoring and Inspection Board and General Directorate of State Aids under the organisation of Undersecretariat of Treasury. With the powers conferred to the Board and General Directorate, the whole State Aids system of the country will be covered under a single framework that is planned to be compatible with the EU's State Aids acquis.

It is understood that tax expenditures will also be encompassed within the framework of the overall State Aids system. Introducing the new governmental body under the organisation of Undersecretariat of Treasury may lead to a criticism from the EU on the grounds of insufficient segregation of duties in the respect that the provider and the inspector of the State Aids is the same institution i.e. Undersecretariat of the Treasury.

The aim of this thesis was to focus on the tax expenditures in the EU and Turkey. In today's economic and international trade conjucture national tax systems have their limits in the dealing with the challenges of globalization and development of information technologies. Enhanced cooperation in tax matters, transparency, and fight against harmful tax competition are tried to be established in order to secure financing of the goverment budgets. Tax expenditures are undeniably pervasive and important aspects of tax systems that also have a capacity of changing the neutrality of tax systems in favour of certain economic groups, sectors or activities. The EU requires that such measures taken by Member States to be in conformity with the free competition and common market and not to hamper the functioning of the fundamental freedoms.

Looking at Turkey’s National Programmes, Medium Term Programmes, it may be concluded that the agenda of the Turkish tax authority is in line with the requirements of the EU in the field of tax harmonisation. However, perseverence in enforcement and implementation of the necessary legislation is crucial to fulfil the requirements for closing the taxation chapter of negotiations.

The taxation chapter of the 2009 Progress Report states uneven progress in indirect taxation. Further alignment is needed in VAT for the structure, exemptions, special schemes and application of reduced rates. As per the excise duties some progress is reported regarding the elimination of discriminatory taxation on alcoholic beverages and imported tobacco. Turkey’s need to avoid introducing any measures contrary to the principles of Code of Conduct is emphasized in direct taxation area.

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