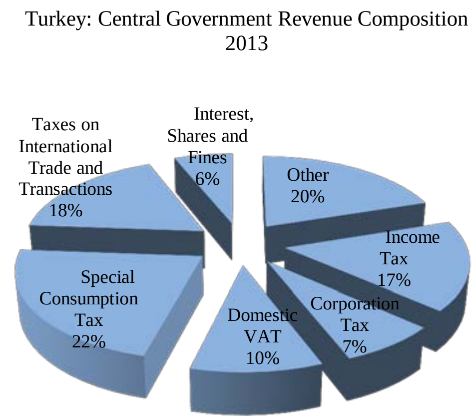
Focus Note on Tax Policy and Sustainable Growth

Turkey receives a large and growing share of its fiscal revenues from consumption-based taxes. This was not always the case. During the last decade, the composition of tax revenues shifted dramatically toward those based on consumption, with indirect taxes now making up over 50 percent of total central government tax receipts and almost 13 percent of GDP (Figure 1). Accordingly, Turkey has the second highest ratio of indirect taxes to total revenues among the OECD economies after Chile[1]. The increase in consumption taxes can be explained both by increases in tax rates on consumption goods (including the special consumption tax hikes introduced in 2013) and by the strength of domestic demand over the last decade. While revenue performance has been strong over the past decade, this is unlikely to continue for two reasons. First, the structure of revenues is sensitive to domestic demand slowdowns and second, further rate hikes may risk base erosion.

Figure 1. Turkey: Revenue Composition



Moreover, the reliance on consumption based taxes could complicate government efforts to raise national savings rates. The Tenth National Development Plan envisages a shift in Turkey's growth model away from the reliance on foreign financed domestic demand growth. A more domestically financed growth model with a higher national saving rate would reduce volatility and engender more sustainable economic growth. However, given the structure of taxation an increase in private savings driven by a reduction in domestic consumption would negatively affect public savings because of a decline in consumption based tax revenues. Recent work by the World Bank 2014[2] models the implications of more domestically financed growth and finds that the fiscal deficit could increase to 4.5 percent of GDP or more in the medium-term if the financing of growth shifts decisively to domestic savings. It is thus not clear if a more domestically financed growth model is compatible with fiscal sustainability. By the same token, a greater public savings effort would need to accompany private savings to ensure external balance.

Changes in the tax system could help support more domestically financed growth while maintaining fiscal prudence. Labor in the formal sector is highly taxed through both payroll taxes and high levels of indirect taxation on private consumption. Capital on the other hand is taxed at much lower effective rates. According to World Bank simulations, a relatively small increase in the effective capital income tax rate from 3.3 percent to 5 percent – which is better thought of as an improvement in enforcement of corporate income tax collection – can offset the decline in indirect tax revenue coming from higher private saving rates. In such a scenario, Turkey could grow faster with higher domestic saving and continued fiscal prudence. Additionally,

[1] OECD Taxation Database (2012)

[2] World Bank, 2014, "Turkey in Transition: Time for a Fiscal Policy Pivot?," Public Finance Review, Report No. 85104-TR (Washington, DC: World Bank). http://www.worldbank.org/content/dam/Worldbank/Feature%20Story/ECA/Turkey/turkey-pfr-report-21-may-2014.pdf

one element of more *effective* capital taxation, namely increased property tax revenues, would promote a better allocation of investment to more productive sectors and away from housing. This too would support the government's ambition for a less volatile economic growth path.

Figure 2. 'Domestically Finance Growth Scenario'

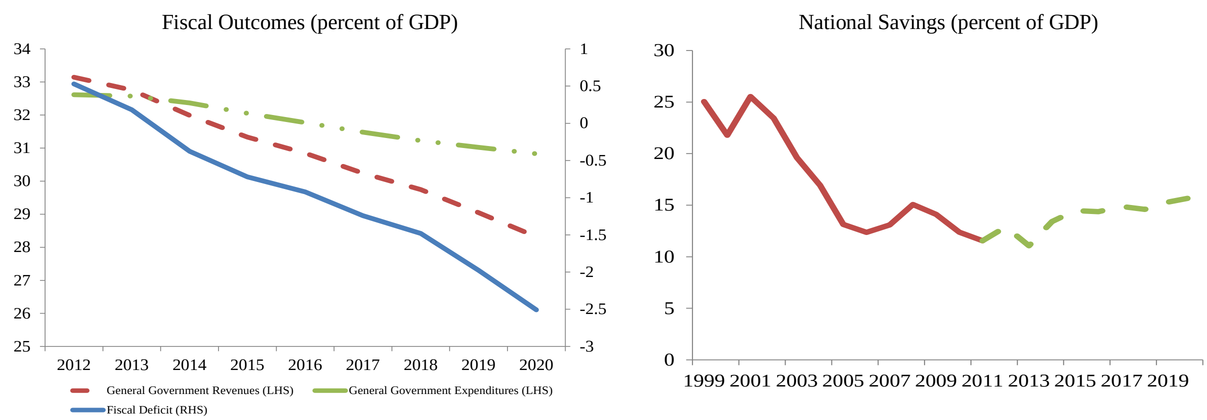
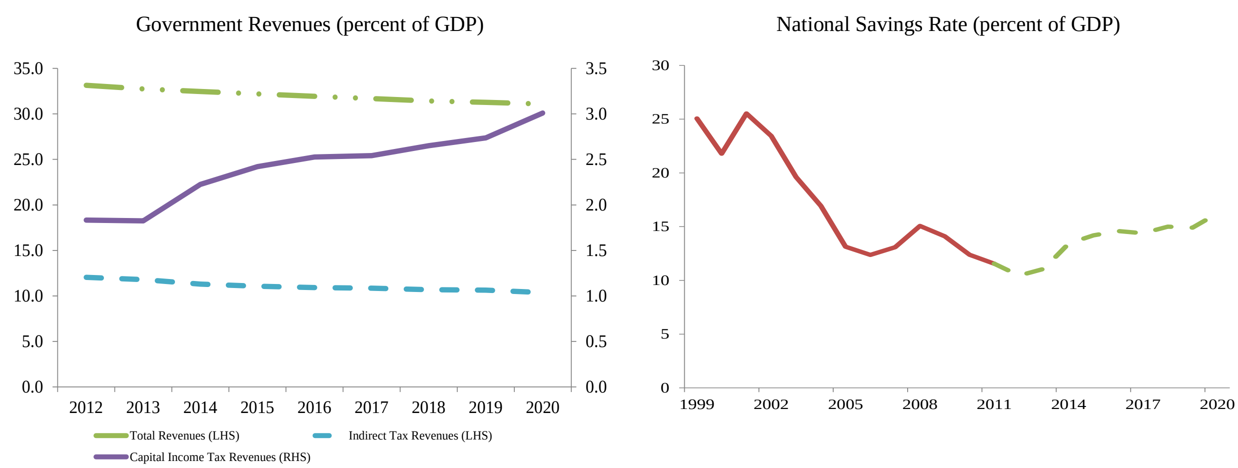


Figure 3. Taxing Capital Income



Source: Bank staff calculations based on model simulations.

The planned reform of income tax legislation represents an opportunity to better support sustainable economic growth. The new draft income tax law, currently at the General Assembly, aims to broaden the tax base while increasing voluntary compliance and reducing the informal economy. A history of amendments to both personal and corporate income tax laws has contributed to making the Turkish tax system relatively complex and costly to comply with. The Draft Law on Income Tax provides a significantly simpler document, merging the existing income and corporate tax laws into a single code, retaining many of the fundamental principles of taxation such as definition of income and gains (including financial and capital markets), rates, definition of tax payers (both for individuals and firms), tax security measures and exemptions. Attempts to increase voluntary compliance and narrow exemptions on speculative capital and property gains will help to make taxation fairer. Yet, the impacts of the proposed incentives on production and investment remain to be seen. To ensure the expected benefits of a rebalanced tax structure materialize quickly income tax reform should be followed swiftly by a reform of the tax procedures code. The proposed tax amnesty, however, would seem to be a step in the wrong direction, given the results of the recent World Bank report.