



TURKISH INDUSTRIALISTS' AND BUSINESSMEN'S ASSOCIATION

LISBON STRATEGY

TURKEY'S NATIONAL REPORT

A CANDIDATE COUNTRY EXPERIENCE

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1. INTRODUCTION

In March 2000, the Lisbon European Council set a strategic goal for the European Union: “to become the most competitive and dynamic knowledge based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion by 2010”.

The communication¹ from the Commission prior to the Stockholm Spring Council stated that “the **candidate countries** too, must become involved in the Lisbon strategy, taking on board wherever possible the targets and objectives the European Union has set”. Upon the aforementioned communication, the Stockholm European Council in 2001 agreed to develop ways and means of actively involving the candidate countries in the goals and procedures of the Lisbon strategy.

At the next spring summit, in March 2002, at the Barcelona European Council, Heads of State or Government, Foreign and Finance Ministers also came together with their counterparts from the thirteen candidate countries to discuss the Lisbon Strategy and its implementation. The European Council underscored the Lisbon strategy as an incentive for candidate countries to adopt and implement key economic, social and environmental objectives and as a two-way learning process.

Like other candidate countries, **Turkey fully adheres to the Lisbon strategy**. In this context, **TÜSIAD** follows closely the progress in the EU with respect to the Lisbon Strategy with the aim of providing the Turkish business community and government with updated information. Within the context of its activities to screen the national reform process towards compliance with the accession criteria, TÜSIAD also follows the governmental policies in order to guide the progress to meet the Lisbon Strategy targets.

With a view to promoting Turkey’s Accession Partnership, TÜSIAD continuously scrutinizes the Turkish economy and business in the light of the Lisbon Strategy goals. With this approach in mind, TÜSIAD decided to participate in the UNICE project to present a national report for the spring summit in March 2003. In this report TÜSIAD presents the priorities of the Turkish business community within the framework of Lisbon goals. Turkey has a considerable potential to grow as a **dynamic market** and a **regional base for international business**, and this potential could be an important input for the EU in achieving its Lisbon Strategy goals.

¹ Realising The European Union’s Potential: Consolidating And Extending The Lisbon Strategy
Contribution of the European Commission to the Spring European Council, Stockholm 23 – 24th March 2001



2. MODERNIZE THE STATE: PUBLIC ADMINISTRATION REFORM

ANALYSIS

Turkey's integration, both into the global economy and the EU requires an effective public administration reform that defines the new role of the state. This requires the re-definition of state's functions in economic activities with relation to the private sector, as well as of its relation to the civil society that would re-describe the relation between the state and the individual.

This re-definition should be achieved by means of a three-fold strategy:

- privatizations;
- abolition of State monopolies;
- rule of law.

With regard to the first axis, the services provided by the state other than clearly-defined core services, should be transferred to the private sector through privatizations. These privatizations should be put in place in a transparent, open and non-discriminatory ways. In parallel, in order to ensure a viable solution to the ineffectiveness of the public sector would be to end the state monopoly on some sectors through opening these sectors to competition, thus empowering the state to regulate the market.

At the same time, the above actions can reap their full benefits only by the reinforcement of judiciary authorities, so to ensure transparent procedures and effective application of the rule of law and enforcement of contractual obligations. The regulatory framework as the foundation watchdog of this approach should be provided through independent judiciary by the state.

Public reform process in Turkey should be handled with the perspective of "restructuring public institutions" and "restructuring public management and increasing management capacity". This perspective requires the implementation of these basic principles of public reform: transparency, accountability, productivity, merit and participatory management. The basic tools to realize this perspective are "total quality management", "e-government" and "regulatory reform".

In terms of increasing the efficiency and the quality of the services provided, total quality management, as a tool for better governance should be used throughout the public sector. This would re-structure the hierarchical organization of the state into a horizontal structure. Thus, this would bring erosion in the red tape activities, more public participation to the decision-making process, efficient coordination of policy outcomes and a reduction in state expenditures in a period when financial bottlenecks became obstacles for sustainable development.

Within the scope of the above approach, application of e-government initiatives throughout the government services would cut the expenditures dramatically, thus increasing the effectiveness and the speed of the services delivered. Technology is also capable of transforming the relation between the state, civil society and the private sector so that a responsive state that places good governance to the core of its management peculiarity is created. It is only possible if the process of reform within



this approach is handled as a mean, not an end in itself, which re-defines itself with the perception and support of citizens, NGOs and the private sector.

The constitution and all codes/laws constitute the “regulatories”. An effective public reform should include “regulatory reform” which comprises a broad area of revising current laws, improving their quality, abolishing unnecessary ones and introducing new ones. The main goal of this regulatory reform is to improve the economic and social welfare of the society.

Another effective measure would be to increase de-centralization of the decision-making processes through empowering the local governments. This would only be effective only if the management capacity of the local governments is increased. A know-how on management capacity should be transferred to the state and handled with the help of NGOs as well as the private sector.

RECOMMENDATIONS:

- Establish the new role of the state functions in economic activities;
- Put an end to the state monopoly on some sectors through opening these sectors to competition;
- Privatize the services provided by the state, with the exception of clearly-defined general interest ones;
- Restructure public institutions and public management by implementing basic principles of public reform: transparency, accountability, productivity, merit and participatory management;
- Apply total quality management, as a tool for better governance, throughout the public sector;
- Implement regulatory reform;
- Promote the application of e-government initiatives;
- Decentralize the decision-making processes through empowering the local governments.



3. PROMOTE ENTREPRENEURSHIP AND INNOVATION

ANALYSIS

Entrepreneurs are not only the driving force in the creation and diffusion of new emerging technologies but also they perform pioneering role in developing new and different business models, processes, and techniques that in result form the basis of the structural evolution process. Entrepreneurs are the ones who foresee the opportunities offered by emerging new technologies and capture them.

If Turkey aspires to improve its industrial infrastructure and competitiveness, which would imply to sustainable economic development and employment with better income distribution, it needs to transform its economic structure into an innovative and entrepreneurial one. In other words, sustainable economic growth without risk of experiencing economic crisis necessitates a long-term solution in which entrepreneurship is one of the crucial elements.

The problems in relation to the human resources, financial infrastructure, legal, social, cultural and political environment hinder the growth of entrepreneurship and thus innovation.

In terms of human resources; Turkey is a country with very young population; 30 % of total population is under the age of 14. However, even though average unemployment (9 %) is relatively not high, most of the unemployed people are below the age of 30. The majority of women are employed in agriculture sector.

Financing is one of the main problems for Turkish firms. Total amount of credits given to small and medium sized firms is very low. Venture capital is one of the critical support mechanisms for the development of innovative and technology-based firms, but it is almost non-existent in Turkey. As financial instruments and institutions are not yet well developed in Turkey, financing is seen as the most important barrier for the technological development.

In addition, Turkey imposes very high corporate and personal income taxes, social security cost of employees, and sales taxes. Turkish entrepreneurs face many problems in starting, running, and closing down a firm due to bureaucracy and corporate life regulations. Uncertainty about the shareholder minority rights is one of these regulation problems.

Turkey is lacking regulations in copyright and patent protection.

In terms of social, cultural and political environment, most of the entrepreneurs believe that public perceives entrepreneurs as opportunistic people. However, survey results show that majority of the population wish to be entrepreneurs in Turkey.

The cooperation among industries or between universities and private sector is not well developed in Turkey.

In terms of incentives and support mechanisms, education on entrepreneurship has been very recent



event and still quite limited. Supporting institutions for entrepreneurs do not have satisfactory human and capital resources. The number of consultancy firms serving to entrepreneurs is inadequate.

As the above results, Turkey needs to take necessary steps in order to reach an entrepreneurial economy since it has great potential for growth with its two precious resources for entrepreneurship, namely women and young population.

RECOMMENDATIONS (Entrepreneurship):

- Entrepreneurship should be included among the top government priorities;
- A clear vision for entrepreneurship has to be developed and well communicated so that it can be used to integrate industrial and technology strategies and policies;
- Bureaucratic barriers in the establishment and closing of firms should be removed;
- Regulations for intellectual property rights should be improved and enforced;
- New and specialized organizations are needed to perform the technology transfer activities;
- Credits given to SMEs should be increased;
- New financial institutions such as venture capital should be established;
- There is an urgent need to form platforms that will not only bring together entrepreneurs but also support them. These platforms could organize nationwide supporting programs and manage the information flow among institutions and individuals interested in entrepreneurship;
- The role of entrepreneurship in social and economic development should be well communicated to public in order to increase awareness;
- A sound scientific infrastructure has to be established;
- The informal economy should be transformed into formal economy;
- Political stability has to be established. This will also bring sustainability in economic policies.

RECOMMENDATIONS (Innovation):

- Technological innovation should be recognized as the major driver of economic growth and social development; New mechanisms for supporting innovation and industrial upgrading are needed if productivity growth is to be sustained; Turkey has to promote a culture open to innovation and creativity;
- Teaching of creativity and innovation should be included in the education systems; the teaching practices and materials should be amended;
- Exemplars of innovation in enterprises should be honored through innovation awards;
- Number of (small) innovative firms should be increased;
- Seed capital/start-up funds linked to viable intermediaries and research structures should be strengthened;
- Funding measures for “knowledge carriers” or mentoring schemes in firms should be developed;
- Diffusion of knowledge in the economy should be strengthened;
- Funding for collaborative projects involving groups of smaller firms with research infrastructures should be provided;
- Policy-making process conducive to innovation policy should be established;
- Innovation policy units-design should be established, initiatives for innovation should be coordinated and evaluated and technology foresight should be undertaken.



4. FACILITATE ACCESS TO CAPITAL

ANALYSIS

Over the last decades, large public sector borrowing requirements, chronic high inflation, use of tax advantages to favor government debt, deposit insurance that undermined market discipline, lax prudential regulation and supervision, and undercapitalized state banks all contributed to the deterioration of the Turkish banking system. Furthermore, generous deposit insurance and a lax regulatory and supervisory environment triggered moral hazard and encouraged risk seeking. Connected lending, high exposure concentrations, large foreign exchange positions allowed banks to increase risk and lenient prudential regulations allowed these risks to remain hidden.

Fragile banking system led the stabilization program supported by IMF stand-by agreement to end up with twin crises, which resulted in credit crunch and severe shrinkage in banking sector. In response to severe banking crises, the government has taken a number of serious reform actions. These include:

- (i) significant reform of prudential regulations (such as new risk management legislation, inflation account legislation...);
- (ii) strengthening of regulatory and supervisory authority (assurance of independency of BRSA);
- (iii) restructuring of private and public banks (takeover of unhealthy banks by SDIF and capital injection to SDIF and public banks);
- (iv) re-capitalization of the banking system; and
- (v) debt re-structuring for the corporate sector (Istanbul approach). The government's financial sector reform program has been supported by the FSAL, and PFPSAL-I and II provided from World Bank.

Brief assessment of banking sector points out immediately that the sector holds very poor credit penetration in an international context due to large crowding out by public sector borrowing. Extremely high intermediation spreads also obstruct intermediary role of the sector. Even more, an indicator of the level of efficiency with which the sector fulfills its intermediating role is the difference between credit and deposit interest rates (intermediations spreads). Reasons of unbearable intermediation spreads may broadly be classified into two categories, micro and macroeconomics factors. While, macroeconomic instability spawned by critically high fiscal debt burden and reflected via chronic and volatile inflation is one of the fundamental cause of high spread level, fiscal and para-fiscal costs bearing by banking sector also take a crucial place in this inefficiency.

As the banking sector acts an intermediary channeling depositors' savings to the real sector for new investment purposes, removing obstacles to reduce high spreads should be taken as a primary action. In other words, fiscal and para-fiscal burdens bearing from banking sector limit the funds provided by the banks and trigger legislation arbitrage and offshore banking. Governmental tax policies rely heavily on indirect taxes due to collection facilities so that indirect tax burdens on banking operations reach intolerable level. In deed, local investors switch to foreign market to find cheap fund. Thus these fiscal and para-fiscal burdens should be reduce to international level.



Another issue is the assignment of zero risk weighing and tax incentive to Turkish Treasury bills and bonds. This unfair competition between government securities and banking sector's instrument boosts the crowding out effect of the public sector and scarcity of capital in private sector. Given that the spread on Turkish Eurobonds have been increasing, it may be prudent to attach some risk-weight to these instruments and tax advantage of these also should be annulled.

Aftermath of twin crisis banking sector experienced credit crunch following with boom in non-performing loan (NPL). In order to resolve NPL problem Istanbul approach put in action. However, execution and bankruptcy law stands as a significant obstacle to implement Istanbul approach properly and it should be amended via market requirements. Moreover, government should encourage the foundation asset management companies and establish a suitable endowment in which it could function properly.

In the long term, a healthy and effective banking system requires a stable macroeconomic environment, reduced public sector borrowing needs, lower state ownership, a lower regulatory and taxation burden and a better designed deposit insurance scheme that does not undermine the private parties incentives to monitor the banks.

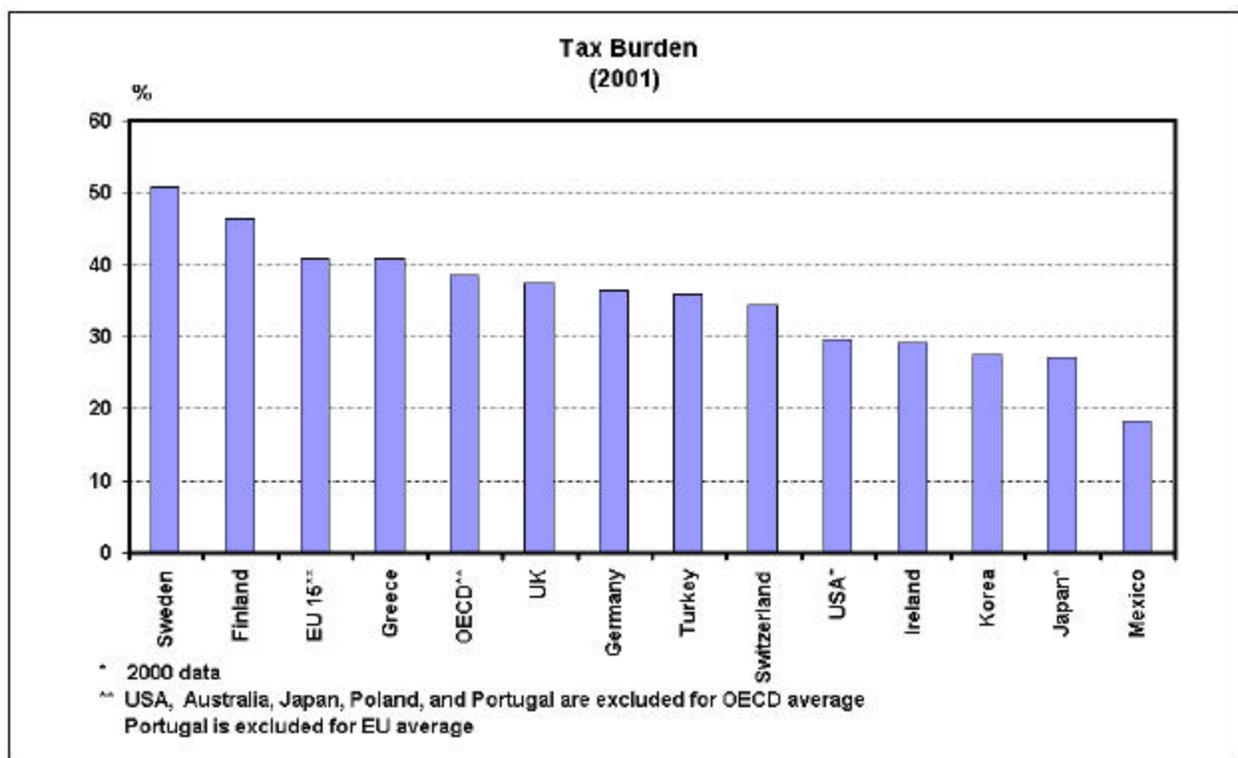
RECOMMENDATIONS:

- A stable macroeconomic environment should be created;
- Necessary measures should be taken by the government to remove the obstacles which avoid reduction of the high intermediation spreads of the banking sector;
- Government should reduce heavy indirect taxes applicable to banking operations;
- The unfair competition caused by the zero risk weigh and tax advantages of the government bonds should be avoided

5. REDUCE TAX PRESSURE

ANALYSIS

The rising demand for funds deriving from constant public sector deficits was largely covered by increasing the tax rates in the last decade. According to OECD tax figures for 1995-2000, Turkey's tax burden rapidly increased from 22.6% up to 33.4%, whereas the average tax burden of OECD countries elevated from 36.1% to 37.4% in the same period.



Taking the economic activities into account, tax burden in Turkey is growing incoherently, increasing the burden on certain categories of taxpayers, thus resulting in an inappropriate taxation environment for the investors. In addition, permanent budget deficits and growing informal economy persistently delayed the restructuring of taxation in a strategic frame concordant with medium to long-term economic and social perspectives.

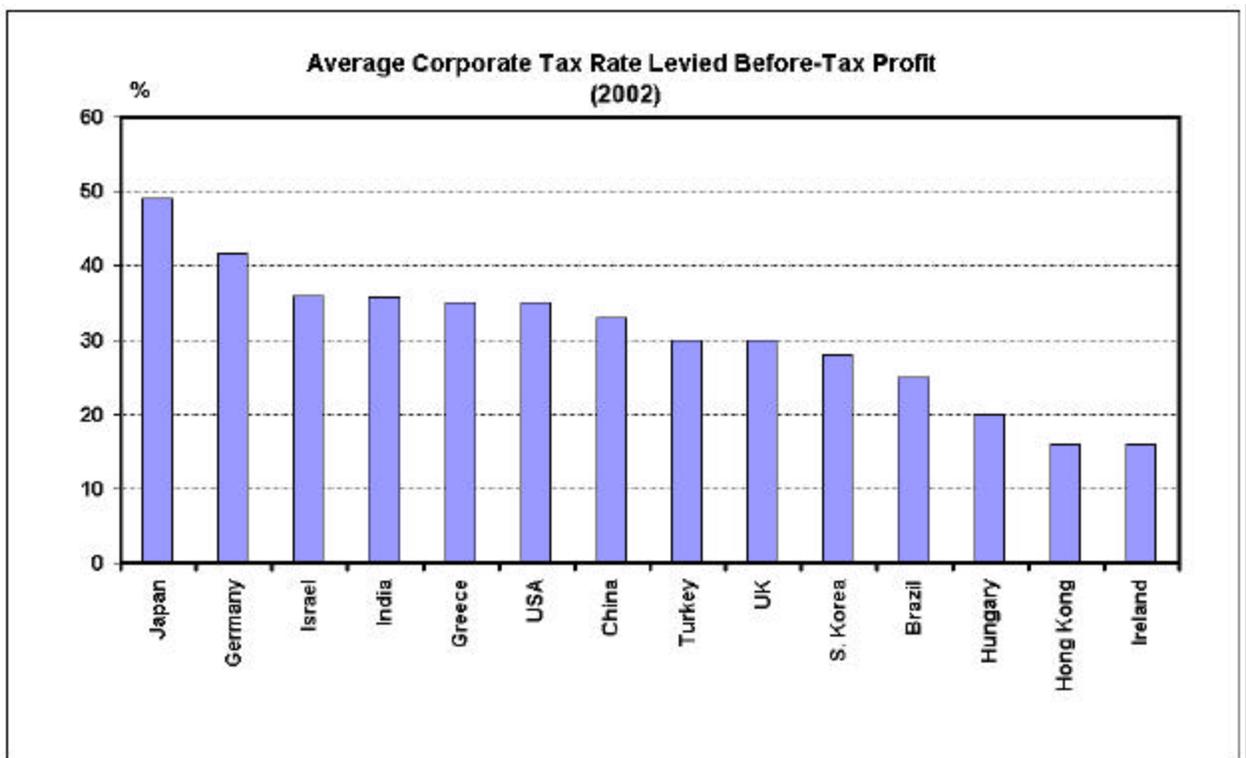
The indirect taxes provide for the largest share of total tax revenues in Turkey and still tend to increase. Indirect taxes in Turkey are; value added tax, custom tax, special consumption tax, stamp duty, excise tax (banking and insurance transaction tax), and source using support fund.

The share of indirect taxes in total tax revenues in Turkey went up to 66% in 2002, from 48% in 1990. This indicates that the failure in collecting direct taxes result in higher indirect tax burden than of OECD and EU countries.



Gradually growing failure in collection of income and corporation taxes tips some significant points. As of 2001, the share of withholding taxes in income tax reached to 37% in wages, and 95% in total. Concentration of income tax in the same period indicates that first 1500 corporate taxpayers (0.26% of total corporate taxpayers) provide the 85% of total corporate taxes. This indicates that the development of a systematic structure in tax system is hampered; legality principle of taxation is harmed; and that the current tax system provides an incentive to evasion.

International comparison offers a better understanding of the current situation. The average corporate tax rate levied on before-tax profit in Turkey is the same as in UK and lower than US rates. Ireland and Hong Kong, where lowest taxes are levied on corporate profits, are practicing the half of Turkey's rates.



Since the end of 1999, Turkey is going through an intensive structural reform program in line with the IMF-supported economic programs. In an economy where the ratio of public debt to GNP stands just below 100% and the sum of tax revenues hardly covers the interest payments, there is not a single viable policy to put the economy on a new growth path other than realizing the structural reforms. As this fact is now well understood by the public and the politicians, the structural reforms, which will pave the way for a new economic order, are starting to being realized in the last three years.

TÜSIAD advocates tight fiscal policy and expenditure cuts in the public sector in light of downsizing the public sector and improving the fiscal balances. TÜSIAD believes that levying additional taxes to compensate poor public reform deteriorates the tax base. Especially in the case of intermediate inputs, this taxation deteriorates the cost structure and expose pressure on production capacity.



Therefore, TÜSIAD believes that the tax reform should aim to improve the fiscal administration's efficiency and enlarge the tax base correspondingly to reduce the unregistered part of the economy. The large amount of unregistered part of the economy imposes an unfair competition and more than required tax burden on the registered part causes the misallocation of resources. Consequently, the tax rates should be rationalized in line with the international practices and considering the competitiveness of the economy.

In January 2002, the Council of Ministers announced an overall strategy for reforming the tax system. As the first phase of the program, the indirect tax system had been simplified and the special consumption tax was introduced. The Special Consumption Tax replaced 16 different taxes and excise duties previously levied on more than 200 types of goods. The second phase was delayed mainly due to the elections and the formation of the new government. Therefore, the government has to carry on with the delayed reform process in direct taxation promptly. Simultaneously, the reform program that is slowly processing in the modernization of the tax administration should gain pace.

RECOMMENDATIONS:

- The tax burden on corporations and individual businesses should be equal;
- Publicly listed companies should benefit from lower taxation in order to support the enhancement of capital market;
- The inflationary effect on the tax base should be eliminated;
- Consolidated group taxation should be available to companies;
- Taxes on investment income should be harmonized;
- The investment incentives system should be rationalized;
- The system of credits against income tax should be reformed.



6. INVEST IN EDUCATION

ANALYSIS

Education is an indispensable process in the socio-cultural and economic life and determines the future by directly influencing the country's improvement and development. In the age of science and technology and as the focal point of life, education lies at the heart of solving the fundamental problems.

The improvements in the Turkish education system in relation to the EU membership progress are remarkable. In 1997, the period of compulsory primary education was increased from five to eight years, with the aim of increasing the general education level of society and very positive results in terms of quality and quantity are achieved. The enrollment rate, which was 85% in 1997-1998 academic year, increased to 100% in 2001-2002 academic year. For girls, this rate increased from 79% to 97%, and for boys from 91% to 100%. While preparing education programs to quickly achieve EU standards in education, principles of free circulation for goods, services and people in EU countries shall be considered.

However, education reform should continue and principles underpinning the education system such as equal access, equal opportunities, education for all need to be considered. Compulsory education must be increased to twelve years and the secondary education system should be restructured, putting special emphasis on vocational education and training. Teaching programs in vocational education and training should be reorganized to enable horizontal and vertical transition in a modular system. A measurement and evaluation system needs to be developed on the basis of vocational standards and certification principles. Support for vocational education and training should be obtained from all public institutions, civil society organizations and the public. Regarding the demographic facts, more students must be able to take vocational education and training and the demographic pressure on universities must be decreased. Universities must be able to adapt to fast changing technologies and economy and they need to be restructured to train students as creative, flexible and technologically competitive workforce. Turkish Education system must keep pace with the information age, to become a society of information and technology so to continuously increase the competitive power of the nation.

RECOMMENDATIONS:

- Compulsory education period should be increased to 12 years;
- More emphasis should be given to the vocational and technical schools and the education system at these schools should be modernized;
- The education system should be restructured by strengthening the relations between education-manpower and employment;
- Lifelong learning, distance learning and e-education should be promoted;
- The share of GNP spending for education should be increased;
- Larger resources should be allocated to invest in all levels of education;
- Private sector investment in education, particularly at the higher education level should be encouraged;



7. IMPROVE EMPLOYMENT AND LABOUR MARKET

ANALYSIS

Total Turkish labor force amounts to 22 millions, the male-female distribution of which is approximately 75% and 25% with the women participation rates on increase. Although the share of agricultural labor force has declined constantly from 50% in 1988 to 35% in 2001, it still constitutes a relatively high share in total. Most of this employment (especially for women) is in the form of unpaid family labor. Agricultural subsidies helped so far to keep this population in the rural areas, although urbanization is steadily on the rise. The sectors that should absorb the supply coming from the agricultural sector and women are manufacturing and services. Since the share of industrial sector seems to be stabilized around 16-18%, the services sector's absorption accounts for the most labor supply.

While the least educated workforce is employed in the agricultural sector, the average education level tends to increase in all sectors and reached to 7 years on average. The services sector is well above the average ranging from 10.3 years in social services to 11.1 years in financial sector. Considering the total labor force the share of higher educated males and females is 6% and 9% respectively.

When the wage structure is considered, it is observed that, excluding the professional-technical occupations from the services sector, lowest wages are in agriculture and services while the manufacturing and financial sector wages are higher than the overall average. However, the successive crises from 1998 onwards deteriorated real wages both in manufacturing and financial services sector and overall level declined significantly and stabilized despite the continuous increase in productivity.

Considering the demographic facts pointing the increase of potentially active labor force in Turkey the need for measures needed in order to have a stable and safe labor market becomes vital.

Since labor market flexibility plays an important role in the achievement of a low level of unemployment and a high level of productivity, it has been crucial to review the Labor Law, had many rigid provisions and did not give space to flexible working patterns. Though there are actions taken in the field of designing a new labor law, further progress is required with regard to collective redundancies, transfers of undertakings, insolvency, working time, fixed-term and part-time work, young people at work and posting of workers, health and safety in fixed-term and temporary employment.

There is a high rate of tax burden on wages and this is an important factor to decrease the rate of registered labor. Consequently, an unfair competition occurs between firms employing registered labor and those having unregistered work force.

The Economic and Social Council, which should function as a platform for reaching social consensus in determining economic and social policy, does not work effectively. The Economic and Social Council has some structural deficiencies, such as the predominant position of the Government,



undermine the value of the Council and should be reviewed together with all the social partners. Private sector, public authorities and social partners need to show their commitment to social dialogue and take necessary measures to remove obstacles.

Several burdens on employment like notice payment and unemployment insurance should be re-arranged so as to lessen the burdens and increase the competitive power of enterprises. In addition, deductibility of provisions for severance payments or other employee related future liabilities from corporate tax should be taken into consideration. An employment-friendly taxation system is needed to facilitate foreign investment as well.

Women face particular problems in gaining access to employment, in career advancement, in earnings and in reconciling professional and family life. It is therefore important to ensure that active labor market policies are made available for women. Furthermore, In order to be able to end the imbalance between women and men with regards to unemployment, it is a necessity to reduce the imbalance that emerges as a result of men and women concentrating in certain economic and occupational sectors and to promote women's participation in the labor market.

RECOMMENDATIONS:

- The labor law should be revised with a view to giving space to flexible working patterns;
- The high tax and social security cost burden on wages should be relieved;
- Social dialogue among private sector, public authorities and social partners should be strengthened and necessary measures to remove obstacles should be taken;
- Provisions for severance payments or other employee related future liabilities should be deductible from corporate tax;
- The problem of imbalance between men and women in the labor market should be tackled.



8. RECONCILE SUSTAINABLE DEVELOPMENT AND COMPETITIVENESS

ANALYSIS

Turkey has been going through dramatic economical and political reconstruction process in the last decade and accompanying this process it has experienced increased environmental pressures. Some institutional and legislative elements of environmental reform have been put in place but Turkey still needs to consolidate its environment policy within the context of sustainable development and industrial competitiveness. Turkey also needs to complete the task of harmonizing its environmental law and directives in accordance with the EU legislation.

Creating a functioning environmental infrastructure, implementation of the new environment directives, fulfilling the country's international environmental commitments, and putting serious efforts at consolidating sustainable development and competitiveness are among the essential challenges Turkey is facing.

RECOMMENDATIONS:

- Environment policy must be determined by large participation, representing all segments of the society including industry. Each institution should be accountable for its operations against environment;
- A sustainable environment policy could be achieved only by making citizens environmentally conscious. Environmental consciousness must be incorporated into the education system in a manner that sustainability would direct each individual's every-day life;
- Turkey should comply with the obligations assumed by signing the international agreements in the field of environment protection and sustainable development. Turkish environmental regulations also must be completely harmonized with the European Union legislation;
- The environmental impact assessment (EIA) must be used effectively in order to ensure environmentally friendly investment projects;
- Government must provide the industry with incentives in order to prevent pollution at its source and also to encourage further investment in protection measure. Establishing an Environmental Development and Investment Bank means a major accomplishment for this purpose;
- Government must enable that new market-based instruments are used for the regulation of environment such as tradable certificates.