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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Turkey were reviewed by the Committee on 19 June 2008. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 30 June 2008.

The Secretariat's draft report was prepared for the Committee by Rauf Gönenç, Rina Bhattacharya, Olcay Çulha and Cafer Kaplan under the supervision of Andreas Wörgötter. Research assistance was provided by Béatrice Guérard.

The previous Survey of Turkey was issued in October 2006.

BASIC STATISTICS OF TURKEY (2007)

THE LAND

Area (2006, thousand km^2):		Major cities (2000, thousand inhabitants):	
Total	784	Istanbul	10 019
Agricultural area	222	Ankara	4 008
Forests	212	Izmir	3 371

THE PEOPLE

Population (million)	70.6	Civilian labor force (2006, million)	23.7
Inhabitants per km^2	90.1	Civilian employment (2006, million)	20.9
Annual rate of change of population,		Agriculture, forestry, fishing	6.1
1997-2007	1.0	Industry	4.4
		Construction	1.3
		Services	10.6

PRODUCTION

Gross domestic product (GDP, TRY billion)	856	Origin of GDP (%):	
Per head (GDP, $ PPP)	12 660	Agriculture, forestry, fishing	7.7
Gross fixed investment (TRY billion)	184	Industry	24.5
Per cent of GDP	21.5	Services	67.8
Per head ($ PPP)	2 722		

THE GOVERNMENT

Public consumption (% of GDP)	12.2	Gross public debt (provisional, % of GDP)	41.3
Central government current revenue		Domestic	31.8
(% of GDP)	22.1	Foreign	9.6

FOREIGN TRADE

Exports of goods and services (% of GDP)	21.9	Imports of goods and services (% of GDP)	27.0
Main exports of goods (% of total):		Main imports of goods (% of total):	
Road vehicles	14.6	Petroleum	11.4
Articles of apparel and clothing		Road vehicles	7.1
accessories	13.0	Gas	7.0
Iron and steel	8.9	Iron and steel	6.7
Textile	8.3	Other imports	67.8
Other exports	55.2		

THE CURRENCY

Monetary unit: New Turkish lira		Currency units per USD (period average):	
		Year 2007	1.2999
		April 2008	1.2955
		Currency units per EUR (period average):	
		Year 2007	1.7795
		April 2008	2.0399

Executive summary

Far-reaching institutional and structural reforms following the 2001 crisis underpinned an unprecedented period of high growth until 2007. More recently, however, tensions arose and growth slowed down as a result of loss of competitiveness in large areas of the economy, the deterioration of international conditions, and a weakening of confidence domestically. New government initiatives to strengthen the macroeconomic policy framework, and upgrade the competitiveness of industry and its capacity to create jobs, would help the economy resume a stronger growth course. The main challenges in this respect are:

- *Preserving the gains of fiscal consolidation and making fiscal policy more compatible with higher growth.*
- *Resuming disinflation and better aligning structural policies as well as fiscal policy with the inflation targeting framework.*
- *Reducing barriers to formal employment in order to mobilise the productivity potential and improve the resilience of the Turkish economy.*

Consolidating macroeconomic policies

In the area of **fiscal policy**, *the gains of recent fiscal-institutional reforms and vigorous fiscal consolidation should be preserved, and credibility enhanced, in the wake of transition from IMF monitoring. This can be achieved by enforcing multi-yearly spending ceilings combined with a primary surplus target, aimed at continuing to reduce the public debt ratio.*

In the area of **monetary policy**, *the disinflation strategy of the Central Bank needs the support of more comprehensive policies to improve inflation expectations, including the full implementation of a robust fiscal framework, competition reforms to moderate service price growth, and encouraging social partners to adopt the inflation target as an anchor in pricing and wage behaviour.*

Bolstering the competitiveness and job-creation capacity of the business sector

The business sector has to cope with rising competition from low-cost countries, and trend real currency appreciation, by accelerating productivity gains, keeping wage growth in line with profitability, and innovating and differentiating products. This should be achieved not only in the most sophisticated segments of industry, but also in traditional labour-intensive activities.

Latent productivity and competitiveness potential should be mobilised by facilitating formalisation, thereby encouraging firms, which make fuller use of modern technology, skilled labour, capital and FDI resources.

Two top priorities in fostering the growth of the more productive part of the economy are: i) reforming labour market regulations to overcome the divide between law-abiding but rigid and very flexible but law-breaching employment practices; and ii) upgrading corporate finance markets to permit firms joining the formal sector to rapidly improve their capital base, productive capacity and productivity.

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By deepening the recently started reform initiatives in these areas, Turkey can improve employment prospects for the growing urban working-age population, restore full confidence in its growth prospects, improve risk premia and its credit-rating, and thereby move to a faster catching-up path.

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Assessment and recommendations

The challenging path from post-crisis recovery to sustainable growth

Over the past two decades Turkey has successfully shifted to a growth strategy based on open and competitive markets. However, recurrent macroeconomic instabilities slowed down trend growth. The recovery from the 2001 crisis has brought an unprecedented period of high growth and the first palpable signs of sustained catch-up and convergence. Currently Turkey is in the difficult transition period from a successful exit from "post-crisis recovery" to a path of sustainable high growth. The main challenges that present themselves during this transition are:

- Preserving the gains of fiscal consolidation and earning credibility with a fiscal rule which allows prioritisation of expenditure programmes, avoids pro-cyclical policies and reduces the risk perceptions of international investors.
- Enabling monetary policy and inflation targeting to "go the last mile" by better setting other policies, in particular structural policies, on a firm disinflationary trajectory, and ensuring that fiscal policy supports this objective.
- Reducing barriers to formal employment in order to mobilise the productivity potential and improve the resilience of the Turkish economy.

Achieving this transition is far from trivial, as witnessed by the nervousness of financial markets, increased exchange rate volatility, growing tensions in the economy, as well as a disappointing growth performance since mid-2007. Embarking on a new, sustainable path of high growth will require policy action, but internal as well as external political tensions complicate the decision making process. Finding the right exit from the transparency-increasing and credibility-generating IMF umbrella also needs attention. However, addressing the above mentioned challenges with decisive reforms will allow Turkey to more fully exploit its comparative advantages, reap the benefits from globalisation and open capital markets and improve its resilience in the face of adverse international shocks.

Between 2002 and 2007 high growth was achieved on the back of fundamental macroeconomic and structural reforms

After the most severe of a succession of "boom and bust" cycles in 2001, a fundamental fiscal, monetary and institutional reform package was implemented. Backed by a favourable international environment and by the opening of accession negotiations with the EU, achieving an average growth rate of almost 7% in the period of 2002-07 made a

welcome beginning to a process of catching up with the OECD average. Large numbers of jobs were created in industry and services amid exits from agriculture, while inflation declined. A primary fiscal surplus of around 6% of GDP was achieved for several years, and public debt was brought down and put on a sustainable path.

Increased competition from low-cost countries and strong trend currency appreciation has put pressure on labour-intensive sectors…

During the same period, accelerated capital inflows attracted by very high real interest rates and opportunities for lucrative rates of return, pushed up the exchange rate strongly in real terms – except during short periods of adverse international or domestic shocks. Trend appreciation helped with disinflation but also amplified the competitive challenges that Turkey's traditional export industries face from lower-cost emerging countries. Sophisticated industries coped well and created new employment opportunities but traditional industries, drawing on low-skilled labour, the abundant factor resource of the Turkish economy, tended to lose market share and faced sharply accelerated import penetration. Employment in these industries declined and with re-employment being hampered by skill and regional mismatches, net employment creation of the overall economy fell clearly short of the increase in working age population. The total employment rate declined as a result and the aggregate unemployment rate slightly increased.

… underlining the need for further structural reforms to reduce Turkey's dependence on favourable external circumstances

An external imbalance arose due to strong domestic demand fuelled by capital inflows, increasing import penetration, and the global surge in energy and raw material prices. This higher external deficit increased Turkey's sensitivity to shifts in investor sentiment. Still, analyses developed for this *Survey* suggest that, in terms of economic fundamentals, Turkey's risk assessment by financial markets could have improved more than it actually did through the 2000s. The thorough revision of Turkey's national accounts in March 2008, resulting in GDP more than 30% higher and reducing the public debt/GDP and current account deficit/GDP ratios to relatively more benign levels, also reinforced prospects for a rating upgrade. However, this did not materialise due to the deterioration of international financial and domestic political conditions in the first half of 2008. These events reinforce the case for further structural reforms so as to reduce Turkey's dependence on favourable external circumstances.

Domestic political and international financial conditions have further slowed growth

In early 2008 important tensions arose in the domestic political environment, with a parallel deterioration of conditions in international financial markets. The exchange rate depreciated by about 14% in the first four months of 2008. While this allowed some recouping of the earlier competitiveness losses, interest rates also increased significantly, inflation outcomes and expectations accelerated further above targets, and the growth of

Turkey's export markets slowed down. In these circumstances, consumer and business confidence weakened and macroeconomic projections for 2008 and 2009 are currently the weakest of the post-2001 period. *To stimulate an upturn, confidence in the stability of the overall governance environment should be restored, and the business sector should be provided with more supportive structural conditions*. A return to a stronger growth path with a pick-up in employment growth would help strengthen domestic and international confidence and improve conditions for lower risk premia, a credit rating upgrade, and further investment and growth. If this improvement takes place Turkey would then likely face again the challenges of strong real currency appreciation, and this would reinforce the case for the acceleration of structural reforms needed to cope with it.

A new fiscal strategy should be at the core of a confidence-building macroeconomic policy framework

After six years of very tight fiscal policies, bolstered by the agreement with the IMF which provided the central anchor, which has been decisive in restoring macroeconomic stability, Turkey faces a fiscal policy challenge of how to strike an appropriate balance between the conflicting time horizons of important objectives:

- preserving a rigorous fiscal policy stance; while
- strengthening the growth-enhancing public services; and
- simultaneously reducing the most distortive aspects of the tax system.

With the IMF agreement having come to an end in May 2008, Turkey should put in place a credible framework to preserve the confidence gained under IMF surveillance, while delivering the necessary changes in revenue and spending composition. The government's decision to publish fully fledged general government accounts according to international accounting standards from 2009 on will be an important step in enhancing fiscal transparency, and should be implemented according to schedule. Following the macroeconomic slowdown, which puts pressures on public finances, the transition to a new plan also needs to be supported by a robust fiscal management framework, to defuse the uncertainties of local and foreign investors. The recently announced Medium-Term Fiscal Framework provides a good guidance for the available fiscal room in the years 2008-12, but requires a broad range of measures.

Recently legislated fiscal reforms should be fully implemented and effective multi-yearly spending ceilings should be introduced…

Turkey is in a strong position to move towards such a new fiscal strategy. Thanks to past fiscal restraint, public debt is on a sustainable path, and fiscal institutions are being modernised with changes in the legal and institutional framework, including a state-of-the-art *Public Financial Management and Control Law*. Under strong spending pressures, arising notably from the social security system, all provisions of the new law could not be fully implemented to date: spending drifts in 2007 gave warning signals of the urgency of the full implementation of the new framework. In addition, to supplement the earlier primary surplus benchmark – which fulfilled a key role through the 2000s in bringing

public debt down and putting public finances on a sustainable path, but is less useful as the only anchor for fiscal policy looking forward – multi-yearly spending ceilings for main spending categories would be helpful. The *Survey* suggests that *Turkey's new fiscal institutions should be fully implemented and enforced, and complemented with effective multi-year spending ceilings*.

… and should be supported with revenue safeguards

The new fiscal framework rule should not only specify the primary surplus path which is compatible with sustainability of public debt, but also the total volume and structure of revenues which are necessary to finance the expenditure programmes under the ceiling. With fiscal policy now set on a sustainable path, which is protected by the framework, policy can provide adequate countercyclical flexibility to support the economy when GDP growth and tax revenues decline cyclically, as in 2008. In order to maintain credibility in the context of the recent fiscal slippages and the transition to a new arrangement with the IMF, *spending ceilings should be supported with an adequately defined primary surplus target which should be adjustable in the case of exceptional circumstances*.

Both the modernisation of fiscal institutions and strong political will are needed for the success of the new fiscal strategy

Both on the expenditure and tax revenue sides, the new fiscal strategy will need adequate fiscal institutions as well as a strong political stance. Strong commitment of policymakers is in particular needed to:

- *clarify and enforce Turkey's top spending priorities, such as in the critical areas of infrastructure investment and education both for the young and adult population;*
- *shift to more cost-efficient supply arrangements in key public services, where the status quo is generally costly as well as difficult to monitor and calls for more market-responsive provision, including through competition among private sector suppliers;*
- *reduce the most distortionary tax wedges, notably by continuing to cut mandatory social security contributions, while closing the most blatant tax loopholes and strengthening tax enforcement; and*
- *fully implement the recently voted social security reform, and promote a less fiscally costly mandatory public scheme, which is complemented by larger voluntary private saving , in order to preserve the sustainability of the social security system and reduce distortionary tax wedges (see below).*

Monetary policy was successfully managing disinflation but is now facing strong inertia of inflation expectations

Monetary and exchange rate policy was a successful pillar of the post-2001 recovery. However when, encouraged by this success, the Central Bank set an explicit medium-term inflation target of 4% for 2007-10, this objective met with important challenges. On the one hand, inflation inertia together with adverse supply shocks meant that headline inflation settled in at around 9%. On the other hand, prospects for real interest rates and high rates

of return became very attractive, fuelling strong capital inflows and currency appreciation. Thus the Turkish economy faces a typical challenge of successful catching-up economies – inflation inertia requiring a tight monetary policy, but competitiveness losses apparently going beyond the adaptation capacity of some sectors and generating pressures for lower interest rates and slower currency appreciation. The challenge became more evident in late 2007 and in the first half of 2008, when very high food and energy price increases fuelled headline inflation creating an upward risk for inflation expectations. *Core inflation* remained below *headline inflation* for a while but started to move towards it in Spring 2008, creating concerns about a new inflationary spiral. In this context, monetary policy needs an orchestrated support from a variety of policies to restart the disinflation process. Only then will the Bank be able to use its instruments successfully to keep inflation around the target. In this context, it is important that the revision of the inflation target for the next three years announced by the Central Bank in June 2008 is seen as an exceptional measure in the wake of unforeseeable shocks. In this environment the Central Bank is rightly maintaining a tight policy stance despite the cyclical weakness of the economy in order to avoid a misperception of a loosening commitment to "go the last mile" in achieving low inflation rates.

The sacrifice ratio of monetary policy can be significantly reduced if other policies are supportive

The *Survey* argues that Turkey's monetary policy needs to be supported by policies which allow it to reach the target with reasonable costs. As is usually the case for a successful catching-up economy, potential output is a moving target and capacity constraints are either closed by imports or new investments. Tight monetary policy can put brakes on the economy, but its task will become prohibitively expensive if inflation expectations are not contained. In these circumstances, *additional policy tools could be utilised to reduce domestic inflationary pressures and thereby improve inflation expectations, such as competition reforms to achieve price moderation in services, a fully enforced multi-year fiscal framework, and employers and employees adopting the inflation target as an anchor in their pricing and wage policies*. The success of such policies would help alleviate the burden on the Central Bank's policy interest rate as the unique instrument to increase the credibility of the inflation target.

Enhancing the competitiveness of labour-intensive activities remains essential

The business sector's successful post-crisis performance and employment creation capacity has come under strain, independently from the domestic and international shocks of early 2008. Mounting competition from low-cost countries and strong trend real currency appreciation have severely weakened the trade-exposed sector, notably cost-sensitive activities highly dependent on domestic inputs and low-skilled labour. Since low-skilled labour is the economy's most abundant resource and these sectors have a large share in total output and employment, as well as exports, these strains spilled-over to the entire economy. Trade-sheltered activities were initially boosted by the household income gains stimulated by real currency appreciation. However, higher than expected inflation and rising unemployment curbed real incomes throughout the economy and also affected the

non-tradable sector, contributing to a weakening growth performance. An upturn is only possible with the improvement of the competitiveness of Turkey's labour-intensive activities.

The improvement of competitiveness should draw on stronger structural foundations

Competitiveness gains needed to re-balance the dynamics of growth cannot come from a policy-induced reversal of trend real currency appreciation, which is an integral part of the catching up process. External and internal shocks trigger depreciations but these generally prove to be of short duration while long-term dynamics of capital inflows remain very strong. In these circumstances the necessary competitiveness gains in the business sector can only be achieved by boosting productivity growth, moderating wage increases, and successfully differentiating its output (in order to be able to charge higher prices than lower-cost competitors). In other words, it is a flexible labour market as well as a competition-friendly product market environment which is needed to do the job. The *Survey* confirms that manufacturing industry has been achieving remarkable performances in these areas but the gains are concentrated in the modern part of the economy. *Productivity growth and competitiveness gains need to be generalised to the entire economy with additional reforms.*

Productivity potential should be mobilised by fostering the growth of the formal sector

There are large productivity reserves latent in the business sector. They arise from a large part of economic activity still being carried out in informal and semi-formal activities. If more resources can be shifted to formal business activities, the aggregate productivity and competitive performance of the economy would benefit from better access to financial services, opportunities to deepen the division of labour and develop own comparative advantages as well as better incentives to invest in firm-specific human capital. Formal firms draw more effectively on the technology, skilled labour, capital and FDI resources becoming available in the rapidly globalising economy. *Overcoming the duality between formal and informal sectors, and accelerating the shift of resources to the formal sector, should be the centrepiece of Turkey's structural reforms*.

Ongoing reforms should be complemented with further measures to reap synergies

The government has launched a range of important initiatives to strengthen the business sector and Turkey has started to move up in various international rankings of doing business indicators. In particular, an *Employment Package* enacted in May 2008 entailed significant measures for reducing labour tax wedges and promoting national employment services emphasising the upgrading of the skills of the labour force. However, progress has been limited in some of the most critical areas, and this also holds back the effectiveness of other reforms. Top priorities in fostering the development of the formal sector are:

- *a thorough reform of labour market regulations along OECD best practices; and*
- *accelerating the modernisation of capital markets to increase the benefits of formality and to stimulate investment, productivity and employment growth.*

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Making product markets competitive and reducing the administrative burdens for doing business in the formal sector should also remain an ongoing objective, in particular in the service sectors where competition remains less vibrant than in trade-exposed activities.

Labour market reforms

Labour market rules remain among the most rigid in the OECD area, even after the implementation of the 2008 employment package. Priority should be given to reforms to:

- *reduce the legal employment costs of low-skilled workers by containing the growth of mandatory minimum wages and creating a framework to differentiate minimum wages across sectors and regions;*
- *continue to cut mandatory social contribution rates, and increase the role of voluntary saving schemes in financing the social security system;*
- *make permanent labour contracts more flexible by reducing mandatory employment protection and promote negotiated forms; and facilitate more flexible forms of employment such as fixed-term contracts and agency work; and*
- *eliminate size thresholds in the application of the labour law.*

Capital market modernisation needs fuller financial transparency, but this raises challenges

Corporate finance markets are currently underdeveloped in Turkey. Enhancing financial transparency is the key requirement for the development of markets for medium-to-long term bank loans, corporate debt securities, private equity placements and listed equities. These capital sources all have a role to play in the development of higher productivity and more competitive firms in the formal sector. Three areas are particularly important and have been addressed by the authorities, but progress has been slower than expected. These areas relate to:

- the transition to Basel II rules for corporate banking;
- the adoption of a new Commercial Code prescribing that companies of all sizes produce externally audited accounts; and
- the modernisation of collateral registers and the collateral regime.

The authorities should identify obstacles to progress in these areas and maintain efforts to increase financial transparency for the development of formal capital markets.

Transition to stronger enforcement of rules should go hand-in-hand with the deepening of structural reforms

The enforcement of business regulations has recently been intensified and this is highly welcome. However, if structural reforms are not deepened in parallel, thereby reducing the costs of doing business in the formal sector, this may generate output and employment losses. *The government should develop and implement a comprehensive "formalisation strategy" combining continuing structural reforms in top priority areas with the stronger enforcement of rules and regulations.*

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Chapter 1

New challenges facing the Turkish economy

Over the past two decades Turkey has successfully implemented a growth strategy based on competitive markets. The strategy nurtured a highly dynamic and vibrant private business sector, which started to make much more effective use of global capital, technology and market resources. However, this new growth trajectory remained vulnerable to deep and recurrent macroeconomic shocks. After the most severe of a succession of "boom and bust" cycles in 2001, a far-reaching fiscal, monetary and institutional reform package was put in place.

A steady acceleration in economic growth followed, with an average growth rate of nearly 7% per year over the period 2002-07, confirmed by the latest GDP revisions. Large numbers of new jobs were created in industry and services, together with a spectacular decline in inflation. Fiscal balances improved remarkably and the public debt ratio was put on a steadily declining path.

At the same time, driven by the high level of FDI and foreign borrowing by the private sector stemming from supportive conditions in global capital markets, and capital inflows attracted by high local interest rates, the Turkish currency tended to appreciate very strongly in real terms – except during periods of international capital market turbulence or internal political tensions. Trend currency appreciation helped with disinflation but also amplified the competitive challenges that industry faced from lower-cost countries. Sophisticated industries coped well with these pressures, but traditional segments drawing on low-skilled labour and local inputs tended to lose market share and faced sharp import penetration. The resulting decline in net exports and increase in the external deficit have weakened macroeconomic performance and, despite an overall improvement in macroeconomic fundamentals, made the economy more vulnerable to shifts in external conditions.

Turkey has the resources required for resuming a more balanced and stronger growth path. However, this can only be achieved by irreversibly consolidating the macroeconomic policy framework and providing the entire business sector – both its modern and less productive segments – with a significantly more growth- and employment-friendly microeconomic business environment.

A new era of macroeconomic stabilisation and growth acceleration

Turkey is set to embark on a strong market driven growth path provided the government continues its reform minded policy. After several decades of state-led import-substitution policies, assertive domestic and external liberalisation triggered a dynamic wave of private sector-driven growth throughout the country from the 1980s. Following the full liberalisation of capital movements in 1989, foreign capital inflows responded to the opening of markets and contributed to the funding of this new growth wave.

However, this phase of deep liberalisation reforms lacked strong institutional and legal frameworks for macroeconomic policy-making.[1] The growth of private investment and consumption went hand-in-hand with pro-cyclical fiscal and quasi-fiscal spending, deepening current account deficits and undermining the quality of capital allocation in the financial system. Cycles of inflation accelerations and balance of payment crises ensued. The resulting "boom-and-bust" pattern became the landmark of the Turkish economy until very recently.

After the most severe of these "busts" in 2001, a far-reaching fiscal, monetary, and financial reform package was implemented.[2] Actively backed by international financial institutions, this package was successfully applied by two successive legislatures. The resulting comprehensive strengthening of the macroeconomic and financial frameworks made the economy more resilient and attractive for domestic and foreign investment.

Fiscal controls were radically strengthened, and a tight primary surplus rule was implemented. Transparency was achieved by close monitoring through the IMF. As a result, the debt to GDP ratio decreased considerably. The banking sector, which had played an important role in earlier pro-cyclical credit drifts, was consolidated and re-capitalised. Financial intermediation was made subject to modern prudential supervision. The Central Bank was also made independent, with a mandate to focus on price stability. The entire package took the Turkish macroeconomic framework closer to OECD standards.

These policies provided the base for a strong and lasting recovery. Annual GDP growth averaged 7.2% over the period 2002-06, and the economy created more than 2 800 000 new jobs outside agriculture, representing employment growth of 3.9% per year. During this period Turkey was also affected by the turbulences which occurred in international markets, but related exchange-rate depreciations proved to be of short duration in 2004 and 2006 and the real exchange-rate stayed on a steadily appreciating medium-term path.

The resulting increase in household incomes and living standards helped maintain popular support for ongoing reforms, which were also backed by the opening of accession negotiations with the EU in 2005. In the legislative elections in July 2007 the government was confirmed in office with a single-party majority. In its electoral campaign and its programme the government made clear its intention to stick to its policy of cautious macroeconomic management and ambitious structural and public service reforms aimed at convergence with OECD and EU best practices. Despite periodic internal political tensions and difficult geopolitical conditions, including military operations, this environment heralded a broadly favourable medium-term economic outlook.

The challenges of sustaining higher growth

The economy nonetheless faces important macroeconomic and structural policy challenges. Some of these challenges derive from unfinished tasks from various post-2001 reforms, while others arise, paradoxically, from the attractiveness of the economy for international capital inflows and the resulting currency appreciation and competitiveness pressures.

Macroeconomic challenges are typical for a catching-up economy

- *Fiscal policy*. Turkey's fiscal policy is faced with tensions between expenditure needs in key public services such as physical infrastructures and irrigation (which have been restricted through the post-2001 fiscal consolidation), the need to tackle the most distortive aspects of the tax system, and the necessary continuing commitment to a prudent fiscal stance.
- *Social security reform*. The reform of the social security system, which had stalled since 2006 until the passage of a revised social security reform bill by parliament in April 2008, should continue as a matter of priority. In addition to (and independently from) the reform bill, the government intends to reduce social security contribution rates significantly over time, in order to stimulate legal employment in the formal sector. Handling the fiscal implications of these cuts and reconciling them with the actuarial neutrality of the social security system will call for additional measures.
- *Monetary policy* was successful in reducing inflation from nearly 70% in 2001 to below 8% in 2005. It now has an explicit and more ambitious disinflation target, but is faced with inertia in headline inflation. There are strong exogenous price pressures from international commodity and energy markets, and inflation expectations remain well above targets. The Central Bank has the difficult task of reducing inflation without keeping interest rates too high and provoking excessive exchange rate appreciation pressures and competitiveness losses.
- *Real currency appreciation*. The appreciation of the Turkish lira in real terms has been very strong since 2001 – despite short-lived depreciation episodes due to temporary weakenings in international capital markets, which were at times compounded by internal political tensions. Trend real currency appreciation, combined with mounting competition from low-cost countries, has put significant pressures on the labour-intensive parts of the economy.
- *Dependence on foreign capital inflows*. Capital inflows have more than funded the large current account deficit of more than 5% of GDP in the past three years. The economy keeps growing on the back of these inflows, and therefore remains vulnerable to shifts in external market conditions and investor sentiment. Despite the overall improvement in economic fundamentals, Turkey's credit rating stays for this reason *sub-investment grade* and its risk premia and real interest rates remain very high.

Structural challenges

- *The regulatory framework is still too rigid*. Turkey continues to have some of the most rigid labour and product market regulations of the entire OECD area. Doing business *in compliance with the law* remains less attractive than in most other OECD countries, and *a fortiori* compared to Turkey's direct competitors in the emerging world.

- *Informal activity presents itself as an "easy and costly" way out*. Operating in informality or semi-formality has become a common recourse for lower productivity firms faced with increased competition from home and abroad. This isolates them from Turkey's modernising capital and skilled labour markets and restricts their access to foreign direct investment.
- *Shortcomings of the human capital stock*. The average educational attainment of the working age population is less than 7 school years. Only three years of schooling, in particular for girls in rural areas is not uncommon. This makes human capital accumulation significantly lower than in OECD countries. There is a narrow but very well-trained fringe of the workforce which is highly effective in absorbing international best practices in the modern part of the business sector, but the majority of workers have considerably weaker human capital. Inertia in cohort effects, and persisting weaknesses of the education system, do not herald an easy way out of these gaps.
- *Imbalances between demand and supply of low-skilled labour*. Demand for low-skilled labour has been declining as a result of competition from low-wage countries in tradable activities, and from modern service firms in traditionally low-skilled service activities such as retail trade and construction. Costs of employment of low-skilled people in the formal sector are too high, confining them to informal work in grey areas and reducing their chances of building human capital on-the-job.

An account of the post-2001 growth acceleration is provided below. The following section takes stock of the persisting structural weaknesses which continue to tax Turkey's rate of catching-up and upgrading to *investment grade* status and lower risk premia. The last section introduces the following chapters, which review the new government's policy responses and remaining challenges in the most crucial of these areas.

The economy has significantly strengthened since 2001

Growth was driven by a vigorous private sector

The Turkish economy has grown regularly for 24 quarters since 2002. This degree of macroeconomic strength had not been seen in Turkey in recent history, and has been stronger than in most other countries in the region (Figure 1.1).

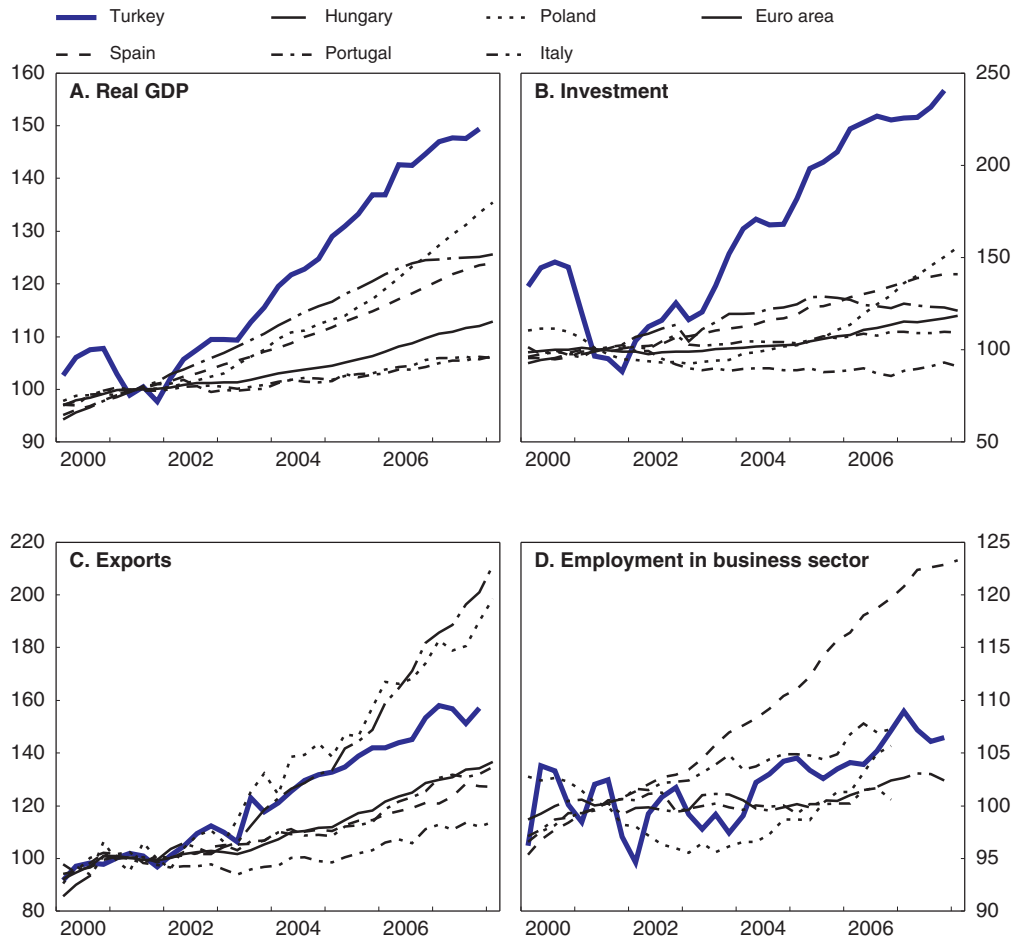
A decomposition of the sources of growth reveals that the acceleration resulted primarily from productivity gains associated with capital deepening. In contrast, Turkey's convergence towards OECD's labour mobilisation and utilisation rates has remained very slow (Figure 1.2).

Growth was entirely driven by private-sector investment and employment (Figure 1.3). Far-reaching structural changes *within* the business sector underpinned its contribution to growth, with three groups of enterprises engaged in highly different dynamics (Figure 1.4):

i) ***Modern domestic firms of the formal sector*** performed very well since 2001 in terms of output, exports and productivity. The largest 500 firms generated 49% of total industrial valued added and 54% of exports in 2006 (Figure 1.4). They however employ only 12% of the industrial labour force. Their limited contribution to employment reflects their high capital intensity, and their strong productivity gains of the recent period.

Most of the modern domestic firms have not been adversely affected by the competitive squeezes resulting from trend currency appreciation and low-cost country competition. They could protect their profit margins through productivity gains,

Figure 1.1. **The post-2001 growth acceleration**
2001 = 100



Source: OECD (2008), *OECD Economic Outlook No. 83 database*.

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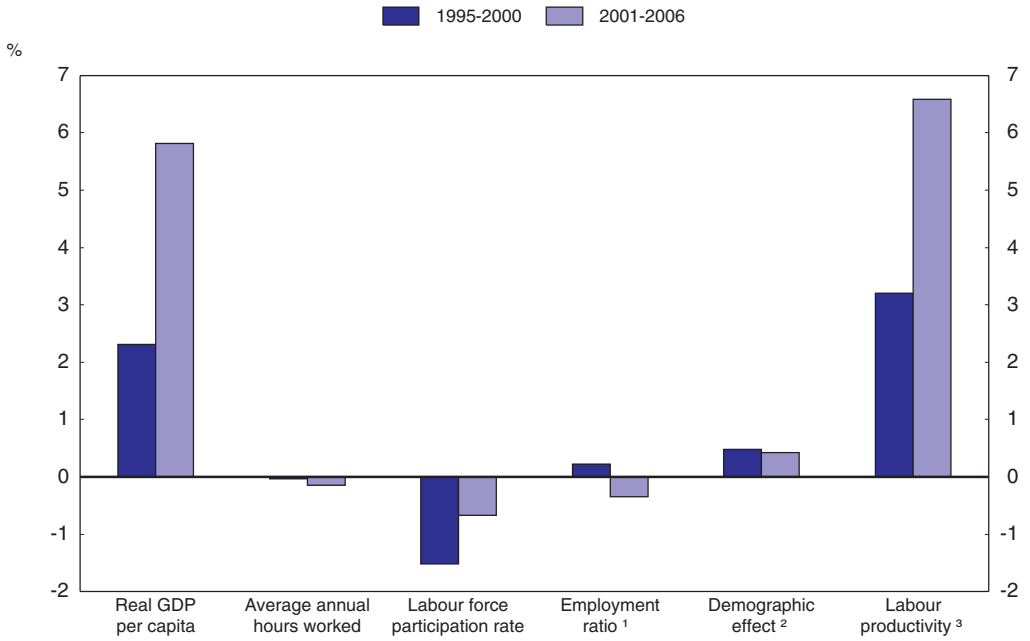
recourse to imported inputs, and a re-centering of their activities on the domestic market.[3] Many firms also started to invest abroad, backed by the real appreciation of the Turkish lira and their large cash resources.[4]

ii) ***Foreign-controlled firms*** were very few in Turkey until 2001, but have increased in number. Initially confined to specific sectors such as oil exploration and distribution, the bulk of FDI was realised through joint ventures with local partners. Fully foreign-controlled firms expanded in the 2000s after privatisations and large-scale mergers.

FDI firms are concentrated in domestic market-oriented activities such as banking, telecommunications and retail trade. Their role in export-oriented manufacturing is minor, except in the car industry. They contribute to the innovation and capital formation process, but their role in employment and export growth is very limited.

Figure 1.2. **Productivity more than employment catch-up underpinned the acceleration**

Annual growth rates



1. The ratio of employment to the labour force.
2. The share of working age population in total population.
3. Labour productivity is measured as GDP per hours worked.

Source: OECD (2008), *National Accounts database*; OECD (2008), *Productivity database*; and OECD (2008), *Labour Force Statistics database*.

StatLink http://dx.doi.org/10.1787/418184144807

iii) ***Emerging medium-sized enterprises*** have been the main engine of growth in the 2000s. They have boomed throughout the country, including in traditionally non-industrial regions. They are, in general, highly entrepreneurial family businesses of first generation. They draw on local labour and inputs, and can still be highly successful in export markets, particularly during periods of exchange-rate depreciation which helps them to maintain their competitiveness. Many medium-sized enterprises resort to informal low-cost employment through a variety of channels.

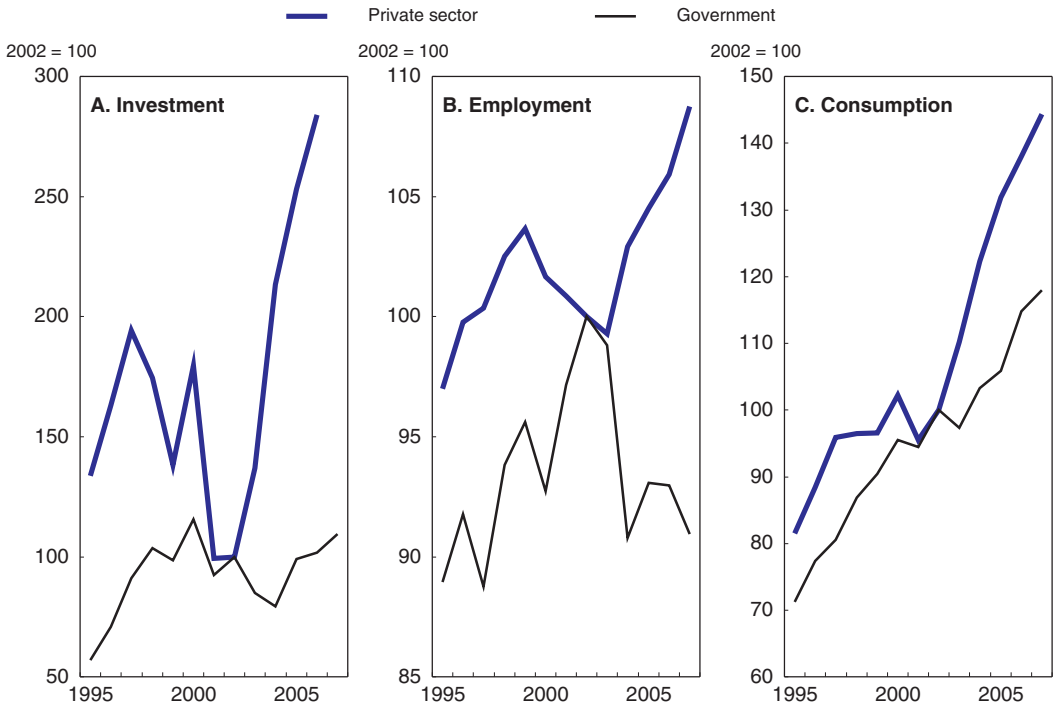
These firms have created an estimated 700-800 000 new jobs in manufacturing alone since 2000, while 100 000 net manufacturing jobs have been lost in the modern formal sector. At the same time, these firms have been more severely hurt by trend real currency appreciation and mounting competition from low-cost countries than more modern firms.

According to some recent analyses, the growth of medium-sized enterprises heralds also a new phase in Turkey's cultural and social modernisation[5] (Box 1.1).

The globalisation of the economy is progressing

The globalisation of the economy has taken greater hold since 2001 (Figure 1.5). Three forces have been behind this phenomenon: i) an increase in the share of exports in output;

Figure 1.3. **Growth was entirely private-sector driven**



Source: OECD (2008), *OECD Economic Outlook No. 83 database*.

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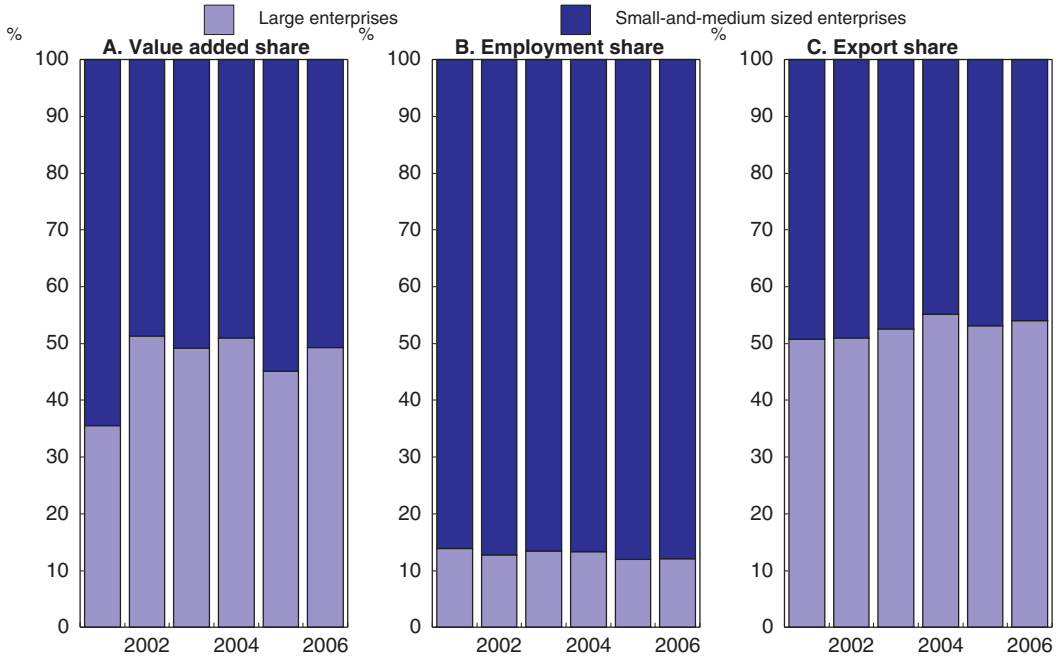
ii) the opening of domestic markets to import competition; and *iii)* increasing recourse to international savings in funding investment.

i) Without being a major world exporter, Turkey has increased its share in international markets. It remains specialised in textiles, clothing and a relatively small number of medium-technology activities such as car assembly, consumer electronics, white goods and light industrial machinery. Despite the slowly changing sectoral pattern of trade, Turkey's trade specialisation was upgraded in the 2000s as manufacturers clearly climbed up quality and product innovation ladders. The gap between the qualitative sophistication of the economy and its relatively stagnant sectoral specialisation may be revealing a tension between the entrepreneurial momentum of the business sector and its relatively thin technological endowment (Box 1.2).

ii) The domestic market is increasingly exposed to foreign competition. This trend gathered speed with Turkey's Customs Union agreement with the EU in 1996, and accelerated after 2001. The post-2001 acceleration of import penetration has probably resulted from structural changes in the manufacturing industry towards more imported input- and imported capital equipment-intensive production processes, and growing imports from low cost Asia, both supported by trend currency appreciation. Increased import penetration generally did not provoke the feared output loss for local industries (until the most recent abrupt currency appreciation). Recent research documented that higher import competition tended to generate above-trend productivity and output growth in trade exposed industries[6] (Figure 1.7).

Figure 1.4. **Respective shares of large enterprises and medium and small sized enterprises in industry**[1]



1. Large enterprises are defined as those in the Istanbul Chamber of Industry's "Top 500 Turkish enterprises" list. Medium and small sized enterprises represent all the others.

Source: Courtesy of Istanbul Chamber of Industry.

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Box 1.1. **The rise of "Anatolian Tigers" as cultural change**

Researchers from the European Stability Institute came forward with an analysis shedding new light on the drivers of business sector development in Turkey. They based this analysis on a detailed study of the drivers of growth in Kayseri, a medium-sized town in in-land Anatolia which is one of the successful examples of this transformation. The insights of this study on the dynamics of this growth acceleration are the following:

- *Endogenous growth*: *i)* Growth takes place in technical clusters where tens of local firms compete and co-operate (furniture, textile fabrics, electric cables); *ii)* entrepreneurial drive, thrift and hard work are decisive in company success stories; *iii)* access to foreign technologies plays an important role: foreign engineers are honoured and welcomed; *iv)* trade protection has played a role, by facilitating the start-up of new activities; and *v)* Turkey's entry in the *EU single market* gave a new stimulus to industrial development.
- *New entrepreneurial ethics*: *i)* A stream in the traditional culture emphasises enterprise, hard work and frugality as lifestyle principles; *ii)* pious networks diffuse these values in the social fabric (in Kayseri 600 "teaching/learning" congregations are recorded); *iii)* these networks serve also as platforms for business co-operation, information sharing and trust-based transactions between members; and *iv)* there are also many local networks which focus on business, technology and education matters of common interest.
- *Emphasis on education*: *i)* Medium-sized entrepreneurs emphasise the importance of education (despite their own generally weak formal education background); *ii)* professionally managed charities concentrate on school construction and funding; *iii)* local students' performances in national tests are closely monitored; and *iv)* gifted students are granted support and scholarships to attend universities at home and abroad.

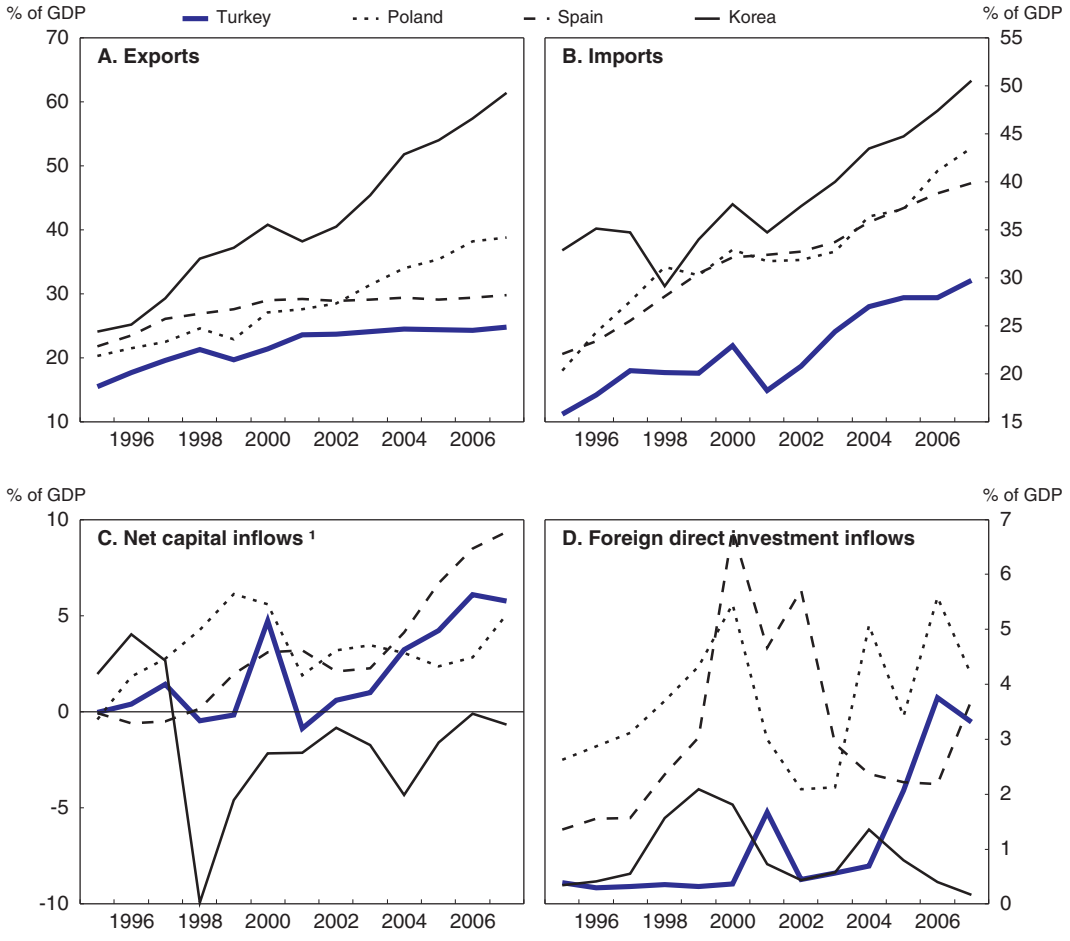
Box 1.1. **The rise of "Anatolian Tigers" as cultural change** *(cont.)*

- *Pragmatic finance*: *i)* family-savings are the prime source of investment; *ii)* interest-based borrowing is utilised when needed, it is not rejected on the basis of religious precepts; *iii)* risk-sharing funding has also been utilised; *iv)* as businesses grow, they may resort to islamic financing instruments but apparently in limited proportions; *v)* family governance prevails, but trusted professional managers are also employed; and *vi)* to avoid leadership dilution in second generation firms, consensual divestitures (splits of enterprises between second generation members) can be utilised.
- *Women's role*: *i)* Local women generally do not work; *ii)* some "path-breaking" working women have emerged, but still in small numbers; *iii)* these women could find employment in businesses which departed from traditional work habits; *iv)* daughters of successful entrepreneurs all go to university; *v)* all local parties agree, more or less enthusiastically, that labour market bottlenecks will make more female employment indispensable in the future.

Source: European Stability Initiative, *Islamic Calvinists: Change and Conservatism in Central Anatolia*, September 2005.

Figure 1.5. **The globalisation of the Turkish economy**

1995-2007



1. Financial account balance including change in official reserves.

Source: OECD (2008), *OECD Economic Outlook No. 83 database*; and OECD (2008), *Main Economic Indicators database*.

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Box 1.2. **Turkey's Revealed Comparative Advantages**

Turkey's trade specialisation has been assessed with the help of Revealed Comparative Advantage (RCA) indicators. Two measures have been used: the "Balassa" measure (RCA1)[1] and a competitiveness indicator derived from Vollrath (1991) (RCA2).[2]

Over 1993-2006 Turkey remained chiefly specialised in "Articles of apparel and clothing accessories". Both RCA1 and RCA2 are highest in this sector, by a wide margin. The sector accounted for an average of 23% of total exports over the reference period, and an average 0.5% of total imports. At the same time this specialisation is becoming less exclusive with the emergence of new strength areas.

"Textile yarn and related products" is the other major specialisation area. RCA1 is high while RCA2 is average, showing that Turkey is also a large importer of textile inputs. These products have had average weights of 12% in total exports and 4.5% in total imports between 1993-2006.

"Road vehicles" is Turkey's new and rising area of specialisation. Both RCA1 and RCA2 turned positive in the 2000s and continue to increase rapidly. The share of "road vehicle" exports in total exports rose from 1.9% in 1993 to 13.7% in 2006.

"Iron and steel" is also slowly becoming a specialisation area. RCA1 is average whilst RCA2 is low. These products represented 8.5% of total exports and 5% of total imports during the reference period.

"Electrical machinery and appliances" is another area of recent progress. Both RCA1 and RCA2 are still below unity, as other electrical equipment producers also gained ground in international markets and Turkey is a large importer of such products, but both are rising. In 2006, the share of electrical products in total exports attained 5%.

"Vegetables and fruits" were an area of specialisation for Turkey in the 1990s. However, despite its generous natural endowment for these products, Turkey lost ground in the more recent period *vis-à-vis* other international exporters.

Dynamic changes in revealed comparative advantages have also been assessed, using a Spearman rank ordered correlation coefficient as proposed by Clark, Sawyer and Sprinkle (2005). Each sector has been ranked in 1996 and in 2006 according to their RCA value. The Spearman correlation coefficient, a non-parametric test statistic, is the correlation coefficient between these two rankings. A value close to 1 indicates a high ranking correlation between 1996 and 2006 and is interpreted as sign of inertia in the specialisation pattern. A low coefficient indicates that the ranking has changed considerably, suggesting a more rapid structural change.

Table 1.1. **Spearman correlation rank coefficient, 1996 RCA *versus* 2006 RCA**

	Turkey	Mexico	Korea	Spain	Portugal	United States
R_s(RCA96, RCA06)	0.87	0.88	0.79	0.83	0.76	0.95

After the United States, Turkey and Mexico have the highest coefficients and show more inertia in their sectoral specialisation than in the other countries. Spain, Portugal, and Korea have a lower coefficient, which indicates a more rapid structural change in their specialisation pattern.

Increasing "unit values" of exports reveal, by contrast with the slow structural change of trade, a rapid increase in the innovativeness and quality of exported products. Relative unit values of exports are increasingly used in the international literature as an indicator of the innovativeness and qualitative differentiation of a country's industry. On this account Turkish exporters appear to have climbed up innovation and quality ladders rather rapidly in the recent period (Figure 1.6).

1. RCA1ij = (Xij/Xit)/(Xnj/Xnt), where Xij = exports by country i (n = total OECD) of good j (t = total goods).
2. $RCA2_{ij} = [(X_{ij}/X_{it})/(X_{nj}/X_{nt})]/[(M_{ij}/M_{it})/(M_{nj}/M_{nt})]$, where X_{ij} = exports by country i (n = total OECD) of good j (t = total goods) and M_{ij} = imports by country i (n = total OECD) of good j (t = total goods).

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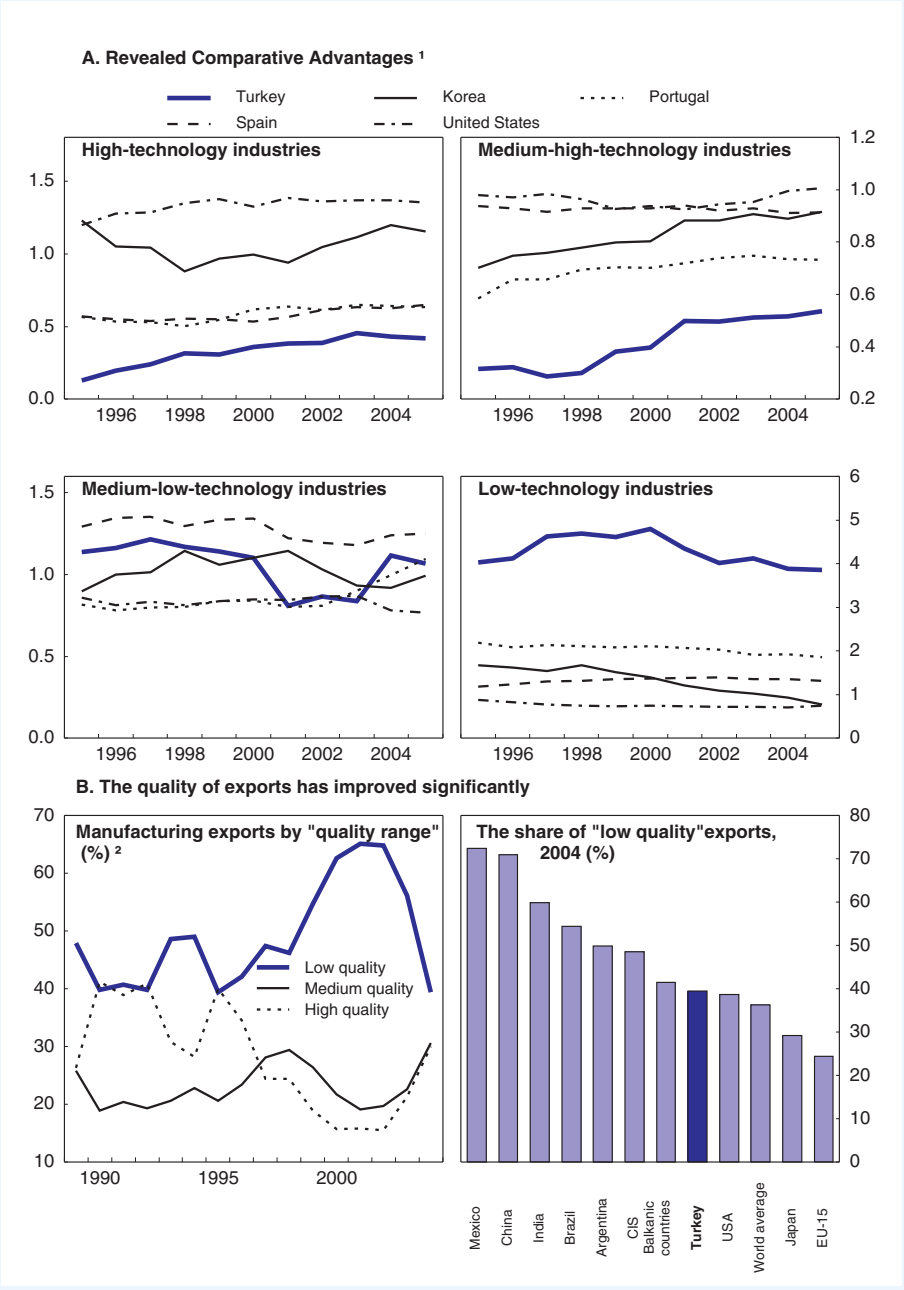
Box 1.2. **Turkey's Revealed Comparative Advantages** *(cont.)*

Figure 1.6. **Trade specialisation is not very dynamic but quality improves**



1. The revealed comparative advantage indicator proposed by Vollrath (1991) has been compiled for each country *versus* the total OECD. It is defined as RCA = [(Xij/Xit)/(Xnj/Xnt)]/[(Mij/Mit)/(Mnj/Mnt)] with X = exports, M = imports. i = country, j = manufacturing industry classified by technology level, n = all OECD countries and t = all manufacturing industries. When RCA is greater than 1 then the country has a relative comparative advantage for the product j.
2. As a proxy for quality, "world unit values" (UV) are computed. For each product and each year, UVs are categorised as "medium quality" = [Average UV –25%, Average UV +25%], "low quality" = [Minimum, Average UV –25%] or "high quality" = [Average UV +25%, Maximum].

Source: OECD (2007), *International trade by commodity statistics database* and OECD calculations; CEPII, *Baci database*, Courtesy of D. Unal-Kesenci.

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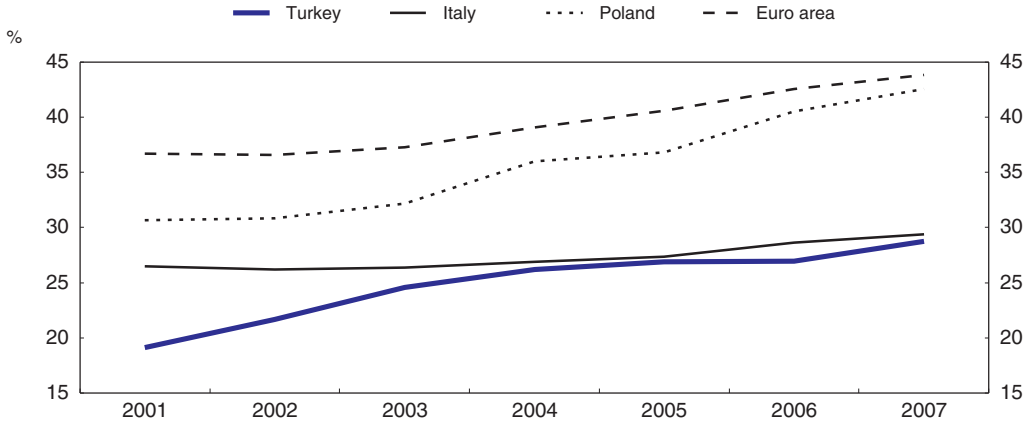
Figure 1.7. **Import competition in the domestic market**
Percentage share of imports in final domestic demand



Source: OECD (2008), *OECD Economic Outlook No. 83 database*.

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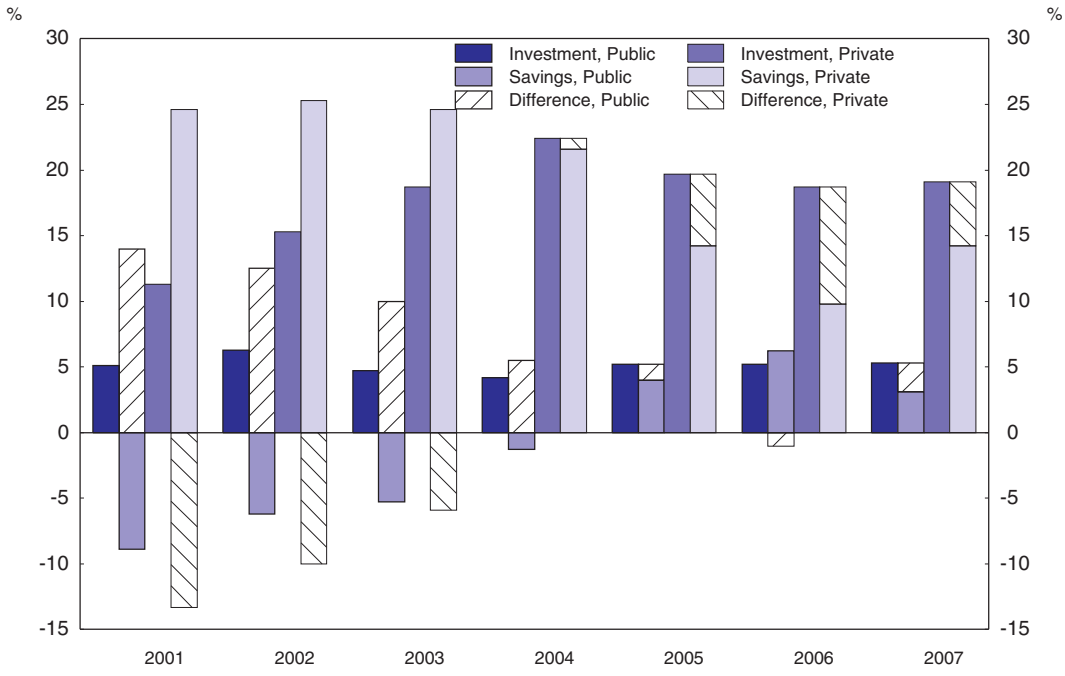
iii) Greater interest by all categories of international investors in Turkey after 2001 also gave Turkish borrowers fuller access to international savings. Portfolio investors in the stock market, medium-to-long term bank lending to local banks and non-financial corporations, trade and supplier credits, and plain foreign direct investment all participated in this surge. Trend currency appreciation also contributed, by widening

Figure 1.8. **Capital inflows increasingly fund private investment and consumption**
As percentage of GDP[1]



1. Ratios are calculated on basis of old GDP series.

Source: Annual Programmes, SPO and OECD calculations.

StatLink http://dx.doi.org/10.1787/418322512780

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the gap between high capital costs in the local market and much lower costs of externally borrowed funds after exchange-rate adjustments. Fiscal consolidation having cut public borrowing needs, international savings funded for the most part increases in private business investment and household consumption (Figure 1.8).

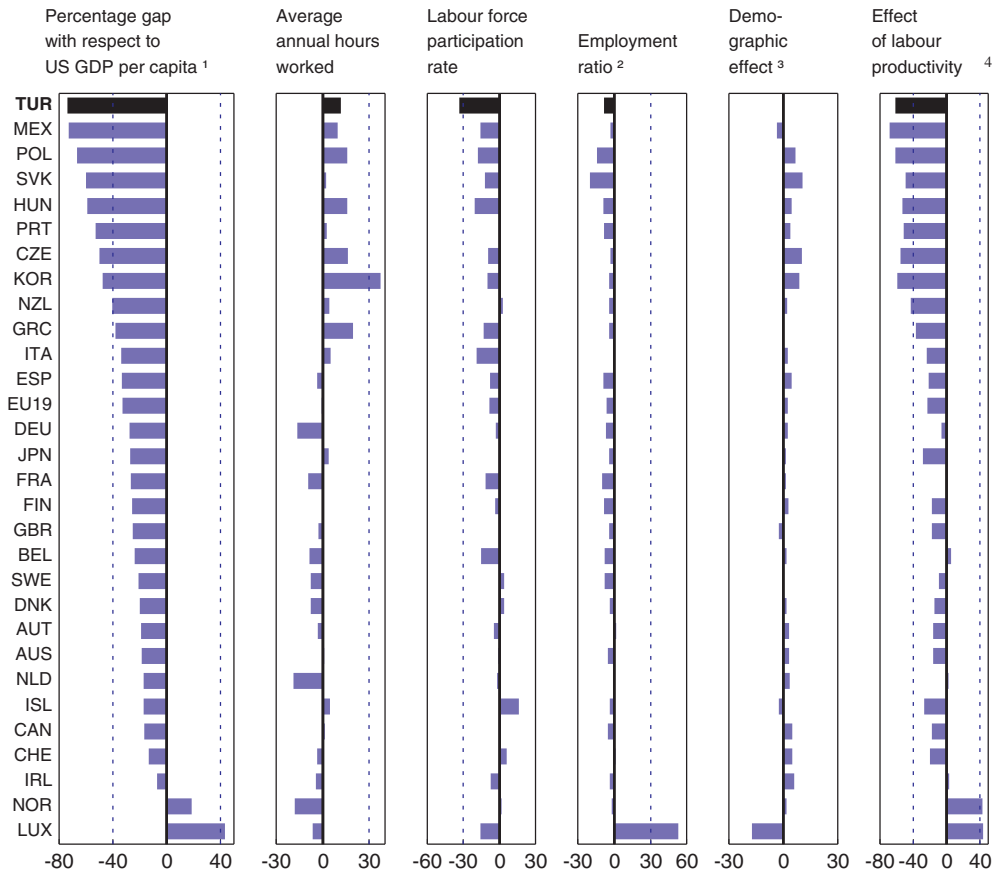
Structural weaknesses slow down the catching-up process

Gaps remain large against OECD living standards

Even after six years of strong growth, Turkey remains, by a wide margin, one of the lowest income OECD countries. The determinants of GDP per capita confirm that sizeable gaps against OECD benchmarks remain in both labour productivity and labour utilisation. Turkey's demographic advantage of boasting a relatively large working age population (with a comparatively lower proportion of elderly workers, and higher proportion of young cohorts) plays only a marginal positive role (Figure 1.9).

Figure 1.9. **Sources of real income differences**

2006



1. Based on year 2006 purchasing power parities (PPPs).
2. The ratio of employment to the labour force.
3. The share of working age population in total population.
4. Labour productivity is measures as GDP per hours worked.

Source: OECD (2008), *National Accounts, Productivity and Labour Force Statistics databases* and OECD calculations.

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But these low averages hide "thick tail" distributions. Labour force participation and employment rates are uneven across population groups, and productivity levels differ greatly across enterprise types. Working age men have significantly higher participation and employment rates than working age women, and modern enterprises of the formal sector are considerably more productive than informal and semi-formal firms. These large gaps between different categories of firms exist in manufacturing, services and agriculture alike.

Work incentives are strong but human capital is weak

Average education and employment rates are indeed clearly lower than in other OECD countries (Figure 1.10). Self-employment is very widespread, considerably above OECD averages, despite the low quality of work and low incomes associated with most self-employment activities. This phenomenon reveals the intensity of work incentives for working age men. Women migrating from rural to urban areas generally withdraw from the labour force, as they abandon their unpaid family worker status. This trend is expected to persist as there is still a large backlog of internal migration.[7] Labour force participation by women increases with educational attainment but the average education level of women remains lower than for men.

Shortcomings of the human capital stock have two aspects: *i)* Low *average* educational attainment of the working age population, which improves for young cohorts but changes only slowly for the labour force as a whole because of demographic inertia and inadequate post-school training; and *ii)* the uneven *quality* of education provided to young cohorts. Young cohorts are formally more educated than earlier generations but only a minority receives enough fundamental education to become ready to accumulate further labour market-relevant training. The distribution of Turkey's PISA results corroborates this highly skewed structure of human capital formed in the education system[8] and growing numbers of vacancies for semi-skilled job positions confirm the severity of this educational quality and skill gap.

The formal regulatory framework is not supportive of growth

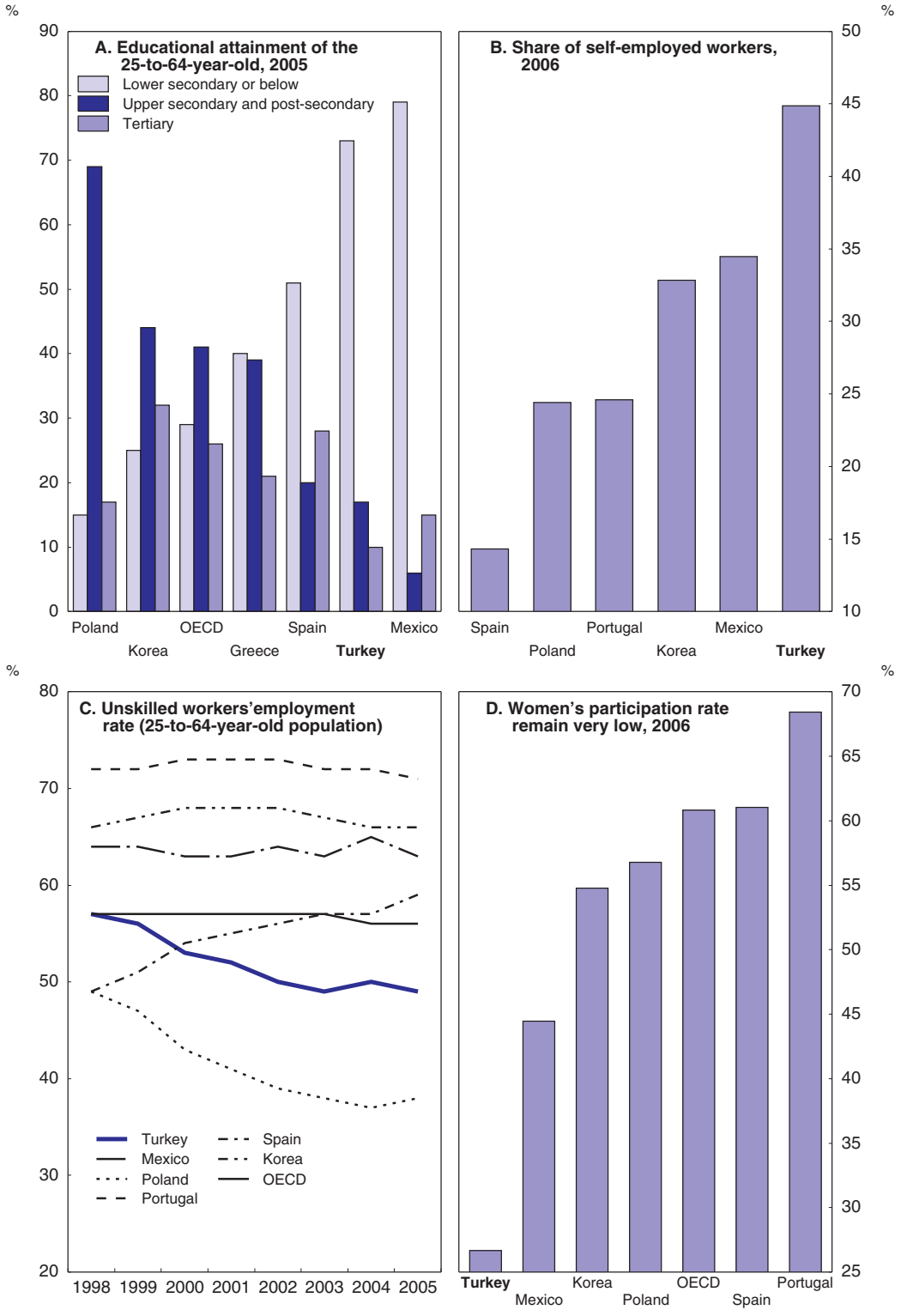
The official regulatory framework (the formal rules for doing business) is not supportive of productivity and employment growth. Important reforms in the 2000s, which mainly concerned the liberalisation of the foreign investment regime and helped Turkey achieve notable progress in the World Bank's *Doing Business* indicators, have not yet addressed the most challenging problems.

Product and labour market regulations still make it difficult for businesses to fully comply with the law (Figure 1.11). Operating in the formal sector, and gaining full access to modern capital, skilled labour, technology and foreign direct investment resources, is costly. Highly productive firms have the means to operate in legality and financial transparency, but the mass of less productive informal and semi-formal enterprises operate through grey areas, and bear the handicaps of this status.[9] This framework is not conducive to modernisation and productivity convergence in the entire business sector.[10]

Among regulatory challenges, the most severe relate to labour market rules. The main issues are: *i)* very high minimum wage/average wage ratios; *ii)* high labour tax wedges; and *iii)* rigorous employment protection and the highest severance payments in the OECD area.

Self-employment, very widespread, is not well supported by regulations either. It takes place largely in informality. More than 40% of the Turkish workforce is self-employed: 90% of agricultural, nearly 30% of service, and nearly 15% of manufacturing workers are

Figure 1.10. **Structural shortcomings of the labour market**



Source: OECD (2007), *Education at a Glance*; OECD (2008), *OECD Economic Outlook No. 83 database*; and OECD (2008), *Labour Force Statistics database*.

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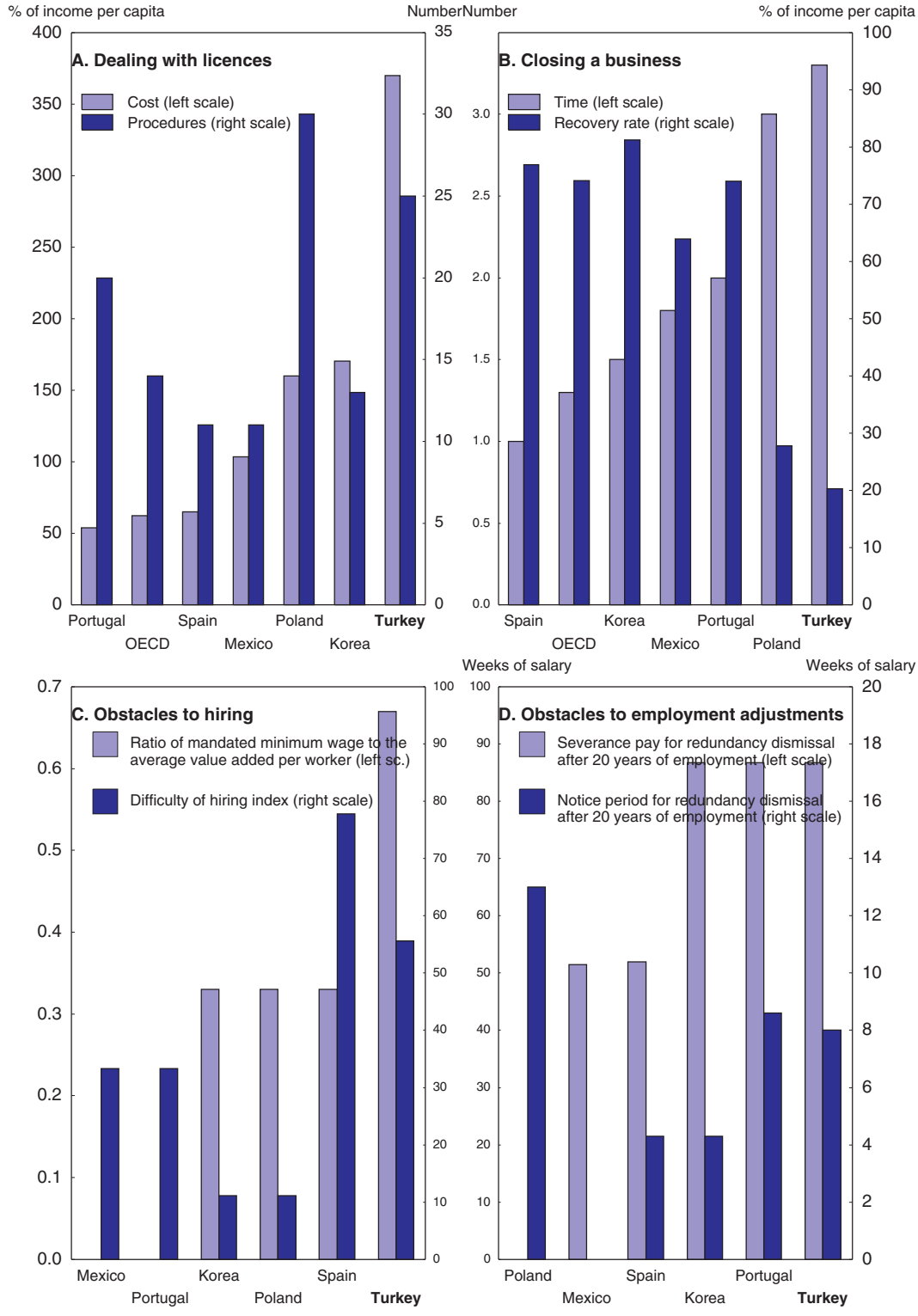
Figure 1.11. **Product and labour market regulations**



Source: World Bank (2007), *Doing Business*.

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self-employed. Most self-employment is informal, and takes place outside the realms of the tax and social security systems. The large majority of self-employees are trapped in a sub-standard status.

Another regulatory deficiency of the economic framework concerns commercial justice. Problems arise both from capacity shortcomings in the administration of commercial justice and, also, from long-accumulated inconsistencies in the legal system. Unpredictabilities may originate from internal conflicts between different sources of Law. A recent example was the High Court's cancelling the Social Security Reform Law in 2006 on the basis of constitutional provisions on the special prerogatives of civil servants.

The justice system has, at the same time, proven flexible enough to deal with the special needs of the informal economy. An example is the judicial validity of non-formal ownership evidence, which makes market transactions possible. However, such flexibilities in the judicial system are of course a costly second-best avenue which is not well adapted to the requirements of a modern economy. In particular, international investors have difficulty coping with such unpredictabilities.

The competitiveness of the economy has come under pressure

The competitiveness of the economy has come under severe pressure in the most recent period. Turkey is the OECD country which has faced the most pronounced rate of real currency appreciation in recent years, and in particular through 2007. These pressures originated from both a large inflation differential with trade partners, and the nominal appreciation of the Turkish lira. In the first quarter of 2008 the deterioration of international financial conditions and internal political tensions generated an important exchange rate depreciation; however, the likely duration of these special circumstances is not known and key sectors in the economy remain vulnerable to a re-intensification of pressures on its competitiveness (Figure 1.12).

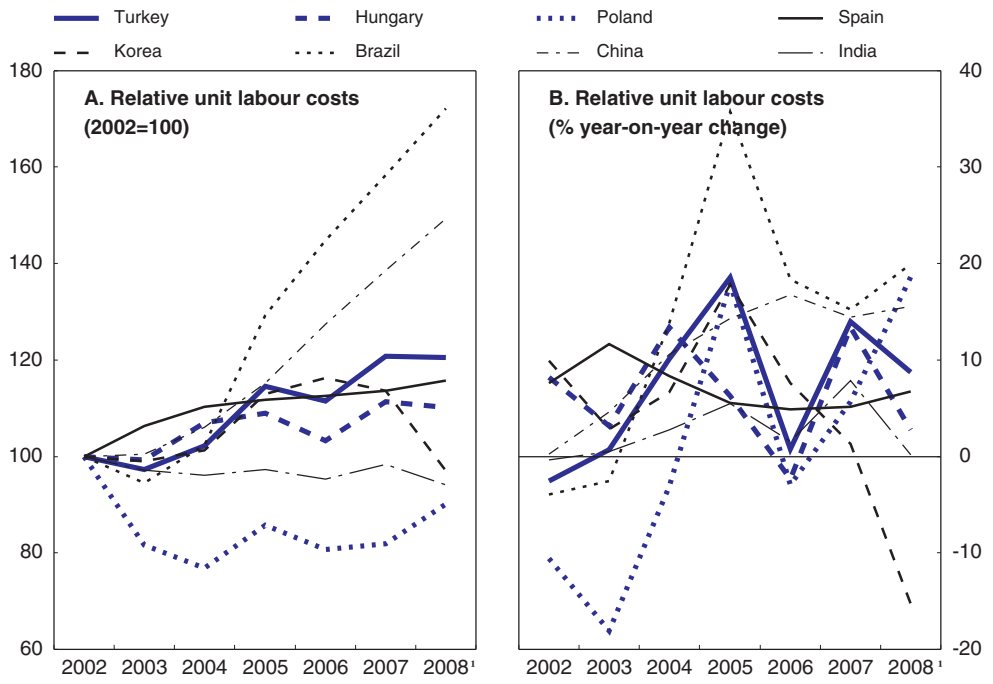
An investigation was undertaken for this *Survey* of the evolution of Turkish industry's competitiveness between 1998-2007. The channels through which the industry responded to competitive pressures, including through product differentiation, wage moderation and productivity gains have been investigated (Box 1.3).

Demand for low-skilled labour has weakened

As a result of competiveness losses in low-technology industries, which have the lion's share in total manufacturing output, demand for low-skilled labour has slowed down significantly (see Chapter 4). In contrast, supply of low-skilled labour is increasing as a result of ongoing exits from agriculture.

Turkey therefore faces increased difficulties in mobilising its most abundant resource – low-skilled labour. Labour demand remaining robust in the more sophisticated areas of the economy does not reduce this pressure. Chapter 4 provides a discussion of the employment challenges of low-skilled individuals in areas other than low-quality self-employment (which is increasingly a form of hidden underemployment).

Figure 1.12. **Relative ULCs: Turkey and Benchmark countries**



1. Based on the average index for q1 and q2 2008.

Source: OECD (2008), *OECD Economic Outlook No. 83 database*.

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Box 1.3. **Turkey's international competitiveness under real exchange rate fluctuations**

A quantitative analysis was undertaken, with the support of Central Bank's Research and Monetary Policy Department, to disentangle the sources of Turkey's international competitiveness. Building on a methodology developed for the 2006 OECD Survey of Turkey[1] price-adjusted unit labour costs have been calculated. Contributions of exchange rate changes, productivity gains, wage growth, and price mark-ups – capturing the effect of product differentiation – have been estimated (Figure 1.13).

The methodology was extended to capture the influence of "non-labour" cost components on competitiveness. Unit capital costs (which declined as a result of macroeconomic stabilisation), unit input costs (which differ across sectors according to their share of imported inputs), and unit energy costs (which fluctuate according to administrative price decisions) have been taken into account. This extension was undertaken to improve the assessment of the actual competitive stance of the Turkish industry.[2]

Four periods can be distinguished:

i) A gradual erosion of competitiveness between 1998-2000, prior to the 2001 currency crisis.

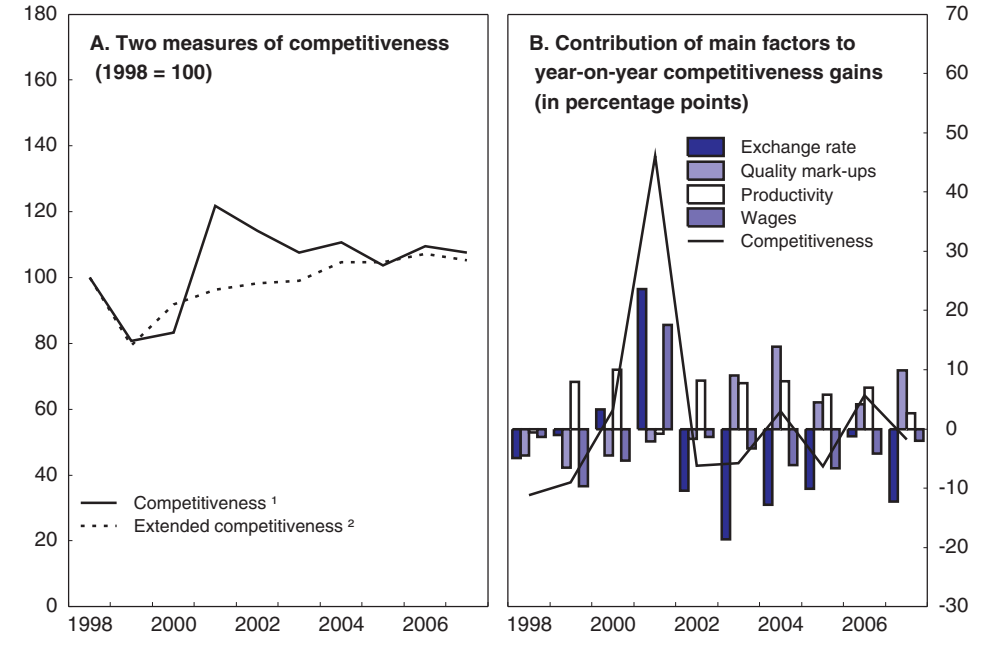
ii) A sudden restoration of competitiveness in 2001, due to sharp currency depreciation and real wage declines (following the inflation acceleration and open unemployment which occurred during the crisis).

iii) 2002-06 as a normalisation phase: competitiveness worsened and improved alternately in line with currency appreciation and depreciation periods (depreciations generally arose from turbulences in global markets, and have been of short duration).

iv) 2007 as a period of exceptional competitiveness squeeze. Pressures resulted from a combination of large inflation differential with trade partners, and strong nominal appreciation.

Box 1.3. **Turkey's international competitiveness under real exchange rate fluctuations** *(cont.)*

Figure 1.13. **Turkish industry's competitiveness, 1998-2007**



1. On basis of unit labour costs (export prices/unit labour costs).
2. On basis of unit labour, capital, energy and imported input costs (export prices/weighted sum of unit costs).

Source: G. Yilmaz and R. Gönenç (2008, forthcoming). Calculation methodology and detailed results are presented in this source.

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Various competitiveness indicators utilised in the research give specific insights:

v) *Price-adjusted unit labour costs* indicate relative stability of export profitability for the industry as a whole. Estimated margins for total manufacturing declined at the end of 2007 only to their 1997 level. The upturn in margins achieved in 2001 provided a hefty buffer that the economy could use until the end of 2007.

vi) However, this buffer was entirely exhausted at the end of 2007. Any further competitiveness losses will have to be absorbed by income cuts of all factors of production.

vii) When export competitiveness is estimated more comprehensively, by taking into account unit cost components other than labour, margins appear less squeezed. For the manufacturing industry as a whole, *estimated margins* might still be 20% above their 1997 level.

viii) The competitiveness of different sectors has evolved in highly different directions. Traditional labour intensive activities have been much more squeezed than higher productivity capital intensive industries.

ix) Manufacturers' profitability in the domestic market has been less squeezed than in international markets. Manufacturers drew on some sort of "local market power" to adjust domestic prices less than export prices.

x) This price shelter proves to be ephemeral. In 2007 domestic and export prices evolved for the first time in parallel. Domestic margins declined in proportion with export margins, reflecting an increased degree of integration between domestic and external markets.

Box 1.3. **Turkey's international competitiveness under real exchange rate fluctuations** *(cont.)*

Key determinants of the evolution of Turkish industry's competitiveness during this period were the following:

xi) Variations in exchange rates were crucial. They have the highest variance among all factors, and the highest impact on margins (as expected, competitiveness erodes sharply in periods of appreciation and recovers in periods of depreciation).

xii) However, exchange rates are by no means the unique determinant of competitiveness. Changes in the unit value of products (quality mark-ups) also play a significant role. Two periods should be distinguished in the evolution of these mark-ups:

- Until 2002, mark-ups on export prices have been "negative", that is to say export prices increased less than predicted by the estimation model (interpretation: exporters could not resist international price declines imposed by competitors).
- From 2002, the situation started to change. Exporters could set prices at levels above their predicted value, and estimated mark-ups turned positive. Raising the unit value of products above competitors started to become a common response of many Turkish manufacturers to competitive pressures.

xiii) Labour productivity brought a major positive contribution to competitiveness throughout the period. This contribution accelerated after 2001.

xiv) Real wages increased regularly (except in years of inflation accelerations), but remained below productivity growth. This moderation supported competitiveness and facilitated the expansion of output and employment during this time.

xv) Outcomes differ very significantly across business sectors. More sophisticated activities succeeded in improving their competitiveness, while lower technology activities relying on low-skilled labour and local inputs have been more severely squeezed. There is a large intermediary group of sectors continuing to struggle to preserve their competitiveness through various channels.[3]

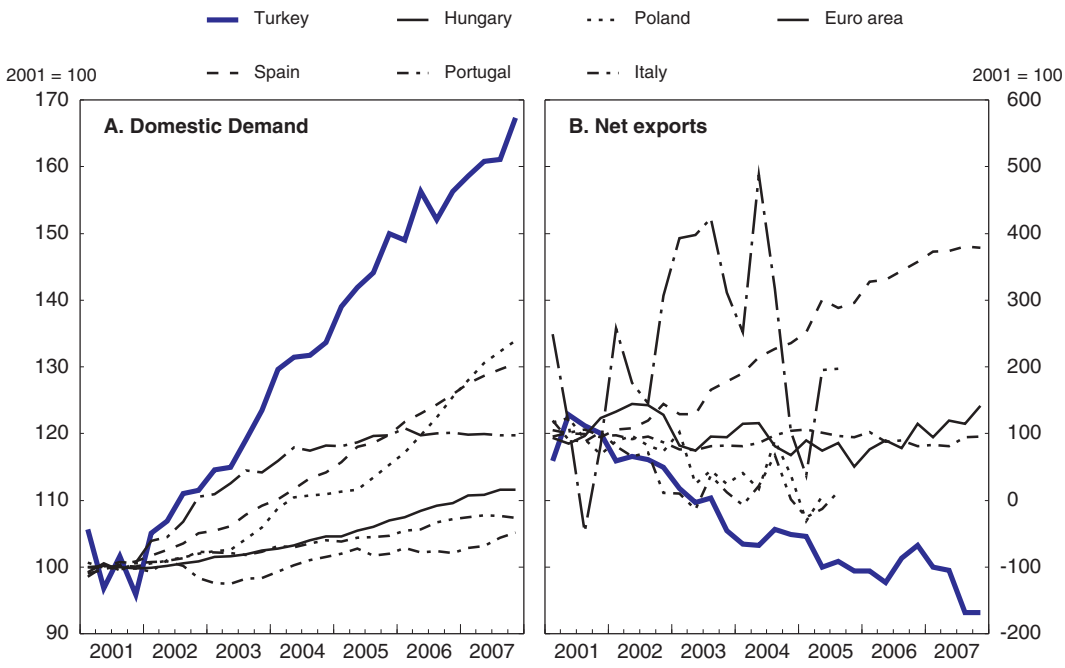
1. *OECD Economic Survey of Turkey*, 2006, Annex 3: "An analysis of the evolution and determinants of profitability in Turkish manufacturing industry, 1998-2005".
2. Details will be published in: G. Yilmaz and R. Gönenç (2008), "How Did Turkish Industry Respond to Increased Competitive Pressures, 1998-2007?", *Turkish Central Bank Discussion Paper,* forthcoming.
3. Chapter 4 provides additional insights on these findings.

Persisting imbalance between domestic and external demand

The vigour of domestic demand fuelled by real income gains entailed by currency appreciation contrasted, until recently, with the deceleration in net external demand provoked by competitiveness losses and terms-of-trade gains. This is not a sustainable mix in the medium-term. Even if the bias in favour of domestic and against external demand is common to catching-up economies, it is generally less pronounced than in Turkey. If the competitive squeeze is too harsh for the absorption capacity of the economy and if the capacity to reallocate resources is not improved through additional structural reforms growth performance is unavoidably affected (Figure 1.14).

A better balance between the sources of growth may be achieved through exchange rate adjustments under the floating exchange rate regime and purposeful microeconomic reforms. Otherwise, persisting weaknesses in external demand generate negative demand spill-overs through the economy, and undermine confidence. Despite greater political stability after the summer elections, and a broadly supportive international environment, a weakening of confidence of this type has occurred in the Turkish economy since the second half of 2007, which was amplified by the effects of a drought in agriculture and worsening conditions in international financial markets in the second half of the year (Box 1.4).

Figure 1.14. **Demand sources are less balanced than in other catching-up economies**



Source: OECD (2008), *OECD Economic Outlook No. 83 database*.

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Turkey is not yet perceived as a fully resilient economy

Turkey is still perceived as an economy vulnerable to external shocks. The recent literature on the determinants of national economies' vulnerability to external conditions feature a number of risk factors. In combination, these factors shape the international risk status and rating of a country. Parts of the recent literature refer explicitly to the Turkish experience. The main factors identified are listed below and Turkey's recent progress and persisting shortcomings in these areas are summarised in Table 1.2. Figure 1.15 plots Turkey's position against other emerging countries.

Despite major progress made in recent years on both the macroeconomic and structural front, Turkey's credit rating remains *sub-investment grade*, and has been improving only slowly. This raises the obvious question of whether such a rating is unduly low, or whether it is justified on the basis of Turkey's current fundamentals. This question is investigated in the section below. The central undermining factor continues to be identified as the high current account deficit, but continuing political uncertainties affecting the pace of reforms may also play a role.[11]

The stand-by arrangement with the IMF, enforced consistently since 2001, played a major role in re-establishing the credibility of Turkey's macroeconomic policy in international markets, as discussed in Chapter 2.[12] The completion of this arrangement in May 2008 poses an important challenge for Turkey. A credible substitute to the IMF programme should be devised to preserve the credibility that Turkey's policies started to gain under the close monitoring and international visibility provided by the IMF arrangement.

Box 1.4. **Short-term economic developments and prospects**
(*OECD Economic Outlook*, Spring 2008 projections for Turkey)

Strong growth decelerated to an annualised rate of 3.4% in the final quarter of 2007, and settled at 4.5% for the year as a whole. The deterioration of the net contribution of trade to growth spilled over to all sectors of the economy, and to all demand components. Net job creation slowed down, and unemployment picked up since end-2007.

Risk premia increased and the exchange rate depreciated in the first quarter of 2008. Deteriorating international financial conditions and uncertainties in the political environment contributed to larger increases in Turkey's risk premia and interest rates than in other emerging countries.

Growth should slowdown to below 4% in 2008, before picking up to about 4.5% in 2009 – assuming that current uncertainties ease. There are downside risks related to the conditions of transition from the IMF agreement, and to possible domestic political complications, which could increase risk premia and interest rates and hamper growth. If, however, confidence is restored in economic policies, and if the implementation of structural reforms accelerates, growth could pick up more rapidly.

Turkey: Demand, output and prices

	2004	2005	2006	2007	2008	2009
	Current prices TRL billion	Percentage changes, volume (1998 prices)				
Private consumption	398.6	7.9	4.6	4.6	3.0	4.1
Government consumption	66.8	2.5	8.4	2.8	1.1	4.6
Gross fixed capital formation	113.7	17.4	13.3	3.3	2.0	4.7
Final domestic demand	579.1	9.1	6.8	4.1	2.6	4.3
Stockbuilding[1]	–5.3	0.0	–0.1	1.5	0.8	0.0
Total domestic demand	573.8	9.2	6.7	5.5	3.4	4.2
Exports of goods and services	131.7	7.9	6.6	6.7	6.3	4.9
Imports of goods and services	146.4	12.2	6.9	11.1	4.4	3.7
Net exports[1]	–14.7	–1.3	–0.3	–1.6	0.2	0.1
GDP at market prices	559.0	8.4	6.9	4.5	3.7	4.5
GDP deflator	–	7.1	9.3	8.1	9.5	7.3
Memorandum items:						
Consumer price index	–	8.2	9.6	8.8	9.6	7.5
Private consumption deflator	–	8.3	9.8	8.2	9.5	7.5
Unemployment rate	–	10.0	9.7	9.5	10.2	10.5
Current account balance[2]	–	–4.7	–6.1	–5.8	–5.4	–5.3

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD, *OECD Economic Outlook No. 83 database*.

Recent macroeconomic consolidation and Turkey's credit rating

Since the 2001 crisis Turkey's fiscal position has considerably improved. Public debt has fallen dramatically, domestic banks have been recapitalised, the inflation rate has fallen to single-digits, and economic growth has been strong until the end of 2007. Despite these achievements, Turkey's sovereign credit rating remains speculative (sub-investment) grade and has improved only slowly; Standard and Poor's for instance has upgraded Turkey's

Table 1.2. **Potential factors behind Turkey's external vulnerability**

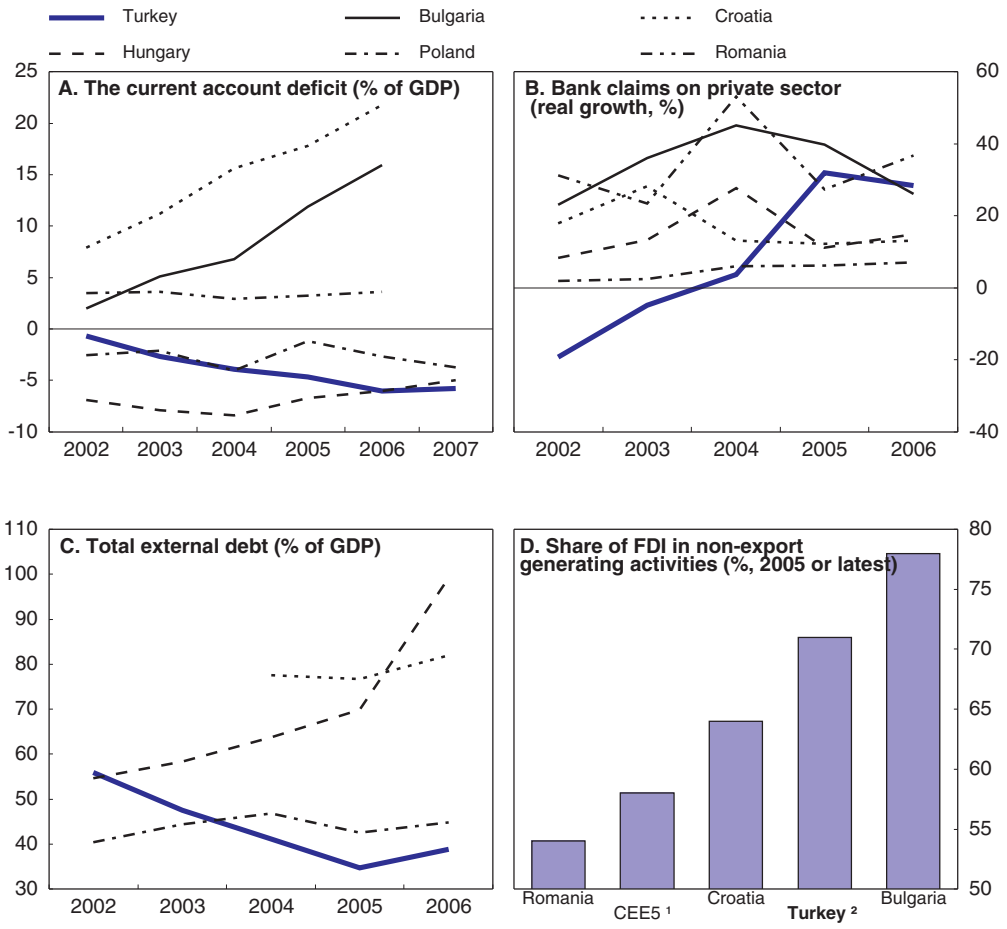
Sources of external vulnerability	Emerging country benchmarks	Turkey's recent record and position
Fiscal sustainability	A total budget surplus/GDP ratio higher than 2-3% is desirable.	Major progress was achieved in the primary balance (even if the total balance is still short of benchmarks). There are remaining transparency shortcomings and some electoral drifts occurred in 2007.
Public debt growth	The consolidated public debt/GDP ratio should be lower than 50%.	Turkey's gross public debt stock is around 40% of GDP, and its net public debt stock around 30% of GDP.
Monetary stability	Inflation rate should be lower than 4%.	Spectacular progress was achieved in escaping hyperinflation and inflation volatility. Still, the explicit low inflation target faced the inertia of inflation outcomes and expectations.
Current account balance	The current account deficit should be lower than 3% of GDP.	The deficit declined from 6.1% of GDP in 2006 to 5.8% of GDP in 2007.
External debt growth	The external debt ratio should be lower than 50% of GDP.	Turkey's gross external debt amounts to around 38% of GDP
Composition of capital inflows	FDI and long-term lending should account for the bulk of current account financing.	Major recent improvement in the share of FDI and long term-debt.
Destination of FDI inflows	FDI inflows should be strong enough in tradable activities generating significant export revenues.	Recent FDI inflows were directed mainly to domestic market-oriented services such as banking, communications and retail trade.
Pace of domestic credit growth	Annual credit growth should be lower than 25%, in real terms.	Private sector credits increased very rapidly, to fund both business investment and household consumption.
Real exchange rate appreciation	Excessive real exchange rate appreciation is a source of vulnerability.	Turkey experienced one of the fastest rates of real currency appreciation until the end of 2007.
Banking sector soundness	Banks' non-performing loan ratio should be below 5%.	Following the 2000s' banking-prudential reforms the non-performing loan ratio declined from above 20% in 2002 to below 5% in 2007.

sovereign rating by only three notches, from B– at end-2002 to BB– at end-2007 – before downgrading the rating outlook in April 2008 (Table 1.3).[13] The implication is that Turkey is still highly vulnerable to external shocks. But do Turkey's fundamentals justify this assessment?

Early "first generation" models of vulnerability[14] emphasised loose monetary policy and a continuous deterioration of macroeconomic fundamentals leading to a steady depletion of the gross official reserves of the central bank. In these models, rapid credit growth is associated with monetary financing of large public sector deficits. It is true that real credit growth has been very rapid in Turkey in the period since mid-2004. However, it is credit growth to the private sector rather than to the government that has been growing strongly (Figure 1.16). Moreover, gross official reserves are not exceptionally low in comparison with other emerging countries: Turkey's gross reserves are similar to those of the Czech Republic, Poland and Hungary when measured as a ratio of broad money, and significantly higher when measured in months of imports of goods and services. Yet, Turkey's sovereign credit rating is significantly lower (Figure 1.16, Table 1.3).

The later "second generation" models of external vulnerability emphasised the role of fiscal policy and indebtedness.[15] If public deficits are financed by borrowing, rather than through money creation, this would limit excess money supply and prevent both a jump in inflation and a continuous decline in international reserves. However, if the real interest rate exceeds the real growth rate of the economy and there are no offsetting primary surpluses, public debt growth would not be sustainable. This would render the economy vulnerable to self-fulfilling speculative attacks, although the timing would be hard to predict. In the Turkish case, as discussed in Chapter 2, the government has been steadily strengthening its fiscal position (with the notable exception of 2007) and net public debt has been falling steadily from nearly 70% of GDP in 2001 to an estimated 30% of GDP in 2007. By contrast, the private sector increased its borrowing from abroad at a rapid pace. As a consequence, Turkey's total external debt to export ratio, having fallen steadily over

Figure 1.15. **Why Turkey is still perceived as a vulnerable economy – international comparisons**



1. Includes Czech Republic, Hungary, Poland, Slovak Republic and Slovenia.
2. Refers to 2006.

Source: IMF (2008), *International Financial Statistics*, OECD (2008), *OECD Economic Outlook No. 83 database*, World Bank, JEDH, WIIW, NBS and CBRT.

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the period 2001 to 2005, increased in 2006 before declining again in 2007. Turkey's external debt indicators and its debt service ratio are at present quite high in comparison with other emerging market economies (Figure 1.17, Table 1.3).

External debt simulations for Turkey suggest that the country's external debt dynamics is vulnerable to short-term shocks. Figure 1.18 presents an update of the four external debt scenarios discussed in the 2006 *OECD Economic Survey of Turkey*. The methodology and the assumptions underlying these scenarios are presented in Annex 1.A2.

- The *baseline scenario* assumes a continuation of sound macroeconomic management but no acceleration in the structural reform agenda, with growth picking up from 3.7% in 2008 to 6.0% by 2010. Although there is no crisis under this scenario the gross external debt stock rises from 37.5% of GDP in 2007 to around 39% of GDP by 2010.

Table 1.3. **Sovereign credit ratings and vulnerability indicators**

2007 or latest year available, unless indicated otherwise

	Argentina	Brazil	Bulgaria	Czech Rep.	Hungary	Korea	Mexico	Poland	Romania	**Turkey**
Credit ratings[1]										
Standard and Poor's:										
Local currency debt	B+	BBB	BBB+	A+	BBB+	A+	…	A	BBB	BB
Foreign currency debt	B+	BB+	BBB+	A	BBB+	A	…	A–	BBB–	BB–
Fitch ratings:										
Long-term local currency debt	B	BB+	BBB+	A+	A–	AA	A–	A	BBB+	BB
Long-term foreign currency debt	RD	BB+	BBB	A	BBB+	A+	BBB+	A–	BBB	BB–
Macroeconomic indicators										
GDP growth 2006	8.5	3.7	6.1	6.4	3.9	5.0	4.8	6.1	7.6	6.9
CPI inflation (end year), 2007	8.8	3.6	8.4	2.9	7.9	2.5	4.0	2.4	4.8	8.9
Investment in per cent of GDP, 2006	23.4	16.8	26.2	24.6	21.7	29.0	20.4	19.9	24.6	22.3
Overall fiscal balance, general government (% of GDP), 2006	2.0	–2.8	3.5	–2.9	–9.1	1.8	–0.7	–0.9	–1.7	–1.7
Gross public debt (% of GDP), 2006			24.7	30.1	65.5	36.5	43.5	48.8	18.5	47.9
Current account balance (% of GDP), 2006	3.8	1.3	–15.2	–3.0	–6.0	0.7	–0.2	–3.0	–9.6	–6.1
Gross official reserves, USD bn, 2006	30.9	85.2	10.9	31.2	21.5	238.9	76.3	46.4	28.1	60.9
In months of imports of goods and NFS, 2006	9.0	8.0	4.8	3.3	2.7	7.5	3.3	3.7	5.7	4.9
In per cent of broad money, 2006	42.3	13.2	50.9	31.8	32.3	37.5	16.2	27.2	56.5	26.9
Gross total external debt, USD bn (2006)	106.3	186.6	23.0	51.9	112.0	232.8	173.2	153.5	. .	193.5
In per cent of GDP	49.5	17.4	72.7	36.3	99.2	26.2	20.6	44.9	. .	36.5
In per cent of exports of goods and NFS	200.4	119.5	112.6	47.9	127.5	61.0	64.7	111.3	. .	161.0
Gross short-term external debt, USD bn (2006)	23.4	18.2	6.7	14.0	13.2	98.0	21.3	21.0	. .	40.1
In per cent of gross total external debt	22.0	9.7	29.1	27.0	11.7	42.1	12.3	13.7	. .	20.7
In per cent of gross official reserves	75.8	21.3	61.2	44.9	61.1	41.0	27.9	45.4	. .	65.9
Debt service ratio, 2006[2]	31.6	37.3	12.4	…	33.1	. .	18.9	24.7	18.4	33.2
Real effective exchange rate appreciation (CPI based), 2007[3]	–2.40	8.42	4.28	2.77	11.64	–0.42	–0.74	3.37	7.56	8.47
Balance sheet indicators										
Non-bank private sector debt to foreign banks/exports	61.02	41.47	62.88	25.78	20.57	30.35	42.18	36.57	–	87.43
Total private sector debt to foreign banks/exports	72.73	73.78	92.20	39.53	64.45	71.59	46.65	56.16	–	133.55
Total (private and public) debt to foreign banks/exports	204.03	125.24	124.25	52.06	118.23	77.61	67.60	114.91	–	224.40
Total short-term debt over Total debt to foreign banks	22.37	11.78	42.86	33.03	16.05	44.12	12.51	17.38	–	20.51
Real credit growth to private sector, % change	22.7	20.6	16.2	16.9	12.3	12.1	26.7	22.7	46.7	30.3
Capital adequacy ratio	16.8	18.5	14.5	11.9	11.0	12.8	16.1	13.2	17.8	22.0
Commercial banks' non-performing loans NPLs (% of total loans)	3.9	3.6	2.2	3.0	2.5	0.9	2.0		8.4	3.8

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Table 1.3. **Sovereign credit ratings and vulnerability indicators** *(cont.)*

2007 or latest year available, unless indicated otherwise

	Argentina	Brazil	Bulgaria	Czech Rep.	Hungary	Korea	Mexico	Poland	Romania	**Turkey**
Banking system liquid assets to total assets	15.7		24.9	28.6	20.0		26.7	35.1	54.4	39.6
FC-denominated bank loans to total bank loans			48.6	13.7				28.0	47.2	27.3
FC-denominated bank liabilities to total bank liabilities			56.7		39.3				44.1	37.6
Household debt to GDP		10.1	28.4	17.3	21.1			18.2		12.4
Market flexibility indicators										
OECD: product market regulation indicator (2003)										
Overall				1.7	2.0	1.5	2.2	2.8		2.3
Barriers to entrepreneurship				1.9	1.4	1.7	2.2	2.3		2.5
Barriers to trade and foreign investment				0.9	1.4	1.3	2.4	2.4		1.7
Administrative regulation				2.4	1.5	1.8	2.0	2.9		3.0
Economic regulation				2.0	2.7	1.6	2.1	2.7		2.1
OECD: employment protection regulation indicator (2006)				2.1	1.8	2.0	3.2	2.3		3.5
Business environment, 2007[4]										
Ease of doing business	109	122	46	56	45	30	44	74	48	57
Starting a business	114	122	100	91	67	110	75	129	26	43
Dealing with licenses	165	107	103	83	87	22	21	156	90	128
Enforcing contracts	47	106	90	97	12	10	83	68	37	34
Closing a business	65	131	72	108	53	11	23	88	81	112
Employing workers	147	119	57	55	81	131	134	78	145	136
Rigidity of employment index	41	46	29	31	30	37	48	37	66	42
Difficulty of hiring index	44	78	17	33	0	11	33	11	78	56
Rigidity of hours index	60	60	60	40	80	60	40	60	80	40
Difficulty of firing index	20	0	10	20	10	40	70	40	40	30
Firing costs (weeks of wages)	139	37	9	22	35	91	52	13	8	95

1. Credit ratings are either *investment grade*, ranging from highest quality (AAA) to adequate payment capacity (BBB+ to BBB–), or *speculative grade*, ranging from likely to fulfill obligations but ongoing uncertainty (BB+ to BB–) to high-risk obligations (B+ to B–).
2. Debt service ratio defined as total debt service to exports of goods and services (including workers' remittances).
3. 2006 for Bulgaria and Romania.
4. From World Bank's *Doing Busness*, 2008.

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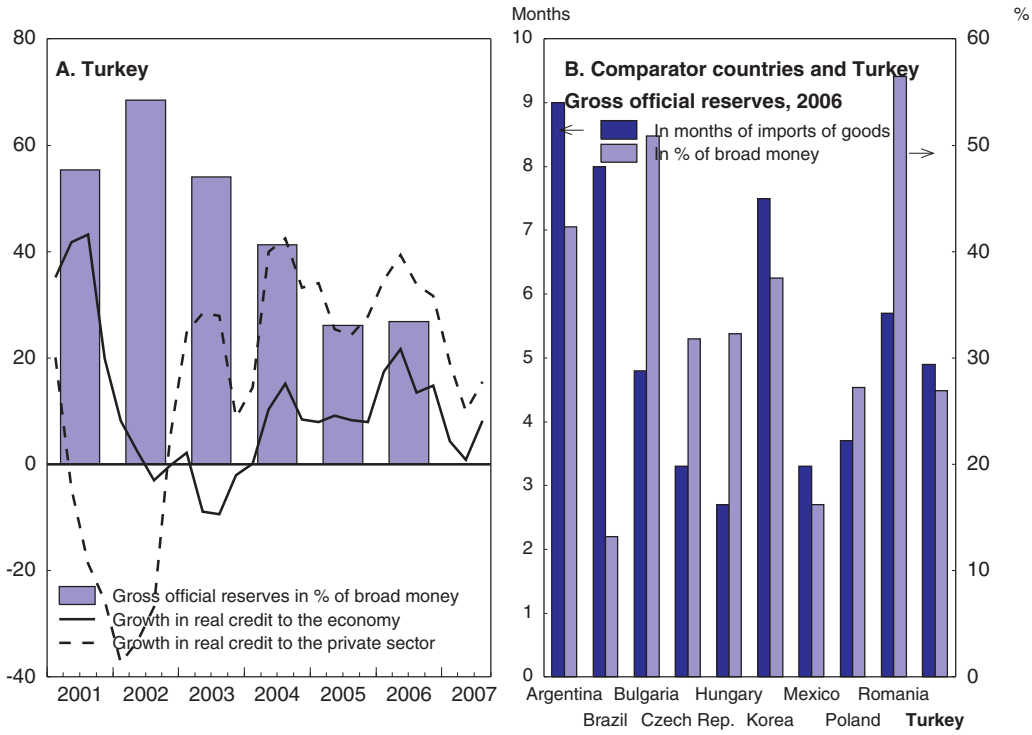
Figure 1.16. **Gross official reserves and credit growth**



Source: IMF, *International Financial Statistics*.

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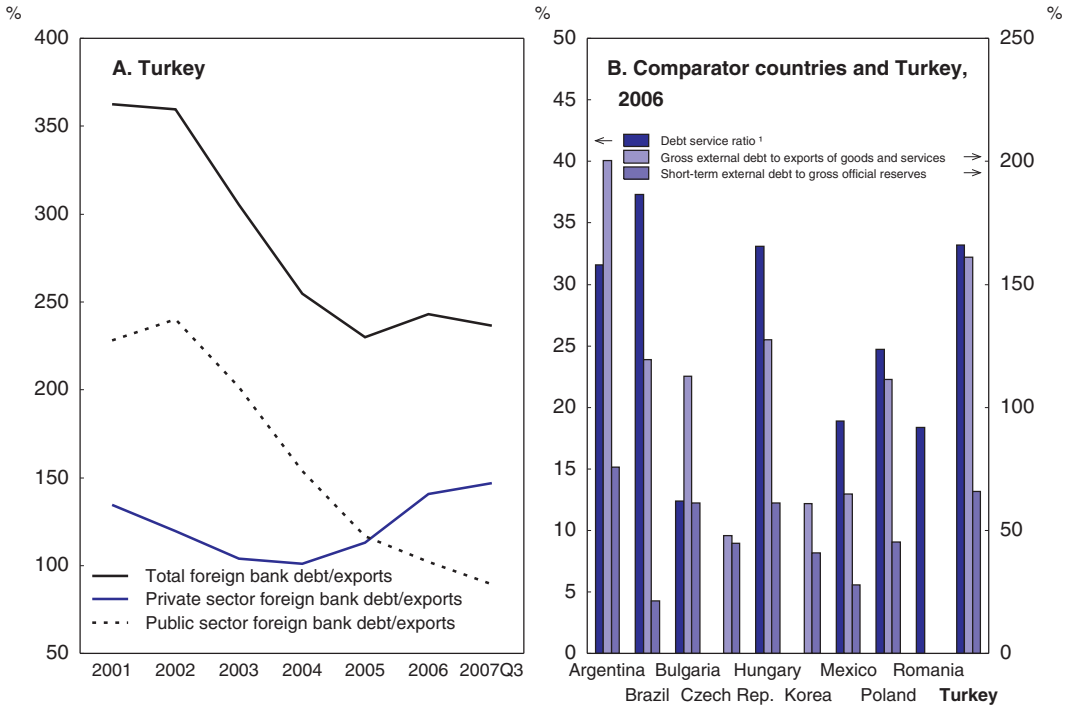
- The gross external debt stock rises more sharply under the *external shock scenario*, which analyses the impact of lower risk appetite in world financial markets and a loss of confidence in emerging markets. Under this scenario revaluations of the existing external debt stock resulting from exchange rate depreciations and higher debt servicing costs pushes external debt to over 45% of GDP by 2010.
- A faltering of the structural reform agenda could also generate a negative shock if it results in a loss of competitiveness in export markets, with a significant worsening of the trade and current accounts deficits leading to nominal exchange rate depreciation and higher interest rates. Under the *no further reform: loss of competitiveness scenario* presented in Figure 1.18 the gross external debt stock rises to almost 44% of GDP by 2010. By contrast, under the *accelerated structural reform scenario* Turkey's gross external debt declines from 37% of GDP in 2008 to 33% of GDP by the end of the projection period.

Not surprisingly, the rise in the ratio under the first three (least favourable) scenarios is mainly due to rising private sector external debt, which increases from 24% of GDP in 2007 to 35% of GDP under the *loss of competitiveness* scenario, and to just under 37% of GDP under the *external shock* scenario, by the end of 2010. This highlights the importance of further strengthening the framework for financial sector supervision to account for and limit the risks which may arise from this rapid growth of private sector external debt.

Figure 1.17. **External debt indicators**



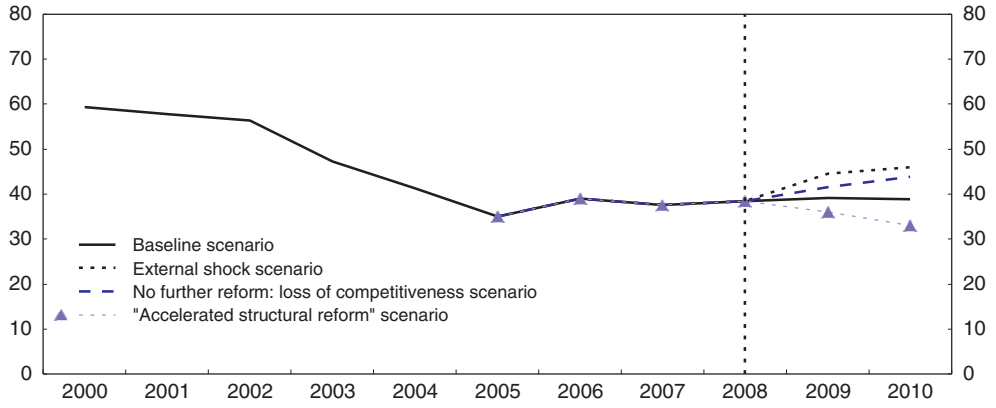
1. Total debt service payments in per cent of exports of goods and services.

Source: IMF, *International Financial Statistics;* World Bank, *Global development finance* and *Joint external debt hub.*

StatLink http://dx.doi.org/10.1787/418651748148

Figure 1.18. **Gross external debt stock under alternative scenarios**

% of GDP



Source: OECD calculations based on Turkish Treasury data.

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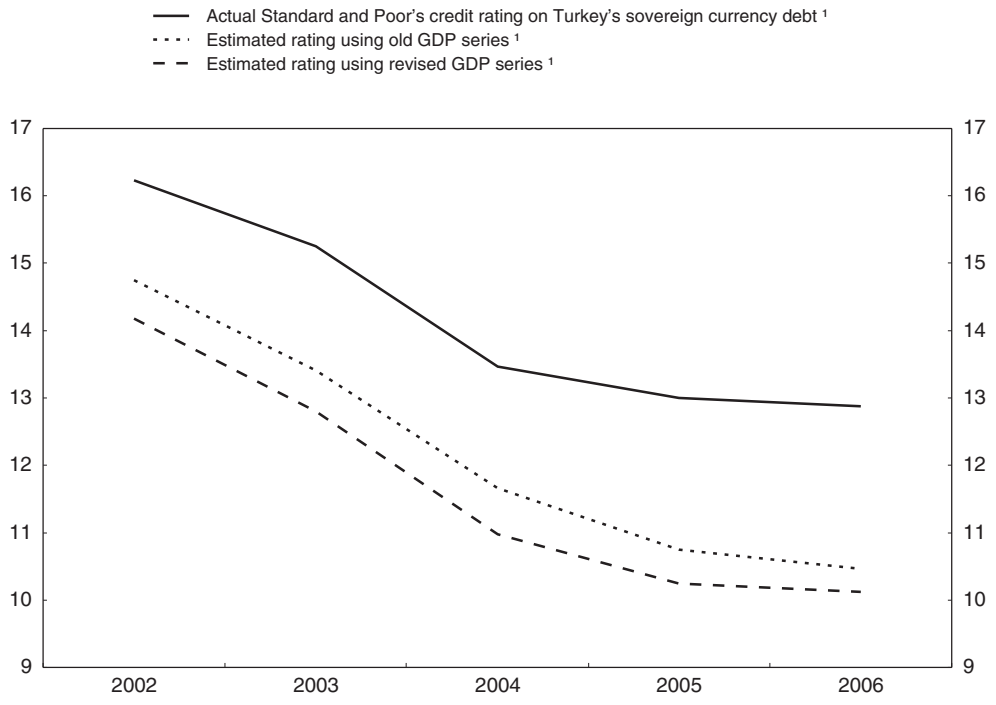
Underpinning Turkey's external indebtedness is Turkey's large and growing current account deficit, which rose from 2.6% of GDP in 2003 to an estimated 5.8% of GDP in 2007. This is high in comparison with most emerging market economies, even if the rise of international oil prices contributed importantly to this increase in the deficit[16] (Table 1.3). At the same time, Turkey has been fairly successful in attracting non-debt-creating financing

for its current account deficit. In the recent period, a large part of it was financed by foreign direct investment (FDI) and non-debt creating portfolio inflows, and as a result Turkey's external debt has not seen a sharp rise despite a widening current account deficit.[17] On the other hand, it has only been in the period since 2005 that Turkey has managed to attract significant amounts of FDI and the majority of these inflows went into sectors that do not generate any significant export earnings (such as banking, retail trade, telecom and energy sectors). Also, the presence of a large stock of short-term foreign capital in the economy makes it vulnerable to shifts in global market sentiments. For these reasons the concerns, expressed for example by Goldstein (2005) after a systematic review of a wide range of macroeconomic factors in emerging countries which concluded at a high degree of vulnerability in the Turkish economy, continue to deserve attention, even if Turkey has successfully weathered recent deteriorations in international financial markets.

Does its strong dependence on foreign savings explain Turkey's unfavourable sovereign credit ratings? To answer this question a model estimated by Mulder and Perrelli (2001) was applied: it seeks to explain foreign currency sovereign credit ratings for emerging market economies as a function of their debt rescheduling history, and other macroeconomic variables.[18] Applying this equation to Turkey and comparing the estimated results with (a linear transformation of) actual credit ratings, it is found that Turkey's present rating is clearly worse than what should be expected on the basis of macroeconomic fundamentals. The gap between actual and expected ratings also appears to be growing over time. According to the model, Turkey could have expected to earn an investment grade credit rating of BBB- at end-2006 instead of BB- (Figure 1.19).

Figure 1.19. **Estimated and actual sovereign ratings for Turkey**



1. Actual and estimated credit ratings have been linearised. For effective credit ratings see Table 1.3.

Source: Standard and Poors and OECD calculations.

StatLink http://dx.doi.org/10.1787/418682671186

A so-called "third" generation of vulnerability models focus on balance sheet indicators of the main sectors of the economy.[19] With regard to the government sector, the key vulnerability would relate to the relatively short maturity of domestic public debt, which averaged 34 months in 2007. However, the average maturity of domestic public debt has been steadily increasing – it was only 14.8 months in 2004. Standard and Poor's (2007) points out however that, despite Turkey's falling public debt burden, less progress has been made in addressing the long-term structural weaknesses in both the revenue and expenditure sides of the budget. This leaves Turkey vulnerable to business cycle fluctuations. Revenues are largely dependent on special consumption taxes that exist on petroleum products, white goods, autos, and tobacco and alcohol, such that fluctuations in domestic demand and oil prices translate strongly into revenue volatility. On the expenditure side, the wage bill, social security payments and interest payments account for almost 65% of total central government spending, and adding other current transfer payments raises this figure to almost 80%. This leaves little flexibility to adjust public spending in response to unexpected developments.

Turning to banks, and despite an exceptionally rapid growth of their credits which raised a number of concerns,[20] there is a commonly shared view that the recent strengthening of prudential supervision, and the relatively comfortable capital adequacy of banks,[21] have made their balance sheet situation broadly sound. However, it must be noted that about a quarter of bank loans are in foreign currency or foreign exchange-indexed, and expose banks to indirect foreign currency risks via the exposure of their customers.[22]

The bulk of such indirect exposure arises from corporations' balance sheets. The open foreign currency position of the corporate sector has continued to widen, adding to balance sheet vulnerabilities.[23] Corporate loans denominated in lira but linked to a foreign exchange index have also been growing rapidly in recent years, and may be a source of rising foreign exchange risk, particularly among SMEs.[24] There are also some concerns regarding the quality of hedging in certain parts of the banking and corporate sectors.

Keller, Kunzel and Souto (2007) applied a Contingent Claims Approach to Turkey that takes various balance sheet exposures into account, incorporating interlinkages between them, and deriving quantitative measures of default risk. The basic idea is to model the sovereign balance sheet similarly to a firm's balance sheet, by grouping the main accounts into assets, liabilities and "equity". The results are broadly consistent with the sovereign credit ratings assigned to Turkey by the major rating agencies (with the one-year ahead cumulative default probabilities obtained from applying this methodology similar to the historical averages of sovereign default probabilities for BB rated sovereigns). The authors argue that taking into account the balance sheet weaknesses of the government, bank and corporate sectors, Turkey's sovereign credit rating is broadly appropriate. However, this assessment has not taken into account the latest revision of Turkish GDP which could positively affect *sovereign equity* through lower debt-to-GDP ratios.

In addition to these traditional approaches to Turkey's external vulnerabilities, which focus on macroeconomic balances, new streams of analysis in the vulnerability literature emphasised the role of the structural characteristics of markets and institutions.[25] In particular, the importance of product and labour market flexibility in response to macroeconomic shocks has been stressed.[26] There is a general consensus that greater product and labour market flexibility reduces the amplitude of the effects of domestic and external shocks. Indicators compiled by the OECD and the World Bank suggest that, from

this point of view, the Turkish economy is in principle more rigid than other emerging market countries, particularly when it comes to administrative regulations, difficulty in hiring workers, adjusting employment etc. (Figure 1.10 above and Table 1.3). At the same time, a large informal sector has brought significant flexibility to the Turkish economy to date, making it better able to cope with shocks than would be expected on the basis of formal indicators of product and labour market rigidities.

Turkey's vulnerability to external shocks has many sources, including a high dependence on foreign savings, risks associated with balance sheet vulnerabilities, the rigidity of formal product and labour markets and domestic political uncertainties. At the same time, Turkey's existing credit rating and risk premia are excessively cautious when compared to its relatively strong macroeconomic fundamentals. The persistence of a perception of unaccounted for (hidden) vulnerabilities and risks should be addressed with additional confidence-building macroeconomic and structural reforms.

The 2007 elections vested the government with a mandate to stick to prudent macroeconomic policies, and continue with ambitious structural reforms. After the elections, the government announced its intention to conduct its policies in the framework of medium- and short-term priorities. A medium-term action plan was announced in December 2007, with specific quarterly, annual and multi-annual targets. Objectives are set in compliance with the *Ninth Development Plan 2007-2013* finalised by the government before the elections, with five main objectives: *i)* enhancing competitiveness; *ii)* increasing employment; *iii)* ensuring regional development; *iv)* increasing the quality and effectiveness in public services; and *v)* strengthening human development and social solidarity.

The following chapters of the *Survey* review the main challenges facing the Turkish authorities, and the government initiatives which are either under way or are recommended in the areas of fiscal, monetary and structural policies.

Fiscal reforms (Chapter 2)

After six years of very tight fiscal policies, Turkey faces key fiscal policy challenges: how to *i)* preserve a rigorous fiscal policy stance while; *ii)* strengthening its growth-enhancing public services and infrastructure; and *iii)* simultaneously reducing the most distortive aspects of the tax system. With the IMF Stand-by agreement having come to an end in May 2008, a credible domestic framework should be put in place to preserve the confidence gained under IMF surveillance, while achieving the needed changes in revenue and spending composition.

The country is in a strong position to move towards such a new fiscal strategy. Public debt is on a sustainable path, and fiscal institutions are being modernised with major improvements in the legal framework for fiscal policy. However, this new framework could not be fully implemented to date. Both on the expenditure and revenue sides, Turkey's new fiscal strategy will need to rely on the complete enforcement of the new framework for fiscal management, but also on strong political commitments for clarifying Turkey's top spending priorities, shifting to more efficient and competitive provision of key public services and infrastructures, and reducing the most distortionary taxes and closing the main tax loopholes. Chapter 2 reviews the ongoing government initiatives in this area and makes additional recommendations.

Monetary policy (Chapter 3)

Monetary and exchange rate policy was a successful pillar of the post-2001 recovery. However, when the Central Bank set a more ambitious medium-term inflation target for 2007-10, this met with persisting inflation inertia, which was compounded with major exogenous supply and price shocks in the most recent period. Meanwhile, interest-rates remained very high and could not be reduced. Monetary policy is today faced with the difficult task of improving inflation expectations and outcomes without excessively tightening monetary conditions during a period of cyclical downturn.

Monetary policy needs to be supported by more comprehensive policies to allow it to pursue its targets without relying exclusively on the policy interest-rate. Exclusive dependence on this instrument may both meet difficulties in achieving the inflation target, and entail excessive output and employment costs for the economy. Additional policies include a fully credible fiscal framework backed by strong rules, competition reforms to foster price competition in non-tradables, and encouraging social partners to adopt the inflation target as a central anchor in pricing and wage policies. The need to support inflation targeting with more comprehensive policies is discussed in Chapter 3.

Structural reforms to strengthen the business sector (Chapter 4)

The necessary competitiveness gains to re-balance the dynamics of growth cannot come from a durable reversal of trend real currency appreciation. Accelerated productivity growth, wage moderation, and successful innovation of products are needed to preserve competitiveness in the face of competition from low-cost countries and upward pressures on the currency. It is only through progress on these fronts that the business sector can resume a stronger growth trend.

There are large productivity reserves in the business sector, which arise from a significant part of economic activity still being carried out in informal activities. These reserves can be mobilised by shifting more resources to the modern formal sector. Accelerating the shift requires further structural reforms to reduce the costs of doing business in the formal sector. They include a streamlining of labour market regulations according to OECD best-practices, additional modernisation of financial markets and continuing facilitation of entry and exit into product markets. Chapter 4 investigates this agenda.

Notes

1. See *OECD Regulatory Reform Review* (2002).
2. The *OECD Economic Survey of Turkey* 2004 provided a detailed description of the programme. IMF supported the package with extensive financial facilities and technical aid, and close monitoring. As a result of the implementation of the package Turkey became IMF's biggest and one of World Bank's three top borrowers during 2002-06.
3. The main eight industrial groups (Koç, Sabanci, Dogus, Eczacibasi, Alarko, Sanko, Ulker and Dogan) realised record-high profits in 2007.
4. Outward foreign direct investment reached USD 2.3 billion in 2007, representing 31.5% of total outward FDI realised between 2001-07. Turkish firms invest mostly in Balkan countries, former Soviet Union, and India. Through these investments they aim at overcoming Turkey's weakening competitiveness in low-skilled activities and to gain access to new regional markets. Gaining access to the US market via free-trade agreements that neighbouring countries such as Egypt and Jordan have established with the United States is also a motivation.

5. These firms are often dubbed *Anatolian Tigers*. However, their rise is by no means limited to Anatolian towns and might be even more prominent in the traditional industrial centres such as Istanbul and Bursa. The phenomenon has been nonetheless associated with countryside towns where change is most visible.
6. See Taymaz (2006).
7. Agriculture still occupies 27% of the total labour force. This proportion is expected to decline to about 10% in the medium-term.
8. OECD-PISA 2003 results presented in OECD, *Education at a Glance*, 2005.
9. As analysed extensively in the *OECD Economic Survey of Turkey*, 2006.
10. Recent news confirmed that informality is preventing the access of many Turkish firms to foreign direct investment. It is also a fact that a number of *private* (non-listed) foreign firms could deal with half-transparency in their Turkish partners. This nonetheless narrowed the options of Turkish firms for foreign partnerships.
11. In April 2008, Standard and Poor's changed Turkey's rating outlook from stable to negative.
12. Regular multi-monthly reviews by IMF staff on the basis of direct and on-site access to fiscal, monetary and macroeconomic data permitted regular monitoring of performance. These reviews were examined, cleared and approved by the IMF Governing Board, also on the basis of detailed Letters of Intent provided by the Turkish government.
13. A rating of B– is given to high-risk obligations and of BB– to obligations that are likely to be fulfilled despite considerable uncertainty.
14. Following Krugman (1979) and Flood and Garber (1984).
15. See for example Calvo (1988).
16. If international oil prices had stayed at their 2002 level and with all other things being equal, Turkey's current account deficit in 2007 would have settled at about 2.7% of GDP against the actual 5.8%.
17. Nevertheless, a significant part of capital inflows are associated with external bank loans and purchases of government bonds which continue to create debt.
18. Including real GDP growth, inflation, ratios of investment and of the general government balance to GDP, the ratio of total external debt to total export earnings, and the ratio of short-term external debt to gross official reserves – see Annex 1.A3.
19. Chang and Velasco (1998) and Krugman (1999).
20. Credit expansion into new activities – including housing lending and credit cards – involving new borrowers pose some challenges. In particular, households have started to use consumer credit loans to pay back their credit card obligations, which is a source of concern in the light of the steady increase of their indebtedness. At the same time, the Central Bank (2007) notes that the ratio of household liabilities to GDP is clearly below the levels prevailing in many emerging market economies.
21. The capital adequacy ratio of banks is presently above regulatory requirements, even if it decreased in the recent period. It was of 19.4% in September 2007, against 28.3% in 2004. It should decline further with the "downgrading" of government securities for capital adequacy measurements after transition to Basel II. It should nonetheless remain above regulatory benchmarks.
22. It appears that current restrictions on foreign currency lending to non-exporters are sometimes circumvented, for example through loans granted via offshore branches (IMF, 2007).
23. See footnote 40 in Chapter 4.
24. Regulations governing foreign exchange lending only allow banks to lend in foreign exchange for trade-related purposes. However, companies can receive bank credit in lira linked to foreign currencies. Most of the resulting unhedged foreign exchange risk is concentrated in SMEs, who are least likely to be in a position to manage these risks. More companies should rely on the Turkish Derivatives Exchange (TurkDEX) in order to hedge against their foreign exchange rate risks.
25. See Loayza and Raddatz (2006).
26. Easterly *et al.* (1993) and Caballero *et al.* (2005).

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ANNEX 1.A1

Selected recommendations of the 2006 OECD Economic Survey and national follow-ups

OECD recommendations	National follow-ups
Fiscal policy	
Announcing an intention to publish consolidated *general government* accounts according to national accounting standards, together with a timetable for getting there. At a minimum, the goal should be to begin publishing these accounts before the end of the government's current agreement with the IMF.	Regarding the *central government*, cash based reports are published monthly and annually. Accrual based reports are published annually. It has been decided to publish these reports on a monthly basis.
	With regards to *local governments*, accounting reports of municipalities and their affiliated administrations, and special provincial administrations are published on a quarterly and annual basis.
Set performance objectives for core public services, on a multi-year perspective and realistically taking into account present performances and resource levels. Audit results against objectives.	Multi-yearly strategic plans and performance objectives have been set for a number pilot administrations.
Fully implement accrual based accounting at all government levels and produce accrual based accounts.	A framework regulation was issued for General Government Accounting, to adopt accrual based accounting at all general government levels. Specific implementation regulations for central government, local governments and social security institutions have been issued.
Social security reform	
In addition to the provisions of the social security draft law (adopted in April 2008) introduce an actuarially equivalent reduction (of 4-6% per year) to the pension benefit of anyone who chooses to retire younger than the normal retirement age of 60 for men and 58 for women.	Not on the agenda.
Reduce net replacement rates by taxing pension income and deducting a health insurance premium from all pensions.	Not on the agenda.
Remove the entitlement of retiring workers to severance payments.	The government started work for a reform of severance payments.
Accelerate the convergence of the formal-sector retirement age to the informal-sector retirement age (65) and equalise the retirement ages for women and men sooner.	Not on the agenda.
Focus a social security registration and income tax enforcement team on pensioners who continue to work.	On the agenda.
Introduce a voluntary savings scheme into which workers would be automatically enrolled, with the option of active opt-out, and into which the difference would be paid between the employees' current (high) and future (low) social security taxes.	Not on the agenda.

OECD recommendations	National follow-ups
Tax policy	
Simplify the tax regime of small firms with more recourse to presumptive and lump sum taxation.	Certain small-size taxpayers that meet the conditions determined by Law are exempted from taxation. Taxpayers with sales below a Law-defined threshold are subjected to lump sum taxation. Taxpayers with higher sales are taxed according to normal procedures.
	The presumptive regime for small enterprises was abolished in 1999 and a "simple method" of taxation has been adopted. Small enterprises are taxed on the basis of their declarations, with simplified accounting and documentation. Professional organisations of small enterprises assist their members on taxation procedures.
Improve tax administration by making the autonomous Tax Collection Agency fully operational.	Turkish Revenue Administration was established on May 2005, with a semi-autonomous status. The Tax Collection Department of the Revenue Administration works on various projects to improve capacity and efficiency of tax collection.
Agriculture	
Fully implement the Agricultural Reform Project (ARIP) initiated after the 2001 crisis (replacing product-specific subsidies with direct income support to farmers and rural development policies) and avoid stepping back to traditional support purchases.	ARIP will be completed in 2008 and a new *Law on Agriculture* was adopted in 2006. Direct Income Support represents at present 40% of total agricultural subsidies. Agricultural Policies will be aligned with the EU's by 2010 and a new agricultural strategy will be put into action.
Pursue the transition from "sheltered" to "competitive" agriculture as a strategic objective of agricultural policy. To maximise returns from reforms pursue liberalisation in the full set of product, land, input, capital and infrastructure markets in agriculture.	An *Agricultural Strategy Document* adopted in 2006 for the period 2006-2010 includes the following objectives: *i)* sustainable growth of agricultural production, and improvement of product quality; *ii)* improving food security and safety; *iii)* strengthening the competitive capacities of farms; *iv)* reinforcing agricultural markets and strengthening farm-market linkages; *v)* improving rural incomes and living conditions; *vi)* strengthening farmer organisations. A *Rural Development Strategy* was also approved in 2006
Monitor trends in land consolidation and make sure that legal and transaction costs remain affordable. Monitor the effects of the 2001 change in the Civil Code on land fragmentation at bequests. Make the completion of the agricultural cadastre a priority.	Land consolidation activities and cadastral work are accelerated, through the new investment budgets made available to the concerned departments of Ministry of Agriculture (including from ARIP funds).
Avoid water waste by farmers who have easy and excessively cheap access to it. The price of irrigation water should be based at least on operational costs.	Measures to promote and improve irrigation (including the recommendations of the OECD) are taken into consideration by the Ministry of Agriculture and the Ministry of Environment and Forestry.
Make irrigation investment a fiscal priority. At the same time ensure that projects are selected according to economic criteria and are run efficiently. Resume and fund the irrigation leg of the South-East Anatolian (GAP) project.	Irrigation investments are given a high priority in the total investment budget allocated to the agricultural sector. Projects included in the government investment program have been rationalised and new selection criteria have been put into force. A new government action plan for GAP was announced in May 2008.
Involve private investors in irrigation. Pilot projects can play a demonstration role and water-using farmers as well as third-party commercial investors should be encouraged to participate.	A Law Amendment was enacted and published in the Official Gazette in May 2008, to encourage commercial investors to participate in irrigation investments.
Anticipate Turkey's future liberalisation obligations in the context of the WTO and EU negotiations, and target more pro-active liberalisation.	Further liberalisation of the agricultural sector is being considered within the context of Turkey's negotiations with WTO and EU.

Source: Turkish Authorities and the OECD Secretariat.

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ANNEX 1.A2

Gross external debt sustainability: methodology and assumptions

External debt dynamics*

In nominal terms, an equation defining the stock of external debt (*i.e.* debt owed to foreigners) at time t can be derived from the following balance of payments identity:

$$TD_t + (r1^*_t K^{FDI}_t + r2^*_t K^{Port}_t + r3^*_t FD^G_t + r3'^*_t FD^P_t) - Tr_t = FDI_t + Port^{Debt}_t + Port^{Equ}_t + (L^G_t + L^P_t) - \Delta Res_t \quad (1)$$

where:

TD: trade deficit on goods and services.

$K^{FDI/Port}$: Net stock built-up from FDI/Portfolio investment flows.

$FD^{G/P}$: Net foreign-currency-denominated debt of the government/private sector.

r1* and r2*: Nominal interest rates (dividend payments) paid on the stocks of FDI and of portfolio investment.

r3* and r3'*: Nominal interest rates paid on foreign debt by the government and the private sector.

Tr: Transfers.

$Port^{Debt/Equ}$: Portfolio flows, debt and equity.

$L^{G/P}$: New loans (borrowing) subscribed by the government and the private sector.

ΔRes: Change in the shock of foreign reserves (an increase in the stock of reserves would reduce the external funds available for current account financing needs).

All stock variables are expressed as end-of-period values, while flow variables and interest rates are period averages.

This identify can also be expressed in terms of new debt flows that contribute to external indebtedness ($L^G + L^P + Port^{Debt}$):

$$L^G_t + L^P_t + Port^{Debt}_t = (TD_t + r^*_t Liabilities_t - Tr_t) - (FDI_t + Port^{Equ}_t) + \Delta Res_t \quad (2)$$

* The focus of this analysis is on gross rather than net external debt in recognition of the fact that, although some private sector participants have external assets, these are not normally the same agents who hold the external liabilities, so that dollar- and euro-assets would normally provide little hedge to debtors in the face of a significant exchange rate depreciation.

In other words, all capital outflows resulting from the trade deficit and net investment income payments, that are not offset by capital inflows stemming from net transfers, capacity-building investments and sales of domestic assets (FDI and equity portfolio inflows), has to be financed via increased external indebtedness of the government sector (L^G) or the private sector (through external borrowing by commercial banks [L^P] and/or portfolio debt flows [$Port^{Debt}$]), and/or by the use of reserves by the central bank.

In practice, however, since the Central Bank is not permitted to use foreign exchange reserves to reduce the level of MOF or private sector external indebtedness, this term is dropped from the equation. With all variables expressed in lira terms, the stock of gross foreign debt (FD) expressed as a percentage of GDP (fd) at time t is given by the following equation:

$$fd_t = [(1 - e_t)\, fd_{t-1} + r1^*_t\, k^{FDI}_{t-1} + r2^*_t\, k^{Port}_{t-1} + r3^*_t\, fd^G_{t-1} + r3'^*_t\, fd^P_{t-1}]/ (1 + g_t) + td_t - tr_t - (fdi_t + port^{Equ}_t) \quad (3)$$

where:

fd: Gross external debt expressed in domestic currency as a percentage of GDP.

$k^{FDI/Port}$: Net stock built-up from FDI/portfolio investment flows in terms of GDP.

$fd^{G/P}$: Net external debt of the government/private sector in terms of GDP.

r1*, r2*: Nominal interest rates (dividend payment) paid on the stocks of FDI and of portfolio investment.

r3*, r3'*: Nominal interest rates paid on foreign debt by the government and the private sector.

td: Trade deficit on goods and services, as percentage of GDP.

tr: Transfers, as percentage of GDP.

fdi: Net FDI flows, as percentage of GDP.

$port^{Equ}$: Net equity portfolio flows, as percentage of GDP.

Equation 3 is then used to produce the external indebtedness scenarios illustrated in Figure 1.18 in this chapter. The key economic assumptions behind the ***baseline scenario*** are summarised in the table below.

Table 1.A2.1. **Baseline assumptions for external debt scenarios**

	2007 (estimates)	2008	2009	2010
Real GDP growth (%)	4.5	3.7	4.5	6.0
Domestic inflation rate (%)	8.8	9.6	7.5	6.5
Nominal effective exchange rate appreciation (%)	2.3	–4.4	–5.0	–4.5
Real effective exchange rate appreciation (%)	8.3	2.4	0.0	0.0
Net transfers	0.4	0.4	0.4	0.4
Net FDI flows (% of GDP)	3.0	3.5	3.5	3.5
Net portfolio equity capital flows (% of GDP)	0.1	–0.5	0.0	0.5
Trade deficit (% of GDP)	5.0	5.5	5.2	5.0
Weighted dividend payments on net FDI (%)	1.5	2.0	2.5	2.5
Weighted dividend payments on net portfolio equity capital[1] (%)	3.2	3.5	4.0	4.5
Weighted nominal interest rate on public sector external debt (%)	6.6	6.0	5.7	5.4
Weighted nominal interest rate on private sector external debt (%)	9.6	9.0	8.7	8.4

1. Estimated cash returns only, not including capital gains.

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The baseline scenario assumes a continuation of sound macroeconomic management but no acceleration in the structural reform agenda, with the result that net FDI and net portfolio equity capital inflows remain constant as a share of GDP over the period 2008-10. Dividend payments increase on account of robust growth in the economy but nominal interest rates on (public and private) external debt decline steadily as sound macroeconomic management reduces the risk premium. Real GDP growth picks up from 4.5% in 2007 to 6.0% by 2010, after slowing down in 2008. The real exchange rate appreciates by 2.4% in 2008 (down from 8.3% in 2007) and remains constant thereafter. Although there is no crisis under this scenario the gross external debt stock rises from 37.5% of GDP in 2007 to around 39% of GDP by 2010.

For the other three scenarios the assumptions for 2009 and 2010 are modified as follows:

External shock scenario. This scenario looks at the case where lower risk appetite in world financial markets and a loss of confidence in emerging market economies lead to a sharp slowdown in net FDI inflows. All interest rates are 400 bps higher; GDP growth falls to 2% per annum; net FDI flows fall to 1% of GDP in both 2009 and 2010, mostly reflecting privatisation receipts; the nominal exchange rate depreciates by 12% in 2009 and does not change in 2010; in response to the exchange rate depreciation, the trade deficit improves to 4.0% of GDP in 2009 and to 3.5% of GDP in 2010.

Under this scenario the gross external debt stock rises more rapidly. The revaluations of the existing external debt stock resulting from the exchange rate depreciations and the higher debt servicing costs pushes external debt to almost 46% of GDP by 2010.

Loss of competitiveness scenario. A faltering of the structural reform agenda could also generate a negative shock if it results in a loss of competitiveness in export markets, with a significant worsening of the trade and current accounts deficits, leading to nominal exchange rate depreciation and higher interest rates. This scenario assumes a widening of the trade deficit to 7.3% of GDP in 2009 before declining slightly to 6.8% of GDP in 2010, a further 5.0% nominal exchange rate depreciation in each of these two years, and a 200 basis points increase in nominal interest rates on external debt. These assumptions result in a rise in the gross external debt stock to almost 44% of GDP by 2010.

Structural reform scenario. Net FDI flows pick up to 5% of GDP per annum; GDP growth increases to 6½ per cent in 2009 and to 7% in 2010; and the real exchange rate appreciates by 3% per annum, in line with improved productivity growth and business sector competitiveness. Under this scenario Turkey's gross external debt declines from 37.5% of GDP in 2007 to 33% of GDP by the end of the projection period.

ANNEX 1.A3

Estimating sovereign credit ratings for emerging markets

Mulder and Perrelli (2001), using panel data for 25 major emerging market economies and covering the relatively short period 1997Q1 to 1992Q2, use feasible generalised least squares (FGLS) to estimate the following equation:

$$\text{RATING} = 9.84 + 4.06\ \text{Ln (INFLATION)} - 11.20\ \text{GRGDP} - 24.83\ \text{FBGDP} - 8.33\ \text{IGDP} + 0.62\ \text{DEBTX} + 0.75\ \text{RSCH} + 0.69\ \text{STDR}$$

where:

RATING is a linear transformation of Standard and Poor's credit rating for foreign currency debt with AAA assigned a 1 and the default rating C assigned a 20. Speculative ratings commence at BB+ or 11 on a linear scale. A common weight of 0.3 is added in the case of a negative outlook, zero in the case of a neutral report, and –0.3 in the case of a positive outlook;

Ln(INFLATION) is the natural logarithm of the 12-month change in the consumer price index;

GRGDP is the growth rate of real gross domestic product;

FBGDP is the ratio of the general government balance to gross domestic product;

IGDP is the ratio of investment to gross domestic product;

DEBTX is the ratio of total external debt to exports of goods and services;

RSCH is a dummy indicator of debt rescheduling between 1970 and 1993 that takes a value of 1 if there was rescheduling and zero otherwise; and

STDR is the ratio of short-term external debt to gross official reserves.

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Chapter 2

Shifting to a pro-growth fiscal strategy

Following six years of very tight fiscal policies, which contributed to the restoration of macroeconomic stability, debt sustainability and investor confidence after the 2001 crisis, Turkey is faced with a fiscal policy challenge: how to: i) *preserve a rigorous fiscal policy stance; while* ii) *both improving the quality and cost-efficiency of key public services and developing the country's infrastructure; and* iii) *simultaneously reducing the most distortive aspects of the Turkish tax system. In response to this challenge the government is trying to develop a new pro-growth fiscal strategy. As the Stand-By Arrangement with the IMF – which formed a decisive anchor for fiscal policy since 2001 – expired in mid-2008, Turkey faces the task of putting in place a suitable macroeconomic and institutional framework which would preserve the credibility gained under IMF surveillance, while delivering the needed changes in revenue and public expenditure structures.*

Turkey is in a strong position to move towards a new fiscal strategy. Thanks to past fiscal restraint, public debt is on a robustly sustainable path, and a major law on Public Financial Management and Control has established a state-of-the-art institutional framework. The letter and spirit of this law, however, has not been fully implemented to date. Important spending drifts occurred in 2007, and were identified only with some lag, giving a warning signal on the urgency of full implementation of the new framework.

Meeting Turkey's medium-term fiscal challenges undoubtedly requires further modernisation of fiscal institutions, as well as strengthening and simplification of the budgetary framework. Turkey's improved debt dynamics also suggests that there is a case for shifting the anchor for fiscal policy to an expenditure rule with binding multiyear ceilings, supported by a primary surplus target (as at present) that is consistent with the long-term sustainability of public debt. This chapter, however, argues that the new fiscal strategy should go beyond this. In particular strong political commitment and decisions are needed, including on: i) *clarifying Turkey's functional spending priorities;* ii) *shifting determinedly to more efficient supply arrangements in key public services; and* iii) *closing the most blatant tax loopholes and strengthening tax enforcement. A new strategy developed along these lines can be expected to make a major further contribution to macroeconomic stability, competitiveness, social equity and sustainable growth.*

Despite past achievements much remains to be done

This chapter focuses on the key fiscal policy challenges facing the Turkish authorities. It starts by discussing existing difficulties in monitoring Turkey's fiscal stance on a timely and comprehensive basis. After noting the important progress that has been made with fiscal consolidation in recent years, the chapter goes on to highlight key areas where reforms are essential to strengthen the management of public finances in Turkey, to upgrade and develop public infrastructure, and to improve the quality and cost-efficiency of public services while ensuring fiscal sustainability over the medium- and long-term. Policy options that could form key elements of a new fiscal strategy to meet these challenges are discussed.

The monitoring of the fiscal stance is difficult

Regular fiscal reporting is complex, incomplete and published with long delays, in spite of the progress already achieved. Three sets of accounts exist, which cover different areas of the public sector and report fiscal developments at uneven frequency and accuracy levels:

- The *central government (cash) budget* is reported monthly, and local government (cash) budget is reported quarterly (starting from 2006), by the Ministry of Finance.
- The *consolidated government accounts*, compiled by the Treasury according to the so-called "IMF definition" on the basis of the Ministry of Finance's central budget data and the balances of the social security institutions, three extra-budgetary funds, the Unemployment Insurance Fund and 23 State Economic Enterprises (SEEs), are reported monthly on a cash basis.
- The *total public sector*, coming closest to the international definition of general government, is periodically estimated by the State Planning Organisation (SPO), outside formal reporting procedures of the Turkish Statistical Institute. The definition of total public sector includes the total and consolidated revenues and expenditures of the central government budget, social security institutions, extra-budgetary funds, revolving funds, the Unemployment Insurance Fund, local governments and the financial balances of all the SEEs. Resulting definitional uncertainties[1] and lack of regularity regarding the publication of the data make its formal and regular utilisation difficult.[2]

"Total public sector" accounts have been estimated for the purposes of this *Survey*.[3] They provide the basis for the analyses in the reminder of the chapter. These series are however a customised compilation and do not represent a standard and regularly published source of information on the fiscal accounts.

The Ministry of Finance has been working with Turkstat, the Central Bank, SPO and the Undersecretariat for Treasury to redefine the scope of the general government for statistical purposes, in order to comply with the *general government* definition of European System of Accounts (ESA 95) and to meet Eurostat requirements by end-2009.

Under the provisions of the Stand-By Arrangement put in place after the 2001 crisis, the IMF has closely monitored Turkey's fiscal developments. Turkey's compliance with mutually agreed fiscal objectives has been scrutinised and documented through regular reviews (three times a year, on average).[4] The IMF has used in these reviews a customised definition of "consolidated government balances" which focused on the most important and fiscally most risky components of public finances. The IMF has also collected information on other areas with potential effects on fiscal outcomes (such as financial developments in state-owned enterprises, public banks, agricultural purchasing board etc.). In addition monthly fiscal monitoring reports by the Economic Policy Research Foundation TEPAV/EPRI provide a regular assessment of monthly fiscal developments, which are seen as a useful third-party information source by markets.

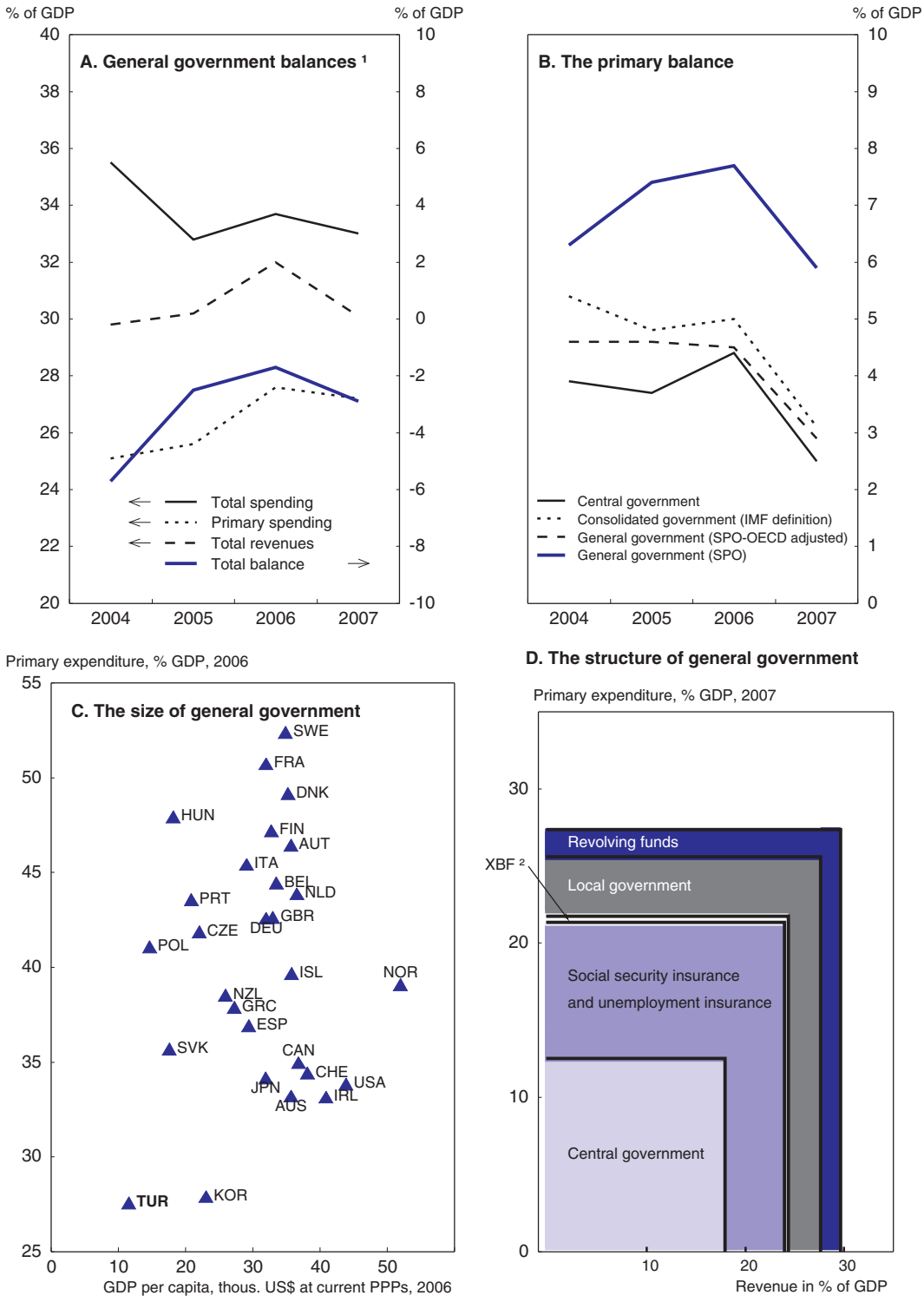
The market and the general public have relied on this 'hands-on' monitoring of Turkey's fiscal outcomes. The judgments of the IMF teams on fiscal developments, given the multiplicity and complexity of the underlying elements, were received by users as reliable expert analysis and advice although they were not based on data compiled in accordance with internationally comparable accounting standards. Associated with the authorities' determination to comply with fiscal targets, this *ad hoc* arrangement fulfilled a very useful role in the years after the 2001 crisis. It helped foster domestic and international confidence. This was however a peculiar mode of transparency, achieved outside the standard channels of publication of complete government accounts, and is clearly not a permanent solution.

Post-2001 fiscal consolidation has been spectacular but slippages occurred in 2007[5]

Turkey has made an impressive recovery from the 2001 crisis, reflecting a combination of determined fiscal restraint, sound disinflation policies, and important privatisation and structural reforms. Most impressively, a consolidated public sector primary surplus of more than 6% of GNP has been maintained over the period 2004-06. As a consequence, net public debt fell from 66.4% to 34.2% of GDP (based on revised national accounts numbers), and its structure improved (longer maturity structure, and steady shift in composition towards domestic currency-denominated debt), over the five years from 2001 to 2006. In Turkey today the central government budget has pre-eminence, social security revenues and expenditures have a large share, and the total weights of government revenues and expenditures in the economy are relatively modest (Figure 2.1).

However, the sustainability of the factors underlying the fiscal adjustment achieved between 2001 and 2006 is questionable. The consolidation to date has relied primarily on tax increases, and on cuts in public capital spending, and less on the rationalisation of current expenditures (IMF, 2007).[6] The IMF has for example estimated that in 2006, the primary surplus adjusted for exceptional items (mostly large one-off revenue windfalls) fell to around 5% of GNP, even though the consolidated primary balance based on the so-called *IMF definition* showed a surplus of 6.6% of GNP. The government's response in adopting a cap on the consolidated primary spending of the central government and social security institutions was welcome. However, this cap was exceeded by the end of the year. At the same time, central government capital spending has been cut, falling from 2.8% of GNP in 2002 to an estimated 2.1% of GNP in 2005 and 2006. Such low levels of investment spending are unlikely to be sustainable in the context of Turkey's large infrastructure development and maintenance needs (although it is relevant to note here that central government capital expenditures is only about half of total government capital spending, with local governments undertaking significant amounts of spending on capital projects).

Figure 2.1. **Recent fiscal developments**



1. OECD estimations on basis of SPO data.
2. Extra-budgetary funds.

Source: SPO, Ministry of Finance, Treasury, Turkstat and OECD estimations.

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Moreover, there were important fiscal slippages in 2007 that reflected a number of factors. Most important perhaps were the electoral spending pressures that gradually built up during the first half of the year. The slowing down of the economy – with growth of real GDP decelerating from 7.6% in the first quarter of 2007 to 3.4% in the fourth quarter – also adversely affected tax revenues, and in particular indirect tax revenues and specifically VAT receipts. In addition rising input costs combined with price restraint affected the performance of the SEEs, and the problems of the state energy companies further aggravated the fiscal situation. Moreover, there were large increases in current transfers to the social security institutions, agricultural support payments and health expenditures. A more detailed analysis of the monthly data indicates that most of the public expenditure overruns took place ahead of the elections, with some fiscal tightening afterwards. Finally, recent policy decisions –particularly on VAT (see below) – added to the pressures on public finances. Moreover, there is also some evidence that additional slippages may have occurred in 2007 in a number of quasi-fiscal areas, without being reflected in formal government accounts. In particular, there has been a build-up of arrears in the social security system, involving the revolving funds of hospitals. In addition, the balance sheets of quasi-fiscal institutions in energy and agricultural purchasing do not fully reflect their losses and are therefore not integrated in the overall picture of government balances. These facts suggest that the accuracy and completeness of fiscal reporting at general government level should be further improved.

As a consequence of these fiscal slippages the 2007 fiscal targets agreed with the IMF – on the primary surplus of the consolidated government sector (including and excluding the SEEs); the primary spending of the central government and social security institutions; and the overall balance of the social security institutions – were missed. Data estimates from the SPO suggest that the consolidated government primary surplus based on the IMF definition fell from 6.1% of GNP in 2006 to 4.5% of GNP in 2007, even though the programme target was unchanged at 6.5% for both years. Despite declining interest payments the overall fiscal balance also worsened, from a deficit of 0.6% of GNP in 2006 to a deficit of 1.9% of GNP in 2007.

Three main medium-term challenges for Turkish fiscal policy

After six years of restrictive fiscal policies based on tax increases and spending restraint Turkey now needs to focus on three main challenges, namely: how to: *i)* maintain a robust and sustainable fiscal policy stance; while *ii)* improving the quality and cost-efficiency of key public services, and developing the country's infrastructure; and *iii)* simultaneously reducing the most distortive aspects of the Turkish tax system. These challenges in turn call for a new fiscal strategy that goes beyond the modernisation of fiscal institutions. Major *political* decisions are also required, including: *i)* a serious re-assessment of functional spending priorities; *ii)* a determined shift toward better practices in the provision and delivery of key public services; and *iii)* a closing of major loopholes in the tax system and a strengthening of tax enforcement. The rest of this chapter goes on to discuss each of these issues in some detail.

Reviewing the appropriate fiscal policy stance and anchor

The nominal primary surplus benchmark has become too constraining

The constant 6.5% of GNP primary surplus target (defined on the basis of pre-revision GDP figures), which has been a key element of the IMF-supported programme in recent

years, played a crucial role in restoring Turkey's fiscal credibility following the 2001 crisis. However, given the significant reduction of public debt over the past few years, an important issue to address is whether such a tight fiscal stance is still required, given Turkey's needs for significantly higher public spending and tax reductions (see below). The Turkish government indeed initially adopted a lower primary surplus target of 5.5% of GNP for 2008 based on the IMF definition of total public sector and pre-revision GDP numbers; this corresponded to a target of 4.2% of GDP based on revised national accounts figures released in March 2008. More recently, in May 2008, this target was further reduced to 3.5% of GDP with the agreement of the IMF (see below).

Two separate pieces of analysis were carried out to determine a range for the minimum primary surplus required to ensure the sustainability of Turkey's public debt dynamics. Turkey's net public debt stock has already come down to a relatively low level, estimated at around 30% of GDP at end-2007. Klingen (2005) has argued that a *gross* public debt ratio of 40% of GDP might be a sensible yardstick for Turkey, and this happens to be broadly comparable to a *net* public debt ratio of around 30%. Simple simulations were carried out to get an indication of the size of the primary surplus needed to maintain Turkey's net public debt at 30% of GDP from 2007 onwards.[7] The results of these simulations are summarised below in Table 2.1 and suggest that a primary surplus of between 1% and 3% of GDP is likely required to attain this objective.

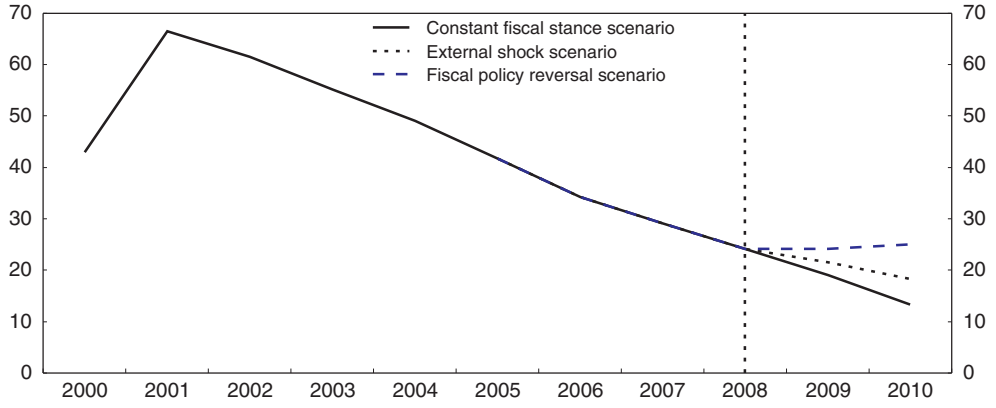
Table 2.1. **Turkey: Primary surplus required to maintain net public debt at 30% of GDP over the period 2007-15**

	Real interest rate minus growth rate of the economy (%)					
	9	8	7	6	5	4
Primary surplus to GDP (%)	2.7	2.4	2.1	1.8	1.5	1.2

The second set of analysis applies a more detailed and sophisticated model, elaborated in Annex 2.A1, with four different sets of interest rates – namely, floating and fixed interest rates on domestic and external public debt respectively – to simulate the net public debt stock path if the fiscal policy stance were to remain unchanged over the projection period 2008-10. In addition we present two other scenarios to look at the sensitivity of Turkey's public debt dynamics to adverse shocks (Figure 2.2). These scenarios use SPO data and 2007 estimates relating to the general government fiscal accounts, adjusted for one-off (mainly revenue) items, and are updates of the net public debt scenarios presented in the 2006 *OECD Economic Survey of Turkey*. The methodology and the assumptions underlying these scenarios are presented in Annex 2.A1.

The *constant fiscal stance scenario* is a scenario which assumes that the primary surplus remains constant at 3.5% of GDP over the period 2007-10. Real GDP growth slows from 4.5% in 2007 to 3.7% in 2008 and then picks up to 4.5% in 2009 and to 6.0% in 2010. The domestic inflation rate accelerates from 8.8% in 2007 to 9.6% in 2008 before declining to 7.5% in 2009 and to 6.5% in 2010. The real exchange rate appreciates by 2.4% in 2008 (down from 8.3% in 2007) and remains constant thereafter. Nominal floating and fixed interest rates on *domestic* public debt decline steadily over the projection period but still remain high at an average of 15.0% and 13.0% respectively in 2010. Nominal floating and fixed interest rates on *external* public debt are constant at 6.0% and 5.0% respectively over the projection period. Under these assumptions the net public debt stock declines to around 13.5% of GDP in 2010.

Figure 2.2. **Net public debt stock under alternative scenarios**
% of GDP



Source: OECD calculations based on Turkish treasury data.

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The *external shock scenario* looks at the case where there is a significant reduction in the appetite for risk-taking in global financial markets, arising perhaps from growing vulnerabilities in the global economy. In this case it is assumed that all (floating and fixed) interest rates on Turkish debt would rise by 400 basis points in 2009 and 2010, with real GDP growth slowing down to 2.0% per annum and the Turkish lira depreciating by a further 10.0% in each of the two years. Consistent with this it is assumed that cyclical pressures cause the primary surplus to fall back to 2.7% of GDP in 2009 and 2010. Even under these unfavourable circumstances the net public debt stock declines steadily to below 19% of GDP by 2010.

The *fiscal policy reversal scenario* assumes that weaker fiscal discipline and pressures on public finances lead to a significant reduction in the primary surplus to 1.0% of GDP in 2009, with the surplus disappearing in 2010. This causes financial markets to reassess the riskiness of Turkish debt, and the resulting sell-off of Turkish debt instruments leads to a significant (800 basis points) increase in floating interest rates and a 400 basis points increase in fixed interest rates. Consistent with this it is assumed that the economy would fall into recession, with real GDP contracting by 2.0% in both 2009 and 2010. These circumstances give rise to a reversal of the steady decline in the net public debt stock, which rises slightly as a share of GDP from around 24.2% in 2008 to 25% in 2010.

The simulation results thus strongly suggest that Turkey's debt dynamics would be resilient to lower primary surpluses, even under adverse scenarios, and that the government's initial primary surplus target of 4.2% of GDP in 2008 (based on the revised GDP numbers) has become too constraining.

A new anchor for fiscal policy should be adopted

Despite this, it is undoubtedly true that the 6.5% of GNP primary surplus target has served Turkey well in the recent past and has helped to significantly reduce Turkey's indebtedness. But, with a substantially reduced level of public debt, is a formal fiscal policy rule still needed? And what sort of fiscal policy rule(s) should Turkey adopt?

Fiscal policy rules have generally been found to be beneficial in terms of promoting fiscal discipline. For example, the European Commission (2006) finds that an increase in the share of government finances covered by numerical fiscal policy rules leads, *ceteris paribus*, to lower deficits or higher surpluses. The study also reports evidence that an increase in the share of government finances subject to expenditure rules leads to a reduction in the primary expenditure to GDP ratio. Moreover, the analysis in the report suggests that the effectiveness of fiscal policy rules depend on their statutory base (whether they are enshrined in law or in the constitution) and on whether there are independent and effective monitoring and enforcement mechanisms to ensure respect of the rule.

As discussed above, Turkey's improved public debt dynamics can accommodate some reduction of the primary surplus target. Indeed, in May 2008 the Turkish authorities announced a Medium-Term Fiscal Framework (MTFF) covering the period 2008-12 that entails higher spending. The main aim of the MTFF is to bring down the gross public debt stock (EU definition) from 38.8% of GDP in 2007 to 30.0% of GDP in 2012. The primary surplus target (based on revised GDP numbers) for 2008 has been lowered – with the agreement of the IMF – from 4.2% of GDP to 3.5% of GDP. This target is unchanged from the outturn for 2007. The primary surplus target is projected to decline steadily over time, as follows.

Table 2.2. **Turkey: Primary surplus targets in the Medium-Term Fiscal Framework (MTFF)**

	2007	2008	2009	2010	2011	2012
Primary surplus (% of GDP)	3.5	3.5	3.0	2.7	2.5	2.4

Central government primary expenditures are projected to decline from 18.1% of GDP in 2007 to 17.7% of GDP in 2008, before rising gradually to 18.5% of GDP by 2011. The increase in government expenditures is due to labour reforms aiming at job creation and investments in the South-eastern Anatolia Project, which are designed to build dams and power plants and to expand the irrigation network to boost agricultural production in the region.

The empirical analysis presented above suggests that such a reduction in the primary surplus target is unlikely to threaten the sustainability of Turkey's public finances, at least over the medium-term, under reasonable assumptions. Nevertheless there are still good reasons to maintain a prudent fiscal policy stance. Specifically, Turkey's private sector savings rate is low and has been falling steadily over recent years (Meier, 2007). Unless and until this is reversed a high level of public sector savings, and continued fiscal consolidation, is needed to bring down Turkey's large current account deficit, estimated at 5.8% of GDP in 2007. Also, given the high level of interest rates set by the Central Bank of the Republic of Turkey to achieve the (dis)inflation objectives of the government, maintaining a prudent fiscal policy stance would avoid any additional pressures on monetary policy to achieve the inflation targets.[8] Indeed, the *Pre-Accession Economic Programme 2007* states that "it is of utmost importance to support monetary policy by fiscal policy in order to reach medium and long term inflation targets in the forthcoming period" (SPO, 2007, p. 27). Moreover, as discussed below, a stronger underlying fiscal position would also create room to finance the fiscal costs of desirable structural reforms, such as additional cuts in social security contribution rates. Finally, given the potential volatility of Turkey's economy, it would be wise to maintain a fiscal "cushion" to help deal with exogenous shocks that adversely affect Turkey's public finances. For all these reasons it is advisable not to loosen fiscal policy beyond that envisaged under the MTFF.

At the same time, the transition to a somewhat looser fiscal policy needs to be carefully managed as market participants might interpret this as a return to the discretionary and volatile fiscal policies of the past.[9] This needs to be avoided. From this perspective a fiscal policy rule (or rules) could help not only to promote/maintain fiscal discipline but also to anchor market expectations during the transition.

There is also a case now for Turkey adopting a somewhat more sophisticated type of anchor for fiscal policy. The dominant primary surplus anchor was relevant when public debt was very high and the priority was to bring it down to sustainable levels. Looking forward, however, the key challenge for fiscal policy will be to manage pressures on public spending – consistent with the implementation of the MTFF – and to ease the tax burden (on employment and labour income in particular) in a way that is most conducive to sustainable growth.

In this context Turkey could consider moving towards an expenditure rule with binding multiyear ceilings for aggregate government spending compatible with the MTFF. In general an expenditure rule, while affording only partial control over public debt accumulation, offers a number of important advantages. It can be designed to be counter-cyclical, by excluding interest payments and cyclically sensitive expenditure components (such as unemployment benefits). Moreover, expenditure rules directly target the part of the budget that the government controls most directly – primary spending – and so the government can be held highly accountable for ensuring respect of the rule. Third, under a spending rule incentives for optimistic revenue projections are minimised. Fourth, in the particular case of Turkey a key virtue of a cap on the growth on public spending is that it would focus politicians and the general public on the need for rigorous expenditure prioritisation and rationalisation.[10] A final consideration that is of particular relevance to Turkey at this point in time is that expenditure rules tend to encourage more predictable fiscal behaviour, which in turn can lead to easier coordination with monetary policy and to greater confidence and steadier behaviour within the private sector.[11] It is crucial here to point out that such a rule can work only if significant progress is made in the areas of fiscal transparency and provision and availability of fiscal data, particularly on expenditures: as discussed above, even with IMF monitoring, there have been long delays and problems in obtaining reliable and comprehensive data on total revenues and total expenditures of general government, and their composition.

A binding multi-year aggregate expenditure rule would help the government attain the primary surplus targets set out in the MTFF and could be important in maintaining the credibility of fiscal policy. The expenditure rule should include all spending by extra-budgetary institutions (including the Social Security Institution) and incorporate multi-year targets or sub-ceilings at the disaggregated level for broad public expenditure categories at the functional level. There may be a case for separate ceilings for *aggregate* public current and capital spending, with binding multi-year ceilings on current expenditures but some flexibility on capital spending, so that unused capital expenditure appropriations in one fiscal year would be allowed to be carried over to the following year to avoid end-of-the-year spending sprees. These ceilings should be entirely consistent with the Medium-Term Fiscal Plan.[12] Unused investment budget allocations could be transferred into reserve funds, but the use of the reserve funds should be adequately regulated and controlled so that the Finance Ministry can retain sufficient control over public spending.

The expenditure rule should be supported by a primary surplus target that is consistent with the long-term sustainability of public debt – as laid out in the recently announced MTFF. There may also be a case for introducing some flexibility into the primary surplus targets by allowing for unanticipated cyclical developments. Empirical evidence from OECD countries suggests that an output gap of 1% of GDP has a negative cyclical impact on government revenues of around 0.4 percentage points of GDP. On the expenditure side, the current structure of general government spending in Turkey has a relatively small, but growing, cyclical component. Some flexibility for unexpected cyclical factors could be introduced by allowing the primary surplus targets to be reduced (raised) by at most 0.4 percentage point for every 1% shortfall (over-performance) in the realisation of the government's economic growth assumption for the fiscal year, provided that the logic is clearly explained and communicated to the public and to the markets.

The Medium-Term Fiscal Plan should be based on cautious revenue projections, particularly since revenues are hard to forecast in an economy with a large informal sector and where the effectiveness of measures that are being taken to actively promote formalisation of the economy are hard to predict. The aggregate expenditure ceiling(s) should only be adjusted (increased) if accompanied by offsetting structural tax reforms that ensure that additional tax revenue will be raised to finance the higher spending. It is also advisable to move cautiously with tax reforms involving cuts in tax rates and to seek to preserve the actuarial neutrality of the social security system (see below). Fiscal space should be created for future cuts in social security contribution rates, but even if these are actuarially neutral over the long-run they may, at the same time, impose short-term fiscal costs. Given the importance of promoting the formalisation of the Turkish economy, as advocated in this *Survey,* there may be a case for absorbing these fiscal costs (revenue shortfalls) and taking them into account in setting the primary balance target, provided that the sustainability of Turkey's public finances and debt dynamics is preserved.

Spending reform challenges

Pressures on public spending are likely to build up strongly over the medium- to long-term

The second key challenge to fiscal policy stems from growing pressures on public expenditures. These pressures arise from: *i)* Turkey's drive to catch-up with other OECD countries in terms of public service infrastructure and quality; *ii)* demographic pressures of a rapidly growing population; and also *iii)* specific remedial needs in areas where important lags built-up under recent spending restraints (particularly with regard to physical infrastructures). In the future these pressures are likely to build up in four key areas in particular: *education*, *health services*, *pensions* and *energy and physical infrastructures*. This section discusses each of these in turn, followed by the presentation of a long-term baseline fiscal scenario which tries to incorporate the budgetary impact of these spending pressures.

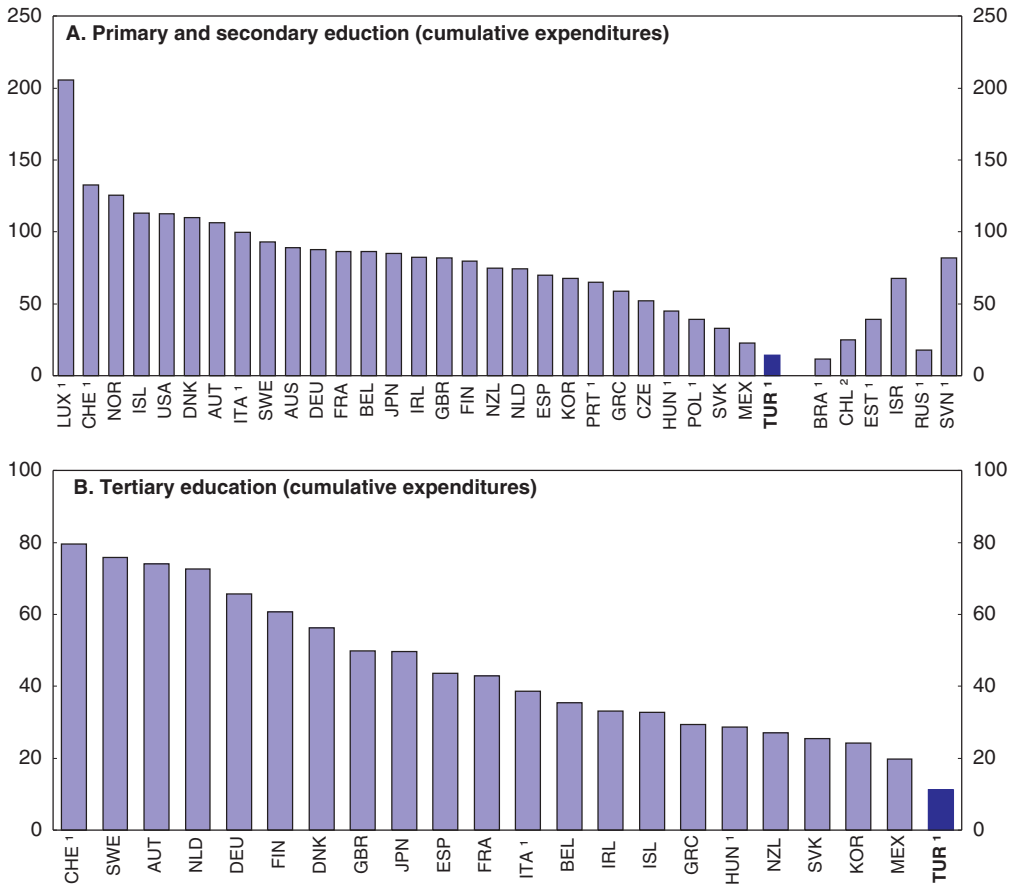
Education

More public spending will be needed on education, as well as more private funding (particularly at the tertiary level), for at least three reasons (OECD, 2006a). First, the growth rate of the school-age population is still high, even though in recent years the percentage of school age population to the total population has been decreasing. Second, educational enrolment in Turkey lags behind comparable middle-income emerging countries, notably with regard to post-primary school education for girls. Indeed, in 2005 only 36% of the

population aged 25-34 had at least an upper secondary education, much lower than the EU19 and OECD averages of 79% and 77%. In parts of the poorer south-east of the country the percentage of girls attending secondary school is generally very low, at times as low as 14%. Lastly, the upgrading of the quality of teachers, educational materials and school facilities will claim additional resources (see Annex 2.A2).[13]

Measured in equivalent PPP-adjusted US dollars, Turkey spent in 2004 about USD 1 100 per student in primary education and USD 1 800 per student in secondary education, compared to an average of USD 5 800 and USD 7 300 respectively for OECD member countries. Turkey is also far behind many other emerging countries in terms of total real resources dedicated to the education of each pupil and student[14] (Figure 2.3). Despite a lower GDP and obvious catching-up needs, public spending on primary, secondary and post-secondary education amounted to about 2.4% of GDP in Turkey against an OECD average of 3.8%.

Figure 2.3. **Education spending per student (2004)**
In thousand USD converted using PPPs for GDP



1. Public institutions only.
2. Year of reference 2005.

Source: OECD (2007), *Education at a Glance*.

StatLink http://dx.doi.org/10.1787/418733685660

Public education spending and educational achievement levels also remain highly uneven across regions and school types. Indeed, the education system is characterised by an important dualism, with the vast majority of students receiving a low quality education while the most able students receive a high level education geared towards preparing them for university and/or employment in the formal sector. In tertiary education as well there are capacity bottlenecks and large quality differences between universities. As a consequence, while graduates from elite universities have little difficulty finding a well-paid job in the formal sector, at the "middle-skill level" there is an important mismatch in the demand for, and supply of, good quality technical and vocationally trained workers in particular. In short, dualism in the Turkish labour market reflects, to a large extent, the dualism of its educational system. The low level of spending on education, and its uneven quality and distribution across regions and school types, is reflected in Turkey having one of the lowest overall employment rates, particularly for women, in the OECD. Equally important, the employment rate is strongly and positively correlated with the level of education attained, and since 2000 the employment rates for illiterate workers and those with less than high school education have been on a noticeable downward trend for both men and women. This calls for an important shift in education policy, away from the current focus on elite schools and universities towards a broader focus on preparing all students completing primary and secondary education for entering the labour market and/or higher education (OECD, 2006a). There is also a need for a much stronger focus, and dedication of more public resources, to retraining and adult education programmes to upgrade the skills of adult workers with little or no formal education or vocational training. Parallel to these needs, a Lifelong Learning Strategy Paper that has been prepared as part of the EU harmonisation process will be finalised in 2008.

Health

As in all OECD countries, pressures will mount on health spending, but with additional catch-up pressures specific to Turkey. The population's average health status needs improvement, and claims for better health services are expected to mount with the ongoing introduction of universal health care coverage. Over the medium- to long-term, health spending per capita should be expected to converge toward levels prevailing in emerging market/middle-income countries, as the Turkish economy develops and living standards improve (OECD, 2006a).[15]

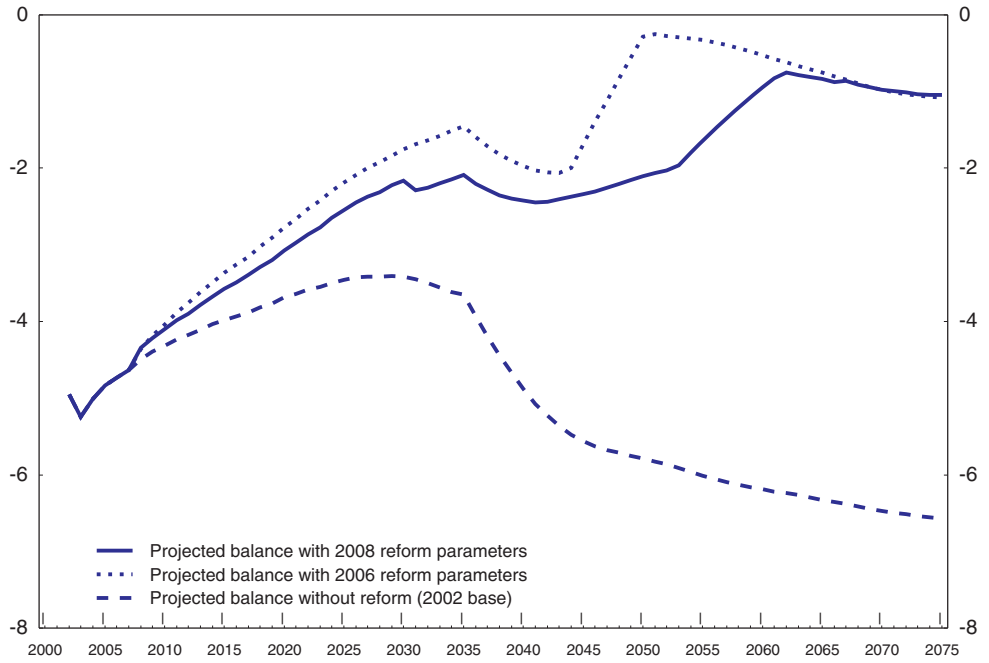
Public spending on health care is considerably lower than the OECD average. More strikingly, when measured per capita in equivalent PPP-adjusted US dollars, public spending on health care is (as of 2005) only USD 418, compared to USD 1 135 for the comparator group, and an OECD average of almost USD 2 000.[16] This reflects, among other factors, the low number of practicing physicians and nurses relative to the population (see Annex 2.A3). Moreover, as in the case of education, there are significant regional disparities in access to health care services. In the *Pre-Accession Economic Programme 2007* (PEP) the State Planning Organisation projects the share of government spending going to education and health to rise to 10% and 12% by 2010, and on social security and welfare to 25%.

Pensions

Despite favourable demographics the public pension system ran increasingly high deficits in the 1990s, requiring growing transfers from the general budget. A pension reform in 1999 led to a temporary improvement. Subsequently, however, budgetary transfers to

social security institutions started to rise again as a result of discretionary increases in the pension level, and a shrinking premium base. In response, parliament passed a Social Insurance and Health Reform Law in May 2006, to attain a better balance between contribution and benefit parameters over the medium term, but the Constitutional Court ruled that these reforms were unconstitutional and cancelled the Law. A revised Social Insurance and Health Reform Law was passed by parliament in April 2008. If the basic parameters of the system were unchanged an annual deficit of more than 3% of GDP would be projected until 2030, with a further deterioration toward 6-7% of GDP thereafter (World Bank, 2006b).[17] If the reforms were actually implemented along the initially intended 2006 parametric changes, the pension system would still have continued to face a yearly deficit above 2% of GDP until 2025, and would have stayed in deficit – albeit declining – over the projection period. With the 2008 reform parameters the social security deficit will gradually decline to 2% of GDP around 2030 and is projected to level off at around 1% of GDP in the long-term. Figure 2.4 illustrates this.

Figure 2.4. **Pension system balances with and without reform**
Per cent of GNP



Source: Social Security Institution.

StatLink http://dx.doi.org/10.1787/418737157713

Physical and energy infrastructure

Infrastructure development and maintenance needs are large in Turkey. The 2006 *OECD Economic Survey of Turkey* (OECD, 2006a) argued that government spending on infrastructure is exposed to upward pressures, while savings opportunities exist at the same time. While infrastructure development needs are obvious in the areas of energy, communications and transportation, there is also evidence of less necessary items in the

existing project portfolio, even though the government has made significant progress in streamlining these areas. Moreover, more recourse to private participation in energy, water and other infrastructure may diminish the need for direct public funding in the future (see below). On the other hand, the requirements of regional development will entail massive infrastructure investment in the less developed eastern and south-eastern regions, notably in irrigation (OECD, 2006a).

Overall, Turkey's infrastructure falls short of OECD and EU standards. Budget constraints have limited new infrastructure investments since the mid-1990s, and there remain major concerns regarding the efficiency of public spending in this area. The dominant transport mode – road – suffers from localised congestion and deteriorating road quality. The railway density is the lowest of any EU member country, and the railway infrastructure is relatively old. Consequently the railway lines between the highly populated cities are not suitable for high speed and good quality service. In the area of irrigation recent budget constraints have reduced the expansion of irrigated land to 50 000 hectares per year. This in turn has significantly slowed down progress on the important GAP project, which caters to the irrigation needs of the underdeveloped South-East Anatolia region where only 13% of the intended coverage area has been irrigated despite high positive social returns on early irrigation efforts (OECD, 2006a). However, recently the government has announced a new investment package for the GAP region. The package includes additional central government budget financing over the 2008-12 period so as to accelerate the completion of public projects and the development of the region. As of 2012 the official targets envisage an increase in the coverage of irrigated lands from 13% to 60%. On energy the European Commission estimates that primary energy consumption, which reached around 99 million tons of oil equivalent (toe) in 2006, will rise to 126 million toe in 2010 and to 222 million toe by 2020. At present around 30% of total energy demand is being met by domestic production, with the rest being imported from diversified sources.

In the wake of a recent review, the World Bank noted that businesses in Turkey are "burdened by costly, low quality backbone infrastructure services. In particular, the cost of telecommunications services and energy remains among the highest in the OECD area, while quality is among the worst in that area." (World Bank, 2006a, Vol. 1, p. 65). The Turkish Industrialists' and Businessmen's Association makes the same point (TUSIAD, 2004).

In response to these needs Turkey's *Ninth Development Plan 2007-2013* has projected public fixed capital formation growing at an average rate of 8.1% per annum in real terms over the period 2007-13, against an annual average of 1.9% over the period 2002-06. The Turkish government intends to more fully utilise its indigenous hard coal and lignite reserves, hydro and other renewable resources (such as wind and solar power) to meet the country's growing energy demands. Development of nuclear energy is intended to be one of the main tools in responding to the growing electricity demand while avoiding increasing dependence on imported fuels. Nuclear power plants corresponding to a total installed capacity of 5 000 MW are expected to be commissioned before 2020.

Overall fiscal implications of catching up in key public services

To assess the impact of these expenditure pressures on public finances, medium- to long-term fiscal projections for the period 2005-35 were carried out by the OECD Secretariat. These projections are based on gradual "catching-up" assumptions in key public services, and baseline projections for tax revenues. The methodology and technical parameters of the exercise are described in Annex 2.A4, and Table 2.3 summarises the main results.

Table 2.3. **Turkey, 2005-35: Long-term fiscal projections**
Per cent of GDP

	2005	2006	2007	2008	2009	2010	2015	2020	2025	2035
General government, SPO definition										
Total revenues	30.2	32.0	30.1	29.5	29.6	29.6	30.0	30.4	30.8	31.5
Public expenditures										
Capital expenditures	3.4	3.3	3.5	3.2	3.3	3.4	3.9	4.3	4.5	4.7
Current expenditures										
Education	3.1	3.2	3.2	3.3	3.4	3.6	4.3	4.9	5.6	5.8
Health	3.8	3.9	4.0	4.1	4.2	4.4	5.8	7.3	7.8	8.8
Pensions	6.1	6.0	5.9	5.6	5.5	5.4	4.8	4.3	3.8	3.3
Other	9.1	11.1	10.0	10.4	10.4	10.4	10.6	10.7	10.8	11.0
Current primary expenditures	22.1	24.2	23.1	23.4	23.5	23.8	25.5	27.2	28.0	28.9
Total primary expenditures	25.5	27.5	26.6	26.6	26.9	27.2	29.4	31.5	32.5	33.6
Primary balance	4.7	4.5	3.5	2.9	2.7	2.4	0.7	–1.1	–1.7	–2.1

Source: OECD estimates.

Even with the recently passed pension reforms, and the optimistic assumptions on containment of public health care spending, the simulations show a steady rise in total primary expenditures over the medium-term, with an increase of 5.9 percentage points of GDP over the period 2008 to 2025. As a result the primary balance shifts from a surplus of 2.9% of GDP in 2008 to a deficit of 1.7% of GDP in 2025, and this deficit gradually rises to over 2.0% of GDP by 2035 (Table 2.3). To a large extent these spending pressures reflect demographic factors, namely a steady and sharp increase in projected student numbers until 2025 and a rising dependency ratio throughout the projection period, as well as the government's commitments on provision of health care services to the entire population.

At the same time the simulations suggest that the 3.5% of GDP primary surplus assumption over the 2008-10 period underlying the baseline scenario for net public debt presented above will be difficult to achieve and will likely require a reversal of the sharp rise in other current expenditures seen in 2006-07. Our projections also suggest that further efforts at containing current expenditures are likely to be needed to achieve the reduction of 2.7 percentage points of GDP in general government primary spending over the 2006-13 period targeted in the *Ninth Development Plan 2007-2013*.

Functional spending priorities must be clarified

The magnitude of simultaneous spending needs in many key public services calls for a politically difficult, but indispensable, prioritisation strategy. Proceeding to a clear prioritisation in the framework of an explicit strategy would help policymakers resist the many – and often legitimate – claims for additional budget resources, emanating from various quarters. The National Development Plans, which started to play a positive (pro-reform and pro-competitive) role in Turkey, can be made more instrumental in outlining and assessing functional priorities – notably in terms of offering options to policymakers and to Parliament.

Total general government spending (SPO definition) in Turkey is estimated to take up almost 34% of the country's gross domestic product – significantly lower than the averages for the EU19 (47%) and OECD member countries excluding Turkey (45%). But what is most striking is the composition of general government spending (Table 2.4). The share of government spending going to general public services is very high, at 26%, compared with

Table 2.4. **Government spending by functional classification, 2005 (or latest year available)**

	In per cent of GDP			In per cent of total government spending		
	Turkey[1]	EU19 average[2]	OECD average[3]	**Turkey**[1]	EU19 average[2]	OECD average[3]
General public services	8.7	6.7	6.3	26.0	14.2	13.9
Public order and safety	1.5	1.7	1.7	4.4	3.6	3.8
Education	3.1	5.6	5.8	9.2	11.7	12.9
Health	3.6	6.2	6.5	10.8	13.3	14.6
Social security and welfare	7.4	18.1	15.9	22.1	38.1	34.5
Housing and community amenities	1.1	0.9	0.9	3.3	2.0	2.0
Economic services	5.5	4.7	4.7	16.5	10.1	10.7
Other	2.5	3.3	3.4	7.7	7.0	7.7
Total	**33.7**	**47.1**	**45.1**	**100.0**	**100.0**	**100.0**

1. Year 2006.
2. Unweighted average.
3. Excluding Mexico, Switzerland and Turkey. Unweighted average.

Source: OECD National Accounts except for: *i)* Australia, Canada and Hungary: IMF, *Government Finance Statistics Yearbook*, and *ii)* Turkey: State Planning Organisation (SPO).

an OECD average (excluding Turkey) of 14%, and is by far the highest among OECD countries. It is important to note, however, that this to a large extent reflects the government's high (but falling) indebtedness; in 2006 and 2007 around 65% of total central government expenditures on general public services went on interest payments. The share of government spending on economic services (comprising mainly various subsidies and investment in rural development and infrastructure) is also very high, at 16.5% of total general government spending; only Korea devotes a higher share of government expenditures to economic services, and the OECD average is only 10.5%.

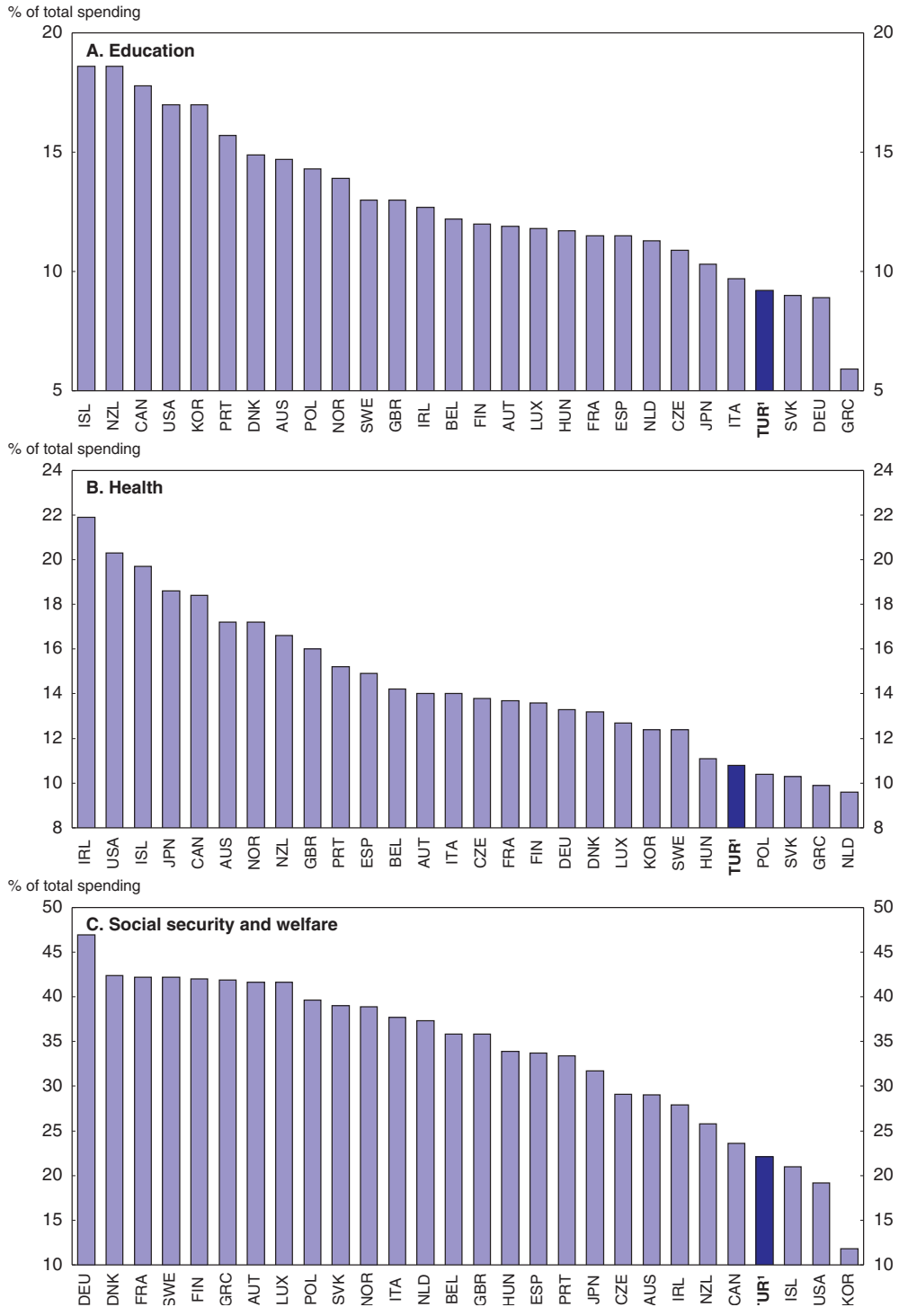
By contrast, Turkey devotes a significantly smaller share of its public resources to social security and welfare – 22%, compared to an average of 34.5% for OECD member countries (excluding Turkey). However, it is relevant here to note that the authorities consider that these figures may underestimate the true level of social spending in Turkey and are making progress on improving the transparency of public spending in this area. The share of government spending going to education and health is also low in comparison with OECD member countries (Table 2.5). To a large extent the low level of social security and welfare spending reflects Turkey's very young population and low old age dependency ratio, as well as still-functioning alternative social safety networks; taking these demographic factors into account, the World Bank (2006b) argues that Turkey's social security and welfare expenditures are oversized in international comparison.

The effectiveness and cost-efficiency of public spending needs to be improved

There is considerable empirical evidence to suggest that the overall efficiency of public spending in Turkey is low in a number of key areas, partly because the current provision of most public services are organised as non-market responsive monopolies. In education, for instance, OECD estimates suggest that for unchanged inputs (teaching and computer resources), and after controlling for the socio-economic status and language background of students, Turkey could boost its average PISA (Programme for International Student Assessment) score by over 15% – more than in any other OECD country (Sutherland *et al.*, 2007). Similarly in the health sector there is evidence of significant inefficiency and waste

Figure 2.5. **General government spending on education, health and social security and welfare: an international comparison**

2005 or latest available



1. Data for 2006.

Source: OECD National Accounts except for: i) Australia, Canada and Hungary: IMF, *Government Finance Statistics Yearbook*, and ii) Turkey: State Planning Organisation (SPO).

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in the allocation of spending in two main cost items: hospital expenditures and drug reimbursements (OECD, 2004). Moreover, the rapid increase in public health expenditures in recent years is almost entirely explained by increased spending on hospitals and pharmaceuticals (World Bank, 2006b). Health care service utilisation is growing rapidly but still remains comparatively low by EU standards. A large number of hospitals continue to be underutilised, and huge variations still exist in hospital occupancy rates among provinces. Regarding pharmaceuticals, expenditures on this item have risen to almost 40% of total public spending on health *versus* 15% in other OECD countries, strongly hinting at over-utilisation. In the power sector electricity theft and losses remain high at around 17%, and electricity and natural gas tariffs do not fully reflect production and distribution costs.

In this context it is important that Turkey adopt OECD best practices in public service delivery by promoting accountability and market competition. The sixth strategic objective – "development axis" – of the *Ninth Development Plan 2007-2013* is indeed to increase the quality and effectiveness of public services. Promoting greater cost-efficiency and higher quality in the delivery of public goods and services will require structural reforms at both the individual sectoral level and at the institutional level (what the World Bank, 2006b, calls "horizontal" reforms to improve the efficiency of expenditure programmes across sectors). The *Public Financial Management and Control Law (PFMCL*) discussed below was indeed designed to provide the legal and institutional framework for strengthening and streamlining the budgetary process in Turkey and improving public expenditure management by initiating "horizontal" reforms. At the same time, by *i)* promoting expenditure prioritisation through medium-term expenditure plans along with the adoption of functional and results-oriented budgeting at the central government level, and *ii)* introducing strategic planning and use of performance indicators at the level of line ministries and public spending agencies, it was hoped that these reforms would promote greater cost-efficiency and higher quality of public spending at the individual sectoral level. These issues are discussed in greater detail below.

Further strengthening and streamlining the budgetary framework

A major effort at modernising Turkey's fiscal institutions was undertaken after 2001 and supported by the IMF. The two main pillars of this renewal were the *Public Financing and Debt Management Law (PFDML)* adopted in 2002, and the *Public Financial Management and Control Law (PFMCL*) adopted in 2003. Both have been framed along OECD best practices.

The PFMCL aimed at thoroughly restructuring public expenditure management in Turkey by consolidating all fiscal operations of the general government in an integrated general government approach, from the preparation to the closing stages of the budget. The law provided the legal framework for important reforms to the budgeting process, including: *i)* broadening the scope of financial management and fiscal control; *ii)* extending the coverage of the budget and financial accounts to all sectors of general government in accordance with international standards of national accounting (SNA93, ESA95); *iii)* introducing a Medium-Term Program and Medium-Term Fiscal Plan covering three years; *iv)* introducing a new, more functional classification system for the budget; *v)* laying the groundwork for a shift to performance-based budgeting and away from input-based budgeting; *vi)* transferring responsibility for internal financial controls and auditing from the Ministry of Finance to the line ministries and special budget agencies; and *vii)* adopting a formal legal schedule and calendar for the main budget preparation, implementation, and monitoring processes.

These new laws contributed prominently to more systematic public expenditure and debt management in Turkey in the 2000s. However, many important concerns remain regarding their legal status. In particular, there is concern that the provisions of the PMFCL may be diluted, or overwritten, by the passage of subsequent legislation since the PMFCL is not an organic law. As the IMF (2006) and Kraan *et al.* (2007) note, it is therefore essential to ensure that the PFMCL has primacy over matters that relate to public financial management, and to prevent situations where other legislation, seemingly unrelated, can dilute its provisions.

Table 2.5 below summarises the progress made to date regarding implementation of various elements of the PFMCL and provides updated recommendations. To summarise, in Turkey's present circumstances four areas appear to deserve high priority in furthering the transition to more effective public expenditure management: i) *achieving full and reliable fiscal transparency at general government level;* ii) *using an operational medium-term fiscal framework;* iii) *shifting to programme budgeting; and* iv) *completing the administrative reforms needed to back the new fiscal institutions* (see Kraan *et al.*, 2007). Achieving the latter two objectives in particular, while containing the growth of public sector primary spending, is likely to require a (politically very sensitive) fundamental reform of the civil service governance, incentive and pay structure (Box 2.1).

Table 2.5. **Turkey: Progress with implementation of the Public Financial Management and Control Law**

Area	Progress made to date and challenges	Recommendations
Coverage of general government sector	While the general government sector as defined by the PFMCL is broadly in accordance with Government Finance Statistics (GFS) principles, it is not fully comprehensive. It for instance excludes the Iller Bank which, while nominally an investment bank, operates under the Ministry of Public Works and has many characteristics of an extra-budgetary fund, providing financial and other services to municipalities and investing in municipal infrastructure. Moreover, there continue to exist revolving funds that are not included in the budget.[2] There is a new proposal to amend PFMCL to give the Ministry of Finance, together with the Statistical Institute the Central Bank, the Treasury and SPO to redefine the scope of the general government for statistical purposes.	*Extend the coverage of general government to include the Iller Bank.*[1] *The status of remaining revolving funds should be reviewed to ascertain whether they are of a commercial nature. The revolving funds of a commercial nature that have been set up for cost recovery may be maintained. They should be excluded from the central government classification but their transactions should be included in the budget in gross terms for information. Revolving funds of a non-commercial nature should be eliminated.*
Quality of data provision	The government's financial reports and national accounts continue to show discrepancies with ESA95 standards. In particular, transition to accruals-based accounting lagged.	*Publish as soon as possible consolidated general government accounts according to national accounting standards and on an accruals-basis.*
Budget constraints on social security institutions and local governments	Social security institutions and local governments have no obligation, under the PFMCL, to comply with any overriding fiscal policy rule constraining total general government spending or deficits, other than budgetary limits on central government transfers to them and relatively flexible rules concerning their borrowing. Of particular concern is that municipalities can build up substantial payments arrears on servicing their debt without the Treasury's knowledge, and there are no effective controls on borrowing by municipal public enterprises, which creates uncertainties for fiscal sustainability (IMF, 2006).	*Impose stricter limits on domestic borrowing by the (now unified) social security institution and local governments. Improve monitoring of domestic borrowing by these entities.* *Check whether the available data on domestic borrowing by sub-national governments is complete, and in particular if suppliers' credit is fully reported.*

Table 2.5. **Turkey: Progress with implementation of the Public Financial Management and Control Law** (*cont.*)

Area	Progress made to date and challenges	Recommendations
Medium-term Fiscal Plan	The 2006 budget has been placed within a multi-year perspective, and some progress has been made in medium-term programming and planning, but it is too early as yet to assess the impact of this important reform.	*Ensure that the multi-year expenditure estimates fit into the overall medium-term fiscal plan for each year of the programme, and are updated regularly to take into account the fiscal costs of new policies and unexpected economic and political developments.* *Ensure that the medium-term expenditure estimates allocate sufficient funds to take into account the recurrent expenditures from new investment projects.* *Explain in the budget documentation the factors behind changes in the numbers underlying the medium-term fiscal plan from one budget to the next.*
Performance-based budgeting	Transition ambitions to performance-based budgeting were very high, but actual progress has been limited in practice. Explicit strategic objectives and targets have been determined by line ministries, but the necessary background for the evaluation and follow-up of these targets has not been established as yet. Budget documentation remains heavily focused on inputs, and the budget management and accounting systems, although substantially improved, are not yet configured to manage a programmatic, performance-based budgeting system.[3] Transition to programme-based budget classifications, a first fundamental step in transition to performance-based budgeting, has not yet been achieved.	*Start as soon as possible the reclassification of the budget, in particular with the reclassification of government expenditures into programmes.* *Start Spending Review procedures as a support mechanism for performance-based budgeting (as in the United Kingdom, Holland, Australia and Canada).*
Training of public sector officials	The training of public sector officials is ongoing. However, its scope should be broadened, notably to include local administrations. Training activities should focus on: *i)* the formulation of medium-term performance-based budgets; *ii)* the implementation of new accounting practices; and *iii)* adherence to new reporting requirements.	*Expand and intensify the public sector training programme in key areas relating to implementation of the PFMCL, particularly in the Strategic Development Presidencies and Departments in the line ministries and special budget agencies.*
External auditing	A draft Turkish Court of Accounts (TCA) Law to bring external auditing in line with international best practice was submitted to Parliament in February 2005 but has yet to be enacted.	*Enact the new Turkish Court of Accounts (TCA) Law that was submitted to Parliament in February 2005.*
Internal controls and internal auditing	Internal control and internal audit systems have been established in all public administrations. As these responsibilities have been transferred from the Ministry of Finance to line ministries the administrative capacity should be strengthened. As of May 2008, the government assigned 802 internal auditors to general government administrations. The PFMCL was amended in April 2007 to facilitate proper staffing of the Strategic Development Presidencies and Departments, which are responsible for internal financial controls in the line ministries and special budget agencies.	*Taking into account existing resource constraints, expand as rapidly as feasible the recruitment and training of internal auditors and accountants, and provide them with the necessary technological and physical equipment and infrastructure to carry out their functions effectively.*

1. Foundations solicit public donations (often at the time the service is provided). Resources are used to supplement line ministry activities (for instance, by purchasing vehicles). Despite the fact that revolving funds are excluded from the central government budget, budgetary figures thereof are included in budget documentation in gross terms, for information. Work on the restructuring of revolving funds continues.
2. Revolving Funds are extrabudgetary accounts of line ministries and other budget and annexed agencies which collect revenues in return for services.
3. IMF (2006).

Box 2.1. **Civil service (pay) reform**

A key element to containing the growth of public spending will be control over the public sector wage bill. Personnel expenditures account for around 30% of total central government primary spending in Turkey, with around 20% of this going to general public services and economic services. The wage system for civil servants is relatively rigid, based on educational starting levels and automatic steps according to seniority. The compensation system in Turkey also includes a multitude of allowances and side benefits that are exempt from income tax, with the share of allowances being disproportionately large for the highest grades in the civil service.[1] This partly compensates for an excessively compressed set of pay differentials between more and less skilled civil servants.[2]

Recent internationally comparable data on general government employment and wages is scanty, but available figures suggest that Turkey's overall general government wage bill is not high in comparison with countries with similar per capita incomes (Figure 2.6). However, it is important to note here that civil service pay is far from transparent in Turkey because of the complex allowance system and in-kind benefits (housing, food, transport, etc.). While the total basic salaries and the annual inflation adjustments are published and accounted for in the budget, information about total personnel compensation costs is lacking. Moreover, many of these benefits are accounted for under other budget items than wages and are not part of the personnel budget (Kraan *et al.*, 2007). Hence the overall general government wage bill is most likely underestimated in Turkey. Available data also indicate that general government employment as a per cent of the population is somewhat above that prevailing in other emerging market economies such as Korea and Mexico, but well below the levels seen in other eastern European countries, including new EU member states. However, average compensation of general government employees is high in international comparison when measured as a ratio to per capita GDP (Figure 2.6).[3]

The government's policy of restricting nominal compensation growth in the public sector so as not to exceed the rate of consumer price inflation has, over the past few years, not been enough to contain the growth of general government personnel expenditures, because other forms of compensation have increased faster than the inflation rate (World Bank, 2006b).

At the same time, while there is a need to contain the public sector wage bill on fiscal consolidation grounds, a case can be made for providing higher pay for highly qualified and skilled personnel in the public sector to improve the quality of public services. The relatively high average compensation of general government employees to a large extent reflects strong union representation of public sector workers primarily employed by subsidised SEEs. By contrast, university-educated civil servants tend to be paid less than their private sector counterparts. In this context higher pay for highly qualified and trained public sector workers may be desirable to reduce wage differences between the public and private sectors, for teachers and health care professionals among others, and to attract and retain high calibre professionals such as judges in public service (OECD, 2004).

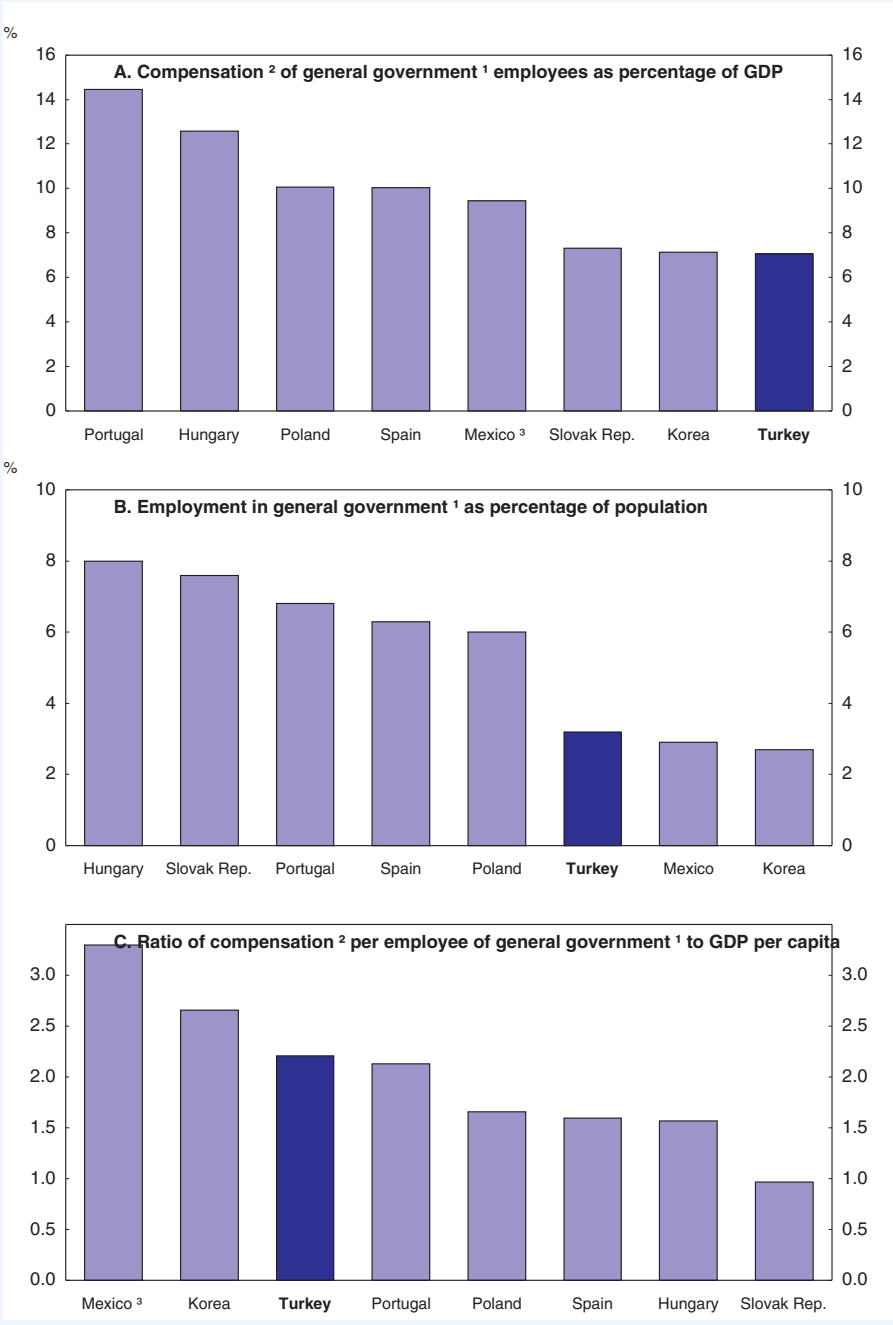
Thus a comprehensive civil service pay reform to contain the growth of the public sector wage bill, while achieving a decompression in compensation scales, may be necessary if Turkey is to improve the quality of its public services without jeopardising the sustainability of its public finances.

1. About 32% of personnel compensation is composed of various allowances, compensations and rewards, with many of these benefits being exempt from tax.
2. The ratio of the highest to the lowest wages for civil servants has been estimated at 7 in 2004, considerably below internationally observed averages of around 12-13.
3. These findings are consistent with those reported in World Bank (2006b).

Box 2.1. **Civil service (pay) reform** *(cont.)*

Figure 2.6. **General government[1] employment and compensation[2] for selected OECD countries**

2005



1. Consists mainly of central, state and local government units together with social security funds.
2. Consists of: i) wages and salaries payable in cash or in kind; and ii) social security contributions payable by employers.
3. Data for 2004.

Source: OECD (2008), *OECD Economic Outlook No. 83 database*; OECD (2007), *Comparison of employment in the public domain Survey* and OECD calculations.

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At the same time there is a case for reducing the number of budgetary line-items. At present the Turkish budget contains around 34 500 legally binding line-item estimates or appropriations – far more than in any other OECD member country. However, the Turkish Parliament votes only at a more aggregated level, with the result that each vote authorises a large number of appropriations (Kraan *et al.*, 2007). Significantly reducing the number of line items would not only provide more flexibility to line managers, but would also allow Parliamentarians to focus on key aspects of fiscal policy without getting bogged down in unnecessary details. It would also considerably reduce the amount of resources (including the time of civil servants) devoted to preparing the budget. Giving line managers greater flexibility should go hand-in-hand with their taking on greater accountability for the achievement of clearly defined targets.

Challenges in implementing key elements of the PFMCL

The PFMCL provided a broad framework for public finance management in Turkey in the context of an integrated approach covering the fiscal operations of the general government sector. The Law aimed specifically at improving public expenditure prioritisation and promoting higher quality and cost-efficiency in the delivery of public services through the setting of strategic objectives for government spending in the context of a Medium-Term Fiscal Plan, complemented with the introduction of functional and results-oriented budgeting. This was to be reinforced by a gradual shift towards strategic planning and results-oriented budgeting in the Line Ministries and Special Budget Agencies, to be implemented by the establishment of financial services units (Strategic Development Presidencies and Departments – SDPs and SDDs). However, as mentioned above, progress in effectively implementing these measures has been slow and rather limited to date. Also, given resource constraints in the public sector, there is a case for arguing that such reforms should initially be limited to certain high priority areas, namely education, health services, energy and physical infrastructures. At the same time the government is promoting greater use of Public-Private Partnerships (PPPs), both to help in financing important infrastructure projects and to promote greater (technical and allocative) efficiency in the provision of infrastructure services. The use of PPP contracts, while having the potential to yield significant benefits in terms of higher quality and cost-efficiency in the delivery of public services, poses a number of important challenges for policy-makers. All these issues are discussed in further detail below.

Medium-term budget framework

Expenditure prioritisation using programme budgeting tends to work best when the budget is designed in a multi-year framework. Turkey adopted a three-year medium budget framework in the context of its 2006 budget. Although it is too soon to judge its effectiveness, there are some early concerns regarding its status and coverage. First, there are no medium-term expenditure targets or ceilings for local governments and the Social Security Institution. Second, the three-year appropriation targets are not binding and can be exceeded during the budget preparation process; they serve only as indicators.

An effective medium-term budget framework requires not just medium-term expenditure estimates, but detailed discussion and analysis of how the estimates for a given budget year evolve over time as the medium-term budget framework is updated, as well as analysis and explanation of deviations in outturn from budgeted spending. At present the information provided in the budget documentation does not show the

difference between the present estimates for the upcoming budget year and the multi-year estimates of the previous budget for the same year. Moreover, information on the outcomes of previous years and multi-year estimates for future years is provided at a different level of aggregation and in different parts of the budget documentation, making it hard to assess how the fiscal framework has evolved over time (Kraan *et al.*, 2007). In this context Turkey should seek to ensure that its budget documentation includes: *i)* a macroeconomic framework that lays out clearly the key budget assumptions for the current and future years; *ii)* a routine examination and explanation of deviations in outturn from budgeted spending, which should be used to guide and justify future budget requests; and *iii)* a discussion of the factors underlying changes in the targets/ceilings for broad expenditure categories for a given year from one budget to another, explaining the extent to which the new estimates reflect revisions based on updated data and unanticipated new developments as opposed to new policy initiatives. This information should be presented in a user-friendly way so that the general public would have a clear idea of the evolution of fiscal policy over time. At this stage the Annual Programme (which is a decree by the Council of Ministers, and is submitted to the Parliament along with the Budget) includes various pieces of information, analyses and assessments on the course of budgetary developments.

Shifting to performance-based budgeting

A key tool used in a steadily growing number of countries to improve the quality and cost-efficiency of public spending is performance-based budgeting, which seeks to improve expenditure efficiency by systematically linking funding to results, making use of performance information to achieve that linkage. The objective is to redesign the budget process so as to improve the allocation of public expenditure, directing it towards goods and services of greatest social value, and also to increase efficiency in the production and delivery of public goods and services.

The form of performance-based budgeting that the Turkish authorities have chosen to adopt is *programme budgeting*, which uses information about the costs and benefits of objective-based ("programme") expenditure categories for expenditure prioritisation (Robinson, 2007). The focus here is on *allocative* efficiency, but the information provided for the use of performance-based budgeting is also expected to help improve *technical* efficiency. A key first step in the implementation of programme budgeting is reclassification of government expenditures into programmes – "objective-oriented classifications so that programs with common objectives … are considered together" (Carlson, 1969) – with the objective of each programme being explicitly defined.

A phased transition to performance-based budgeting has been targeted in Turkey, consistent with strategic planning objectives. A *Performance-Based Budgeting Guide* was published at the end of 2004, for utilisation by a number of pilot administrations, but practical results have been limited. On the basis of this early experience, the reference document is being revised and a new *Guide* should be available by the end of 2008. In this context, an important short-term priority for the government should be to simplify the current budget classification and harmonise it with a programme-based budgeting approach (Kraan, 2007). There is also a need to provide more training to public sector officials on formulation and implementation of medium-term performance-based budgets.

Effective implementation of performance-based budgeting would also require better forecasting of, and tighter controls over, certain key spending items – most importantly health and social security spending, and transfers to local governments and municipalities. In the recent past expenditure slippages in these areas have forced the government to offset them by scaling back the resources available to line ministries and spending agencies towards the end of the fiscal year in order to achieve the primary surplus target. If this continues the resulting uncertainty over resource availability will make it very difficult for line ministries and spending agencies to implement strategic planning. This in turn will be a major handicap to their being granted greater autonomy over public spending at the sectoral level and to the implementation of performance-based budgeting. Overcoming this requires imposing binding multi-year expenditure ceilings on the Social Security Institution.

It is important to note, however, that Turkey is just at the initial stages of implementing performance-based budgeting, and that even when fully implemented, obtaining tangible results will take time. This is partly because its effective implementation will require a major cultural change among civil servants, with the emphasis at the government level shifting from detailed control over inputs to increased flexibility for line managers in determining how to best deliver public goods and services in return for stronger accountability for results. Box 2.2 offers some lessons from cross-country experiences with performance-based budgeting that might be useful to bear in mind as Turkey moves ahead in this direction.

In the transition to full and effective implementation of performance-based budgeting, and as a complement to it, the Turkish authorities should consider undertaking and making greater use of surveys and performance/impact evaluations of key spending programmes. There are important examples of public expenditure tracking surveys and quantitative service delivery surveys having a positive impact on efficiency in the production and delivery of public services, *e.g.* with primary schooling in Uganda (Reinikka and Svensson, 2002). In the United Kingdom in October 2007, following the 2007 Comprehensive Spending Review, the government announced a set of 198 National Indicators that will be used by the central government to performance-manage local government from 1 April 2008. These include 25 performance indicators that are to be determined by measuring citizens' views and perspectives through the use of surveys undertaken by local authorities.

Public-Private Partnerships

The government is seriously contemplating greater use of Public-Private Partnerships (PPPs), particularly in telecommunications, electricity, natural gas, irrigation and transport. A number of countries, both advanced and emerging, have made use of PPPs, with mixed results. This approach has the potential to yield great benefits for Turkey, provided that these partnership contracts are carefully and wisely designed. Here it is important that full account be taken of the lessons that can be learnt, not only from Turkey's own experience to date with PPPs, but also from other countries' experiences with PPPs (Box 2.3). In general international experience with PPPs is that efficiency and quality of service could be expected to improve rapidly, provided that private operators are employed under contracts with strong incentives for good performance and sanctions for failure to reach explicit performance targets. PPPs have the added benefit of forcing the government contractual party to carefully set contractual performance targets and allocate risks fairly and efficiently.

Box 2.2. **Lessons from cross-country experiences with performance-based budgeting**

As discussed in the text, Turkey is currently at the initial stages of adopting one model of performance-based budgeting, namely programme budgeting. As Turkey moves ahead in this area it will be important to take into account the lessons that can be learnt from the experiences of other countries with performance-based budgeting. OECD (2007b), Robinson (2007) and Schick (2007) highlight several key policy lessons that might be relevant in the Turkish context:

First, designing government-wide systems that automatically link performance results to resource allocation should be avoided. Such automatic linkages distort incentives, ignore the underlying causes of poor performance, and require a very high quality of performance information that is rarely available (OECD, 2007b). Direct linkage may be possible in certain sectors; for example, there is strong empirical evidence that the "diagnostic-related group" (DRG) purchaser-provider system of hospital funding has delivered significant improvements in technical efficiency in the health sector (Robinson, 2007).* However, formula funding mechanisms are impractical in the case of many public services where the relationship between outputs (or outcomes) and funding is too uncertain.

Second, expenditure reviews should cover the entire gamut of public expenditures and not be confined to so-called "discretionary" expenditures, with important components of spending such as civil service salaries and social security benefits exempt from the scope of these reviews. Moreover, the expenditure prioritisation process must include a review of "base" public expenditures on existing programmes. Robinson (2007) argues that the absence of such a review virtually guarantees that expectations about the impact of performance-based budgeting will be disappointed, since it is precisely in the review of existing programmes that performance information can be expected to make its greatest contribution.

Third, although performance information should be integrated into the budget process, it is essential not to overload the budget process. Often new budgetary procedures are introduced that require more information than can be handled in the confined timetable and ultimately fall into disuse because they get in the way of doing the budget. This leads Schick (2007) to argue that far-reaching reforms may be more successful when the government purges some old information requirements to make room for new ones instead of layering new data on the old. The expenditure prioritisation mechanism should also recognise the limits on the capacity of decision-makers to analyse information for planning purposes. One option is to conduct periodic rather than annual reviews of expenditure priorities, as is done in the United Kingdom, which conducts infrequent "Comprehensive" Spending Reviews, supplemented with less in-depth Spending Reviews conducted in-between (usually on a biannual, but occasionally triannual, basis). Another approach is to target a comprehensive review of expenditure priorities on a staggered basis over a number of years. For example, the US Program Assessment Rating Tool (PART) is applied each year to 20% of government programmes, with all programmes being reviewed over a five-year cycle.

Fourth, it is critical to develop the staff and resource capacity of the key fiscal policy-making and co-ordinating institutions and the spending ministries, and to design incentives to motivate civil servants and politicians to change their behaviour.

Fifth, central budget decision-makers should in general focus their attention on broad expenditure allocations, mostly at the sectoral level, while providing substantial room for decentralised allocative decision-making at the line agency level. This in turn raises a key policy challenge – how to design a central budget process that provides incentives for, and pressures on, line agencies to be cost-efficient and to make maximum use of performance information in determining their own expenditure priorities at the sectoral level.

Sixth, timely and straightforward assessments of performance information should be carried out independently of the spending ministries and be supported by external expertise and monitoring.

* DRGs have been designed to classify treatments according to their resource costs, and employ a complete and consistent coding system to establish and cost bundles of appropriate inputs for one or more diagnosis-based treatment. The idea is that services associated with a particular treatment are reasonably predictable and can be bundled into a group to which a monetary value can be attached.

Box 2.3. **Lessons from cross-country experiences with Public-Private Partnerships**

Turkey has a need for significantly higher spending on infrastructure, particularly on road transport, energy (including nuclear energy) and irrigation. However, budget constraints have limited new infrastructure investments since the mid-1990s. In the face of financing constraints, the Turkish government in the mid-1990s increasingly resorted to various forms of Public-Private Partnerships (PPPs), notably in the energy and water sectors, through Build-Operate-Transfer (BOT) and Build-Own-Operate (BOO) contracts whereby private investors agreed to build up additional infrastructure capacity in exchange for long-term purchase agreements at guaranteed prices. However, the Turkish experience with these types of contracts has at best been questionable. Specifically, these contracts came under growing criticism for providing unjustifiably high rates of return to private investors, because the reference cost levels they were based on appear to have been well above international standards due to unfamiliarity with the innovative technical processes involved. Also, the government built up considerable contingent liabilities as it guaranteed minimum sale and price levels to BOT and BOO investors, with the Treasury committed to top up the difference whenever market demand and price projections fall below these thresholds. However, since the full commercial details of these contracts were never published, it is difficult to quantify the potential cost to the Treasury of these contingent liabilities.

Despite the unsatisfactory record of BOT and BOO operations in the mid-1990s, the practice after 2000 has been more successful and transparent as new contracts have been finalised on airports, customs, ports, etc. On the other hand, private provision of publicly funded services may raise legal challenges, as the Constitution seems to not currently permit such sub-contracting due to an Article stating that public services should be provided by employing civil servants (Article 28). On the other hand, the scale of infrastructure needs in Turkey, and the need for better public services, suggest that the government could consider making more use of these types of contracts. For example, the *2006 OECD Economic Survey of Turkey* recommended making irrigation investment a fiscal priority, and seeking opportunities to involve private investors in irrigation projects. At the same time it is important that, in drawing up PPP contracts, Turkey takes full account of the lessons that can be learnt, not only from its' own experience to date with PPPs, but also from other countries' experiences with PPPs. These lessons may be summarised as follows:

- Perhaps the most important lesson to be learnt is that the primary objective of PPPs should be value-for-money (VFM), and not to finance infrastructure projects off-budget and thus circumvent budget constraints arising from fiscal rules and expenditure limits. While PPPs may, under certain circumstances, be a useful source of finance for desirable projects that the government could not otherwise afford – at least not in the short-term – all efforts should be taken to ensure maximum VFM for the public. In other words, PPPs should not be exposed to softer budget constraints than other public investment projects.
- Another key lesson to learn from Turkey's past experience is the importance of appropriate risk-sharing between government and the private partner. In most cases high transactions costs, along with higher credit risk, raise the financing costs for a PPP above those of public sector provision and delivery. For a PPP to yield better VFM these higher costs have to be offset by greater technical and allocative efficiency on the part of the private sector. Such efficiency gains can only be achieved through a sufficient transfer of risk to the private partner to provide incentives for the private sector to be as efficient as possible. Risk in this context may be defined as the probability that the actual outcome (*e.g.* sales, costs and profits) will deviate from the expected outcome. It is also important to distinguish between endogenous and exogenous risk; endogenous risk, unlike exogenous risk, represents the case where the private partner can do something to ensure that the actual outcome approximates the expected outcome. In general risk must be carried by the party best suited to carry the risk, that is to carry the risk at least cost, be it the government or the private partner. In most cases the government is in a better position to carry legal and political risks, whereas the private partner should bear the brunt of commercial risks. The latter include construction risks, supply-side operation risks and demand-side risks arising, for example, from changes in consumer preferences, the emergence or disappearance of substitute or complementary products, import competition and changes in income and demographics.

Box 2.3. **Lessons from cross-country experiences with Public-Private Partnerships** *(cont.)*

- Competition and contestability are key elements to ensure the effective transfer of risk to the private partner. This includes competition *for* the market (*i.e.* in the bidding process) as well as competition or contestability *in* the market once the contract is concluded and in operation. In the absence of competition effective risk transfer will not occur, limiting the realisation of efficiency gains. In practice however there is usually limited scope for competition in the supply of infrastructure assets and services because sunk costs are often large, many infrastructure services require the setting up of extensive networks which in turn introduces an element of natural monopoly, and/or because the government is the main purchaser. Thus, in cases where a private sector monopolist is free to sell services to the public it is important that an adequate regulatory and legal framework be set up to contain monopoly profits and protect consumer interests.
- A Public Sector Comparator (PSC) could strengthen the scrutiny of PPP projects and improve the assessment of VFM. Prior to undertaking a PPP the Turkish government should, ideally, seek to ensure that a PPP will deliver better VFM compared to traditional public procurement. This will require an *ex ante* comparison of the VFM of both the PPP and the traditional public procurement route in every case where the government contemplates using a PPP. PSCs are useful instruments for conducting such a comparison. This task could be given to the Turkish Court of Accounts if it is endowed with adequate resources.
- The fiscal implications of PPPs should be properly accounted for and reported. PPPs offer opportunities to bypass expenditure controls and to move public investment off-budget and debt off the government balance sheet, mainly to meet fiscal rules or targets. Full transparency about the fiscal consequences of PPPs can help to prevent their misuse and to make increased efficiency the principal motivation for engaging in such contracts. Thus budget documentation should disclose all information on PPPs in a transparent way, including information on what and when the government will pay, government guarantees and contingent liabilities. As noted above, such transparency was notably absent in the PPP contracts signed by the Turkish government in the mid-1990s, and is something that should be borne in mind when engaging in future PPP agreements.

Presently, Turkish authorities are working on a new and comprehensive PPP legislation by taking into consideration the national and international experiences.

Tax reform challenges

Turkey's tax system is characterised by a relatively low tax revenue yield – at around 24% of GDP, compared with an average of around 31.5% for a group of ten comparator OECD economies – and a heavy reliance on indirect taxes, and in particular on excise duties.[18] However, this low revenue yield masks the fact that the formal sector faces a very high tax burden. Regarding the tax structure it can be argued that this dependence on indirect taxes is not necessarily a bad thing; indeed, OECD (2007c) finds that higher reliance on consumption taxes is associated with faster growth, compared with greater dependence on (personal and corporate) income taxes. On the other hand, social security contribution rates continue to be high in Turkey, which acts as an impediment to employment growth and to further formalisation of the economy. The low revenue yield is a reflection of low (average and marginal) effective tax rates which are significantly lower than nominal tax rates. While imposing fiscal costs, the "outsourcing" of economic activity into the informal and semi-formal sectors helped to make the business sector better able to cope with shocks. Thus the challenge is to combine better tax enforcement and streamlining of tax exemptions with measures to make the legal tax burden more affordable, especially to businesses, by lowering nominal tax rates. These issues are discussed in further detail below.

Tax distortions affecting growth and employment should be reduced

The tax wedge on labour in Turkey is still high compared to the OECD average and seriously hinders employment in the formal sector (see Figure 4.5 in Chapter 4). A strong case therefore exists for a shift in the structure of taxes in a manner that promotes growth and employment in this higher productivity part of the economy. Previous *OECD Surveys* suggested 'substantial, as much as halving' cuts in social security contributions, to be funded primarily by other spending reductions and structural changes in the social security system, and other fiscal measures. As part of a new *Employment Package* adopted in May 2008 (see Chapter 4 of this *Survey*), the government reduced the social contribution rates of employers by 5 percentage points and confirmed its intention to phase in additional rate cuts in subsequent years.

A significant cut in social security contribution rates will however have important fiscal consequences, through its impact on government revenues. This is the reason why the intended cuts could not be immediately implemented. The government decided to start with a 5 percentage point reduction in employer contribution rates in the first year (amounting to a reduction in existing employer rates of almost 25%), to be followed by additional cuts in following years, depending on the budgetary room created. Box 2.4 provides a discussion and an estimation of the likely fiscal impacts of a substantial (40%) reduction in total social security contribution rates; the estimates suggest that the budgetary costs would be non-negligible and could initially amount to a government revenue loss of around 1½ per cent of GDP. However these costs are likely to fall steadily over time, to about ½ per cent of GDP after ten years.

Social security reform, and the *reduction of social security contribution rates*, have to date been handled as two separate and independent government objectives. A key policy challenge here is to make sure that the reduction of social security contributions does not undermine the actuarial neutrality of the social security system, which is an overriding objective of social security reform in Turkey. It appears that the government intends to gradually reduce the cost of social security contributions to employers by financing part of these costs through budgetary subsidies, without any cuts in either *mandatory* social security contribution rates or in social security benefits. This, however, would put additional pressures on public spending and on the sustainability of Turkey's public finances. One option is to introduce a distinction between mandatory public and complementary voluntary schemes for pensions, with *mandatory* cuts in employer social security contributions being offset by *actuarially neutral* cuts in pension benefits. Simultaneously, to preserve existing benefit levels, current formal sector workers can be automatically enrolled in the voluntary scheme with the option of active opt-out, and with the difference between the current (high) and future (low) social security contributions being paid into the scheme. Informal sector workers would face reduced contribution rates to lower the costs of moving to the formal economy, while qualifying for proportionately lower pension benefits.

Tax enforcement should be strengthened and major tax loopholes closed

A cross-country comparison of Turkey's current tax structure shows a heavy reliance on indirect taxes (Figure 2.8). It can be argued that this tends to have a regressive incidence on income distribution, and that the composition of tax revenues should be rebalanced towards a higher share of direct taxes. However, a closer look at the data shows that the revenue yield from general consumption taxes is not exceptionally high in Turkey, with a

Box 2.4. **Likely fiscal costs of a significant cut in labour taxes**

Expected fiscal costs of a hypothetical 40% reduction in social security contribution rates have been estimated for the purposes of this Survey, involving a reduction in employers' social security contribution rates from 21.5% to 6.7% of gross wages. Since social security revenues from the private sector are a relatively small source of revenue in Turkey due to low compliance, the direct first-round impact of a significant reduction in social security contributions is likely to be fairly modest, in light of the exceptional size of unregistered employment (both in terms of numbers of undeclared workers, and underreported wages). Indeed, countries with statutory contribution rates in the same vicinity as Turkey, such as Spain and Portugal, have revenues as a share of GDP which are at least 60% higher than in Turkey. The direct fiscal costs of a 40% reduction in social security contribution rates can be mechanically estimated on the basis of a *pro rata* reduction of revenue projections and yield an estimated reduction of net government revenues of roughly 1.5% of GDP.[1]

The initial fiscal costs are likely to be partly offset over time through higher compliance rates and greater formalisation of the economy. Starting from a 47% registration rate for all employees, we assume: *i)* a 1.5% increase in aggregate employment per annum, compared to an average of around 1.3% in 2005 and 2006; *ii)* no increase in wage declarations; and *iii)* a limited 2 percentage point per annum increase in the "registered share of employment". Under these assumptions the additional revenue impacts are non-negligible and are estimated at around 0.1% of GDP one year after the reform, rising to 1.0% of GDP after ten years.

Against this, if as a result of the cut in social security contribution rates the number of registered workers increases – as is expected – this is likely to give rise to additional spending pressures. Increased formalisation of the economy will, over the long-term, increase the number of workers eligible for pension benefits. It is assumed that the *actuarial neutrality* of the public pension scheme – a key principle underlying the Social Insurance and Health Reform Law – is preserved, *i.e.* the long-term pension benefits are reduced in the same proportion as short-term pension contributions. Thus the reduction of social security contributions does not affect the long-term parametric balances of the social security system. On the other hand, in the short term increased formalisation would also broaden the population eligible for health insurance (*i.e.* workers joining the formal sector and their dependents), generating additional public health care costs, estimated at about 0.1% of GDP in the first year and thereafter falling steadily over time.[2]

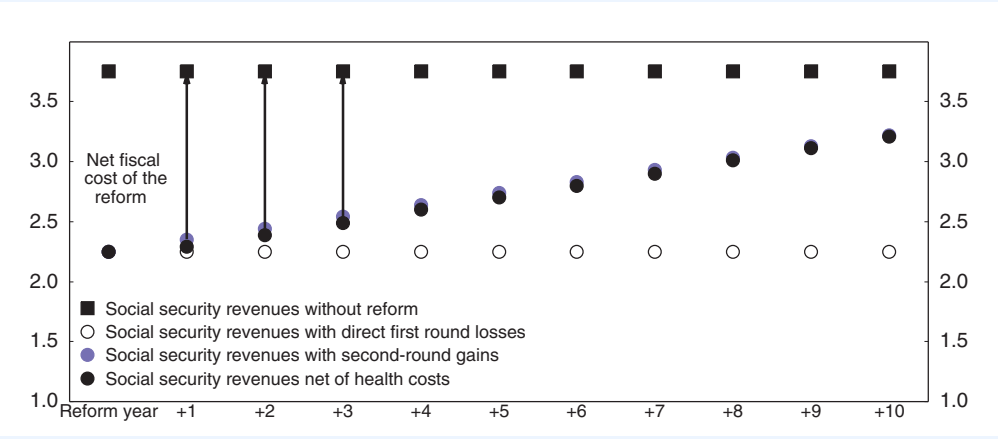
Figure 2.7 shows the estimated net fiscal costs of a 40% cut in social security contribution rates under these assumptions. Our calculations indicate that the net fiscal effects should be relatively contained, although not negligible, at 1.5% of GDP, in the first year of implementation. The additional costs are likely to fall steadily over time, to about 0.5% of GDP after ten years, as the additional fiscal revenues from increased formalisation would be only partially offset by smaller increases in health care costs.

1. Net social security revenues received by the government amount to about 3.8% of GDP in Turkey (*versus* nearly 15% of GDP in other countries with high social security contribution rates). Thus, if the social security contribution rates are reduced by 40%, the direct cost to net government revenues would be around 1.5% of GDP.
2. The additional indirect fiscal costs are difficult to quantify, particularly in the context of the introduction of universal health care. Until recently health coverage through formal sector participation (and social insurance) was more generous, and therefore more fiscally costly than coverage through social protection (green card holders). The draft Social Insurance and Health Reform Law aims to introduce universal health care and to unify the health benefits granted through social protection and social insurance, thereby limiting the additional fiscal costs of increased registration through higher health care spending. However, the actual implementation of universal health care is likely to take time, and in the meantime increased registration of workers is likely to put pressure on health costs. We assume that, in the first year of implementation, 60% of the increase in registered workers would already have been covered by health benefits under the formal social insurance system, that 10% were previously green card holders, and that 30% gain previously unavailable access to health coverage. Consistent with the data in World Bank (2006b), we assume that green card holders absorb only 40% in health care costs compared to those formally covered under social insurance. Starting from an initial 4.1% of GDP public spending on health care, under these assumptions the additional health care costs are estimated at 0.1% of GDP in the first year. These additional costs are assumed to fall steadily to zero by 2020 with the gradual implementation of universal health care, and as an increasing proportion of the population, whether registered or not, have access – and not just eligibility – to the health care services currently enjoyed by those covered by social insurance.

Box 2.4. **Likely fiscal costs of a significant cut in labour taxes** *(cont.)*

Figure 2.7. **Net fiscal costs of the labour tax reduction**

Social security contributions collected as % GDP, net of additional spending

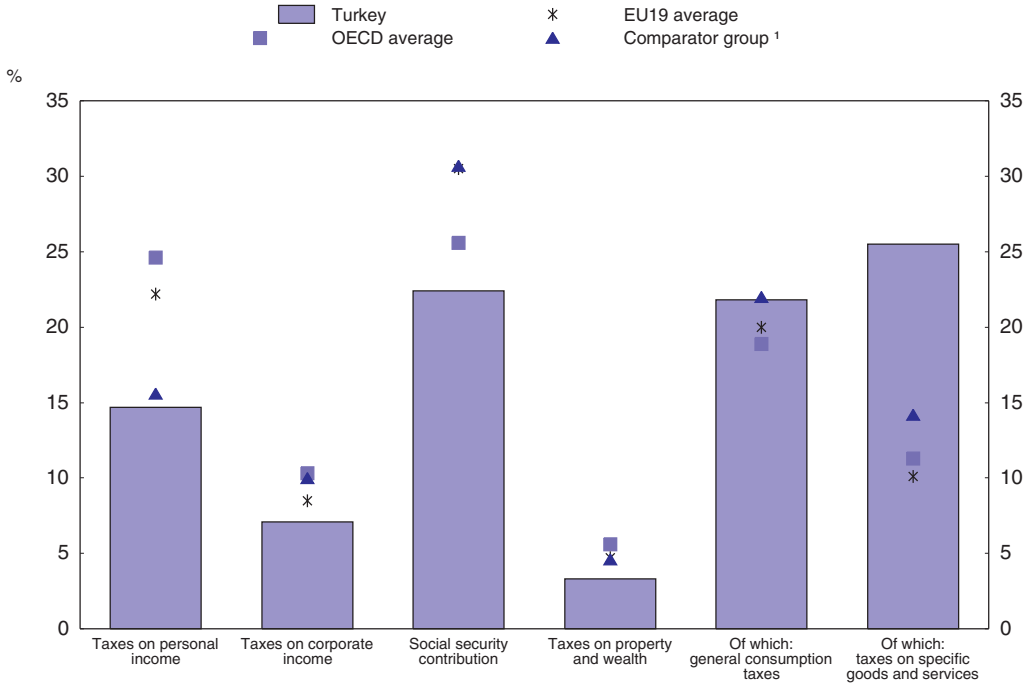


Source: OECD estimations on the basis of national Social Security System statistics.

StatLink http://dx.doi.org/10.1787/420054683818

Figure 2.8. **Tax revenue comparisons, 2005**

Per cent of total tax revenues



1. Includes Mexico, Korea, Czech Republic, Greece, Hungary, Ireland, Poland, Portugal, Slovak Republic and Spain.

Source: OECD (2006), *Revenue Statistics*.

StatLink http://dx.doi.org/10.1787/420055334277

share of around 22% of total government revenues compared to EU19 and OECD averages of 20% and 19% respectively. What is striking is the share of excise duties in total tax revenues, which is more than twice the EU19 and OECD averages; only in Mexico among the comparator group of countries is the contribution of excise duties higher (Figure 2.8). Since excise duties in Turkey tend to be levied mostly on items consumed by the well-off, the regressive nature of this heavy reliance on indirect taxes is less than what might appear to be at first sight.[19]

Moreover, in the short run it can be argued that reliance on indirect taxes may be a reasonable way of ensuring some degree of compliance by those taxpayers who would otherwise escape taxes altogether, given the presence of a large informal sector (World Bank, 2006b). What is perhaps of greater concern is that reliance on indirect taxes has been accompanied by a proliferation of special regimes and exemptions; the March 2006 reduction in VAT rates from 18% to 8% on textiles, clothing and some leather products – sectors where informal activity is predominant – is a case in point. The same VAT tax rate cut was extended in June 2007 to most food items and to subcontractors in the textiles sector, and to hotel and catering services and to some further food items in 2008. These special regimes and exemptions distort prices and can give rise to inefficiencies in the economy. Furthermore, heavy reliance on excise duties in particular may promote the growth of the informal sector, further undermining the tax base as well as the efficiency of the economy as a whole. Also, empirical findings by the OECD suggest that, given the overall tax level, a higher reliance on consumption taxes is associated with faster growth compared with a greater dependence on corporate and personal income taxes (OECD, 2007c). However, these results need to be interpreted with caution since possible interdependence between the overall tax burden and the revenue shares could bias the estimation results.

Turning now to direct taxes, what is striking is the low share of personal income taxes in total tax revenues, at less than 15% compared to a EU19 average of over 22% and an OECD average of 24.5%. This is despite a relatively high average personal income tax rate – in comparison to most OECD member countries – of 30.5%. The relatively low personal income tax yield is thus probably a reflection of the high degree of informality of the Turkish economy. By contrast the corporate income tax rate, at 20%, is on the low side when compared to the rates currently prevailing in OECD member countries. There is thus a case for bringing down the top marginal personal income tax rate of 35% significantly over time to lower the tax wedge on labour and to reduce existing tax distortions that serve as disincentives to work in the formal sector. However, for reasons of fiscal sustainability this should be done cautiously and only as adequate fiscal space is created through a broadening of the tax base.

At the same time tentative estimates by the OECD Secretariat suggest that there is considerable scope for financing a cut in the top personal income tax rate through strengthened tax enforcement. Table 2.6 provides estimates of the average ratios of actual taxes paid to estimated tax liabilities for eighteen broad professional categories. These ratios are below 20% for a number of important professions, including entrepreneurs in the construction sector, the dental and accountancy professions, travel agents, furniture producers, and restaurant and clothing workshop owners. This suggests that an important priority for the government should be to significantly strengthen the Revenue Administration, and in particular the Large Taxpayer Unit (LTU). Thus the government's plans to raise the number of auditors assigned to the LTU and to increase the human

Table 2.6. **Actual and expected personal income tax liabilities in different professions**

In Turkish new lira

Activity areas	Number of taxpayers	Estimated yearly net income	Estimated average PIT liability per person	Actually reported yearly net income	Actual average PIT paid per person	Actual taxes paid/estimated tax liability (as a percentage)
All activities	496 260			7 812	2 285	
Gas retail	6 913	30 000	8 926	10 254	3 051	34.2
Food retail (incl. supermarkets)	80 466	15 000	3 323	3 266	724	21.8
Construction	425	70 000	25 863	10 737	3 967	15.3
Hotels	4 542	20 000	5 390	5 742	1 547	28.7
Bakeries	11 859	15 000	3 464	4 566	1 055	30.4
Lawyers	27 814	35 000	10 999	13 486	4 238	38.5
Dentists	9 221	30 000	6 841	4 593	1 047	15.3
Dental prothesists	1 480	25 000	5 304	1 769	375	7.1
Physicians	16 131	40 000	11 517	11 183	3 220	28.0
Travel agents	6 161	35 000	8 205	3 442	807	9.8
Furniture producers	30 354	30 000	7 217	3 128	753	10.4
Restaurant owners	40 420	20 000	4 911	2 706	664	13.5
Construction materials trade	35 317	40 000	10 066	3 761	947	9.4
Foreign trade (exporting and importing)	1 571	35 000	12 816	22 963	8 408	65.6
Clothing workshop owners	7 923	30 000	8 300	4 643	1 284	15.5
Certified accountants	28 774	100 000	29 287	19 555	5 727	19.6
Minimum wage earners				4 530	680	

Source: OECD staff estimates.

resources of the Unit are welcome. In addition, the audit powers of the Revenue Administration should be enhanced by enabling the tax authorities to cross-check income and expenditures. Finally, integrating tax and social security contribution collection could yield significant efficiency and compliance benefits. In this context the recent establishment of a committee to enhance cooperation and strengthen information sharing between the Social Security Institution and the Revenue Administration, and government plans to put in place a unified tax declaration form in the near future, are important steps in the right direction.

On VAT as well there is scope for extending the tax base to cover items not currently in the VAT net and to strengthen tax enforcement. Turkey's VAT efficiency ratio – defined as the ratio of VAT revenues to GDP divided by the standard rate (expressed as a percentage) – is estimated at 30%, well below the OECD average of around 40%.[20] This suggests that there is scope for extending the VAT tax net.At present, for example, goods and services supplied at theatres, concert halls, libraries, sports facilities, reading rooms and conference halls are exempt from VAT (with no refunds for VAT paid on inputs). At the same time a number of goods and services are zero-rated, with tax credits for VAT paid on inputs. These include among others the supply of sea, air and railway transportation for business purposes; services supplied at harbours and airports for vessels and aircraft, including loading and unloading services; and deliveries of goods and construction contract works to those who engage in the construction, renovation and widening of harbours and airports.

Finally, following the publication of an October 2007 Ministry of Finance report that estimated total tax expenditures in 2007 at around 1.4% of (revised) GDP, but there are many tax expenditure items that have not been included in the report. The government could consider producing and implementing a timetable for reducing them over time. Here it is worth noting that IMF and World Bank staff estimates of tax expenditures are much higher, at around 2.9% of (revised) GDP in 2003, including estimates of the cost of employee tax benefits for civil servants and other workers and for certain self-employed persons (World Bank, 2006b).

Conclusions

The analysis and simulations presented above suggest that the time has come for a new, pro-growth fiscal strategy in Turkey. The short-term public debt dynamics appears to be sustainable, and the key challenge for fiscal policy looking forward is not so much to bring down the public debt stock but rather to manage pressures on public expenditures, re-allocate public spending and ease the tax burden (on labour income in particular) in a manner that promotes growth and employment. The focus should be on raising the overall tax revenue yield, primarily through stronger tax enforcement and administration and broadening the tax base, while increasing public spending in key priority areas such as education, health, irrigation, and energy and physical infrastructures. In this context the government could consider shifting the anchor for fiscal policy to an expenditure rule with binding multiyear ceilings, supported by primary surplus targets that are consistent with the long-term sustainability of public debt, and as laid out in the Medium-Term Fiscal Framework (MTFF).

Action is also needed to complete and fully implement the modernisation of fiscal institutions, and to clarify and refine fiscal policy priorities. In addition, notwithstanding important progress to date in the budget formulation and execution process, further steps can be taken to simplify and strengthen the budgetary framework. In this context it is important that measures be taken to effectively implement the provisions of the *Public Financial Management and Control Law*. A new fiscal strategy should at the same time go beyond the modernisation of fiscal institutions. Strong political commitment and decisions are needed, including on: *i)* clarifying Turkey's functional spending priorities; *ii)* shifting determinedly to more efficient supply arrangements in key public services; and *iii)* closing major loopholes in the tax system and strengthening tax enforcement. In light of these fiscal challenges Box 2.5 presents recommendations for making fiscal policy more growth-promoting.

Box 2.5. **Summary of recommendations for a growth-promoting fiscal policy**

Achieving fiscal transparency and integrity

- Start to publish as soon as possible up-to-date general government accounts according to national accounting standards, through standard international statistical procedures and on an accruals basis.
- Ensure that the *Public Financial Management and Control Law* (PFMCL) has full primacy over all matters that relate to public financial management and reporting. Prevent situations where other legislation dilutes the provisions of these laws.
- Ensure that the medium-term fiscal framework prescribed by PFMCL effectively includes: *i*) a routine examination of deviations in outturn from budgeted spending, and *ii*) a discussion of the factors underlying changes in the targets/ceilings for broad expenditure categories for a given year from one budget to another. This information would help the users of budget documents to form a clear view of the evolution of fiscal policy over time.
- Endow the Turkish Court of Accounts (TCA) with adequate legal, administrative and professional powers as well as resources to make it an active and credible scrutiniser of public finances. Enact the new TCA Law that was submitted to Parliament in February 2005.

Consolidating fiscal macroeconomic management

- Shift from a nominal primary surplus target to an expenditure rule with effective multiyear ceilings, supported by primary surplus targets that are consistent with the long-term sustainability of public debt. This would also help in attaining the broad primary surplus targets laid out in the Medium-Term Fiscal Framework.
- Complete the medium-term fiscal framework with area-specific expenditure targets to protect priority areas such as public investment spending.

Improving significantly the quality of spending

Allocative efficiency

- Clarify Turkey's strategic spending priorities to enable the government to allocate resources to top priority areas such as education and physical infrastructure.
- Fully implement the provisions of the PFMCL in the areas of strategic prioritisation of spending and the training of budgeting officials for an effective shift to strategic and results-oriented budgeting.
- Streamline the budget process by integrating various central and line ministry planning documents and significantly reducing the number of line items in the budget.

Technical efficiency

- Press ahead with steady progress with performance-based budgeting, starting with the reclassification of government expenditures into programmes.
- Make greater use of customer satisfaction surveys to improve the quality and cost-efficiency of public goods and services and to carry out performance/impact evaluations of key services.
- Build on Turkey's own and other OECD countries' experiences to achieve a major improvement in the quality and cost-efficiency of key public services (notably of education and health services). Explore avenues for fuller recourse to public funding and competitive provision.
- Adjust the public wage structure to ensure that the public sector can employ sufficient numbers of highly-qualified and trained professionals. At the same time take measures to contain the growth of public sector employee compensation, including tax-exempt allowances and side benefits which are not performance-related.

Box 2.5. **Summary of recommendations for a growth-promoting fiscal policy** *(cont.)*

- Promote greater use of Public-Private Partnerships (PPPs), particularly in telecommunications, electricity, natural gas, irrigation and transport, while taking full account of the lessons that can be learnt from Turkey's own and other countries' experiences with PPPs.
- Expand and intensify the public sector training programme, including for: *i)* the formulation of budget documents according to new fiscal laws; *ii)* the roll out of the new system to local governments; *iii)* the implementation of new accounting practices, particularly at local government level; and *iv)* the adherence to new reporting requirements.

Reforming tax structures

- Significantly reduce social security contribution rates, for example by 40%, and finance this step by saving on low-priority expenditure items, better tax enforcement and other reforms that increase employment in the formal sector.
- Preserve the actuarial neutrality of the social security system by introducing a distinction between *mandatory public* and *complementary voluntary* schemes for pensions. The present workers in the formal sector can be automatically enrolled in the voluntary scheme with the option of active opt-out, with the difference between the current (high) and future (low) social security taxes being paid into the scheme.
- Close the most blatant tax loopholes and strengthen tax enforcement relating to both direct taxes and VAT.
- Consider extending the VAT tax base to cover items not currently in the VAT net.
- Improve tax administration by enhancing the audit powers of the Revenue Administration and enabling it to cross-check income and expenditures and integrate tax and social security contribution collection.
- Produce and implement a timetable for reducing tax expenditures over time.

Notes

1. Uncertainties relate in particular to the treatment of "one-off" fiscal items in the *total public sector* accounts; for example items related to privatisation operations have made the reading and interpretation of these accounts difficult in the recent period.
2. As an example, the fiscal slippage which occurred in 2007 was reflected in this data but with a long delay. Turkish policymakers and market participants had no accurate timely information on actual fiscal developments in 2007.
3. The OECD Secretariat is grateful to the State Planning Organisation for having carried out related calculations and having shared the relevant data. Several adjustments have been needed on published "total public sector" figures to eliminate one-off items and come closer to an international concept of 'above the line' government accounts.
4. Following each review the IMF made a public statement emphasising the key results concerning compliance with programme objectives. Underlying review material and statistics have been made public according to a less systematic schedule, following clearance and approval by the government and the IMF Executive Board (as is the usual procedure for a programme country).
5. Except for Figure 2.1, all the ratios to GNP (GDP) mentioned in the text in this section are "pre-GDP revision" figures that do not incorporate the revised GDP series released in March 2008.
6. A number of arguments and empirical studies suggest that spending restraint (notably with respect to government consumption and transfers) is more likely to generate lasting fiscal consolidation and better economic performance. See Alesina and Perotti (1996), Alesina and Ardagna (1998), Von Hagen *et al.* (2002) and Guichard *et al.* (2007).
7. The dynamics of public sector debt were simulated based on the standard equation $\Delta bt = xt + bt^*(rt - gt)$ where bt is the public debt to GDP ratio in year t, xt is the primary deficit to GDP ratio in year t, rt is the real interest rate and gt is the growth rate of real GDP. This formulation does not take into account seigniorage, *i.e.* monetary financing of the fiscal deficit.

8. The Pre-Accession Economic Programme 2007 states that "fiscal policy will continue to have dual roles. Improvement of fiscal balances and reduction of debt stock will be considered on the one hand, and the disinflation process will be supported on the other" (SPO, 2007, p. 1).
9. As suggested also by Lombardo (2007).
10. As also argued by Lombardo (2007).
11. As discussed in Anderson and Minarak (2006).
12. It is however important to bear in mind that the adoption of "golden rules" (rules that exclude public investment from fiscal policy constraints) may provide incentives for the reclassification of current into capital spending, thereby creating scope for debt accumulation.
13. The *Ninth Development Plan 2007-2013* promises further public spending to, among other objectives: *i)* expand pre-school education, with a targeted increase in 4-5 year olds school enrolment rates from 20% in 2005/06 to 50% in 2012/13; *ii)* meet teacher and physical infrastructure requirements in schools; *iii)* reduce school dropout rates and increase rates of transition to secondary education; *iv)* lower classroom sizes and reduce the practice of double shift education, with a targeted reduction in the number of students per classroom from around 44 to 30 in primary education, and from 38 to 30 in general secondary education, over the period 2005/06-2012/13; and *v)* increase university quotas in order for teacher requirements to be met in areas where there are not enough teachers.
14. An analysis by the World Bank indicated that Turkey's per student spending on pre-primary education is very low, while spending on primary schools is consistent with expectations given its per capita income. For secondary and tertiary education Turkey spends somewhat more per student than what would be predicted on the basis of its per capita income.
15. The *Ninth Development Plan 2007-2013* promises measures to eliminate the shortage of health personnel while improving the quality of health education. The number of physicians is targeted to increase by over 16% between 2006 and 2013, the number of inpatient beds by almost 20% and the number of new admissions to faculties of medicine by over 45%.
16. The comparator group includes the Czech Republic, Greece, Hungary, Ireland, Korea, Mexico, Poland, Portugal, the Slovak Republic and Spain.
17. These estimates are based on pre-revision GDP numbers.
18. The comparator group includes the Czech Republic, Greece, Hungary, Ireland, Korea, Mexico, Poland, Portugal, the Slovak Republic and Spain.
19. As examples, the excise duty rates on vehicles are highly progressive, depending on the size and type of vehicle, and the 2006 increases in the special consumption tax – from 6.7% to 20.0% – were targeted on a range of luxury good items, such as cosmetics.
20. The efficiency ratio is widely used as a summary indicator of the performance of the VAT. A low ratio in particular is typically taken as *prima facie* evidence of erosion, either by exemption and reduced rates within the tax law, or by imperfect enforcement.

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ANNEX 2.A1

Net public debt sustainability scenarios: methodology and assumptions

This annex describes the identities that were used for as a base for developing the stress-testing framework for net public sector debt discussed in the text, and the assumptions behind the baseline scenarios.

Public debt dynamics

In nominal terms, the stock of public debt at time t can be explained by the following identity:

$$B_t = (1 + r_t)B_{t-1} + D_t - S_t - Pr_t \quad (1)$$

where:

B: Public debt (bonds).

r: Weighted average nominal interest rate on government bonds.

D: Primary fiscal deficit.

S: Seigniorage (monetary financing of the fiscal deficit).

Pr: Privatisation receipts.

All stock variables are expressed as end-of-period values, while flow variables and interest rates are period averages.

By expressing the key variables as a percentage of GDP (small letters), by differentiating between public debt denominated in local *versus* foreign currency, and by introducing nominal exchange rate appreciation/depreciation so as to account for the revaluation of last period's foreign-currency denominated debt, the following equation is obtained:

$$b_t = [(1 + r^{fl}_t)\,\gamma\, b_{t-1} + (1 + r^{fl*}_t)(1 - e_t)\,\gamma^*\, b^*_{t-1} + (1+ r^F_t)(1 - \gamma)\, b_{t-1} + (1 + r^{F*}_t)(1 - e_t)(1 - \gamma^*)\, b^*_{t-1}]/(1 + g_t) + d_t - s_t - pr_t \quad (2)$$

where:

r^{fl}, r^{fl*}: Domestic and foreign nominal interest rates on floating rate debt.

r^F, r^{F*}: Domestic and foreign nominal interest rates on fixed rate debt.

g: Nominal GDP growth rate.

γ, γ^*: Shares of floating debt in total lira-denominated and foreign-currency-denominated debt respectively.

e_t: Per cent nominal exchange rate appreciation over period t. The nominal exchange rate is expressed as units of foreign currency per unit of domestic currency (*i.e.* an increase in E corresponds to a nominal appreciation).

Equation 2 is the one that is used to produce the public debt scenarios in Figure 2.2 of this chapter. The key economic assumptions behind the constant fiscal stance scenario are summarised in the following table.

Table 2.A1.1. **Assumptions for the constant fiscal stance scenario**

	2007 (estimate)	2008	2009	2010
Real GDP growth (%)	4.5	3.7	4.5	6.0
Domestic inflation rate	8.8	9.6	7.5	6.5
Nominal effective exchange rate appreciation (%)	2.3	–4.4	–5.0	–4.5
Real effective exchange rate appreciation (%)	8.3	2.4	0.0	0.0
Primary fiscal balance (% of GDP)	3.5	3.5	3.5	3.5
Privatisation receipts (% GDP)	1.4	1.2	1.2	1.2
Baseline interest rate assumptions				
Nominal floating interest rate on domestic public debt (%)	22.2	19.5	17.0	15.0
Nominal fixed interest rate on domestic public debt (%)	18.3	17.0	15.0	13.0
Nominal floating interest rate on external public debt (%)	6.5	6.0	6.0	6.0
Nominal fixed interest rate on external public debt (%)	5.3	5.0	5.0	5.0

For the other two public debt scenarios the assumptions for 2009 and 2010 are changed as follows:

External shock scenario: All interest rates 400 bps higher; GDP growth falls to 2% per annum; the primary fiscal surplus falls to 2.7% of GDP; and the nominal exchange rate depreciates by 10% in each of 2009 and 2010.

Fiscal policy reversal scenario: In this scenario it is assumed that the primary fiscal surplus falls to 1.0% of GDP in 2009 and disappears in 2010, and this is entirely due to a weakening of fiscal discipline rather than due to cyclical factors. Floating interest rates are assumed to be 800 bps higher, while fixed rates are assumed to be 400 bps higher, and GDP contracts by 2% per annum.

ANNEX 2.A2

Education performance – Turkey in international comparison

	Annual expenditure per student, 2004[1]			Total education spending[3] (in per cent of GDP) 2004 (or latest year available)			% of population aged 25-34 with at least upper secondary education, 2005
	Primary education	Secondary education	Post-secondary non-tertiary education	Public	Private	Total	
Australia	5 776	8 160	7 969	3.5	0.7	4.2	79
Austria	7 669	9 446		3.6	0.2	3.7	87
Belgium	6 636	7 751		4.0	0.2	4.1	81
Canada							91
Czech Republic	2 791	4 779	2 191	2.8	0.4	3.2	94
Denmark	8 081	8 849		4.2	0.1	4.3	87
Finland	5 581	7 441		3.9	. .	3.9	89
France	5 082	8 737	4 081	3.9	0.2	4.1	81
Germany	4 948	7 576	10 573	2.8	0.6	3.5	84
Greece	4 595	5 213	5 688	2.1	0.1	2.2	74
Hungary[2]	3 841	3 692	6 361	3.3	0.2	3.5	85
Iceland	8 434	7 721		5.2	0.2	5.4	69
Ireland	5 422	7 110	5 169	3.3	0.1	3.4	81
Italy[2]	7 390	7 843		3.3	0.1	3.4	66
Japan	6 551	7 615		2.7	0.3	2.9	94
Korea	4 490	6 761		3.5	0.9	4.4	97
Luxembourg[2]	13 458	17 876		3.8			77
Mexico	1 694	1 922		3.6	0.7	4.3	24
Netherlands	6 222	7 541	6 624	3.3	0.2	3.4	81
New Zealand	5 190	6 299	5 412	4.4	0.6	5.0	85
Norway	8 533	11 109	. .	4.2			83
Poland	3 130	2 889	3 147	3.7	0.1	3.8	62
Portugal[2]	4 681	6 168	. .	3.8		3.8	43
Slovak Republic	2 073	2 744	. .	2.6	0.5	3.0	93
Spain	4 965	6 701	. .	2.8	0.2	3.0	64
Sweden	7 469	8 039	3 437	4.5		4.5	91
Switzerland[2]	8 570	12 176	8 401	3.9	0.6	4.5	88
Turkey[2]	**1 120**	**1 808**	**. .**	**2.2**	**0.2**	**2.4**	**36**
United Kingdom	5 941	7 090	. .	3.8	0.6	4.4	73
USA	8 805	9 938	. .	3.7	0.4	4.1	87
EU19 average	5 788	7 236	4 726	3.4	0.2	3.6	79
OECD average	5 832	7 276	4 315	3.6	0.3	3.8	77

1. In equivalent USD converted using PPPs for GDP, by level of education, based on full-time equivalents.
2. Public institutions only.
3. Primary, secondary and post-Secondary non-tertiary education.

Source: OECD (2006), *Education at a Glance: OECD Indicators 2006*, OECD, Paris.

ANNEX 2.A3

Health performance – Turkey in international comparison

	Expenditure on health per capita USD, PPP 2005				Practising physicians per 1 000 population 2005 or latest year available	Practising nurses per 1 000 population 2005 or latest year available	Infant mortality rate deaths per 1 000 live births 2005 or latest year available	% occupancy rate of acute care hospital beds 2005 or latest year available
	Total	% of GDP	Public	% of GDP				
Australia	3 128	9.5	2 110	6.4	2.7	10.4	5.0	70.6
Austria	3 519	10.2	2 665	7.7	3.5	9.4	4.2	79.0
Belgium[1]	3 389	10.3	2 451	7.4	4.0	6.1	3.7	
Canada	3 326	9.8	2 337	6.9	2.2	10.0	5.3	90.0
Czech Republic	1 479	7.2	1 310	6.4	3.6	8.1	3.4	74.6
Denmark[1]	3 108	9.1	2 614	7.7	3.6	7.7	4.4	
Finland	2 331	7.5	1 813	5.9	2.4	7.6	3.0	
France	3 374	11.1	2 693	8.9	3.4	7.7	3.6	73.4
Germany	3 287	10.7	2 527	8.2	3.4	9.7	3.9	75.6
Greece	2 981	10.1	1 277	4.3	4.9	3.8	3.8	
Hungary[2]	1 337	8.1	942	5.7	3.0	8.8	6.2	75.7
Iceland	3 443	9.5	2 842	7.9	3.7	14.0	2.3	
Ireland	2 926	7.5	2 281	5.8	2.8	15.2	4.0	85.6
Italy	2 532	8.9	1 938	6.8	3.8	7.0	4.7	76.4
Japan[2]	2 358	8.0	1 927	6.6	2.0	9.0	2.8	79.2
Korea	1 318	6.0	698	3.2	1.6	1.9	5.3	71.6
Luxembourg[2]	5 352	8.3	4 851	7.5	2.5	13.9	2.6	64.7
Mexico	675	6.4	307	2.9	1.8	2.2	18.8	61.0
Netherlands[2]	3 094	9.2	1 733	5.5	3.7	14.5	4.9	63.9
New Zealand[1]	2 343	9.0	1 829	7.0	2.2	9.5	5.1	
Norway	4,364	9.1	3 647	7.6	3.7	15.4	3.1	87.6
Poland[1]	867	6.2	601	4.3	2.1	5.1	6.4	77.0
Portugal[1]	2 033	10.2	1 478	7.4	3.4	4.6	3.5	73.2
Slovak Republic	1 137	7.1	846	5.3	3.1	6.3	7.2	66.7
Spain[1]	2 255	8.2	1 609	5.9	3.8	7.4	4.1	78.8
Sweden	2 918	9.1	2 469	7.7	3.4	10.6	2.4	
Switzerland	4 177	11.6	2 493	6.9	3.8	14.1	4.2	86.1
Turkey	**586**	**5.7**	**418**	**4.1**	**1.5**	**1.8**	**23.6**	**64.5**
United Kingdom	2 724	8.3	2 371	7.2	2.4	9.1	5.1	83.9
United States	6 401	15.3	2 884	6.9	2.4	7.9	6.8	67.4
Comparator group[3]	**1 701**	**7.7**	**1 135**	**5.1**	**3.0**	**6.3**	**6.3**	**75.1**
OECD average (unweighted)	**2 759**	**8.9**	**1 999**	**6.4**	**3.0**	**8.6**	**5.4**	

1. Preliminary estimate.
2. Preliminary estimate for 2004.
3. Includes the Czech Republic, Greece, Hungary, Ireland, Korea, Mexico, Poland, Portugal, the Slovak Republic and Spain.

Source: OECD Health Data 2007.

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ANNEX 2.A4

Long-term baseline fiscal projections, 2005-35

(methodology and technical assumptions)

GDP growth. Real GDP grows by 3.7% in 2008, accelerating to 6.0% per annum over the period 2009/15 before declining steadily to 5.0% per annum by 2020 on account of demographic factors. From 2020 onwards real GDP grows by 5.0% per annum for the rest of the projection period.

Exchange rate. The real exchange rate of the Turkish lira against the US dollar, measured on purchasing power parity (PPP) basis, is held constant throughout the projection period.

Revenues. The base for the revenue projection is the 2005 general government revenue outturn of 30.2% of GDP. 2005 was a relatively "normal" year for government revenues from a structural point of view.[1] From a cyclical perspective IMF estimates indicate an output gap of around 0.5% of GDP for that year. We assume, in line with empirical evidence from other OECD countries, an output gap of 1% of GDP has a negative cyclical impact on government revenues of 0.4% of GDP, and also that, over the projection period as a whole, the economy operates with an average output gap of 1% of GDP. By contrast, given that the structure of public spending in Turkey has a relatively small cyclical component, the impact of the business cycle on general government expenditures is assumed to be negligible. An additional factor that has to be taken into account on the revenue side relates to the significant and permanent cut in the corporate income tax rate from 30% to 20% in 2006; revenue outturns for the period 2005 to 2007 suggest that this had the effect of reducing corporate tax revenues by around 0.5% of GDP. On this basis we project general government revenues at 29.5% of GDP in 2008, rising steadily to 31.5% of GDP by 2035 – the average tax revenue to GDP ratio of a group of ten emerging market comparator economies.[2]

Capital spending. For 2007 and 2008 general government capital expenditures are in line with the projections for public investment in the *Pre-Accession Economic Programme 2007* (adjusted for the revised GDP series).

For the longer-term projections, OECD staff estimates suggest that the incremental capital-output ratio (ICOR) for the whole economy has fallen from around 1.4 over the period 1960/81 to 1.2 over the period 1982-2004. In our projections the ICOR is assumed to decline steadily from 1.2 to 1.0 over the period 2009/30, and to remain at 1.0 over the rest of the projection period. On this basis we project public capital expenditures growing 1.2 times the growth rate of real GDP in 2009, with the ratio falling steadily to 1.0 times the growth rate of real GDP by 2030. Over the rest of the projection period public capital spending grows in line with GDP. To these estimates were added the projected increases in

capital expenditures arising from higher public spending on education and health over the projection period. In particular it is assumed that health care reforms start being implemented from 2009 onwards and that policy measures are taken to increase public spending on education and health in line with the objectives set out in the *Ninth Development Plan 2007-2013*, with implications for capital spending. More specifically, in line with data from the OECD's *Education at a Glance 2007* and *Health at a Glance 2007*, 6% of the projected increases in health spending and 22% of the projected increases in education spending by the public sector are taken to be capital expenditures.

Education. Our long-term projections assume that enrolment rates rise steadily to the OECD averages by 2025, with the exception of primary and lower secondary education for 5-14 year-olds, where the enrolment rate is assumed to reach 100% by 2015 and to remain there for the rest of the projection period. After 2025 enrolment rates are unchanged. Annual public spending per student is assumed to rise in real terms at a rate 1.0% higher than the growth rate of real GDP from 2009 onwards at all levels of education.

Health. The OECD has recently done some research on projecting health care expenditures in OECD member countries (OECD, 2006b). This empirical analysis suggests that, after taking into account demographic effects, expenditures on health have, on average, grown about 1% faster than incomes in the OECD over the past two decades or so. For emerging market/middle income OECD countries (including Turkey) that were not in transition from Communism, however, the average growth of spending on health was much higher, almost 2.4% faster than real incomes. Our long-term projections use the same methodology to estimate public health care spending in Turkey, assuming that its growth rate decelerates steadily from a rate that is 2.4% faster than real income growth to a rate that is in line with real income growth by 2050, after taking into account demographic factors. This would imply that public spending per capita on health will stabilise as a share of GDP by 2050.

To these figures are added estimates of the additional costs to the budget arising from the introduction of universal health care. The *Pre-Accession Economic Programme 2007* states the intention of implementing a mandatory universal health insurance that covers the entire population, increasing the quality of health services and ensuring easy access to these services. As mentioned in the text, implementation of the Social Insurance and Health Reform Law was delayed by a ruling of the Supreme Court in December 2006, and a revised draft law is currently being debated in parliament. In our projections we assume that the revised law will start coming into effect from 2009 onwards, and that the entire population will be eligible for the same coverage and quality of health care as those currently covered by the Social Security Institution. However, the costs of implementing universal health insurance is likely to substantial, at an estimated 6.3 % of GDP – compared with around 4.2% of GDP at present.[3] Such a large increase in health spending is unlikely to be feasible immediately. In our projections we assume that there will be some rationing of health care services in the beginning, that the effective implementation of universal health care will be steady and gradual given resource limitations, and that the additional budgetary costs will be spread over the period 2009/20.

Pensions. The pension projections are the latest projections by the World Bank and the Social Security Institution, and are consistent with the reforms envisaged in the revised Social Insurance and Health Reform Law that was passed by parliament in April 2008.

Other current primary spending. OECD projections show the proportion of Turkey's inactive population aged 65 and over to the total labour force rising from 14.7% in 2005 to 20.3% by 2025 and to 42.8% by 2050 (OECD, 2007a). Therefore, despite the current favourable demographic situation, Turkey may face some upward pressures on social safety net spending – additional to those on health care and pensions mentioned above – to cover the needs of ageing population (such as subsidised public transport for senior citizens). There may also be non-negligible costs associated with the EU accession process, as discussed in the text. We assume that, given the government's fiscal consolidation objectives, other current primary spending will be brought down to 10.4% of GDP in 2008 but will then rise steadily over the projection period to 11.0% of GDP by 2035.

Notes

1. In 2005, the personal income tax (PIT) system was significantly amended through a broadening of the PIT base, a reduction in the number of tax brackets, and a streamlining of the system of expenditure credits that eased the compliance burden for taxpayers and the Revenue Administration. However, revenue outturns suggest that these reforms were more-or-less revenue neutral, with personal income tax receipts rising only slightly from 4.9% of GDP in 2004 to 5.0% of GDP in both 2005 and 2006.
2. The comparator group includes the Czech Republic, Greece, Hungary, Ireland, Korea, Mexico, Poland, Portugal, the Slovak Republic and Spain.
3. Data from World Bank (2006b) indicates that, in 2002/03, just over 58% of the population was covered by the social security system (not including green card holders) at a cost of 3.6% of GDP. This implies that the cost of providing the entire population with the health care services and facilities currently enjoyed by those covered by the Social Security Institution would amount to about 6.3% of GDP. These figures are based on estimates from the 2002/03 Turkey National Household Health Expenditure Survey, which report a national health insurance coverage significantly below that reported in the national statistics published by the SPO. The national household survey indicates that 67.2% of the population was covered by health insurance, including under the green card programme, compared to almost 85% coverage reported in the national statistics.

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Chapter 3

Monetary policy: facing the challenges

Monetary policy has been one of the main pillars of the post-2001 stabilisation programme. The Central Bank was made an operationally independent institution with a legal mandate to achieve price stability. Fiscal consolidation backed monetary policy, reducing fiscal dominance and reinforcing the independence (the capacity to adjust interest rates independently in order to meet policy objectives) of the Central Bank. Improved fundamentals coupled with a benign global environment have led to a reduction in the risk premium, attracting strong capital inflows and triggering currency appreciation, which also helped with disinflation. Headline inflation fell from around 70% at the end of 2001 to 7.7% by the end of 2005.

Encouraged by this success, the Central Bank shifted from implicit to explicit inflation targeting in 2006, and set a medium-term inflation target of 4%, applicable from end-2007. However this objective faced with two important challenges: On one hand, inflation inertia settled in and non-tradable inflation stagnated at more than 10%. Moreover, persistent surge in global commodity prices and a more challenging global backdrop have hampered disinflation efforts, keeping headline inflation at significantly higher levels than the targets and required the Central Bank to respond by tightening policy in order to contain potential second round effects. On the other hand, real interest rates remained high, continuing to fuel strong capital inflows and currency appreciation, and undermining the competitiveness of labour-intensive segments of the economy. Turkey is, therefore, faced with the classic dilemma of successful catching-up economies: Inflation inertia requires a tight policy while competitiveness losses appear to go beyond the absorption and adaptation capacity of large segments of the economy. In the most recent period this challenge was amplified by exogenous increases in energy and food prices.

This chapter argues that, since monetary policy, as defined by its mandate, is focused on inflation, addressing this challenge requires that monetary policy be supported by broader policies, to give the Central Bank the necessary freedom of action. Complementary tools should be utilised to this effect, such as proactive competition policy to reduce costs and prices in services, enforcement of a credible multi-yearly spending framework to consolidate confidence in fiscal stability, and employers' and employees' commitment to anchor prices and wages more on the inflation target. Success with such policies would help shift the burden away from the Central Bank's interest rate as the only available instrument to increase the credibility of the inflation target.

This chapter reviews the recent achievements of Turkey's monetary policy and the challenges that it is now faced with. It outlines recommendations for reinforcing the response capacity of economic and monetary policy to these new challenges.

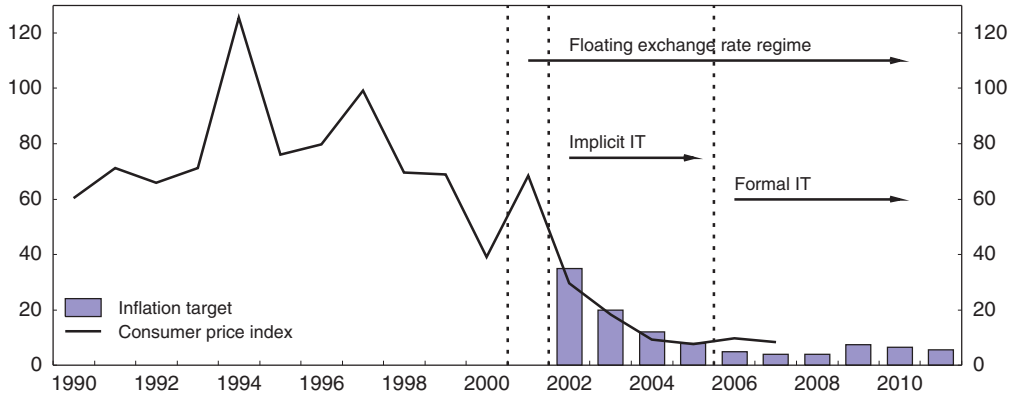
The outline of the chapter is as follows: After a background on the chronic high inflation of the past, which was a key factor in Turkey's macroeconomic instability, policies which made possible successful monetary stabilisation since 2001 are reviewed (Section 2). Then, two major challenges that monetary policy is now faced with are discussed: inflation inertia at relatively high single digit levels, and the competitiveness losses associated with strong trend real currency appreciation. The final section formulates policy recommendations.

The past history of high and chronic inflation

One of the major characteristics of the Turkish economy until the 2001 crisis was very high and persistent inflation (Figure 3.1). High inflation originated mainly from public sector imbalances. Large fiscal deficits funded from Central Bank resources, loose incomes policy raising wages and salaries above productivity levels, and the pricing policy of public utilities used as a means of raising revenues were key factors creating both demand and cost pressures. An unstable macroeconomic and political environment made it difficult to break the inflation inertia. During this period leading up to the crisis, the Central Bank of the Republic of Turkey (CBRT) implemented an accommodative monetary policy and had to sacrifice its price stability objective for the sake of financial stability.[1]

At the end of 1999, an ambitious exchange rate based stabilisation programme was put into effect. The programme was initially accompanied by a surge in capital inflows and it was successful in reducing inflation along with a considerable decline in interest rates

Figure 3.1. **Inflation rates in Turkey**
End-of-year annual percentage change



Source: Turkstat, CBRT.

StatLink http://dx.doi.org/10.1787/420132303545

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and real exchange rate appreciation. However, lower interest rates and exchange rate appreciation fuelled consumption and investment, and undermined competitiveness, resulting in a large current account deficit of up to 5% of GDP. In addition, high international oil prices and the depreciation of the euro against the US dollar also contributed to the deterioration of the trade balance.[2] Besides, foreign confidence was on a knife edge due to a fragile banking sector and failed commitments on the fiscal side. Triggered by a political dispute, the stabilisation programme ended up in one of the deepest crises in Turkey's economic history in February 2001.[3]

Post-2001 disinflation

After the 2001 crisis, a new programme named "Transition to a Stronger Turkish Economy" was put in place, with massive IMF support and tight fiscal targets, the introduction of a floating exchange rate regime, and structural reforms. The new Programme set fighting inflation as a main goal of economic policy. In line with this objective, the Central Bank was granted independence in 2001 and committed to abstain from intervening in foreign exchange markets and to focus on reducing inflation to the targeted levels. Base money growth consistent with the inflation targets and the estimated GDP growth path was to serve as a nominal anchor. This framework was formalised as *implicit inflation targeting* at the beginning of 2002, and implemented until the end of 2005.

This regime contained many of the features peculiar to full-fledged inflation targeting, such as a numerical inflation target, and the utilisation of short-term interest rates as the main policy instrument. On the other hand, it lacked published inflation forecasts, which is one of the key instruments of inflation targeting. The term "implicit" also reflected a preparation phase during which technical capability, institutional capacity and transparency of monetary policy would be enhanced. Macroeconomic preconditions such as a strong fiscal position and a stable financial environment were also to be fulfilled during this phase. In this environment and until 2005, inflation rates declined to single-digit levels, after several decades of double-digit inflation. Disinflation was also accompanied by strong growth performance. Financial sector stability was maintained, reflecting both declining risk premia and interest rates. High levels of primary fiscal surplus were also achieved and concerns over fiscal dominance faded out.[4]

Although most of the preconditions were fulfilled, the Bank did not immediately shift to explicit inflation targeting. Transition to explicit inflation targeting was announced in 2006, after putting in place a comprehensive operational framework as set out in Box 3.1.[5]

Determinants of disinflation

Both consumer and producer prices decelerated sharply after 2001. Consumer inflation declined to single digit levels for the first time in thirty years in 2004, and inflation targets were undershot until 2006 (Figure 3.1). Turkey's institutional reforms and prudent macroeconomic policies played the key role in this stabilisation, while strong world growth, liquidity abundance in international markets and high risk appetite for emerging markets also helped. Disinflation was achieved despite both strong capital inflows and consumer confidence fuelling robust domestic demand. The key factors which permitted this sharp disinflation were:

i) *Central Bank's independence and focus on price stability*: The amendment of the Central Bank Law in 2001 was a cornerstone, which defined the primary objective of monetary policy as price stability. The law bestowed the Bank with operational independence and

Box 3.1. **The operational framework of inflation targeting**

The operational framework of monetary policy developed gradually toward full-fledged inflation targeting:

2002-05: Implicit inflation targeting

Point end-year inflation targets for CPI set jointly with the government.

Base money and inflation targets were used together as anchors to affect expectations.

Monetary policy decisions were made by the Governor at monthly meetings, with a focus on current and future inflation. The Monetary Policy Committee (MPC) played an advisory role.

Short term interest rates were the main policy instrument.

2005: Transition period

The monthly meetings of the MPC became pre-scheduled.

The analyses and rationale behind monetary policy decisions were published.

2006: Full-fledged inflation targeting

Point inflation targets were announced, with a multiyear target horizon. Targets were 5% for 2006, 4% for 2007 and 2008.

MPC became the decision authority, instead of the Governor.

An uncertainty band of ±2% around the central target was to create boundaries for an accountability mechanism (open letter to be provided to the government if boundaries are breached).

A quarterly path of inflation for 2006, consistent with the end-year targets was announced.

A quarterly Inflation Report started to be issued as the main communication tool.

Inflation forecasts were published, with a 6-quarters policy horizon.

2007 to date: Innovations

Summary of the MPC minutes were to be released within 8 working days.

English translation of decisions and summary minutes started to be published on the same day as the Turkish version.

The forecast horizon was extended to 8 quarters.

The inflation target has been maintained as 4% until 2010, before a revision in June 2008 to 7½ per cent, 6½ per cent and 5½ per cent, respectively in 2009, 2010 and 2011.

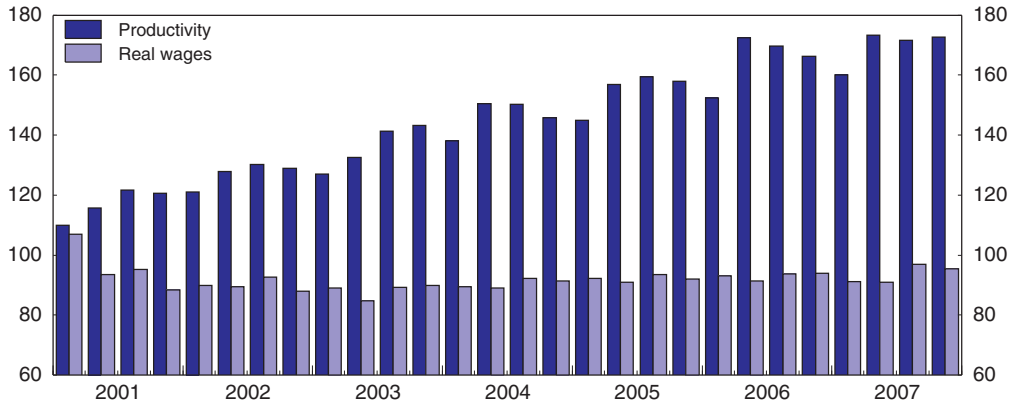
prohibited the funding of the public sector from Bank resources. Arnone *et al.* (2007) documents that Turkey made a major progress with this law in developing central bank autonomy according to international standards.[6] Effective Bank independence boosted the credibility of the new monetary regime.[7]

As in other emerging countries with an inflation target, economic agents in Turkey remain sensitive to any developments which might overshadow Central Bank independence. In fact, one of the factors which caused Turkey to be affected by the international turmoil of May-June 2006 more than other emerging market countries was market concerns over the excessively long process of appointment of the new Bank Governor.These concerns were however subsequently defused, with no-surprise appointments which were endorsed by the market.

ii) *Productivity gains and wage moderation*: An ambitious structural reform programme was introduced after the 2001 crisis. Although this process is not yet fully completed, these reforms, and the additional growth that they stimulated, fostered important productivity increases. The production process became more technology intensive and more competitive (see Chapter 4 below) while, amid strong labour force growth and the resulting labour market slack, wage growth remained moderate. The combination of strong productivity gains and wage moderation made a considerable contribution to the success of disinflation (Figure 3.2).[8]

Figure 3.2. **Productivity and real wage developments**

Index 1997 = 100



Source: Turkstat.

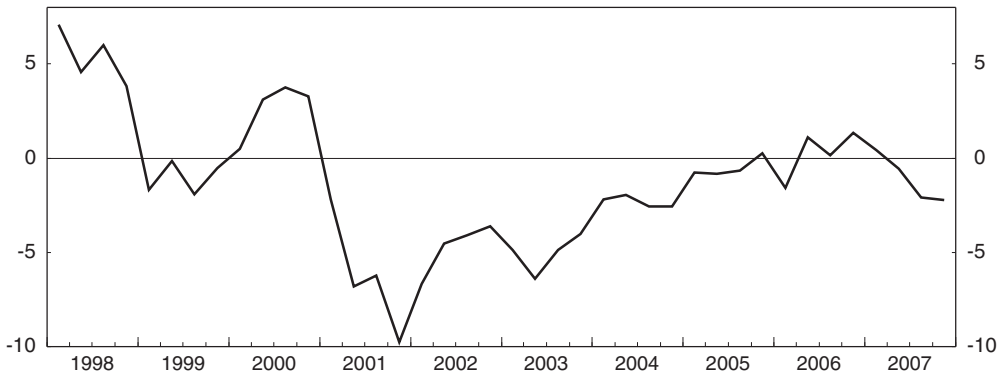
StatLink http://dx.doi.org/10.1787/420143763822

iii) *Fiscal consolidation and financial sector rehabilitation:* A tight and credible fiscal policy and a robust financial system are essential for successful inflation targeting. Loose fiscal policy and a fragile banking system constrain and limit the room available to the Central Bank in tightening monetary conditions, because this would create excessive risks of fiscal and financial strain in the economic system.[9] This *fiscal and financial prevalence* over monetary policy characterised the economic policy environment in Turkey before 2001.

Fiscal consolidation in the post-2001 period acted as an important anchor for the credibility of monetary policy. In this period debt sustainability concerns gradually declined, the net government debt/GDP ratio falling from 90% in 2001 to 45% in 2006.[10] In addition, structural reforms in banking strengthened banks' capital adequacy, and helped minimise their interest rate risk exposure, therefore making them much less vulnerable to Central Bank's tightening decisions.[11]

iv) *Output gap:* Another important factor which contributed to disinflation was the rise in the economy's productive capacity. This resulted from additional capital formation and strong employment growth in industry and services. At the same time, massive entries of new working age cohorts, and exits from agriculture kept labour force reserves very high. Although GDP growth has been very strong, averaging 7.2% between 2002 and 2006, the output gap remained in negative territory during most of the period and helped contain inflationary pressures (Figure 3.3).

Figure 3.3. **An estimation of the output gap**[1]



1. The OECD measure of potential output, on which the gap is based, is calculated using an Hodrick-Prescott filter with constraints. For other countries, calculations are based on a production function with smoothed capital services.

Source: OECD (2008), *OECD Economic Outlook No. 83 database*.

StatLink http://dx.doi.org/10.1787/420160002418

Recent inflation inertia

Transition to full-fledged inflation targeting started under single digit inflation in 2006. Annual consumer price inflation had declined from 9.3% at the end of 2004 to 7.7% at the end of the 2005, undershooting the end year target of 8%. However, after transition to explicit inflation targeting, inflation targets which were set respectively at 5% and 4% for 2006 and 2007, were severely breached. Inflation reached respectively 9.7% and 8.4% in 2006 and 2007, and expectations remain above 9% for the end of 2008 (Table 3.1).

Table 3.1. **Inflation targets and outcomes**

End-year – per cent

	Target	Actual	Deviation from target (percentage points)
2002	35	29.7	–5.3
2003	20	18.4	–1.6
2004	12	9.4	–2.7
2005	8	7.7	–0.3
2006	5	9.7	4.7
2007	4	8.4	4.4

Missing the target in the first two years of the new regime raised the question of whether preconditions for inflation targeting were actually met; that is, whether it had been premature to shift to formal inflation targeting.[12] Another issue was whether the selected inflation targets were set at too low levels with respect to the fundamentals of the Turkish economy.

On the first question, international experience shows that not meeting the *full* set of preconditions does not hinder the success of inflation targeting. No inflation targeters had fully met *all* preconditions before shifting to the new regime.[13] In fact, as described above, Turkey adopted a step-by-step strategy to meet preconditions.[14] Yet, the timing of transition to explicit inflation targeting was somewhat controversial, given uncertainties on the degree to which the Central Bank could actually influence inflation expectations. In explicit inflation targeting the Central Bank is in principle supposed to influence inflation

expectations through its control of demand conditions. In the case of Turkey however, as expectations are only slightly affected by cyclical factors, the adoption of explicit inflation targeting might be seen as a too ambitious step with respect to the actual leverage of the Central Bank on inflation expectations (see Box 3.3 below).

The second question is whether the level of the inflation target was optimal. In OECD countries there is a general consensus that the adequate level of inflation ("price stability") is around 2%. In emerging economies with high growth rates and productivity gains, price stability could be defined at higher levels due to various catching-up effects.[15] However, a counterargument is that productivity growth triggered by economic reforms should produce lower inflation.[16] All in all, the adoption of a flat medium-term inflation target of 4%[17] as the Central Bank did appears adequate in Turkey's circumstances.

The targeted *pace* of disinflation is also relevant. Setting too steep a disinflation path could result in large output loss and erosion of Central Bank credibility if the target is missed. On the other hand, a too flat disinflation path would also be perceived as a sign of lack of commitment and undermine credibility.[18] The critical factors in determining the desirable disinflation path are therefore the *sacrifice ratio*[19] and the *credibility risk*. As inflation was at 7.7% in Turkey at the end of 2005 the year-end inflation target of 5% for 2006 meant a commitment to reduce inflation by 2.7 percentage points in one year. Subsequently, the announcement of inflation targets of 4%[20] for 2007 and 2008 implied commitments to reduce the 2006 year-end inflation by 3.7 percentage points. These are sharp paces of disinflation, but remain below the pace of disinflation achieved between 2001-04, even if reducing inflation from a 70% level was a different challenge. The Bank adopted such a strategy to avoid another deterioration of inflation expectations.[21] As the sacrifice ratio was low in Turkey during that period,[22] the envisaged disinflation path did not look unreasonably ambitious.

However, the outcomes did not meet the targets in 2006 and 2007, and the same is expected to happen in 2008. Inflation overshot objectives by about 4½ percentage points in 2006 and 2007, and a drift of a similar magnitude is expected in 2008. Missing the targets in three consecutive years has inevitably weakened the nominal anchor role of the medium-term inflation target. Considering the persistence of supply side price pressures and the prolonged gap between inflation and the medium-term target, the Central Bank and the government mutually agreed to revise the inflation targets. The new targets envisage a more gradual reduction in inflation through 2009-11 (Box 3.2).

Despite this revision of inflation targets, it cannot be concluded that the adoption of explicit inflation targeting was a failure.[23] The close examination of the three key factors which underpinned inflation inertia after the adoption of explicit inflation targeting shows that all three of them have been largely outside the realm of monetary policy:

i) *Supply shocks:* Turkey was subject to important supply shocks, including strong increases in international oil and food prices and in domestic administered prices between 2006 and 2008. If the behaviour of *core inflation* excluding these items is considered, outcomes were closer to targets until early 2008. Core inflation excluding energy and unprocessed food but including processed food declined to and stayed at around 7% since mid-2007. An arguably more accurate measurement of core inflation, excluding also processed food, was not systematically published until May 2008 but gravitated between 4-5% between September 2007 and the end of the first quarter of 2008. However, both core inflation measures showed an upturn toward headline inflation from March-April 2008 (Figure 3.4).

Box 3.2. **Revision of inflation targets**

Above target inflation outcomes and persistingly high inflation expectations undermined the anchoring role of the official inflation target. The most recent research by the Central Bank on the formation of inflation expectations* confirms that the weight attached by economic agents to inflation targets has been declining in the recent period. Agents have been attaching more weight to recent inflation while forming their expectations.

The Central Bank and the government assessed that these developments potentially increase the cost of disinflation, by increasing the sacrifice ratio associated with further disinflation. As a response they mutually agreed on 3 June 2008 to change the inflation target, in order to rebuild the credibility of the inflation targeting regime. The new target path envisages a more gradual convergence to the 4% medium-term inflation target.

Table 3.2. **Revised inflation targets**

	Before revision	After revision
2009	4	7.5
2010	4	6.5
2011	–	5.5

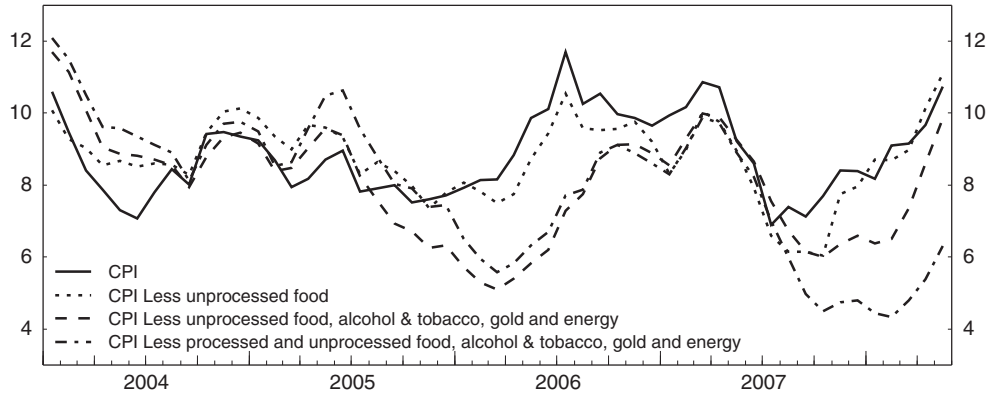
The authorities acknowledge that this revision carries potential risks such as leading to further deterioration of inflation expectations, undermining the credibility of the Central Bank, and increasing the inflation risk premia. The credibility risk may become greater if the revision of the inflation target is perceived as the monetary authority shying away from responding to inflationary pressures. With this in mind the Central Bank started to tighten monetary policy, despite the cyclical weakness of the economy. The policy rate was increased again on 16 June 2008 by 50 basis points, reaching 16.25%.

The Turkish experience can be seen as an exceptional case, in which the revision of the inflation target may have been appropriate. Although the revision entails short-term costs, it may contribute to restore the credibility of the inflation targeting regime in the medium-term, and to reduce the costs of future disinflation. This calls for the move to be backed by supportive economic policies, such as a credible medium-term fiscal framework, pro-competition reforms to contain service price growth and productivity enhancing reforms.

* See Başkaya, Kara and Mutluer (2008).

The contribution of food prices to inflation was 3.1 and 3.4 points in 2006 and 2007 respectively, and is expected to reach 3.7 points in 2008, amounting to as much as 32%, 41% and 40% of headline inflation[24] (Figure 3.5). Food prices constitute almost one third of the CPI basket and were affected by adverse weather conditions and strong price hikes in world markets. Energy and administered price increases were also important factors. Inflation is particularly sensitive to changes in international oil prices because imported crude oil is the primary source of energy in Turkey. The increase of administered electricity prices and of special consumption taxes on oil, natural gas and electricity also markedly lifted energy prices, and this contributed 1.6 points to inflation in 2007. Food and energy prices continue to be important drivers for inflation in 2008.

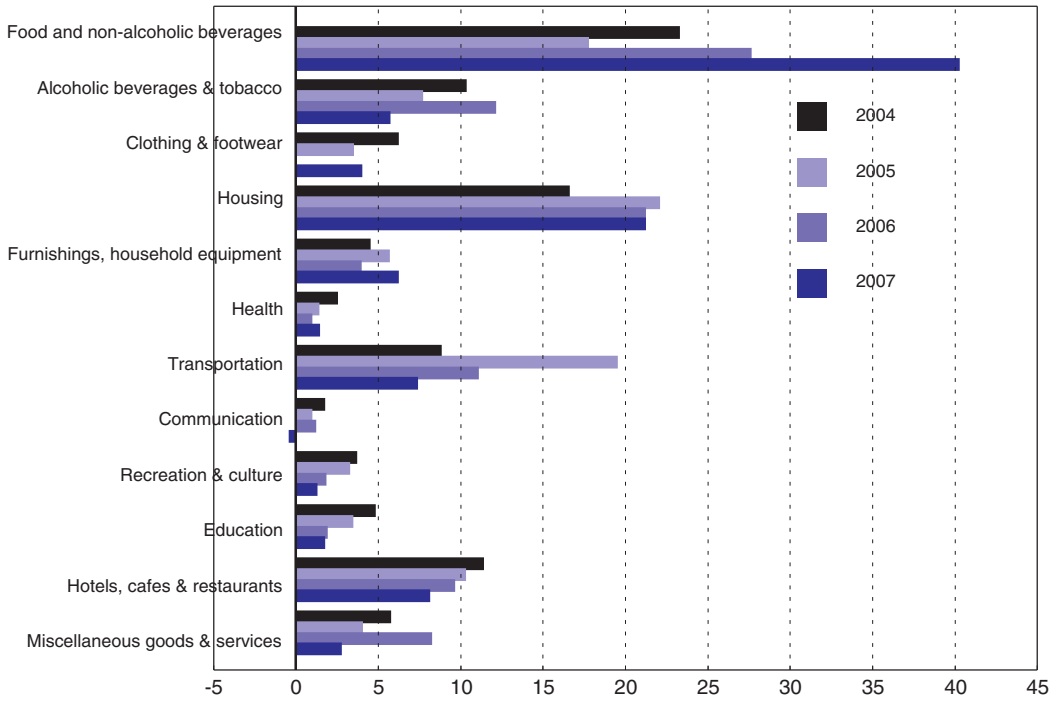
Figure 3.4. **Core inflation**
Year-on-year percentage change



Source: Turkstat, CBRT.

StatLink http://dx.doi.org/10.1787/420225545815

Figure 3.5. **Components of inflation**
Percentage

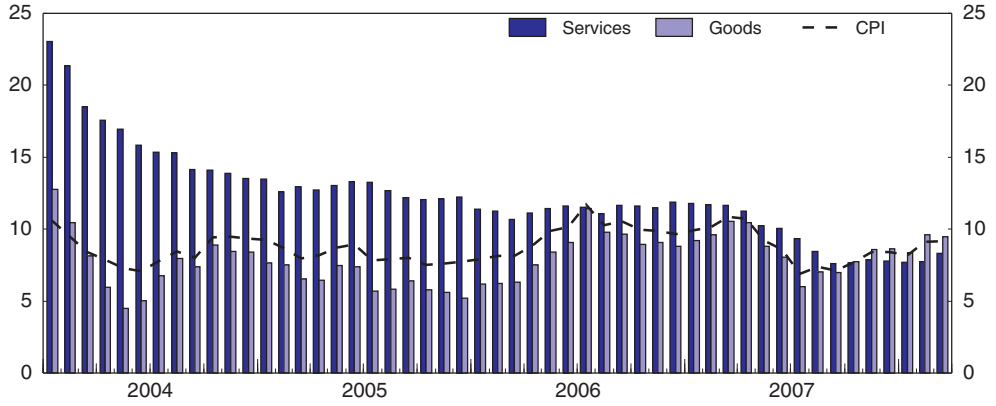


Source: Turkstat, CBRT.

StatLink http://dx.doi.org/10.1787/420241262773

ii) *Inertia in service sector prices*: Although the deceleration of service price inflation backed disinflation between 2001 and 2003, they have stayed clearly above headline inflation since 2003. This has become one of the main sources of inflation inertia in Turkey, especially after 2005. Although service inflation started to decline from early 2007, it remains still high compared to inflation in manufactured goods. The gap between

Figure 3.6. **Goods and service prices**
Year-on-year percentage change



Source: Eurostat.

StatLink http://dx.doi.org/10.1787/420273017653

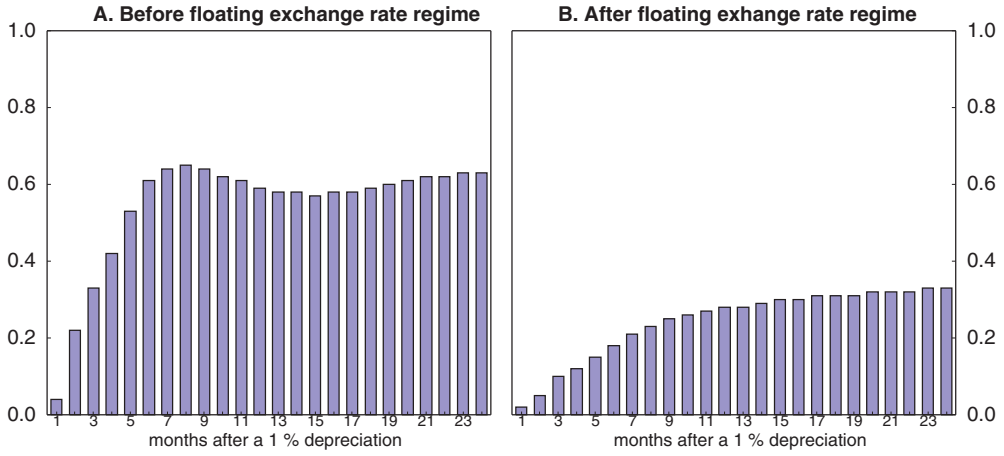
goods and service prices reversed after the strong pick-up of energy and food prices since the last quarter of 2007 but it remains positive and important once this effect is taken into account (Figure 3.6).

High service prices mainly result from imperfect competition, as observed in the areas of education, health, housing, transport and communication in Turkey. There is strong potential for productivity growth in these services, and for this reason assumptions of genuinely slower productivity growth in service sectors do not necessarily hold in Turkey's circumstances (so that the main factor behind the Balassa-Samuelson effect is likely to be weaker than in other catching-up economies). Stronger productivity growth and price rivalry in services can be stimulated with more pro-competitive regulatory frameworks and competition policies.

iii) *Exchange rate pass-through:* The pass-through from exchange rates to prices has traditionally been high in Turkey (Figure 3.7). Exchange rates affect inflation not only through imported goods' prices, but also by spilling-over to the prices of all tradable goods. In the recent period, the depreciation of the Turkish lira by nearly 30% during the international turmoil of May-June 2006 had an important impact on inflation. Currency appreciation through 2007 had apparently a limited effect, while a negative impact is expected from the nearly 20% depreciation in the early months of 2008. At the same time, the floating exchange rate regime appears to have moderated the pass-through effect somewhat, as market agents – notably importers and their domestic competitors – anticipate reversals in any sharp changes in exchange rates and await gradual convergence toward long-term trends, and may thus refrain from immediately and fully adjusting their prices.[25]

Trendwise, the strong real appreciation trend of the currency after 2002 made a considerable contribution to disinflation. An asymmetry in the pass-through should however be noticed, depreciation appearing to reflect more on prices in the long-term than appreciation, which may be indicating imperfect competition and opportunities for implicit collusion not to cut prices.

Figure 3.7. **Cumulative exchange rate pass-through to headline inflation**



Source: Kara and Ogunç (2005).

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In the presence of these major exogenous factors bearing on inflation outcomes, monetary authorities may continue to use core inflation measures to strengthen their communication on *core inflation*.[26] Core inflation more directly reflects domestic inflationary pressures and can be expected to be more responsive to monetary policy, as observed with its having come closer to the target bracket in the first two years of explicit inflation targeting. To the extent that the authorities can minimise feed-back pressures from headline to core inflation, headline inflation should be expected to converge toward core after exogenous shocks and their base-period effects fade out. However, minimising this feedback may be very challenging when headline inflation persists, as currently experienced in Turkey.

The social partners, including the main representative organisations of employers and employees, should be invited to recognise that the gap between headline and core inflation reflects an almost certainly durable change in Turkey's terms of trade, and in the structure of relative prices. The resulting losses of purchasing power need to be absorbed by domestic agents, and cannot be off-set by the adjustment of domestic prices and wages. Such a recognition would help contain feedback pressures from headline to core inflation, and help defuse price and wage spirals.

The structural dilemma of economic policy

The short term interest rate as the main monetary policy instrument

Short term interest rates have been used as the Central Bank's main policy instrument to affect demand conditions and price expectations since 2002.[27] The Bank started to set its policy rates in pre-scheduled Monetary Policy Committee meetings from 2005. The rationale of interest-rate decisions is published shortly after each meeting.

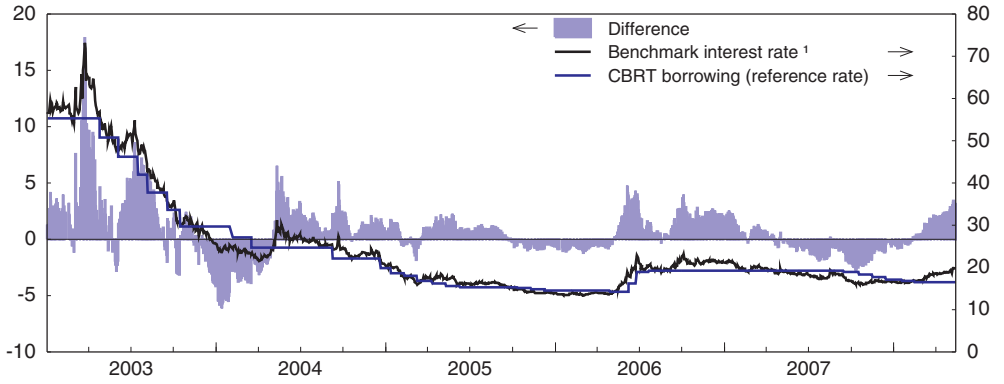
The Bank reduced its borrowing rate (the reference rate for the market) from 18% at the end of 2004 to 13.25% in April 2006, before increasing it by 425 basis points during the financial turmoil in May-June 2006. It then kept the interest rates at 17.50% until September 2007, before starting an easing stance that it discontinued in early 2008, and slightly reversed in May. Following a 50 basis points tightening the borrowing rate stood

at 15.75% (and the lending rate at 19.75%) at the end of May 2008. Given the persistence of high inflation and unfavourable expectations, the Monetary Policy Committee made it clear in May that additional tightening decisions could be made in the rest of the year.

The influence of interest rate decisions can be gauged by their impact on short and long term market interest rates. The relationship between policy and market rates is affected by both the transmission mechanism and central bank credibility. A visual inspection of the relationship between the Central Bank's overnight borrowing rate (policy rate) and the benchmark interest rate in Istanbul Stock Exchange's Bonds and Bills Market (the market rate) shows that both rates evolved generally in parallel, but they diverged in certain periods depending on the market's risk perceptions (Figure 3.8). Market's risk perceptions were high during the Iraq war in early 2003, at the time of the Federal Reserve's decision to raise interest rates in early 2004, during the international turmoil in May-June 2006, and as a result of deteriorating international financial conditions and domestic political tensions in early 2008. In contrast, markets' risk perceptions seemed surprisingly low through 2007, despite uncertainties due to dual elections and international financial fluctuations. This may have reflected markets' improved confidence in Turkey's macroeconomic fundamentals and in the stability of its basic governance framework in 2007 during that period.

Figure 3.8. **The policy rate of the Central Bank and the market interest rate**

Compound-per cent



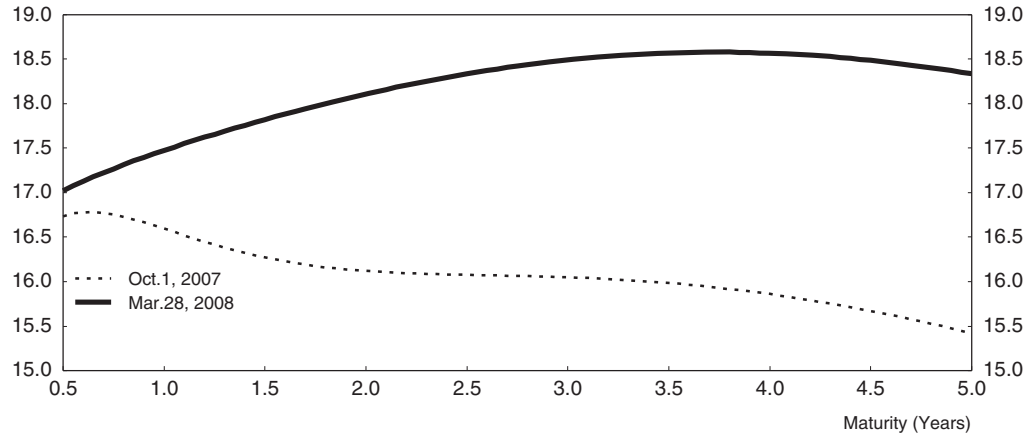
1. Benchmark interest rate is the return of the most traded securities in ISE Bond and Bills Market.

Source: CBRT, ISE.

StatLink http://dx.doi.org/10.1787/420282125034

Towards the end of 2007 however, the long end of the yield curve moved upwards and the yield curve inverted. The long end of the yield curve is driven by markets' inflation and growth expectations, whereas the short end is more directly dominated by monetary policy. This recent inversion could therefore be interpreted as a deterioration of medium and long term inflation expectations and risk perceptions by the markets. Turkey's being more clearly in the trough phase of a business cycle in 2008 than in 2007 could also have contributed to the expectation of higher future rates (Figure 3.9).[28]

Figure 3.9. **Yield curves**



Source: CBRT.

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The policy dilemma

The common *dilemma* of catching-up economies has also emerged in Turkey. The dilemma arises from the normalisation and improved credibility of the macroeconomic framework, whilst policy and market interest rates remain still high in international standards. This situation attracts strong capital inflows which cause real exchange rate appreciation and resulting competitiveness losses, thereby undermining growth and employment despite strong domestic demand. This dilemma has increasingly characterised the Turkish economy in recent years and, assuming that confidence-weakening events remain temporary, it will persist as a structural challenge.

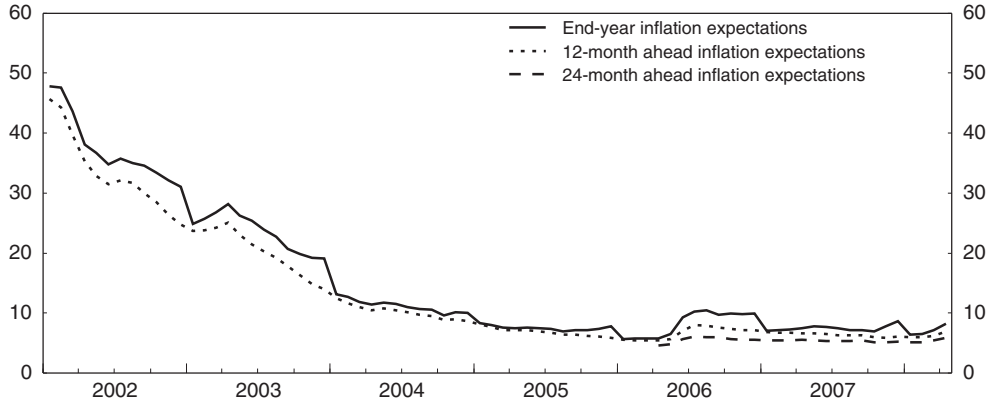
The Central Bank has been widely criticised for implementing excessively tight monetary policy and undermining the competitiveness of the Turkish economy. How should the Bank respond to such social pressures, which are at times also echoed by other policymakers?

Managing inflation expectations

Inflation expectations, after improving regularly between 2002-06, started to deteriorate due to supply shocks and unfavourable international and domestic conditions. Episodic downturns in expectations occurred also at the end of 2001 in relation with domestic political uncertainties, in the summer of 2002 due to the early election decision taken by the Parliament, and in March 2003 when the Iraq war broke out. The May-June 2006 international financial turmoil had however the most salient impact, suggesting a possible structural break in the trend improvement in inflation expectations[29] (Figure 3.10).

None of these downturns in expectations were due to cyclical tensions in the economy. In fact, inflation expectations in Turkey are chiefly determined by: *i)* past and current inflation; *ii)* the fiscal stance; *iii)* the exchange rate; and *iv)* the credibility of the inflation target (see Box 3.3 below). Demand conditions have had a relatively limited effect on expectations in the recent period. The downward slope in inflation expectations which prevailed until June 2006 should be attributed to a large extent to a steady build up of confidence in monetary and fiscal discipline.

Figure 3.10. **Inflation expectations**
Year-on-year percentage change

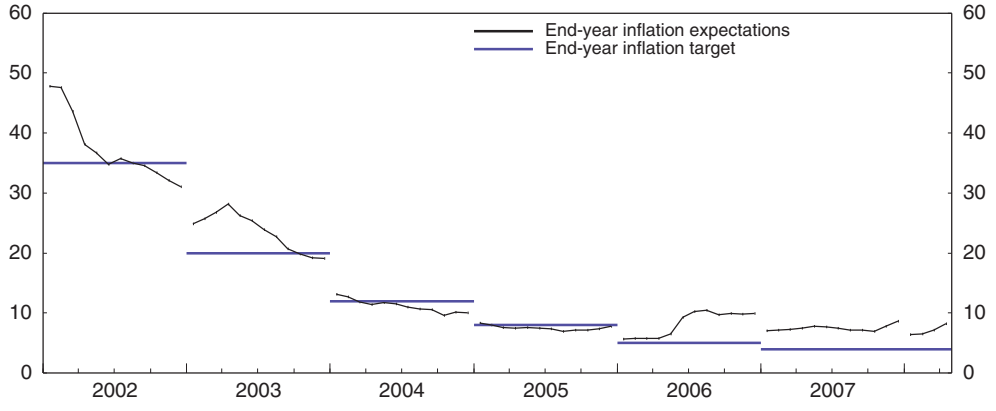


Source: CBRT.

StatLink http://dx.doi.org/10.1787/420312340212

The credibility of the Central Bank is determined by the confidence of the public in its ability to reach its objectives. A widely used measure of credibility is the gap between the official inflation target and the inflation expectations of the market. In terms of this measure, the credibility of the Central Bank appears to have improved between 2002 and mid-2006, before declining through 2007 and early 2008, together with the decision to lower the inflation target (Figure 3.11).

Figure 3.11. **Credibility gap**
Year-on-year percentage change



Source: CBRT.

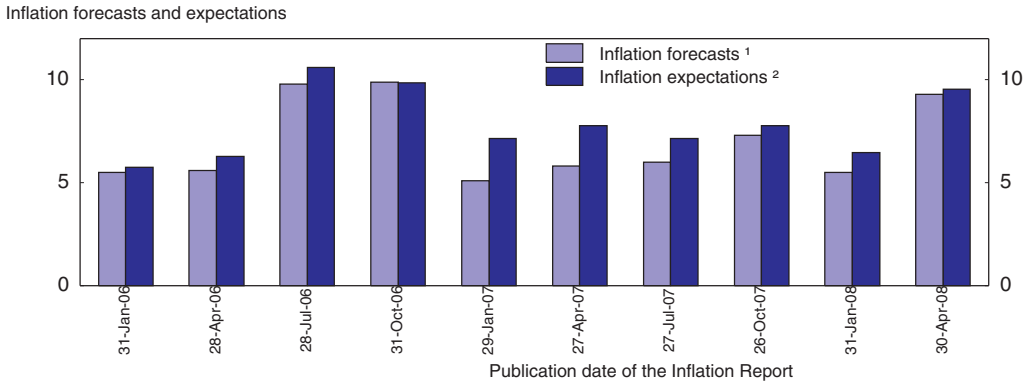
StatLink http://dx.doi.org/10.1787/420328070861

The difference between the inflation forecast – not the target but the regularly revised forecast[30] – of the Central Bank and market's inflation expectations is another measure of credibility. This is consistent with the Bank's goal that economic agents should rely on its short term forecast in forming their expectations. However, this measure also confirms an upward credibility gap since mid-2006: the Central Bank and market forecasts for end-year

inflation remained more apart in 2007 than in 2006, and converged more slowly through 2007 than through 2006. Diverging expectations concerning energy and food prices may have contributed to slower convergence in 2007 (Figure 3.12). It is true also that other inflation targeting countries suffered similar inflationary pressures in 2007 and the gap between inflation in Turkey and these other countries declined from 6 percentage points in 2006 to 3 percentage points in 2007.[31]

Figure 3.12. **Inflation forecasts and expectations**

Year-on-year percentage change



1. End-year inflation forecast.
2. The first end-year inflation expectation following the publication of the *Inflation Report*.

Source: CBRT.

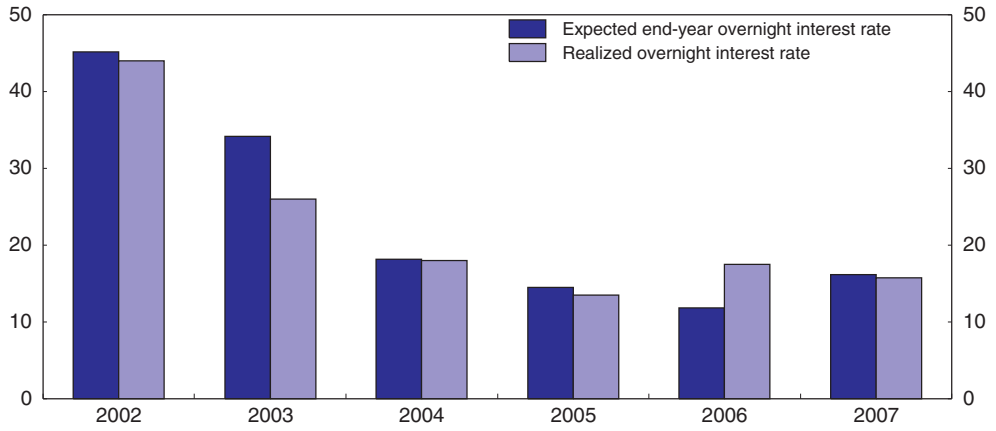
StatLink http://dx.doi.org/10.1787/420337386686

Transparency is also essential for Central Bank credibility. First the *implicit* and then the *explicit* inflation targeting regimes represented considerable progress in monetary policy transparency in Turkey. The Central Bank has gradually developed its communication by publishing regular reports and press releases, which provided a better exposition of the Bank's monetary policy objectives, strategy and decision making process. This in turn increased the predictability of monetary policy actions (Figure 3.13). Greater transparency has been one of the main factors making inflation expectations less sensitive to past inflation (Box 3.3).

Fiscal discipline is also a key factor in managing inflation expectations. Indeed, fiscal policy has long been a central element shaping inflation expectations in Turkey and the recent widening of monetary policy's credibility gap might partly be related to fiscal policy drifts through 2007 (see Chapter 3.2). On the other hand, there are signs that domestic and international markets have somewhat tolerated this drift on the grounds that Turkey cannot be expected to entirely escape electoral cycles in fiscal policy. Still, a firmer and more predictable fiscal framework would contribute to the improvement of inflation expectations.

Since expectations are a main driver of inflation outcomes in Turkey, as analysed in Box 3.3, it is of considerable importance to the Central Bank to steer expectations in order to reach its inflation targets.[32] However, the Bank is faced with two difficulties in this task: First, inflation expectations are still largely based on past inflation outcomes, notably in the non-financial sector, and to a lesser extent in the financial sector. This implies that the Bank needs to reinforce its communication policy, in particular with the non-financial sector.[33] Secondly, the fact that inflation expectations are weakly associated with the

Figure 3.13. **Predictability of Central Bank's policy decisions**



Source: CBRT.

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Box 3.3. **An empirical assessment of the dynamics of inflation expectations in Turkey**

To analyse the key determinants of inflation expectations a reduced form inflation expectations equation was estimated, covering the period 2002-07. The equation builds on Cerisola and Gelos (2005), Celasun *et al.* (2004) and Minella *et al.* (2003), focusing on the relative roles of past inflation (backward-looking behaviour), the credibility of inflation targets, the real interest rate, the exchange rate, demand pressures, and the stance of fiscal policy. The model was estimated by using ordinary least squares and results are summarised below (with *t* statistics in parenthesis[1]):

$$\pi^{e}_{t} = -6.62 + 0.46^{*}\pi_{t-1} + 0.16^{*}\pi^{T}_{t} + 0.61^{*}r_{t-1} + 0.14^{*}er_{t-1} + 0.06^{*}ip_{t-2} + 0.41^{*}bb_{t-6} + u_{t}$$
$$(-6.27)(13.18) \quad (3.64) \quad (8.58) \quad (4.50) \quad (2.22) \quad (2.99)$$

π^{e} is the 12-month ahead CPI inflation expectation (from the CBT Expectations Survey), π_t is the annual CPI inflation rate, π^{T} is the end-year inflation target, *r* is the real short-term interest rate (policy rate), *er* stands for monthly percentage change in the nominal exchange rate,[2] *ip* stands for the annual percentage change in the industrial production index (as a proxy for cyclical tensions)[3] and *bb* is the government's budget deficit. All coefficients except the industrial production index are statistically significant at 1% level of (statistical) significance, and they all have the expected signs except for the real interest rate.

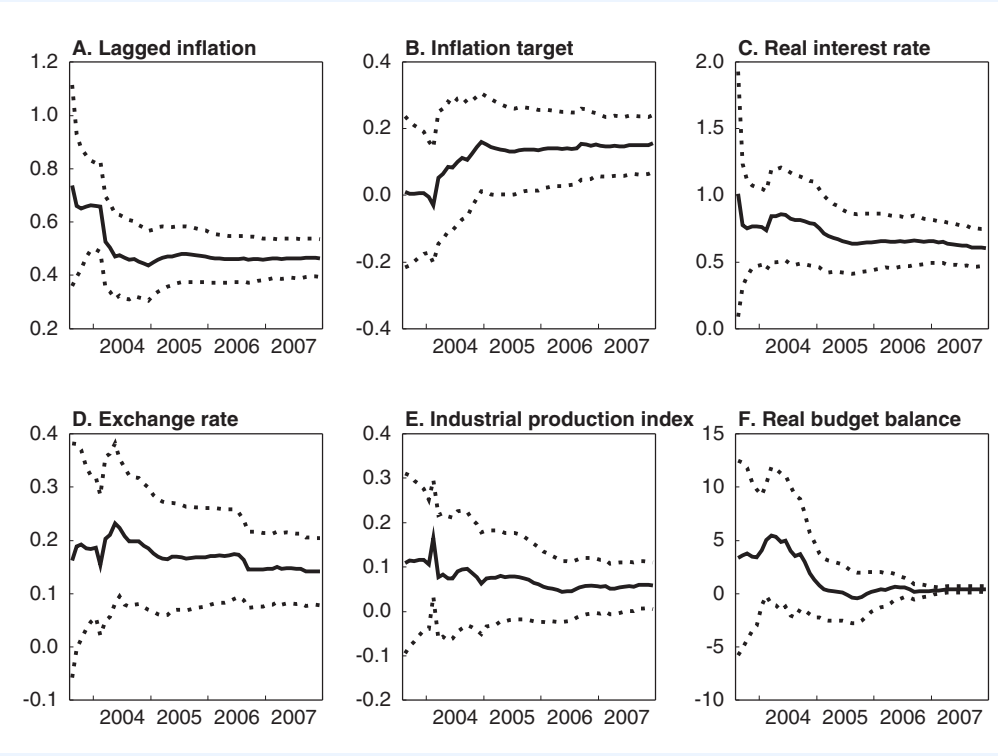
- The relative importance of *past inflation* in determining expectations is high, indicating the persistence of backward-looking perceptions.
- The coefficient of the *inflation target* is positive, with an estimated value of 0.16. In a fully credible inflation targeting regime the value of this coefficient would have been expected to be equal to 1.
- There seems to be a positive correlation between the real interest rates and inflation expectations. However, this seemingly positive correlation should be attributed to the synchronized co-movements of the two variables, especially during the 2002-05 period that appears to dominate the full sample period, rather than a causal relationship.
- The coefficient of the *nominal exchange rate* confirms the presence of pass-through effects.
- *Cyclical tensions* (the demand factor) has a restricted influence on inflation expectations.
- The *fiscal policy stance* is an important factor shaping expectations, even if the indicator available is imperfect in fully gauging it.

Box 3.3. **An empirical assessment of the dynamics of inflation expectations in Turkey** *(cont.)*

A *recursive coefficients estimation* of the model[4] helped asses the *shifts* in the respective weights of key variables, bringing interesting additional insights (Figure 3.14):

- There has been a decline in the influence of the backward-looking component of expectations during 2004, while, by contrast, the influence of the official inflation target has improved.
- Between 2005 and 2007 the credibility of the inflation target has not weakened but has not improved either.
- The impact of the nominal exchange rate on inflation expectations tended to diminish, confirming the general reading that the rate of pass-through declined in the post-2001 period.
- The impact of the business cycle seems to have remained weak.
- The influence of the fiscal stance lessened somewhat between 2004 and 2006 and remained stable in the more recent period.
- The relevance of the real interest rate slightly diminished.

Figure 3.14. **Changing influences on expectations – recursive coefficient estimates**



Source: Çulha *et al.* (2008), forthcoming.

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1. The variables do not seem to have unit roots except for the real interest rate and real budget balance (results are not reported). Hence, it was preferred to use the variables in levels rather than first differences. Only the real budget balance variable is in the logarithmic form.
2. A real exchange rate gap measure, which is calculated as the deviations of the real effective exchange rate from its trend (calculated by HP filter), was also employed in the equation as an explanatory variable. However, monthly changes in the nominal exchange rate appeared to perform better in the regression.
3. Some other demand gap measures, proxied by the industrial production index, private consumption expenditures and real GDP, which were calculated as deviations from their trends, were also tested in the equation, but appeared to be statistically insignificant and generally with unexpected signs. Annual changes in the industrial production index were selected as the best proxy for demand pressure.
4. Recursive coefficient estimates help assess the evolution of the impact of an explanatory variable on the dependent variable over the sample period as more sample data are added for the estimation.

business cycle lowers the efficacy of interest rates in shaping expectations via their influence on domestic demand, even if inflation targeting requires that the business cycle is smoothed. These factors shift part of the burden of credibility building onto instruments other than the policy interest rate (Box 3.3).

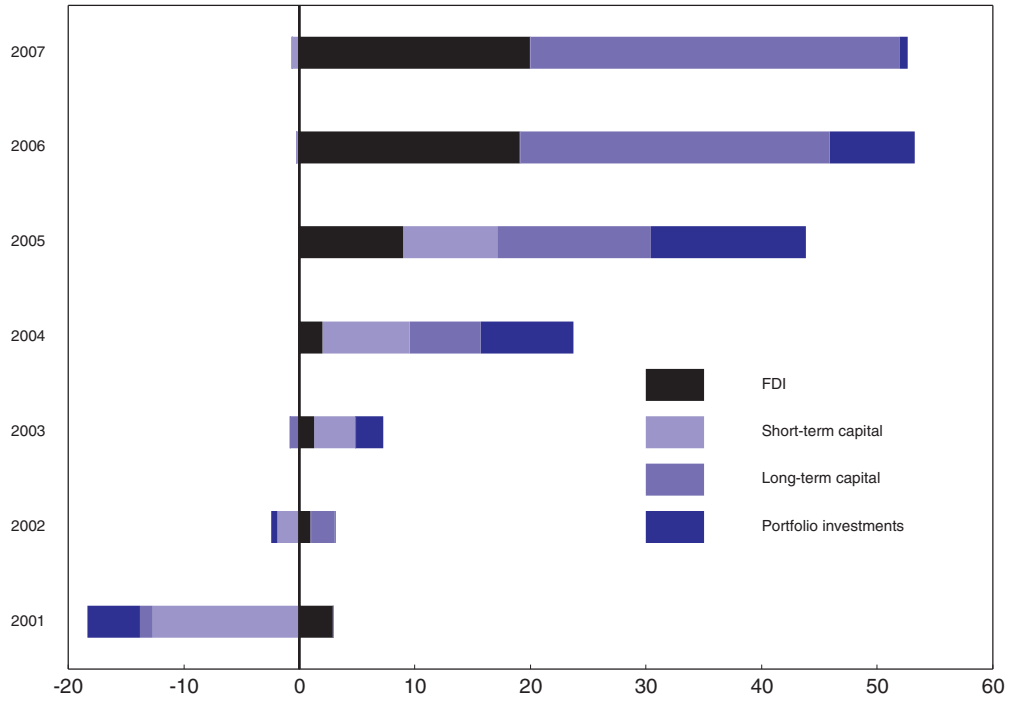
Responding to trend exchange rate appreciation

In the post-2001 reform period Turkey has combined macroeconomic stability, strong growth and sharp disinflation. The Central Bank maintained a tight policy stance with a high real interest rate. In this attractive environment for capital inflows, which were also furthered by high international appetite for emerging market assets, international funds poured in Turkey.

Net capital inflows soared especially after 2004 and reached 10% of GDP in the first half of 2007 before setting at 8% at the end of the year. Their composition has also changed (Figure 3.15). The share of FDI and long term capital reached more than 80% of the total in the first half of 2007, more than offsetting the outflows observed in 2006 because of international turbulence. Foreign direct investments (FDI) reached USD 20 billion in 2007, up from UUSD 9 billion for the whole year of 2005. As a result, the foreign reserves held at the Central Bank rose to UUSD 73.3 billion in 2007 (11% of GDP).[34]

One effect of this capital surge has been strong real exchange rate appreciation (Figures 3.16 and 3.17). The real exchange rate has appreciated trendwise since mid 2002, despite sporadic, short lived reversals related to international developments at the end of 2003, in early 2004, and in May-June 2006. The duration of the early 2008 depreciation is

Figure 3.15. **Capital inflows**
Billion USD



Source: CBRT.

StatLink http://dx.doi.org/10.1787/420354440050

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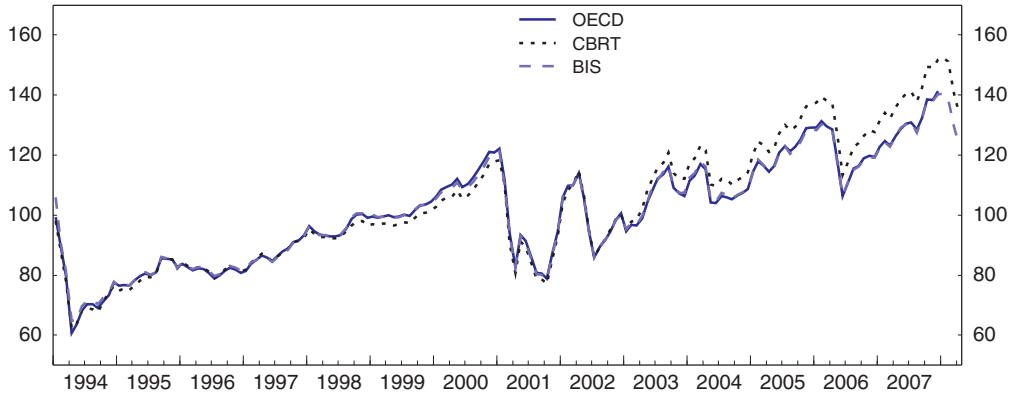
Figure 3.16. **Different measurements of real exchange rates**
Index, 2002 = 100



Source: OECD, CBRT and BIS.

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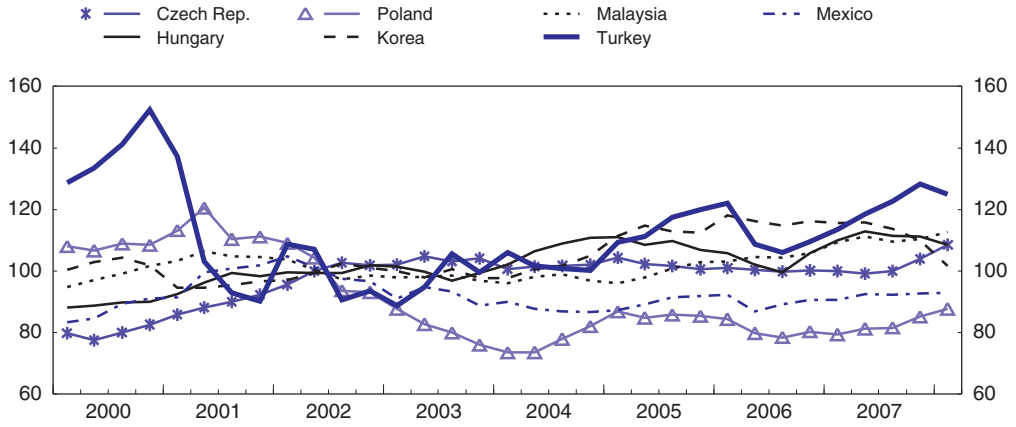
Figure 3.17. **Real exchange rates in selected countries**
ULC based, 2002 = 100



Source: OECD (2008), *OECD Economic Outlook No. 83 database*.

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still unknown. The real exchange rate reached its highest level at the end of 2007, when it was shaped by the *addition* of a large inflation differential with trade partners and straight nominal appreciation. The nominal appreciation channel increased competitiveness challenges for the economy because all enterprises faced the same price pressures, while the effects on the real appreciation from the inflation differential side permit a larger variety of relative price adjustments. International comparisons confirm the culmination of these real exchange rate pressures in Turkey through 2007 (Figure 3.16).

While the exceptional pace of real appreciation was obvious, determining whether the lira was truly overvalued in 2007 and, if so, to what extent is not easy. *A priori*, the lira's value appears to have been above its equilibrium level on that year given the rapid increase in the trade deficit. The analysis in Box 3.3 seems to confirm that the real effective exchange rate has remained generally overvalued since mid-2003 (Box 3.4).

Box 3.4. **How overvalued was the Turkish lira in the period up to 2007?**

For a tentative estimation of real exchange rate misalignment, a behavioural equilibrium exchange rate (BEER) model was estimated for the period 1995-2007. Following Clark and MacDonald (1998), the real exchange rate was expressed as an outcome of five fundamental variables:

RER = f (RIR, TOT, TNT, NFA, DEBT)

RER = the *real effective exchange rate*;[1] RIR= the *real interest rate differential*;[2] TOT = the *terms of trade*;[3] TNT = the *relative price of non-traded to traded goods*;[4] NFA = *net foreign assets*;[5] and DEBT = the *total public debt stock*.[6]

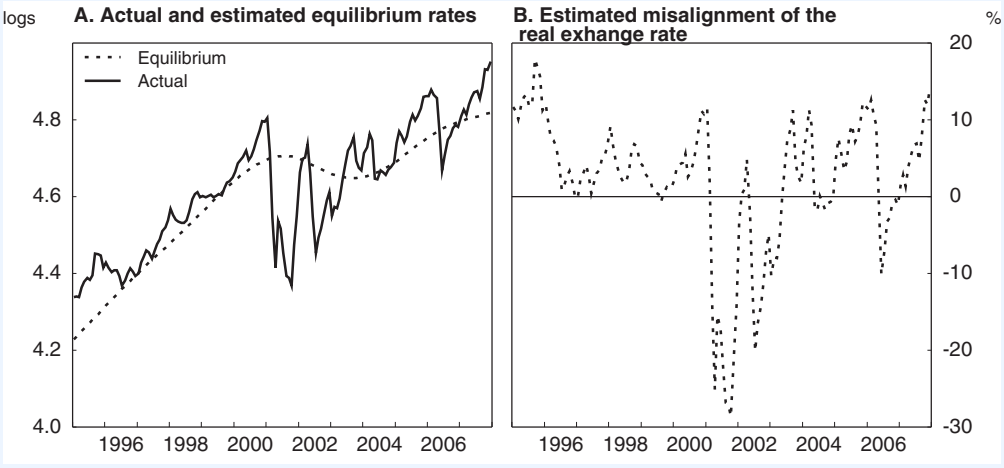
A co-integration equation was estimated as:[7]

$$RER = -0.001RIRD + 0.391TOT + 0.475TNT + 0.023NFA + 0.014DEBT$$
$$\qquad\quad (0.001) \qquad (0.232) \qquad (0.241) \qquad (0.003) \qquad (0.001)$$

Between 1995-2007, stronger terms of trade and higher relative prices of non-traded goods were correlated with real currency appreciation. In contrast, higher interest rate differentials were correlated with real depreciation (risk premia prevailed over interest rate parity). A higher public debt ratio went together with appreciation (demand and price stimulation effects from fiscal deficits appeared to prevail over risk perceptions).

An *equilibrium* rate of appreciation was estimated through the period[8] and the *misalignment* of the exchange rate was measured as the difference between actual and fitted values (Figure 3.18).

Figure 3.18. **An estimation of the overvaluation of the real exchange rate until 2007**



Source: Çulha *et al.* (2008, forthcoming).

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These estimates imply that, according to the behavioural model used, the Turkish lira remained generally overvalued between 1995 and the crisis at the end of 2000. However, these misalignments were generally of short duration. The lira then depreciated sharply in February 2001, at the time of the crisis. The real exchange rate remained undervalued for one year before recovering to its equilibrium level by early 2002. It plunged again in mid-2002

Box 3.4. **How overvalued was the Turkish lira in the period up to 2007?** *(cont.)*

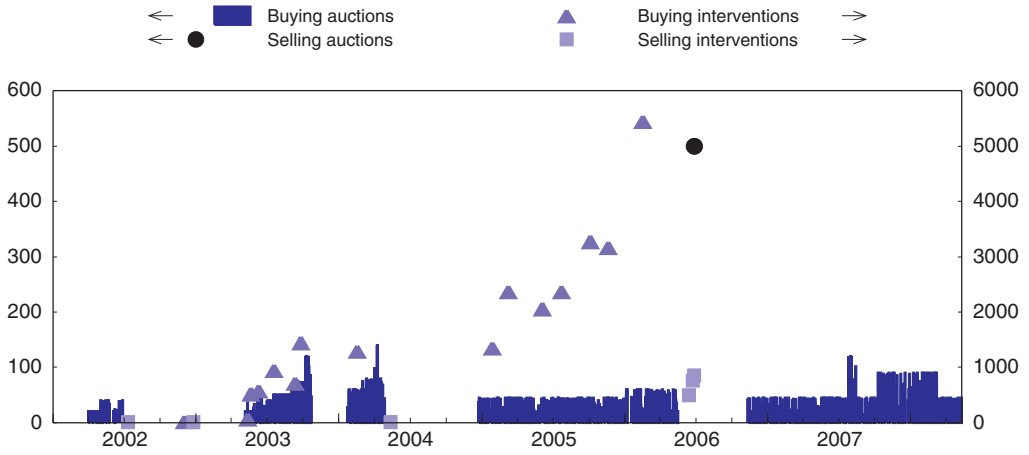
when domestic political tensions augmented and early elections were announced. After market confidence was restored following the November 2002 elections, a positive gap started to form again. Between 2003 and 2007 the currency was generally overvalued except in the second half of 2004 when the Federal Reserve started to raise policy rates, and in May-June 2006 after the international turmoil. An upward misalignment followed with the real exchange rate reaching 14% above its expected value by the end of 2007.

1. The real effective exchange rate based on CPI, as calculated by the OECD, in log form.
2. Calculated as the difference between Turkey's (Central Bank policy rate) and US's (FED funds rate), in real terms. The expected effect of this variable on the real exchange rate is ambiguous. According to the uncovered interest rate parity (UIP) hypothesis, the currency with the higher interest rate should depreciate, to eliminate any arbitrage opportunities. On the other hand, a high interest rate may stimulate capital inflows, fostering the appreciation of the currency.
3. Calculated as the ratio of Turkey's terms of trade divided by the trade-weighted average of the terms of trade of Turkey's main trading partners. A rise in TOT is expected to generate a positive effect on the real exchange rate, by shifting production towards tradable goods, increasing wages in the tradable sector and then leading to a rise in overall price level and therefore an appreciation in the real exchange rate. For the measurement of TOT Germany, Italy, UK, France, USA, and Spain have been considered as Turkey's main trading partners.
4. Calculated as the ratio of Turkey's consumer price index (CPI) to its producer price index (PPI), divided by the trade-weighted relative price ratio of Turkey's main trading partners, in log form. This variable is expected to be positively associated with real exchange rate appreciation, because any productivity differential between tradable and non-tradable activities creates higher inflation. This is also known as the Balassa-Samuelson effect.
5. Calculated as the ratio of the difference between total foreign assets and total foreign liabilities to GDP. An increase in NFA is expected to increase the real exchange rate, as net capital inflows increase domestic currency demand.
6. Expressed as a ratio to GDP. As a risk indicator, the sign of DEBT is expected to be negative: more public debt could increase the risk premium and may lead to a real exchange rate depreciation. On the other hand, if additional debt finances more government expenditure on non-tradables, this may lead to a rise in the general price level and thus foster real exchange rate appreciation.
7. The Johansen co-integration method was used on a monthly basis, covering the period 1995-2007. An unrestricted vector auto-regression (VAR) was estimated, with three lags of the six variables, according to the Schwarz information criterion, and including a dummy variable for the 2001 crisis. The cointegration test results point to the existence of one cointegrating equation on the basis of trace and maximum eigenvalue statistics at the 1% significance level. NFA and DEBT are statistically significant at the 1% level, while TOT and TNT are significant at the 5% level. RIRD appears to be statistically insignificant. Standard errors are in parenthesis.
8. Explanatory variables were smoothed by using a Hodrick-Prescott filter and expected (fitted) values were obtained by multiplying these smoothed variables by their coefficients from the co-integration equation.

The strong real exchange rate appreciation in 2007 was clearly detrimental to competitiveness, even if it helped with disinflation. The trade-exposed sector showed a remarkable ease of adjustment in the early phases of appreciation, but pressures became too strong through 2007 (Chapter 4 provides a more detailed discussion of these pressures).

Policy responses to such adverse effects of capital inflows have long been discussed in the literature. The experience of other emerging countries show that conventional measures like foreign exchange interventions and sterilisations, or capital controls, generally do not prove sufficient or sustainable (see Annex 3.A1). Turkey had a large scale *de facto* foreign currency purchase and sterilisation programme in the 2000s, as part of a strategy to build significant foreign reserves. Additional and more occasional foreign exchange operations carried out until mid-2006 to smooth out excessive volatility could also be seen as an effort to alleviate some of the most abrupt pressures (Figure 3.19). Neither of these interventions slowed down trend real currency appreciation despite, in addition, the decline of interest rates until the international financial turmoil in

Figure 3.19. **Central Bank's foreign exchange interventions and purchase auctions**



Source: CBRT.

StatLink http://dx.doi.org/10.1787/420423587271

May-June 2006. Absent shocks, upward pressures on the real exchange rate appear as a structural pressure bearing on the Turkish economy, as a combined result of these capital inflows, and the consequences of catching-up on domestic wages and prices. Both *interest rate-sensitive* and *non-interest rate sensitive* inflows are expected to remain strong in the medium-term, as confidence improves and risk premia fall. So long as strong fundamentals and credible economic policies continue to attract capital inflows, this tension will be here to last.

Turkey needs to mobilise additional policy instruments to face this endemic challenge – irrespective of short-term disturbances on exchange rates. Strong collective and structural action would help face the challenge in the medium-term. Box 3.4 illustrates the potential role of social and political co-operation in meeting similar external pressures on competitiveness of middle-income countries when exchange-rate depreciations are not an available or reliable adjustment channel (Box 3.5).

Monetary policy needs to be supported by an environment giving it more freedom of action. Rigorous fiscal policy remains important for permitting additional interest rate reductions by the Central Bank. At the same time, if transition to a lower primary surplus is successfully achieved by taking full account of the structural needs and the cyclical situation of the economy as advocated in Chapter 2, this should not undermine disinflation – so long as the inflation target is adequately supported by other credibility-enhancing measures. The development and implementation of such measures call for stronger support by social partners, as confirmed by the experience of other small open economies.

Box 3.5. **The role of social dialogue in backing macroeconomic and monetary objectives**

Reducing inflation to stable levels without sacrificing economic growth and employment has long been a challenge for middle-income countries. Tight fiscal policy, and income policies based on wage and price containment have been typical suggestions to keep inflationary pressures low and preserve competitiveness. In a longer term perspective, labour market flexibility and product market reforms to increase productivity and price competition in the business sector have also been emphasised.

Country experiences show that successful achievement of disinflation and macroeconomic stability depends not only on policies implemented but also on social support. Social support has been at times formalised in explicit agreements between social partners, as in Ireland.

The Irish economy was confronted with slow economic growth, high unemployment and fiscal imbalances until late 1980s. Under these unfavourable circumstances, the social partners agreed to cooperate through a "Strategy for Recovery" in 1986, extended with a "Social Partnership Agreement" in 1987. These agreements were subsequently renewed for successive three-yearly periods.[1]

These collaborative programmes were based, principally, on wage moderation and tax reductions. There was agreement between parties that wage increases were to remain below productivity gains, and the difference would be compensated by tax reductions. Competitiveness would be preserved, macroeconomic strength maintained, inflation controlled and public finances improved largely through the higher resulting growth.

The Irish economy took off in the 1990s: productivity and competitiveness soared, and strong economic growth followed. There were certainly other factors behind Ireland's achievements as well, but social partnership agreements played an important role in moderating inflation, preserving competitiveness and sustaining macroeconomic performance.

Blanchard (2006) analysed the contrasting experience of another middle-income EU accession country: Portugal.[2] A main difference between Ireland and Portugal concerned their wage policies. In Portugal, the boom after the participation in the European Exchange-Rate Mechanism initially reduced unemployment. Wage growth then increased above productivity growth, causing a sharp increase in unit labour costs. The impossibility of exchange-rate adjustment locked-in Portugal into a durably weak competitive position, which persisted in the euro area. How can Portugal restore its competitiveness today? Blanchard invokes three avenues: *i)* Portugal can allow the economy to adjust itself, and bear high unemployment rates until competitiveness is re-established. Such a "competitive disinflation" process would however be long and politically demanding; *ii)* productivity growth can be actively stimulated by public policies, which would also take time; and *iii)* nominal wages could be decreased, but this would be politically, legally, and psychologically very demanding.

1. *Program for National Recovery* for 1988-90, *Program for Economic and Social Progress* for 1991-93, *Program for Competitiveness and Work* for 1994-96, *Partnership 2000* for 1997-99, *Program for Prosperity and Fairness* for 2000-02, *Sustaining Progress* for 2003-05, *Towards 2016* for 2006-08.
2. Blanchard, O. (2006), "Adjustment within the euro: the difficult case of Portugal", *MIT Department of Economics Working Paper*, No. 06-04.

Policy recommendations

Box 3.6 summarises the policy recommendations of this chapter.

Box 3.6. **Recommendations for a comprehensive monetary policy strategy**

Reinforce communication

In the face of large and widened gaps between the inflation target and outcomes and expectations, reinforce communication, emphasising the role of the recent supply shocks.

Stress the evolution of core inflation (excluding both unprocessed and processed food) as a revealing indicator of genuine domestic inflationary pressures.

Highlight core inflation's having entered the target bracket since August 2007 as an achievement of inflation targeting. At the same time, acknowledge the pick-up of core inflation toward headline inflation as a negative and undesirable development.

Continue to emphasise headline inflation as the main nominal anchor in the economy and the main target of monetary policy.

Consolidate the inflation targeting framework

Strengthen the role of inflation forecasts in the inflation targeting framework and develop the required technical infrastructure.

Make Central Bank's inflation forecasts the most technically credible and accurate forecasts available, and make them a reliable anchor even in the presence of large deviations from inflation targets.

Support efforts to increase the freedom of action of inflation targeting

The Central Bank should explicitly support efforts to introduce a robust medium-term budget framework and spending rule (see Chapter 2). The transition to the new fiscal framework should be monitored closely and reported about in the Inflation Report.

Monitor domestic price pressures in services such as housing, retail trade (including for unprocessed and processed food), transportation and energy, and report about them in Inflation Reports. The authorities should strengthen regulatory reforms and competition policies in these areas in support of monetary policy.

Cultivate social partners' backing of disinflation policy through their commitment to the inflation target as a benchmark for price and wage determination.

The social partners should also be invited to recognise that if Turkey's terms of trade deteriorate, the resulting decline of purchasing power has to be absorbed by domestic agents. This recognition could help contain feedback pressures from headline to core inflation and contribute to alleviate price and wage spirals.

Notes

1. A literature survey on the causes of inflation in Turkey is found in Kibritcioglu (2002).
2. The majority of Turkish exports are denominated in euros and the majority of imports in US dollars.
3. See OECD (2002) for an analysis of the crisis in 2001.
4. See CBRT (2004), CBRT (2005) and Serdengecti (2006).
5. With the introduction of full-fledged inflation targeting in 2006, base money lost its role of additional nominal anchor for inflation targets. Accordingly, performance criteria of IMF program on base money was replaced with the "inflation consultation" criteria (see CBRT, 2005). During this period, the Central Bank defined its exchange rate policy as follows: "Under the floating exchange

rate regime, exchange rates are determined by demand and supply conditions in foreign exchange markets and the Bank does not target any level of exchange rates. However, the Bank may intervene to smooth out excessive short-run exchange rate volatility in both directions. In addition, the Bank can conduct foreign exchange purchase auctions to improve its international reserve position". Daily purchase auctions have been held continuously, except for temporary suspensions. Officially, the Central Bank has not intervened directly in the exchange rate market since June 2006. Still, reserve objectives were periodically revised upward, until a downward revision decided on 10 March 2008.

6. An index of "Central Bank Independence" is drawn and calculated for 163 countries. The index for Turkey shows that political autonomy increased from 0.50 in late 1980s to 0.67 at the end of 2003 while economic autonomy increased from 0.60 to 1.0. Overall autonomy increased from 0.55 to 0.82 in the associate periods. (Political autonomy takes into account the appointment process of governor, length of governor's term of office, involvement of goverrnment in central bank board and policy formulation, objectives of central bank, and conflict resolution process, while economic autonomy considers the limitations on the term, persistence and amount of direct credits to the government, and involvement of the central bank in the primary market for public debt securities.)
7. In emerging market countries with weak fiscal and financial institutions, currency substitution, and liability dollarisation, Central Bank independence is indispensable for the credibility of monetary policy. See Amato and Gerlach (2001), Eichengreen (2002) and Mishkin (2004).
8. See Gönenç and Yilmaz (2007).
9. See Schaechter *et al.* (2000), Amato and Gerlach (2001) and Carare *et al.* (2002).
10. Before recent GDP revisions.
11. See OECD (2002) for detailed analysis of structural reforms in the banking sector.
12. The widely accepted preconditions of inflation targeting can basically be identified as the existence of an independent central bank, a floating exchange rate regime (or absence of an anchor other than inflation), technical capacity for inflation modelling and forecasting, absence of fiscal dominance, and general macroeconomic stability that ensures the resilience of the economy against shocks. See for example, Schaechter *et al.* (2000), Amato and Gerlach (2001), Eichengreen (2002), Carare *et al.* (2002) and Mishkin (2004).
13. See IMF (2005).
14. A floating exchange rate regime and the independence of the Central Bank were already secured at the beginning of implicit inflation targeting. Fiscal discipline was achieved and the main fiscal targets were on track. A range of structural reforms, especially in banking, were supporting financial and macroeconomic stability. See Kara (2006) on Turkey's implicit inflation targeting experience.
15. Such as the Balassa-Samuelson effects, and price measurement problems stemming from the improvement of the quality of goods during convergence.
16. See Jonas and Mishkin (2003).
17. Inflation targets were set as "point targets". The Central Bank has also included an "uncertainty band" of 2 percentage points on both sides around the target, to serve in the accountability mechanism.
18. See Heenan *et al.* (2006).
19. Percentage points of output to be sacrificed to achieve one percentage point of decline in inflation.
20. Same as in footnote 17.
21. See CBRT (2006).
22. See Benes *et al.* (2007).
23. Roger and Stone (2005) provide a detailed analysis of the degree at which early inflation targets were achieved in inflation targeting countries. Many countries failed to meet their early targets but this did not compromise their capacity to successfully establish and operate the new regime.
24. According to the Central Bank's projections of 13% increase in food prices by end-2008, and the 9.3% headline inflation forecast for year-end 2008. See, CBRT, *Inflation Report*, Q2 2008, 30 April 2008.
25. See Kara and Ogunc (2005) and Kara *and al.* (2007). The second study analyses the sources of the change in the exchange rate pass-through in Turkey.

26. Turkish statistical Institute (Turkstat) started to publish seven core inflation indicators in 2005, called "special CPI aggregates" (SCA).These are: A. CPI excluding seasonal products; B. CPI excluding unprocessed food products; C. CPI excluding energy; D. CPI excluding unprocessed food products and energy; E. CPI excluding energy, alcoholic beverages, tobacco products; F. CPI excluding energy, alcoholic beverages, tobacco products, other products with administered prices and indirect taxes; and G. CPI excluding energy, alcoholic beverages, tobacco products, other products with administered prices, indirect taxes and unprocessed food products. Later, two more indicators, namely H and I, were added in September 2006 and May 2008, respectively. H is defined as CPI excluding energy, unprocessed food products, alcoholic beverages, tobacco products and gold, while I indicate H excluding processed food. Since the transition to the inflation targeting regime in 2006 the central Bank has emphasized that different core inflation indicators will be used in inflation analysis and communication policy, with attention drawn to different CPI indicators depending on the source of the shocks (see CBRT, 2005, 2006, and 2007).

27. Before transition to full-fledged inflation, base money was used as a nominal anchor. However, the Central Bank stated explicitly that it would not consider base money as a central benchmark (see IMF-Letter of Intent, May 2001). This position was based on the fact that it was difficult to estimate money demand during disinflation, and the relationship between monetary aggregates and inflation was weak in Turkey.

28. Inal (2006) examined this relationship empirically.

29. A recent Central Bank research paper also seems to confirm this hypothesis. See Başkaya *et al*. (2008).

30. The target and the forecast of the Central bank are identical over a two-year horizon, as Central Bank's policy instruments are supposed to be powerful enough to reach the target. They may however differ in the short-term, for example for the year ahead. Market's expectations may still differ from the revised projections of the Central Bank for the same period.

31. Other inflation-targeting countries are: Brazil, Czech Republic, Israel, Colombia, Philippines, South Africa, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia and Thailand. See *CBRT Inflation Report*, Q1 2008.

32. See also Celasun *et al*. (2003).

33. See Başkaya *et al*. (2008).

34. The weight of FDI confirms that *non-interest sensitive and structural* pull-factors are becoming more important. This reduces the scope of interest-rate cuts for reducing capital inflows. See Çulha (2006).

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ANNEX 3.A1

Experiences of other middle-income countries with capital inflows: lessons for Turkey

The recent experiences of other emerging market economies with the acceleration of capital inflows were reviewed with a view to draw lessons for Turkey (Table 3.A1.1).

Beyond individual country experiences, a recent cross-country study screened 109 episodes of capital inflow accelerations to 49 countries in Europe, Asia and Latin America between the 1990s and 2007, and analysed policy responses and observed consequences.* It reached the following conclusions:

- Public expenditure restraint during capital inflows helped both with lower real exchange rate appreciation and stronger GDP growth after the deceleration of inflows.
- Policies of "resistance" to appreciation have generally not been successful. When they were implemented, they were often followed by a sharper reversal of capital inflows at the end of the inflow cycle.
- Restrictions on inflows did not significantly slow real appreciation, as a general rule. Neither did they facilitate a soft landing at the end of the inflow cycle.
- Capital importing countries with high current account deficits are relatively more vulnerable to a subsequent reversal of capital inflows.

Table 3.A1.1. **Policy options to reduce the adverse effects of capital inflows**

Policies	Pro's	Con's
No policy response		
Allowing nominal appreciation	Discourages speculative inflows by imposing FX risk on market participants.	Inflation target may be undershot.
	Allows exchange rate movements to absorb the effects of capital inflows.	Facilitates real appreciation, with adverse effects on the external balance.
	Real exchange arte appreciation is likely to occur through nominal appreciation rather than through higher inflation.	
	Supports inflation targeting.	
Monetary and exchange rate measures		
Exchange rate intervention	Directly reduces pressure on the exchange rate.	Creates inflationary pressure by causing monetary and credit expansion.
		Threats the credibility of inflation targeting if it is perceived as dictated by competitiveness concerns.
		Ineffective if fundamentals are truly strong and continue to attract foreign capital.
		Ineffective if it further encourages capital inflows by keeping interest rates high.

* IMF (2007b).

Table 3.A1.1. **Policy options to reduce the adverse effects of capital inflows** *(cont.)*

Policies	Pro's	Con's
Sterilisation	Prevents monetary expansion.	Faces difficulties when implemented through: *Open Market Operations:* It requires well developed financial markets. It is costly because the use of government securities increases the debt burden of the government and the central bank. Crowding out effect may emerge if banks invest their funds in the central bank instead of lending to the business sector. *Required Reserves:* Costly if reserves are remunerated. Frequent changes in reserve requirements reduce the banking sectors' flexibility in liquidity management.
Widening the exchange rate fluctuation band *(Under fixed exchange rate regime)*	Discourages speculative inflows motivated by appreciation expectations. Gives the central bank more flexibility in its interventions in the foreign exchange market.	There is more room for speculative plays within the fluctuation band.
Interest rate cut	Discourages interest sensitive capital inflows by making interest arbitrage less attractive. Useful for avoiding the difficulties of sterilisation.	May threat the inflation target. Difficult to determine the amount of interest cut consistent with the intended decrease in capital inflows. Ineffective if inflows are not interest-rate sensitive (FDI, etc.).
Fiscal measures		
Expenditure cuts and tax increases	Restricts total demand and reduces inflationary pressures. Save on sterilisation costs. Open more room for monetary policy. Open more room for fiscal stimulus when capital inflows decline. Leads to lower risk perceptions and attracts longer term capital.	It may accelerate capital inflows by reducing country risk. Long lead times because of the inertia of budget procedures. Politically difficult because of pro-cyclical borrowing ease.
Financial regulatory measures		
Banking supervision and regulations	Reduces the vulnerability of the financial sector.	Financial institutions can circumvent the measures through various balance sheet operations.
Capital controls		
Controls on capital inflows	May stabilise capital inflows directly and rapidly. Diminishes risks of shock from sudden stops. Allows more independent monetary policy.	Generally circumvented when utilised for a long period of time. May frighten longer-term capital rather than speculative inflows. Distorts resource allocation when enterprises are deprived of cheaper capital from abroad.
Liberalising capital outflows	Reduces net capital inflows. Facilitates portfolio diversification of investors. Provides positive signals on the future full liberalisation of the capital account.	Encourages additional capital inflows by improving confidence. Creates risks of capital flight.

Source: Calvo *et al.* (1994); Lee (1997); Lopez-Mejia (1999); Ho and McCauley (2003); Arvai (2005); Eichengreen and Choudry (2005); Otker-Robe *et al.* (2007); IMF (2007a); IMF (2007b), Roubini (2007).

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Chapter 4

Enhancing competitiveness by fostering the growth of the formal sector

The Turkish business sector's successful post-crisis performance has come under strain. Mounting competition from low-cost countries and strong real currency appreciation – until the early months of 2008 – have together undermined the performance of the trade-exposed sector, in particular of the segments dependent on low-skilled labour and domestic inputs. The resulting competitive squeeze gradually spilled-over to trade-sheltered activities, slowing down GDP growth.

The sources of growth should not be expected to be re-balanced as a result of a permanent reversal of trend real currency appreciation. External and internal shocks do trigger depreciations, but these generally prove to be of short duration and the long-term dynamics of capital inflows remain strong. In the presence of resulting pressures on competitiveness the business sector's capacity to accelerate productivity growth, moderate wage increases, and successfully differentiate products (in order to be able to charge higher prices than lower cost competitors) are longer-term sources for improving competitiveness for Turkey. Investigations for the Survey confirm that manufacturing industry achieved a remarkable record in all these three areas, even if gains were concentrated in the modern part of the economy and fell short of fully offsetting the very strong pace of real appreciation prior to the shocks of early 2008.

The chapter argues that important competitiveness reserves remain latent in the business sector, and should be mobilised. They arise from a large part of economic activity still being carried out in the informal and semi-formal sectors. If more resources can be shifted to the modern formal part of the economy, aggregate productivity and competitiveness would be enhanced. Formal firms draw much more effectively on the modern technology, skilled labour, capital and FDI resources becoming available in the rapidly globalising Turkish economy.

Facilitating the growth of modern firms requires a purposeful strategy. Two top priorities are a far-reaching reform of labour market regulations, and further progress in the modernisation of capital markets. Ongoing government efforts to accelerate the formalisation of the economy through more assertive implementation of regulations need to be backed by structural reforms in top priority areas.

The employment and macroeconomic costs of competiveness losses have exposed policymakers to growing demands for remedial responses. Pressures emanated first and foremost from employer and employee organisations in trade-exposed activities but, as output and employment losses spilled-over to the economy as a whole, they were echoed in wider circles. Demands for policy response found such wide support because conventional correction mechanisms of external imbalances through exchange rate adjustments have been perceived as not fully sufficient, except at the occasion of temporary internal or external shocks.

Weaker economic performance created a more supportive environment for the acceleration of structural reforms. The announcement of an *Urgent Action Plan* in December 2007, three months after the publication of the government programme, and of a new *Employment Package* in spring 2008 reflected this shift toward a more activist policy stance.

This chapter reviews first the deepening of performance divergences in the business sector in the recent period, which underpinned the weakening of macroeconomic performance (Section 1). It then reports on new government initiatives being introduced to improve the performance of the business sector (Section 2). It concludes by recommending a further acceleration of reforms for streamlining labour market regulations and modernising capital markets in order to facilitate the growth of the formal, modern part of the economy (Section 3).

Performance divergences in the business sector have deepened

Business sector performance is never uniform in a competitive economy and *a fortiori* in a rapidly changing economy like Turkey's. Businesses start up and grow to seize new opportunities while others adjust down, and resources consequently shift. Yet, recent performance divergences between the different parts of the Turkish economy appear to have accelerated beyond traditional trends.

These divergences are best documented in the manufacturing sector, thanks to data availability.[1] Outcomes are more difficult to monitor in services, but it appears that similar pressures are also in force in service sectors, even if they are in general not exposed to trade competition.[2] Competitive pressures mount on the same type of entities in all activities: lower productivity, less capital intensive and less sophisticated enterprises are more severely squeezed than in the past. In trade-exposed activities, pressures originate from low-cost countries and trend currency appreciation. In trade-sheltered sectors, productivity gaps between traditional suppliers and modern entrants grow and their respective market shares appear to change more rapidly. Turkey's core structural adjustment challenge arises from the declining part of the economy being also the prime user of the economy's most abundant resource, low-skilled labour.

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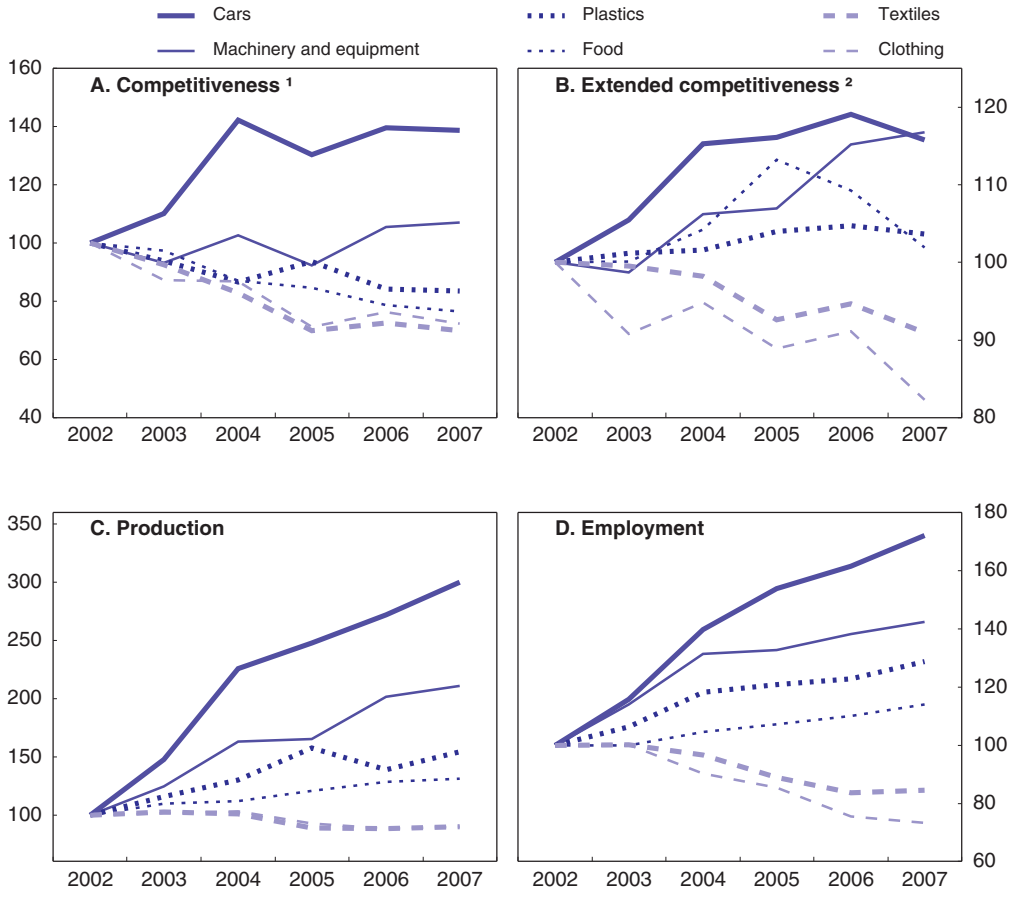
Competitive versus declining sectors

A statistical investigation of the competitive performances of a range of manufacturing sectors was realised for this *Survey*.[3] Developments in the key areas which together shape competitive performance were analysed: sectoral price pressures, labour productivity, labour costs, other unit costs and product differentiation. The analysis revealed that manufacturing sectors cluster into three groups, the performance of which has significantly diverged since 2001 (Figure 4.1).

Figure 4.1. **Performances of well-performing, squeezed and intermediary sectors, 2002-07**

2002 = 100



1. On basis of unit labour costs.
2. On basis of unit labour, capital, energy and imported input costs.

Source: SIS and OECD calculations.

StatLink http://dx.doi.org/10.1787/420425502046

i) *Well performing sectors*: These include enterprises which do consistently well along most determinants of competitiveness. In the 2000s, they included car manufacturing, consumer durables, industrial machinery, chemicals and steel production. They did clearly better than national averages in productivity growth, wage setting in line with

normal profitability, product differentiation and the reduction of their capital and input costs.[4] On this basis, they achieved outstanding output, export and employment growth – despite strong real currency appreciation.

ii) *Squeezed activities:* these activities include enterprises which tend to under-perform in most dimensions of competitiveness. Traditional specialisation areas of the Turkish economy drawing on low-skilled labour and cheap local inputs recently faced this situation on an important scale. Such activities include textile and clothing, which represent nearly one third of total manufacturing output and employment. Many firms in these sectors failed to raise their productivity, moderate their wages or differentiate their products at a sufficient pace to preserve their competitiveness against low-cost country competition and strong currency appreciation. Their output, export and employment performance have significantly suffered.

iii) *Sectors in an intermediary situation*: these activities experienced varying paces of price pressures, productivity and wage growth, and partial gains on their capital and input costs. The manufacture of electronic goods, furniture, plastics and food products is in this category. Their output, export and employment performance have been generally average.

The investigation took into account not only standard *unit labour costs* but also *unit capital*, *energy* and *imported input* costs. The most significant insights are:

- The most competitive industries being also the most capital- and imported-input intensive ones, they gained from the decline of capital and imported input costs after 2001 and during real exchange rate appreciation periods.
- Less sophisticated activities benefitted less from these factors. Yet they are also becoming more capital intensive and import a higher share of their inputs. Nonetheless, their gains from post-2001 developments were not large enough to offset the pressures of price squeezes and unit labour cost growth.
- All activities faced a strong increase in competitive pressures in 2007, when higher interest rates and energy costs compounded pressures from accelerated currency appreciation.

Successfully restructuring firms in declining sectors have still limited weight

Competitively squeezed areas of the Turkish economy have not remained inert in the face of these pressures. Even in the most pressured sectors such as textiles and clothing, many firms have done much better than sector averages by improving the quality of their products and controlling their unit labour costs. They withstood international competition and managed to increase their output and employment[5] (Box 4.1).

The future of Turkey's labour-intensive industries will be shaped by the pace of diffusion of these qualitative upgrading and cost-reduction strategies. Such innovative strategies will bear on aggregate performance only if the new business models gain pre-eminence instead of remaining peripheral. Their successful diffusion appears to require: *i)* completing employment adjustments in the market segments directly (irreversibly) exposed to low-cost country competition; *ii)* achieving a major improvement in the skills of entrepreneurs, technical personnel and workers; and *iii)* reforming business regulations and tax structures in a way that formalisation is facilitated.

Upgrading experiences at local level are worthy of mention. A number of Organised Industrial Zones acted as diffusion factors of the new business models. The leather industry provides an interesting case. After relocating from Istanbul's centuries-old leather

Box 4.1. **The slow adjustment of the textiles and clothing sector**

The textiles and clothing sector is today, by far, Turkey's largest manufacturing sector. In early 2000s it represented 23% of manufacturing value-added, and nearly 36% of total manufacturing employment. Exports represent more than 50% of domestic output, and certain regions of the country (such as Denizli and Adiyaman) are almost mono-producers of textile and clothing. Turkey is the world's second biggest exporter of these products after China (the third if EU exporters are considered as a single group) and supplies 4.5% of total world imports and 8% of EU imports. In no other OECD and emerging economy has this sector gained such a weight in manufacturing. Its performance bears heavily on Turkey's aggregate employment and business and household confidence.[1]

The sector was exposed to intensifying competitive pressures arising from trend real currency appreciation, mounting market rivalry from other emerging producers notably in Asia (such as China and India), and from the phasing out of trade quotas in OECD markets. The full impact of quota liberalisation on the sector, and in particular on its employment performance, may however be still coming up.[2] The most important insights from existing evaluations of the sector's competitive position are:

- Turkish industry is increasingly faced with growing cost-competition, and does not appear well-equipped to face it. Labour costs, which represent 12 to 20% of production costs according to market segments, are higher in Turkey than in competitor countries. According to a sectoral review,[3] hourly labour costs in textiles and clothing amounted to USD 2.88 in Turkey in 2005, against USD 1.50 in Bulgaria, USD 0.88 in Egypt, USD 0.67 in India and USD 0.48 in China. Energy costs, which count for an average 10% of production costs, are also higher in Turkey, amounting to 8.12 cents/kwh in 2005, above the cost level prevailing in competitor countries. By contrast, Turkish exporters enjoy a cost advantage in transportation and logistics, which amount to 5% of total supply costs in textiles and clothing when delivering to the EU markets.
- Turkish industry is better positioned in "middle-to-high" market segments where competition is not mainly *cost-based,* but is also *marketing-based*.[4] Around 40% of the world's textiles and clothing market belong to this category and call on suppliers' ability to differentiate products, increase product quality, refine designs and quicken delivery times for small-batch products. A survey of European Union's textiles and clothing importers highlighted Turkey's good standing in these areas. China's good position indicates however that this standing is not immune to price competition (Table 4.1).

Table 4.1. **Competitive standing of EU's textiles and clothing suppliers**

Scoring over 5

Supplier countries	Labour quality and cost	Materials and supply capacity	Infrastructure and funding	Design and delivery speed	Weighted standing
China	4.50	4.10	3.90	2.80	4.80
Turkey	**3.75**	**3.80**	**3.85**	**4.18**	**4.60**
South Korea	3.20	3.00	3.95	3.65	4.00
Bulgaria	3.53	2.30	2.75	3.80	3.80
India	3.63	3.30	2.25	2.45	3.70
Romania	3.58	1.50	3.15	3.65	3.60

Source: Institut Français de la Mode, 2004.

Different parts of the Turkish textiles and clothing industry appear unevenly equipped to shift from cost-based to marketing-based competition:

- A minority of *upgraders* are sophisticated, have design and production facilities, and are human capital intensive. These firms import a rapidly growing share of their inputs from competitive international suppliers. Imported inputs have rapidly increased and represented in the mid-2000s about 40% of all clothing inputs utilised in the domestic market and about 70% of all clothing inputs utilised for export markets.

Box 4.1. **The slow adjustment of the textiles and clothing sector** *(cont.)*

- The bulk of the industry, however, has low-productivity and low-skills. Average enterprise size in the industry is of 18 employees in textiles, and 9 employees in clothing. 62% of employment in textiles and 80% in clothing is in informal enterprises. Informal enterprises gained some additional weight in the recent period as a result of competitive pressures which incited enterprises unable to match competition to reduce costs by higher recourse to informality.

1. The *Special Expert Group on Textile and Clothing* of the IXth Development Plan 2007-2013 has recently produced a highly detailed study of the sector. An informative recent overview is also available in: E. Ongut, "Turk Tekstil ve Hazir Giyim Sanayii'nin Degisen Dunya Rekabet Sartlarina Uyumu" (Turkish Textile and Clothing Industry's Adjustment to Changing Competition Conditions in Global Markets), DPT Uzmanlik Tezi, Ankara, 2007.
2. Textile and clothing trade was supposed to be fully liberalised according to standard WTO rules in 2005, after the phasing out of the quota-based *Agreement on Textiles and Clothing* (ATC) signed in 1995 for ten years. However, the sharp increase of exports from China in the first months of 2005 incited large importers, including the EU and the United States, to reintroduce quantitative restrictions for several product categories until 2008. After 2008, tariff rates averaging 15% in the EU, and 30% in the US, will remain in principle the only trade barriers in the sector. Turkish textiles and clothing products, which are presently imported freely to the EU market, and under average quota and tariff conditions to the US market, are expected to suffer from liberalisation. The two available simulations of the consequences of liberalisation (WTO, 2004 and EU/Institut Français de la Mode, 2004) herald significant losses for Turkish industry. According to one of the studies Turkey would be the largest loser from liberalisation, with a cumulative decline of 23% of its textiles output and employment, and of 33% of its clothing output and employment.
3. Werner (2005).
4. Ongut (2007).

cluster into a new Organised Industrial Zone, the most dynamic parts of the industry accelerated their modernisation. However, due to the Russian crisis in the late 1990s and big increases in leather good and footwear imports from China between 2003-07, the sector experienced serious job losses (Box 4.2).

Competitive pressures have extended to the domestic market

Turkey's export markets were exposed until recently to more intense competition than the domestic market.[6] This may be related to the traditionally strong local market power of incumbents and to lags in the development of the marketing and distribution channels of new overseas entrants.

However, this shelter has been vanishing in the recent period. Price convergence has accelerated and competitiveness challenges broadened from export to domestic markets. The acceleration of imports rather than the deceleration of exports has indeed been the principal consequence of the weakening of competitiveness. Traditional exporters, apparently better resourced to match competition, coped better with pressures than the traditionally less sophisticated, less trade-exposed, domestic market-oriented manufacturers. The share of imported inputs in industrial production increased from an average of 15-20% in the late 1990s, to an average of 35-40% in the mid-2000s.

Low-skilled employment is the most vulnerable part of the economy

As a result of these competitiveness losses low-skilled employment declined. For these workers, employment losses of low-skilled workers in squeezed industrial sectors were not offset by job creation in highly competitive sectors, because these latter activities are still relatively limited in size, are more capital-intensive, and employ a much lesser proportion of low-skilled workers. By contrast, they succeeded in creating considerable additional employment for medium-to-high skilled workers (Figure 4.1 above, and Figures 4.2 and 4.3).

Box 4.2. **Modernisation in the leather industry**

Leather manufacturing is an important export industry (even if the pervasiveness of luggage trade in the sector makes the compilation of trade statistics difficult).After a period of rapid expansion driven by very strong export growth to CIS and in particular to Russia, the industry searches for a new future after the saturation and slowdown of these markets. It is also faced with rising competition from new players such as China and Brazil.[1]

An important trigger of modernisation was the relocation of the old leather cluster in the European side of Istanbul to an organised industrial zone on the Asian shore. Most leather *processing* firms participated in this relocation, while the bulk of smaller size *clothing* firms stayed in the old cluster:

- The relocation of large firms facilitated mergers between companies.
- The new zone provided advanced environment protection facilities, which are essential in leather production, and hosted a vocational school.
- They also started to shift to more expensive product ranges in export markets. As an example: in lamb skin products, the average price of Turkish unit exports is about USD 280, where it is USD 1 000 for Canada, USD 750 for Italy, and USD 90 for China.[2]
- Shoe manufacturers failed to achieve a similar upgrading. The quality of the shoes produced in Turkey is still low and their average prices, at USD 18, remain very close to China's USD 14. The average price of Spanish shoes is around USD 50 and that of Brazil's USD 22.

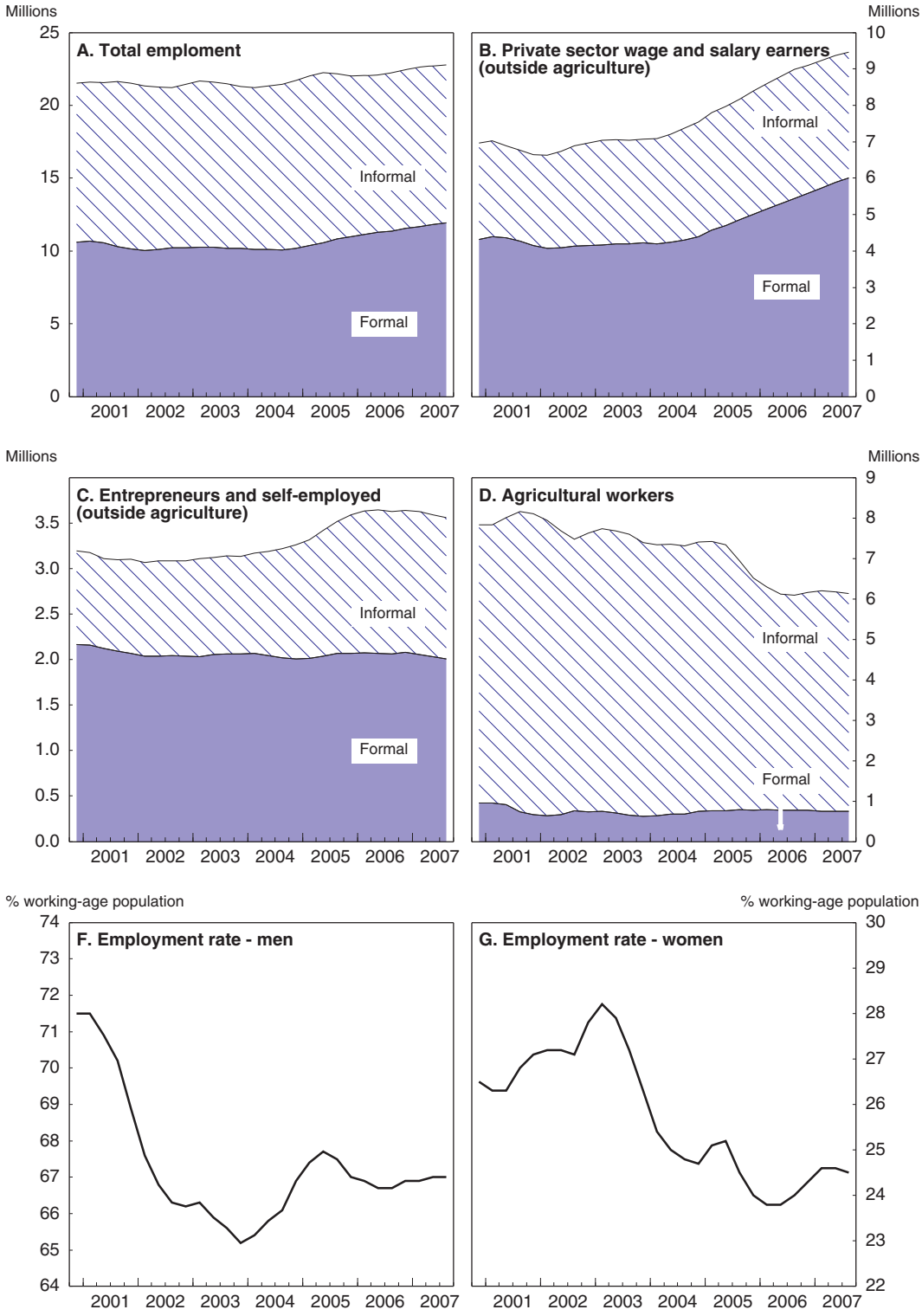
1. See "Deri Sanayi Ozel İhtisas Komisyonu Raporu" (Report by the Special Expert Group Report on Leather Industry), IX. Kalkinma Plani, 2007, DPT.
2. KOBI Finans, "Deri raporu ihracatçiya yol gosteriyor", 30 July 2007.

The large size of the *low-skilled working age population* remains a serious challenge for the absorption capacity of the industry. As labour-force participation of the low-skilled is weak, notably for women, their share in working age population is even higher than their share in the labour force. Inactive low-skilled persons represent a shadow supply of workforce in the labour market. Amid continuing exits from agriculture and rural areas, low-skilled workers are also changing geographical locations and increasing the supply of labour in urban zones.[7]

The employment of the lowest-skilled was traditionally secured in Turkey through informal work. As their employment cost in the legal sector is very high, 95% of illiterate workers and 65% of primary school graduates work informally.[8] Sectors employing this workforce are primarily agriculture, construction, retail trade, and small-scale manufacturing.

These venues of employment came under strong strain in the recent period as a result of competitive pressures discussed above. A recently launched "formalisation" initiative by the government also made informal activity more risky for entrepreneurs.[9] In these circumstances, business sector demand for low-skilled labour is likely to remain weak in the period ahead.

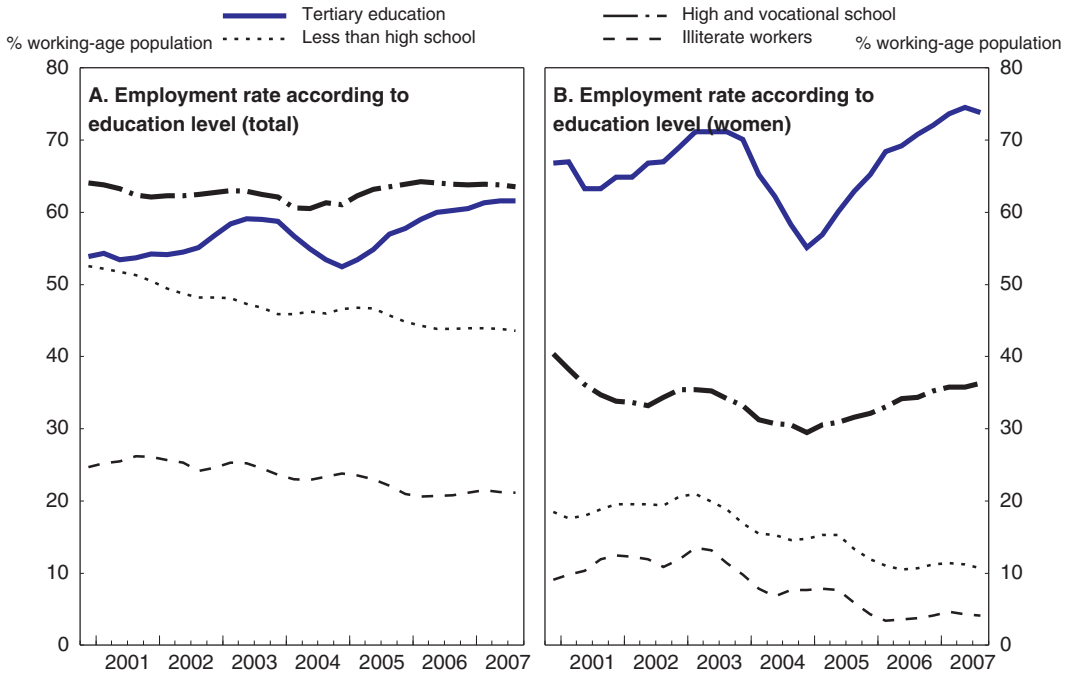
Figure 4.2. **Employment in the post-2001 period**
4-quarter moving averages



Source: OECD estimations on the basis of Turkstat.

StatLink http://dx.doi.org/10.1787/420428407676

Figure 4.3. **The vulnerability of the low-skilled, 2000-07**
4-quarter moving averages



Source: Turkstat and OECD calculations.

StatLink http://dx.doi.org/10.1787/420482075153

The new government agenda to strengthen the business sector

The authorities intend to back the competitiveness of the business sector with new policy initiatives. Various measures were recently suggested by public and private circles and think-tanks, in the form of either broad policy concepts (denominated "second generation reforms") or in form of more specific measures (such as targeted tax cuts, trade policy measures, etc.).[10] Work effected by the Council for Improving the Investment Environment (YOIK), through extensive consultations between private and public sectors, were also helpful in distilling this new agenda.[11] In addition, the unfavourable assessment of existing business sector incentives, found to be too unfocused,[12] motivated calls for more effective incentives[13] (Box 4.3).

The case for stronger incentives for the business sector were brought up in the 2007 election campaign, and was introduced in the government programme for the 2007-12 legislature. The *Urgent Action Plan* of December 2007, and the *Employment Package* of May 2008 emphasised certain of these measures as priorities:

Additional tax measures

Between 2006-08, the corporate income tax rate was reduced from 30 to 20%, the value-added tax (VAT) on textile and clothing from 18 to 8%, and the value added tax on hotels and restaurants from 18 to 8%. These tax reductions were intended to alleviate the tax burden on formal businesses, and their customers.

Box 4.3. **Existing business sector incentives**

There are at present six main categories of incentives for business activity. They are available equally to domestic and international investors:

1. Horizontal investment incentives

These generally available investment incentives consist mainly of tax benefits: *i)* exemptions from customs duties for the machinery and equipment utilised in business investment; *ii)* VAT exemptions for locally purchased or imported capital goods (generally available in other countries as well); and *iii)* subsidies on interest rates, provided on the basis of location, scale, and scope of investment projects. Investments in "priority development regions" (see below), SME projects, R&D projects and environmental projects can benefit from these interest-rate subsidies.

2. Regional incentives

Regional incentives are granted in more than half of Turkey's 81 provinces (eligible provinces are shown in the map below). They include: *i)* personal income tax reliefs (80 to 100%); *ii)* subsidies to employers' social security contributions for *newly created* jobs (according to regions, 80 to 100% of these costs are subsidised, for a period of time determined by the related Law); *iii)* subsidies to energy expenses (20 to 50% depending on the location of investment); and *iv)* free land allocations. These incentives are granted in provinces with a GDP per capita level equal to or less than USD 1 500 as of end-2001, those with a negative socio-economic development index value for 2003 as calculated by State Planning Organisation, and in "priority development regions".

Regional incentives in the recent period have served as a *natural experiment* on the job creation impacts of tax and labour market reforms: the number of registered workers in eligible provinces increased by 66% between 2003-07, while the equivalent increase was of 47% in the other provinces. The success of regional incentives inspired the idea of creating special regional economic zones where more far reaching reforms could be experimented with.*

However, regional tax incentives also entail significant drawbacks. They may complicate tax administration, and create opportunities for tax avoidance, in particular if firms shift profits to subsidiaries in tax-favoured regions via transfer pricing.

Source: Republic of Turkey Investment Support and Promotion Agency.

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Box 4.3. **Existing business sector incentives** *(cont.)*

3. Small and Medium Sized Enterprise (SME) incentives

SME incentives are granted by the *Agency for the Development* of *Small-and-Medium Sized Enterprises* (KOSGEB) through: *i)* concessional credits; *ii)* incubator facilities; *iii)* R&D facilities; and *iv)* business training.

4. Research and Development incentives

Scientific and Technological Research Council of Turkey (TÜBİTAK) and Turkish Technology Development Foundation (TTGV) refund part of eligible R&D expenses in the following areas: *i)* new concept development; *ii)* feasibility research; *iii)* industrial design; *iv)* prototype production; *v)* construction of pilot facilities; *vi)* test production; and *vii)* patenting documentation. In addition and more recently, a *Research and Development Law* was enacted in March 2008 providing additional incentives for R&D including the deduction of R&D expenses from the corporate income tax base, substantial personal income tax exemptions for R&D and support staff, and reductions in employers' social security contribution rates for R&D personnel.

5. Technology Development Zones

Twelve *Technology Development Zones* (Technopoles) have been created around large universities. They offer: *i)* infrastructure facilities; *ii)* total corporate tax exemption for revenues derived from software production and R&D activities until 2013; *iii)* the wages of software and R&D personnel are exempt from personal income taxes until 2013; *iv)* sales are exempt from value-added taxes in selected information technology (IT) sectors; and *v)* machinery and material purchases are exempt from customs duties and levies.

6. Export promotion

Export promotion schemes are available to subsidise: *i)* up to 50% of business expenses incurred in creating international brands; *ii)* international market research; *iii)* participation in international exhibitions; applications for international patents and trademarks.

* A pilot project is invoked for the dynamic Eastern city of Gaziantep near the Syrian border.

Source: On the basis of information by the Investment Support and Promotion Agency of Turkey, and other sources.

The reduction of VAT on hotels and restaurants must have improved the price competitiveness of tourism service providers, at a tax loss which should be assessed against its benefits. By contrast, the VAT cut on textiles and clothing has in principle no impact on trade flows and its main contribution was, possibly, reducing the cost and price disadvantage of formal production and distribution channels in this sector against informal production and distribution. Yet, the revenue loss from this measure should be calculated and government authorities should re-assess if restoring a normal VAT rate and using additional tax revenues to fund targeted reductions in employers' social security contributions would not be more effective in stimulating formalisation, productivity growth and competitiveness in textiles and clothing.

The taxation of small entrepreneurs will also be affected by planned changes in the personal income tax system. This is a particularly important area in Turkey as more than 40% of the labour force is self-employed. In a recent evaluation study by tax authorities, the question was examined whether to maintain the current "simplified" tax system for small entrepreneurs or to extend its coverage (The *simplified* system exempts small entrepreneurs

below a legally defined sales threshold from income taxes, and permits an intermediary size group – with revenues in an intermediary sales bracket defined by Law – to be taxed on the basis of simplified tax reports). No decision has yet been made. In practice, the income statements and tax obligations of the higher-income self-employed – including most liberal professions which actually pay very low taxes, as discussed in Chapter 2 – will be more closely monitored, and their liabilities will be more effectively enforced.

Supporting the modernisation of small-and-medium sized firms

Given the special role that medium-sized enterprises (the "Anatolian Tigers") have played as the main engine of the post-2001 growth, and the competitive pressures that many of them are now facing, any policies backing their competitive performance may have important macroeconomic consequences. Firm-level surveys indicate that the rate of enterprise creation is still high in Turkey but new firms face growth bottlenecks once they reach a certain size.[14] The government intends to address more actively the obstacles to the growth of small-and-medium sized enterprises.[15]

The *Agency for the Development of Small-and-Medium Sized Enterprises* (KOSGEB) will reinforce its managerial and technical up-skilling programmes. These programmes reduce enterprises' costs of employing skilled managerial and technical personnel by subsidising up to 70% of eligible costs for a period of 12-18 months in developed regions, and up to 80-90% in less developed regions. Technology companies are granted additional training support to help them absorb new software and information technologies.[16] In 2007, the total number of firms participating in KOSGEB's training programmes reached reportedly 300 000, and 6 000 training instructors were active in the field. Higher objectives are being set for the future.

More active utilisation of Organised Industrial Zones

The government plans to mobilise the Organised Industrial Zones (OSBs, which gather medium-sized enterprises) and Small Industrial Sites (KSSs, hosting small firms and workshops) more actively in the future.[17] OSBs and KSSs offer low-cost and functional physical infrastructures[18] and their number and capacity have increased in the 2000s. In 2007, almost 20 000 medium-sized enterprises were operating in 87 Organised Industrial Zones, and about 90 000 small firms and workshops were operating in 393 Small Industrial Sites. Certain of these facilities are sectorally specialised, and provide a platform for sector-specific services and skilled and semi-skilled labour markets.[19] They play an important role in the development of a new generation of SMEs across Turkey.

The government stated its objective of making more active use of Organised Industrial Zones in the future. Municipalities and local chambers of industry show a willingness to develop such structures. Organised zones specialised in agro-food, organic food, etc., are also envisaged, to stimulate agro-food industries which should foster the modernisation of regional agriculture.[20] These projects are expected to stimulate vertical interactions between complementary players in value-added chains. One example is the new shipbuilding cluster near Istanbul. Located in a new Organised Industrial Zone, it has become, within a few years, a world contender in the construction of commercial ships and high quality leisure yachts. It is at the same time faced with important regulatory challenges which concern the interactions between first-tier enterprises and their sub-contractors (Box 4.4).

Box 4.4. **The rapid growth of the shipbuilding cluster and its regulatory challenge**

The shipbuilding industry grew very rapidly in the 2000s.[1] Forty-four shipbuilding firms were established in an Organised Industrial Zone near Istanbul in early 2008, and employed about 5 400 workers. These firms worked with about 560 sub-contracting firms, employing about 15 000 workers. The industry has gained a good international reputation and order books are reportedly full up to 2011.

The growth of shipbuilding revealed a conflict between the flexibility requirements of a modern industry and the rigidity of Turkey's present labour laws. Shipbuilders work through irregular (batch) projects and need to employ a fixed-term workforce. This is very difficult under the present Turkish law and the industry thrived by circumventing existing employment regulations by sub-contacting large parts of its activity to informal and semi-formal builders.

However, these operators enforce poorly the health and safety regulations which are critical in physically dangerous shipbuilding work.[2] Work accidents proliferated in the shipbuilding cluster, fatal accidents alone reaching 17 in the first four months of 2008, creating public outrage. The Ministry of Labour reacted by envisaging to make shipbuilders responsible for the compliance of their sub-contractors with health and safety regulations.

Excessively rigid employment rules should be reformed so as not to hinder the development of the industry. At the same time, warranted health and safety regulations need to be fully enforced. Operating in a legal and regulatory limbo cannot be a sustainable solution for this flagship industry.

1. *Dunya* shipbuilding special issues. See also: Ph. Mishkin, "Boat Builders Help Transform Turkey Into a Regional Star", *Wall Street Journal*, 14 September 2006.
2. "Tersane Kazalari Bakanligi Harekete Geçirdi" (Shipbuilding Accidents Mobilise the Ministry), Sabah, 20 February 2008.

Upgrading the supply of intermediary inputs

Turkey's competitive industries are merely assembly industries which import a high share of their inputs.

Domestic suppliers of intermediary inputs for these industries – notably for cars, white goods, and consumer electronics – have also grown in recent years. However, they have remained generally dependent on individual customer firms, and even if they are considered generally reliable in technical terms, most of them remained of small size and partly informal, with low levels of innovativeness and productivity by international standards.[21]

Weaknesses of suppliers reinforced customer firms' tendency to import their inputs. This, in turn, undermined their local supplier base further, tending to deprive them of an important source of product differentiation and innovation. Two examples have been illustrative in the recent period: *i*) the weakness of the local supply of LCD flat screens became a prime handicap of the Turkish consumer electronics industry;[22] and *ii*) the lack of world-class upstream technical capabilities in car mechanics (in the areas of car engines, and transmission gears) reportedly became a handicap for the design capabilities of the car industry.[23]

The Ministry of Finance announced the creation of a working group to study the sources of these weaknesses, and to evaluate why they are not remedied through market responses. Restructurings and mergers remain rare among input providers, even among those component suppliers servicing high growth industries. According to the Ministry, no

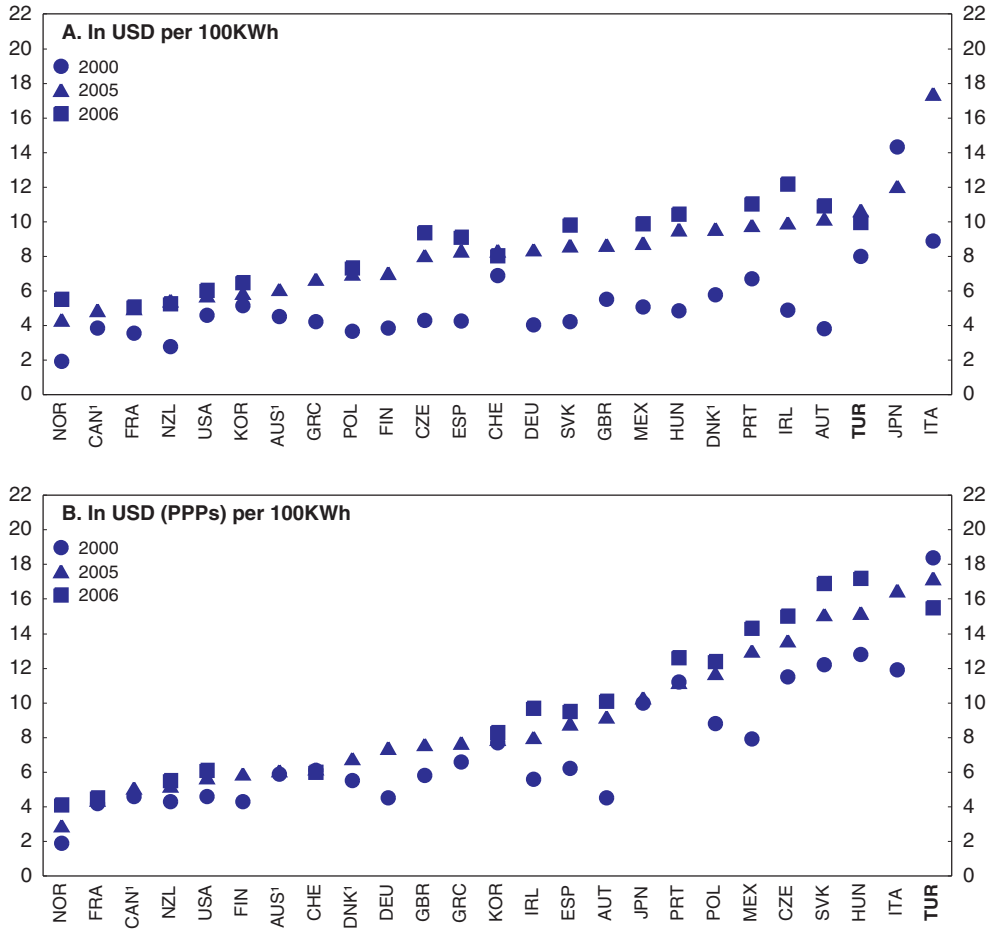
trade protection is envisaged to support the local supply of inputs, but public incentives to promote co-operation between user and supplier firms and to encourage joint R&D activities are being considered.[24]

Stabilising energy costs

To reduce the traditionally high electricity prices for industry,[25] the authorities kept electricity prices nominally constant between 2003 and 2007. The price gap with OECD benchmarks was therefore reduced, even if Turkey remains still a comparatively "high price" country for energy in international benchmarks (Figure 4.4).

However, this policy entailed high fiscal costs. As fiscal performance was closely monitored against targets in the 2000s, the government decided not to subsidise these costs directly from the budget, but permitted the accumulation of duty losses within the state-owned companies of the energy sector. Payment arrears from distribution to production firms mounted. These hidden losses reached very high levels by the end

Figure 4.4. **Electricity prices in industry**



1. Data for 2004.

Source: IEA (2007), *Energy Prices and Taxes*.

StatLink http://dx.doi.org/10.1787/420483365463

of 2007, and started to distort total public deficit and debt figures. To stop these drifts, the government decided on an increase of 15% in the electricity price for industry (and 20% for households) at the end of 2007 and announced its intention to shift to an automatic, cost-based adjustment scheme of electricity prices in the future.[26]

Such a shift would amount to a highly welcome overhaul of energy pricing in Turkey. However, normalisation should not undermine the competitiveness of industry, as before 2003. Transition should be accompanied by efficiency-enhancing reforms in electricity production and distribution, and regulatory safeguards and effective market disciplines will be needed to keep costs and prices close to international benchmarks.

The new employment package

An *Employment Package* was enacted in May 2008, as part of a labour market reform programme entailing reform measures in eight areas. While not all intended measures have yet been finalised, this first package indicates that the authorities are committed to tackle the structural shortcomings of the labour regulatory environment:

i) Employers' social security contributions were reduced by 5 percentage points (over the present rate of 21.5 per cent of gross wages), applicable from October 2008. The government announced that further cuts may be introduced later, according to the fiscal situation and the observed effects of the initial cuts. This is in line with a recurrent OECD recommendation.[27] However, the government specified that employers' reduced contributions will be paid by the Treasury, creating an open-ended fiscal pledge which may make the future continuation of these cuts difficult. Nonetheless, combined with the personal income tax allowance granted to low-income workers in 2007, these cuts represent a non-negligible first step in the reduction of labour tax wedges in Turkey (Table 4.2 and Figure 4.5).

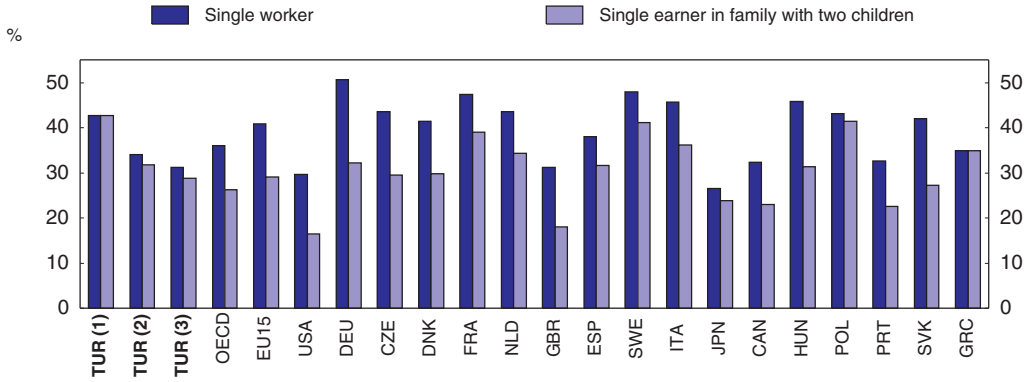
ii) The severance payment system, which is one of the most costly elements of legal employment in the formal sector has not been included in the May 2008 package. It is however high on the agenda, and will be considered together with restructuring plans in the Unemployment Insurance Fund. One option envisaged by the authorities is to create *individual severance accounts,* funded by regular monthly premia rather than through an unfunded accumulation of severance liabilities in enterprises – as of today. Transition to such a system would facilitate the mobility of workers, secure their rights, help set contribution and benefit levels according to actuarial balances, and assist with formalisation efforts.

Table 4.2. **Labour tax wedge before and after reforms**

	Labour tax wedge in 2006			Labour tax wedge in 2008 (after the introduction of the PIT allowance)			Expected labour tax wedge in 2008 (after the intended reduction of social contributions)		
	At average wage level (APW)	67% APW (%)	167% APW (%)	APW (%)	67% APW (%)	167% APW (%)	APW (%)	67% APW (%)	167% APW (%)
Single worker	42.76	41.89	44.6	40.28	38.18	43.11	37.71	35.53	40.67
Single earner in married couple	42.76	41.89	44.6	39.78	37.44	42.82	37.19	34.76	40.36
(with one child)	42.76	41.89	44.6	39.41	36.88	42.59	36.81	34.18	40.13
(with 2 children)	42.76	41.89	44.6	39.03	36.33	42.37	36.42	33.60	39.90
(with 3 children)	42.76	41.89	44.6	38.79	35.96	42.22	36.16	33.21	39.74

Source: Ministry of Finance calculations, 2008.

Figure 4.5. **Labour tax wedge for minimum wage earners before and after reforms**



1. Before reforms.
2. After the introduction of the minimum personal income allowance.
3. Expected level after the phasing in of the 5 percentage points reduction in employers'social security contributions.

Source: OECD (2006), *Taxing Wages* 2005-06.

StatLink http://dx.doi.org/10.1787/420506412424

iii) Compulsory hiring of a certain proportion of terror victims and former convicts has been phased out. Enterprises which employ more than 50 workers will continue to mandatorily hire 3% of handicapped workers. If enterprises employ more than 3% of handicapped workers the social security contributions for these workers will be paid by the Treasury.

iv) Unemployment benefits were increased by 12%. Eligibility conditions for unemployment compensation may be re-considered in the future in the light of developments in the actuarial balances of the Unemployment Insurance Fund.[28]

v) The Ministry of Labour made the provisions of the labour law independent of enterprise size, instead of the present rules entailing higher obligations for larger enterprises.

vi) The National Employment Service will develop active labour market policies to help reduce the mismatch between the skills on offer and on demand in the labour market. According to the new Law up to 30% of state contributions to the Unemployment Insurance Fund can be utilised for active labour market policies by the National Employment Service. First, short-term services centred on individual guidance to job seekers and short-term re-training programmes will be introduced.[29] Local labour market surveys investigating skill demands at provincial level will guide these activities. More comprehensive and longer-duration up-skilling programmes will be gradually developed.[30]

vii) Employers' social security contributions for young and female workers were reduced. The exemption covers the totality of employers' contributions in the first year of employment of eligible workers, 80% in their 2nd year, and moving down in steps until 20% in the 5th year.

viii) To promote employment in Southeast Anatolia, YTL (Turkish Lira) 1.3 billion from Unemployment Insurance Fund reserves, and YTL 1 billion from the privatisation proceeds of the Privatisation Fund will be transferred to the central government budget (nearing 0.3% of GDP). These funds will be used in employment-supporting investment

projects in the region. Furthermore, for 2009-12, 25% of the interest revenues of the Unemployment Insurance Fund and YTL 2.5 billion (updated by the GDP deflator for each year) of the privatisation proceeds of the Privatisation Fund will be earmarked, and utilised for the same purpose.

Two top priorities in facilitating the growth of the formal sector

The new measures introduced and envisaged by the government are welcome, because they directly address actual practical bottlenecks faced in the business sector and for employment creation. In particular, the 2008 *Employment Package* is important because it starts to address some of the most entrenched regulatory shortcomings in the economy.[31]

At the same time, these measures do not yet address all the key obstacles to the modernisation of the business sector and to legal job creation. Turkey still has an overall regulatory framework which is too costly and rigid in comparison to the best performing OECD economies. This creates heavy burdens for formal companies complying with the law, and continues to force lower productivity enterprises to operate in informality and semi-formality.

The resulting dual structure of the economy does not permit the higher productivity, modern firms to grow more rapidly and absorb a higher share of the labour resources of the economy, as was discussed in the previous *OECD Survey of Turkey*. Only such a shift can durably improve the competitive and productive performance of the aggregate economy. Overcoming this duality should for this reason be a centrepiece of Turkey's structural reforms.

On the basis of past OECD work, and other surveys of the business sector, two areas emerge as being particularly important for the more rapid growth of the higher productivity part of the economy:

i) streamlining labour market regulations to overcome the divide between *law-abiding but rigid* and *veryflexible but law-breaching* employment practices; and

ii) modernising *corporate finance markets* to help firms joining the formal sector to develop more rapidly their capital base, thereby enhancing their productivity and job creation capacity.

Streamlining labour market rules

In addition to the initiatives announced in the recent *Employment Package*, three areas appear in need of further measures:

Reforming the Labour Code

The Labour Code has been amended several times in the recent period, but Turkey continues to have one of the most rigid Codes of the OECD area. A recent OECD review identified Turkey as the member country having introduced the narrowest and the most superficial labour market reforms over the period 1995-2005.[32] Turkey's modern enterprises need a better adapted employment framework to develop their businesses in compliance with law and create higher-productivity jobs. Two areas are particularly important:[33]

i) Legal rules and prevailing judicial practices make the termination of permanent contracts subject to highly restrictive tests, and difficult in practice. They should be reformed as in other OECD countries, to make them compatible with the needs of a competitive economy, while at the same time offering workers adequate protection.

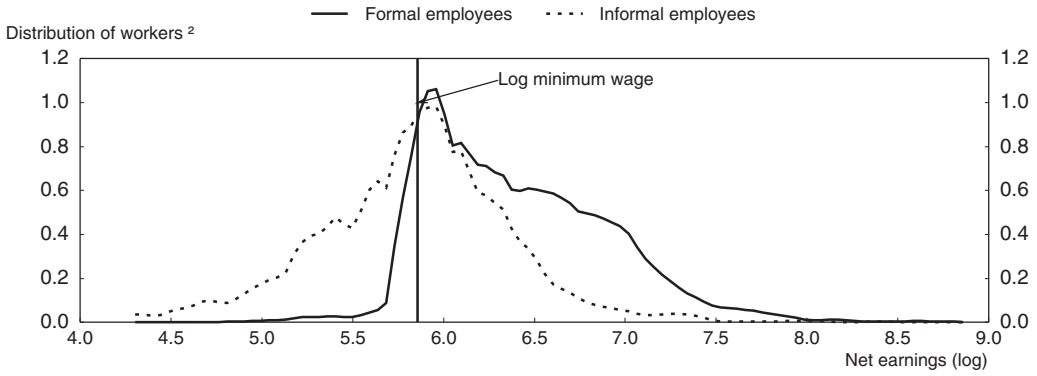
ii) Fixed-term contracts and agency and interim work continue to be discouraged. Their easing would permit additional job creation in activities requiring this type of work.

Reducing the employment costs of the low-skilled

Employer costs of the low-skilled remain very high in the formal sector, both in absolute and relative terms. Effective employment costs are lower in the informal sector (Figure 4.6). To free hiring opportunities of the low-skilled in formal, modern activities, legal employment costs should be significantly reduced, notably in the less-developed regions where weak human capital makes legal employment particularly difficult.[34] The reduction of employment costs can be achieved by limiting the nominal progression of the official minimum wage, and creating room for higher negotiated minimum wages at branch or regional level.

Figure 4.6. **The minimum wage limits labour demand in the formal sector**[1]

2005



1. Earnings distribution of full-time, non-farm employees (Kernel density functions).
2. Scaled density, the area under each curves is equal to one.

Source: OECD (2008), *OECD Employment Outlook*.

StatLink http://dx.doi.org/10.1787/420514112051

Continue to reduce mandatory social security contributions and upgrade social protection with negotiated and voluntary schemes

As discussed in the *2006 OECD Survey of Turkey*, the prevailing contribution and benefit rates of the mandatory social security system remain high in Turkey in international comparison, and with respect to the economy's productivity level and productivity distribution structure. Combined with a high minimum wage/average wage ratio, mandatory social contributions create strong incentives for informal employment both in the supply and demand sides of the labour market. The social security reform adopted in early 2008 restored the long-term financial balances of the pension system by tightening benefit parameters, but did not address the high level of mandatory contributions.

The announced reduction of employers' social security contributions as part of the 2008 employment package was a welcome step in the right direction. However, the envisaged funding mechanism of these reductions through off-setting subsidies from the public treasury creates *open-ended* fiscal costs and uncertainties as to the fiscal affordability of further reductions, as discussed in Chapter 2.

In these circumstances, reducing the scope of the mandatory social security programme to a more reasonable scale for the Turkish economy deserves consideration. Both the level of mandatory contributions and benefits can be kept at a lower level in the pension system – instead of being subsidised by the Treasury. The level of pension benefits can be enhanced through voluntary schemes, when employer firms have higher productivity and more resources to contribute, as discussed in the *OECD Survey of Turkey 2006* and in Chapter 2.

Accelerating the modernisation of corporate finance markets

Modern and efficient corporate finance is a key springboard for formal sector enterprises' developing their capital base, productivity and employment capacity. Firms operating in and joining the formal sector can open up the potential to achieve important cost reductions and competitiveness gains over the longer term, after, possibly, initially higher costs.

Corporate finance markets, including medium-to-long term bank loans, corporate debt securities, and private and listed equity sources are at present underdeveloped in Turkey. The share of total bank lending in GDP is not lower than in other middle-income countries, but a larger share of loans are directed to the household sector, and corporate loans have shorter maturity and higher costs.[35] Most recently large-size corporate borrowers could partly circumvent the limitations of the domestic market through direct borrowing from foreign sources.[36]

Corporate debt securities are practically non-existent, and much of the external financing in the business sector is secured through trade credits. Trade credits rely on informal and private information channels and are confined to relatively narrow groups of borrowers and lenders.[37] Despite the strong growth of stock market activity in the 2000s external equity funding of corporations through organised public markets and private investment channels continue to play a limited role (Box 4.5).

Three areas appear critical for the development of corporate finance markets:

Transition to Basel II rules for corporate lending

With the transition of banks to Basel II rules for corporate lending, audited financial accounts will become the basis for lending decisions and loan pricing. Banks are already equipped for the transition, but the majority of corporations do not appear fully prepared.[38] Bank loans have been extended until recently mainly on private (bilateral) information, rather than on the basis of formal financial accounts. Anticipated difficulties in the transition for corporations caused a postponement of the implementation of Basel II in Turkey, from 2008 to 2009. The exact magnitude of transition challenges in the corporate sector should be identified and areas where difficulties are acute can be addressed with accompanying measures.

Transition to the audited financial reporting requirements of the draft Commercial Code

The draft Commercial Code submitted to the parliament in 2006, after a lengthy preparation which took into account OECD experiences and best practices, prescribed that all companies should produce audited financial accounts according to international accounting standards. Corporations of all sizes were to be subject to these rules. The adoption of this draft Code met difficulties with the previous legislature, and was

Box 4.5. **The emerging role of the stock exchange as a funding source**

The Istanbul Stock Exchange (IMKB) has developed rapidly in the post-2001 period. Currently there are 320 firms listed, the majority of which have small capitalisations or a limited free float. Thirteen holding companies and their 8 affiliated banks account for about 40% of total stock market capitalisation. Among these, 11 holding companies are controlled by 11 leading families. A minority of the total capital of large and small corporations alike are listed in the stock exchange, and all listed firms are majority-owned and controlled. Several corporations issued *dual-class* shares, which lock in control with founding families, but additional issuance of dual-class shares is now banned by the Exchange.

A total of USD 255 billion of equity capital (nearly 50% of 2007 GDP) has been created since the establishment of IMKB through initial and secondary public offerings, but both IPOs and SPOs have become rather rare in the recent period. The bulk of stock market activity concerns secondary market transactions between investors. Of these, 70% in terms of outstanding positions are of foreign origin, with a large majority for global emerging market funds. Domestic institutional investors are very thinly developed and are practically absent from IMKB as investors.

IMKB quotes hardly any private *commercial papers* and *corporate bonds*. To date, crowding out by public securities hindered the development of markets for private debt securities. The bulk of transactions in Turkey's securities' markets still concern government bonds.

The recognised challenge in IMKB's taking a more important role in corporate funding in Turkey is to cultivate stronger investor confidence in the quality of corporate securities and better protect minority shareholders, for a larger population of enterprises. Recent efforts to improve corporate governance and financial transparency helped, but there is more room for progress.* Price/earnings ratios embody high risk premia. Efforts to introduce new listings, notably by start-ups and medium-sized firms via new market segments in recent years (the "New Economy" and "Secondary National" markets) have met with limited investor interest.

In recognition of and in response to these difficulties, the authorities recently envisaged to launch a new stock market for small-size companies (called Developing Enterprises Market). Instead of establishing a new stock exchange as initially envisaged, the plan was recently shifted to set up a new market within IMKB. This new platform would be more lightly regulated than the other markets within IMKB and permit the listing of a larger number of small-and-medium-sized enterprises. Although enterprise listings with corporate governance and financial transparency standards weaker than in the other markets within IMKB could meet with difficulties in attracting investor interest, the *primary dealership* and *regional transaction platform* procedures envisaged for the new market could help tackle this challenge.

More active debt and equity security markets for smaller-size companies are certainly desirable but appear as a medium-term objective in Turkey's present circumstances. The higher priority is making progress in the transparency and corporate governance of blue chip corporations, reducing risk premia, and strengthening domestic and international investor interest. Increasing the floated share of corporations listed in IMKB, and fostering the emergence of their commercial paper and corporate bond markets appear as the most crucial next steps for the development of securities markets.

* See: OECD, *Turkey's Corporate Governance: A Pilot Study*, 2006.

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postponed to the present one. To facilitate the transition, available avenues to minimise compliance costs for small firms could be explored, and the draft law includes provisions for this.[39] However, the real difficulty probably originates from the reluctance of the many informal and semi-formal firms to produce formally audited accounts that would amplify their tax and social security liabilities.[40] If this is confirmed as the main problem with the adoption of the new commercial code, authorities may wish to consider the introduction of time-limited tax arrangements to facilitate the transition.

Modernising the collateral registers and the collateral regime

Collateral available to secure borrowing is not documented and enforced satisfactorily at present. The real estate register (the cadastre) is not complete for land assets, and registers for movable assets remain regional (for vehicles) or incomplete (for machinery and equipment). The result is that small firms cannot easily pledge most of their assets, which limits their borrowing ability (under the old as well as the new Basel II lending rules). Collateral requirements for formal sources of credits also remain very high (about 200%), and personal guarantees are frequently required for corporate borrowing – further constraining borrowing ability. The enforcement of collateral rights also tends to fall short of standards in other emerging economies.[41]

Managing transition from informality to formality

In encouraging the transition from informality to formality, the government has to deal with the gap that entrepreneurs face between *paying no taxes in the informal sector* and *paying the effective tax rate in the formal sector*. Many semi-formal firms also face trade-offs between declaring a higher or lower share of their effective revenues, profits, and employment.[42] To overcome the "informality trap", transition policies need to smooth, to the extent possible, any abrupt tax and regulatory burdens which would arise from progress in formalisation and financial transparency. Authorities also need to ensure that transition-facilitating arrangements do not distort competition excessively, by penalising existing law-abiders at an undue extent.

The government announced that it is working on a "formalisation strategy" that will be finalised in the course of 2008. However this project, rather than dealing with the comprehensive set of structural reforms required for formalisation not to undermine the flexibility and entrepreneurial drive of the economy, will apparently focus more on the enforcement side of formalisation. Efforts were recently bolstered for stronger enforcement, by the Ministry of Finance for purposes of improving tax collection efficiency, and by the Ministry of Labour for more comprehensive worker registration and fuller enforcement of workplace health and safety rules.[43] An inclusive *Project to Fight the Unregistered Economy* (KADIM) was launched under the co-ordination of the Ministry of Labour, and with the participation of the Ministry of Finance, the Social Security Institution and other agencies. KADIM activities aim at thoroughly informing employers and employees on the disadvantages of informality and the benefits of registration. They were recently bolstered with national campaigns and field visits to enterprises.

In crafting an adequate path of action on the difficult tightrope between a *too constraining and output reducing* versus *too lax and competition distorting* formalisation policy, Turkish authorities may wish to draw lessons from a relevant recent Italian experience dealing with the same challenges (Box 4.6).

Box 4.6. **Lessons from Italy's "regularisation" campaign in the 2000s**

Italy is the high-income OECD country which probably has the largest informal and semi-formal business sector among other OECD countries.[1] Informality may have played a role in the entrepreneurial dynamism and flexibility of small-size Italian businesses, but it also raised serious competition distortions and generated considerable tax losses for public finances. After a lengthy preparation process, a "regularisation" strategy was adopted in early 2000s, embodied in a special law voted in 2001. The design and implementation of this registration campaign involved employers, unions and regional representatives.

Regional "committees for formalisation", including representatives from local economic chambers, tax offices, labour inspectorates, and trade unions were to devise local registration policies, which were to take into account local sectors' and enterprise categories' productivity and profitability level, and ability to cope with the burdens of registration. This approach raised administrative challenges, but also had important advantages in minimising output and employment losses in lower productivity activities.

A large variety of employment contracts were introduced (around 30), creating significant flexibility, but also introducing a somewhat chaotic structure in labour law. Incumbent employees of formal firms remained under their traditional legal protections. Such "grandfathering" was seen as unavoidable but the resulting fragmentation raised challenges.

It is reported that stronger enforcement of taxes, even at reduced rates, did put some exit pressure on marginal enterprises. Most SMEs, however, were estimated to have been given sufficient room to cope.

After two years of implementation of the new law, only 385 000 Italian workers were regularised, well below initial expectations. The main impact appears to have been to facilitate the registration of illegal immigrant workers from outside the EU, 700 000 of whom legalised their situation.

In 2007, under fiscal pressures, the government re-activated the policy of formalisation and succeeded in extracting considerable additional tax revenues from SMEs. However, this created political costs, contributing to the weakening of the government.

According to *ex post* assessments of Italy's regularisation experience by several of its architects and participants,[2] an agreement emerges that structural reforms supporting registration may not have gone far enough. Despite several sweeteners (tax arrangements) offered to registering firms, tax collection concerns appear to have taken gradually precedence over structural reforms. The *OECD Economic Survey of Italy 2007* hints that "*a high tax wedge (47% not counting the labour component of the company value-added tax, IRAP) and labour regulations Lower fiscal pressure is essential. Social charges on low skilled workers should be reduced to induce their participation*". One of the main participants to the 2000s' registration campaign also concluded that: "*The fight against underground economic activity and tax evasion must, together with the customary instruments of controls, become an element of a policy aimed at changing the structure of the Italian economy. However, in the face of the need for immediate revenue, the structural approach is shelved in favour of more or less vast amnesty schemes. Paradoxically, the conviction that there is a large pool of underground economic activity that can generate receipts for the state treasury in the short-term constitutes an obstacle to the real battle against the underground economy.*"[3] Other participants also hinted at limited progress in labour regulatory reforms as a major factor slowing down the regularisation process.

1. See: *OECD Economic Surveys of Italy*, 2005 and 2007. See also: G. Gobbi and R. Zizza, "Does the Underground Economy Hold Back Financial Deepening?", *Banca d'Italia Working Paper*, November 2007.
2. Testimonies were published in the special issue of the *Review of Economic Conditions in Italy* on "The Controversy Over the Underground Economy", January-April 2003.
3. I. Cipolletta (Chairman, UBS-Warburg), "The Illusions of the Underground Economy", *Review of Economic Conditions in Italy*, January-April 2003.

Summary of recommendations

The key recommendations stemming from this chapter are summarised in Box 4.7.

Box 4.7. **Policy recommendations: Enhancing competitiveness by fostering the growth of the formal sector**

Learning to live with real currency appreciation

Adapt social expectations to the new outlook of trend real currency appreciation (inflation accelerations and subsequent exchange-rate depreciations are not likely to continue to operate as the main competitiveness restoration mechanism of the Turkish economy).

Create public awareness that low-skilled employment in trade-exposed and trade-sheltered sectors alike will be more challenging than in the past.

Enhancing competitiveness through structural reforms

Build a general consensus that in Turkey's new circumstances, accelerating productivity gains, moderating wage growth and facilitating product innovations (to promote greater price differentiation) are the only sustainable avenues to enhance competitiveness.

Enhance these capacities of the Turkish economy by facilitating the growth of the formal sector, where access to global technologies, professional skills and investment capacities are much stronger.

Priorities for fostering the growth of the formal sector

Reforming labour market regulations

Align labour market regulations for both *permanent* and *temporary* contracts with OECD best practices.

Implement the announced reduction of employers' social security contribution rates by 5 percentage points before the end of 2008, and plan for additional cuts in following years. A possible medium-term target would be reducing employers' contributions (which currently amount to 22% of gross wages and will decline to 17% by the end of 2008) to below 10%.

Introduce a distinction between *mandatory public* and *complementary pension* schemes. Workers now in the formal sector could be automatically enrolled in the voluntary scheme with an option for opt-out (and into which the difference between the current (high) and future (low) social security taxes could be transferred).

Limit the growth of the national mandatory minimum wage. Aim at reducing the real minimum wage in regions where productivity is lower, and create room for negotiations for higher minimum wages in higher productivity regions and sectors.

Accelerate the modernisation of capital markets

Encourage external equity investments in enterprises by improving financial transparency.

Build on the draft Turkish Commercial Code which prescribes audited accounts for all firms, while minimising compliance costs for small firms.

Further improve corporate governance, including by strengthening the protection of small shareholders and enhancing the role of institutional investors.

Back corporate bank lending by achieving the intended transition to Basel II rules in 2009. Identify and address transition challenges with supportive policies.

Unify and modernise collateral registers at national level, and extend them to movable assets.

Box 4.7. **Policy recommendations: Enhancing competitiveness by fostering the growth of the formal sector** *(cont.)*

Other policies to facilitate doing business in the formal sector

Evaluate if restoring a normal VAT rate in textiles and clothing and using the additional tax revenues to fund targeted reductions in employers' social security contributions would not be a more productive measure to encourage formalisation, productivity and competitiveness in the textiles and clothing sector.

Review and simplify the various licensing rules, and minimise local government authorisations for doing business.

Reinforce the commercial justice system and reduce conflicts between different sources of law.

Minimise energy and other infrastructure costs by implementing EU directives for the liberalisation of these network industries.

Continue to upgrade the knowledge base of small entrepreneurs through technical and managerial up-skilling schemes.

Balancing the "enforcement" and "reform" legs of formalisation policy

Back the ongoing government efforts which aim at accelerating formalisation through stronger enforcement of rules with structural reforms and other incentives to make doing business in the formal sector less costly and more attractive.

Ensure that any transition arrangements from the informal to the formal sector for newly formalising firms do not distort competition excessively by unduly penalising the existing law-abiders.

Notes

1. Manufacturing Surveys have satisfactory scope and frequency despite distortions due to widespread informality.
2. And also in agriculture. The 2006 *OECD Survey of Turkey* included a special chapter on structural change in agriculture.
3. The detailed results of this investigation will be published in Yilmaz and Gönenç (2008).
4. Wage moderation reflected the flexibility of wage agreements in more sophisticated industries and in the upper segments of the labour market. This contrasts with the rigidity of wage costs in lower segments, mainly as a result of political decisions on mandatory minimum wages. See *OECD Economic Survey of Turkey*, 2006.
5. There were recent surveys of innovative firms in traditional sectors which succeeded to change their business pattern and enhance their position in international value-added chains. See, for example, Turkan and Yukseler (2006). See also Kapital (2007). Some examples: *i) Hey*: a large clothing firm which has become the icon of successful rehabilitation in Turkish clothing industry: it supplies EU markets with 3-4 week delivery times – a performance unmatched by Asian competitors; *ii) Soktas*: a worldwide supplier of top quality shirt fabrics, *iii)* Boydak (a large supplier of high-quality denim to top international blue jean brands), *iv)* Ferzan (a worldwide supplier of processed vegetable products to fast food chains).
6. Sectoral product prices in domestic markets remained generally above international prices in periods of currency depreciation and appreciation alike.
7. See also discussion in Chapter 1.
8. See, for a detailed review, Turkan, 2007.
9. The Ministry of Labour announced a new "registration" campaign, with 800 labour inspectors tracking informal workplaces across the country.
10. See for example contributions by TEPAV, Economic Policy Research Foundation.
11. *OECD Economic Survey of Turkey,* 2006.
12. Except in "high priority" provinces where they helped relocate activities from "non priority" provinces.

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13. See for example Saglam (2008).
14. World Bank (2007).
15. The Ministry of Industry, with a former Chairman of an industrial chamber representing small-and-medium sized enterprises as Minister, is a vocal advocate of this objective.
16. Start ups are offered two types of training. *General* management training is offered in KOSGEB's facilities on managerial and technical topics of general interest. *Specialised* training is provided by accredited public or private organisations. According to regions, between 70-90% of *general* education costs are subsidised and an equivalent of [euro] 4 000 per enterprise is available for *specialised* training.
17. Turkish OSBs and KSSs attract growing international interest. Their co-operative funding and governance structures between central and local governments and local industrial chambers are found particularly successful. These semi-public establishments avoided discouraging the settlement of less formal firms by refraining from taking over any regulatory enforcement roles.
18. In particular, their entitlement to generate their own electricity (*self-generation*), permitting them to generate cheaper electricity than available on the national market, was an important factor of attraction.
19. A number of them have quality control and certification laboratories and sectoral vocational schools.
20. See the special chapter on the modernisation of agriculture of the 2006 *OECD Economic Survey of Turkey*.
21. See Taymaz and Ozçelik (2004).
22. "Profilo'dan sonra Beko ve Vestel de zor durumda" (Following Profilo, Beko and Vestel are also facing challenges – Profilo, Beko and Vestel are the three main Turkish electronic firms), Referans, 27 December 2007.
23. Even when local car producers are part of worldwide brands, they fail increase local value-added if they cannot integrate more innovative functions. See "Otomotivci ara mali ithalatini azaltmak için maliye kapisinda" (Car producers apply to the Ministry of Finance for a reduction of input imports), Referans, 14 January 2001.
24. *Referans* (2008).
25. High electricity costs originated from excessively high sunk costs in hurried capacity investments realised in the 1990s, high system losses, and cross-subsidies from industrial to household users. See *OECD Economic Surveys of Turkey,* 2004 and 2006.
26. Turkey committed to apply the EU directives for electricity and gas market liberalisation, in principle according to the same time schedule as the EU members. However these plans had to be postponed. It is suggested that the next *OECD Economic Survey of Turkey* provides a detailed account of the liberalisation of energy markets in Turkey and their price implications.
27. *OECD Economic Survey of Turkey,* 2004 and 2006; and OECD, *Going for Growth,* 2006 and 2007.
28. At present, the completion of 600 days of contributions in the past three years and 120 days of continuous contributions until unemployment are required for eligibility. As a result of these relatively tight requirements a large surplus has been accumulated in the Unemployment Insurance Fund. See *OECD Employment Outlook 2008,* Chapter 2.
29. The number of participants to such programmes was less than 600 in 2005, and grew to 9 300 in 2007.
30. A Professional Proficiency Institution was created under the authority of the National Employment Service, to test and certify professional skills, and to orient the curricula of vocational schools and private training organisations.
31. *OECD Economic Survey of Turkey*, 2006.
32. With the exception of Iceland. *OECD Job Strategy Re-assessment, OECD Employment Outlook*, 2006.
33. An informative overview is available in Alpagut (2008).
34. The Mayor of the large-size Eastern town of Erzurum recently declared that large numbers of local workers earn presently about YTL 200 ([euro] 100) per month in informal employment, without any social protection, against legal minimum gross wages of YTL 740, and net wages of YTL 480. According to the Mayor, a regional minimum wage of YTL 250 would provide workers with higher net actual incomes, associated with social protection, without being unaffordable for employers. See "Gundem Farki" ("Another Agenda"), Sabah, 15 April 2008.

35. The average maturity of corporate loans in Turkey was of about 15 months in 2005, against 30 to 40 months in Poland, Hungary and Czech Republic. *Nominal* corporate interest rates were above 20% in Turkey on the same year, versus 10-14%, for longer maturity loans, in the same eastern European countries. See World Bank, 2007.

36. According to a 2005 *Survey*, the share of foreign currency loans in total corporate borrowing averaged 14% for non-exporters and 40% for exporters. The proportion was higher at 20% for large non-exporting firms and 48% for large exporting firms. See World Bank, 2007. According to a monography on the borrowing behaviour of 16 of Turkey's very large non-financial corporations, foreign currency loans had reached 62% of the total outstanding borrowing of these corporations at the end of 2006. According to this study, these 16 firms counted for about 70% of the total foreign borrowing of the corporate financial sector in Turkey. H. Atasoy, "Foreign Borrowing of Turkey's Largest Non-Financial Corporations", mimeo, March 2008.

37. At present, the official accounts of non-stock market listed firms, which represent the vast majority in the corporate sector, frequently understate their actual sales, incomes, profits and wage bills, as a way to minimise their tax and social security obligations. Proprietary information governing trade credits are not based on formal financial data.

38. A comprehensive recent report on Turkey's transition to Basel II stated: "The weight of informality in Turkish SMEs is a major challenge for credit rating. It is a concern that benefits of informality in terms of tax savings are high enough to discourage firms from achieving the financial transparency needed for credit evaluation and rating. If financial transparency is not achieved, bank credits available for SMEs may shrink and credit costs could increase". See Aras (2007).

39. The draft law prescribes that Turkish National Accounting Board is entitled to adopt simplified reporting standards for SMEs, provided that these are compatible with international standards of small company accounting.

40. Another stumbling block has been opposition from the auditing profession which may not be fully equipped to cope with international accounting standards and which was possibly concerned about prospects of massive losses of clients to the "big four".

41. According to the World Bank's latest *Business Environment Survey* in 2007, the cost of bankruptcy proceedings in Turkey is double the average for the OECD, at about 15% of per capita GDP. It is also higher than the average for Eastern Europe and against a number of comparator countries such as Portugal, Bulgaria and Romania. The recovery rate through bankruptcy proceedings is also very low in Turkey. It is only 20 cents to the dollar, compared to an OECD average of 74 cents to the dollar, and 70 cents to the dollar in Portugal and Spain. Turkey's Legal Rights Index estimated by the World Bank (which measures the degree to which a country's collateral and bankruptcy laws facilitate lending, and ranges from 0-10) scores 3.0, significantly lower than the OECD average of 6.4. The Czech Republic, Hungary, Bulgaria, Romania and Spain have all scores of 6.0 or above.

42. The present gap between the expected and actual corporate tax revenues hints at the magnitude of tax evasion through revenue underreporting. The corporate income tax yields about 1.6% of GDP in Turkey, while the equivalent amount is 3.4% in OECD countries where corporate income tax rates are broadly comparable.

43. The Ministry of Labour announced in early 2008 that it was steeping-up its enforcement activities with an important increase in the number of labour inspectors mobilised in the the field. See also footnote 9 above.

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ARIP	Agricultural Reform Implementation Project
BEER	Behavioural equilibrium exchange rate
BOO	Build-Own-Operate
BOT	Build-Operate-Transfer
CBRT	Central Bank of the Republic of Turkey
CPI	Consumer Price Index
FDI	Foreign direct investment
FGLS	Feasible generalised least squares
GFS	Government Finance Statistics
IMKB	The Istanbul Stock Exchange
KADEM	Project to Fight the Unregistered Economy
KOSGEB	Agency for the Development of Small-and-Medium Sized Enterprises
KSS	Small Industrial Sites
LTU	Large Taxpayer Unit
MARA	Ministry of Agriculture and Rural Development
MPC	Monetary Policy Committee
OSB	Organised Industrial Zones
PEP	Pre-Accession Economic Programme 2007
PFDML	Public Financing and Debt Management
PFMCL	Public Financial Management and Control
PISA	Programme for International Student Assessment
PIT	Personal income tax
PPI	Producer price index
PPP	Public-Private Partnerships
PSC	Public Sector Comparator
RCA	Revealed Comparative Advantage indicators
SDD	Strategic Development Departments
SDP	Strategic Development Presidencies
SEEs	State Economic Enterprises
SME	Small and Medium Sized Enterprise
SPO	State Planning Organisation
TCA	Turkish Court of Accounts
TTGV	Turkish Technology Development Foundation
TÜBİTAK	Scientific and Technological Research Council of Turkey
TurkDEX	Turkish Derivatives Exchange
UIP	Uncovered interest rate parity
VAR	Vector auto-regression
VAT	Value added tax
YOIK	Council for Improving the Investment Environment

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