POLICY BRIEF

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Summary

Turkey is at a crossroads. After hitting the most severe crisis of its recent history in 2000-2001, the economy bounced back and is now among the fastest growing economies in the OECD. A new institutional framework for monetary and fiscal policies as well as for product, labour and financial markets, infrastructure industries, and agricultural support opened a window of opportunity to escape from the three traps of low confidence, weak governance and high informality which underpinned the boom and bust cycle of the past and to embark durably on a higher growth path. Success will depend on fully implementing and completing the new policy framework.

Strong growth, sharply falling inflation, large productivity gains and relatively low job creation characterise the ongoing recovery. Yet it is too early to determine at this point to what extent the rebound reflects a transition to a higher medium term growth path. Tight monetary and fiscal policies increased confidence, reduced risk premia and thereby fostered growth; however, the current account deficit has widened. Macroeconomic policy should continue to be based on a high primary budget surplus to improve debt sustainability, and tight monetary conditions to keep disinflation on a steep downward path. Given the strength of the economy and the risk of a further widening of the current balance deficit, the authorities should resist any temptation to loosen the fiscal stance and use additional revenues from higher growth for debt reduction. Monetary policy should remain focused on the requirements of continuing disinflation and smoothing out erratic exchange rate fluctuations.

The quality of fiscal consolidation needs to be improved by reorienting expenditures to priority and growth enhancing areas. A new public expenditure management system has been introduced, based on functional multi-year budgeting and integrated general government accounting. It should be fully implemented by rapidly diffusing the necessary technical know-how in line ministries, and by putting in place an effective audit infrastructure which should help build credibility for the new system and diffuse best expenditure management practices. In the core public services which are particularly critical for growth, such as justice, education and infrastructure services, more

This Policy Brief presents the assessment and recommendations of the 2004 OECD Economic Survey of Turkey. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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proactive policies to rapidly improve service quality are required. As a response to entrenched cost-inefficiencies and low responsiveness to user and local needs in public administration, an ambitious fiscal decentralisation is now in the pipeline, transferring large service and spending responsibilities to sub-central layers of government. The reform will also fully separate public funding from private provision of services, and new regional development agencies will co-ordinate infrastructure enhancement and private-sector based economic development initiatives. The principles of these reforms are in line with OECD best practices, but implementation risks loom concerning fiscal drift, diseconomies of scale and quality shortcomings in decentralised services. The authorities need to ensure that fiscal discipline, cost-efficiency and service quality are guaranteed.

The business environment has improved and exhibits many strengths. However, a major problem is the significant extent of unregistered activities, which account for more than 50 per cent of total employment and lead to a narrowing of the tax base. A strategy based on enforcement and economic incentives is needed to reduce the size of the informal sector. This should include less onerous regulations in product and labour markets and shifting the burden of tax and social security charges away from labour. Privatisation should be advanced in order to increase economic efficiency. It would also help to attract FDI inflows. The bank restructuring following the 2001 crisis improved banking regulation and supervision significantly and there are early signs of improving credit funding for investment. However, ongoing reforms of corporate governance structures should be pursued in order to further improve the integrity of the banking system, and the privatisation of public banks would be an important step in that direction. Despite liberalisation efforts in infrastructure industries, competition and private investment in electricity, natural gas and parts of telecommunications remain underdeveloped and services are offered at high costs, especially for business users. Independent sectoral regulators and competition authorities should be fully operational in enforcing competition and adequate rules for price formation and market entry in those industries where monopolistic incumbents prevail.

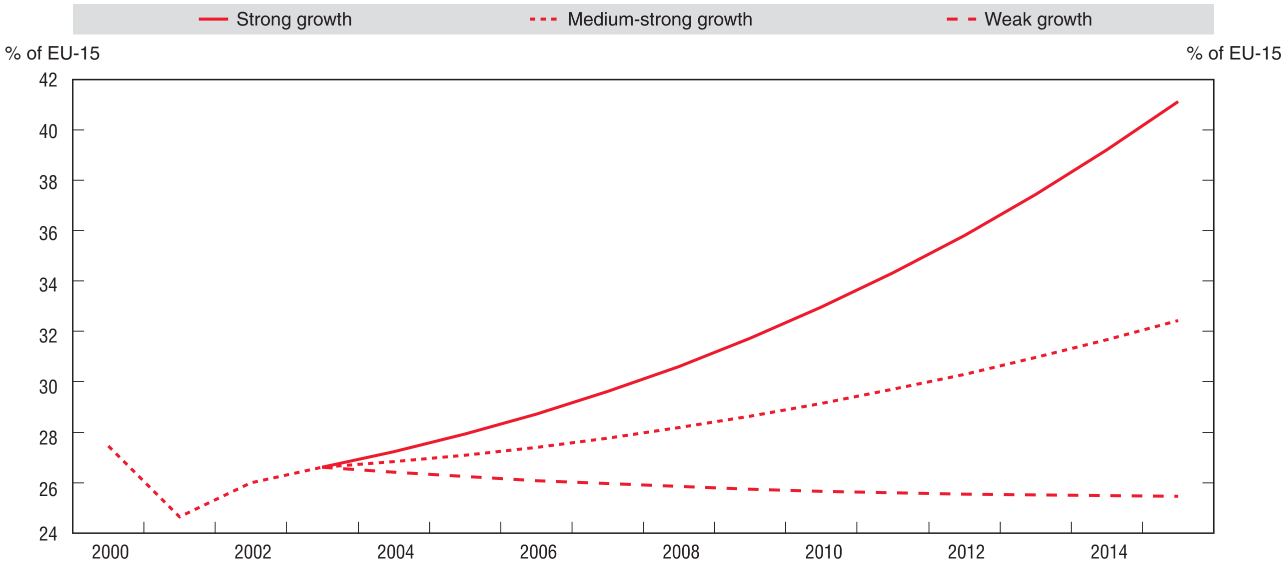
For Turkey to truly establish a new “economic regime” for growth based on macroeconomic and structural policy renewal, it is of crucial importance that confidence in government policies remains intact. So far, the convergence with the EU acquis, and the close co-operation with the IMF and the World Bank have contributed critically to the momentum of policies. The recent recommendation by the EU commission to start EU accession negotiations – if confirmed by the European Council in December – promises to strengthen the international anchors and could underpin Turkey’s shift to a new economic regime.

Is Turkey at a crossroads?

After hitting the most severe crisis of its recent history in 2000-01, the Turkish economy bounced back and is now among the fastest growing economies in the OECD. At the same time, the inflation rate has declined sharply and could fall to a single digit annual rate in 2005, for the first time in three decades. A new

Turkey's income level relative to the EU-15 under alternative growth scenarios

Per capita GDP, in purchasing power parities



institutional framework for monetary and fiscal policies as well as for product, labour and financial markets, infrastructure industries and agricultural support has opened a window of opportunity to escape from the boom and bust cycle of the past and embark durably on a path of higher growth and stronger employment. But seizing this opportunity requires fully implementing the new policy framework and further advancing the reform process. So far, the convergence with the EU *acquis*, and the close co-operation with the IMF and the World Bank have contributed critically to the momentum of policies. The recent recommendation by the EU commission to start EU accession negotiations – if confirmed by the European Council in December – promises to strengthen the international anchors and could underpin Turkey's shift to a stronger growth path.

After slumping by 7½ per cent in 2001, GDP recovered by around 8 and 6 per cent respectively in 2002 and 2003 and should rise by more than 8 per cent in 2004, exceeding government targets. It is driven by strong productivity gains and by robust private consumption, investment and exports, and has not been hindered by cuts in government consumption and investment. Tight macroeconomic policies, based on a high primary surplus and on strict monetary conditions which have kept inflation on a steep downward path, have significantly improved confidence and have proved to be expansionary. However, imports are growing faster than exports and the current account deficit could exceed 4 per cent of GDP in 2004; should foreign direct investment inflows remain weak, the deficit will be funded almost entirely by additional foreign debt which could raise concerns about its sustainability. Given the strength of the economy and the risk of a further widening of the current balance deficit, the government should resist any temptation to loosen the fiscal stance and aim at devoting additional revenue gains from stronger growth to debt reduction.

Output growth has led to little improvement in the labour market in aggregate, as job losses from ongoing restructuring were only very partly offset by job creation in new activities. Employment thus remains subdued in spite of its most recent improvement. The unemployment rate, at more than 9 per cent by mid-2004, was 3 percentage points above its 2000 level, and has reached almost 13 per cent in urban areas and 17 per cent for youths. In addition, labour force participation declined as many job-seekers became discouraged. Employment growth is expected to pick up somewhat as the recovery continues, but high structural unemployment and low labour force participation will remain key policy issues. Indeed, improving labour market conditions is urgent as continuously high unemployment could undermine the social and political support for reforms.

What structural traps does Turkey need to avoid?

Only strong and sustained growth together with structural reforms can help absorb the growing working age population into employment. Indeed, Turkey has an enormous potential for catching-up and job creation. The employment rate, at 46 per cent of the working age population, remains the lowest in the OECD area and labour productivity is currently around 35 per cent of the OECD average. On the basis of favourable assumptions of progressive convergence with the productivity and labour utilisation performance of the southern and central European countries, it is estimated that Turkey could grow at a trend rate above 7 per cent per year. In the past, Turkey could not seize this catch-up potential because it was caught in a vicious circle characterised by three traps:

- Low confidence in political and macroeconomic stability together with high government deficits and debt levels led to very high real interest rates, bouts of depreciation and inflation (a *confidence trap*).
- Shortcomings in core public services and institutions with mismatches in employment, wages, resources and duties undermined the quality of services and the efficiency of enforcement in the public sector (a *governance trap*).
- This adverse environment incited private businesses to shift more activities to the informal sector while, with a narrowing of the tax base, an increasing burden was imposed on firms that stayed in the formal sector (an *informality trap*).

Addressing these problems would make it possible for Turkey to enter into a virtuous circle of improved confidence, strengthened governance and increased formalisation that could underpin a sustained period of strong growth.

The reform agenda following the 2000-01 crisis, based on the National Convergence Programme to the EU *acquis* and on the Stand-By Arrangement with the IMF, and later reinforced by the Urgent Action Plan of the current government, has indeed aimed to address these problems. This agenda includes ambitious macro-stabilisation and institutional reforms and has been endorsed by two successive governments. The new policies are perceived as pre-requisites for the possible opening of accession negotiations with the EU and enjoy remarkable public support. Ongoing efforts to overhaul *the macroeconomic policy framework*, to strengthen the *key public institutions and services*, and to fully establish an *open and business-friendly environment* amount to building a new "regime" for economic growth. They have a potential to durably increase the *confidence* of domestic and international investors, enhance *public* *governance* and help the *business sector* to increase investment and productivity. Turkey's success in implementing and further developing this ambitious reform agenda will determine its ability to shift to a stronger, sustainable and job-rich growth path. Political stability is supporting this process. If micro-and macroeconomic reforms result in stronger growth, additional resources will become available to pursue social and environmental objectives. If the public perceives that social and environmental dimensions of sustainable development are not left behind but form an integral part of the reform agenda, support for pro-growth initiatives will strengthen.

The establishment of the new macroeconomic settings was of key importance for improving confidence. It started in response to the 2000-01 crisis and has concerned fundamental changes in both monetary and fiscal policy-making. On the *monetary side*, the Central Bank became independent from the government in April 2001, with an explicit price stability objective, and is no longer allowed to lend to the Treasury. While interest and exchange rates continue to be heavily influenced by fiscal policies due to the large public sector borrowing requirements, the Central Bank has been successful in building up credibility over time and is increasingly shaping inflation and interest rate expectations. The process of disinflation has been impressive with the inflation rate declining from 54 per cent in 2001 to 25 per cent in 2003 and to 12 per cent in the first half of 2004. The Secretariat estimates that the inflation rate will continue to decline to 8-9 per cent in 2005. For the first time in three decades Turkey would then have attained single-digit annual inflation. This assumes, however, that monetary and fiscal policies remain on track and that there are no headwinds from exchange rate developments. Both fiscal and exchange rate developments are interrelated; with the high government debt, any loss in confidence would increase interest rates and government net interest payments and raise concerns about fiscal sustainability, thereby triggering a depreciation of the Turkish Lira and an increase in import prices. This would make it difficult for the Central Bank to control inflation. However, with ongoing progress in fiscal consolidation and disinflation, financial market confidence should continue to strengthen so that the *monetary authorities could then gradually reduce interest rates further to improve investment conditions*. Moreover, after having achieved a good track record in meeting end-of-year inflation targets, *the monetary authorities should eventually move from the current* "*quasi inflation targeting*" *to a formal targeting framework, which would entail increased transparency and visibility, and hence further strengthen their commitment to achieving price stability.* In parallel, *the Central Bank should continue to smooth temporary imbalances of foreign currency supply and demand in order to avoid sharp exchange rate fluctuations with their potentially adverse impacts on the economy*.

On the *fiscal side*, the post-crisis agreement between the government and the IMF on an ambitious primary surplus target of 6.5 per cent of GNP has marked a break from the past and the success in broadly meeting this target has played a key role for macroeconomic stabilisation. The fiscal stance is now more closely managed, as most off-budget funds have been phased out and quasi-fiscal activities are much harder to undertake without corresponding budget appropriations. Nevertheless the Treasury's borrowing requirements and interest payments remain very high. *It is therefore essential to continue with strict fiscal consolidation and the generation of sizeable primary surpluses to foster trust in the government's new fiscal prudence and further reduce risk premia and interest rates over time.* In this context, *the new general government accounting system should be fully and swiftly implemented and integrated with national accounts. The government should continue to stick to existing international policy anchors, such as the close collaboration with the IMF, in order to add credibility to its fiscal policy objectives, to maintain and strengthen investor confidence, and to reduce interest payments on sovereign debt.*

Has the sustainability of public debt improved?

The level and growth rate of public debt became the primary source of macroeconomic vulnerability in Turkey following the crisis, with a public net debt to GNP ratio around 90 per cent in 2001 and concerns in domestic and international markets about its sustainability. The debt stock's short maturity and the large share of foreign-currency linked securities implied particularly high rates of rollover on domestic and international markets, increasing the vulnerability to interest rate and currency rate shocks. Although Turkey has made remarkable progress in restoring debt sustainability with high primary surpluses, lower borrowing costs, currency appreciation and high growth – which all helped reduce the public net debt to GNP ratio to about 70 per cent at the end of 2003 – risk factors remain, albeit to a lesser extent. Any rise in risk premia not only increases the government's current borrowing costs, but immediately reflects on the financing costs of the large stock of liabilities. The latter easily increase or decrease by several percentage points of GNP in response to fluctuations in risk premia. This exposure to market sentiment makes fostering confidence and reducing risk premia particularly important. Indeed, political tension, even that arising from non-economic issues, has a major impact on markets. As a result, maintaining today's welcome political consensus in support of the reform agenda is very important. *Improvements in communication policies* *could in this context play a role, in particular stressing the widely shared commitment to the reform agenda.* The recent introduction of a more transparent debt management and reporting system will also contribute to better market information and reduce risk perceptions. *This reporting system should be fully applied to all general government liabilities and non-guaranteed borrowings of sub-central governments and other public sector entities.*

While the speed of fiscal consolidation is on track, the "quality of consolidation" has still to be improved. Since a large part of spending is "mandatory" and therefore politically difficult to curb in areas such as public wages and social security transfers, cuts had to be effected elsewhere on an *ad hoc* basis, including in important public services and infrastructure investment. As total non-interest spending could be reduced only slightly as a share of GDP because of pressures from mandatory items, the bulk of consolidation came from tax increases effected on an *ad hoc* basis – and with limited regard for the overall structure and incentive implications of the tax system. Many "temporary" taxes introduced for short term fiscal consolidation also tended to become entrenched. The authorities have now initiated an assessment of the existing tax policy and tax collection procedures, have launched a simplification of corporate and indirect taxes, and are projecting an important overhaul of the tax administration system along functional lines. *They should continue to improve the quality of spending so that key public services and infrastructures are no longer crowded out and public resources are allocated according to economic and social priorities.*

Public spending has not been managed in the past according to clear policy objectives and there has been no comprehensive accounting framework to measure actual costs and outcomes. But reforms are now under way. The Public Financial Management and Control Law of 2003 brings Turkish budgetary practices closer to international standards. It integrates all extra-budgetary and revolving funds in the budget, requires that functional areas are identified with their performance targets, and legislates a rolling three-year budget framework. This system will become operational with the 2006 budget and will pose implementation challenges. *The authorities should rapidly phase-in the specific technical training needed for its application in line ministries; adapt the public personnel regime to permit adjustments in government employment according to policy objectives; and establish the necessary conditions for effective auditing which should play a critical role in the credibility and performance of the new system*. Since public expenditures and government employment are areas traditionally suffering from suspicions of favouritism, *the authorities should make sure that the highest degree of transparency is applied during the implementation process*.

In spite of a favourable demographic structure, the low rate of registration of workers, the underreporting of their incomes and drifts in spending are causing growing imbalances in the social security system with an expected deficit of 4 per cent of GDP in 2004. Important parametric changes legislated in the pay-as-you-go retirement system in 1999 increased the minimum retirement age for men and women to respectively 60 and 58, while no such minimum age existed before and workers completing 25 years of service could retire in their mid-40s. Yet the system's fiscal balance will only improve gradually because of the inertia of grandfathered rights. *Authorities should further increase the retirement age and implement the envisaged unification of the three components of the system* (for wage earners, civil servants and self-employees), which would reduce the administrative costs and increase the efficiency of services. The government is also working on a thorough reform of the health system, based on universal health insurance and a full separation of the funding and provision of services. International experience and Turkey's recent difficulties with containing public health spending – notably pharmaceutical costs – call for a careful design of the new system to avoid new spending drifts. *The future costs of introducing universal insurance should be carefully assessed, and the health care package needs to be carefully designed to provide essential services of good quality while containing costs.*

What are the expected benefits and risks of decentralisation reforms?

Turkey's highly centralised public administration has been criticised as being not adequately responsive to user and local needs and creating cost-inefficiencies. The government decided to introduce an ambitious decentralisation reform transferring major spending powers to special provincial administrations, metropolitan municipalities and municipalities. Regional Development Agencies (RDAs) will also be formed in the 26 newly created regions, to co-ordinate regional infrastructure projects and lead local development initiatives. These reforms have the potential to better tailor public services to user and local needs but they also involve important risks that should be contained. Given the small size and limited human capital of many municipalities, diseconomies of scale may also be created. *Amalgamations and service unions between municipalities should be encouraged to exploit scale advantages*. The most important risk is, however, that the "tide" of decentralisation leads to spending drifts at the local level and a weakening of the budget constraint. *It is therefore of crucial importance to fully apply the new fiscal and debt management framework to sub-central entities in order to limit their overall borrowing and prevent off-budget and quasi-fiscal spending*.

In the past, serious gaps and deficiencies accumulated in core public services of justice, education, health, rural development and infrastructure planning and management, contributing to the governance trap for economic growth. The severity of these shortcomings is largely recognised and the government sees the introduction of functional budgeting as an essential technique to monitor and target the quality of services. Given the unavoidable delays in the full introduction of this new technique in line ministries, *the government may wish to directly assess existing service quality, coverage and objectives in the most important core service areas.* In order to focus attention at the highest government level and address the functional and fiscal aspects in an integrated manner, the approach utilised for the elaboration of the social security white paper is recommended. The paper evaluates the present situation and reform options through close co-operation between central economic agencies and line ministries and has been made available for public comment. *The government should request similar assessments on justice, education, infrastructure development and rural development services. New policy initiatives should, wherever possible, create room for competition and private provision of services, under regulatory safeguards ensuring service quality and non-discrimination among users.*

The business environment in Turkey was in the past characterised by high administrative burdens and uneven application and enforcement of requirements across firms. Important differences remain between formal and informal sector enterprises. Product, capital and labour market reforms have recently been launched with the aim of streamlining regulations and providing the business sector with a more level playing field. These efforts have started to provide companies with more transparent and predictable framework conditions, as well as more supportive physical, technical and legal infrastructures. *The authorities should continue the regulatory reform process in order to fully establish business friendly administrative practices* and to make it possible for firms to exploit their entire potential for productivity enhancement and employment creation.

The bank restructuring following the 2001-crisis improved banking regulation and supervision significantly and there are already signs of improving credit funding for investment. With the recovery in the economy, postponed consumption is being realised and with declining government borrowing requirements banks turned more towards the consumer credit market. At the same time, sharply falling nominal interest rates fostered demand for credits. As a result, household indebtedness has increased markedly. The authorities are confident that recent reforms have put in place adequate institutional safeguards to prevent any systemic risks in the financial sector, including those arising from consumer loans. Nevertheless, conditions should be improved for channelling more savings to private investment. *Reforms of corporate governance structures* under way in banks have the potential to improve the integrity of the financial system and *need to be carried through without deviation*. Although draft legislation addresses many corporate governance issues in the banking sector, *adjustments in the ownership of banks, including through privatisation of public banks, would make them less vulnerable to external influences.* In parallel, *the government should encourage long-term equity investment and public listings on the Istanbul stock market* in order to foster transparency and expose companies to market discipline.

How to reduce the very large extent of the informal sector?

The large extent of informality is a major policy concern. The informal sector employs more than half of all workers. High labour taxes, in particular social security charges, and stringent regulations constitute barriers to becoming formal which trap firms and workers in the informal economy, where they are deprived of access to public and banking services and cannot reap benefits from economies of scale. Given the large negative effects of informality on fiscal balances, tax wedges and productivity growth and the complexity of the informality phenomenon, an integrated government strategy is required to reduce it. The authorities already envisage strengthening enforcement through a tax administration reform. While effective application of existing laws and regulations is doubtless of importance, *the government should consider complementing enforcement by improving the economic incentives for formalisation*. The burden is particularly heavy for firms that employ large numbers of workers at minimum wages, such as those operating in regions of high underemployment. The new Labour Code adopted in 2003 has eased the burden of regulations on temporary and part-time employment. These reforms are welcome, but further action in the labour market is indispensable in order to reduce the labour tax wedges. One important element in an overall strategy to reduce informality and tax evasion could be to significantly reduce the social security contribution burden on wages. Indeed, Turkey's labour tax wedges are among the most substantial in the OECD. *The authorities might, therefore, consider to fund part of the social security charges on labour through other taxes and efficiency gains* (*e.g*. if half of the social security charges would be cut additional revenues of about 2 per cent of GDP would be needed without considering any second-round effects). In addition, *improvements in the conditions of financing of business investment by banks (notably via cuts in financial transaction taxes) would make formalisation more attractive.The supply of* *high-quality public services for small-scale firms, in order to facilitate their technological modernisation and access to international markets, would also provide a pull towards formalisation.*

To stimulate demand for low-skilled labour in general, the authorities should slow down the growth of minimum wages and reverse the sharp increase in the minimum wage relative to the average wage. Furthermore, they should regionally differentiate the minimum wages, in order to adjust them to differences in the costs of living in different parts of the country and to foster job creation in the poor, high-underemployment areas. As the reduction of the relative minimum wage will also reduce the tax base of those employees who are declared at the minimum wage but earn more, it should be accompanied by strengthened enforcement, particularly in sectors and among smaller firms where such under-reporting is most prevalent.

What to expect from privatisations and FDI?

Infrastructure services have for a long time been offered at comparatively high costs, particularly for business users. One major reason for this poor performance is that competition and private investment in electricity, natural gas, air transportation and parts of telecommunications have remained underdeveloped. In response to these problems, liberalisation reforms in accordance with EU rules have been launched since 2001. Some tangible benefits from increased competition have already become apparent, with real fares in air transportation declining by 60 per cent. However, in other infrastructure industries, competition-enhancing rules are not always sufficiently well enforced and in several cases the scope of and the funding sources for public service obligations, notably concerning supply to households and less developed regions, need to be clarified. A step in the right direction is recent legislation which prohibits cross-subsidisation in state-owned enterprises. A further crucial prerequisite for achieving a successful involvement of the private sector will be the phased introduction of a cost-based tariff structure, which would have the added benefit of reducing the rate of growth of greenhouse gas emissions. *The authorities should* address these problems by *providing transparent funding sources for well specified public service obligations rather than relying on cross-subsidies within incumbent firms.* Moreover, *independent sectoral regulators and competition authorities should co-operate to fully implement the existing market rules and facilitate new entries into the monopolistic or oligopolistic parts of infrastructure industries.*

Inflows of foreign direct investment (FDI) have been paltry, amounting to less than 1 per cent of GDP in recent years. The streamlining of procedures in the 2003 Law on FDI is an important step to improve the attractiveness of Turkey for foreign investors. *These reforms should be backed by policies to overcome implementation difficulties. The original approach of identifying problem areas in co-operation with the independent Investor Advisory Council has proved productive and should be continued. The privatisation of public banks and large industrial and network service firms should be an occasion to attract highly-performing international operators to Turkey*. Besides generating FDI inflows, privatisation has the potential to significantly improve the efficiency of the economy. *Any remaining legal and judicial obstacles to smooth privatisation should be cleared in order to encourage international investments*.

Even though more than 30 per cent of the labour force is employed in agriculture, this sector contributes only 12 per cent to Turkey's GDP, indicating very low productivity. Many farmers, among whom illiteracy is high, limiting access to modern agricultural know-how and technology, still rely on traditional production methods. The recent agricultural policy reforms have started to replace input and production-linked subsidies by direct income support payments, which will expose farmers more directly to domestic and international market competition and thereby improve production efficiency. Deficiency payments for some products and livestock subsidies are still applied. Turkey has very favourable natural conditions to expand its output of labour-intensive, high value-added agricultural produce, such as fruit and vegetables, and could increase its exports of these products, particularly if there is greater opening of foreign markets. However, in order to realise this potential, *an upgrade of the training and advisory services in agriculture is crucial to support farmers in the new, more market-oriented environment with advice on appropriate cropping patterns, new farming technologies, and the improvement of marketing practices*. *Where the overall supply of irrigation water is limited, realistic pricing is necessary to contain demand and ensure that the resource is used efficiently. Non-farm rural activities also deserve to be promoted as alternative employment and income sources*. *Foreign direct investment could play an important role in diffusing new technologies in rural areas and should not be impeded.*

For further information

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