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OECD ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of Turkey, 2006

oecd Observer

Summary

Substantial progress in macroeconomic stabilisation and institutional reform has laid a foundation for strong GDP growth. However, the recent inflation shock and turmoil in the financial markets highlight Turkey's on-going vulnerabilities. A further comprehensive programme of structural reform would increase productivity growth, expand the formal sector of the economy and consolidate macroeconomic stability.

Managing macroeconomic risks

The main macroeconomic priority is to consolidate the progress already made.

In the area of fiscal policy, the Government should follow through with its announced intention to complement the annual primary fiscal balance target with an expenditure cap. This move would allow the government to register a primary surplus above the target in economic upswings. The Government should also further improve budgetary transparency and the quality of institutions and processes and adhere to National Accounting Standards.

In the area of monetary policy, the Central Bank needs to restore inflation to the desired path and the Banking Regulation and Supervisory Authority should strengthen its corporate governance and human resource management.

Improving framework conditions for the formal sector

Because of the high burden of regulations, a large number of firms and individuals are pushed into the informal sector, where productivity is low and working conditions are poor. In order to overcome this impediment to growth, the Government needs to:

This Policy Brief presents the assessment and recommendations of the 2006 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.

- *Improve conditions for job creation in the formal sector* by cutting social security contribution rates, adopting more flexible employment protection regulations, replacing severance payments with unemployment insurance, and permitting the minimum wage to vary across regions and gradually decline as a share of the average wage.
- *Implement further changes to the pension system to raise formal sector employment.* Cuts in pension contribution rates would make it cheaper to employ labour in the formal sector, and the cut can be partly funded by a package of other reforms including a reduction in early retirement incentives.
- *Further simplify the legal and regulatory environment* governing the business sector, eliminate remaining obstacles to foreign direct investment, and focus on promoting competition and competitiveness in all sectors of the economy, avoiding sector-specific measures.
- *Re-focus educational priorities, within the limits of budget discipline, towards making good quality education available to the entire youth population,* rather than just to the most able. Better prepare young people directly for the labour market.
- *Continue to replace agricultural subsidies with income support to farmers,* and raise productivity in agriculture by strengthening the legal framework for land consolidation, enhancing technology transfers and encouraging private investment in irrigation. ■

What are the main challenges?

The recovery from the 2001 crisis has been impressive. Over the 2002-05 period, output increased by a third, representing the strongest pace of growth among OECD countries. At the same time, annual inflation fell steadily, reaching single digits in 2004 for the first time in three decades, while sound fiscal and monetary policies improved confidence and reduced risk premia, thereby enhancing business investment and FDI inflows. Thus good progress has been made towards a shift to a stronger and more sustainable growth path. Indeed, the process of real income convergence seems to have begun, following the disappointing periods of the late 1980s and the 1990s. If this path can be maintained, this would represent a significant break from the past decades of short-lived economic booms, followed by sharp downturns or recessions.

Turkey's positive macroeconomic performance between 2002 and 2005 was also supported by a favourable international environment, characterised by strong world trade and – despite higher oil prices – relatively low inflation, low interest rates and a strong global appetite for emerging market assets. In early-to-mid 2006, however, interest rate hikes in major industrial countries prompted a change in the risk appetite of the international financial markets. This significantly affected the Turkish economy: the currency depreciated significantly, long-term interest rates rose sharply and inflation accelerated. More recently pressures weakened and the exchange rate recovered somewhat and long-term interest rates declined again. Turkey was not the only country hit by the reduced risk appetite of international investors, but it was among the group of emerging market economies that was most affected. One reason for this was Turkey's large and widening current account deficit, fed by large capital inflows, including a large share of portfolio capital, which had fuelled an appreciation of the currency. Furthermore, Turkey's relatively short history of responsible macroeconomic policies makes it vulnerable to external shocks. Last but not least, market uncertainty may also have been fuelled by concerns about the independence of key institutions, further progress in structural reforms and some emerging political tensions within Turkey. *Sustained strong economic performance in this more difficult international environment will require the bolstering of confidence in macroeconomic policy and political commitment to structural reform.* ■

How can inflation be curbed and the banking system strengthened?

The Turkish central bank has gained much credibility and achieved an impressive record in lowering inflation since being made independent in 2001 and charged with the task of disinflation. Tight fiscal policies, structural reforms and high productivity growth also contributed to the disinflation process. Furthermore, exchange rate appreciation played a particularly important role in reducing inflation while price rises in non-traded goods remained sticky at around 12-14% per annum. To a large extent, this seems to be due to remaining barriers to competition, and other structural rigidities – such as in the labour market – which keep prices artificially high and slow the pace of disinflation, making it more difficult for the Central Bank to lower interest rates. The challenge faced by the Central Bank has become even more acute in recent months following an unexpected up-tick in inflation, together with significant exchange rate depreciation. The Bank responded to the inflation surprise by abandoning its previous course of interest rate cuts and raising the short-term policy rate in three consecutive rounds by a total of 425 basis points, pushing the short-term interest rate up to 17.50%. Although the Bank acknowledged that the 2006 end-year inflation target of 5% (with an uncertainty band of +/-2%) would not be achieved, it stressed its commitment to achieving the medium-term inflation target of 4%. Given the circumstances, the Bank's policy action was essential. But surveys indicate that over the summer medium-term inflation expectations have risen sharply and despite a recent small decline are still significantly above the medium-term target. *The Bank thus faces significant challenges in restoring inflation to the desired path and further sensible policy measures will be required, together with strong communication of the analysis underpinning these measures, to convince the public that the deviation of inflation from target is temporary. More generally, a broad-ranging structural reform programme is needed to facilitate the disinflation process and bolster credibility.*

Following the 2001 crisis, bank regulation and supervision was significantly upgraded, and this limits the potential risk that increased foreign indebtedness of the private sector and the recent boom in domestic credit pose to the soundness of the banking system. The new banking law implemented in 2005 further improved the prudential regulations and, according to the 2006 Financial Stability Report of the Central Bank, banks are in a healthy situation. In particular, the direct exchange-rate risk of the banking sector is reportedly low – although mainly through renewable hedging instruments contracted with other domestic financial intermediaries. But banks remain exposed to the exchange rate through the credit risk of domestic borrowers with unhedged foreign currency liabilities. *In the current risky financial market environment it is crucial to ensure that prudential banking supervision is sound. To this end the quality of financial supervision should be stepped up further, in particular by improving the efficiency and governance of the Banking Regulation and Supervision Authority, as recommended by the Imar Commission. The authorities should also consider additional mechanisms to reduce the indirect foreign exchange exposure of banks.* ■

Has fiscal and budget reform gone far enough?

Since the 2001 crisis, Turkey has achieved some impressive fiscal outcomes – in particular, an increased primary fiscal surplus, although this was achieved partly by raising taxes which were already at a high level. Lower interest rates led to a sharp decline in government interest payments and the overall general government deficit has declined from around 30% of GDP in 2001 to around 1% in 2005. Similarly, net public sector debt declined from 91% of GDP in 2001 to 56% in 2005. While the overall fiscal stance has been relatively tight over the past few years, the practise of targeting the actual primary balance means that it became less tight during the recent cyclical upswing. In order to prevent such pro-cyclical behaviour in future, the government has recently announced an intention to complement the annual primary balance target with an expenditure target. *Expenditure targets should be introduced within the multi-year budgeting framework and extended to all layers of general government, including health care institutions and local governments.*

A number of new laws introduced since the 2001 crisis aim to improve fiscal transparency and budgeting practices. These have included the introduction of a three-year budgeting framework and a reduction in the room for extra-budgetary and quasi-fiscal spending. However, further progress with implementation is important, and uncertainty in the legislative environment should be reduced. In addition, although fiscal notification to the EU represents progress, transparency continues to suffer from the absence of consolidated general government fiscal accounts prepared according to National Accounting Standards. At present, the IMF closely monitors fiscal performance through a range of indicators, as part of Turkey's Stand-By Arrangement, and this provides market participants with a significant degree of reassurance. *Fiscal data prepared according to National Accounting Standards should be published prior to the end of the current programme with the IMF in spring 2008. The government should also take steps to ensure that key fiscal laws cannot be easily weakened in the future, to improve the coordination of fiscal responsibilities, to steadily expand the scope of performance-based budgeting and to incorporate all extra-budgetary funds into the general government accounts. Revolving funds should either be incorporated into the budget or the relevant institution should be corporatised.* Pushing ahead with these reform steps would significantly improve the international perception of the quality and reliability of Turkey's fiscal institutions and facilitate a renewed decline in the risk premium. ■

How can duality in the business sector be overcome?

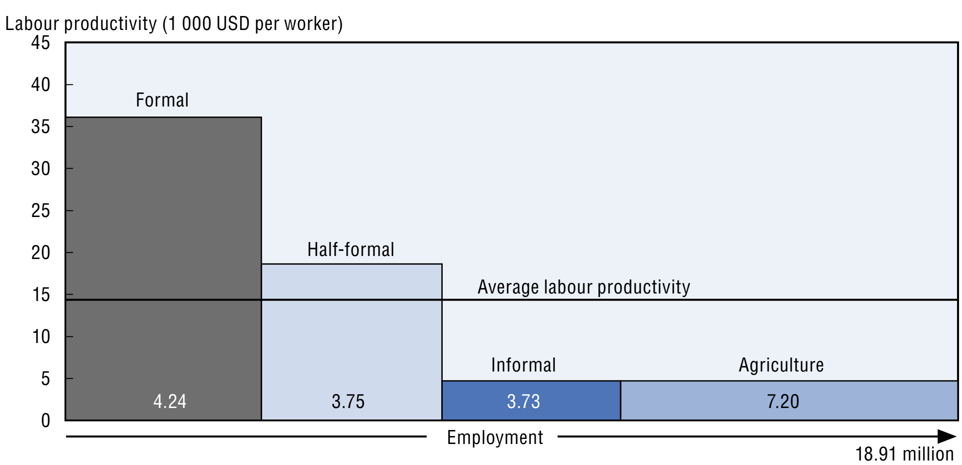
A key reason for Turkey's relatively low GDP per capita is its low level of productivity. However, the low average level hides a very skewed distribution of performance across different parts of the economy. The productivity gap is particularly large between formal and informal enterprises. While informality reduces firms' costs and provides them with the flexibility to survive under difficult conditions, it also limits their access to capital markets, their investment capacity and their ability to develop international partnerships, therefore restricting the potential efficiency gains that they could achieve. Informality thus reduces the overall growth potential of the Turkish economy. *Improving framework* *conditions for firms in the formal sector would enable more firms to expand and become formal, thus narrowing the large productivity gaps between firms and sectors, and raising the average productivity level of the Turkish economy.*

Job creation in the formal sector has been weak, in large part because of the heavy burden of regulations. As a result, the formal sector has been unable to absorb the growing urban labour force, a challenge which will become even more acute in the years ahead with an expected acceleration of the labour force transition out of agriculture and a likely pick-up in labour force participation in the urban areas, notably by women. Enlargement of the formal sector will require a carefully planned combination of reforms in various areas – as policies are closely inter-related. *Priorities include: further reducing tax distortions – including a significant cut in the labour tax wedge; easing labour market regulations; reforming pension rules so that middle-aged workers are not pushed into the informal sector; improving competition in product markets; and facilitating access to bank and equity financing.* Each of these is discussed in more detail below. A successful formalisation strategy would lift the growth potential of the whole economy and broaden the tax base, permitting a reduced burden on formal sector firms and a leveling of the playing field for doing business in Turkey. These reforms would also encourage a pick-up in the level of foreign direct investment flows, which would contribute to stronger long-term growth and improved macroeconomic stability and resilience. By contrast, improving law enforcement alone would be no solution in the present tax and regulatory environment, as many firms could not cope with the additional costs that formalisation would entail, causing firm closures, with net output and employment losses for the economy.

Figure 1.

THE SKEWED DISTRIBUTION OF PRODUCTIVITY

Labour productivity differences between the main segments of the business sector[1]



1. OECD estimates.

Source: TURKSTAT and OECD.

The Turkish labour market is characterised by particularly cumbersome regulations and very high taxes on labour, both of which serve as a significant disincentive to formal sector employment:

- Very high labour tax wedges make the cost of employing someone in the formal sector prohibitive in many cases – particularly for low skilled labour.
- The official minimum wage is too high in relation to the productivity level of the economy. While it could, perhaps, be justified in high productivity and high-cost regions such as the Istanbul area, it is a major obstacle to job creation in the formal sector in some Eastern regions where productivity and living costs are much lower. The ratio of the minimum wage to regional GDP per capita peaks at well-above 100% in the poorest regions.
- The Labour Code is one of the most restrictive in the OECD. Very high severance payment liabilities make *permanent* employment contracts costly, while *temporary* employment is almost completely prohibited, with *fixed-term, interim and agency* work authorized only in very limited circumstances. The intended substitution of severance payments with the newly introduced unemployment insurance scheme has not been achieved so far.
- The Labour Code also requires that firms with more than 50 employees comply with a range of additional regulations, such as the requirement to employ a certain number of disabled people, ex-convicts, etc. The additional costs that this imposes give firms little incentive to grow beyond a certain size, with adverse implications for productivity.

Comprehensive labour market reform is urgently needed to improve the incentives for formal sector employment. Social security contribution rates should be significantly reduced, employment regulations and severance payment requirements should be made much less costly for firms, the minimum wage should be permitted to decline as a percentage of the average wage, and the minimum wage should be differentiated across regions, according to differing productivity levels and living costs. In addition, the administration of tax and social security contribution collection should be improved. The cut in social security contribution rates should be sizeable (for example, a halving of the current rate) to ensure that it has a real effect. At present, the prevalence of informality means that social security contributions from the private sector make up only around 5% of GDP (which is a lot lower than in other OECD countries with similarly high social security contribution rates). This suggests that the fiscal cost of such a large cut could be affordable – given the significant broadening of the tax base that would result if the cut is implemented in the context of a comprehensive formalisation strategy. The fiscal cost of this cut could also be partly funded by reducing the very high net replacement rates in the pension system and by reducing incentives for early retirement. However it is funded, it is vital that the fiscal targets still be achieved. ■

What changes in the pension system are still needed?

Recent social security reform has significantly improved the long-run sustainability of the pension system. However, the transition to the new pension parameters is slow and early-retirement incentives (not all of which are directly related to the pension system) will continue to push many middle-aged qualified workers into the informal sector. Moreover, even once the new parameters are fully phased in, net replacement rates of pensions will remain very high by comparison with other OECD countries, requiring high social security contribution rates, which directly contribute to the high labour tax wedge mentioned above. *The next steps for pension reform should involve i) a significant cut in social security contribution rates to make it more affordable for firms to employ low-skilled workers in the formal sector, and ii) a package of reforms to improve the incentives for middle-aged people to remain in the formal sector labour force. This package will require:*

- *A cut in the net replacement rate, which could be brought about by taxing pension income, and by charging pensioners a health insurance premium.*
- *The introduction of an actuarially equivalent reduction in the pension benefit of anyone who chooses to retire younger than the normal retirement age of 60 for men and 58 for women.*
- *The removal of retiring workers' entitlement to severance payments.*
- *An accelerated increase in the formal-sector retirement age to 65.*
- *Improved enforcement of social security registration and tax compliance among middle-aged pensioners.* ■

Is further regulatory reform needed?

Despite the streamlining efforts undertaken in the first half of the 2000s, formal sector firms remain exposed to a plethora of regulations which are considerably more detailed than those in other OECD countries. This complexity of regulations increases entry costs and creates room for bureaucracy to exert discretionary power over business creation. These risks are compounded by the complexities of the laws governing the conduct of business, which create uncertainty about the decisions of the commercial judiciary. Such shortcomings are particularly taxing for foreign firms, which often do not have the experience or resources to operate in such an environment. Although considerable progress has been achieved, further *simplification of the legal and regulatory rules governing the conduct of business is needed, and the commercial justice system should be reformed to provide a streamlined and predictable framework for enforcement.* Although the regulatory framework for competition in network industries such as electricity, natural gas and telecommunications has been reformed according to EU directives, prices remain very high relative to those in other countries. *Co-operation between the sectoral regulators and the competition authority should be strengthened and further steps taken to accelerate competition in the network industries. Fostering competition in all tradable and non-tradable activities should be a prime objective for reducing inflation and strengthening the competitiveness of the economy.*

Policies that make it easier for firms to join the formal sector will also significantly improve the access of these firms to credit and equity finance, which is now becoming more widely available (as a result of reduced crowding-out by public borrowing and more competition in banking and institutional investment). However, in order to draw on these resources, firms need to demonstrate a high degree of financial transparency and corporate governance – standards that only the most advanced formal sector enterprises are currently able to meet. Capital markets laws and the Corporate Governance Principles set rigorous financial reporting, external audit and governance standards for *publicly held companies* and draft revisions to the Turkish Commercial Code (TCC) will extend similar standards to all companies. As these are demanding standards, *the capacity of smaller companies to comply with any new compulsory requirements should be carefully monitored. If the burden turns out to be too high in relation to benefits, then adaptation of the standards for private, smaller firms could be considered.* ■

Is the education system performing well?

Productivity and living standards are also heavily influenced by the quality of human resources. Turkish primary and secondary school education produces very poor average results, relative to those in other OECD countries. But in the best schools, standards are high. This reflects an education system that focuses on providing a good education to the most able students, who are admitted into the best schools (Anatolian and science high schools) and then channelled towards university and work in the formal sector. As a result, the most binding human capital shortages arise in the middle and low-end of the labour market. Despite this, resources continue to be skewed towards the "high end". Overcoming this education duality, which is mirrored in the economy as a whole, will require a reorientation of education sector priorities, and a reallocation of educational resources so that higher quality education opportunities can be offered to all. *The fundamental purpose of basic education should be reoriented away from the sorting and selecting of students for the elite schools, to a broader focus on providing the majority of young people with the basic literacy and numeracy skills that are necessary for the modern workforce. To achieve this, educational resources will have to increase when budget room is available, and increased spending should be allocated in a way that spreads resources more equitably across schools and regions. In addition, schools should be made more accountable for outcomes. Finally, all exams – including the university entrance* *exam – should be fully aligned with the curriculum to reduce the current barrier to higher education for students who do not have the means to pay for test preparation programmes.* A more efficient and equitable education system will provide Turkey with a significantly higher-skilled labour force in the future, which will permit a higher pace of productivity growth and a significant increase in the average standard of living. ■

How can the agricultural sector be revitalised?

The agricultural sector continues to employ as much as one third of the Turkish workforce and low productivity has been entrenched to date by a protective policy regime. Establishing a more competitive environment would help to modernize agriculture and raise output growth and productivity. In 2000-01 an important reform was introduced, with emphasis given to direct income support for farmers in place of more distortive and fiscally costly input and output subsidies, and the privatization of state-owned organizations which control agricultural output and input markets. *But reform efforts now need to be revitalized. The 2000-01 reform agenda should be fully implemented and accompanied by additional policies to encourage the transition to commercial agriculture, such as ensuring that the legal framework is adequate for the transfer of land ownership to facilitate the creation of larger and more productive farms.* However, given the large population working on small farms, and the absence of a safety net, land consolidation poses significant social challenges. The best way to ease these challenges is to implement the comprehensive package of reforms discussed above, in order to enhance job creation in industry, including in rural areas. *But some social policy measures might also be needed to facilitate the transition, such as an increase in the means-tested public pension, which is currently below the absolute poverty level or the provision of other social support. Additional policies are also needed to improve framework conditions for private investment in irrigation and other infrastructure.*

A broad-ranging reform package, such as that recommended above, would minimise the risk of Turkey falling back into a boom-bust cycle and would also help transform the economy from one with a low average level of human capital and a significant duality between relatively few highly productive enterprises and a large number of low productivity enterprises, to one that operates with a more even playing field, permitting a more rapid catch-up in living standards. Such success would also enhance perceptions of Turkey as a country that can absorb and productively employ its rapidly growing working age population and contribute to Europe's prosperity. In turn, this would facilitate the negotiation process with the European Union. ■

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