OECD Economic Surveys
TURKEY

JULY 2014

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Please cite this publication as:
OECD (2014), *OECD Economic Surveys: Turkey* 2014, OECD Publishing.
http://dx.doi.org/10.1787/eco_surveys-tur-2014-en

ISBN 978-92-64-20700-4 (print)
ISBN 978-92-64-20701-1 (PDF)

Series: OECD Economic Surveys
ISSN 0376-6438 (print)
ISSN 1609-7513 (online)

OECD Economic Surveys: Turkey
ISSN 1995-3429 (print)
ISSN 1999-0480 (online)

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This Survey is published on the responsibility of the Economic and Development Review Committee (EDRC) 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 12 June 2014. 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 4 July 2014.

The Secretariat's draft report was prepared for the Committee by Rauf Gönenç, Oliver Röhn, Fethi Öğünç and Evren Erdoğan Coşar under the supervision of Vincent Koen. Research assistance was provided by Béatrice Guérard.

The previous Survey of Turkey *was issued in July 2012.*

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BASIC STATISTICS OF TURKEY, 2012

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (millions)	75.2		Population density per km[b]	95.9	(34.6)
Under 15 (%)	25.1	(18.4)	Life expectancy (years)[b]	74.6	(80.0)
Over 65 (%)	7.4	(15.3)	Men	72.0	(77.3)
Latest 5-year average growth (%)	1.4	(0.7)	Women	77.2	(82.8)
			Last general election	June 2011	
ECONOMY					
Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	790.8		Primary sector	8.8	(2.5)
In current prices (billion TRY)	1 416.8		Industry including construction	26.7	(27.3)
Latest 5-year average real growth (%)	3.0	(0.6)	Services	64.5	(69.9)
Per capita, PPP (000 USD)	18.3	(37.0)	Median equivalised household income, PPP (000 USD, 2010)	7.1	(20.4)
EXTERNAL ACCOUNTS					
Exchange rate (TRY per USD)	1.792		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	1.032		Manufactured goods	27.0	
In per cent of GDP			Machinery and transport equipment	24.5	
Exports of goods and services	26.3	(53.8)	Miscellaneous manufactured articles	15.7	
Imports of goods and services	31.5	(50.4)	Main imports (% of total merchandise imports)		
Current account balance	-6.1	(-0.5)	Machinery and transport equipment	26.0	
Net international investment position	-53.3		Commodities and transactions, n.e.s.	20.4	
			Manufactured goods	15.2	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (%) for 15-64 year-olds	48.9	(65.0)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	8.2	(7.9)
Men	69.2	(73.1)	Youth (age 15-24) (%)	15.7	(16.2)
Women	28.7	(57.0)	Long-term unemployed (1 year and over)	2.3	(2.7)
Participation rate (%) for 15-64 year-olds	54.0	(70.9)	Tertiary educational attainment 25-64 year-olds (%, 2011)	14.0	(31.5)
Average hours worked per year	1,855	(1,766)	Gross domestic expenditure on R&D (% of GDP, 2011)	0.9	(2.4)
ENVIRONMENT					
Total primary energy supply per capita (toe)	1.5	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2011)	3.8	(9.9)
Renewables (%)	10.2	(8.5)	Water abstractions per capita (1 000 m^3, 2010)	0.6	
Fine particulate matter concentration (urban, PM10, µg/m^3, 2011)	65.4	(28.0)	Municipal waste per capita (tonnes, 2010)	0.4	(0.5)
SOCIETY					
Income inequality (Gini coefficient, 2009)	0.411	(0.305)	Education outcomes (PISA score, 2012)		
Relative poverty rate (%, 2009)	19.3	(10.7)	Reading	475	(497)
Public and private spending (% of GDP)			Mathematics	448	(494)
Health care (2008)	6.1	(8.9)	Science	463	(501)
Pensions (2009)	6.9	(8.7)	Share of women in parliament (%, January 2014)	14.4	(26.5)
Education (primary, secondary, post sec. non tertiary, Public, 2010)	2.5	(3.7)	Net official development assistance (% of GNI)	0.3	(0.4)

Better life index: *www.oecdbetterlifeindex.org*

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

b) 2011 for the OECD.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

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Executive summary

- *Main findings*
- *Key recommendations*

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Main findings

Turkey's business sector dynamism has underpinned strong and inclusive growth in the 2000s, even though well-being indicators suggest there remains ample room for improvement. Economic performance has been supported by robust public finances and a resilient banking sector. However, with low domestic saving and volatile external competitiveness, growth is highly dependent on domestic demand and foreign finance.

Rebalancing growth by achieving financial stability and curbing inflation. External demand is strengthening, in particular in the context of a recovery in the European Union, but high inflation, exchange rate volatility and low productivity growth endure. Competitiveness remains fragile and dependence on foreign savings is very high. Monetary and financial policies aim at disinflation while keeping the exchange rate and credit growth on a sustainable path, but inflation is well above target and private debt levels have risen substantially, albeit from a low level. Credit to SMEs and foreign currency borrowing by large firms have both expanded rapidly, which may increase financial risks. However, the authorities have increased their efforts to keep household debt in check and so far, household and commercial loan default rates have remained low. To help rebalance demand, further improvements in external competitiveness are indispensable. In this regard curbing inflation is essential, calling for a restrictive monetary policy stance.

Preserving the credibility of public finances. Public finances strengthened considerably over the past decade, which has boosted Turkey's international credibility. While the overall fiscal position appears robust, public spending has increased considerably, in particular for education, health and pensions. Demographic trends, active social policies and large infrastructure projects will put additional pressure on public spending. Accrual-based general government accounts need to be aligned further with international standards, and fiscal and quasi-fiscal transactions associated with public-private partnerships need to be reported more systematically.

Fostering structural change, productivity growth and trust in a rule-based business environment. Businesses range from myriad micro, low-productivity firms to a small core of modern, high-productivity corporations. The regulatory framework burdens expanding firms with costly employment, tax and other obligations. Uneven compliance with laws deepens business sector segmentation and tends to weaken trust. As a result, institutionalised enterprises face obstacles to growth. Despite ever-greater government incentives to promote formal businesses and investment in selected regions and sectors, resources do not flow enough from lower to higher-productivity activities. All these factors inhibit productivity growth and entrench a social divide between the earnings, work conditions and human capital development prospects of workers in different segments of the business sector. Stronger trust in a rule-based business environment would encourage faster growth of foreign direct investment firms, which would contribute to productivity gains, inclusive growth and non-debt creating absorption of foreign savings.

Key recommendations

Rebalancing growth by achieving financial stability and curbing inflation

- Ensure the monetary policy stance is sufficiently restrictive to better align inflation and inflation expectations with the inflation target.
- Consider introducing dynamic provisioning and debt-to-income caps across more loan types.
- Further encourage the development of savings and long-term investment.

Preserving the credibility of public finances

- Continue the ongoing fiscal consolidation. Stand ready to provide discretionary stimulus should downside risks materialise.
- Further improve fiscal monitoring by publishing general government accounts according to international standards as well as a comprehensive report on fiscal policy covering all fiscal and quasi-fiscal activities.
- Adopt a multi-year general government spending ceiling and report outcomes transparently to improve compliance.

Fostering structural change, productivity growth and trust in a rule-based business environment

- Improve the overall regulatory framework for doing business, make it more predictable and use OECD product and labour market indicators as benchmarks.
- Continue to reduce *de facto* differences in the tax and social obligations of firms related to their size.
- Eliminate restrictions on the full range of modern employment forms in the formal sector (including temporary work, employment through work agencies, home-based work and remote work).
- Strengthen the social safety net and the up-skilling avenues for the unemployed, expanding the most successful schemes.
- Consider reducing labour tax wedges for low-skilled workers across the country and expanding earned income tax credit type support.
- Continue to strengthen incentives for female labour force participation through reforms facilitating the hiring of women in the formal sector.
- Implement the legislated but not yet operational state aid monitoring system. Evaluate the outcomes of support programmes for the SMEs and workers affected by structural changes. Focus on the most successful schemes.
- Consider harmonising the implicit carbon tax rate across fuels in different uses in the medium term.

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Assessment and recommendations

- *Growth is projected to pick up*
- *Macroeconomic policy to tackle imbalances*
- *Fostering strong and inclusive growth by promoting structural change in the business sector*
- *Managing the social implications of structural change*
- *Growth, well-being and environmental sustainability*

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Broad-based and inclusive growth, driven by a vibrant business sector, resumed after the global financial crisis. However, growth is overly centered on domestic consumption, which is funded too much by foreign saving. The resulting wide current account deficit has recurrently forced the authorities to curb domestic demand. Consumer price inflation is persistently above target, which calls for a restrictive monetary policy stance. Even though below-potential growth helps reduce these imbalances, they remain a source of macroeconomic vulnerability. In mid-2013, the associated risks were illustrated by the financial turmoil triggered by the announcement of a reduction in monetary stimulus in the United States. Aggravated by domestic political tensions, the ensuing financial stress was greater for Turkey than for a number of other emerging countries (Figure 1).

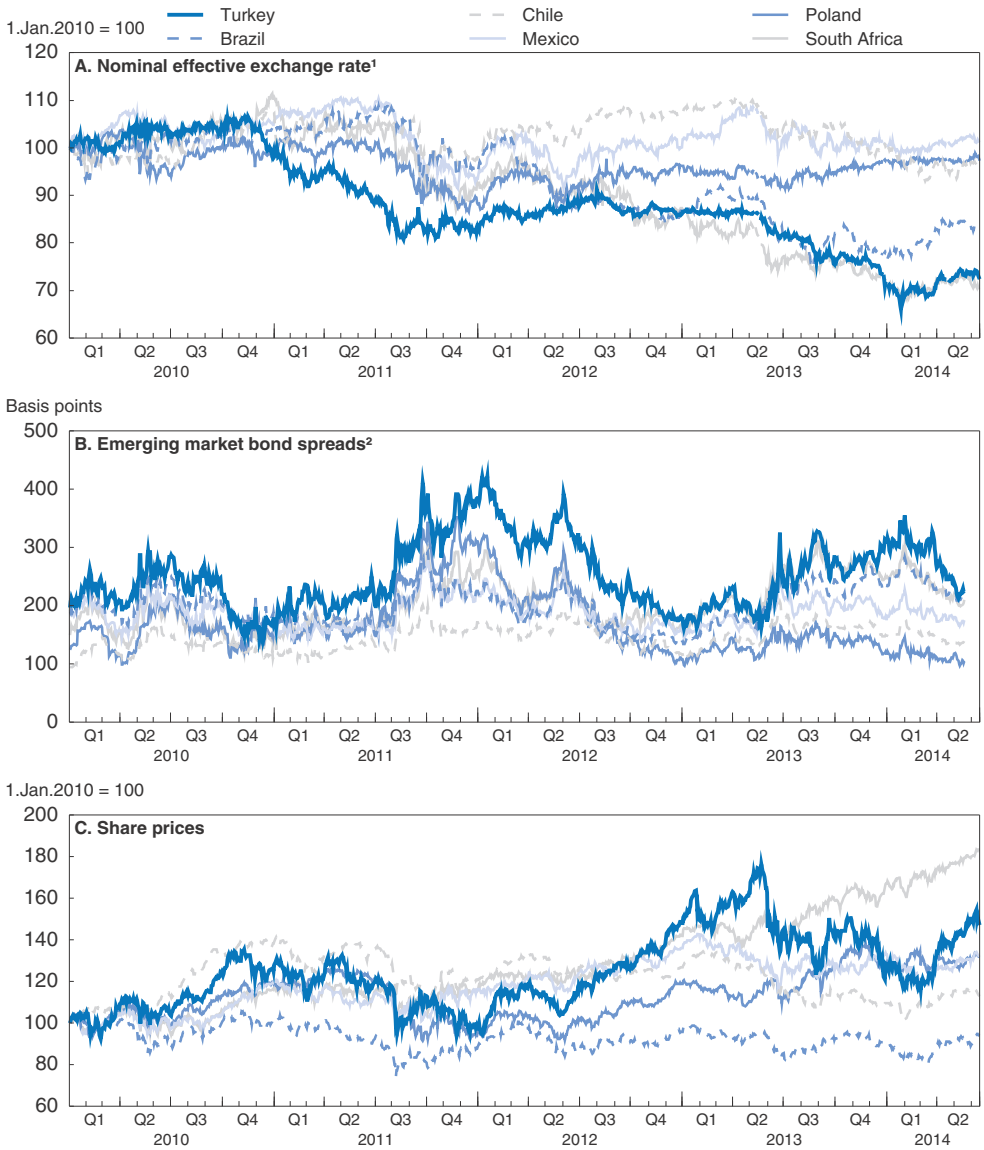
Achieving vigorous growth without widening external imbalances calls for rebalancing the composition of demand from domestic to external sources. Absent such rebalancing, Turkey's economy will remain volatile (Figure 2) and overly dependent on capital inflows, as discussed in Chapter 1 of this *Survey*. Reducing dependence on short-term foreign debt is key and requires raising domestic saving and attracting more FDI (Figure 3). As documented in Chapter 2, structural reform in the business sector is essential, as it would deliver substantial productivity gains and allow Turkish firms to better compete in export markets and at home. It would also attract more FDI, especially of the greenfield type.

Growth is projected to pick up

Growth recently slowed but is projected to pick up. Activity has been held back by tighter financial conditions (see below) but high-frequency indicators, such as business and consumer confidence and industrial production, point to a recovery in domestic demand. A weaker currency – despite some more recent appreciation – combined with a pick-up in export market growth should support exports, help rebalance the economy and narrow the current account deficit. Nevertheless foreign rollover/funding needs (defined as the current account deficit plus maturing gross external debt) are expected to remain large in 2014. However, so far debt has been readily rolled over, even during phases of financial market tensions. Overall, GDP growth is projected to slightly decline to around 3.5% in 2014 before picking up to around 4% in 2015 (Table 1). Inflation is projected to fall in the second half of 2014 but should remain well above the 5% target, partly due to pass-through effects from exchange rate depreciation and from the January 2014 tax hikes.

The main downside risks relate to possible renewed global financial market turmoil during the normalisation of monetary policy in the United States, and to domestic political tensions. If these risks were to materialise, investor and consumer confidence would suffer, risk premia might increase further and tensions could arise in foreign funding with deleterious effects on domestic demand. While the financial sector still looks robust, pressures have built up owing to rapid leveraging in the private sector, including through foreign exchange liabilities (see below). As a result, financial stability could be imperilled if

Figure 1. **Turkey has come under global financial market pressure**



1. An increase in the nominal effective exchange rate (NEER) implies its appreciation.
2. JPM EMBI global diversified stripped spreads, showing the yield gap in basis points between a JPMorgan emerging market bond index (EMBI), stripping out any credit enhancements such as principal and/or interest collateral, and US Treasuries.

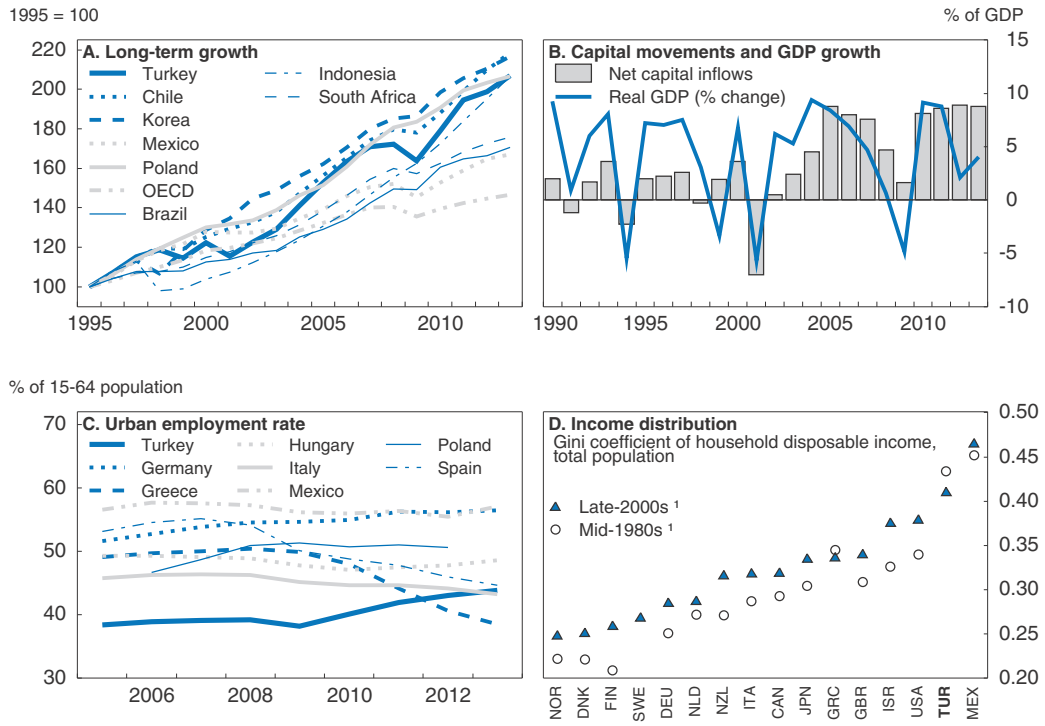
Source: OECD calculations based on *OECD Economic Outlook Database* and Datastream.

StatLink http://dx.doi.org/10.1787/888933097623

capital inflows slowed, funding costs rose markedly or the currency depreciated sharply. To avoid such a scenario, maintaining confidence and credibility is crucial. Growth would also be negatively affected, mainly through weaker exports, if geopolitical risks were to intensify in some MENA countries, Russia and Ukraine. Finally, renewed tensions in the euro area could unsettle financial markets and confidence again, hurting Turkey both through trade and financial linkages.

On the upside, if the recovery in the European Union or the United States were swifter than projected, export growth would be stronger and the rebalancing of the economy more

Figure 2. **Growth furthers social inclusion but remains volatile**



1. The reference year differs across countries. For mid-1980s, it refers to 1985 or nearest available year. As for late 2000s, it refers to 2010 or 2009.

Source: OECD Economic Outlook Database; Central Bank of the Republic of Turkey; ILO, LABORSTA (*http://laborsta.ilo.org*); OECD, *Income Distribution Database*, via *www.oecd.org/social/inequality.htm*.

StatLink *http://dx.doi.org/10.1787/888933097642*

pronounced. Maintaining recent competitiveness gains is crucial to take advantage of such a scenario. Political uncertainty diminished following the March 2014 local elections, which could boost both domestic demand and international confidence more than assumed.

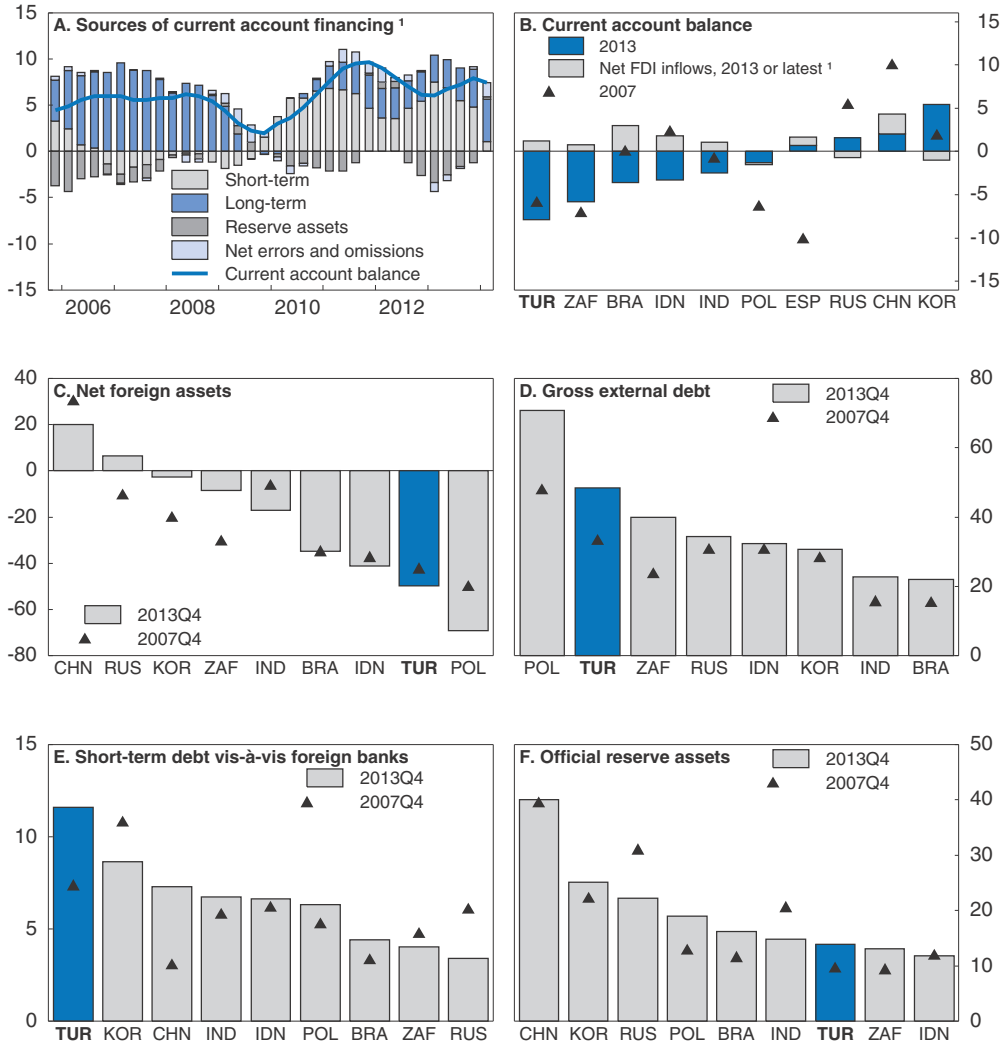
Macroeconomic policy to tackle imbalances

Turkey's impressive growth performance in the 2000s was mainly driven by domestic demand, but this also led to a widening current account deficit (Figure 4). As analysed in detail in the previous *Economic Survey* (OECD, 2012a) and revisited in Chapter 1 of this *Survey*, pressures on competitiveness, a sharp fall in private saving and increasing energy imports lie at the heart of the current account deterioration. While Turkey has successfully improved non-price competitiveness and diversified its exports towards medium-to-high technology sectors, the share of low-technology sectors is still high. These sectors are more vulnerable to the erosion of price and cost competitiveness, owing to higher average inflation and unit labour cost growth compared to trading partners and competitors, notwithstanding bouts of nominal depreciation in times of financial turmoil (Figure 5). The drop in private saving stemmed mainly from a broad-based fall in household saving, encompassing all income groups (Figure 6).

Rebalancing requires both short and long-term actions. The government's 2014-16 Medium-Term Programme and 2014-18 Development Plan rightly focus on domestic saving

Figure 3. **External vulnerabilities are high and have increased since the global financial crisis**

In per cent of GDP



1. Rolling 4-quarter sum as percentage of moving average GDP. Short-term inflows refer to the sum of portfolio investment and short-term other investment net inflows. Long-term inflows refer to the sum of FDI, bond issues and long-term other investment net inflows.

Source: IMF, *International Financial Statistics*; IMF, *Balance of Payments*; *OECD Economic Outlook Database*; World Bank, IMF, BIS, OECD Joint External Debt Hub.

StatLink http://dx.doi.org/10.1787/888933097661

and external competitiveness. To boost saving, the voluntary private pension system was reformed. While participation in the scheme has increased substantially, it has yet to be seen to what extent this will be offset by declines in other forms of household saving. The authorities have also introduced many schemes to improve competitiveness by mitigating some of the excess costs and barriers to resource reallocation created by weak regulatory product and labour market settings. As discussed below and in Chapter 2 of this *Survey*, longer-term reforms in the overall institutional framework and governance structures of the economy are indispensable to unleash long-term investment and productivity growth

Table 1. **Macroeconomic indicators and projections**

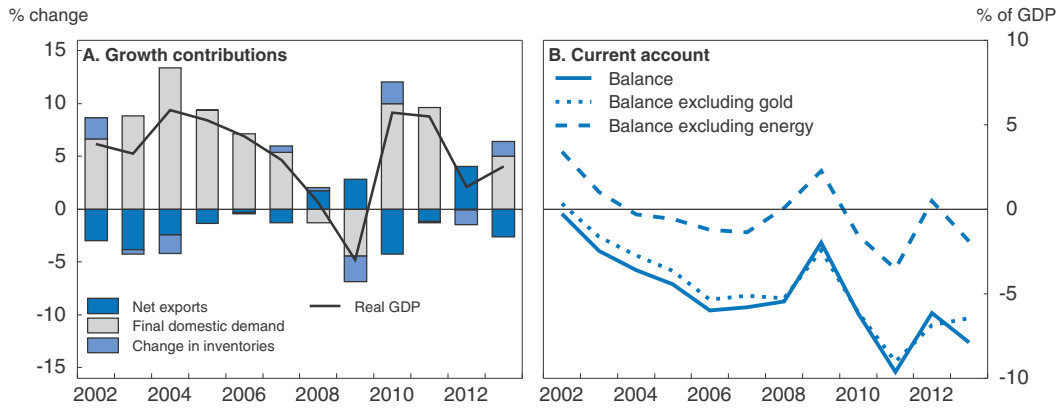
	2010	2011	2012	2013	2014	2015
	Current prices TRY billion	Percentage changes, volume (1998 prices)				
GDP	1 098.8	8.8	2.1	4.0	3.3	4.0
Private consumption	787.8	7.7	-0.5	4.6	2.8	4.2
Government consumption	157.5	4.7	6.1	5.9	6.6	3.6
Gross fixed capital formation	207.8	18.0	-2.7	4.3	-1.2	5.7
Final domestic demand	1 153.1	9.1	-0.1	4.8	2.5	4.6
Stockbuilding[1]	6.7	-0.1	-1.4	1.4	-1.3	-0.1
Total domestic demand	1 159.8	8.9	-1.4	6.1	1.2	4.5
Exports of goods and services	233.0	7.9	16.3	0.1	9.6	6.4
Imports of goods and services	294.0	10.7	-0.4	8.5	0.7	7.7
Net exports[1]	-61.0	-1.2	4.0	-2.6	2.2	-0.8
Other indicators						
GDP deflator		8.6	6.9	5.9	8.5	6.6
Consumer price index (CPI)		6.5	8.9	7.5	8.0	6.5
Core CPI		6.8	8.1	6.6	8.1	5.9
Employment		6.6	2.9	2.8	1.8	2.4
Unemployment rate[2]		9.6	9.0	9.5	9.8	9.6
Current account balance[3]		-9.6	-6.1	-7.9	-6.4	-6.6

1. Contributions to changes in real GDP (percentage of real GDP in previous year).
2. As a percentage of labour force.
3. As a percentage of GDP. Includes volatile gold sales and purchases.

Source: OECD, *OECD Economic Outlook 95 Database*.

Figure 4. **Growth driven by domestic demand has led to imbalances**

Percentage changes

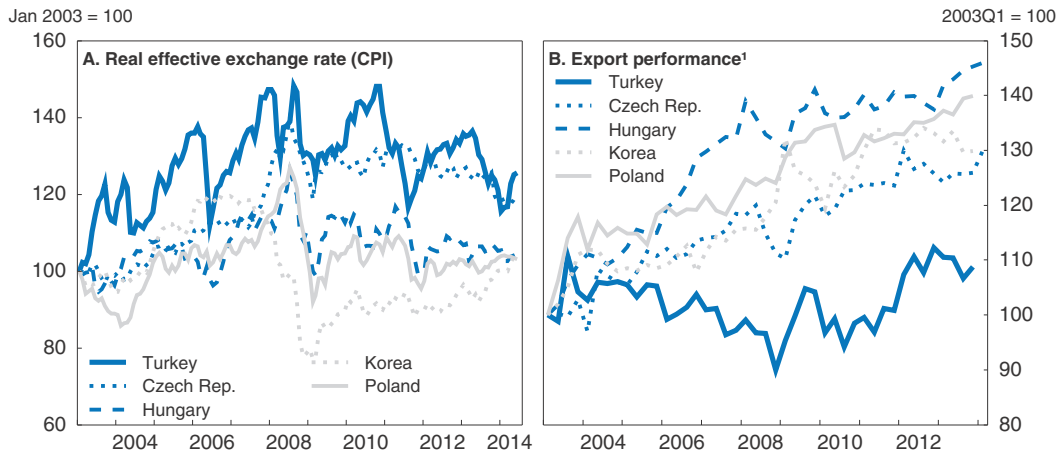


Source: *OECD Economic Outlook Database* and Central Bank of Republic of Turkey.

StatLink http://dx.doi.org/10.1787/888933097680

in the business sector and strengthen competitiveness. If successful, such reforms would reduce uncertainty and improve confidence. They would also promote social inclusion as well as enterprise profits and saving. However, they face political economy obstacles and may take time to implement. In the meantime, the burden will fall on macroeconomic policies to preserve competitiveness by keeping inflation, nominal wage growth and the exchange rate on a sustainable path.

Figure 5. **International competitiveness has fluctuated**

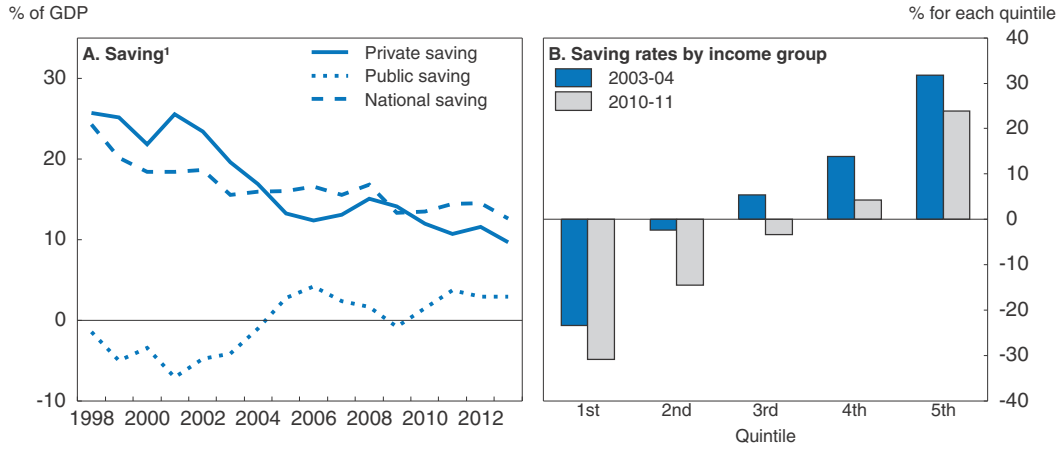


1. "Export performance" is actual volume growth in exports relative to the growth of export markets. An adjustment is made for Turkey to exclude gold exports.

Source: OECD calculations based on Turkstat data; *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888933097699

Figure 6. **Private saving has declined**



1. Data for 2013 are Ministry of Development estimates.

Source: Ministry of Development; Turkstat, Household Budget Surveys.

StatLink http://dx.doi.org/10.1787/888933097718

Monetary policy

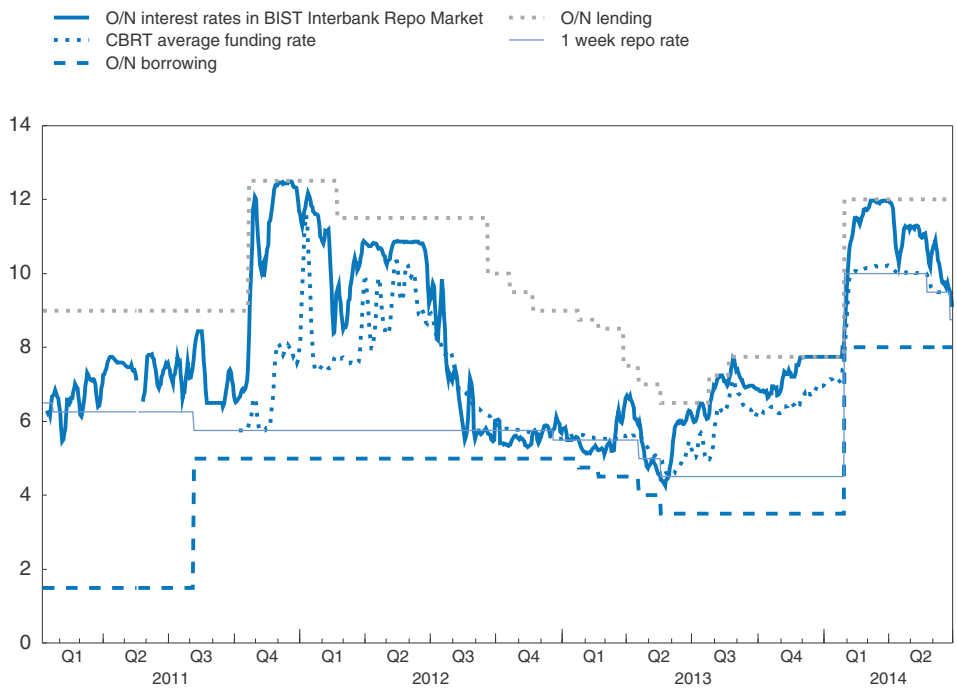
Given Turkey's open capital account, the CBRT faces the difficult task of taming inflationary pressures while avoiding potentially destabilising capital inflow surges. Other things equal, raising policy interest rates to contain inflation encourages capital inflows, which push up the exchange rate, harming competitiveness, and fuel domestic credit booms, inducing a build-up of foreign currency liabilities that weakens balance sheets. The same challenge arises when global liquidity expands and global rates decline, but high domestic inflation calls for tight monetary policy.

In the face of this "trilemma", the CBRT moved away from a pure inflation targeting approach in 2010, adopting financial stability as an additional objective and focusing also

on credit growth and the real exchange rate, as discussed in the previous *Economic Survey* (OECD, 2012a). The medium-term inflation target is set at 5% for 2014, 2015 and 2016. The central bank views annual nominal credit growth of about 15% as a prudent benchmark, and trend real effective exchange rate appreciation as consistent with a catch-up process and measurement bias due to quality improvements.

This multiple-objective approach has called for the use of a variety of policy instruments. A key one has been an asymmetric and relatively wide interest rate corridor, delineated by overnight borrowing and lending rates. The CBRT has been steering interest rates within this corridor on a daily basis, allowing it to react quickly to capital inflows (Figure 7).

Figure 7. **The monetary policy stance**



Source: Central Bank of the Republic of Turkey.

StatLink http://dx.doi.org/10.1787/888933097737

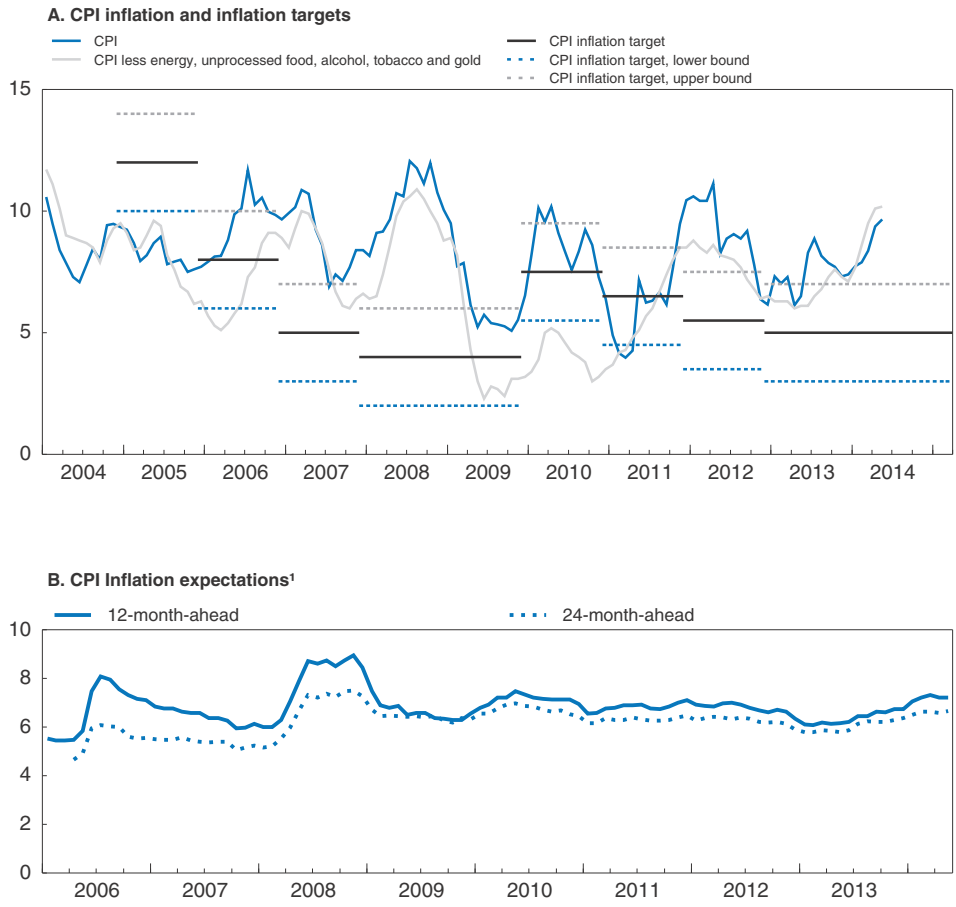
Another tool is the Reserve Option Mechanism (ROM), introduced in late 2011. The ROM allows banks to meet their lira reserve requirements with foreign exchange (up to 60%) or gold (up to 30%), and indeed banks have built up their foreign exchange liquidity buffers and accumulated around USD 50 billion through the ROM at the CBRT. However, reserves accumulated through the ROM are not under the full control of the central bank. Since the beginning of the financial market turmoil in May 2013, the CBRT has been forced to conduct foreign exchange selling auctions to stem depreciation pressures since banks did not release much foreign exchange from the ROM amid rising costs of domestic funding.

The record of this framework has been mixed. During periods of benign external conditions it helped reduce exchange rate, capital flow and credit growth volatility (Oduncu et al., 2013, Aysan et al., 2014). However, it has not delivered low and stable

inflation. Moreover, inflation expectations have become increasingly de-anchored from the inflation target and have trended up since 2013 (Figure 8). Higher inflation expectations may become entrenched through wage setting mechanisms and may lead to real exchange rate appreciation pressures and competitiveness losses.

Figure 8. **Inflation and inflation expectations are high**

Year-on-year percentage changes



1. Based on the Central Bank of Turkey's Survey of Expectations Descriptive Statistics.

Source: OECD, *OECD Economic Outlook Database* and Central Bank of the Republic of Turkey.

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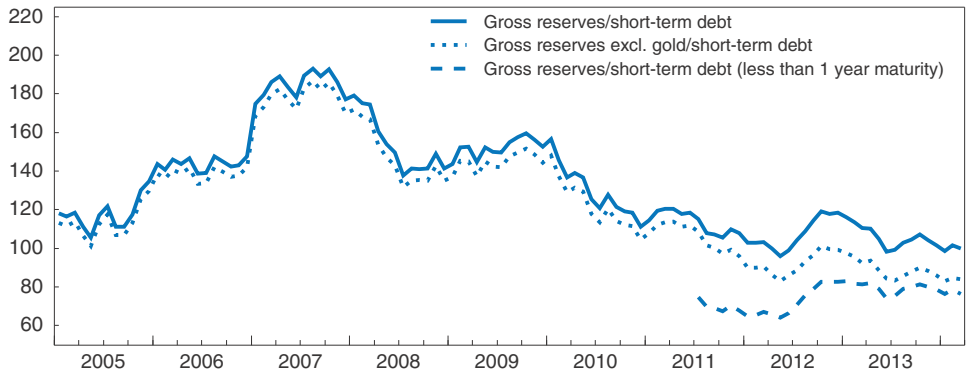
In January 2014, the CBRT tightened the monetary stance sharply and streamlined its operating framework. The one-week repo rate became the key policy rate again and was raised from 4.5% to 10%. Then, in a context of benign global liquidity conditions and improvement in Turkey's risk premia, the policy rate was cut in May and June, by respectively 50 and 75 basis points. A restrictive monetary stance is needed, and may have to be stiffened further, to ensure inflation falls back towards target and to help anchor expectations. It may also be advisable to narrow the interest rate corridor, to strengthen the commitment to the inflation target. Without a credible inflation target, inflation expectations may become increasingly backward-looking, forcing monetary policy to react

more to temporary inflation shocks, and causing greater volatility in output and unemployment. Once disinflation is on track, any room for manoeuvre could be used to help smooth the exchange rate and capital flows. The authorities could also use foreign exchange purchases to build up reserves, which are not particularly high (Figure 9).

Figure 9. **Gross official reserves**

Per cent



Source: Central Bank of the Republic of Turkey.

StatLink http://dx.doi.org/10.1787/888933097775

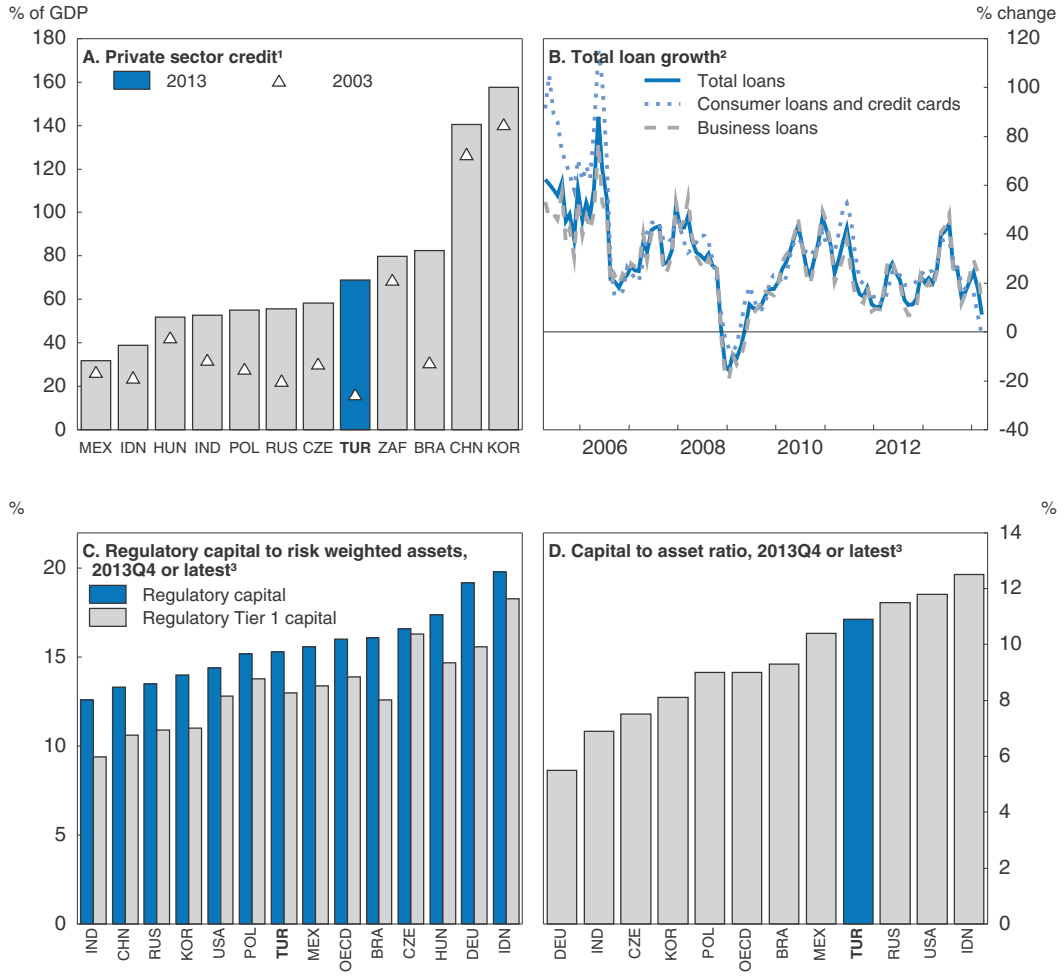
However, if used over an extended period, such purchases would run into the "trilemma" and thereby undermine inflation targeting. In this environment, preserving trust in the independence of the central bank is essential.

Financial market policies

Over the past decade, the private sector has rapidly increased its leverage, though from a low base. Growing availability of credit enabled low-income households and small and medium enterprises to increase borrowing and expand consumption and investment. Credit growth had reached almost 40% between late 2010 and early 2011 before both the central bank (at the end of 2010) and the Banking Regulation and Supervision Agency (BRSA) (in June 2011) took measures to slow loan growth. Credit growth re-accelerated sharply in the first half of 2013, far exceeding the central bank's 15% reference rate (Figure 10) but the BRSA started to take further macroprudential measures only in October 2013. While credit expansion has supported inclusive growth and living standards, it may raise concerns related to some debtors' capacity to repay. Risks have increased since May 2013, as financial conditions in Turkey have deteriorated.

Nevertheless, the banking sector appears robust in international comparison. Both capital and leverage ratios are high in international comparison and the regulatory capital to risk-weighted asset ratio well exceeds legal and target ratios of 8% and 12%, respectively (Figure 10). To build in further safeguards, the authorities recently introduced leverage-based reserve requirements. The overall non-performing loan (NPL) ratio remains below 3%. In addition, banks' liquidity adequacy ratios for total and foreign exchange liquidity have been well above the legal thresholds of 100% and 80% respectively.

Figure 10. **Leverage has increased substantially but the banking sector remains robust**



1. 2004 figure instead of 2003 for Poland.
2. Annualised growth rate of the loan stock, calculated as the 12th power of 3-month moving average of monthly growth rates. For total and commercial loans, growth rates are foreign exchange rate adjusted using a basket consisting of 70% US dollar and 30% euro.
3. The OECD average is calculated as an arithmetic average of available countries.

Source: IMF, *International Financial Statistics*; Banking Regulation and Supervision Agency (BRSA) and IMF, *Financial Soundness Indicators*.

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The supervisory framework has also been strengthened. The Basel II (2.5 principles) framework was fully adopted by mid-2012 and most of the draft regulations pertaining to Basel III are complete. The BRSA has used various macroprudential tools to rein in credit growth in recent years, such as hikes in risk weights on consumer loans or loan provisioning requirements. The establishment in 2011 of the Financial Stability Committee (FSC), which comprises the CBRT, the BRSA, the Treasury, the Deposit Insurance Fund and the Capital Market Board, has improved coordination. The macroprudential framework is being strengthened further, notably through countercyclical capital requirements. It could be reinforced even more via dynamic provisioning.

The banking sector faces several risks. Banks' maturity mismatch may hurt profitability in the near term, as higher external and domestic funding costs cannot readily be passed on to customers. Banks' direct exchange-rate risk is low, as their net foreign currency liability position is almost fully hedged by off-balance sheet transactions (mostly swaps), but they are indirectly exposed through their lending to the non-financial corporate sector. That sector's foreign currency liabilities have more than quadrupled since 2004, opening up a short position in foreign currency of about USD 170 billion (21% of GDP). Currency depreciation therefore raises debt servicing costs and puts pressure on corporate profits. However, most of the foreign currency liabilities are long-term, reducing rollover risks. Domestically operating banks are only allowed to lend in foreign currency if the borrower has income in foreign currency – or else loans must be at least USD 5 million with at least one year maturity, which are mainly extended to large corporations, with better access to financial hedging. Nevertheless, there may be a case for raising risk weights and provisioning requirements for foreign currency loans extended to firms without revenues in the same currency, bearing in mind the provisions of the OECD Code of Liberalisation of Capital Movements.

Banks are also exposed to small and medium sized enterprises (SMEs) and to credit card loans. Loans to SMEs expanded rapidly in the recent past as did credit to low-income households. SMEs borrow predominantly at short maturities and may thus be hit harder by the recent interest rate hikes. The BRSA recently reduced general provisioning requirements on SME loans, to encourage such lending. With slower economic growth, household NPL ratios may rise, in particular for low-income groups (Chapter 1). In October 2013, the BRSA linked credit card limits to income, increased card payments and risk weights and extended loan provisioning regulations to credit cards, overdrafts and vehicles loans. This has helped slow consumer loan growth. Recent empirical research suggests that DTI ratios are effective macroprudential tools to restrain credit growth and housing boom-bust cycles (Claessens et al., 2013), and such ratios should be implemented more broadly across the banking sector and consumer loan types. This would increase household balance sheet resilience, althrough it would disproportionately constrain poorer families.

Real house prices have increased by about 14% since the start of the official data series in January 2010. The authorities should continue to monitor housing market developments closely and stand ready to tighten macroprudential measures, for example through a decrease in loan-to-value ratios (while also taking into account equity implications for borrowers).

Fiscal policy

Turkey has not yet caught up with OECD norms on fiscal transparency, notwithstanding improvements, such as better reporting of general government cyclically-adjusted balances. Annual Programmes, Pre-Accession Economic Programmes and Public Debt Management Reports contain relevant information but accrual-based consolidated general government accounts need to be published timely and aligned further with international standards.

As discussed in the previous *Economic Survey* (OECD, 2012a), fiscal analysis would be considerably facilitated if all one-off and cyclical revenue and spending items were better identified. A more detailed structural analysis of the general government budget should be included in Turkey's Pre-Accession Economic Programmes and other policy and budget documents, according to international standards. Investment and debt of public entities,

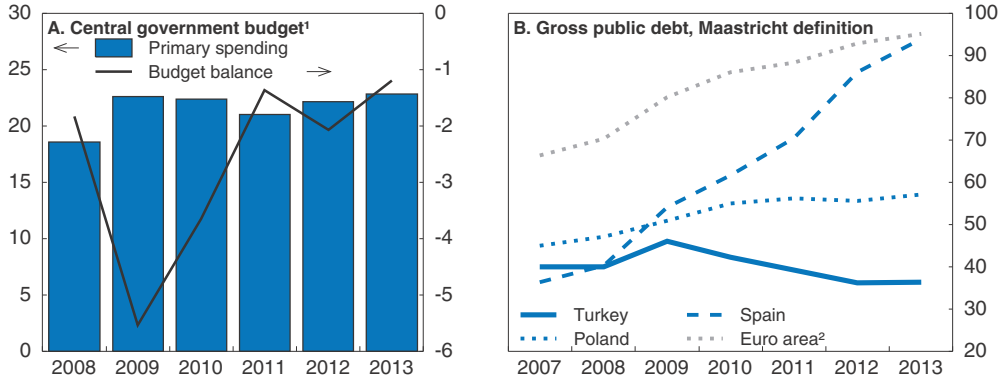
such as the public housing agency (TOKI) and municipally-owned enterprises, should also be better monitored; some welcome progress in this direction has already been achieved. There are also plans to more comprehensively account for government liabilities which arise in the context of expanding public-private partnerships (Chapter 1). In addition, the prospective financial costs of the expanding social security system call for close scrutiny. This is particularly important as health and pension costs have started to increase rapidly.

A regular *Fiscal Policy Report* (similar to the central bank's *Inflation Report*) containing a full set of cyclical adjustments and relevant information on the long-term balances of the social security system and on the activities of public entities not included in the general government sector would improve fiscal transparency. An independent Fiscal Council, along the lines of those existing in a number of OECD countries, could draw on the work of the Court of Accounts, which has been vested with wider auditing powers by a 2010 Court of Accounts Law that has yet to be fully implemented (Chapter 1). These institutional innovations would help implement Turkey's plans to reform spending and revenue structures (World Bank, 2014).

Notwithstanding these caveats, Turkey's overall public finance position and sustainability appears to remain robust. Fiscal policy continues to outperform the objectives published in the successive medium-term programmes, mainly thanks to stronger-than-projected revenue growth, which was not all spent. According to official estimates, the general government deficit stood at 1.6% of GDP in 2013 and the debt-to-GDP ratio, now at 36.3%, will continue to fall (Figure 11). The immediate impact on public finances from the recent depreciation and hike in risk premia will be less than in the past, as the share of foreign-currency-denominated debt has fallen, debt maturities have lengthened and most of the debt has been issued as fixed-rate bonds.

Figure 11. **The fiscal position is strong**

In per cent of GDP



1. Data for 2013 are estimates from the 2014-16 Medium Term Programme.
2. 15 first members of the euro area.

Source: Undersecretariat of Treasury and *OECD Economic Outlook Database*.

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The government targets set out in the October 2013 *Medium-Term Programme* foresee further reductions in the general government budget deficit to 0.7% of GDP, and public debt to 30% of GDP by 2016 (Government of Turkey, 2013). This implies a tightening of the fiscal stance in the context of below-potential growth. A prudent fiscal stance should help

preserve credibility and confidence in the context of the current electoral cycle and political tensions. Should downside risks materialise, for example in the form of a sudden stop in capital inflows, the existing room for discretionary stimulus could be used.

Primary spending, in particular for personnel, infrastructure and social expenditures (education, health, social protection and pensions), increased markedly in recent years, but general government primary spending is to be restrained at around 36% of GDP according to latest *Medium-Term Programme*. However, these spending targets, based on *ex-ante* budget appropriations, have repeatedly been breached in the past – though usually not by much. The general government spending targets should become a hard spending ceiling, even if implementation may be constitutionally challenging. Outcomes should be reported transparently so as to improve compliance. In the event of revenue windfalls, keeping to such a general government spending ceiling would help preserve a tight fiscal stance and boost national saving.

Macroeconomic and financial policy recommendations

Monetary and financial market policy

- Ensure the monetary stance is sufficiently restrictive to better align inflation and inflation expectations with the inflation target.
- Consider introducing dynamic provisioning and debt-to-income caps across more loan types.
- Further encourage the development of savings and long-term investment.

Fiscal policy

- Continue the ongoing fiscal consolidation. Provide discretionary stimulus should downside risks materialise.
- Further improve fiscal monitoring by publishing general government accounts according to international standards as well as a comprehensive report on fiscal policy covering all fiscal and quasi-fiscal activities
- Adopt a multi-year general government spending ceiling and report outcomes transparently to improve compliance.

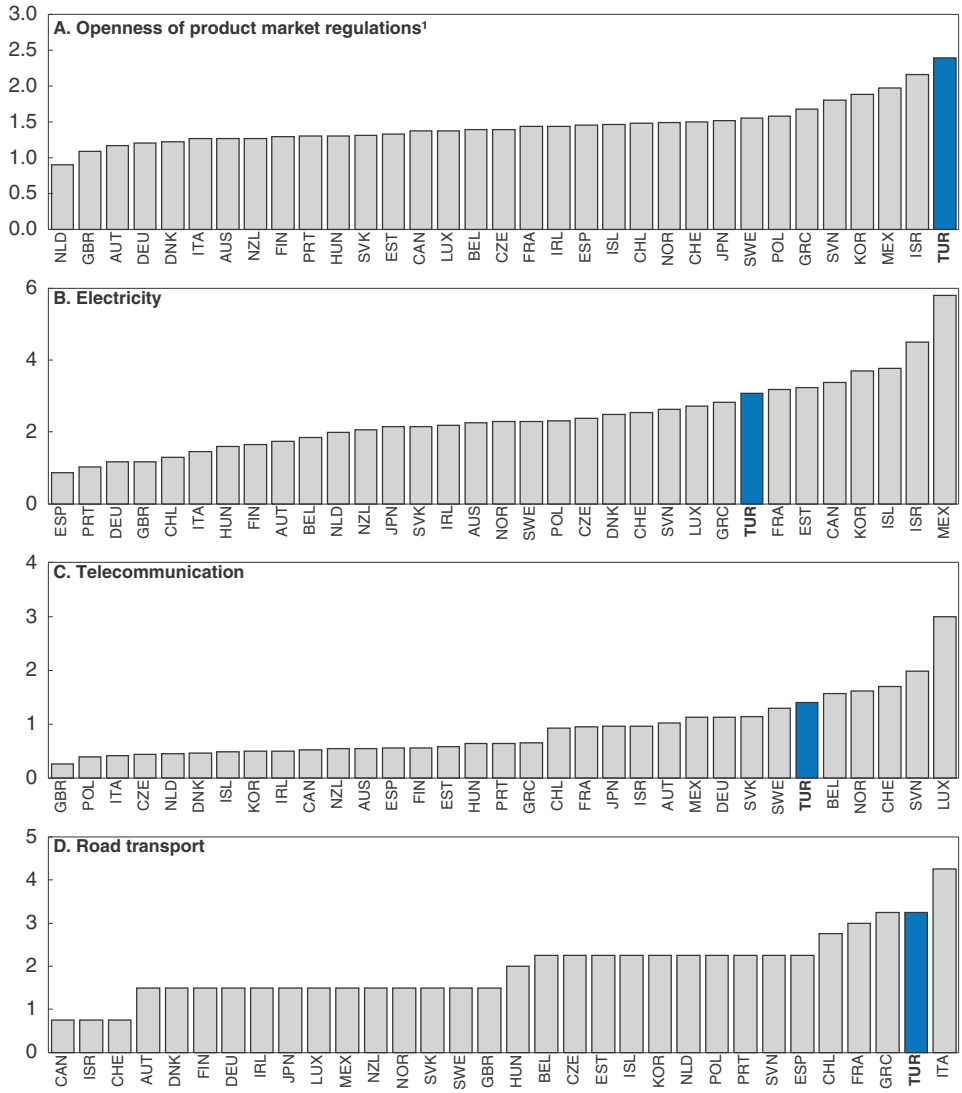
Fostering strong and inclusive growth by promoting structural change in the business sector

There is ample room to foster productivity gains in the business sector through structural change. Over one fifth of the workforce is still in low-productivity agriculture, and the bulk of those working outside agriculture are in low-productivity businesses. With greater productivity gains inside enterprises ("within" gains) and more of a shift of employment to higher-productivity firms ("between" gains), aggregate productivity and the competitiveness of the economy could be significantly improved. Turkey would thereby achieve faster and more sustainable growth, with less dependence on foreign savings.

However, there are important regulatory and institutional obstacles to such structural changes and major improvements are needed in the general business environment. Progress would help unlock additional productivity and growth potential in all enterprises. Preliminary OECD indicators for 2013 suggest that product market regulations are not competition-friendly, including in network sectors (Figure 12), while a number of service

Figure 12. **Product market regulations hinder competition**

Scores from 0 to 6 - from least to most restrictive, 2013



1. The reported indicators for Luxembourg, Mexico, Poland and Turkey are based on preliminary estimates as some of the underlying data has not been validated with national authorities. Subsequent data validation may lead to revisions to the indicators for these countries.

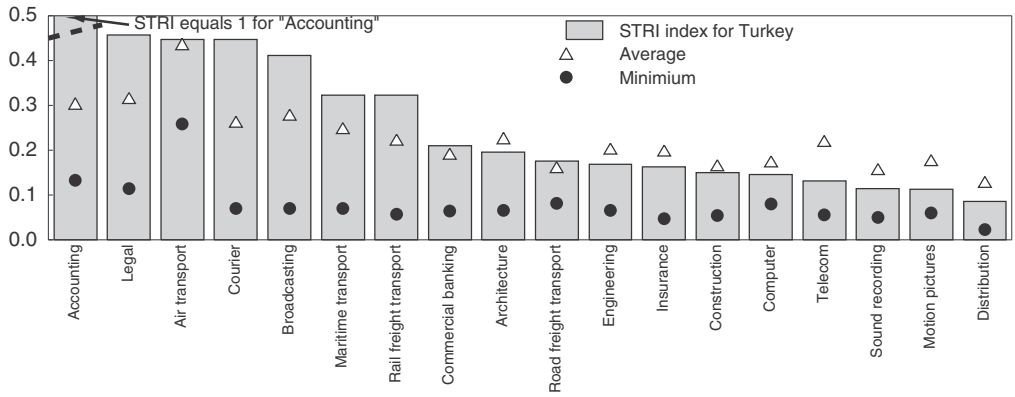
Source: OECD, *Product Market Regulation Database.*

StatLink http://dx.doi.org/10.1787/888933097832

sectors remain sheltered from international competition (Figure 13). Labour market regulations, notably those determining the flexibility of employment, are among the most rigid in the OECD (Figure 14). Non-compliance has long prevented these regulations from hindering growth (OECD, 2012a). As a consequence, many new firms have opted for semi-formality, stunting their natural growth and their maturation into higher-productivity entities. Despite ever-expanding government incentives to promote formal businesses in selected regions and sectors, resources do not flow sufficiently from lower to higher-productivity activities.

Figure 13. **There is room for trade liberalisation in services**

Services trade restrictiveness indices by sector, from 0 to 1 - from least to most restrictive, 2014



Note: The STRI indices take values between zero and one, one being the most restrictive. They are calculated on the basis of the STRI regulatory database which contains information on regulation for the 34 OECD members, Brazil, China, India, Indonesia, Russia and South Africa. The STRI database records measures on a Most Favoured Nations basis. Preferential trade agreements are not taken into account. Air transport and road freight cover only commercial establishment (with accompanying movement of people). The data have been verified and peer reviewed by OECD members.

Source: OECD, *Services Trade Restrictiveness Index Database*.

StatLink http://dx.doi.org/10.1787/888933097851

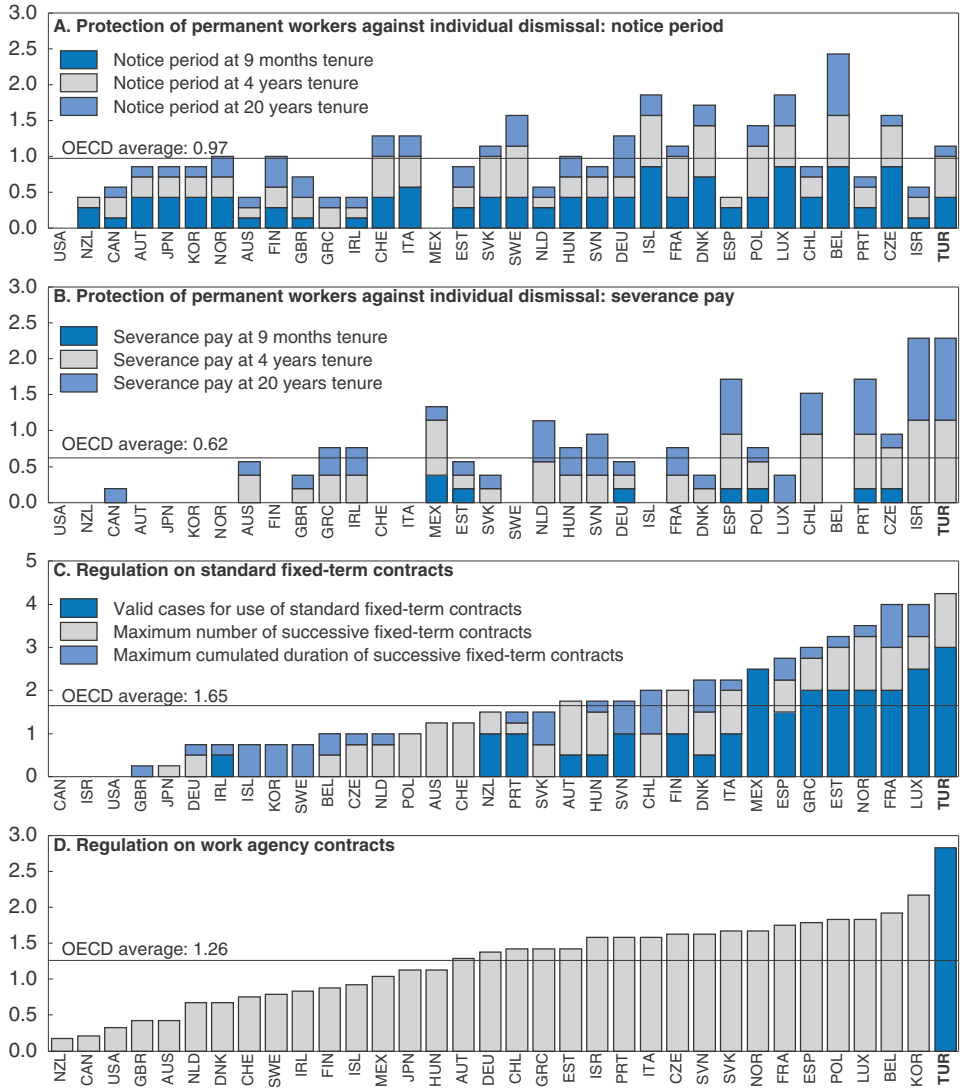
Turkey's business sector is highly segmented, ranging from a myriad of micro, informal, low-productivity firms to a small core of modern, high-productivity enterprises. As shown in Chapter 2, five types of firms co-exist, differing in human and physical capital, management quality, and degree of access to domestic and international product, capital and labour markets: i) micro-enterprises (which represent about 45% of total business sector employment outside agriculture), ii) small-and-medium-sized businesses (about 35% of employment), iii) large family firms (about 15% of employment), iv) institutionalised corporations listed on the stock exchange (no more than 3% of employment), and v) "skilled stars" (sophisticated start-ups representing less than 1% of employment). The productivity of these firms varies enormously, and most of the workforce is still concentrated in the low-productivity end of the associated distribution. This holds back economy-wide productivity and creates a social divide between workers of different types of enterprises, whose earnings, work conditions and human capital development prospects diverge (Figure 15).

In addition to structural gaps in human capital endowment, Turkey's rigid regulatory framework means that the relative cost of doing business for formal firms is fairly high. This handicaps the growth of modern enterprises, especially in trade-exposed manufacturing, where Turkey faces intense international competition. Likewise, size-specific provisions in the Tax Code expose different categories of firms to different types of taxation, even though tax rates (corporate as well as personal rates which apply in certain businesses) do not vary with firm size. Further, shortcomings in the predictability of rules for doing business seem to make the environment more friendly for owner-managed medium-sized firms with lower capital intensity, than for larger, institutionalised, professionally managed firms.

On top of legal provisions, and perhaps more importantly, are less formal differences in practice. Smaller firms are less transparent financially and can evade obligations regarding employment rules and taxes more easily than large firms. More generally, non-

Figure 14. **Labour market regulations are still among the most rigid in the OECD**

Scores from 0 to 6 - from least to most restrictive, as of 2013



Source: OECD, *OECD Employment Outlook 2013*.

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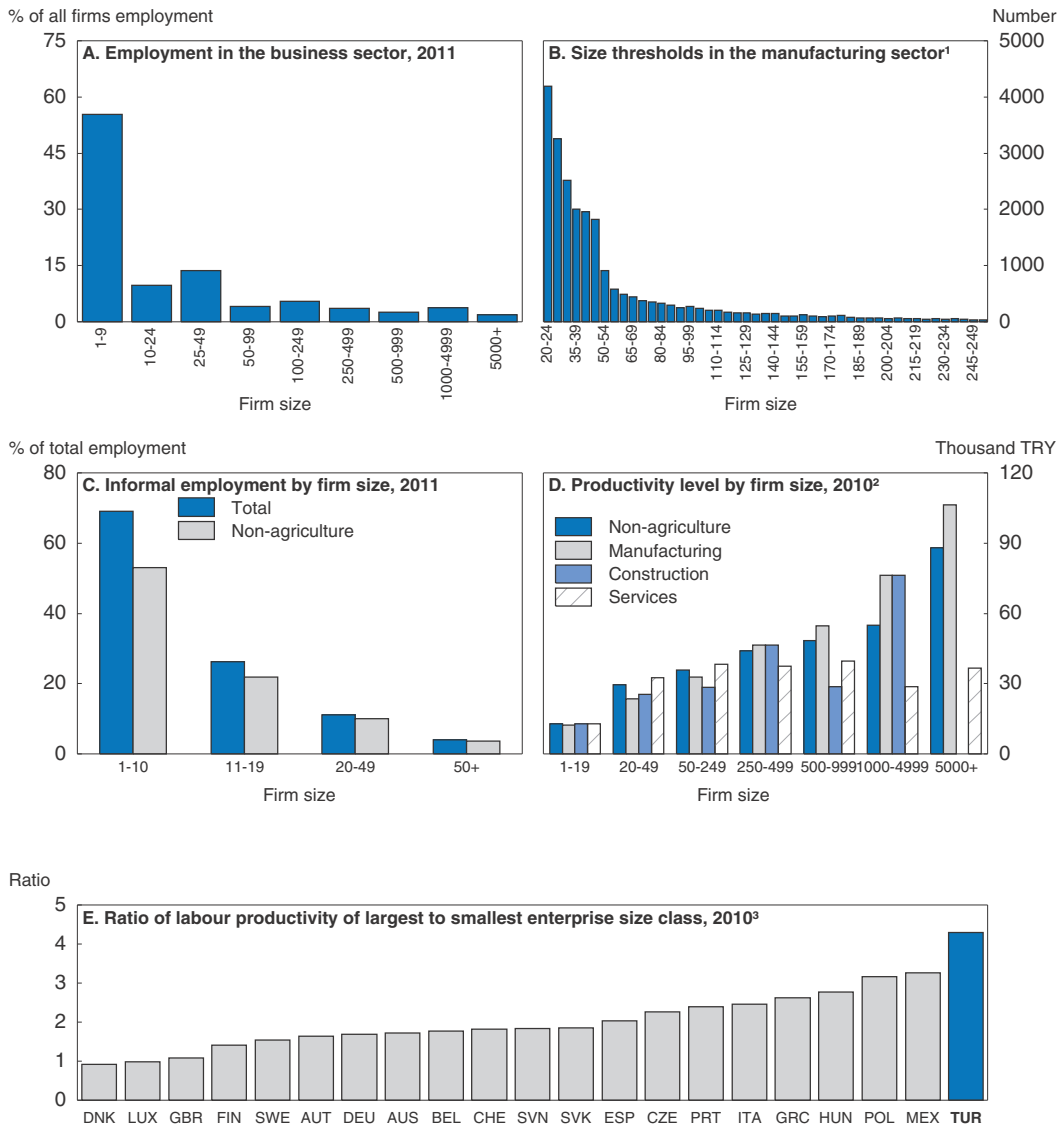
compliance creates an unfair business environment for law-abiding firms and hinders their entry or expansion. This problem is particularly acute for institutionalised businesses such as FDI firms. The small share of institutionalised (more formalised) firms in Turkey deprives the country of an important source of productivity and employment growth.

Freer development of all types of firms would boost productivity gains within firms and, by allowing labour and capital to more easily move to more efficient uses, between firms (Andrews and Criscuolo, 2013). A level playing-field would foster: i) further corporate development of first-generation entrepreneurial firms in Anatolian Tiger regions; ii) further institutionalisation and stock market listing of traditional family firms and a wider presence of FDI firms; and iii) structural change in the large heartland of the economy made up of small businesses.

Figure 15. **The business sector is highly segmented**



1. Number of firms by size classes (according to number of employees).
2. Productivity is measured by the value added per person employed.
3. Ratio of value added per person employed for enterprises of more than 250 employees to value added per person employed for enterprises of 1 to 19 employees. 2008 figure for Mexico. Size classes are different for Mexico (0-50, 51-250, 251+).

Source: Turkstat; OECD calculations based on data from OECD, *Entrepreneurship at a Glance 2013* and Turkstat.

StatLink http://dx.doi.org/10.1787/888933097889

Stimulating structural change in this heartland is now a well-established policy goal in Turkey. A wide range of related policy initiatives have been launched and additional technology diffusion and know-how dissemination programmes are being phased in. To facilitate the financing of innovative investments in small firms, tax incentives have been offered to business angels and venture capitalists, an Emerging Companies Market was created, and counter-guarantees for SME loans were introduced (Çanakcı, 2014). A Special Commission on SMEs (Ministry of Development, 2013b) has recently reviewed these

policies, and proposed areas where they could be strengthened. The 10th Development Plan followed up by confirming "Increasing Productivity in Production" as its first "priority transformation programme" for 2014–18. This programme aims at accelerating total factor productivity growth in the business sector and focuses notably on small businesses. It will rest on stronger co-ordination between the involved ministries and agencies (Ministry of Development, 2013a).

Programme outcomes will need to be monitored and efforts should be concentrated on the more successful schemes. State-of-the-art impact assessment techniques have begun to be implemented in Turkey (Hirshleifer et al., 2014). They should also be applied to SME support schemes, which attract expanding public resources and can contribute substantially to structural change. As intended in the National Development Plan, all SME support programmes presently on offer – discussed in Chapter 2 – should be evaluated to identify the most effective schemes and concentrate resources accordingly.

Further corporatisation and institutionalisation of firms in the higher strata of the business sector has attracted comparatively less policy focus, but is crucial and calls for policy action in three areas: i) the high degree of informality (mostly benefitting low-productivity firms) should be reduced by modern labour market rules applicable to all firms; ii) business taxation should be made as size-neutral as possible, through reforms in tax schemes as well as in their administration, so that higher-productivity firms can grow without being held back by tax considerations; iii) the broader regulatory framework should be made more friendly for large, modern business organisations, in line with OECD best practices.

Managing the social implications of structural change

Upgrading the business environment along these lines would deliver productivity and growth gains but would also have important social implications. Faster growth of higher-productivity firms would generate more rewarding and human-capital enriching jobs for a larger part of the population. However, low-productivity firms, in particular micro enterprises, the self-employed and low-skilled workers will need help. Properly designed, policies can facilitate the adjustments.

The formal sector will need to provide more job opportunities to the low-skilled. Lower employment costs would encourage higher-productivity firms to opt for more labour-intensive factor combinations. Reducing labour tax wedges is therefore a priority. Large social contribution reductions, adopted since 2008 (at different rates for different categories of workers and in different regions) successfully stimulated job creation, suggesting that applying them more broadly for unskilled workers across the country would boost job creation. Also, given the large gaps in informality across regions – which are related to differences in skills, productivity and living costs – minimum wages should be adapted to regional circumstances. This would facilitate the re-employment of the low-skilled in the formal sector.

Women's labour force participation has increased from 29.3% in 2008 to 37.3% in 2012 for prime-age women between 25-54. Recent gains were helped by policy measures including social security contribution cuts. This in particular concerned women with low education, and contributed importantly to social inclusion and income gains in low-income households. However, a large proportion of women, especially those with low education, are employed informally. Labour market reforms reducing effective

employment costs and facilitating flexible employment in the formal sector would help enhance the quality of female employment, strengthen incentives for female labour force participation and support social inclusion.

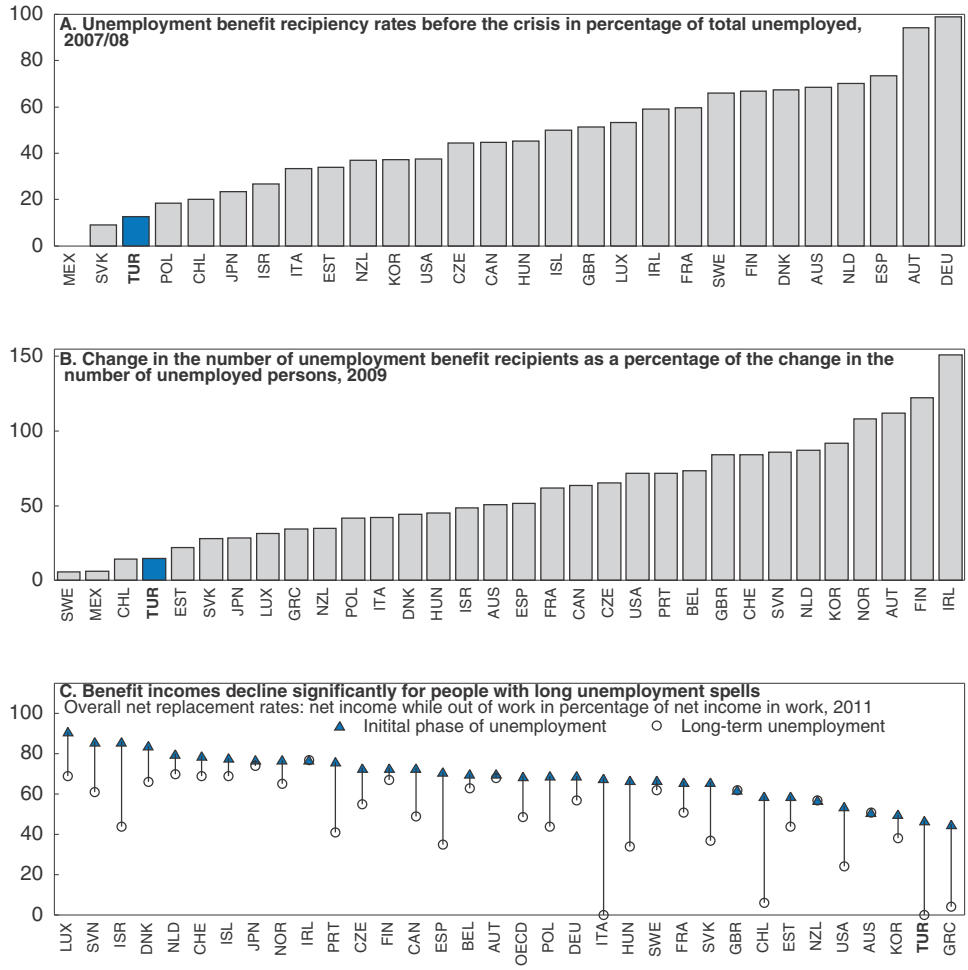
A far-reaching labour market reform (National Employment Strategy) was prepared by Turkey's Ministry of Labour after thorough consultations with social partners. It was also included as a top priority in the 10th Development Plan 2014-2018 (Ministry of Development, 2013a) and was published in May 2014 (Ministry of Labour, 2014). This project, in line with OECD good practices, emphasises human capital and skills, vulnerable groups, dialogue with social partners and enabling labour legislation. It aims at reforming the costly severance payment regime and facilitating modern employment forms: permanent labour contracts with severance saving accounts (more secure for workers, and potentially more affordable for enterprises), less restrictive fixed-term contracts, temporary employment, employment through work agencies, employment at call and home-based work. Many of these forms had been prohibited or highly restricted in the formal sector, in contrast to their massive utilisation in the informal, small, low-productivity enterprises.

However, earlier efforts in this direction faced strong resistance from both unions and employers. Unions argued that as actual worker rights and protections – including union representation – were *de facto* restricted in Turkey, greater employment flexibility and wider recourse to non-standard employment forms would undermine industrial relations and social protection. Semi-formal and informal employers rejected any employment protection rules and social protection costs, from which they have been exempt to date. Formal employers viewed the transition to a fully-funded severance saving regime as unaffordable unless contribution rates were reduced. The lack of social consensus led the government to halt the discussion on severance payment reform in September 2013.

These reform efforts should be reactivated, with a view to agree on a new "social pact" based on greater flexibility and stronger social protection. Collective social protections in Turkey, including unemployment insurance, up-skilling for the unemployed, and Earned Income Tax Credit-type of transfers to the working poor are still limited in scope (Figure 16). The schemes in place do not offer a credible alternative to enterprise-level job protections, neither for the minority of formal sector insiders nor for the majority of workers aspiring to the same protections.

Strengthening social safety nets could help garner stronger social support for the necessary reforms. These are indispensable to overcome the entrenched divide between the high-productivity-but-rigid versus flexible-but-low-productivity parts of the economy. Segmentation could then be reduced, firms could grow more naturally, and resources could shift to more productive uses. Other OECD countries, notably in Southern Europe, have faced similar challenges in the past and progress in dealing with them has been slow, holding back productivity-enhancing restructuring (OECD, 2013a). Turkey should find more creative reform avenues.

Figure 16. **Social safety nets can be broadened substantially**



Source: OECD, *OECD Employment Outlook 2011* and *OECD Society at a Glance 2014*.

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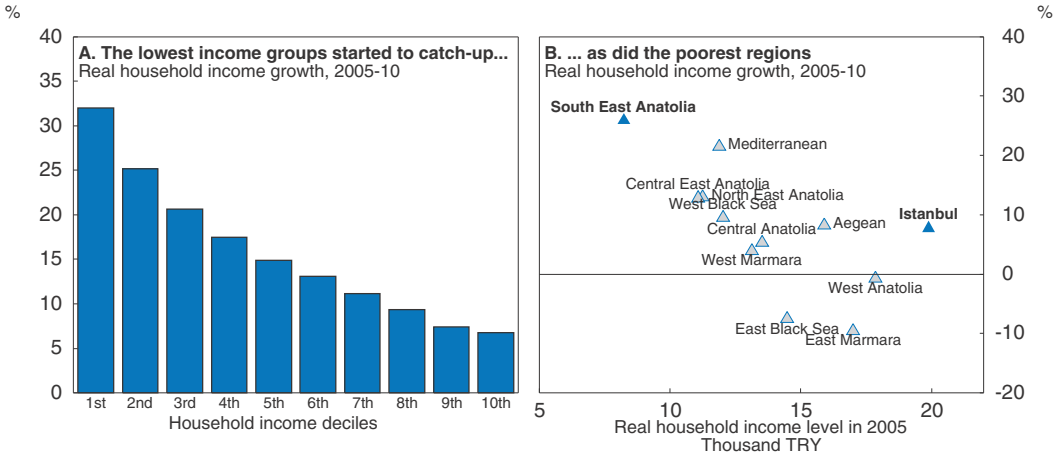
Growth, well-being and environmental sustainability

As a result of broad-based industrial development and massive job creation throughout the country, growth became more inclusive in the 2000s (Figure 17). Income inequality, poverty and material deprivation all declined (Box 1). Income gaps between regions have narrowed. Relative income poverty also declined in Turkey's all twelve regions between 2006 and 2012 (Doğan, 2014). Nonetheless, Turkey still compares unfavourably in a large number of dimensions of well-being (OECD, 2014a). Nationwide scores continue to fall short of OECD averages and gaps across groups remain wide, notably with respect to education, work/life balance, environmental quality and subjective well-being (Box 2 and Figures 18 and 19).

Upgrading human capital for all is key to promote social cohesion and well-being over the longer term (OECD, 2012b). Structural upgrading in the business sector also has a major role to play. It can make existing human resources more productive, enhance the quality of workplaces, promote on-the-job learning and improve income distribution. It would also

Figure 17. **Growth has been quite inclusive during the 2000s**



Note: In this figure household income refers to average household disposable income. Regions are at NUTS 2 level.
Source: Turkstat.

StatLink http://dx.doi.org/10.1787/888933097927

Box 1. **Developments in income distribution**

Turkey is one of the few OECD countries where inequality of household disposable incomes declined in the 2000s, even if some of the progress achieved was reversed following the onset of the global crisis. Various indicators of poverty have improved (OECD, 2012a; Şeker and Jenkins, 2013; Azevedo et al., 2014). According to OECD Better Life indicators, average net annual household income at purchasing power parity reached USD 13 000 in 2011, against an OECD average of USD 23 000s. Average household financial wealth stood at USD 10 000, against an OECD average of USD 40 000. Standard indicators of income distribution improved: the Gini coefficient of income inequality declined from 0.49 in mid-1990s to 0.41 in 2011 – the largest improvement among OECD countries – against an OECD average of 0.33, 0.47 in Mexico and 0.50 in Chile. "Direct poverty" – defined as lack of access to basic nutrition, clothing and heating – declined from 29% in 2006 to 21% in 2010.

Box 2. **Gaps in well-being**

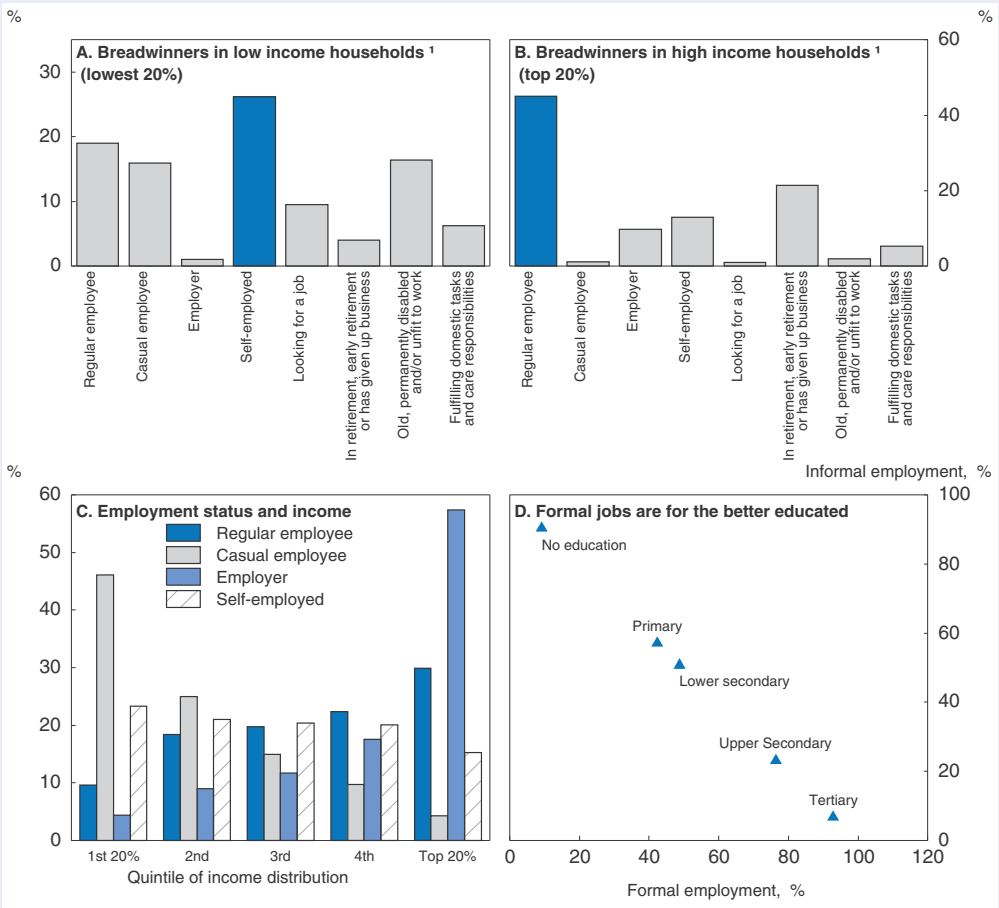
Education has seen progress but more is needed. Educational enrolment remains far below the OECD average, as does the quality of education (OECD, 2013c). However, between 2003 and 2012, Turkey's performance improved markedly in the three areas tested in PISA: mathematics, reading and science (OECD, 2014b). Much of the improvement was concentrated among students with the greatest educational needs. The degree to which students' socio-economic status predicts their performance also shrank. Students attending schools in smaller towns improved their performance more than students in cities.

Work/life balance is not satisfactory. Around 70% of men are in paid work (against the OECD average of 73%), compared with 28% of women. Those in employment work very long hours: 46% of employees report working excessively long hours, much higher than the 9% OECD average. Relatedly, the distribution of household work is the most imbalanced OECD-wide: men contribute an average of 21 hours per month to household tasks, much less than the OECD average of 74 hours.

Box 2. **Gaps in well-being** *(cont.)*

Figure 18. **Breadwinners' labour market experience continues to vary considerably across groups**

In 2011



1. "Unpaid family worker", "Pupil, student or unpaid work experience" and "Other inactive person" categories which have a very small share were excluded from the figure.

Source: Turkstat.

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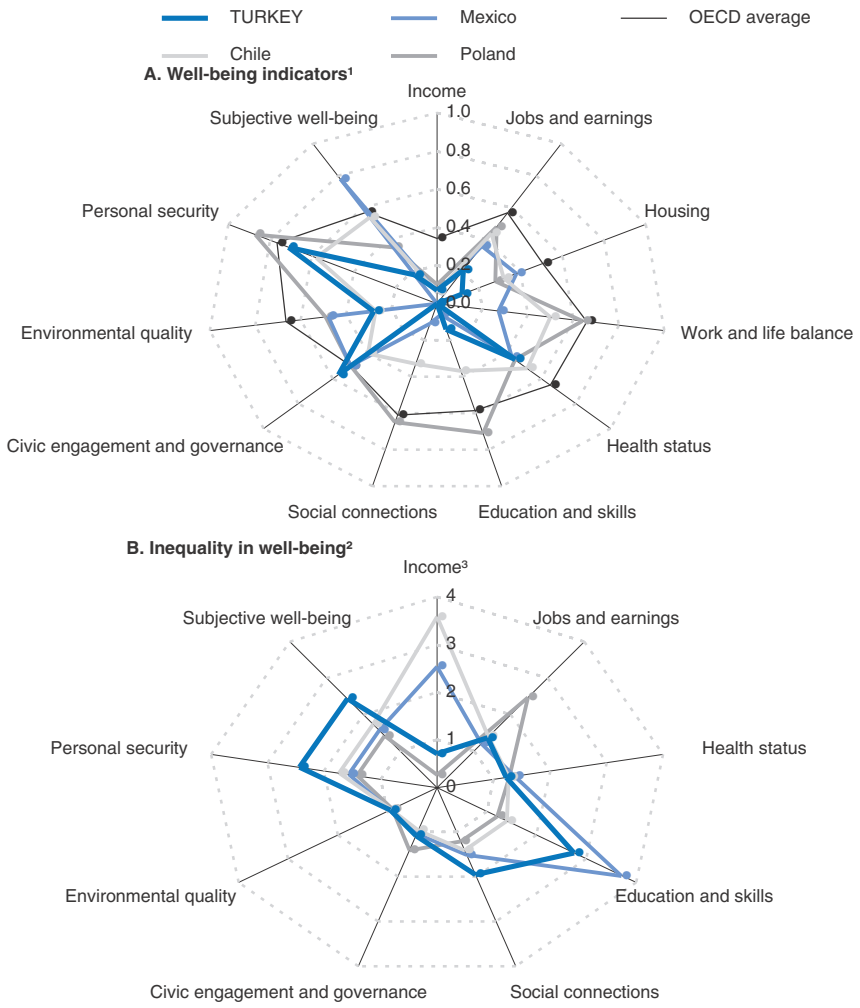
Environmental quality leaves much to be desired. PM10 levels (tiny particulate matter inhaled into the deepest part of the lung) are 36.7 micrograms per cubic meter (with higher peaks in certain regions), far above the guideline limit of 20 by the World Health Organization and the OECD average of 20.9. Access to clean water is also not yet satisfactory: only 61% of people say they are satisfied with water quality, the lowest in the OECD. 33% of people feel that they have no access to green spaces, as against an average of 12% in OECD European countries.

Subjective well-being is low. Turks rated their life satisfaction 5.3 on a scale from 0 to 10 in 2012, below the 6.6 OECD average. In terms of balance between positive and negative feelings, 68% of people reported more positive experiences (pride in accomplishment, enjoyment, rest, and so on) than negative ones (pain, worry, sadness, boredom) on an average day. This was the lowest OECD-wide and far below the 80% OECD average.

help generate greater fiscal resources for social transfers and other policies that support social inclusion.

Remaining gaps in labour force participation and deep divides between types of employers and jobs underpin much of the remaining inequalities. The size of the firm and the formal versus informal status of jobs also make a major difference. Inclusive growth will require overcoming this segmentation (Figures 18 and 19).

Figure 19. **Well-being in Turkey in international comparison**



1. Each well-being dimension is measured by one to three indicators from the OECD Better Life Indicator set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 1 (best) and 0 according to the following formula: (indicator value - minimum value)/(maximum value - minimum value).
2. The ratio of well-being indicators for advantaged versus disadvantaged social groups. Groups depend on indicators, according to a standard cross-country definition. Results may vary according to the assumptions made for the calculation of average indicators in each well-being dimension. Here, all indicators have been given an equal weight within each dimension.
3. Ratios for income dimension range from 90 to 6 across countries. In the income dimension of the figure, the score is divided by 25.

Source: OECD (2013), *How's Life? 2013 Measuring Well-Being*.

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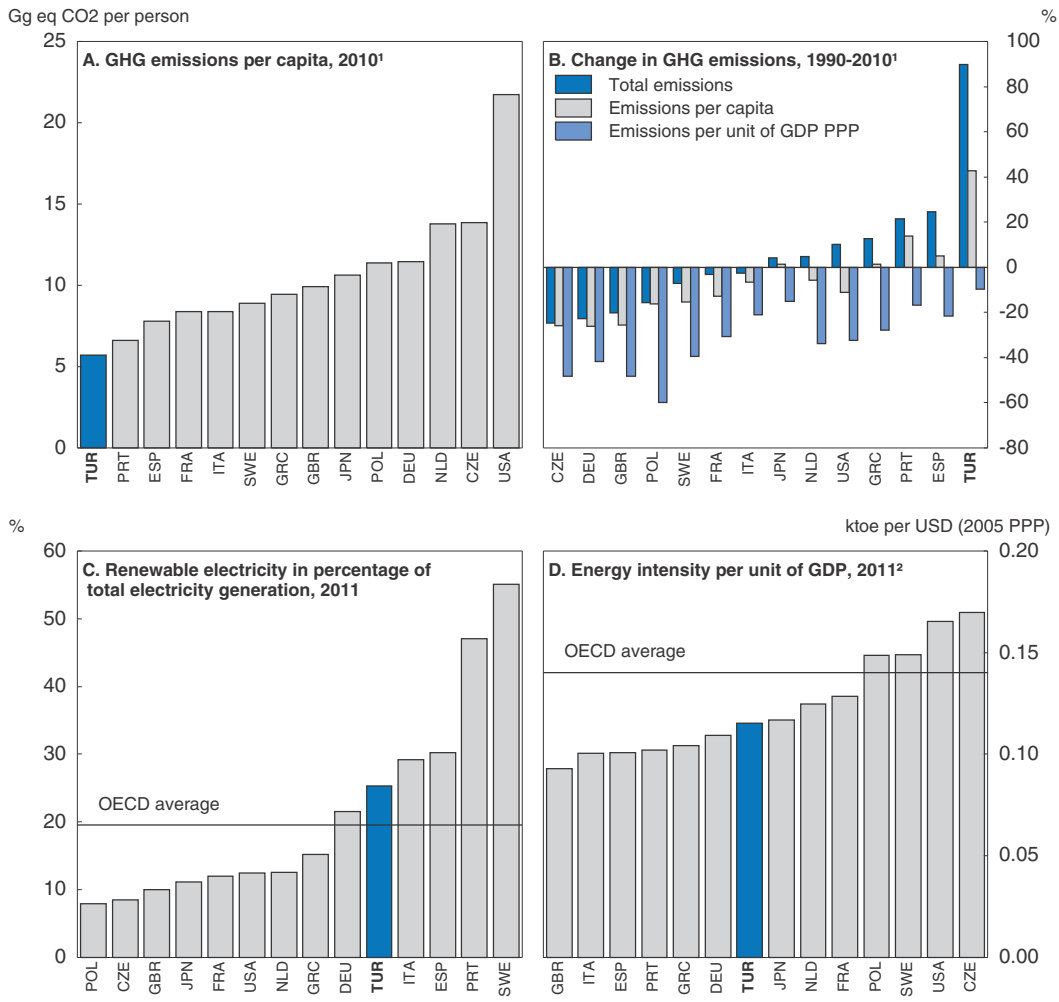
Environmental policy challenges

Turkey became a party to the UN Framework Convention on Climate Change (UNFCCC) in 2004 and ratified the Kyoto Protocol in 2009. Although Turkey's "special circumstances" as a developing country have been recognised in the UNFCCC framework, it remains the only OECD country (including Chile, Mexico and Poland) which does not have a national emissions target and which has not made an international emissions commitment for 2020. Even so, Turkey has set itself quantified objectives to increase the share of renewable energy in electricity production to 30% by 2023, from currently slightly above 25%, and to cut energy intensity by 20% by 2023 compared to 2011. Reaching these goals would not only "green" growth but also help reduce Turkey's external imbalance, as Turkey's energy deficit accounts for about 6 percentage points of the 8% of GDP current account deficit in 2013. It

Figure 20. **Greenhouse gas emissions are low but have strongly increased**



1. Including positive values of land use, land-use change and forestry (LULLUCF), i.e. including sources of GHG emissions and excluding removals/sequestration of greenhouse gas, for carbon dioxide (CO2) emissions in tonnes CO2 equivalent. The model EDGAR is used to determine which emissions from LULUCF are included. "Positive" values refer to emissions of greenhouse gases, and negative values refer to removals/sequestration of greenhouse gases.

Source: IEA/EDGAR model results for 2010; *OECD Environment Database* and *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888933097984

would be desirable to complement these goals with quantitative mitigation targets for greenhouse gas emissions.

Turkey's carbon footprint per capita is still relatively low, but greenhouse gas (GHG) emissions are increasing rapidly and have not yet been fully decoupled from GDP growth (Figure 20). There are favourable conditions for renewable energy, in particular wind and solar, and generating capacity is expanding rapidly. The main policy instruments to spur the deployment of renewable capacity include feed-in tariffs with extra bonuses depending on the share of domestically-manufactured generating equipment, VAT and customs exemptions for equipment, preferential allocation of land to renewable energy producers and licence exemptions for generation facilities up to 1 MW. To stimulate a swifter expansion of renewable energy, the comparatively low level and duration of feed-in-tariffs could be increased. In addition, licensing and permission procedures for medium to large-scale projects as well as grid connection for wind capacity could be facilitated, and the cost and availability of financing improved (IEA, 2013). In addition, the energy intensity of the economy, although below the OECD average, could be further reduced through stricter enforcement of existing policies such as minimum standards and required energy performance certificates, central heating and metering systems for new buildings, and mandatory energy audits for public buildings exceeding a certain size. Finally, transition to wider and more efficient use of economic instruments (such as explicit carbon taxes and cap-and trade systems) would mitigate emissions at lower costs. In the medium-term, and also taking into account fiscal and social implications of such initiatives, there is room to reduce variations in implicit carbon tax rates (taxes per tonne of CO_2) across fuels in different uses (OECD, 2013d).

Recommendations to foster strong and inclusive growth by promoting structural change in the business sector

- Improve the overall regulatory framework for doing business, make it more predictable and use OECD product and labour market indicators as benchmarks.
- Continue to reduce *de facto* differences in the tax and social obligations of firms related to their size.
- Eliminate restrictions on the full range of modern employment forms in the formal sector (including temporary work, employment through work agencies, home-based work and remote work).
- Consider reducing labour tax wedges for low-skilled workers across the country and expanding earned income tax credit type support.
- Continue to strengthen incentives for female labour force participation through reforms facilitating the hiring of women in the formal sector.
- Strengthen the social safety net and the up-skilling avenues for the unemployed, expanding the most successful schemes.
- Implement the legislated but not yet operational state aid monitoring system. Evaluate the outcomes of support programmes for the SMEs and workers affected by structural changes. Focus on the most successful schemes.
- Consider harmonising the implicit carbon tax rate across fuels in different uses in the medium-term.

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ANNEX

Progress in structural reform

This annex reviews actions taken on recommendations from the 2012 Economic Survey of Turkey. They cover the following areas: labour market reforms, education reforms and product market and other structural reforms. Each recommendation is followed by a note briefly describing the actions taken. Recommendations that are new in this Survey are not listed in this annex.

This annex presents, under each theme:

- Recommendations from earlier surveys
  - ❖ ***Action taken since the previous* Survey (2012)**

A. Labour market policies

- *The severance payment regime should be re-designed in line with international best practices to make permanent labour contracts more flexible. Temporary and agency employment should be allowed, without sectoral restrictions.*
  - ❖ ***Some action taken.*** *A National Employment Strategy adopted in May 2014 includes such reforms but implementation requires legislative changes which are opposed by several social partner organisations.*
    - – Making available modern employment forms in the formal sector, including permanent labour contracts with severance savings accounts (more secure for workers and potentially more affordable for firms), temporary employment and employment through work agencies are among the top priorities of the 10th Development Plan 2014-2018.
- *Official minimum wages should be kept in check. Wage adjustments to productivity gains should be sought more through collective bargaining at enterprise level.*
  - ❖ ***No action taken.*** *Starting from 2014, the official minimum wage for workers above and below 16 will be unified.*
- *The scope and eligibility conditions for the official unemployment insurance scheme should be broadened. This is key for progress towards "flexicurity" adapted to the Turkish context.*
  - ❖ ***No substantive action taken*** *but the scope and eligibility conditions of the official unemployment insurance scheme will be re-assessed in the context of the forthcoming National Employment Strategy.*
- *Increase women's labour force participation by providing high-quality and affordable child and elderly care.*
  - ❖ ***No substantive action taken*** *but an Action Plan on "Increasing Women's Labour Force Participation and Employment" is being prepared, encompassing child, patient and elderly care issues, regulatory innovations to promote gender equality in work, and vocational training programmes for female labour market entrants.*
- *Offer effective lifelong education programme to upgrade the labor market skills for adults whose schooling was inadequate.*
  - ❖ ***Some action taken.*** *A number of policy initiatives are being carried out according to a "Life Long Learning (LLL) Strategy Plan 2014-2018". A National LLL Co-ordination and Information Centre and a LLL web portal are in operation.*

B. Education policies

- *Reduce the large quality gaps among both schools and universities by granting them more autonomy in exchange for more accountability for performance, and by shifting to per student funding, with adjustments for socio-economic disadvantages.*
  - ❖ ***Limited action taken.*** *The Ministry of Education launched an Information Management System Project for Education Finance and Training Expenditure and a Budget Based School Performance Monitoring Project. A Quality Assurance System for Vocational and Technical*

Education is in the works, requiring each school to prepare a quality improvement plan to which it will be held accountable.

C. Product market and other structural policies

- *Liberalise agricultural product markets by reducing the high degree of price interventions, using less distortive forms of support and offering greater scope for import competition. Social cohesion policies in agriculture should rest on direct transfers to eligible farmers and rural development.*
  - ❖ ***No substantive action.*** *However, the National Development Plan 2014-2018 sets the goal of "making converge minimum welfare levels in rural areas to national standards". Yearly plans are being prepared to strengthen rural economies, improve human capital, improve social and physical infrastructures and reduce rural poverty. Moreover, future cuts in agricultural tariffs are to depend on the outcomes of WTO negotiations. Alignment with the EU common agricultural policy framework is ongoing, but accession negotiations on the "Agriculture and Rural Development" chapter have yet to be opened.*
- *The comprehensive energy liberalisation plans prepared in the 2000s should be fully implemented.*
  - ❖ ***Actions taken:***
    - The privatisation of electricity distribution companies in all of the 21 electricity distribution regions was completed in 2013.
    - Three power plants were privatised in 2014 and four other privatisations are planned for the remainder of the year.
    - The eligibility level for competitive electricity procurement was reduced to 4 500 kWh per year in January 2014. Competitive procurement will be generalised in 2015.
    - A new Electricity Market Law No. 6446 was adopted in March 2013. It specifies new measures to facilitate the operation of generation, transmission, distribution, wholesale, retail sale and export and import activities in the electricity sector.
    - Amendments are planned in the Natural Gas Market Law. The state-owned gas company BOTAS will be unbundled into different companies specialised in transmission, trade and storage, and LNG activities. This should facilitate new entries in the gas sector.
- *Review the structure of fuel taxes and harmonise the implicit carbon tax rate on different fuels in different uses. Co-ordinate fuel taxation initiatives with Climate Change Action Plan priorities.*
  - ❖ ***No action taken*** *but new measures are under consideration to promote the utilisation of renewable energy sources.*

Thematic chapters

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Chapter 1

Reducing macroeconomic imbalances

Turkey recovered swiftly from the global financial crisis but sizeable macroeconomic imbalances arose in the process. High consumer price inflation and a wide current account deficit of around 8% of GDP are sources of vulnerability. Even though below-potential growth helps rebalancing and disinflation, these imbalances endure. The financial sector still looks resilient thanks to buffers built up mainly prior to the financial crisis. However, private sector balance sheet risks have gained prominence as leverage increased. Macroeconomic and structural policy levers need to steer a passage between robust but externally unsustainable growth and externally viable but low growth. Monetary policy needs to bring inflation and inflation expectations closer to target. Macroprudential policies could more systematically lean against capital inflows and credit cycles to reduce private sector balance sheet vulnerabilities. The fiscal stance is broadly appropriate, but compliance with a multi-year general government spending ceiling would help avoid pro-cyclical loosening in case of revenue surprises and help boost domestic saving. Overall, policies should help reduce the risk of disruptions in capital flows as monetary policy stimulus is being withdrawn in the United States.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Introduction

After a vigorous rebound from the global financial crisis, Turkey entered a period of below-potential growth in the past two years. However, consumer price inflation at over 9% (2014Q1) is far above the target and the current account deficit at around 7.5% of GDP (2014Q1) is much too high for comfort. Turkey's growth is too dependent on domestic demand and foreign savings, which mainly come in the form of short-term debt-creating inflows and have pushed up leverage in the economy. This dependence has increased external vulnerabilities, especially after the global crisis (Figure 1.1). Between mid-2013 and early 2014, the risks were illustrated by the tapering-related financial turmoil. Aggravated by domestic political tensions, the ensuing financial stress was greater for Turkey than for a number of other emerging countries. Risks, including that of a sudden stop in capital inflows, will remain high as monetary policy stimulus is being withdrawn in the United States. If these risks were to materialise, GDP growth and financial stability could be jeopardised.

This chapter discusses the underlying causes of these imbalances, which include macroeconomic policy settings and more fundamentally a dearth of domestic saving and competitiveness problems. It then turns to discussing policies that can reduce the vulnerabilities and foster more balanced growth. Durably rebalancing the economy requires structural policies to unleash productivity growth in the business sector and necessary reforms are discussed in detail in Chapter 2.

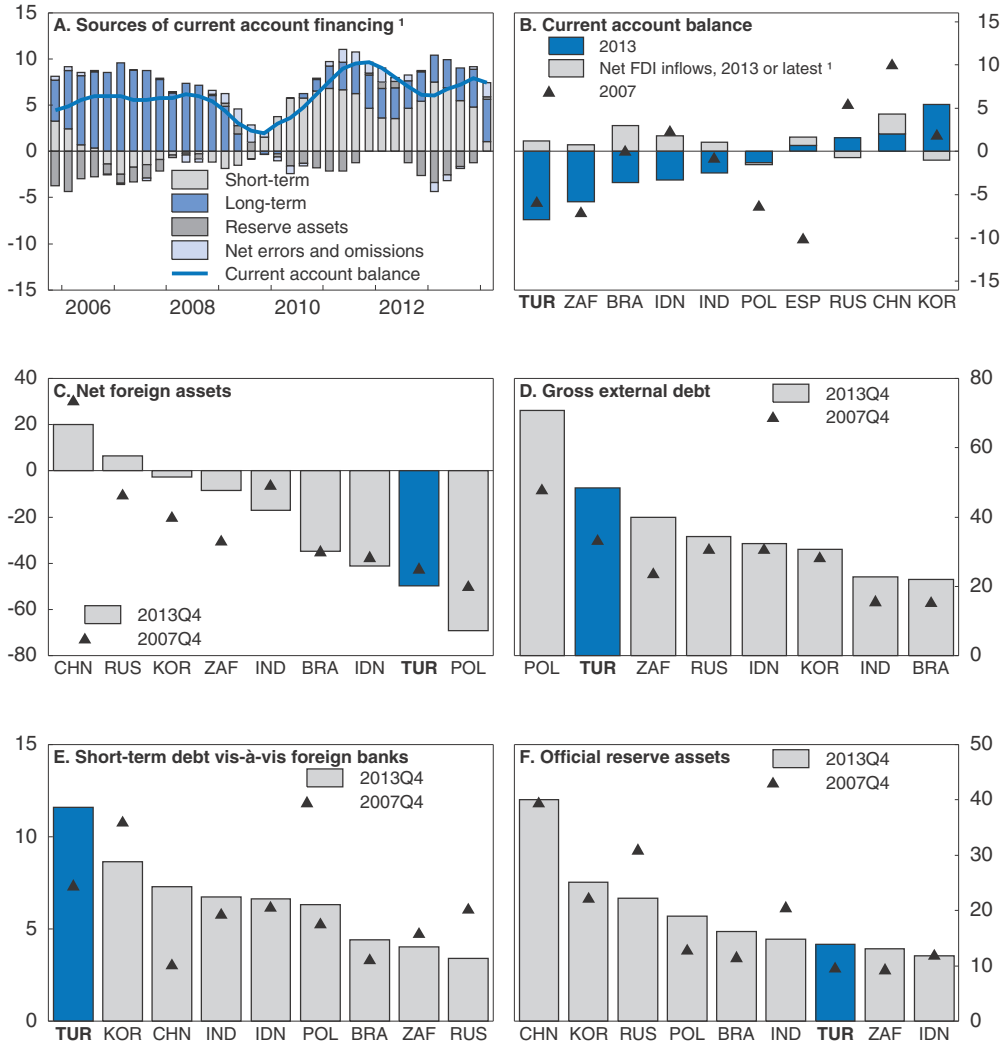
Underlying current account pressures persist

Turkey's impressive growth performance in the 2000s was mainly driven by domestic demand, while contributions from net exports remained small or negative, leading to a steadily widening current account deficit (Figure 1.2). This trend was briefly interrupted during the crisis in 2009, but domestic demand rebounded quickly and the current account deficit in per cent of GDP reached almost double-digit levels in 2011 on the back of strong capital inflows and credit growth. The current account deficit narrowed to around 6% of GDP in 2012 as macro-policies were tightened, capital inflows slowed and one-off factors in the form of exceptional gold exports improved the trade balance. In 2013, the current account deficit widened again to around 8% of GDP, in part due to a restocking of gold inventories. Excluding gold trade, the current account deficit continued to narrow slightly in 2013 (Figure 1.2).

Cyclical conditions played a role in Turkey's current account developments. In particular the sharp deterioration in 2010-11 reflected the swift rebound in domestic activity fuelled by capital inflows on the back of highly expansionary monetary policy in advanced economies. External demand especially in Europe, Turkey's largest export market, remained subdued and the terms-of-trade deteriorated as commodity prices increased. Since then, cyclical conditions have normalised as domestic demand slowed in 2012 and external demand picked up somewhat in 2013. Abstracting from cyclical factors, estimates of a structural current account suggest a sizeable deficit of around 5% of GDP in

Figure 1.1. **External vulnerabilities are high and have increased since the global financial crisis**

In per cent of GDP



1. Rolling 4-quarter sum as percentage of moving average GDP. Short-term inflows refer to the sum of portfolio investment and short-term other investment net inflows. Long-term inflows refer to the sum of FDI, bond issues and long-term other investment net inflows.

Source: IMF, *International Financial Statistics*; IMF, *Balance of Payments*; *OECD Economic Outlook Database*; World Bank, IMF, BIS, OECD Joint External Debt Hub.

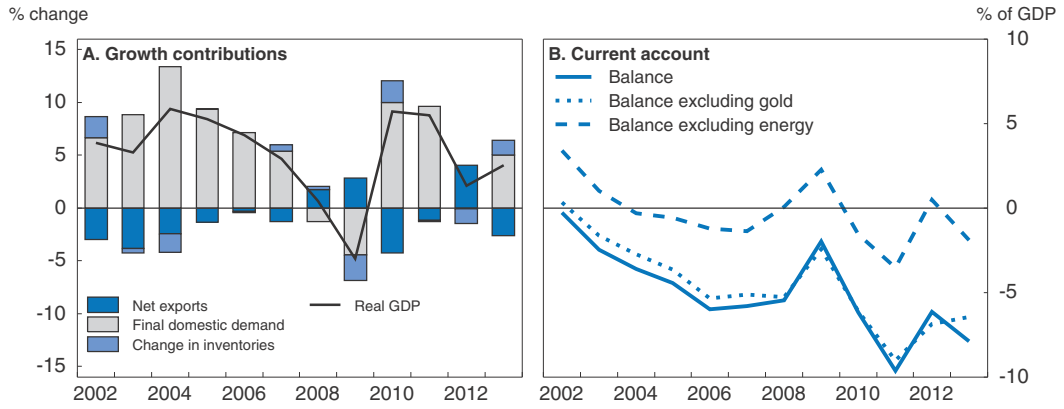
StatLink http://dx.doi.org/10.1787/888933097661

2012 (IMF, 2013a; Kara and Sarikaya, 2013). In addition, Kara and Sarikaya (2013) find that the structural current account deficit has widened slightly over the last decade, from below 4% until about 2005 to around 5% in recent years.

Current account deficits are to be expected in catching-up emerging markets with a young population. However, estimates relating the current account to fundamentals such as demographics, GDP per capita and natural resource abundance and policies such as fiscal, social and financial policies indicate that Turkey's structural current account deficit in 2012 may have been 1.5-3% of GDP larger than implied by fundamentals and desirable

Figure 1.2. **Growth driven by domestic demand has led to imbalances**

Percentage changes



Source: *OECD Economic Outlook Database* and Central Bank of Republic of Turkey.

StatLink http://dx.doi.org/10.1787/888933097680

policy settings (IMF, 2013a; Philips *et al.*, 2013). Policy or market distortions may therefore account for at least part of Turkey's current account deficit.

In addition, the financing structure of the current account deteriorated after the crisis, with a growing share of more volatile short-term debt-creating inflows, which are more prone to sudden reversals. Since 2012, the share of long-term inflows has increased again somewhat, helped by policy measures, but the share of FDI inflows remains low. The banking sector channelled part of the short-term inflows into long-term loans to finance productive capacity enhancing investments and there are no clear signs of asset price bubbles (see below). However, the banking sector faces a maturity mismatch and leverage has built up swiftly in the non-financial private sector, which may raise financial stability concerns.

External debt, which is almost entirely foreign-currency denominated, stands slightly below 50% of GDP. Some simple calculations, based on the methodology outlined in Röhn (2012), can illustrate the implications of the current account deficit and composition of inflows for the evolution of external debt. For example, assuming 4% real GDP growth, 5% inflation (measured by the GDP deflator), no nominal depreciation and debt-creating inflows of around 7% of GDP (as observed in late 2013), the gross external debt-to-GDP ratio would rise, converging to around 80%, with half of the adjustment completed after eight years. Under the same assumptions for real GDP growth and inflation, but assuming that debt-creating inflows were reduced by 3 percentage points to 4% of GDP, both by raising domestic saving and by attracting more FDI, the gross external debt-to-GDP ratio would stabilise at the current level of around 50%.

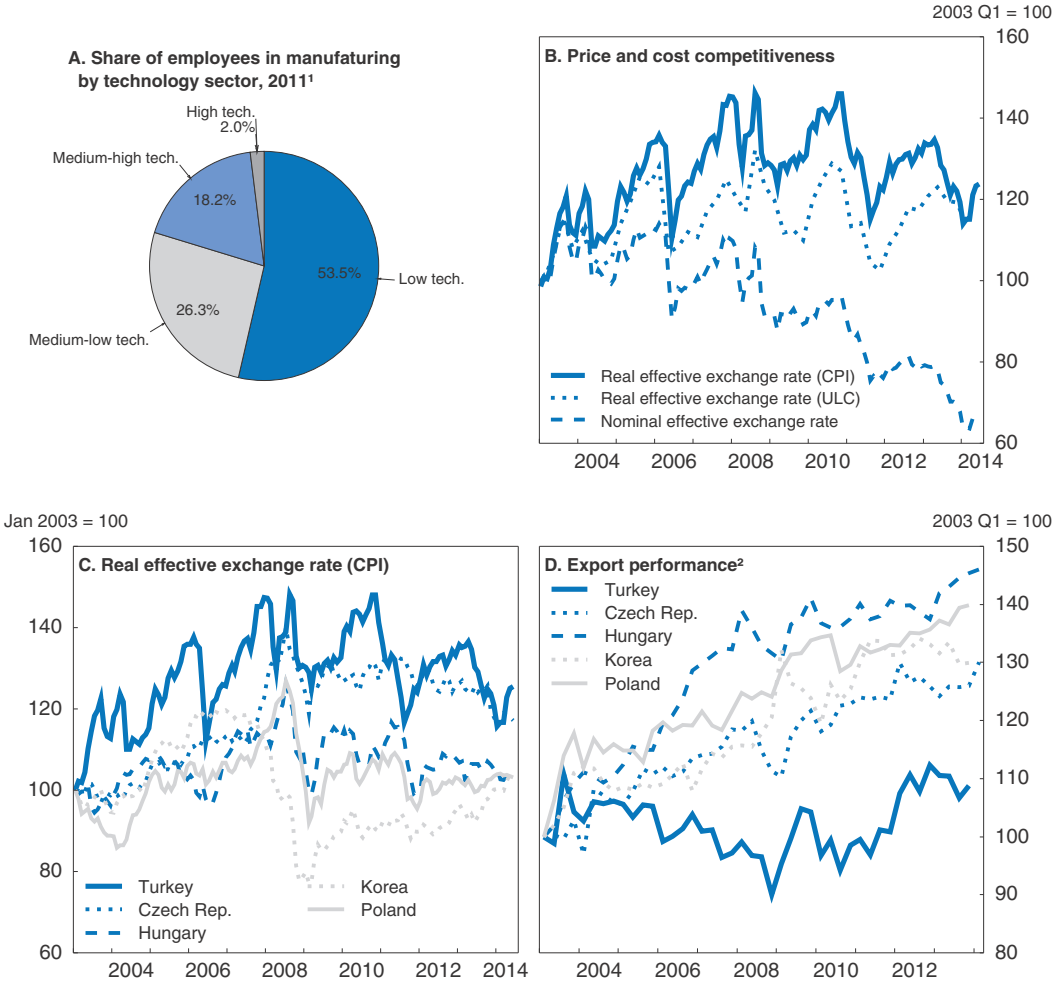
To achieve more balanced and socially inclusive growth, Turkey needs to tackle the underlying current account pressures. Recent IMF research estimates that *ceteris paribus* – holding the real exchange rate, terms-of-trade and structural determinants of saving constant – GDP growth in excess of 2¾ to 3½ per cent has been historically associated with a deteriorating current account in Turkey (IMF 2013b). While growth in the vicinity of 3% may lead to more balanced growth, it is unlikely to create enough jobs to absorb an expanding workforce (due to rural migration, demographics and increasing female labour force participation) and to reduce unemployment in line with targets. To overcome this "speed limit", Turkey needs to durably strengthen competitiveness and raise private saving

as analysed in detail in the previous *Economic Survey* (OECD, 2012a) and revisited in this one. In addition, improving energy efficiency and reaping the full potential of renewable energy resources will not only reduce Turkey's reliance on energy imports and foreign saving but will also promote greener growth.

Competitiveness

Turkey's price and cost competitiveness has come under pressure over the past decade mainly owing to higher average inflation and unit labour cost growth compared to trading partners and competitors (OECD, 2012a). The trend real exchange rate (both in CPI and unit labour cost terms) appreciation has been steeper than in most peers notwithstanding temporary bouts of depreciation driven by the nominal exchange rate in times of financial turmoil (Figure 1.3). This has hurt export growth while boosting imports and domestic

Figure 1.3. **Recent competitiveness gains need to be preserved**



1. Based on full-time equivalents. Sectoral classification based on OECD technology classification.
2. "Export performance" measures export market share developments and is calculated as actual volume growth in exports relative to the growth of the country's export market, which represents the potential export growth for a country assuming that its market shares remain unchanged at their 2005 level. An adjustment is made for Turkey to exclude gold exports.

Source: OECD calculations based on Turkstat data; *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888933098003

demand, leading to a deterioration of the trade deficit and hence the current account. Turkey successfully improved non-price competitiveness and diversified its export portfolio towards medium-to-high technology sectors, but the export share of low- and low-to-medium technology sectors, which are more vulnerable to deteriorations in price and cost competitiveness, is still high (see Table 1.1). These sectors employ a large share of the workforce in manufacturing and the bulk of Turkey's low-skilled workers (Figure 1.3 and Chapter 2). Therefore, maintaining price and cost competitiveness is not only essential to rebalance the economy but also to foster inclusive growth.

Table 1.1. **Revealed comparative advantage in manufacturing**

In 2009

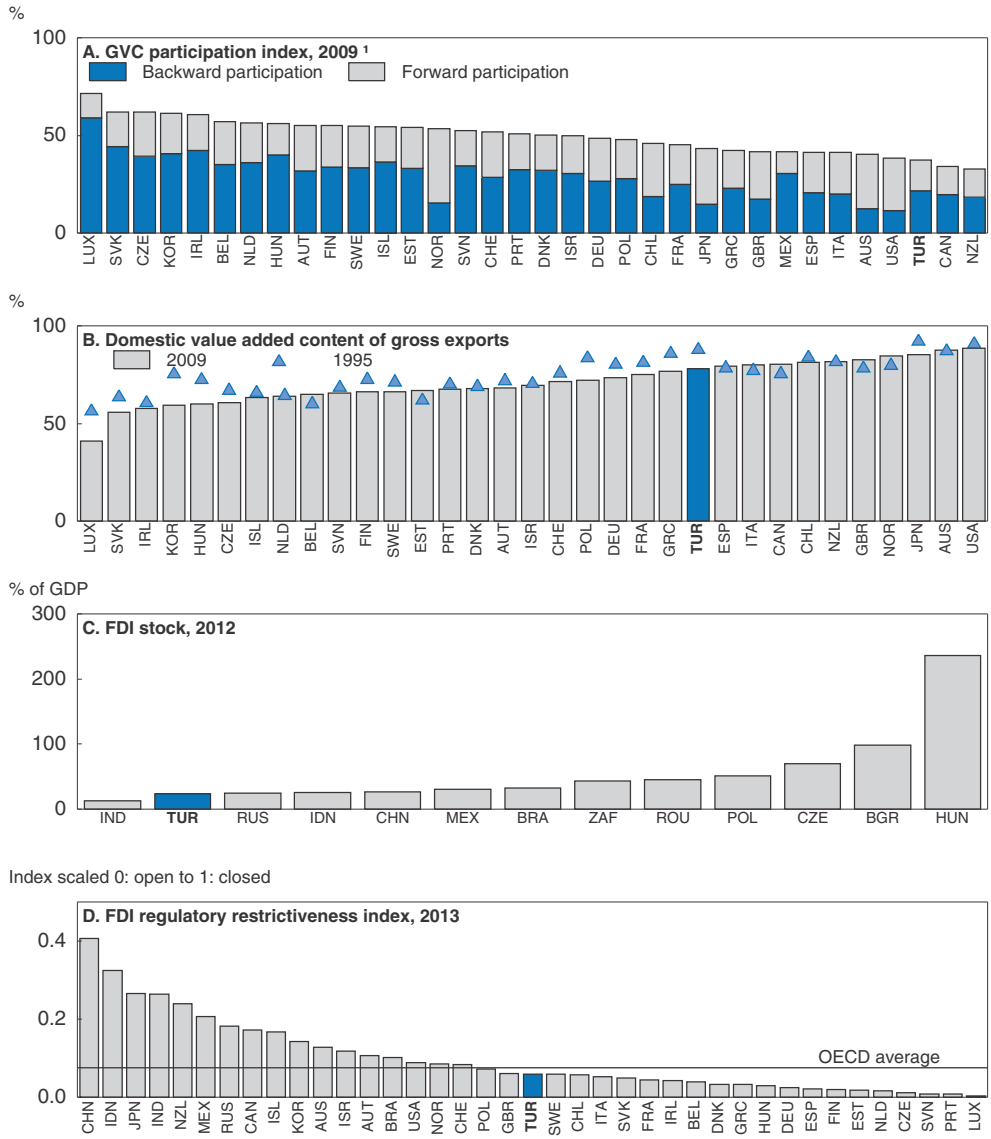
	Based on gross exports	Based on value-added exports
Food products, beverages and tobacco	0.82	0.84
Textiles, textile products, leather and footwear	3.03	3.14
Wood, paper, paper products, printing and publishing	0.34	0.32
Chemicals and non-metallic mineral products	0.70	0.68
Basic metals and fabricated metal products	2.10	1.94
Machinery and equipment (not elsewhere classified)	0.80	0.78
Electrical and optical equipment	0.30	0.31
Transport equipment	1.27	1.24
Other manufacturing; recycling	0.71	0.67

Note: Revealed comparative advantage is calculated as the share of exports of a certain industry by a specific country and the world in relation to the total exports of that country and the world. A value greater than 1 indicates a comparative advantage by a country in a certain industry.
Source: *OECD-WTO-TiVA Database*, June 2013.

Swings in the real exchange rate affect economic performance. After a sharp appreciation driven by strong capital inflows during the rebound from the global financial crisis, the real exchange rate depreciated over the course of 2011 as the central bank took measures and concerns over an intensifying euro area crisis adversely affected risk sentiment. This lowered import demand, helped exporters recoup market shares and contributed to rebalancing the economy in 2012 (Figure 1.3). From 2012 until mid-2013, the real exchange rate appreciated again. Nevertheless, Turkey continued to gain export market share. Following heightened domestic and international uncertainty since May 2013, the real exchange rate (CPI based) has depreciated again, by about 9%, despite some recent appreciation. This more competitive real exchange rate will help further rebalance demand.

Exports could be boosted by better integrating Turkey into global value chains (GVC). Firms especially in the textiles, wearing apparel, basic metal, rubber and plastic, automotives and construction sectors managed to successfully integrate into GVCs in the past two decades. However, Turkey's economy-wide participation appears rather low, also relative to comparable countries such as Poland and Chile (Figure 1.4), even if the underlying data may not adequalty capture recent structural changes. Recent OECD research (OECD, 2013) highlights that to remain competitive in a world dominated by GVCs, firms require efficient access to imports of intermediate goods and to services. Since GVCs involve activities within and between multi-national enterprises and independent suppliers, the ability to enforce contracts is crucial. Countries with sound business structures and legal systems tend to export more in more complex industries. Tasks that require more complex contracts (e.g. R&D, design, branding) are also more easily carried

Figure 1.4. **Participation in global value chains and FDI should be strengthened**



1. Backward participation shows the use of foreign intermediates in a country's exports and forward participation the use by other countries of a country's inputs in their exports.

Source: OECD (2013), Interconnected economies: Benefiting from global value chains; *OECD-WTO Trade in Value Added (TiVA) Database*; IMF, *International Financial Statistics*; *www.oecd.org/investment/index*.

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out in countries with well-functioning business sectors and contract enforcement (OECD, 2013).

Attracting FDI is also essential to better integrate into GVCs as multi-national enterprises are crucial players in GVCs. FDI inflows to Turkey have been low (Figure 1.4) and mainly concentrated in the non-tradable sector, notwithstanding a more recent increase in inflows into the tradable sector. FDI inflows picked up in the second half of the 2000s but slowed during the crisis in 2008-09. They started to increase again but have not yet reached pre-crisis levels. This partly owes to the sluggish recovery in the European Union, Turkey's

main source of foreign investment. But structural problems may also be responsible. Formal FDI restrictions are below the OECD average (Figure 1.4), suggesting that improvements in the broader business environment are key for Turkey to attract FDI (Chapter 2).

Durably preserving Turkey's competitiveness requires structural reforms to unleash long-term investment and productivity growth in the business sector, including by improving the regulatory framework in product and labour markets as suggested in Chapter 2. This would allow Turkish firms to better compete in export markets and at home, and may help attract more FDI. The authorities have introduced many schemes to improve external competitiveness. As discussed in Chapter 2, these schemes may help mitigate some of the excess costs and barriers to resource reallocation created by weak regulatory product and labour market settings. But they support only parts of the economy comprising eligible regions and sectors. Instead, Turkey should align its regulatory settings for the entire business sector with OECD best practices to facilitate a shift of resources to the most productive businesses.

These structural reforms face political economy obstacles and may take time to implement (Chapter 2). In the meantime, a larger burden will fall on macroeconomic policies to preserve competitiveness and prevent Turkey from being trapped between two equilibria with either high but externally unsustainable growth or externally viable but low growth.

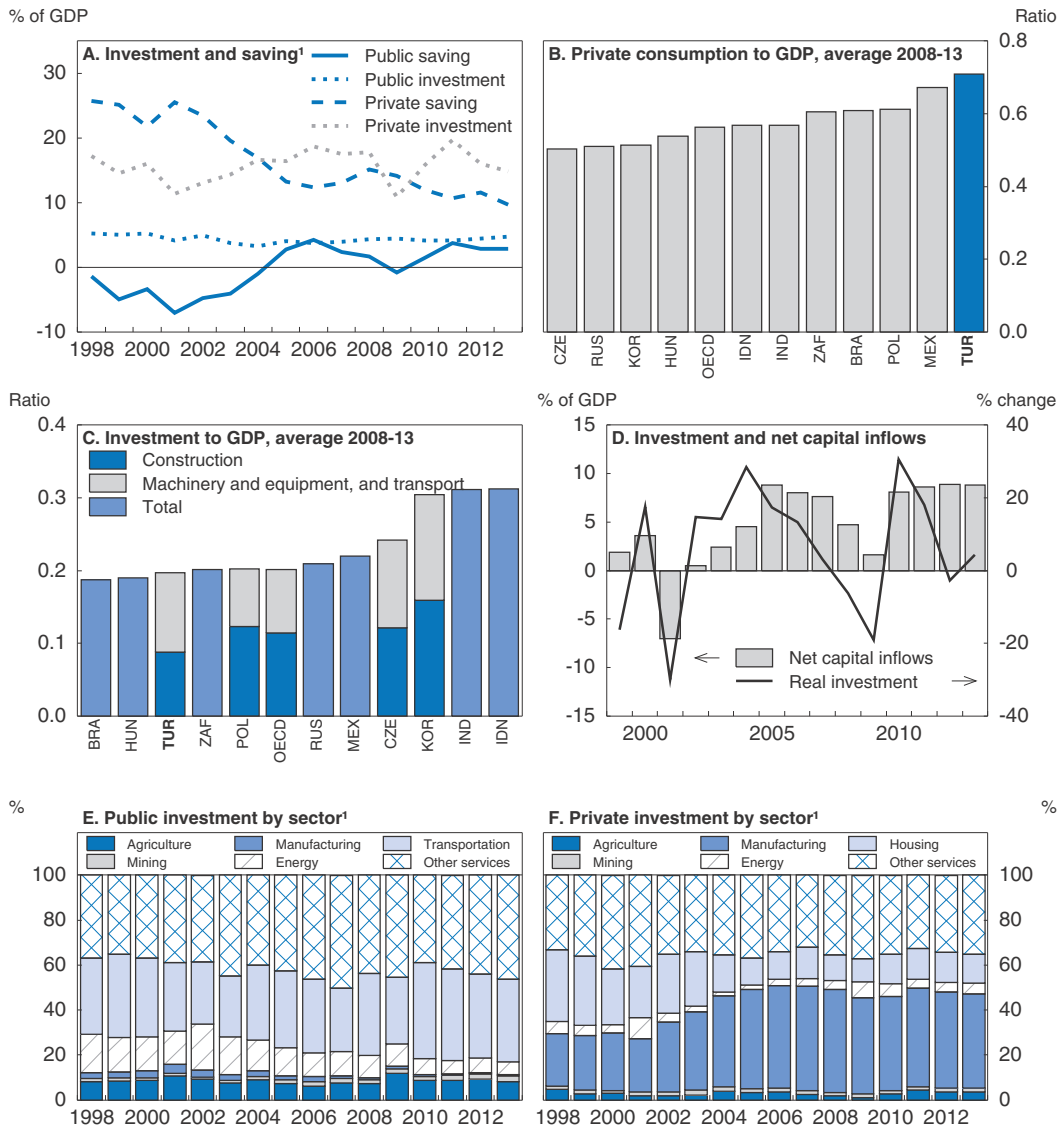
Saving

As discussed in the previous *Economic Survey* (OECD, 2012a), the corollary of the widening trade deficit was the opening up of a domestic saving-investment gap since 2001. This gap reflected both a secular decline in private saving and a surge in private investment (Figure 1.5). In contrast, public saving increased. After a temporary increase during the crisis years 2008-09, private saving continued to decline.

The surge in private investment appears to have been mainly channelled into machinery and equipment and directed towards manufacturing sectors. In addition, investment in transportation and communication remained high. Construction investment expanded moderately and was mainly driven by public investment to enhance transport infrastructure. The share of private residential investment in total private investment was on a declining trend until the crisis after which it picked up again slightly. Overall, the ratio of investment to GDP is low in international comparison, especially compared to fast-growing Asian economies, and the rebalancing observed in 2012–13 was mainly due to falling private investment rather than increasing private saving (Figure 1.5). Thus, if anything, investment needs to be strengthened and closing the saving-investment gap requires boosting domestic saving.

Boosting domestic saving would not only reduce Turkey's dependence on foreign saving, and hence volatile capital inflows, but could also foster more inclusive growth. First, with low domestic saving, investment is at the margin financed through foreign saving, thus making investment dependent on capital inflow cycles and external conditions. This contributes to the traditionally high volatility of investment and GDP growth in Turkey (Figure 1.5). More stable output growth would especially benefit low-skilled people who are usually the first to lose their jobs in recessions. Second, higher domestic saving may be needed to sustain higher growth rates which are needed to absorb

Figure 1.5. **Saving-investment gap**



1. Data for 2013 are Ministry of Development estimates.

Source: Ministry of Development; *OECD Economic Outlook Database*; Central Bank of the Republic of Turkey.

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new entrants into the labour force and reduce unemployment. Third, domestic saving can help domestic banks co-finance foreign investments. FDI is facilitated through domestic co-finance as domestic banks can directly monitor local projects to which the technology must be adapted (Aghion et al., 2006). A higher share of FDI would reduce dependence on more fickle types of inflows. FDI may also spur productivity growth through technology spillovers, though this effect appears to depend on the sectoral allocation and the capacity to absorp foreign technology, which in turn depends for example on human capital endowment (Lesher and Miroudot, 2008).[1] Hence, FDI may contribute to less volatile and higher GDP growth.

Survey evidence suggests that the drop in private saving stemmed mainly from a broad-based fall in household saving, encompassing all income groups (see below), rather than in corporate saving (World Bank, 2012). The empirical literature has identified a set of reasons for this decline after the crisis in 2001: i) higher public saving, which may have induced forward-looking agents to expect lower taxation in the future; ii) greater macroeconomic stability; iii) the expansion of the social security system, which may have reduced the need for precautionary saving; iv) lower real interest rates, which reduced incentives to save; and v) better access to credit after the stabilisation of the banking sector, which reduced precautionary saving further and allowed private agents to better smooth consumption over time. Looking ahead, none of these drivers is likely to reverse in the future, nor does it appear desirable to counteract any of the developments through policy measures, with the exception of credit expansion because it has arguably been excessive (see below). Demographic developments are also unlikely to boost saving substantially in the future. While the youth dependency ratio is projected to decline, which should support saving, this could be at least partly offset by the projected increase in the old-age dependency ratio.

The authorities have identified the need to increase domestic saving as one of their priorities, as reflected in their 2014-16 Medium-Term Programme and the 10th Development Plan. An important measure has been the reform of the voluntary private pension system (see also OECD, 2012a). Existing tax advantages were replaced with matching government contributions in January 2013, which tilted incentives towards participation of lower income households and non-taxpayers. The uptake has been strong, with the number of participants increasing by 33% to 4.2 million from January to December 2013 (Pension Monitoring Center, 2013). However, the amount of funds in the system remains small at around 1.7% of GDP. In addition, it remains unclear whether the reform fosters additional saving or merely shifts funds from other private saving vehicles. Investigating the international experience with similar reforms, Özel and Yalcin (2013) estimate only modest additional saving potential of about 1.5% of GDP. However, 63% of the respondents in a May 2014 survey conducted by the Turkish Treasury and the Pension Monitoring Center indicated that they would not have used other saving vehicles absent the pension reform.

Labour market reforms may help reduce the saving-investment gap. Employment rates, especially those of women, are low in Turkey. Increasing them could boost saving both through higher household income and lower dependency ratios. Several empirical studies for Turkey show that income and saving are positively correlated (World Bank, 2012; Pirgan-Matur et al., 2012). Empirical evidence suggests that structural labour market reforms along the lines suggested in Chapter 2 could improve the current account. The findings in Kerdrain et al. (2010) and Jaumotte and Sodsriwiboon (2010) suggest that high labour costs due to strict employment protection and high minimum wages relative to firm productivity levels may induce firms to substitute capital for labour. Hence, reducing labour costs could reduce investment, at least temporarily. Kerdrain et al. (2010) also find that lower employment protection is associated with higher saving rates if unemployment benefits are low possibly due to higher precautionary saving. However, this latter effect may be offset if unemployment benefits are simultaneously increased. To the extent that the suggested labour market reforms shift more people into the formal labour market, household income and saving potential may be boosted given the sizable wage gap between formal and informal jobs (Baskaya and Hülagü, 2011). Finally, labour market

reforms could help foster resource reallocation and productivity growth, which could positively affect firm profitability and hence corporate saving.

Renewable energy and energy efficiency

Turkey's energy deficit accounted for about 6 percentage points of the 8% of GDP current account deficit in 2013. In contrast to Turkey's lack of fossil fuels, renewable energy resources are relatively abundant. In addition, the scope to improve energy efficiency is considerable. This suggests there is ample room to both reduce the current account deficit and to "green" growth. In this context, Turkey has set itself targets to raise the share of renewable energy in electricity generation to 30% by 2023, from currently slightly above 25%, and improve energy efficiency by 20% by 2023 compared to 2011.

There are favourable conditions for renewable energy, in particular wind and solar, in Turkey, and generating capacity is expanding rapidly. In 2012, natural gas accounted for 44% of total electricity generation followed by coal, hydropower and wind with shares of 28%, 24% and 2.4%, respectively. Solar capacity is under construction but it is not yet operational on a significant scale. The main policy instruments to spur the deployment of renewable capacity include feed-in tariffs with extra bonuses depending on the share of domestically-manufactured generating equipment, VAT and customs exemptions for equipment, preferential allocation of land to renewable energy producers and licence exemptions for generation facilities up to 1 MW. In a recent assessment, the IEA (2013) identified the comparatively low level and duration of feed-in-tariffs, the licensing and permission procedures for medium to large-scale projects, grid connection for wind capacity and the cost and availability of financing as potential bottlenecks hampering a swifter expansion of renewable energy.

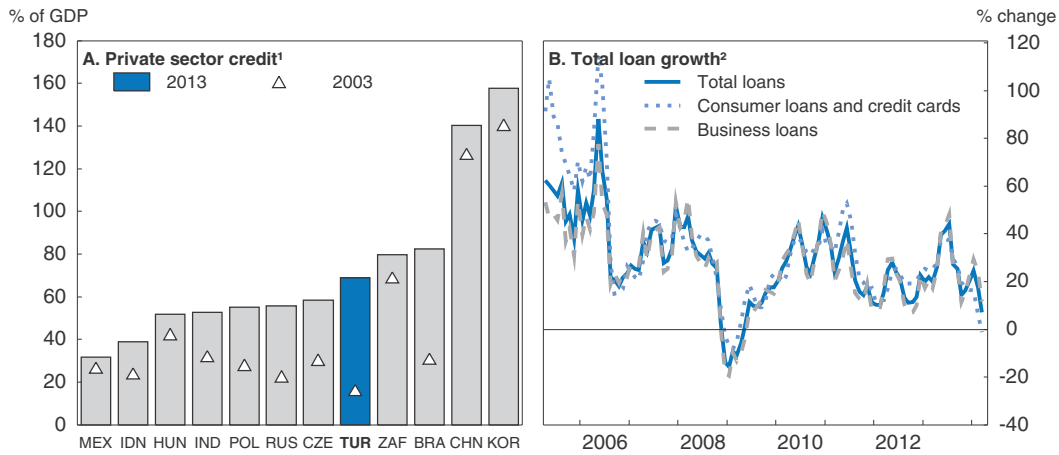
Although the energy intensity of the economy is below the OECD average, large potential exists to increase energy efficiency and progress over time has been limited. A wide range of energy efficiency projects appear profitable for investors even without any energy and climate policies given high energy prices, especially in the area of residential and commercial buildings (EBRD, 2011). Stricter enforcement of existing policies such as minimum standards and required energy performance certificates, central heating and metering systems for new buildings, and mandatory energy audits for public buildings exceeding a certain size, would complement private incentives to seek efficiency gains.

Macroeconomic policy to tackle imbalances

Financial market policies

Over the past decade leverage has increased rapidly in the private sector, although from a low base. Growing availability of credit enabled low-income households and small and medium enterprises to increase borrowing and expand consumption and investment. While this has supported inclusive growth and living standards, it may raise concerns related to some debtors' capacity to repay debt. Although the level of financial intermediation is not particularly high (Figure 1.6) and has not surpassed levels that recent research has identified as possibly detrimental to growth (Cecchetti and Kharroubi, 2012; Law and Singh, 2014), periods of strong credit growth have been associated with higher probabilities of financial crisis (Kaminsky and Reinhart, 1999; OECD, 2012b; Schularick and Taylor, 2012).

Figure 1.6. **Leverage has increased substantially but remains moderate**



1. 2004 figure instead of 2003 for Poland.
2. Annualised growth rate of the loan stock, calculated as the 12th power of 3-month moving average of monthly growth rates. For total and commercial loans, growth rates are foreign exchange rate adjusted using a basket consisting of 70% US dollar and 30% euro.

Source: IMF, *International Financial Statistics*, and Banking Regulation and Supervision Agency (BRSA).

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After the global crisis, Turkey faced strong capital inflows, which translated into domestic loan growth that far outstripped that of other emerging markets, averaging 25% per year. These developments prompted the central bank in late 2010 to adopt an innovative monetary policy framework which puts greater weight on financial stability (see below), and, subsequently, the Banking Regulation and Supervision Agency (BRSA) tightened macroprudential measures. These measures helped curb loan growth from the second half of 2011. After accelerating again sharply in the first half of 2013, loan growth moderated anew.

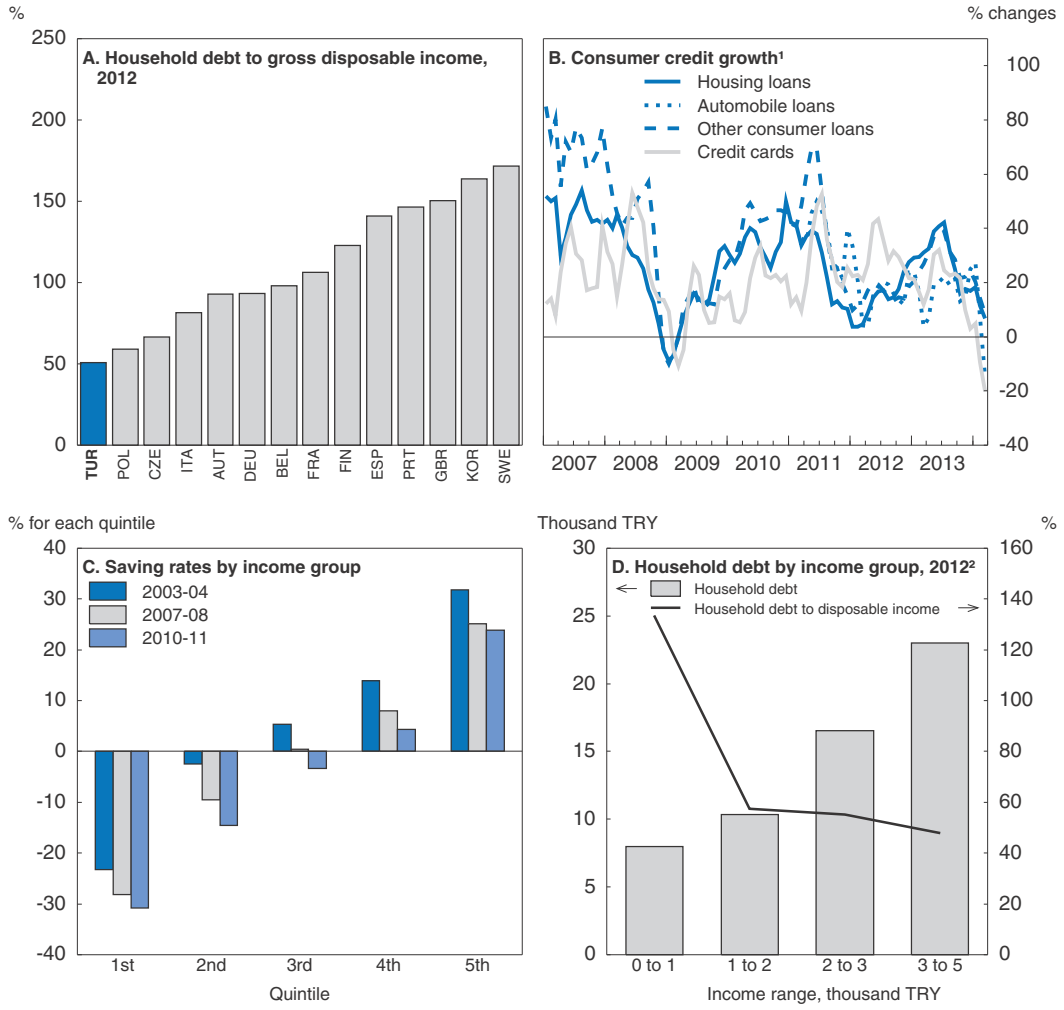
Since May 2013, financial conditions in Turkey deteriorated, notwithstanding the more recent stabilisation. Capital inflows slowed, the currency depreciated sharply and in January 2014 the central bank hiked interest rates. Partly as a result, the domestic economy is projected to slow somewhat in 2014. These factors may put pressure on private balance sheets. The following sections describe developments in different sectors, highlight vulnerabilities and suggest policy options.

Household sector

Household debt has risen sharply over the past decade but remains moderate in international comparison (Figure 1.7). Household liability ratios have doubled since 2006, reaching about 23% of GDP and 50% of disposable income by mid-2013. Debt service costs have also increased but remained manageable at 5.4% of disposable income in late 2013 (CBRT, 2013b). Interest rate and foreign currency risks are limited as most loans are fixed-rate (except for a small share of housing loans) and lending in foreign currency (as well as in foreign currency indexed loans) has been forbidden since June 2009. Indeed, the household sector holds a sizeable long position in foreign currency, which amounted to around USD 191 billion (23% of GDP) as of early 2013 (CBRT, 2013a).

Since the crisis, the authorities have taken a number of macroprudential measures to rein in consumer debt. The introduction of loan-to-value ratios for housing loans (at 75%),

Figure 1.7. **Household leverage**



1. The annualised growth rate of the total loan stock is calculated as the 12th power of 3-months moving average of monthly growth rates. Includes loans from finance companies.
2. Household debt is per capita annual total consumer and housing credit in 2012. Income estimate is the annualized mid-point of monthly income bracket.

Source: OECD Economic Outlook Database; Turkstat, Household Budget Surveys; Central Bank of the Republic of Turkey; OECD calculations; and Banks Association of Turkey.

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higher risk weights on consumer loans and increased provisioning requirements helped curb consumer loan growth in 2011. However, it rebounded in early 2013, mainly driven by housing and general purpose consumer loans (Figure 1.7). Low interest rates, as well as relatively strong increases in house prices and one-off effects due to anticipated regulatory changes in residential real estate taxation, which may have pulled forward demand (see below), have contributed to the pick-up in housing loan growth through the end of 2013. At the same time, improved consumer confidence pushed up demand for general-purpose loans. In October 2013, the BRSA linked credit card limits to income, increased card payments and risk weights and extended loan provisioning regulations to credit cards, overdrafts and vehicles loans. This, together with the substantial hike in interest rates (see below), has helped slow consumer loan growth.

Survey data suggests that the lowest-income groups continuously and increasingly dissaved during the 2000s (Figure 1.7), despite significant income gains. Credit growth for these groups picked up strongly after the crisis. This has helped lower-income groups catch up to consumption levels of higher-income groups. However, it also entails financial stability risks, as the debt-to-income (DTI) ratios of the lowest-income group have increased (Figure 1.7). So far the share of non-performing loans (NPLs) in total consumer loans (including credit cards) has remained low at around 3% at the beginning of 2014, notwithstanding some deterioration in credit card and other personal finance loans observed in recent months. However, with economic growth projected to slow somewhat in 2014, upward pressure on NPL ratios in particular from low-income groups can be expected. DTI ratios should be implemented more broadly across the banking sector and consumer loan types. This would increase household balance sheet resilience, even if it comes at the price of constraining poorer families disproportionately. In addition, recent empirical research suggests that DTI ratios are effective macroprudential tools to restrain credit growth and housing boom-bust cycles (Claessens et al., 2013).

Non-financial corporate sector

Leverage in the non-financial corporate sector has also increased substantially in recent years and corporate financial debt now exceeds 50% of GDP. The share of external debt in total corporate debt has been falling to about 20% and there are no signs that the corporate sector faces difficulties rolling over external debt, despite tightening global credit conditions. Domestic commercial loan growth picked up again in the first half of 2013, with loans to small and medium sized enterprises (SMEs) expanding particularly rapidly. SMEs borrow predominantly in Turkish lira but at comparably shorter maturities. They are thus less exposed to foreign currency risk but may be hit harder by the recent interest rate hikes. The BRSA recently reduced general provisioning requirements on SME loans, which may give a boost to bank lending to SMEs.

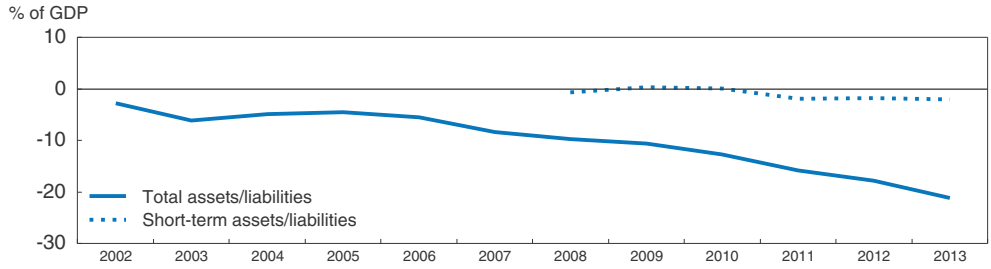
The main risk facing the non-financial corporate sector stems from its widening net foreign currency liability position (Figure 1.8). With a depreciating currency, debt servicing costs increase and put pressure on corporate profits. Foreign currency liabilities have more than quadrupled since 2004 and reached around USD 265 billion (32% of GDP) by January 2014. As foreign currency assets did not grow at the same pace, a short position in foreign currency opened up of about USD 170 billion (21% of GDP). A growing share (now about 65%) of foreign currency loans has been extended by domestic banks after the easing of foreign currency lending regulations in 2009. While this allows for better monitoring of foreign currency risks and increases the traction of macroprudential tools, it has shifted foreign currency related credit risk to the domestic banking sector.

The foreign currency risks of the corporate sector are mitigated by several factors. First, most of the foreign currency liabilities are long term, which reduces rollover risks. The short-term net foreign currency liability position amounts to only about USD 17 billion (2% of GDP). Second, regulations stipulate that domestically operating banks are only allowed to lend in foreign currency if the borrower has income in foreign currency or else loans must be of at least USD 5 million with at least one-year maturity. The latter regulation favours larger firms, which are likely to have better access to financial hedging and increases incentives for banks to carry out proper risk assessments.

Data gaps hamper the assessment of the corporate sector's foreign currency risks. Aggregate data on financial hedges is not publically available, nor is information on foreign

Figure 1.8. **Corporate non-financial sector debt developments**

Net foreign exchange position of non-financial companies



Note: The net foreign exchange position is the difference between foreign-currency-denominated assets and liabilities.

Source: Central Bank of the Republic of Turkey.

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currency collateral. Firm-level data provided by the Turkish central bank provide some insights, even if the firms covered in the database only account for about 40% of the loans granted by domestic and foreign banks. The data suggests that most firms have either no foreign currency loans or at least a partial natural hedge from export income. Only about 12% of the firms have foreign currency loans but no foreign currency income. In addition, foreign currency exposures are smaller in SMEs, with over 65% of them having no foreign exchange loans (CBRT, 2014). Furthermore, information on direct foreign loans by non-resident banks suggests that professional services (mainly R&D), transport and storage, electricity and gas and the construction sector are most heavily exposed to foreign currency loans, and a large share of these loans are extended to finance privatisations and public infrastructure investments (CBRT, 2014).

To counter risks from foreign currency exposure, the authorities could hike their risk weights and provisioning requirements for foreign currency loans extended to firms without revenues in the same currency, bearing in mind the provisions of the OECD Code of Liberalisation of Capital Movements. However, such measures may encourage domestic corporates to increase their borrowing from abroad. Further efforts to develop domestic corporate bond and equity markets could help reduce corporates' reliance on bank loans including foreign currency loans (Chapter 2).

Banks

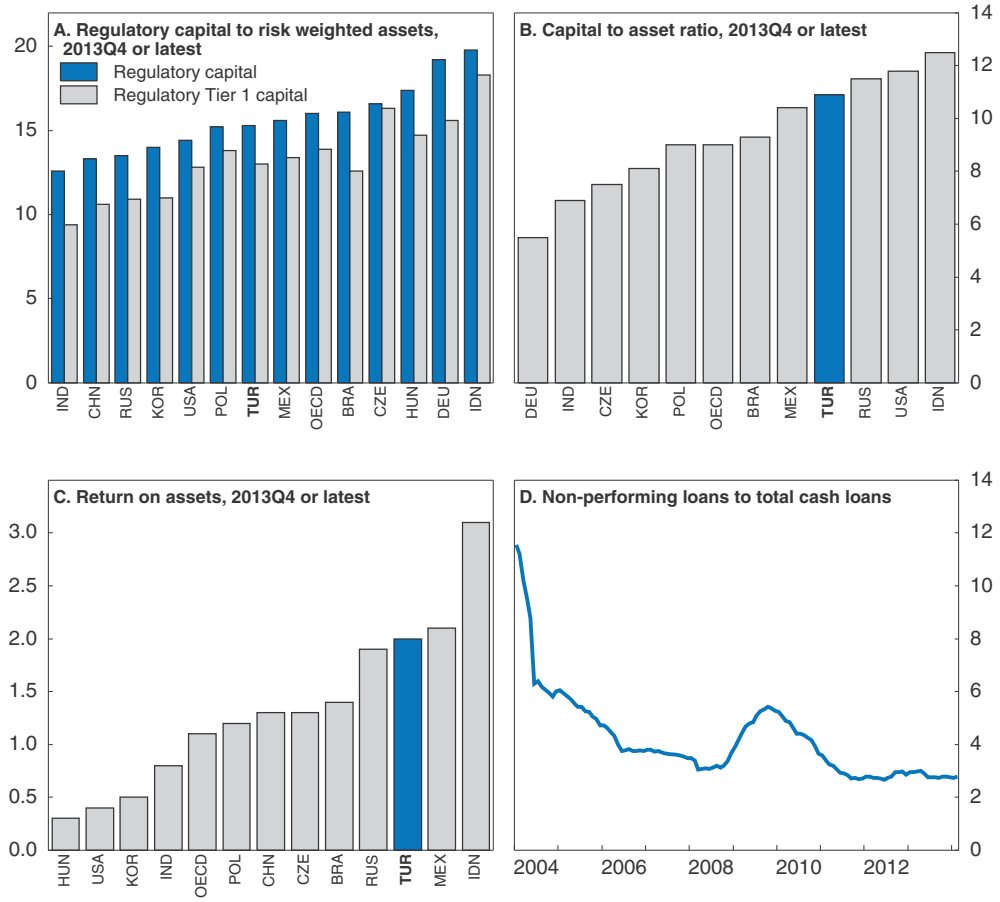
The increasing leverage in the economy is mirrored in the growth of the banking sector. Banking assets doubled from about 50% of GDP in 2003 to over 100% in 2013Q4, mainly reflecting the rapid expansion of loans. Loans have strongly outpaced deposits and the loan-to-deposit ratio reached 110% by the end of 2013. The funding gap has been plugged by stronger reliance on wholesale funding from abroad. The banking system's foreign liabilities reached USD 150 billion (18% of GDP) by late 2013, accounting for about 21% of the banking sector's funding sources (CBRT, 2013b). While these liabilities are predominantly short term, banks have had no problems so far rolling them over as capital inflows into the banking sector continued.

Despite some erosion in financial soundness indicators in recent years, the banking sector still appears robust in international comparison. The Basel II (2.5 principles) framework was fully adopted by mid-2012 and the BRSA has completed most of the draft regulations pertaining to Basel III. These efforts should be maintained. Both capital and

leverage ratios remain high in international comparison and the regulatory capital-to-risk-weighted asset ratio well exceeds legal and target ratios of 8% and 12%, respectively (Figure 1.9). Scenario analysis conducted by the BRSA and the central bank in September 2013, which simulated simultaneous shocks to the exchange rate, eurobond returns, interest rates and NPLs revealed that the capital adequacy ratio of the banking system drops to 7% (slightly below the legal ratio) only in the most adverse scenario (CBRT, 2013b). To build in further safeguards, the authorities recently introduced leverage-based reserve requirements: an additional reserve requirement of 1 to 2% is now imposed on banks that had an average 3 to 3.5% leverage ratio in the last quarter of 2013, and the upper limit of this leverage ratio is to be gradually raised to 5% by 2015.

Figure 1.9. **The banking sector remains robust**

Percentage



Note: The OECD average is calculated as an arithmetic average of available countries.
Source: IMF, *Financial Soundness Indicators*; Banking Regulation and Supervision Agency (BRSA).

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Asset quality also remains high with the overall NPL ratio below 3% at the beginning of 2014 (Table 1.2). In addition, banks' liquidity adequacy ratios for total and foreign exchange liquidity have been well above the legal thresholds of 100% and 80% respectively.

Table 1.2. **Bank loan portfolio**

As of the end of 2014Q1

	Share in total bank loans in %	Non-performing loans in % of total loans in category
Consumer and credit card loans	31	3.3
Housing loans	10	0.6
Vehicle loans	1	3.2
Credit card loans	8	6.0
Other loans	12	3.7
Business loans	69	2.6
Sectors:		
Agriculture, hunting, forestry, fishing	3	3.6
Mining and quarrying	1	3.0
Manufacturing	19	2.5
Electricity, gas and water	5	0.1
Construction	7	4.1
Wholesale and retail trade	12	3.6
Other services	22	2.0
SME loans	26	3.2

Source: Banking Regulation and Supervision Agency (BRSA).

The banking system's foreign exchange liquidity buffers have been strengthened through the introduction of the Reserve Option Mechanism (ROM) at the end of 2011, which allows banks to hold a certain portion of their lira reserve requirements in foreign exchange (see below). Banks have actively used this facility.

The banking sector faces several risks at the current juncture. Maturity mismatch may hurt profitability in the near term, as surging external and domestic funding costs cannot readily be passed on to customers. Furthermore, even though banks' direct exchange rate risk is low, as banks' net foreign currency liability position is almost fully closed by off-balance sheet transactions, mostly swaps, they are indirectly exposed through their lending to the non-financial corporate sector. Finally, banks with heavy exposure to SMEs and/or consumer or credit card loans to low-income households may face deteriorating asset quality.

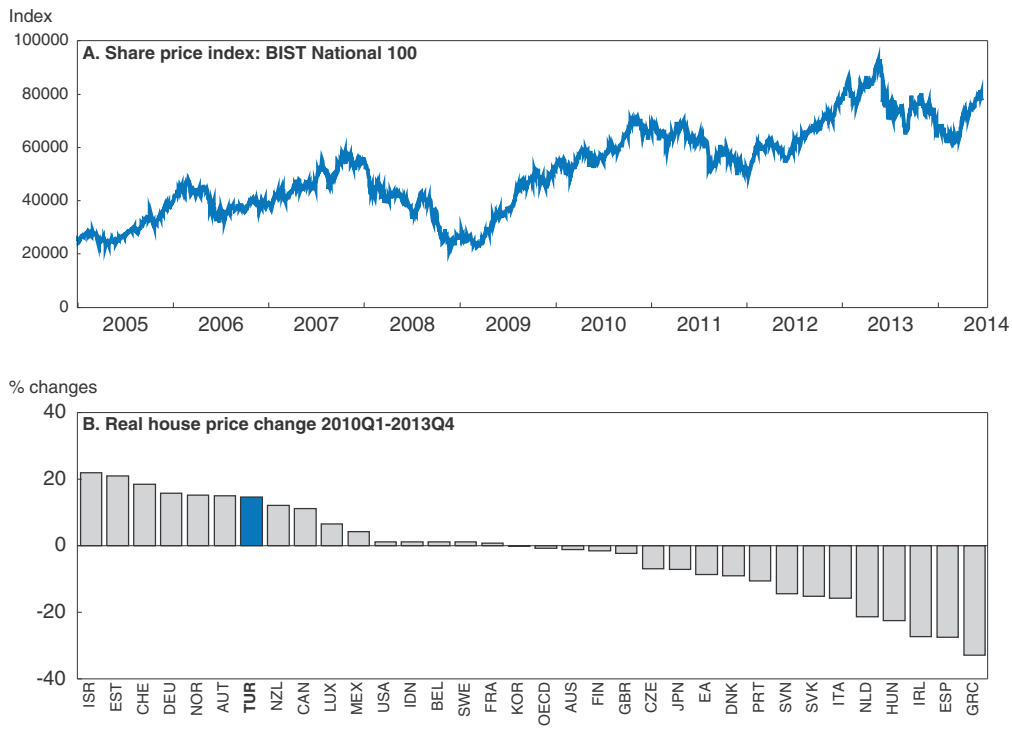
As noted, the BRSA has applied a range of macroprudential tools to rein in credit growth in recent years. Its toolbox is being strengthened further, notably through countercyclical capital requirements. It could be reinforced even more via dynamic provisioning. Coordination with other agencies has also been strengthened with the establishment in 2011 of the Financial Stability Committee (FSC) – which comprises the CBRT, the BRSA, the Treasury, the Savings Deposit Insurance Fund and the Capital Market Board. However, macroprudential measures could be more proactively used to lean against capital inflow and loan growth cycles. Credit growth had reached almost 40% between late 2010 and early 2011 before the BRSA took measures to slow loan growth in June 2011. Credit growth accelerated again sharply in the first half of 2013, far exceeding the central bank's 15% reference rate. But it was only in October 2013 that the BRSA tightened macroprudential measures. As a result, credit, and especially consumer loan growth slowed (Figure 1.6).

Asset markets

After the capital inflow driven rally from early 2009 to May 2013, during which the Istanbul stock exchange index almost quadrupled, the Turkish stock market dropped by more than 30% by March 2014 after which it started to recover (Figure 1.10). The drop reflected mostly a sell-off by domestic residents as foreign investors mostly stayed put. The impact on financial stability and the real economy from the equity market is likely to be limited, as stock market capitalisation is still low and households only hold a small portion of their assets in stocks.

House prices have increased rapidly and may have significant macroeconomic effects. Deflated by the CPI, they increased around 6% in 2013, one of the fastest rates in OECD countries. In Istanbul, they jumped by 12%. Since the start of the official data series in January 2010, real house prices in Turkey have risen by about 14%, a robust increase in international comparison but slower than for example in Norway, Germany, Austria and Switzerland (Figure 1.10). House prices have grown faster than rents and in line with disposable income between 2010 and 2013. Household survey data suggest that the home ownership rate is around 67% in Turkey.

Figure 1.10. **Asset market developments**



Source: Datastream and *OECD House Price Database*.

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The number of house sales jumped by almost 65% in 2013, after rising on average by around 13% between 2008 and 2012. About 40% of house sales have been mortgage financed. The surge in house sales is likely due to a change in the VAT regime of newly-built property, which pulled forward demand for already built and licenced residential

housing. Under the new system, the VAT rate depends on a set of factors including the land value rather than only the size of the property. But the surge in sales may also be due to pent-up supply. After growing sharply in 2010-11, particularly because of increased supply by the Housing Development Administration of Turkey (TOKİ) and urban transformation projects in a number of metropolitan municipalities, building construction output stagnated in 2012-13. Building permit growth (by number of dwelling units) also slowed in 2013 and remained below the long-term average growth rate.

The shortness of most official series makes it hard to assess the housing market. The authorities should continue to monitor developments closely and stand ready to tighten macroprudential measures if needed, for example through a decrease in loan-to-value ratios. Increasing land supply, as advocated in the 10th Development Plan, may also ease pressures on house prices in the medium term.

Monetary policy

Given Turkey's open capital account, the CBRT faces the difficult task of taming inflationary pressures while avoiding potentially destabilising capital inflow surges. Other things equal, raising policy interest rates to contain inflation encourages capital inflows, which push up the exchange rate, harming competitiveness, and fuel domestic credit booms, inducing a build-up of foreign currency liabilities that weakens balance sheets. The same challenge arises when global liquidity expands and global rates decline, but high domestic inflation calls for tight monetary policy.

As discussed in detail in the previous *Economic Survey* (OECD, 2012a), in dealing with this "trilemma", the Turkish central bank (CBRT) shifted from a pure inflation targeting approach introduced in 2006 towards a more unconventional approach in late 2010. While preserving price stability as the main monetary policy goal, financial stability has been adopted as an additional objective.

In this context, the central bank has targeted inflation, while monitoring credit growth and the exchange rate. It began to set a medium-term inflation target with a ±2% uncertainty band in 2006. The target is set at 5% for 2014, 2015 and 2016. In addition, the central bank views annual nominal credit growth of about 15% in the short term as a prudent benchmark based on historical international experience. As credit deepening advances, credit growth should follow a gradual downward path (Kara et al., 2014). Finally, the CBRT has explicitly aimed to avoid excessive exchange rate misalignments. In its view, a trend real effective exchange rate appreciation is consistent with a catch-up process and measurement bias due to quality improvements (Alper et al., 2013), and sharp or persistent deviations from this path should be avoided due to feedback effects from exchange rates to credit growth. For example, rapid lira appreciation improves the balance sheets of firms, which are typically net borrowers of foreign currency. This, in turn, may lead to excessive lending appetite by banks and thus may feed into rapid credit growth and systemic risk. Rapid credit growth, in turn, may lead to a relative rise of non-tradable prices, further increasing real appreciation pressures. This feedback loop between exchange rates and credit growth can become a source of vulnerability and eventually end in a sudden reversal of capital flows (Alper et al., 2013).

This multiple-objective approach has necessitated the use of a variety of policy instruments. A key one has been the asymmetric and relatively wide interest corridor (in contrast to a symmetric and narrow corridor in conventional inflation targeting regimes),

delineated by overnight (O/N) borrowing and lending rates together with a one-week repo lending rate. Through active liquidity management via open market operations, the CBRT has been steering interest rates within this corridor on a daily basis. The CBRT has valued this flexibility as it allows to react quickly to volatile capital inflows. According to the CBRT (Alper et al., 2013), the impact of sharp changes in capital flows on exchange rates can be smoothed through active liquidity policy, thereby reducing the need for more costly direct foreign exchange intervention. The interest rate corridor may also be used to change the composition of inflows during capital inflow surges. By creating short-term interest rate volatility at the lower end of the interest rate corridor via liquidity management, short-term inflows are discouraged, while this volatility is less relevant for long-term investors.

In late 2011, the CBRT added the Reserve Option Mechanism (ROM) to its monetary toolbox. The ROM allows banks to meet their lira reserve requirements with foreign exchange or gold up to a limit. Presently banks are allowed to hold up to 60% of their lira reserve requirements in foreign currency and 30% in gold. Conversion occurs at the market exchange rate multiplied by an increasing penalty parameter, the Reserve Option Coefficient (ROC), which currently ranges from 1.4 to 3.2 for foreign exchange and from 1.4 to 2.5 for gold. The ROM aims to support the foreign currency liquidity management of the banking system, to increase the CBRT's foreign currency reserves, to reduce the need for costly sterilized interventions in the foreign exchange market and to limit the adverse effects of excess capital flow volatility on macroeconomic and financial stability. Utilisation of the ROM depends mostly on the relative costs of domestic versus external funding. The ROM acts as an automatic stabiliser. At times of strong inflows, costs of foreign currency liquidity decline and banks seek to increase the use of the ROM, thereby redirecting inflows into the facility while releasing lira and countering appreciation pressures. The opposite should happen during outflows. With the effective ROC greater than 1, part of the inflows will be automatically sterilized. Since its inception the ROM has been intensively used by commercial banks with the utilisation rate consistently above 80%.

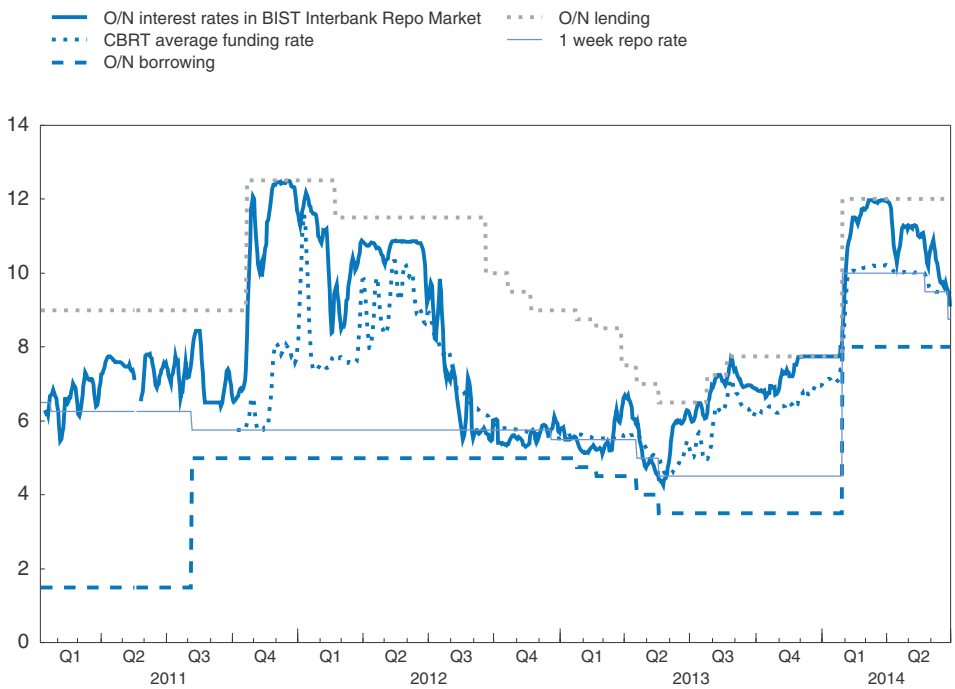
As described in the previous *Survey* (OECD, 2012a), more standard reserve requirements, differentiated by maturity and currency denomination, have also been part of the new monetary framework. These reserve requirements have not been changed since May 2013.

The new framework has undergone different phases (Figure 1.11):

- Late 2010 to July 2011 (US Federal Reserve quantitative easing QE2 and surging capital inflows): the CBRT cut the lower bound of the interest rate corridor (O/N borrowing rate) and increased interest rate volatility to discourage short-term capital inflows; reserve requirements were hiked and differentiated by maturity to influence the composition of flows; the CBRT also carried out sterilised foreign exchange purchase auctions.
- August 2011 to mid-2012 (intensification of the euro area debt crisis): in order to avoid a sudden stop due to the reversal in risk sentiment, to contain depreciation pressures and faced with surging inflation, the CBRT widened the interest rate corridor by increasing the upper bound (O/N lending rate) and provided less liquidity at the one-week repo rate, pushing up market rates; from August 2011 to January 2012, the CBRT also sold around USD 15 billion worth of foreign exchange via auctions and outright interventions.
- Mid-2012 to mid-2013 (diminished tail risks associated with a possible break-up of the euro area): the CBRT responded to the resurgence of capital inflows by increasing

Figure 1.11. **The monetary policy stance**

Per cent



Source: Central Bank of the Republic of Turkey.

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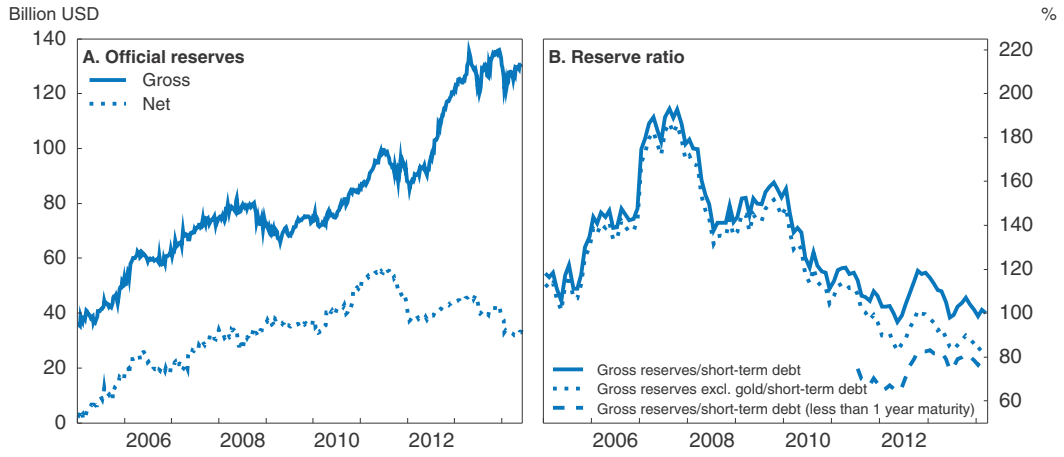
liquidity and thus lowering short-term market rates; the O/N lending rate was gradually cut; instead of resorting to foreign exchange buying auctions, the CBRT fine-tuned the ROM facility to mop up excess foreign exchange liquidity.

- May 2013 to January 2014 (Fed tapering discussion and domestic political tensions): the CBRT successively hiked the O/N lending rate to 7.75% and provided less liquidity to steer market rates towards the upper bound of the corridor. Since August 2013 the goal of the CBRT has been to increase the predictability of monetary policy and to reduce interest rate uncertainty (notably through more information on liquidity management operations). Between June 2013 and end-January 2014 the CBRT provided foreign exchange of over USD 23 billion through outright sales and auctions.[2]

The record of this policy framework is mixed. On the positive side, the interest rate corridor, active liquidity management and the ROM have been shown to reduce exchange rate volatility (Akçelik et al., 2012; Ermişoğlu et al., 2013; Oduncu, et al., 2013a). Değerli and Fendoğlu (2013), in addition, find that the ROM reduced volatility, skewness and kurtosis of exchange rate expectations, implying that tail risks of large exchange rate swings associated with sharp movements in capital flows have diminished. However, developments in late 2013 and early 2014 put these findings into perspective. Empirical results suggest that the new monetary policy framework significantly contributed to the decrease in credit growth volatility (Oduncu et al., 2013b) and reduced the sensitivity of capital inflows to global conditions (Aysan et al., 2014). A drawback of the above mentioned studies is that their assessment is confined to a period of relatively benign external conditions.

The ROM has also contributed to the build-up of banks' foreign exchange liquidity buffers and central bank gross reserves, with banks accumulating around USD 50 billion through the ROM at the central bank in the first two years after the ROM's inception. However, gross reserves still appear relatively low compared to the external short-term debt of the economy (Figure 1.12). Moreover, reserves accumulated through the ROM are not under the full control of the central bank. Net reserves have recently been strengthened by extending export rediscount credits, but these reserves did not match the increase in gross reserves and remain at a moderate level.[3] Since the beginning of the financial market turmoil in May 2013, the CBRT was forced to resume foreign exchange selling auctions to stem depreciation pressures since banks' release of foreign exchange from the ROM was only limited. This partly reflects the fact that capital outflows mainly concerned portfolio flows, while inflows into the banking sector remained relatively stable. Thus banks did not experience any funding problems and were not forced to draw down their foreign currency reserves. However, the limited release from the ROM may also reflect a more general design issue. During outflow periods banks may expect currency depreciation and higher domestic funding costs, expectations that were vindicated by events following both May and December 2013. Both factors provide incentives to banks to hold on to their foreign currency reserves.

Figure 1.12. **Official reserves**



Source: Central bank of the Republic of Turkey.

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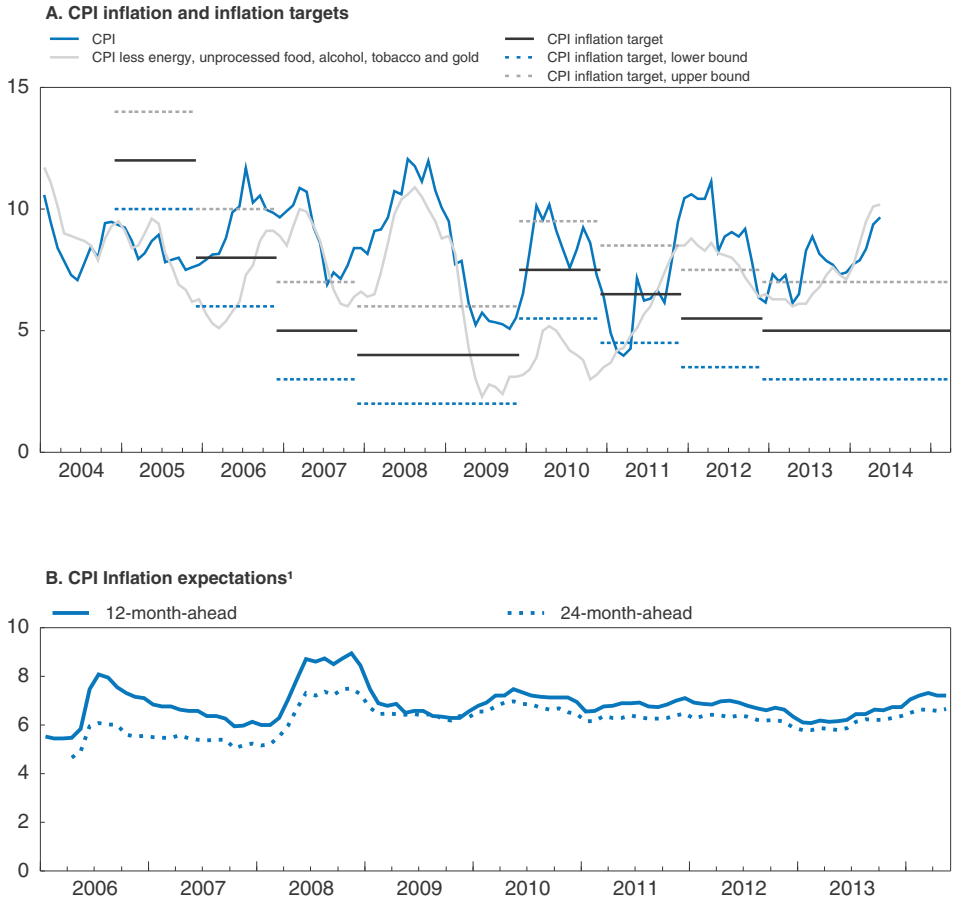
However, the policy framework did not deliver low and stable inflation and inflation expectations have become increasingly de-anchored from the inflation target (Figure 1.13). After reaching double-digit levels in late 2011, consumer price inflation abated but remained volatile. It increased again in the course of 2013, reaching 7.4% in December, and further increased to above 9% in early 2014. Core inflation also started to veer up in the second half of 2013, partly due to pass-through from lira depreciation. Import price increases and exchange rate depreciation are estimated to have added 1.5 percentage points to year-end inflation in 2013. Furthermore, inflation expectations have trended up since mid-2013 and have become increasingly de-anchored from the target, possibly due to the repeated overshooting. Shifts of the inflation target in the past, especially in 2009 and 2010 when its mid-point was temporarily raised, may have also weakened the

Figure 1.13. **Inflation and inflation expectations are high**

Year-on-year percentage changes



1. Based on the Central Bank of Turkey's Survey of Expectations Descriptive Statistics.

Source: OECD, *OECD Economic Outlook Database* and Central Bank of the Republic of Turkey.

StatLink http://dx.doi.org/10.1787/888933097756

anchoring power of the target. In May 2014, 12- and 24-month ahead expectations stood at 7.2% and 6.7% respectively. This may raise inflation through wage and price setting mechanisms going forward and lead to real exchange rate appreciation pressures and competitiveness losses. The central bank expects inflation to remain high until mid-2014 and then to gradually fall to about 7.6% by end-2014 and 5% by end-2015. Tax hikes in January and lagged effects from the exchange rate depreciation between October 2013 and March 2014 are estimated to respectively contribute 0.5 and 0.8 percentage points to year-end inflation (CBRT, 2014).

In January 2014 the CBRT tightened the monetary stance sharply and streamlined its operating framework. In the face of persistent inflation overshooting, rapid depreciation and after having spent a sizeable chunk of its foreign exchange reserves, the CBRT decided in an emergency meeting to hike the marginal O/N lending rate from 7.75 to 12% and the borrowing O/N rate from 3.5 to 8%. The one-week repo rate was increased from 4.5 to 10% and central bank liquidity will henceforth be provided primarily via one-week repos. Then,

in a context of benign global liquidity conditions and improvment in Turkey's risk premia, the one-week repo rate was cut in May and June, by respectively 50 and 75 basis points.

A restrictive monetary stance is needed, and may need to be stiffened further, to ensure inflation and inflation expectations fall back closer to the target. To this end, it may also be advisable to narrow the interest corridor to strengthen the commitment to higher interest rates which would help better manage inflation expectations. While a tight monetary stance may adversely affect growth in the short term, credibility is crucial for monetary policy and macroeconomic stability. Without a credible inflation target, inflation expectations may become more backward-looking and monetary policy may be forced to react more to temporary inflation shocks, causing greater volatility in output and unemployment. Once disinflation is on track, the remaining room for manoeuvre can be used to help smooth exchange rate and capital flows. The authorities could also use foreign exchange purchases to build up reserves, which are not particularly high. However, if used over an extended period, such purchases may run into the "trilemma" and thereby undermine inflation targeting. In this environment, preserving the independence of the central bank is essential.

Fiscal policy

Turkey has not yet caught up with OECD norms on fiscal transparency, notwithstanding improvements, such as better reporting of general government cyclically-adjusted balances. Annual Programmes, Pre-Accession Economic Programmes and Public Debt Management Reports contain relevant information but accrual-based consolidated general government accounts need to be published timely and aligned further with international standards. There are plans to report general government accounts according to accrual-based ESA-95 consolidation norms with shorter time lags from 2015, which would be welcome.

As discussed in the previous *Economic Survey* (OECD, 2012a), fiscal analysis would also be considerably facilitated if all one-off and cyclical revenue and spending items were better identified. A more detailed structural analysis of the general government budget should be included in Turkey's Pre-Accession Economic Programmes and other policy and budget documents, according to international standards. Investment and debt of public entities, such as the public housing agency (TOKI) and municipally-owned enterprises, should also be better monitored. Recently, the Ministry of Finance started to collect financial information from 378 local government-owned corporations affiliated to 250 municipalities, which will form the basis of future systematic reporting. There are also plans to more comprehensively account for government liabilities which arise in the context of expanding public-private partnerships (Box 1.1). The prospective financial costs of the expanding social security system also call for close scrutiny. This is particularly important as health and pension costs have started to increase rapidly.

A regular *Fiscal Policy Report* (similar to the central bank's *Inflation Report*) containing a full set of cyclical adjustments and relevant information on the long-term balances of the social security system and on the activities of public entities not included in the general government sector would improve fiscal transparency. An independent Fiscal Council, along the lines of those existing in a number of OECD countries, could draw on the work of the Court of Accounts, which has been vested with wider auditing powers by a 2010 Court of Accounts Law. These powers extend to the entire general government sector. However, a number of provisions of this law, including the examination of an in-depth annual report by the Court by a specialised Commission of the Parliament, have not yet been

Box 1.1. **Fiscal management of expanding PPPs**

Turkey has been an emerging market pioneer in public-private partnerships (PPPs) for infrastructure development since the mid-1980s. Since then, implementation contracts of 180 PPP projects have been signed, through Build–Operate-Transfer (BOT), Build-Operate (BO), Build-Lease-Transfer (BLT) and Transfer of Operating Rights (ToR) arrangements, including electricity power plants, harbours, motorways, hospitals and airports. These projects were generally technically successful, but created fiscal surprises. In particular, public purchase guarantees at pre-determined prices have been activated more often than expected. After a Court of Accounts review in the mid-2000s, which concluded that government losses from energy PPPs alone (reflecting the gap between purchase and resale prices of electricity) had reached USD 2.3 billion after only a few years of operation (Sayıştay, 2004), qualms about adequate public/private risk sharing in these contracts led to some slowdown in new arrangements. Between 2000 and 2010 several airport, marina and border facility projects were realised under the BOT schemes. After 2010, implementation contracts of major transportation projects such as the Gebze-Izmir Motorway and the third bridge over the Bosphorus have been signed. BLT healthcare projects have also been implemented.

The magnitude of Turkey's infrastructure needs and plans – and the government's objective to limit government borrowing and debt – will nonetheless make additional recourse to PPPs necessary in the period ahead. The 10th Development Plan projects government infrastructure spending of USD 250 billion during 2014-18 and complementary PPP investments of USD 100 billion. Although these preliminary estimates may change after "value for money" analysis, around 30% of total infrastructure spending is expected to be privately financed. During this period PPP projects will include nuclear power plants, harbours, hospitals, marinas, border facilities, schools, dormitories and motorways.

In order to draw on past experiences and more effectively manage these projects, a "Special Ad-Hoc Committee on PPPs" was recently created, with representatives from all ministries and agencies, lenders, contractors and lawyers. The Committee analysed the main governance issues faced in PPP projects, and plans to prepare a strategy paper outlining best practice guidelines for implementation agencies. Accurately accounting for fiscal implications and risks was also high on its agenda. In May 2014, the Treasury formally clarified the procedures and caps on the debt assumption commitment to the creditors of PPP contractors. This is an area prone to "too important to fail" syndromes. More comprehensively, the Treasury and the Ministry of Finance are working on a method to quantify total fiscal commitments related to PPPs, including purchasing guarantees. A full report on Turkey's PPP-related fiscal liabilities is planned for 2015. Finally, the PPP Committee suggested drafting a new Framework Law on PPP agreements.

implemented. These institutional innovations would help Turkey's plans to reform spending and revenue structures (World Bank, 2014).

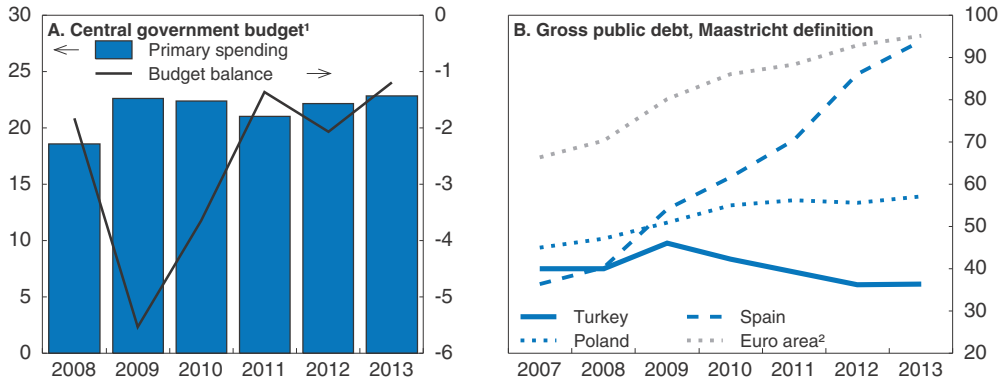
Notwithstanding these caveats, Turkey's overall public finance position appears to remain robust. Fiscal policy continues to outperform the objectives published in the successive medium-term programmes mainly thanks to stronger-than-projected revenue growth, which offset the surge in public infrastructure investment in the first half of 2013. According to authorities' estimates, the general government deficit stood at 1.6% of GDP in 2013 and the debt-to-GDP ratio, at 36.3%, stay on a downward trajectory. In addition, the composition of debt has improved considerably over the past decade. The share of foreign-

currency-denominated debt has fallen to about one third, debt maturities have lengthened and the majority of debt has been issued as fixed rate bonds. This will reduce the immediate impact on public finances of the recent depreciation and hike in risk premia compared to the past.

The government targets set out in the *Medium-Term Programme* published in October 2013 foresee further reductions in the general government budget deficit and debt to 0.7% and 30% of GDP respectively by 2016 (Government of Turkey, 2013). These targets imply a tightening of the fiscal stance in the context of below-potential growth. Such a prudent fiscal stance appears appropriate amid the current electoral cycle and political tensions to preserve credibility and confidence. Should downside risks materialise, such as a sudden stop in capital inflows, room for a discretionary stimulus exists.

Figure 1.14. **The fiscal position is strong**

In per cent of GDP



1. Data for 2013 are estimates from the 2014-16 Medium Term Programme.
2. 15 first members of the euro area.

Source: Undersecretariat of Treasury and *OECD Economic Outlook Database*.

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Primary spending, in particular for personnel, education, health and pensions, increased rapidly in recent years and could only partly be offset by reductions in interest spending. Infrastructure investment has also increased, funded partly through public-private partnerships and state-owned enterprises. Demographic trends, active social policies and large infrastructure projects will put additional pressure on public spending. General government primary spending is to be restrained at around 36% of GDP according to latest *Medium-Term Programme*. However, these spending targets, based on *ex-ante* budget appropriations, have repeatedly been breached in the past – though usually not by much. The spending targets of the general government should become hard spending ceilings, even if implementation may be constitutionally challenging. Outcomes should be reported transparently so as to improve compliance. In the event of revenue windfalls, keeping to such a spending ceiling would help preserve a tight fiscal stance and boost national saving. In addition, in periods of strong capital inflows, a tight fiscal stance would help monetary policy restrain domestic demand and hence inflationary pressures. This would also allow building-up sufficient buffers to counteract a possible capital flow reversal.

Macroeconomic and financial policy recommendations

Monetary and financial market policy

- Ensure the monetary policy stance is sufficiently restrictive to better align inflation and inflation expectations with the inflation target.
- Consider introducing dynamic provisioning, debt-to-income caps across more loan types, and higher risk weights or provisioning requirements on foreign currency loans extended to companies without revenues in the same currency.
- Further encourage the development of savings and long-term investment.

Fiscal policy

- Continue the ongoing fiscal consolidation. Provide discretionary stimulus should downside risks materialise.
- Further improve fiscal monitoring by publishing general government accounts according to international standards as well as a comprehensive report on fiscal policy covering all fiscal and quasi-fiscal activities.
- Adopt a multi-year general government spending ceiling and report outcomes transparently to improve compliance.

Notes

1. The empirical evidence of technology spillovers from FDI in Turkey is rather mixed (Erdoğan, 2011; Sönmez and Pamukçu, 2011).
2. On 23 January 2014, the central bank sold foreign currency worth more than USD 3 billion in one day.
3. Export rediscount credits are extended to firms in Turkish lira to facilitate and reduce the costs of export financing, and are paid back in foreign exchange. Eligibility has been eased in August and November 2013 and the central bank estimates that this has increased net foreign exchange reserves by USD 8 billion in 2012 and USD 13 billion in 2013 (CBRT, 2013b).

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Chapter 2

Fostering inclusive growth by promoting structural change in the business sector

Turkey's business sector dynamism has underpinned broad-based and inclusive growth in the 2000s. However, the business sector is highly segmented, with modern high-productivity corporations, but also myriad small, less formal and low-productivity entities. This hampers efficient resource allocation and tends to entrench social inequalities. It also makes it difficult to build on-the-job human capital for the large number of low-skilled. This segmentation needs to be overcome to raise productivity in the informal, low-skill and low-productivity sector, and to facilitate resource transfers from low to higher productivity business entities. This ought to be achieved by aligning Turkey's formal regulatory and tax framework with OECD best practice, rather than through "second-best" arrangements where non-compliance with rules co-exists with selective subsidies to parts of the formal sector. Labour market and business taxation reforms are particularly important to enable all categories of enterprises to operate flexibly on a rule-based, level playing field and to achieve productivity enhancing and socially inclusive restructuring.

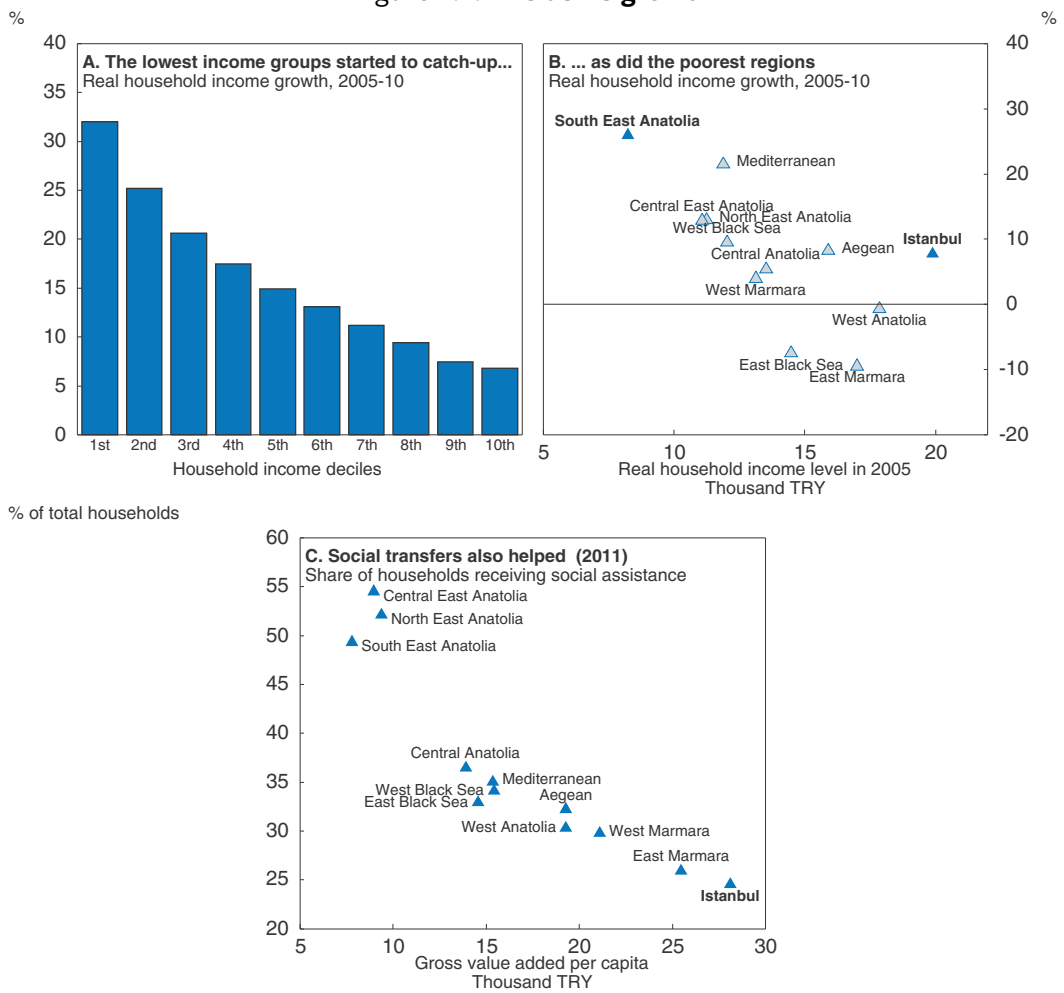
The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Inclusive growth has been driven by thriving business enterprises throughout the country

Broad-based business sector development coupled with social transfers have helped make growth more inclusive during the 2000s (Şeker and Jenkins, 2013; Taskın, 2014). Up to 2007, income distribution improved and poverty diminished, as did material deprivation in both urban and rural areas (Azevedo and Atamanov, 2014). Some of the progress achieved was reversed in the crisis year 2009 but improvements resumed in subsequent years (OECD, 2013; Turkstat, 2014) (Figure 2.1).[1]

The main driver of these gains was the rapid pace of job creation throughout the country, which was also backed by productivity gains. Steady employment growth in

Figure 2.1. **Inclusive growth**



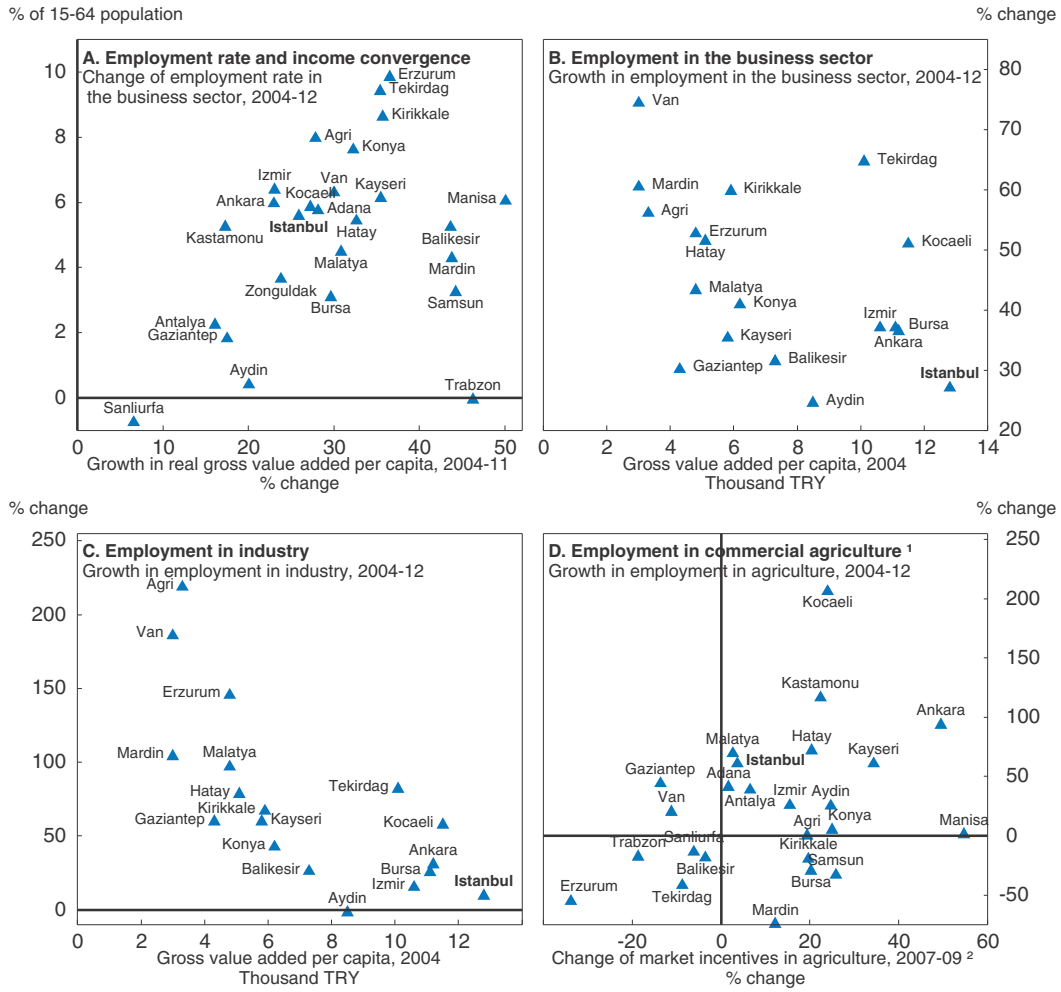
Note: In this figure household income refers to average household disposable income.
Source: Turkstat, *Statistics on Income and Living Conditions (SILC) Database*.

StatLink http://dx.doi.org/10.1787/888933098174

industry and services, including in rural areas previously devoid of industrial activity, has been crucial. As documented in the 2012 *OECD Economic Survey of Turkey*, this has been more pronounced in the so-called "Anatolian Tiger" regions than in the "Developed West".[2] As income inequality in Turkey traditionally stemmed mainly from the labour market, reflecting wide wage dispersion coupled with a low employment rate (Hoeller et al., 2013), broad-based employment creation made a decisive difference and promoted social inclusion (Figure 2.2).

The particularly fast expansion of manufacturing has played a crucial role (Figure 2.2, Panel C). Despite the contraction of global trade during the crisis years, industrial employment grew strongly between 2004 and 2012, with spectacular increases in the Anatolian Tiger regions. Manufacturing is key for economic take-off in regions where low household incomes limit local demand for services. In such regions, however, manufacturing has grown from a very small base, in terms of both entrepreneurial know-how and worker skills. Accordingly, the expansion has been largely in low-tech

Figure 2.2. **Broad based employment growth has driven convergence**



Note: NUTS 2 regions. The business sector refers to activities in industry and services.

1. The Zonguldak region, as outlier, is not shown.
2. Figure based on a methodology proposed by Gursel and Imamoglu (2009). Commercial orientation and intensity of market incentives are gauged through combined growth of relative farm prices and farm output.

Source: Turkstat.

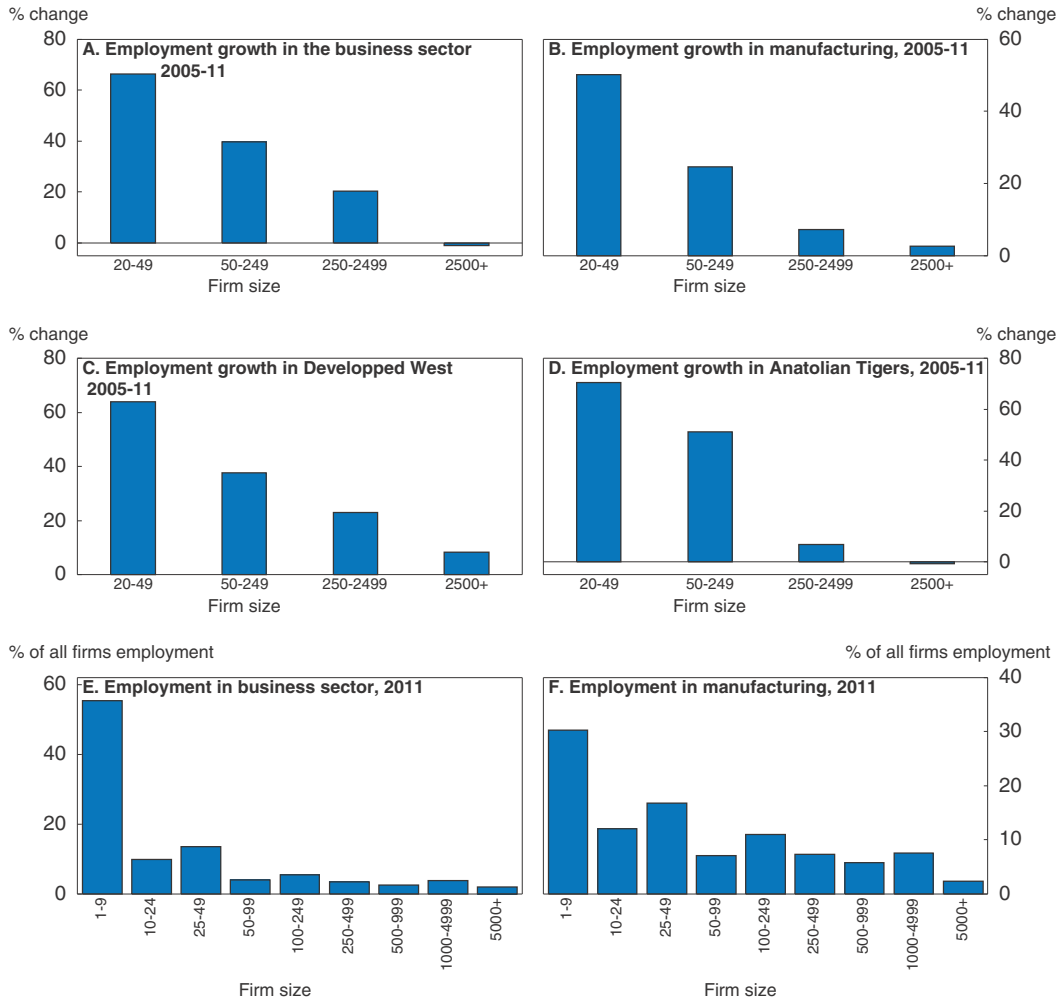
StatLink http://dx.doi.org/10.1787/888933098193

manufacturing where these areas have a comparative advantage, and which now represents over half of total manufacturing employment in Turkey.[3]

Greater market orientation in agriculture – moving away from low-productivity subsistence farming as discussed in the 2006 *OECD Economic Survey of Turkey* – has also helped growth inclusiveness. Agricultural employment rose in regions where the composition of farm output shifted toward products in high domestic and international demand (Figure 2.2, Panel D). In these areas, farm size expanded, agricultural mechanisation moved forward and salaried employment gained ground. Such structural change has been particularly visible in Turkey's Mediterranean regions (Aldan and Çakmak, 2011).

This broad-based entrepreneurial momentum has not only triggered new entry into the business sector but also revived many stagnant businesses which were taken over by new generations of owners. Scores of small businesses have grown in size and become more corporatised. Between 2003 and 2010, employment in firms with 20 to 49 workers grew from 0.5 million to over 1.2 million (+120%) and employment in firms with 50 to 249 workers from 0.9 million to over 1.7 million (+90%). Medium-sized firms grew fastest in the Anatolian Tiger regions (Figure 2.3). Many dynamic firms also started to participate in

Figure 2.3. **Small and medium sized enterprises have been the main engines of growth**



Source: Turkstat, *Annual Industry and Services Statistics (AISS) Database.*

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global value chains, in co-operation with global (especially European) leaders of these chains. In the textiles and basic metal industries and in construction services for example, Turkey is now more integrated with global supply chains than Italy, Spain, Poland, Mexico and Chile. However, this is not the case in other sectors, where a major potential for further global integration remains (OECD, 2013a).

Labour demand by emerging enterprises throughout the country mostly benefitted the previously less active parts of the working age population. Low-skilled men in urban areas, low-skilled women both in rural and urban areas (Box 2.1), and workers above 45 have found new employment opportunities and their participation and employment rates have risen[4] (Figure 2.4).

Box 2.1. **The activation of low-skilled women**

The aggregate participation rate of prime-age women aged 25-54 (a good indicator of female labour force participation in Turkey) rose from 29.3% in 2008 to 37.3% in 2012. This resulted from households' increased incentives to secure second earner incomes in the global crisis, supported by sizeable government subsidies to the hiring of female and young workers (Balkan et al., 2013). Traditionally, women have had very low labour force participation rates in Turkey, reflecting shortcomings in human capital (78% of the female working age population have less than high school education, 58% have primary education or less and 17% are illiterate). In urban areas, women's labour force participation stayed as low as 17% until the mid-2000s. In rural areas, many women are counted as unpaid family workers, artificially increasing participation but often masking low productivity quasi-unemployment in the informal sector. When these women migrated to urban areas they generally found no job and withdrew from the labour force.

Between 2005 and 2012, female participation and employment in urban areas both increased by over 50%. About half of the increase in urban female employment was achieved by university-educated women, but their participation rate stagnated so the expansion solely reflected the growing size of their cohorts. In contrast, participation and employment rates improved for women with high school education and, more drastically, for women with less than high school education, whose participation rate rose from 11.7% in 2008 to 16% in 2012 (Uysal, 2013). Female employment increased more rapidly in services. Nevertheless, the expansion of manufacturing jobs has also been an important driver for women with less than high-school education.

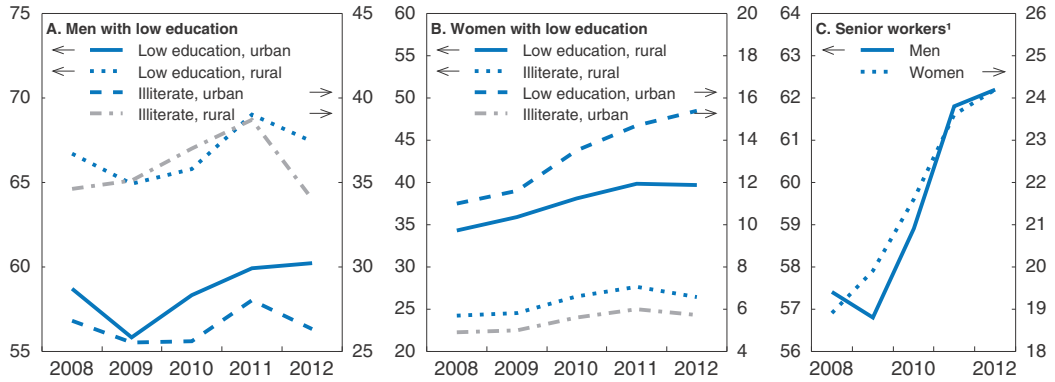
Low-income groups' higher employment rates enabled many households to gain access to bank credit. After the global crisis credit grew most rapidly for low-income groups and in low-income regions. The macroeconomic strains created by the resulting contraction in household saving rates are discussed in Chapter 1 (Figure 1.8).

Social transfers also played a new role (Yentürk, 2013; Alper, 2014). They encompass a wide range of cash and in-kind benefits from a variety of institutions (including the central government, municipalities, official foundations and private charities). Public social service and aid expenditures increased from 0.9% of GDP in 2006 to 1.3% in 2012. They include transfers to poor households, non-contributory pensions and health support to the non-insured. A new Ministry of Family and Social Policies was created in 2011 to more centrally manage these programmes.

Data on all social transfers at general government level, including local and municipal aid, is currently not available in aggregate form but these policies seem to have helped

Figure 2.4. **Job creation has been particularly dynamic for heretofore less active groups**

Employment rates, in per cent of the population



Note: Low education refers to persons with education less than high school.
1. Workers aged 45-64.
Source: Turkstat.

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reduce the incidence of absolute poverty. For households with unemployed breadwinners, the group most at risk, "material deprivation" (defined as lack of access to basic goods) declined from 30% to 20% in Western regions between 2006 and 2010, and from 40% to 25% in the Eastern regions (Finn et al., 2013). These transfers will however need to be better targeted in the future, to improve recipients' work incentives and capacities as recently emphasised by policymakers (Yazici, 2014; Tuna, 2014).

Large inequalities persist, rooted in uneven labour market conditions

The business sector is highly segmented

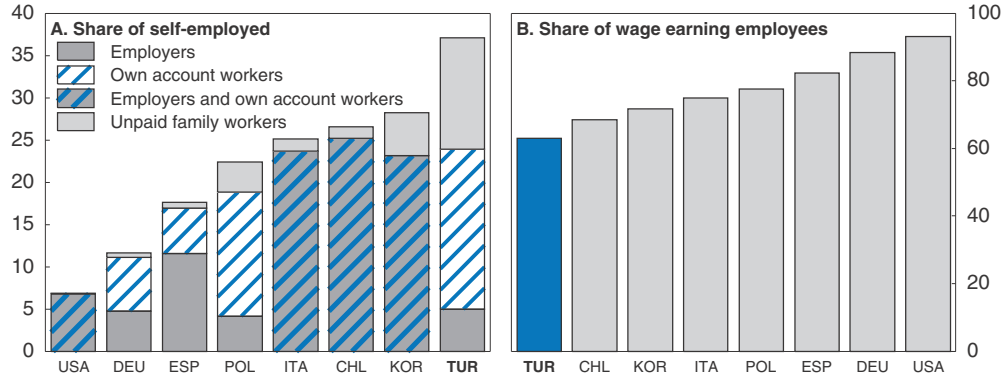
Despite strong growth in the 2000s, Turkey's business sector has remained highly fragmented and its productivity performance uneven. This has kept worker incomes, job quality and human capital on diverging paths. Sustaining inclusive growth will require overcoming this segmentation, accelerating the creation of high-productivity workplaces and promoting better jobs.

Available data on the absolute number of enterprises differ, but all sources point to very high heterogeneity. At the semi-formal end of the spectrum, it is difficult to distinguish "enterprises" and "trade and craftman workplaces" (*esnaf*, which include own-account workers helped by a few apprentices and employees). According to the Ministry of Customs and Trade, 1 543 000 "enterprises" and 1 625 000 "trader and craftman workplaces" were in operation outside farming in Turkey in 2013. Also, the share of regular wage earners is lower than in other OECD countries, whereas the share of own-account workers and employers is significantly higher than in most of them (Figure 2.5).

Half of business sector employment and about one third of manufacturing employment is in small businesses with fewer than 20 workers. As well, many firms seem intent on not surpassing specific size thresholds, in particular the 30 and 50 worker thresholds. This is apparent for the business sector as a whole and notably in manufacturing (Figure 2.6). At the other end of the spectrum, the largest 100 corporations have an average of nearly 6 000 employees and a median of 3 500, the second hundred have

Figure 2.5. **Employers, own-account workers and salaried employees: international comparison**

In per cent of total employment, 2012 or latest



Source: OECD, *Annual Labour Force Statistics Database.*

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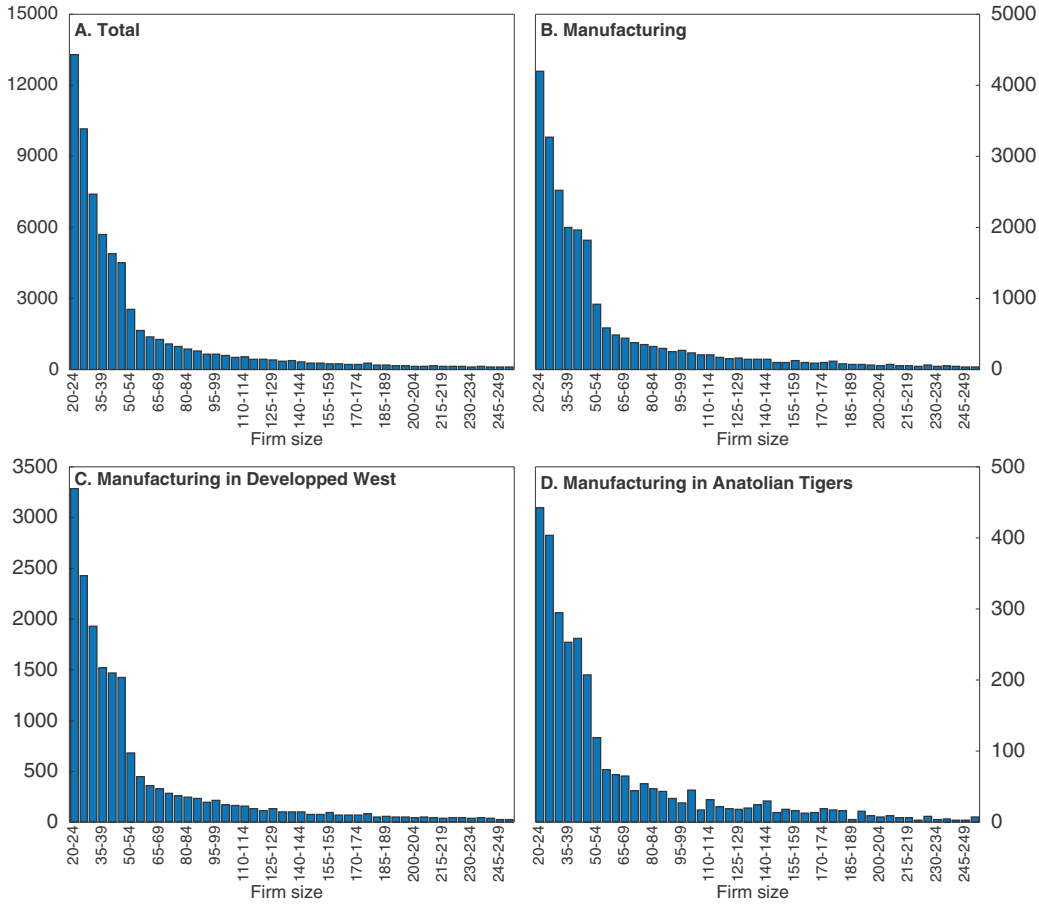
Figure 2.6. **Turkey has a segmented business sector, with apparent size thresholds**

Number of firms by size classes (according to number of employees), 2011



Source: Turkstat, *Annual Industry and Services Statistics (AISS) Database.*

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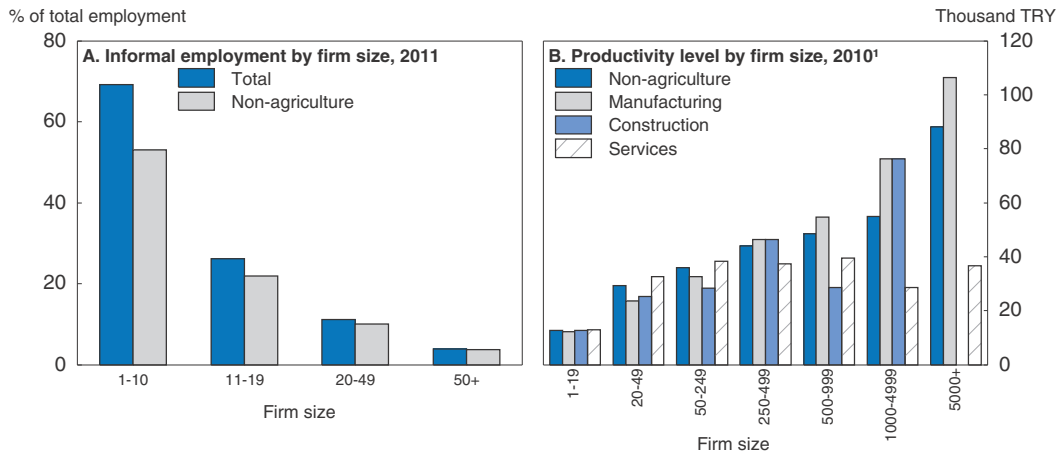
both average and median employment around 1 300, the third hundred around 700, the fourth hundred around 350; but the fifth hundred have only around 120 (Istanbul Sanayi Odasi, 2013). The bulk of non-farm business employment remains in very small firms[5] (Figure 2.3, Panels E and F).

Clearly, firms' performance is not solely driven by size. As in other countries, the human capital of owner and workers, capital intensity, governance and management systems and international connections are all among the determinants of enterprise quality and productivity (Altomonte et al. 2012; Bloom and Van Rennen, 2010). Yet, in Turkey, size appears to exert a major influence on labour productivity (Figure 2.7). While in a country like Denmark small firms are almost as productive as large ones, in Turkey large firms are on average over four times more productive than the smaller ones – the largest gap among OECD countries (Figure 2.8). This is because smaller firms have much weaker owner and worker human capital and lower physical capital intensity. They employ the lower-skilled majority of the working age population in informal or semi-formal jobs at lower than official minimum costs, and have limited access to credit and capital markets. Larger firms abide with laws and regulations, face a cost disadvantage in employing low-skilled labour and refrain from doing so, but have much better access to domestic and international sources of funding, skilled professionals and international sources of know-how.

Figure 2.7. **Firms of different sizes differ sharply in formality and productivity**



1. Productivity is measured by the value added per person employed.
Source: Turkstat, *Annual Industry and Services Statistics (AISS) Database*; and Turkstat, *Statistics on Income and Living Conditions (SILC) Database*.

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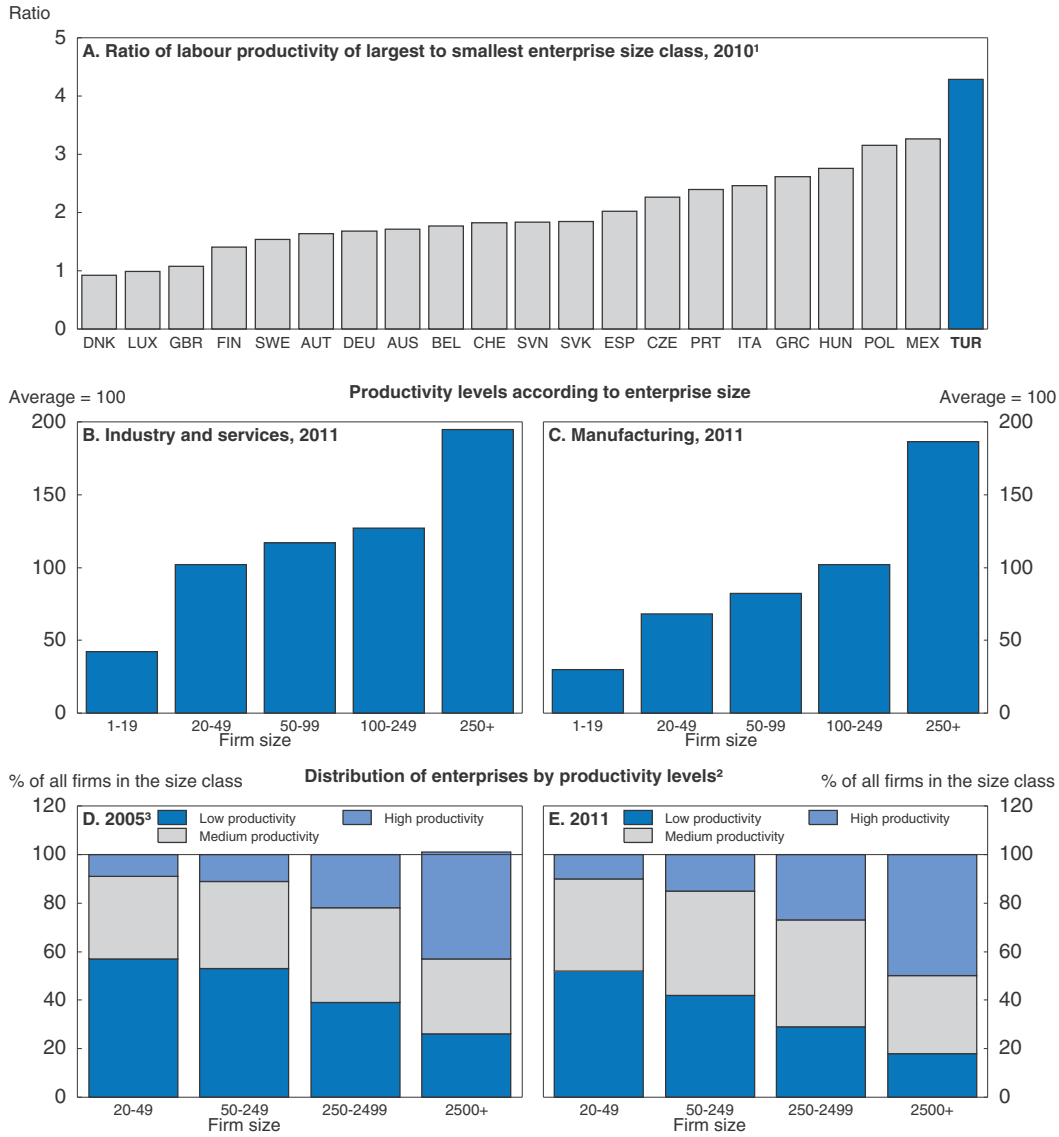
Five different "enterprise types" can be distinguished in the business sector (Table 2.1): micro businesses, mostly first-generation medium-sized entrepreneurial businesses, large family firms, institutional corporations (listed on the stock exchange), and "skilled stars". These enterprises differ in terms of human and physical capital endowment, management quality, formalisation (registration of workers with social security and financial transparency), and degree of access to product, capital and labour markets.

Micro business units encompass very small firms as well as the so-called "trader and craftman workplaces". These businesses are typically owned and led by an entrepreneur

Figure 2.8. **Productivity gaps between small and large firms are wide**



1. Ratio of value added per person employed for enterprises of more than 250 employees to value added per person employed for enterprises of 1 to 19 employees. 2008 figure for Mexico. Size classes are different for Mexico (0-50, 51-250, 251+).
2. Enterprises are classified according to their level of productivity. Only enterprises with at least 20 employees are covered. Low-productivity enterprises are those having a productivity level lower than 25 thousand TRY; medium from 25 to 75 thousand TRY and high above 75 thousand TRY. In 2005 the average productivity level was 42.6 thousand TRY, in 2011 48.9 thousand TRY.
3. 2005 production levels are deflated by using non-agricultural GDP deflator.

Source: OECD calculations based on data from OECD, *Entrepreneurship at a Glance 2013* and Turkstat.

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with very modest education, and staffed by no more than 10 workers, also with limited education. Most of these units declare only some of their workers to social security, and pay no corporate or personal income taxes (though part of them pay a small "simplified business activity tax" – *basit usul vergi*).

Table 2.1. **A taxonomy of Turkish businesses**

	MICRO BUSINESSES	SMAL-AND-MEDIUM SIZED BUSINESSES	LARGE FAMILY FIRMS	INSTITUTIONAL CORPORATIONS	SKILLED STARS
Ownership	Founder	Mostly founder	Founder family	Controlling owner + shareholders	Founder
Legal status	Sole proprietorship or "trader and craftman workplace" (*esnaf*)	Limited partnership or joint-stock company	Joint-stock company	Listed corporation	Limited partnership or joint-stock company
Tax status	Personal income taxation (on basis of either "simplified business activity" or "one book" methods)	For personal income taxpayers, "one-book" or "four-book" taxation according to sales volume. For corporate taxpayers, "four-book" taxation irrespective of sales volume.	"Four-book" corporate taxation	Externally audited four-book corporate taxation	For personal income taxpayers, "one-book" or "four-book" taxation according to sales volume. For corporate taxpayers, "four-book" taxation irrespective of sales volume.
Corporate governance	Owner/manager	Owner/manager	Family board and family manager	Independent board members and professional managers	Owner manager and participatory team
Employment rules and protection	Informal	Frequent circumvention of employment rules	Partial compliance with employment rules	Full compliance	Full compliance
Accuracy of wage reporting and social security contribution	-	Partial	Mostly	Fully	Fully
Financial transparency	-	-	Firms above size thresholds publish audited financial statements	Audited financial statements and quarterly accounts	Some voluntarily publish audited financial statements
Size (approximate number of workers)	1-10	10-250	250-2500	2500+	10-49
Productivity (% of average productivity in 20+ firms)	10-20%	40-80%	100-120%	130-150%	Up to 200% and more
Share in business sector employment	Around 45%	Between 35-40%	Around 15%	Around 4%	Less than 1%
Share in manufacturing employment	Around 25%	Between 40-45%	Around 25%	Around 6%	Less than 1%

First-generation entrepreneurial businesses, owned and led by better educated and commercially active entrepreneurs, are staffed with medium-level technical personnel and employ up to several hundred workers. Their production capacities are flexible, their delivery times short, and they strive to improve the quality of their products. Their distinct strength is their market responsiveness and flexibility, but they face Turkey's very rigid regulatory framework. Many do not report all their employees to social security, seem to hire part of them under legally prohibited temporary forms, appear to pay less than the official minimum wage (notably in regions where living costs are low) and underreport wage payments to minimise tax and social contribution costs. As a result, many of these firms cannot produce transparent and reliable financial reports, which complicates their access to credit and equity capital. Given their role in growth and job creation, a wide range of government support programmes have been phased in for these enterprises in the 2000s. The diversification of traditional commercial banks into this area and the development of interest-free banking have also supported their expansion (Box 2.2).

Large second- or third-generation family enterprises constitute the traditional backbone of the Turkish business sector. They tend to be found in the 250 to 2 500 worker bracket. Over time, they have built up technical expertise in specific manufacturing and service areas, often via co-operation and joint ventures with long-time international partners (Box 2.3). They generally display good performance in terms of productivity levels

Box 2.2. **Financial bottlenecks of medium-sized businesses and "participation finance"**

High-growth medium-sized enterprises need to build up physical and human capital, and tend to face funding bottlenecks. Operating semi-formally weakens their financial transparency and they have limited collateral for banks. This makes their access to credit markets, and *a fortiori* to external equity, difficult. This financial bottleneck has been recognised as a major obstacle to the growth of dynamic SMEs in Turkey (World Bank, 2011; MUSIAD, 2013).

Information available on profit margins and funding patterns of different size groups of enterprises between 2004 and 2012 suggests that one of the most rapidly growing segments of the business sector – medium-sized firms with 50 to 250 employees – faces the greatest funding needs (Figure 2.9). These firms have been the main beneficiaries of the rapid expansion of bank loans in recent years (Table 2.2). This expansion was backed by the Credit Guarantee Fund (KGF), whose resources were augmented by a TRY 1 billion Treasury counter-guarantee after the global crisis. The public SME bank Halkbank and mainstream commercial banks such as Işbank, Akbank, Garanti, TEB have participated in this expansion. Even so, the share of SME loans in total bank loans has remained relatively stable and medium-sized enterprises' funding bottlenecks have persisted, leading many of them to seek supplier credits for imported machinery as well as other foreign exchange-denominated loans.

Table 2.2. **Recent growth of credit to SMEs**[1]

	Private banks		Public banks[2]		Participation banks	
	Nominal amount of outstanding SME credits (2006 = 100)	Market share[3] (%)	Nominal amount of outstanding SME credits (2006 = 100)	Market share[3] (%)	Nominal amount of outstanding SME credits (2006 = 100)	Market share[3] (%)
2006	100	70	100	22	100	7
2007	128	70	114	20	114	6
2008	147	73	126	20	129	6
2009	136	68	136	22	180	8
2010	202	67	206	22	297	9
2011	259	66	275	23	397	10
2012	302	63	358	24	581	11
2013	413	63	492	24	739	11

1. Investment and Development Banks which have a small share are excluded.
2. Halkbank, Ziraat Bank and Vakiflar Bank.
3. Share of bank category in total SME credits.

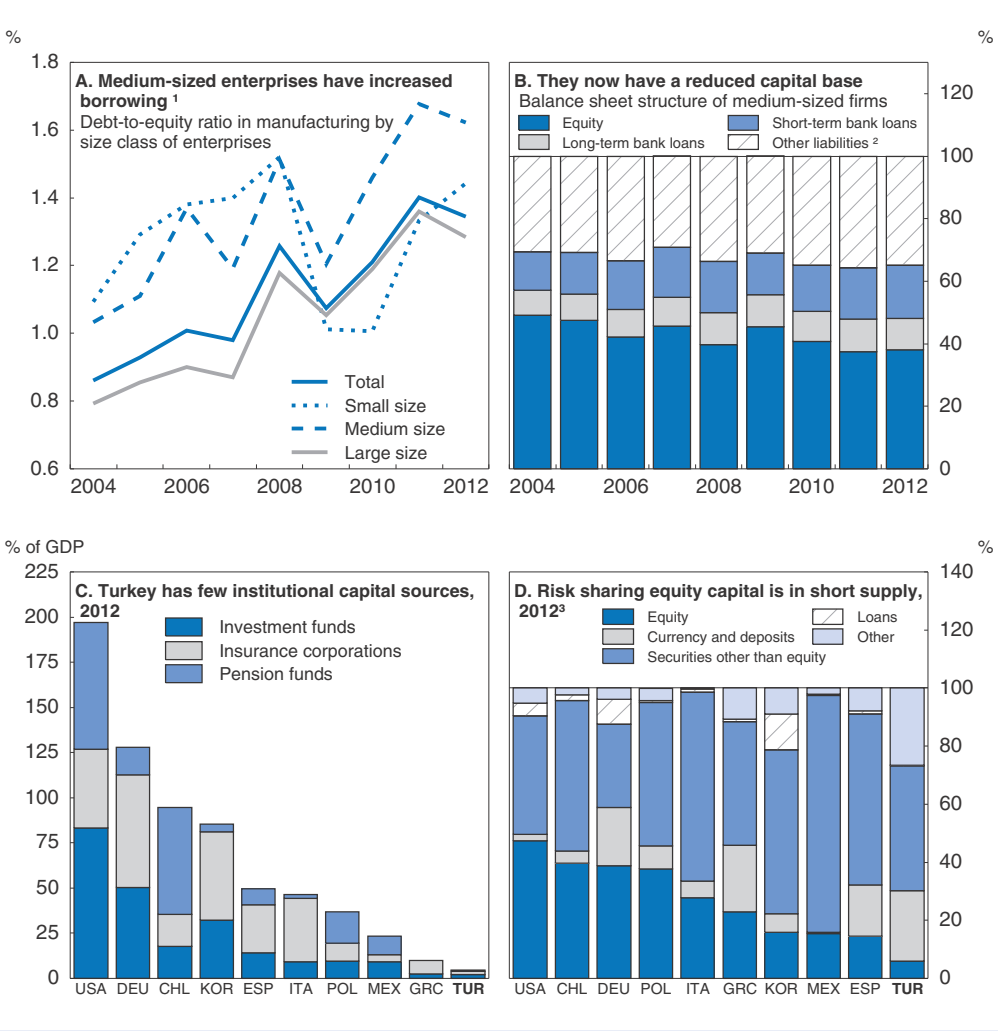
Source: Banking Regulation and Supervision Agency.

The growth of Islamic banking ("participation banking" in local terminology) has played a special role. Participation banks have been the fastest growing component of Turkish banking in the 2000s. They hold about 5% of the banking system's total assets, and have a higher share in the funding of the real sector. They have no portfolio of government bonds and no consumer loans, but participate in housing financing. Their lending to enterprises has been growing by more than 30% per annum in recent years.

Box 2.2. **Financial bottlenecks of medium-sized businesses and "participation finance"** *(cont.)*

Participation banks fund investment and working capital needs with non-interest bearing instruments. They make limited use of firms' standard financial accounts and reports. Recent research suggests that participation banks make massive use of "soft" information sources (Polat and Yeşilyaprak, 2014). They purchase the intermediary inputs (for working capital needs) and machinery (for investment capital needs) on behalf of the customer, and "lend" them to the firm while preserving ownership rights on them until the loan is reimbursed. This amounts to a form of leasing. The margin between the purchasing price of the good and the reimbursement price by the customer is the profit margin of the bank.

Figure 2.9. **Entrepreneurial medium-sized firms face funding bottlenecks**



1. Medium-sized enterprises shown here are manufacturing firms with 50-500 employees.
2. Mainly supplier credits and debts owed to shareholders and deferred payments to government.
3. Portfolio composition of institutional investors.

Source: Central Bank of the Republic of Turkey, *Balance sheet Database*; *OECD Institutional Investors Database* and *OECD National Accounts Database*.

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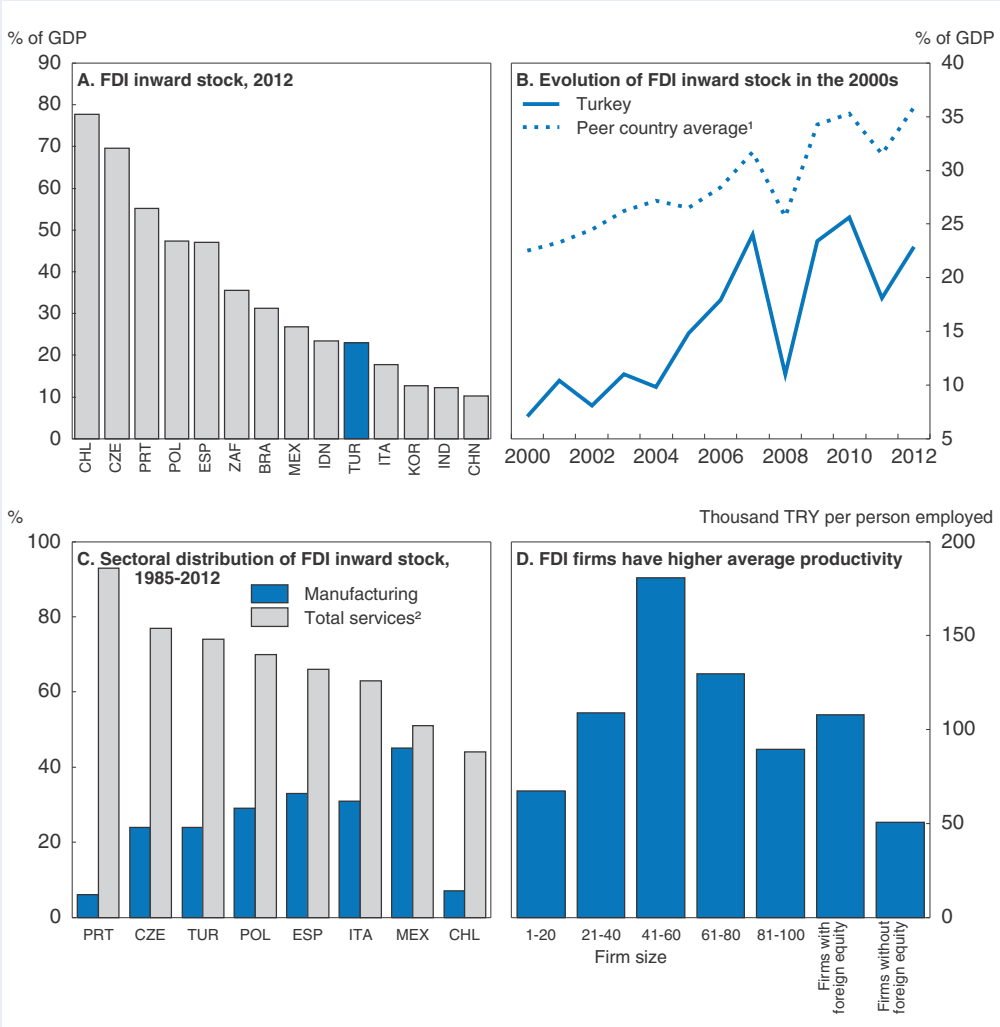
Box 2.3. **FDI firms have a limited presence in Turkey's business sector**

Turkey had a stock of $180 billion in foreign direct investment (FDI) at the end of 2012, representing about 20% of GDP and 1% in the global FDI stock. This is a lower penetration rate than in comparable countries (Figure 2.10). After some reduction in the first half of the 2000s, the gap *vis-à-vis* peer countries widened anew (Panel B).

Over 70% of FDI is in domestic services. This reflects both the attractiveness of the domestic market, as well as Turkey's arguably weak cost competitiveness in tradable sectors. According to OECD indicators, Turkey's regulations are today more open to FDI than for an average OECD country (OECD, 2013f).

Figure 2.10. **Foreign direct investment is limited**



1. Average of Chile, Spain, Indonesia, India, Czech Republic, South Africa, China (excluding Hong-Kong and Taiwan), Portugal, Brazil, Italy, Poland, Mexico and Korea.
2. Total services include "trade and repairs", "hotels and restaurants", "transport, storage and communication", "financial intermediation", "real estate, renting and business activities", "electricity, gas and water", "construction" and "other services". The shares of "agriculture and fishing" and "mining and quarrying" are not shown in the figure.

Source: UNCTAD; *OECD FDI Statistics Database*; and Turkstat, *Annual Industry and Services Statistics (AISS) Database*.

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Box 2.3. **FDI firms have a limited presence in Turkey's business sector** *(cont.)*

The Foreign Investment Association YASED reports that more than 30 000 "foreign investment firms" are presently active in Turkey. This includes all firms with over 10% of equity owned by an identifiable foreign investor. With this broad definition, 138 of the Istanbul Chamber of Industry ISO top 500 firms in Turkey are foreign investment firms. In 2012, they represented 33% of the sales and 28% of the employment of the top 500 firms, and 0.9% of total business sector employment. The above FDI criterion, however, means that many local firms with a foreign partner are included. When fully foreign-owned firms (with more than 90% of foreign-held shares) are taken into consideration, their number in the top 500 list declines to 64 and their share in total employment to 0.4%.

and award high wages to their managers and employees. They tend to be "closed" corporations whose shares are owned by family members. Whereas in an average OECD country family firms' management quality is generally mediocre (Bloom and Van Rennen, 2010), surviving family firms in Turkey have above average productivity. Some of them have started to list their shares on the stock exchange, to facilitate the valuation of the company, handle generational transmissions and improve management. The core development challenge for these enterprises is to further corporatise and institutionalise their governance systems and to professionalise their management. This should improve their access to domestic and international markets for capital, professional labour and foreign business partnerships, and boost their productivity. However, it also entails "formalisation costs".[6] Additional reforms in the regulatory and tax framework would reduce their cost of transition from semi to full formality.

Firms listed on the stock market form the top tier of the business sector in terms of institutionalisation, productivity level and worker incomes. They include: the listed and professionally managed big family conglomerates and holdings; some former state-owned companies which were privatised through public offerings; and international firms operating in Turkey – listed in their country of origin (Box 2.3). These large entities are very visible domestically and internationally, but represent no more than 4% of Turkey's business sector employment when proxied by the 383 firms listed on Borsa Istanbul (including 38 banks and financial institutions), and only 0.3% when proxied by ISO-1000 large companies having issued over 25% of their equity in the stock market. They meet high corporate governance and financial standards, and are subject to the demanding rules set by the Capital Markets Board and the Stock Exchange. About ten of them have issued securities in the international market, and are rated by international rating agencies. However, these firms may not be internationally competitive in labour-intensive industries, as they fully comply with Turkey's comparatively costly labour laws and regulations.[7]

Lastly, "skilled stars" are start-ups in high-tech manufacturing and services, which represent a tiny but essential high-productivity layer of the business sector. They tend to be small and draw on Turkish and foreign highly skilled professionals. They are more formal than other small firms. Part of them have larger firms as shareholders, many use public R&D incentives, and seek to liaise with international technological partners. For these reasons they need to meet higher transparency standards.[8] Compared to international peers, these firms may be handicapped by less technologically advanced local value chains. However, they try to cope by fostering links with global business and

technological hubs (OECD, 2013c; Dunya, 2014). Limited quantitative information is available on the total size of this sector. Young enterprises operating in technoparks, which are one subset in this category, account for 0.1% of total business sector employment.

The five types of enterprises differ greatly in terms of scale, skills, financial resources, production capacities and productivity, but all interact in Turkey's value chains. Downstream firms depend on their upstream suppliers. In a study of large firms' input procurement practices, Saygili et al. (2012) showed that weaknesses of upstream suppliers had serious downstream impacts and constrained their productivity and employment performance. Low-skill, small-scale, non-institutionalised input suppliers limit the technological choices of user firms, leading them to import a large share of inputs. In contrast, in a small number of sectors where suppliers corporatised and professionalised their activities in line with downstream customers, the total performance of the value chain improved with higher aggregate output, employment and productivity, and the imported share of inputs diminished.

One distortion highlighted in this study is large firms' tendency to outsource the labour-intensive parts of production processes to smaller suppliers, even when this may entail productivity losses. Recourse to less formal firms serves to minimise labour costs because, in all likelihood, they circumvent minimum wage and employment regulations.

Fragmentation causes diverging income and human capital development among workers

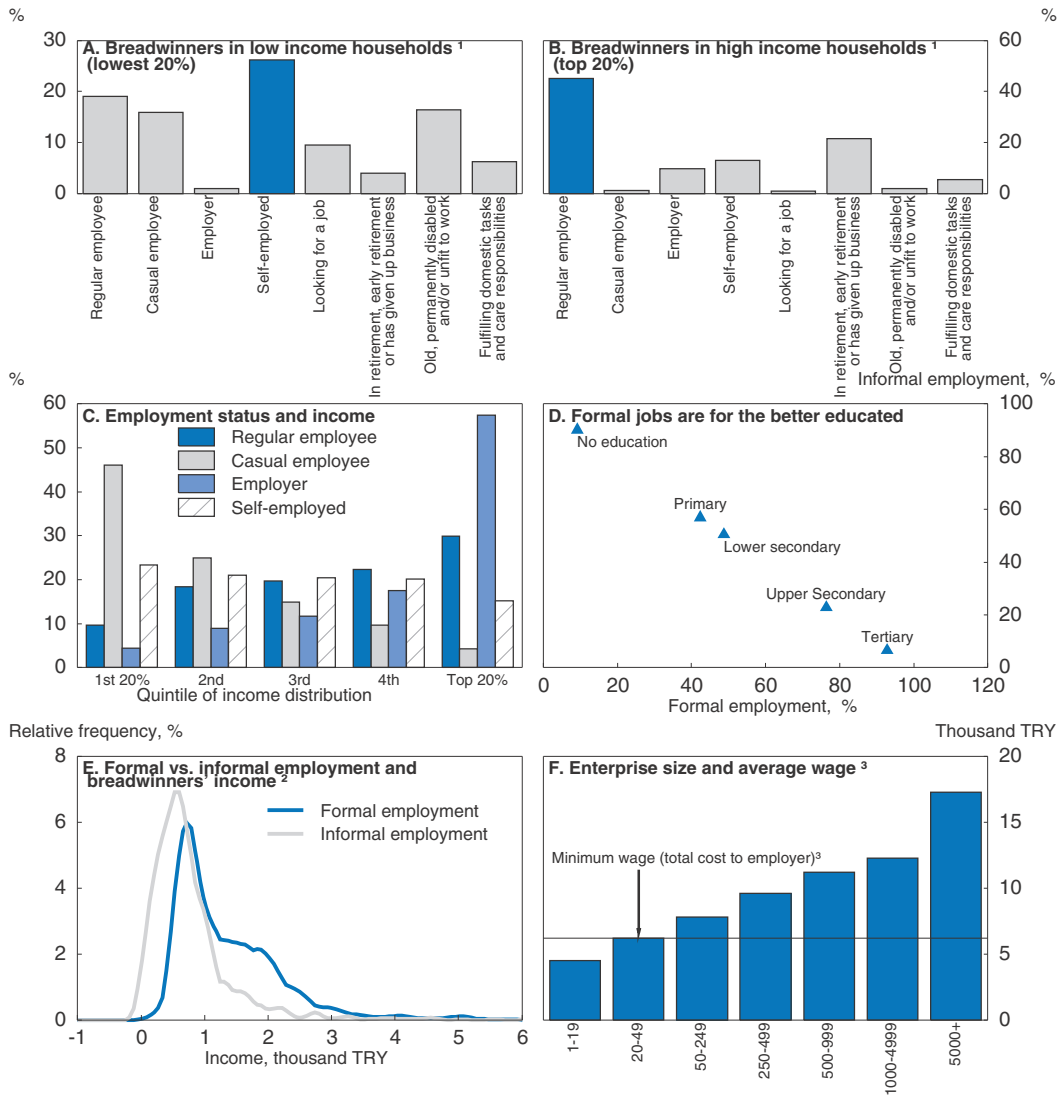
Reflecting the unequal distribution of productivity levels in the business sector, the incomes of employees and households differ strongly according to their breadwinner's employment status (Figure 2.11). Poor households tend to have a breadwinner who is either inactive or self-employed, while in better-off households the breadwinner tends to be a regular formal sector worker or an employer (Panels A, B and C). Workers with more than high-school education generally hold formal jobs, while persons with less education (the majority of the labour force) have mostly informal jobs (Panel D). The income distribution for informal employees is more concentrated, and displays a lower median, than for formal employees (Panel E), and the size of the firm makes a big difference for the income level of the breadwinner (Panel F).

The segmentation between types of firms and jobs undermines both aggregate productivity and social inclusiveness. Traditionally, mobility between different types of jobs has been limited: depending on their educational background, individuals joined a given labour market segment (say, informal self-employment or formal salaried work) or stayed inactive (the majority of low educated women) and then tended to stay in this position through their lifetime – even after changing location, sector and employer. Also, households tended to remain in the income bracket of their main breadwinner. This inertia diminished on the back of broad-based growth in the 2000s, with more low-skilled male workers shifting from informal to formal jobs in more corporatized medium-sized enterprises. More low-skilled women and senior workers also transited from inactivity into informal jobs. However, labour market segmentation remains strong, mirroring persistent business sector segmentation.

Labour market transitions have been analysed by Tansel and Kan (2012a), both for the country as a whole and outside agriculture (Table 2.3). Compared to studies available for countries at a similar stage of development (Jütting and de Laiglesia, 2009 on Mexico; Lehmann and Pignatti, 2007 on Ukraine; and Duryea et al., 2006 on nine middle- to

Figure 2.11. **Breadwinners' labour market experience varies across groups**

2011



1. "Unpaid family worker", "Pupil, student or unpaid work experience" and "Other inactive person" categories which have a very small share were excluded from the figure.
2. Monthly incomes above 6000 TRY have been excluded.
3. Average compensation per hour in industry and services.

Source: Turkstat, *Statistics on Income and Living Conditions (SILC) Database*; and Turkstat, *Annual Industry and Services Statistics (AISS) Database*.

StatLink http://dx.doi.org/10.1787/888933098364

low-income countries) this study suggests that transitions across labour market segments are less frequent in Turkey. However, unlike the comparators, this study, which is the only detailed such investigation available for Turkey, includes the first phase of the global Great Recession. Therefore, it might shed a less favourable light on Turkey's labour market performance than would have been the case otherwise. It distinguishes six types of labour market positions (formal salaried work, informal salaried work, formal self-employment, informal self-employment, unemployment, inactivity) and finds that:

- Most individuals remained in their initial state, except for the unemployed.

Table 2.3. **Transitions to higher labour market status have been relatively rare**

Transition probabilities between labour market states for individuals aged 15 to 64, 2006-09

2006 status	Total sample 2009 status						2006 Status	Non-agricultural sample 2009 status					
	FS	IS	FSE	ISE	U	N		FS	IS	FSE	ISE	U	N
FS	78.7	4.5	0.7	2.6	6.5	7.1	FS	79.6	4.4	0.7	1.5	6.6	7.3
IS	20.5	38.0	1.8	12.4	11.3	15.9	IS	23.9	38.8	1.1	8.3	12.9	14.9
FSE	6.4	3.2	60.5	20.4	1.9	7.6	FSE	8.8	4.4	59.3	15.4	1.1	11.0
ISE	2.7	6.2	6.3	64.6	1.8	18.5	ISE	5.5	9.9	12.7	45.9	5.5	20.4
U	17.3	16.5	3.5	10.0	27.3	25.4	U	17.9	16.3	3.3	5.4	29.6	27.5
N	3.6	3.5	0.2	7.7	3.2	81.7	N	3.9	3.2	0.2	2.0	3.4	87.3
Total	18.8	8.4	3.5	17.5	5.6	46.3	Total	22.8	8.4	2.4	5.0	6.7	54.7

Note: LMS = labour market status; FS = formal salaried; IS = informal salaried; FSE = formal self-employed; ISE = informal self-employed; U = unemployed; N = inactive.
Source: Tansel and Kan, 2012a, based on Income and Living Conditions Survey panel data.

- Outflows from informal self-employment were very limited.
- Outflows from informal to formal salaried work were more frequent, but concerned a minority of workers.
- Formal salaried work was subject to few exits. This confirms the preferred status of formal salaried work – but it is available to only one quarter of the working age population.
- Most women remained either inactive or informally self-employed (including home-based work, for instance in the clothing industry).
- Transitions from unemployment to employment were twice as frequent toward informality as toward formality.
- Better-educated workers had a higher probability of moving into formal employment.

Another study of social vulnerabilities in Turkey also documented labour market segmentation (Finn et al., 2013). Looking at labour market status persistence, it identified 12 specific groups which over time fail to obtain regular formal sector jobs, including i) 25-to-39-year-old informal male workers; ii) self-employed workers aged 45 and over; iii) women in long-term informal employment; and iv) women in unpaid agricultural work.

The lack of opportunities to move into formal salaried jobs is particularly stark in Turkey's poorer regions, where both the employment rate of the working age population and the productivity of the employed are well below those in the Developed West. High-productivity jobs are in short supply in these regions, including in agriculture (Figure 2.12).

Making it easier for higher-quality businesses to flourish

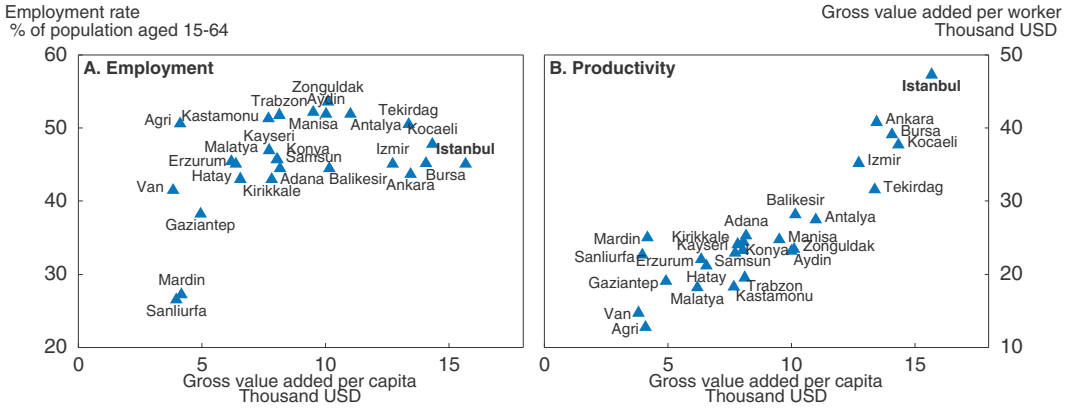
Segmentation can be overcome by stimulating productivity gains within existing firms ("within" productivity growth), and making it easier for resources to shift from lower to higher-productivity firms ("between" productivity gains). Recent OECD and other research highlights the factors that hinder or foster such structural changes (Box 2.4).

Empirical evidence

Turkey's growth performance in recent years can be mapped by drawing on a mix of firm-level and aggregate data. The distribution of employment between high and low productivity firms can be traced, and overall productivity gains can be decomposed into

Figure 2.12. **Regional income differences continue to reflect large gaps in employment and productivity**

2011, NUTS 2 regions



Source: Turkstat.

StatLink http://dx.doi.org/10.1787/888933098383

Box 2.4. **Insights from recent research on structural change and productivity growth in the business sector**

Recent economic research using firm-level data documents that education, research and technology policies are standard drivers of "within" productivity gains, while product, labour and capital market policies play a less widely-understood but crucial role in fostering both "within" and "between" gains. A number of new studies focus on the misallocation of resources across firms (Bartelsman et al., 2013; Andrews and Cingano, 2014). Andrews and Cingano show that many firms in OECD economies may stay durably with lower productivity levels, due to policy-related distortions implying that the marginal product of inputs is not equated across productive units. As a result, relatively high-productivity firms can remain undersized. Their empirical results suggest that national regulatory frameworks have a strong impact on international gaps in allocative efficiency.

Andrews and Criscuolo (2013) emphasise that well-functioning product, labour and venture capital markets and bankruptcy laws improve the efficiency of resource allocation. Countries successful at channeling resources to more productive firms also tend to invest more in knowledge-based capital, fostering synergies between "within" and "between" productivity gains. Another prominent finding in this strand of literature is that startups and young firms – as opposed to small firms – play a leading role in economic performance (Haltiwanger et al., 2013).

Contrasting firm demographics in the United States and Europe, Bravo-Biosca (2010) stresses that European countries tend to have a lower share of high-growth firms and fewer shrinking firms, but also a much larger share of "static firms", which neither expand nor contract. This re-emphasises the need for structural reforms in Europe that remove barriers to entry as well as barriers to growth and contraction.

Bloom and Van Rennen (2010), on the basis of a detailed World Management Survey, show that most of the cross-country difference in the weight of underperforming firms is due to the size of the long statistical tail of badly managed firms. They underscore six empirical regularities: i) product market competition boosts average management quality by eliminating badly managed firms and pushing incumbents to improve their practices; ii) exporters are better managed than non-exporters and less so than multinationals;

Box 2.4. **Insights from recent research on structural change and productivity growth in the business sector** *(cont.)*

iii) family-owned firms with a family member as CEO are generally poorly managed; iv) listed firms are better managed; v) multinationals are well managed; vi) firms with better-educated workers are better managed; vii) lighter labour market regulation is associated with better management practices.

Altomonte et al. (2012) focus on differences in the distribution of firm performance across countries which bear on national economic performance, and underline that: i) the higher the dispersion of firm performance, the more room to reallocate resources; ii) the presence of larger firms normally improves performance; iii) exporters display above-average performance; iv) policies aimed at supporting weaker firms, such as those targeted towards SMEs, may hinder growth and increase the number of less well-performing firms.

These studies focus on the impact of policies on the allocation of resources within sectors. They may actually understate the overall impact of policy-induced distortions on resource allocation to the extent that they do not account for the impacts of regulation on resource flows between sectors, which are likely to reinforce the within-sector effects identified. For example, McMillan and Rodrik (2011), in a cross-country study of productivity-enhancing structural changes find that countries with more flexible labor markets experience greater growth-enhancing structural change. This is consistent with the results of Bassanini et al. (2009), who examine the impact of employment protection legislation on productivity in OECD countries, on the basis of data on labour market regulation and industry-level productivity over 20 years. They document that stricter employment protection influences worker or firm behaviour, and thereby productivity, more in industries where the policy is likely to be binding than in other industries. Regarding Italy, they note that the reforms carried out there since the early 1990s created and eased the use of a multiplicity of atypical contracts, without addressing the difficulty of reallocating workers with open-ended contracts, and suggest that this has contributed to Italy's lackluster productivity performance.

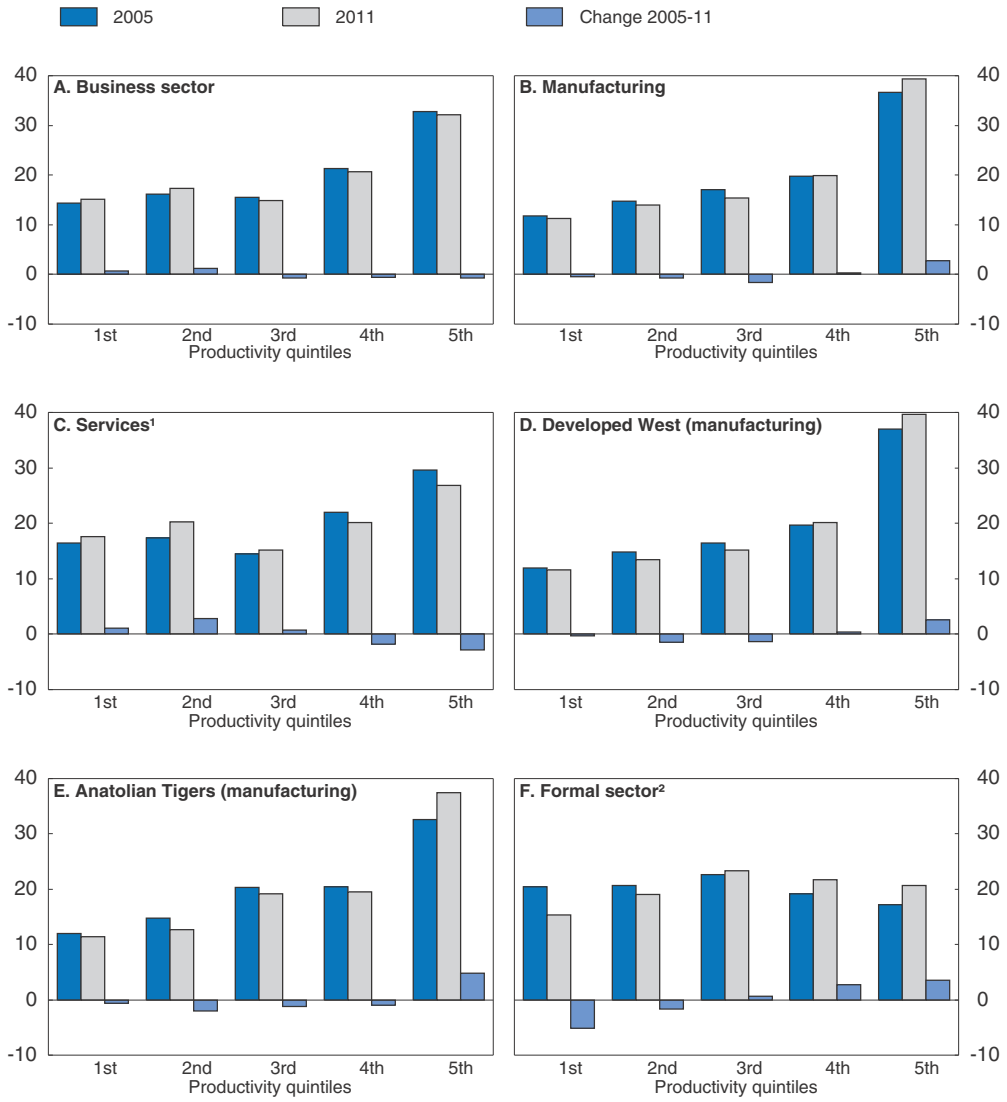
Some recent research investigates the links between regulatory frameworks, resource reallocations and productivity growth in developing countries. Hsieh and Olken (2014) find that large firms in these countries tend to be constrained in their growth as they are subject to above-market wages, onerous regulations and higher taxes. Almeida and Carneiro (2008) and Hasan and Jandoc (2010) reach broadly similar conclusions for Brazil and India respectively.

"within" and "between" gains. However, such firm-level data is only available for those having over 20 employees (Figure 13 and Table 2.4). Nonetheless, taking into account that average productivity in firms with less than 20 employees is much below higher size brackets (see Figures 2.7 and 2.8, for both manufacturing and business sector), the main findings for total employment according to productivity levels of workers are as follows:

- As of 2011, only about 20% of Turkey's non-farm workers were employed by high-productivity firms (defined as those whose productivity matches the top quintile of firms with over 20 employees), significantly lower than in more advanced OECD countries (Bartelsman, 2013).
- As much as 55 to 60% of the workforce is employed in low-productivity units (defined as those whose productivity is in the bottom quintile of firms with over 20 employees). This

Figure 2.13. **Resource allocation has improved but there is ample room for further progress**

Distribution of employment in firms with over 20 employees by productivity quintiles, in per cent



Note: This figure covers the entire population of firms with over 20 employees which were in operation in 2005, identified as a fixed panel of 23 500 firms in Turkstat's AIS database. Firms are classified according to their individual labour productivity level in 2005, calculated as value-added at factor cost per worker in constant prices. The evolution of employment in each firm between 2005 and 2011 allows to evaluate the aggregate direction and pace of redistribution of jobs between high and low productivity firms. Each firm is associated with one of five "productivity quintiles" on the basis of its performance in 2005, the top quintile representing the most productive firms. The figure shows employment shares of the related productivity quintile in total employment in 2005 and 2011, and the change in employment shares between 2005 and 2011. Panel F is based on information from the Balance Sheet Data Base of the Central Bank of Turkey. It covers about 2 600 firms which have formal credit relations with the banking system. Value-added information is not available in this source and labour productivity is approximated by net sales per employee in constant prices.

1. Services include construction, wholesale and retail trade, hotels and restaurants, transport, storage and communication, real estate, renting and business activities, education, health and social work and other community services.
2. The formal sector is defined as firms reporting financial accounts to the Central Bank's balance sheet database. In this source, productivity is calculated as sales per employee in constant prices.

Source: Turkstat.

StatLink http://dx.doi.org/10.1787/888933098402

Table 2.4. **Within and between productivity gains in a fixed panel of firms**

Firms with over 20 employees

2005-11	Annual productivity growth	"Within" productivity gains	"Between" productivity gains
Business sector	-0.20	0.55	-0.75
Manufacturing	2.05	2.82	-0.77
Business in Developed West	-0.10	0.40	-0.50
Business in Anatolian Tigers	1.75	3.13	-1.39
Manufacturing in Developed West	1.76	2.37	-0.62
Manufacturing in Anatolian Tigers	7.71	9.29	-1.58
Manufacturing in Anatolian Tigers (excluding firms with over 2500 employees)	5.36	6.27	-0.91

Note: The decomposition methodology is based on McMillan and Rodrik (2011). A constant (balanced) panel of 23 500 firms has been investigated. This decomposition includes firms with more than 20 employees and focuses on changes within this constant panel of firms (in Turkey and within each region). However, it cannot capture the impact of the shift of resources from micro firms with less than 20 employees to those with more than 20 employees, and the impact of the new entries and exits.
Source: Turkstat/*AISS Database*, OECD Secretariat calculations.

weighs down economy-wide average productivity and drives a large wedge between the income and employment quality of different groups of workers.

- The newly emerging regions (Anatolian Tigers) shift employment more rapidly from low to high productivity firms than in the Developed West. This finding is confirmed by Atiyas et al. (2014).
- Data from a narrower sample summarised in Table 2.5 suggest that formal firms – proxied by enterprises with formal credit relations with banks – are more dynamic. When they reach a high productivity level, they increase employment more rapidly than in the rest of the business sector. Symmetrically, low-productivity formal firms contract more rapidly than in the rest of the business sector.[9]
- Overall, formal firms grew faster than other firms in the 2000s. Between 2005 and 2011, 30% of formal micro businesses with less than 10 workers, 25% of firms with 10-49 workers, and nearly 20% of firms with 50-249 employees shifted to higher size groups (Table 2.5). The growth of formal enterprises in the Anatolian Tiger regions was even stronger: 70% of firms with less than 10 workers, 50% of those with 10-49 employees and 25% of those with 50-249 employees shifted to higher size brackets.
- These drivers of productivity growth are more vigorous in trade exposed manufacturing than in competition sheltered services. The manufacturing sector has a higher share of employment in high productivity firms, improves productivity faster within enterprises, and shift resources more rapidly from low to high-productivity firms.

In sum, broad-based growth over the past decade has unleashed structural change in the Turkish business sector, even though aggregate productivity gains have been limited so far. The respective contributions of "within" and "between" gains highlight the areas where future structural upgrading should deliver benefits: i) the further corporatisation of first-generation entrepreneurial firms in Anatolian Tiger regions could deliver additional productivity gains; ii) the contribution of the formal sector could be enhanced by freeing up the institutionalisation of family firms and the presence of fully foreign-owned firms; and iii) there is a large potential for both "within" and "between" gains in the large hinterland of the economy dominated by very small businesses.

Table 2.5. **Formal sector firms are more dynamic**

Transition probabilities between size groups

A. Formal business sector, Turkey						B. Formal business sector, Anatolian Tiger regions					
Firm status in 2005	Firm status in 2011					Firm status in 2005	Firm status in 2011				
	Mi	S	Me	L	VL		Mi	S	Me	L	VL
Mi	0.65	0.30	0.04	0	0	Mi	0.33	0.67	0	0	0
S	0.12	0.61	0.25	0.03	0	S	0.04	0.49	0.47	0	0
Me	0.04	0.15	0.63	0.18	0	Me	0.02	0.08	0.64	0.26	0
L	0	0.02	0.12	0.84	0.03	L	0	0	0.04	0.89	0.04
VL	0	0	0	0.22	0.78	VL	0	0	0	0.50	0.50

Mi = Micro, 0-9 workers; S = Small, 10 – 49 workers; Me = Medium-sized, 50 - 249 workers; L = large, 250-2499 workers; VL = Very large, over 2 500 workers.

Source: Note: Transition probabilities across columns do not always add up to 1 because of rounding effects.

Source: Central Bank Balance Sheet Database.

Policy requirements for future structural upgrading

The development potential of micro and small firms has long been recognised in Turkey. The Ministry of Industry and Technology has set up several technology diffusion and know-how dissemination programmes, mainly through its SME agency KOSGEB (Box 2.5). The Ministry of Science, Industry and Technology also proposes a *Teknogirişim* (TechnoEntrepreneurship) programme. The National Science and Technology Foundation TÜBİTAK, the Ministry of Economy and various other institutions also propose programmes to help upgrade SME capacities.

Box 2.5. **KOSGEB's SME support programmes**

Eight support schemes are currently administered by KOSGEB, with a total annual budget of TRY 280 million (around USD 135 million). TRY 177 million thereof finance these support schemes directly. Eligible firms are co-financed for up to 50-60% of project costs, under one of the following programmes: i) the *General Support Programme* supporting broad enterprise development activities such as training, marketing, design; ii) the *R&D and Innovation Support Programme*, iii) the *Entrepreneur Support Programme* which coaches first-time entrepreneurs, iv) the *Project Support Programme*, which co-funds specific projects in production planning, marketing and personnel management, v) the *Thematic Programme* for activities such as professional travels and software purchases, vi) the *Co-operation and Partnership Programme* which supports joint ventures between SMEs; vii) the *Capital Market Support Programme*, which co-funds listing costs on the stock market, and viii) the *Credit Interest Support Scheme*, which grants interest rate subsidies to eligible projects.

The SME agency KOSGEB has decentralised its activities and come closer to the small businesses operating in Organised Industrial Zones. The Special Commission on SMEs of the 10th Development Plan 2014-2018 has reviewed all available SME programmes and proposed areas where they could be strengthened (Ministry of Development, 2013b). Notably, the newly created Regional Development Agencies are expected to participate actively in these policy initiatives (Box 2.6). Tax incentives and co-investments were also granted to business angels and venture capitalists, an Emerging Companies Market (ECM) section was created in Borsa Istanbul in 2011, and Treasury counter-guarantees to SME

Box 2.6. **Local policies for structural change: Konya's experience**

Twenty-six Regional Development Agencies (RDAs) were created in the mid-2000s to stimulate local economic development and co-ordinate projects with national development plans. All these agencies are now operational. Between 2008 and 2013, RDAs transferred around USD 350 million to the private sector to contribute to capacity building, productivity growth and structural change in local business sectors.

The experience of the Mevlana Regional Development Agency highlights this potential. The agency serves the Konya-Karaman region in Central Anatolia.* It's "Draft Regional Plan 2014-2023", drawn up in co-operation with local stakeholders, sets out a regional strategic goal, offers bottom-up plan elaboration and revision procedures, and proposes co-operative implementation techniques with the private sector (Mevlana Kalkinma Ajansi, 2013).

The overall goal for the region is to "integrate further with the global economy and become an attractive place for work, wealth creation and living in an hospitable environment". The upgrading of local businesses is emphasised as the main engine to achieve this objective. The RDA has involved many actors from the highly dispersed industrial fabric in elaborating the plan, which discusses local strengths and weaknesses in detail and outlines desirable local development initiatives. Some key goals are:

1. Small, family firms are not sufficiently institutionalised. "Family constitutions" are advocated to accelerate the absorption of modern management techniques.
2. New financing sources available in Turkey are not sufficiently mobilised in Konya. This includes modern trade finance, venture capital and international joint ventures. More transparent financial reporting is needed.
3. The present sectoral diversity is welcome and, for this reason, horizontal development initiatives should have priority. Still, more vertical co-operation, shared know-how acquisition, common training, and joint procurement activities between firms operating in similar sectors is desirable. The potential is particularly large in the agro-food, machinery and car component sectors.
4. Organised industrial zones and small industrial sites are already well-developed. They should be further built on to upgrade the local business environment, including in specific domains and clusters.
5. The universities and vocational schools are key resources for long-term growth. The share of secondary students in vocational education is already above the national average and the five universities are expanding. Yet, links with local businesses are not deep enough and should be developed.
6. Exporters manage to cope with the region's landlocked geography. More competitive transportation and logistics services will be crucial for future growth.

* The Konya region covers 50 000 km^2 – more than several OECD economies – but accounts for only 3% of Turkey's total population and GDP. It was originally a vast agricultural zone ("Turkey's wheat warehouse") but has become a successful *Anatolian Tiger* region over the past two decades, with growth led by export-oriented manufacturing. It now has a highly diversified industrial structure and many dynamic SMEs.

loans via the Credit Guarantee Corporation were significantly increased (Çanakcı, 2014). Comprehensive information on small enterprises– akin to the data available for firms employing over 20 workers – would help monitor outcomes.

Modern impact assessment techniques are beginning to be implemented in Turkey (Hirschleifer et al., 2014) and they could be extended to SME support schemes, which

attract expanding public resources and have a potential to contribute to structural change. Together with KOSGEB programmes, investment incentives and other SME support schemes should be evaluated with a view to identify the most effective schemes. The "R&D, Innovation and Entrepreneurship Co-ordination Committee", chaired by TÜBİTAK, has already initiated such an evaluation. Turkey has also introduced "Regulatory Impact Assessment" procedures in line with EU legislation and these can help evaluate SME programmes.

The institutionalisation and growth of firms in the higher strata of the business sector also deserve close policy attention. Further corporatisation of first-generation entrepreneurial businesses, further institutionalisation of large family firms, and further expansion of stock market-listed enterprises, including fully foreign-owned firms, hold huge potential. Turkey has still too limited a share of such enterprises in total business sector employment. Facilitating their development would help drive up productivity gains, job creation and social inclusion.

For more corporatised and institutionalised enterprises to flourish, policy action is needed in three areas: i) aligning the regulatory framework for doing business with OECD product and labour market benchmarks ; ii) replacing non-compliance with rules by small firms with modern labour market rules applicable to all, in order to overcome the current tension between flexibility and productivity; and iii) enforcing business taxation in fully transparent and uniform ways for all firms, irrespective of size and other attributes, so that higher productivity firms can grow without being held back by tax considerations.

Making the formal regulatory framework more friendly for modern business organisations

The business sector has grown successfully on a broad sectoral and geographical basis but without a fully supportive regulatory framework for doing business. Prevailing regulations in product and labour markets, inherited from earlier periods, do not appear conducive to the free development of modern businesses in an entirely open and flexible environment in line with OECD good practices (Figures 12 and 14). They feature complex licencing rules for market entry, a limited role for competition policy, restricted competition in network industries and public procurement, and rigid employment rules geared to life-time employment. Despite improvements in the 2000s, OECD regulatory indicators, as well as World Bank doing business and governance benchmarks, World Economic Forum *International Competitiveness* reports and the Global Integrity Institution's global integrity index all point to two dimensions where Turkey's environment for doing business should still improve:[10] i) the rules for market entry and exit should be made more competition-friendly; and ii) the transparency and predictability of regulatory enforcement should be improved. Regulators' discretionary decisions should be motivated and publicly explained, and rule changes should be minimised. Both dimensions are highly relevant for the expansion of more formal, more institutionalised enterprises in the Turkish business sector, and for that of fully foreign-owned firms.[11]

The current regulatory framework also creates specific disincentives for the corporatisation and modernisation of firms. Economic and social regulations with legitimate goals, such as promoting disadvantaged groups, improving worker protection and safety, enhancing financial transparency, or tax fairness unintentionally hinder structural change when they apply unevenly to different types of firms. In particular, some employment and tax provisions increase the costs of doing business when enterprises

grow and shift to higher size groups– as also found in other OECD countries (Garicano et al., 2012; Braguisky et al., 2011) (Table 2.6).

Table 2.6. **Tax and regulatory disincentives to enterprise growth**

Cost increases at successive size thresholds

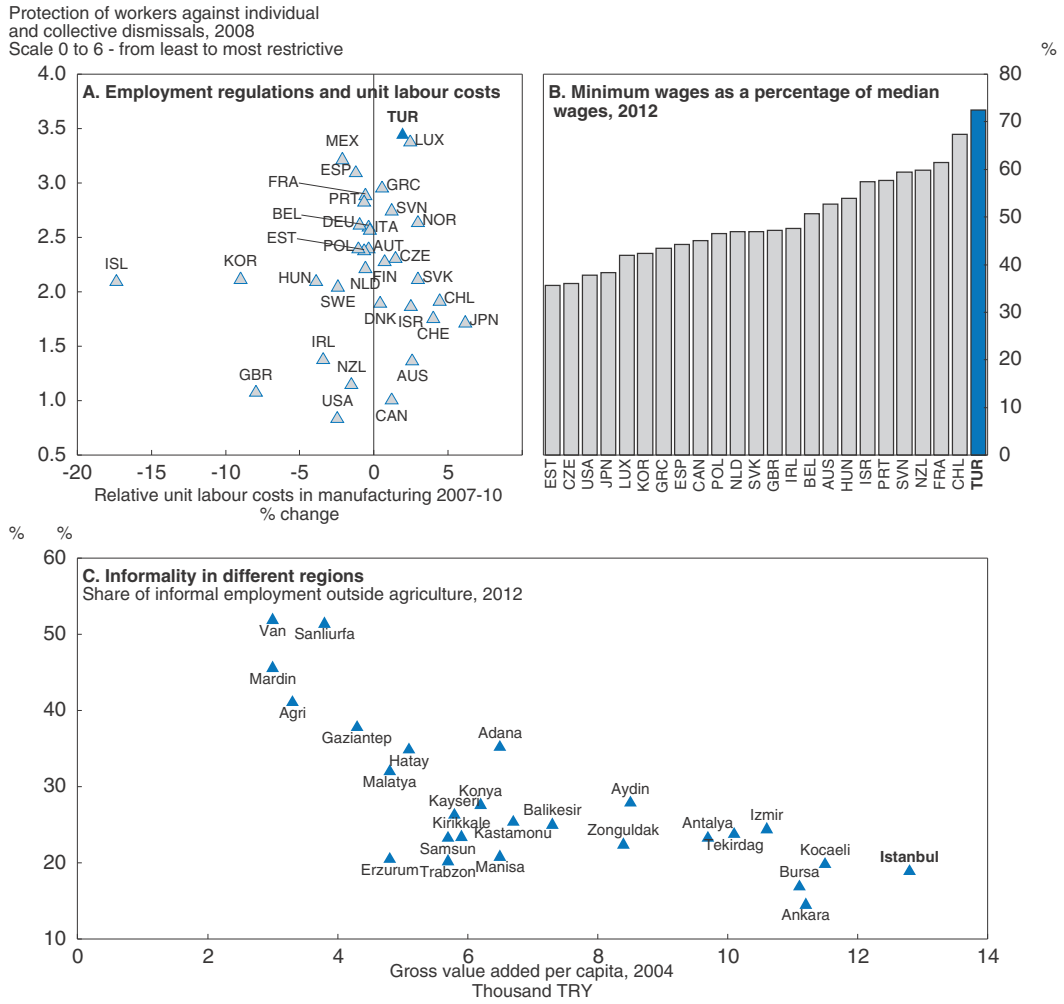
Tax rules	Employment rules
When a "trader and craftman workplace" or a sole proprietorship crosses the threshold of TRY 110 000 in annual sales (as of 2013), it must transit from simplified "business activity" taxation (which generally entails a low liability on reported profit) to "one book" taxation. Both are operated under personal income taxes. This requires the services of a tax accountant at a yearly cost of about TRY 1 800-6 000 for single book tax reporting.	When an enterprise crosses the threshold of 30 workers, it becomes subject to employment protection legislation. It cannot terminate an employment contract without a justification. Bunching effects at this size threshold are partly visible in Figure 2.6 and have been discussed in the Annex 3.A1 of the *2010 OECD Economic Survey of Turkey*.
When a firm which operates under personal income taxation crosses the threshold of TRY 200 000 in yearly sales, or TRY 150 000 in yearly input purchases, it must shift to standard (four book, including a balance sheet) taxation. This is meant to narrow room for tax evasion. It requires the services of a certified tax accountant at a yearly cost of about TRY 4 200-9 000 for standard tax reporting.	When a firm crosses the threshold of 50 workers, it has to have 3% of handicapped persons and 2% of terror victims on its payroll. Employer social security premia for the handicapped are paid by the Treasury. According to certain estimates, these groups have low productivity, evaluated at about 10-15% of average workers', but are paid the official minimum wage. In addition, the enterprise has to employ a company physician (with physical presence proportional to the number of employees in the enterprise), a health auxiliary, and a job safety expert. "Enterprise bunching effects" at this size threshold are visible in Figure 2.6.
When a firm has more than 500 shareholders, or crosses two of three thresholds (250 employees from January 2014 (2 500 employees before), sales of TRY 150 million or a balance sheet of TRY 75 million) it needs to produce annual financial statements according to international standards. External audits and Capital Market Board inspections considerably reduce room for tax avoidance.	When an enterprise crosses the threshold of 100 workers, it has to provide one-month advance notice in collective redundancies when terminating the contract of at least 10% of workers.
When an enterprise is listed on Borsa Istanbul, it needs to produce quarterly, semi-annual and annual financial statements according to international accounting standards. Semi-annual and annual reports must be externally audited. They must notify all events with a material impact on enterprise performance and publish a quarterly strategic report.	When an enterprise employs more than 150 female workers, it has to open a company kindergarten.

The policy goals motivating these provisions should be pursued without discouraging enterprise growth. The size distribution of enterprises shown on Figure 2.6, and some evidence discussed in Annex 3.A1 of the 2010 *OECD Economic Survey of Turkey*, suggest that part of the enterprises refrain from going over the 30 and 50 worker thresholds. Policymakers could pursue two avenues to improve size neutrality: i) make further use of organised industrial zones to provide targeted social services to the employees of small and large enterprises alike (such as health, safety, child care and so forth), and ii) make use of the tax and subsidy system to facilitate the employment of targeted social groups, rather than by imposing hiring obligations on certain types (sizes) of firms.

Adopting modern labour market rules applicable to all firms

Turkey has a highly rigid and costly labour regulatory framework, which was described in detail in the previous OECD *Economic Surveys* (OECD, 2010, 2012). The 2013 update of OECD's employment protection legislation (EPL) indicators confirmed that, in crucial areas such as temporary employment, employment through work agencies, and severance costs, Turkey has still some of the OECD's most rigid rules (OECD, 2013). The ratio of the minimum to the median wage also remains the highest OECD-wide (Figure 2.14).

Figure 2.14. **High unit labour costs encourage informality**



Note: NUTS 2 regions.
Source: *OECD Economic Outlook 93 Database*; *OECD Employment Database* and Turkstat.

StatLink http://dx.doi.org/10.1787/888933098421

These aspects of the regulatory framework have major implications for the operation of the business sector: i) they push up unit labour costs and undermine the international competitiveness of formal firms, which are the most export-oriented part of the economy and have the highest potential of participating in global value chains; ii) they stimulate informality (the share of informal jobs declined from 50% in the economy as a whole and 35% outside agriculture in the early 2000s, but is still around 36% in the entire economy and 22% outside agriculture in 2013); and iii) as informality is easier to achieve in small firms, they tend to trap business activities in lower-productivity units.

The existence of informality creates a trade-off between cost competitiveness and flexibility on the one hand (mainly available to informal and semi-formal businesses) and scale economies and other productivity drivers on the other hand (more accessible to formal firms). To overcome the tension, informality should be minimised by modern labour market rules applicable to all firms. High productivity and law-abiding firms can then grow naturally, and employ a higher share of the labour force, without losing their flexibility.

A comprehensive labour market reform agenda (National Employment Strategy) was published in May 2014. It aims at protecting workers rather than jobs and at supporting the shift of employment to higher-productivity firms. A first draft was made public in 2012 (Ministry of Labour, 2012) and it was included as a strategic priority in the 10th Development Plan 2014-2018 (Ministry of Development, 2013a). This strategy is in line with OECD good practices, as it includes a strong emphasis on human capital and skills, special attention to vulnerable groups, an emphasis on dialogue with social partners and a reform of labour legislation. It proposes to make all modern employment forms legal: permanent labour contracts with severance saving accounts (more secure for workers, and potentially more affordable for enterprises), temporary employment, employment through work agencies, employment at call and home-based work (Box 2.7).

Box 2.7. **The National Employment Strategy**

The National Employment Strategy was published in the *Official Gazette* in May 2014 (Ministry of Labour, 2014). It includes four priorities: i) reinforcing the links between education and employment; ii) enhancing protection and flexibility in the labour market; iii) improving the employability of disadvantaged groups, and iv) making social protection more employment friendly. It sets quantitative goals for 2023: increasing the employment rate from 47% in 2012 to 55%, the female participation rate from 28% to above 40%, and reducing informal employment outside agriculture to 15%. The principle of "flexicurity" is emphasised as the "foundation" of the strategy. Specific measures to adapt worker skills and available employment contracts to market needs in seven sectors (agriculture, tourism, textiles and clothing, health, finance, construction and information technology) are listed. The enforcement of the strategy calls for legislative changes in labour law, some of which are strongly opposed by social partners. It also requires structural changes in the business sector, to reduce demand for informal employment and increase demand for skilled labour.

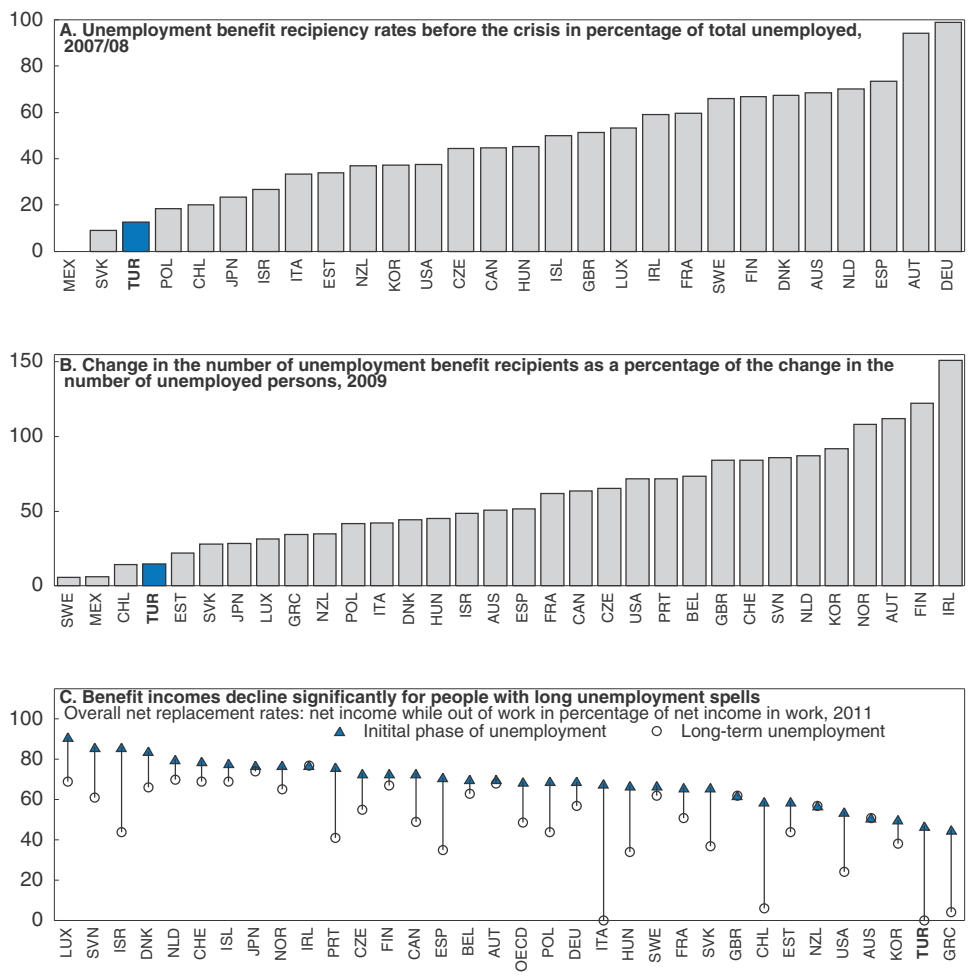
Earlier efforts in this direction have faced strong resistance from both unions and employers. The unions argue that actual worker rights and protections – including union representation – being very limited *de facto* in Turkey, greater employment flexibility and more widespread recourse to non-standard employment forms would generate a regression in industrial relations and in social protection. In turn, semi-formal and informal employers refrain from committing to any employment protection provisions and social protection costs (even reduced) from which they have been *de facto* exempt to date. Formal employers estimate that transition to a fully-funded severance saving regime is not affordable if contribution rates are not reduced, and if entitlements entrench the excess costs of the present regime. In September 2013 the government announced that it would postpone the discussion on severance payment reform.

In this difficult but decisive area, Turkey should draw lessons from the experience of other Southern European OECD economies. These countries have long faced a similar situation. Rigid and costly labour market rules entailed widespread recourse to informality and semi-formality. These countries found it increasingly difficult to carry on with such a degree of duality in their business sector and labour markets, including under the strengthened legal disciplines of the European Union. At the same time, political economy obstacles prevented reform. Second-best approaches were tried out, such as authorising

atypical labour contracts for parts of the economy and of workers, but with unsatisfactory results, as discussed in previous OECD *Economic Surveys of Turkey* (Box 4.6 of the 2008 *Survey* and Boxes 3.1 and 3.2 of the 2010 *Survey*). After the eruption of the global financial crisis, further deterioration in external balances and conditionality in international rescue programmes served to unblock the long-delayed reform process. Southern European economies then started to reform their labour markets, which should gradually take them closer to OECD good practices (Martin and Scarpetta, 2011; OECD 2013d). The challenge for Turkey is to find a smoother and less costly path to reform.

A possible avenue would be to garner stronger social support for complementary social safety nets. As of now, collective social protections, such as income maintenance via unemployment insurance and active labour market policies have still very limited scope in Turkey (Figure 2.15). More re-training was made available for the unemployed in the past four years – with up to six months full-time training offered by the Turkish Employment Agency (*Iskur*)[12] – but the schemes in place do not offer a credible alternative to enterprise-

Figure 2.15. **Social safety nets can be broadened substantially**



Source: OECD Employment Outlook 2011 and *OECD Society at a Glance 2014*.

StatLink http://dx.doi.org/10.1787/888933097908

level job protection, neither for the minority of formal sector insiders nor for the majority of workers aspiring to the same protection. Despite a multiplication of the measures to channel the beneficiaries of social aid to the labour market in recent years, more dependable combinations of income protection and up-skilling opportunities would be needed.

A recent scheme jointly introduced by *Iskur* and the Union of Chambers (*TOBB)* is a promising innovation. It will subsidise, on the basis of individual applications by enterprises, the costs of three-month re-training for the unemployed, supplemented by subsidies for one third of their total employment costs for the subsequent four years. The objective is to make training more labour market relevant (Duman, 2014) and re-hiring more attractive for employers. Results from this type of experiences should be evaluated, and efforts concentrated on the most promising schemes.

New programmes should also help reduce the inactivity traps that emerge from imperfect co-ordination between social transfers and active labour market schemes (OECD, 2012; Ministry of Development, 2013a; World Bank, 2013a). A new Action Plan is implemented to improve co-operation between Labour and Social Policy Ministries on the basis of shared information on the employment capacity of social aid recipients, in order to mobilise this capacity. [13]

Turkey can also draw on international efforts to promote more effective labour market rules better reconciling workers' protection and enterprises' flexibility. International Labour Organisation (ILO) convention No. 94 on subcontracting work and the EU's directive No. 2008/104 on temporary employment are examples. The Turkish Confederation of Employer Organisations (TISK) has recently invited Turkish social partners to use these guidelines more actively as a common reference in domestic dialogue for reforms (İşveren, 2013).

Progress with labour market flexibility and social safety nets can boost job creation for the low-skilled if labour markets function more efficiently. In particular, lower employment costs are needed to encourage higher-productivity firms to opt for more labour-intensive factor combinations. In this regard, reducing labour tax wedges is a priority. Large social contribution cuts introduced since 2008 (at different rates for different categories of workers and in different regions) have stimulated job creation (OECD-ILO, 2011), suggesting that applying them more broadly for unskilled workers across the country may be effective. This would entail fiscal costs, but these fiscal costs would be lower than in other countries because of the scale of informal employment and of a high degree of wage under-reporting, as discussed in the 2006 *OECD Economic Survey of Turkey*.

Given the large gaps in informality across regions – which are related to differences in skills, productivity and living costs – minimum wages may also be usefully adapted to local circumstances. Lower minimum wages would permit formal employers to hire low-skilled workers without being excessively penalised *vis-à-vis* informal and international competitors. Turkey had experimented with regional minimum wages in the past, but this had not been found to be satisfactory, notably on social grounds (Şeker and Küçükbayrak, 2012). Still, more socially acceptable ways of adapting the national minimum wage to local circumstances (for instance via locally negotiated adjustments) could be discussed and explored between government, employer and employee representatives at local level. If necessary, this could be combined with additional earned income tax credit type of support (on top of the existing partial personal tax allowances for low-wage workers) to improve workers' net earnings. Fiscal resource shifts from lower-priority public expenditures and

extra fiscal revenues from stronger growth in the formal sector could create fiscal room for such initiatives.

Promoting a level playing field for enterprise taxation

Turkey has made progress in adapting its corporate tax system to international norms. Nonetheless, further reforming business taxation is a priority to spur the development of larger, more corporatised businesses. Both size-dependent formal differences in taxation and actual differences in financial transparency differentiate effective tax burdens for large and small firms. Simplified taxation rules has benefits in Turkey's circumstances (such as cutting compliance costs and facilitating formalisation), but the magnitude of tax differences seem to have reached distortive proportions. They discourage modern businesses as well as large and indivisible investment projects.

The corporate income tax (CIT) rate was reduced, in steps, from 46% in mid-1990s to 20% by 2006. Only incorporated firms pay corporate taxes. The total number of CIT payers was around 665 000 in 2013. Other businesses are subject to lighter forms of taxation, under personal tax regimes. Most trader and craftman workplaces pay personal taxes on basis of simplified reporting procedures.[14] Many businesses underreport sales to remain eligible for such lighter forms of taxation (Gündüz, 2008).

The administration of business taxation continues to entail enforcement unpredictabilities, despite reform efforts in a new Corporate Income Tax Law adopted in 2006:

- The Tax Code contains only general principles, which are supplemented by communiqués and circulars. Implementation is frequently subject to interpretation, by the taxpayer as well as by tax authorities. This is the case for example for the costs eligible for "expensing", as well as for "transfer pricing" and "thin capitalisation" rules included in the 2006 Law on the basis of OECD best practices. Firms confirm that tax liabilities are often uncertain, implying tax adjustment and penalty risks following inspections.[15]
- Many enterprises reduce their tax liabilities by hiding part of their tax base. The bulk of CIT is paid by a small number of firms, mostly those listed on the stock exchange. These are subject to strict reporting requirements, to inspections by the Capital Market Board and to external audits. Several other top corporate taxpayers are FDI firms. Available information hints at a very uneven distribution of the CIT among enterprises.[16]
- The regional and sectoral investment incentives have grown and introduced important differences between the tax liabilities of firms across sectors and regions.[17] The resulting web of tax subsidies is intended to offset the excess costs of formal firms, and some of these enterprises are exempted for as much as 50% of their CIT liabilities. The schemes are rule-based but when incentives are subject to assessment and negotiation, such as with "large-project incentives", risks of distortion in domestic competition are unavoidable. Systematic monitoring is in order for all existing incentive schemes, to help assess the degree to which they actually offset the additional employment and tax costs of operating formally, their fiscal costs, and their impact on competition. Such evaluations are technically feasible, thanks to the new State Aid Monitoring Law adopted on the basis of EU guidelines – which, however, has yet to be put in application.
- Tax amnesties increase unpredictability. A large number of them have been decided over recent decades (Şenyurt, 2008). This becomes a form of tax discrimination between firms

complying with their tax obligations, and less formal and lower-productivity operators. Small business trade associations are currently demanding a new tax amnesty in 2014, on the grounds that the outstanding tax arrears stand at TL 56 billion (nearly 4% of GDP), and the tax penalties due amount to TL 40 billion (nearly 3% of GDP). If granted, a new amnesty would amount to yet another tax subsidy to less formal businesses.

Unpredictability in business taxation is a source of risk for investors. When the World Economic Forum asked managers of large corporations about their grievances when investing in Turkey, tax issues came very high on the list (WEF, 2011, 2013). In a survey of international governance, Turkey was perceived as lacking good rules and practices in the "enforcement of tax laws uniformly and without discrimination", ranking behind Italy and Poland, with some perceived weakening over time (Global Integrity, 2010).

The fundamental challenge illustrated by the shortcomings of business taxation is that non-compliance creates an unfair business environment for law-abiding firms. In particular, professionally managed organisations operating under rigorous internal control systems are not well-equipped to further their interests in such administrative settings. Risks of corruption and rent-seeking also unavoidably arise in an environment where regulatory compliance is not systematic. Irrespective of policymakers' intentions, departures from level-playing field, rule-based governance tend to undermine trust. The problem is particularly acute for institutionalised businesses such as FDI firms, and may hinder their entry or expansion. This contributes to keeping the share of institutionalised firms small, depriving Turkey of an important source of productivity and employment growth.

Distortion risks arising from business taxation are recognised by the authorities. Consultations for a thorough reform of the system have taken place for a number of years. A "Tax Council" worked on reform proposals through the 2000s, but no consensus was reached. Nonetheless, new ideas and concepts based on international best practices gained visibility among all parties. They all revolve around the principle of broadening the tax base and reducing the tax rates.

A recent assessment of Turkey's business tax reform agenda in international comparison underlined the critical importance of the tax system for economic performance (Abramovsky et al., 2013). It is essential to preserve the strong entrepreneurial dynamism of the business sector, in particular of the first-generation businesses of less advanced regions which have been serving broad-based and socially inclusive growth well. This entrepreneurial momentum has arguably been backed by the low effective income tax rates. Such incentives should be preserved for all firms.

There is certainly merit, in Turkey's circumstances, in facilitating the taxation of very small businesses in order to ease their compliance and encourage their joining the formal sector. Even so, such provisions and their enforcement should minimise transition costs between enterprise sizes, and should not become a trap. This requires re-examining the many concessions for small businesses and further unifying the system. Efforts in this area can draw on the Ministry of Finance's rapidly developing and efficient information technology infrastructure.

There are also many recent and ongoing efforts to utilise the tax system proactively to stimulate restructuring and productivity gains in the business sector. In addition to the sectoral and regional incentives mentioned above, a range of tax incentives for various research, technology and innovation activities have been put in place. To help maximise

benefits from these schemes, while reducing the risks of distortion in competition and resource allocation, the experience of the private sector may be better utilised. To this effect, consultations such as those initiated in the Tax Council could be resumed.

The 10th Development Plan 2014-2018 emphasises industrialisation and productivity growth as two main drivers of Turkey's future growth. Further increases in the country's human capital will condition these changes, as emphasised in recent OECD Surveys. The 10th Plan underlines that improving women's still low labour force participation, which requires further improvements in education, will also be a key driver of growth and social inclusion. Estimates produced in the context of the 10th Plan suggest that reforms along these lines could increase Turkey's trend real GDP growth rate by more than one percentage point (Usta, 2014). However, for this to happen, additional structural transformation in the business sector will be necessary. Resources should flow from the present myriad low-productivity activities to more efficient industrial and business organisations. The latter would create more productive, higher-income and more human capital-enhancing jobs, including for the presently disadvantaged social groups. Thus, the microeconomic reforms discussed in this chapter are crucial for Turkey to achieve its growth and social inclusion objectives.

Recommendations to foster strong and inclusive growth by promoting structural change in the business sector

- Improve the overall regulatory framework for doing business, using OECD product and labour market indicators as benchmarks.
- Continue to reduce *de facto* differences in the tax and social obligations of firms related to their size.
- Eliminate restrictions on the full range of modern employment forms in the formal sector (including temporary work, employment through work agencies, home-based work and remote work).
- Consider reducing labour tax wedges for low-skilled workers across the country, expanding earned income tax credit type support, and differentiating minimum wages according to regional conditions.
- Continue to strengthen incentives for female labour force participation through reforms facilitating the hiring of women in the formal sector.
- Strengthen the social safety net and the up-skilling avenues for the unemployed, expanding the most successful schemes.
- Implement the legislated but not yet operational state aid monitoring system. Evaluate the outcomes of support programmes for the SMEs and workers affected by structural changes. Focus on the most successful schemes.

Notes

1. Turkey's income distribution remains highly unequal compared to other OECD countries (OECD, 2013e). The elderly poverty rate increased from 14% to 18% between 2007 and 2010 and the youth poverty rate from 12% to 17%. However, "direct poverty" – defined as lack of access to basic nutrition, clothing and heating – declined from 29% to 21% between 2006 and 2010 (Gürsel, 2013). Azevedo and Atamanaov (2014) also found that between 2002 and 2011, extreme poverty in Turkey fell from 13 to 5%, while moderate poverty halved from 44 to 22% (defined respectively by using the World Bank's regional poverty lines of 2.5 and 5 USD/PPP). Most of this poverty reduction was driven by growth.

2. Anatolian Tiger regions, as identified in OECD Surveys, include five NUTS 2 regions: TR32- Aydin, Denizli, Mugla; TR52- Konya, Karaman; TR63- Hatay, Kahramanmaras, Osmaniye; TR72- Kayseri, Sivas, Yozgat; TRC1- Gaziantep, Adiyaman, Kilis. Developed West regions include nine NUTS 2 regions: TR10-Istanbul; TR21-Tekirdag, Edirne, Kirklareli; TR22-Balikesir, Canakkale; TR31-Izmir; TR33-Manisa, Afyonkarahisar, Kutahya, Usak; TR41-Bursa, Eskisehir, Bilecik; TR42-Kocaeli, Sakarya, Duzce, Bolu, Yalova; TR51-Ankara; TR61-Antalya, Isparta, Burdur.

3. Rapid growth of low-tech manufacturing has caused relative prices in manufacturing to decline faster than is usual in catching-up processes. This may at least partly explain the contraction of the share of manufacturing value-added in GDP in current prices, while it remained stable in constant prices and manufacturing employment soared (Saygili, 2013). Besides, the employment elasticity of non-agricultural output increased through the 2000s, presumably reflecting the growth of more labour-intensive production (Kalkinma Bakanligi, 2013).

4. The employment rate of illiterate male workers continued to contract, but this is a very small group.

5. The latest data on enterprise demographics in OECD indicate that Turkey is an outlier. Micro firms between 1 and 9 workers (accounting for 55% of total employment in Turkey) represent about 20% of total employment in a sample of 17 OECD countries, while large firms with more than 250 workers (accounting for 10% of employment in Turkey) represent about 35% of average employment in that sample (Criscuolo et al., 2014).

6. Many family enterprises, even large ones, may resort to various degrees of underreporting of their wages and profits and therefore provide only minimal financial information. Except for the small minority listed on the stock exchange, they do not publish standard financial reports. Only enterprises with more than 500 shareholders, and those crossing two of three thresholds (250 employees from January 2014 – 2 500 employees before –, sales of TL 150 million, or a balance sheet of TL 75 million) are required to publish externally audited financial accounts.

7. A sub-group of non-listed enterprises subject to sectoral regulations (in energy, insurance, air transportation, media and gold trade sectors) need to submit audited financial statements according to international standards. For this reason they are *de facto* part of the institutional sector, but their size could not be measured for the purpose of this study.

8. Part of the about 1 800 Turkish companies voluntarily producing audited financial accounts (without being required by regulations) are among these firms – a total of 3 500 Turkish firms produce externally audited financial statements.

9. This is obtained despite rigid employment rules in the formal sector through recourse to semi-formal practices (OECD, 2012).

10. For a detailed discussion of Turkey's position in international business environment comparisons see Box 2.5 in the *OECD Economic Survey of Turkey* 2012 (OECD, 2012). In the World Economic Forum's Global Competitiveness Report 2013-14 (World Economic Forum, 2013), Turkey ranks 44th among 148 countries.

11. The "Co-ordination Council for the Improvement of the Investment Environment (YOIKK)" created in 2001 with a large range of participants from public and private sectors, serves this purpose.

12. The number of beneficiaries expanded from 32 000 individuals trained in 2008 to 250 000 in 2011. According to one ex-post evaluation (Hirshleifer et al., 2014), training made less difference than expected for the re-employment opportunities of beneficiaries. It increased re-employment probabilities in the year following "graduation" but the differential dissipated in the next three years. Certain programmes, notably those offered by private training organisations in areas such as computer-aided accounting, improved the post-training earnings of beneficiaries. However, these programmes concerned the already well-educated.

13. A comprehensive protocol of co-operation was signed between the Ministry of Labour and Social Security and the Ministry of Family and Social Policies in 2012, in order to make social aid more conditional on labour market availability. A further action plan on "Strengthening the link between social aid and employment" is included among the high priority programmes of the National Development Plan 2014-2018.

14. According to the Ministry of Commerce 1.5 million traders and craftmen were active in 2013, and according to the Ministry of Finance 710 000 of them paid personal income tax under "simplified business taxation" (*basit usul vergi*). Small businesses subject to personal income tax with annual sales below TRY 200 000 are also taxed under the so-called "one-book" system, which generally implies a low effective tax liability.

15. Private sector testimonies during the OECD Secretariat visit to Turkey on 2-6 December 2013. The World Bank notes that tax authorities have been developing effective information technology-based tax administration systems, making them faster and more efficient but also that these developments have not yet completely achieved their purpose as with each new implementation, new requirements have also been introduced, which has in turn generated new bureaucratic procedures (World Bank, 2012).

16. In 2012, nearly half of total CIT proceeds of TL 29 billion was paid by the 100 largest CIT contributors. Among these, 7 banks alone paid TL 7 billion, 24% of total CIT proceeds. For the first 100 contributors, the ratio between CIT paid and value-added was about 10%. For the rest of CIT contributors, it fell to an estimated 1.6% (OECD Secretariat calculations). It is assumed in these calculations that half of the firms employing between 1 and 20 workers are liable to the "simplified business activity tax" and not to the CIT.

17. This investment incentive system, which has taken shape between 2004 and 2012, was described in the 2012 *OECD Economic Survey of Turkey* (OECD, 2012).

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Acronyms and abbreviations used in this Survey

AISS	Annual Industry and Services Statistics
BIS	Bank for International Settlements
BIST	Borsa Istanbul (Istanbul Stock Exchange)
BLT	Build-Lease-Transfer
BO	Build-Operate
BOT	Build-Operate-Transfer
BOTAS	National Gas Company
BRSA	Banking Regulation and Supervision Agency
CBRT	Central Bank of the Republic of Turkey
CEO	Chief Executive Officer
CIT	Corporate income tax
CPI	Consumer Price Index
DTI	Debt-To-Income
EBRD	European Bank for Reconstruction and Development
ECM	Emerging Companies Market
EU	European Union
FDI	Foreign Direct Investment
Fed	Federal Reserve
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GVC	Global Value Chains
FSC	Financial Stability Committee
IEA	International Energy Agency
ILO	International Labour Organization
IMF	International Monetary Fund
ISKUR	Turkish Employment Agency
ISO	Istanbul Chamber of Industry
JPM EMBI	JP Morgan Emerging Market Bond Index
KGF	Credit Guarantee Fund
KOSGEB	Agency for Small and Medium Enterprises
LLL	Life-Long Learning
LNG	Liquefied Natural Gas
LULUCF	Land Use, Land-Use Change and Forestry
MENA	Middle East and North Africa
MUSIAD	Association of Independent Businessmen and Industrialists
NEER	Nominal Effective Exchange Rate
NPL	Non-Performing Loan

NUTS 2	Nomenclature of territorial units for statistics (a statistical classification)
OECD-WTO TiVA Database	OECD-WTO Trade in Value Added database
O/N	Overnight (for financial operations)
PPP	Public-Private Partnership
QE	Quantitative Easing
R&D	Research and Development
RDA	Regional Development Agencies
ROC	Reserve Option Coefficient
ROM	Reserve Option Mechanism
SILC	Survey of Income and Living Conditions
SME	Small and Medium Enterprises
TEB	Turk Ekonomi Bankasi
TISK	The Turkish Confederation of Employer Organizations
TOBB	The Union of Chambers and Commodity Exchanges of Turkey
TOKI	Public Housing Agency
TRY	Turkish Lira
TUSIAD	Turkish Industry and Business Association
ULC	Unit Labour Cost
UNCTAD	The United Nations Conference on Trade and Development
UNFCCC	UN Framework Convention on Climate Change
VAT	Value Added Tax
WEF	World Economic Forum
WTO	World Trade Organization
YASED	International Investors Association of Turkey

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(10 2014 13 1 P) ISBN 978-92-64-20700-4 – 2014

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Volume 2014/13
July 2014

OECD*publishing*
www.oecd.org/publishing

ISSN 0376-6438
2014 SUBSCRIPTION (18 ISSUES)
ISSN 1995-3429
SUBSCRIPTION BY COUNTRY

ISBN 978-92-64-20700-4
10 2014 13 1 P

9 789264 207004