TURKISH CYPRIOIT Community: COPING WITH THE TURKISH LIRA DEPRECIATION SHOCK

A Macroeconomic Monitoring Note

SPECIAL ISSUE: THE PRECARIOUS FINANCIAL SITUATION OF LOCAL COMMUNITY BODIES

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<tr>
<td>AIC</td>
<td>Aikake Information Criterion</td>
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<td>CAR</td>
<td>Capital Adequacy Ratio</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<td>DMC</td>
<td>Debt Management Committee</td>
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<td>EC</td>
<td>European Commission</td>
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<td>ERPT</td>
<td>Exchange rate pass-through</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GL</td>
<td>Green Line</td>
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<td>IRF</td>
<td>Impulse Response Function</td>
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<td>KIBTEK</td>
<td>Kıbrıs Türk Elektrik Kurumu</td>
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<td>LCBs</td>
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<td>NPLs</td>
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<td>PIT</td>
<td>Personal Income Taxes</td>
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<td>Producer Price Index</td>
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<td>RoC</td>
<td>Republic of Cyprus</td>
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<td>SBIC</td>
<td>Bayesian Information Criterion</td>
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<td>SVAR</td>
<td>Structural Vector Autoregression</td>
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<td>TC</td>
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<td>TL</td>
<td>Turkish Lira</td>
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The Turkish lira (TL) has depreciated to an extent not seen since the 2001 crisis, reaching its lowest level in September 2018 (TL 6.37/US$1.00), losing 66 percent of its value against the US dollar since January 2018. This Regular Economic Report focuses on the likely impact of the depreciation on the Turkish Cypriot (TC) economy. Although the magnitude of the 2001 depreciation eventually turned out to be double the current depreciation, the reaction of the economy in 2001 offers useful insights into understanding the situation today. The report also discusses the financial situation of Local Communities Bodies (LCBs), whose budgets are highly dependent on transfers from the central administration. With the TL depreciation, fiscal pressures will arise at the central level, as well as the local level, where the quality of service delivery is likely to be eroded as a result.

The TC economy faces specific structural challenges, worsening the impact of the depreciation and the administration’s capacity to respond to it. TC GDP growth is unbalanced, with high consumption and with growth primarily driven by services exports, not by investment. The economy is also failing to make the most of its people, particularly women. Employment growth has slowed, and most new jobs are being created in the low-productivity services sector. Low levels of investment and job creation in low-productivity sectors have resulted in declining aggregate labor productivity growth, unlike in the years prior to 2011. As a result, the TC economy is no longer considered a high-income economy and is not as resilient to shocks.

Similar to 2001, the depreciation is expected to have a negative impact on GDP growth through slower consumption and merchandise export growth. But as the magnitude of the depreciation appears smaller this time round, GDP growth is expected to remain positive (2.5 percent in 2018, down from 5.4 percent in 2017). Consumption will slow due to inflation generated by increased import prices.

In 2001, exports of higher education were not as important as they are today. Exports of higher education and tourism have become the TC economy’s drivers of growth. However, with the TL depreciation, enrolment growth of foreign students has slowed in the 2018/19 academic year. Growth of higher education exports is therefore expected to remain positive but to slow. The other growth driver, tourism exports, should continue to expand and drive growth through 2018 and beyond. The current account before grants is expected to remain in surplus thanks to these tourism and higher education exports.

Given that the administration had no developed social protection system to mitigate the impact of this shock on the poor and vulnerable, it responded to the increase in prices by raising ‘public’ wages across the board. This will increase pressures on ‘public’ finances and require higher domestic financing, resulting in increased domestic debt. The administration will therefore need to both mobilize domestic revenue and reduce inefficient spending if it is to contain the fiscal deficit in the medium term.

Balance sheets of the administration, firms and households will all be impacted by the depreciation. The ‘public’ sector, with a large amount of debt denominated in foreign currency, is the most vulnerable, but firms in the non-financial sectors and households also face risks. This could have knock-on effects in the banking sector.

For the financial sector, the private banking system in aggregate appears to be relatively insulated from an immediate currency depreciation shock. Individual impact may differ, however, depending on each individual bank’s forex positions. Because most banks’ borrowings are domestic, the probability of a liquidity shock is low, and the high level of forex deposits also provides a cushion. However, in the medium to longer term, the TL depreciation could result in a significant increase of non-performing loans (NPLs) (for loans denominated in forex), potentially affecting the stability of the system. The ‘public’ banking system appears vulnerable due to a large amount of a ‘public’ loans not serviced by the administration.

Any worsening of the situation in Turkey could spell trouble for the TC economy. Our economic impact assessment assumes a soft landing, with the Turkish authorities implementing a
The deteriorating situation of the LCBs has two arrears, particularly to contractors and suppliers. It is instead evident in a growing stock of local budget execution reports, which only report expenditure obligations that have been paid. It is instead evident in a growing stock of arrears, particularly to contractors and suppliers. The deteriorating situation of the LCBs has two adverse implications. First, it suggests that LCBs will increasingly be unable to provide the basic services that are critical to growth and the wellbeing of the TC community. Second, it presents a growing fiscal risk to the central administration. At some point in the not-too-distant future, the stock of LCB arrears could become so large that the central administration will come under intense pressure to provide a bailout. Given the central administration’s current fiscal constraints, this would be highly inopportune.

Part of the problem stems from the regulatory framework governing local finance. Central regulations severely limit local tax rates, such that revenues only amount to €24 per capita annually. LCBs are authorized to impose a wide range of tariffs and charges but those applied are insufficient to cover operating expenses. Proposed amendments to the regulations would improve the situation to some extent. The amendments would partially remove the ceiling on the local income tax, providing more autonomy in tariff setting for LCBs. A new local services tax (replacing the tax on solid waste collection and certain other fees) would be introduced.

But more actions could be taken. To increase revenues, the central administration could increase the rate of some taxes and assist LCBs to improve tax administration, enact the proposed local services tax, and consider replacing the local income tax with shares of the centrally administered personal income tax.

To encourage spending reductions, the central administration could toughen its approach and reject budgets based on implausible revenue projections. It could encourage wage bill reductions by enforcing current limits on staffing and overall wage spending. It could also assist LCBs to improve the efficiency of services, such as water supply and solid waste management, by encouraging joint service arrangements among small LCBs. But much of the power to improve the situation lies with the LCBs themselves, as they have a considerable degree of fiscal autonomy despite the limits imposed by central regulations. They can increase basic tax rates up to the rate of inflation and impose higher valuations; and are also free to increase water tariffs (subject only to pro forma review) and the rate of various service charges within a range set by central regulation. Although their ability to reduce the number of civil servants is limited, they have considerable control over the numbers and wages of contracted staff and front-line service providers.

The first section of this report discusses recent economic developments in the TCc with a focus on the likely economic impact of the TL depreciation. The second section assesses the state of the LCBs’
Recent Economic Developments

Introduction

The Turkish lira (TL) has depreciated to an extent not seen since the October 2001 crisis. Between December 2017 and September 2018, the TL lost 63 percent of its value against the euro and 66 percent against the US dollar. On a year-on-year basis, the extent of the TL depreciation in September 2018 is similar to that experienced in October 2001 (Figure 1). Although the magnitude of the 2001 TL depreciation eventually turned out to be double the current depreciation and the TC economy has evolved since then, the reaction of the economy in 2001 offers some useful insights into understanding the situation today.

Both the Turkish and TC economies exhibit similar structural weaknesses. Both economies overheated because recent growth was driven by consumption rather than investment. As a result, production could not meet rising demand, causing inflation to surge. CPI inflation reached 11.1 percent in Turkey and 15.1 percent in the Turkish Cypriot community (TCc) in 2017. Both economies are dependent on external financing and are therefore vulnerable to changes in external financing conditions. Macroeconomic resilience to a prolonged shock is weak, and the administrations both in Turkey and the TCc responded to the crisis with several ad hoc measures that proved insufficient to address it.

Figure 1: The Turkish lira has depreciated to an extent not seen since the 2001 crisis

Source: Central Bank of Turkey.

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1 The monthly average exchange rates in December 2017 were TL 4.55/E1.00 and TL 3.85/US$1.00.
2 See Box 1 for a discussion on recent economic developments in Turkey that trigger the currency depreciation.
3 Turkey’s GDP growth was 1 percentage point above potential, the same as for TC GDP growth.
4 External debt in Turkey reached 56 percent of GDP as of March 2018, while TC external debt stood at about 100 percent of GDP in 2016.
5 For instance, the recent Turkish 10-years Eurobonds were issued at an interest rate up to 7.25 percent. The TC deficit financing from Turkey is dramatically declining.
6 Turkey has a high current account deficit (5.6 percent of GDP in 2017) and a low level of reserves (currently around US$90 billion). Both Turkey and the TCc have relatively lower fiscal space (general government fiscal deficit of 2.4 percent of GDP for Turkey and the central administration fiscal deficit of 1.5 percent of GDP for the TCc in 2017).
7 The Government of Turkey did not act pre-emptively to address overheating risks. For instance, interest rates were raised only after a sharp depreciation; the TC administration favored a blanket increase of all public-sector wages that put pressure on public finances. An increase focused on only the lower salary brackets would have helped ensure public sector employees could have met their basic needs, with only a limited effect on public finances.
Box 1: Explaining recent economic developments in Turkey

What happened recently in Turkey? The Turkish lira has depreciated very sharply since early 2018 as markets grew increasingly concerned about the Turkish economy. These concerns are: (i) partly domestic – the economy has been overheating since the end of 2017 with markets perceiving insufficient policy response, which has been further challenged by a major reorganization of economic institutions after elections in June; and (ii) partly external – rising global interest rates and growing international tensions in August, including threats of sanctions against Turkey, added fuel to the fire.

What has changed in Turkey in recent years? Though the Turkish economy has been growing rapidly in recent years, the nature of that growth was different to that seen in the early 2000s. After suffering a major financial crisis in 2001, Turkey experienced a period of impressive growth between 2002 and 2007, driven by extensive reforms. These reforms helped to usher in a new growth model for the country: the state increasingly became the enabler, rather than producer, and the public sector accelerated service delivery with new found fiscal space.

Policies since the global financial crisis in 2008 had to deal with a series of short-term shocks to demand in the economy. The government responded with short-term stimulus measures through: increased public consumption; public guarantees for commercial credits; some relaxation in macro-prudential regulations to accelerate lending to corporates and households; and subsidies to employers that helped SMEs tide over difficult times.

These policies helped Turkey to avoid a deep recession that could have resulted from such demand shocks, but they also meant a diversion from the additional reforms needed to strengthen long-term supply. This is noticeable in the slowdown in productivity growth in the economy, a phenomenon that has also affected other emerging markets. For Turkey, these policies were essential in helping to avoid major unemployment in the near term, but rebalancing efforts toward increased productivity and long-term growth are essential to sustain its economic performance.

Why did the economy start overheating in late 2017? Following the 2016 coup attempt, the government stimulated demand and supply (through tax breaks and credit guarantees) to prevent a recession. But, by the end of 2017, demand started to exceed what the economy could supply, and this led to overheating: suppliers increased prices rapidly and consumers imported more from abroad. The overheating led to a high current account deficit, at 5.6 percent of GDP.8 9

How can a large current account deficit create difficulties? A high current account deficit is more likely to be problematic when it is primarily financed with external debt, as is the case in Turkey (in contrast, a high current account financed with foreign direct investment helps improve productive capacity). Such a deficit is unsustainable in the long term because the economy becomes overburdened with high interest payments (e.g., Russia, Brazil and some African countries have faced such repayment problems).10 This risk can cause a loss of confidence by foreign investors, leading to a reversal in the flow of capital, causing currency depreciation. In the case of Turkey, the concerns over a high current account deficit financed by debt were aggravated by financial tightening in the US, which is pulling investors away from emerging and developing markets globally, as well as by international tensions and policy weaknesses. The resulting capital outflows caused the Turkish lira to depreciate significantly.

What is the current situation in Turkey? Recent developments are marked by intense market volatility and economic stress. High external exposure leaves the economy vulnerable to prolonged currency pressure. The economic outlook is subject to higher levels of uncertainty with increased chances of a downward adjustment to growth.

Source: World Bank staff.

8 A current account deficit is usually said to be high when it is above 5 percent.
9 A current account deficit means that the value of imports of goods/services/investment incomes is greater than the value of exports.
10 https://www.economicshelp.org/macroeconomics/bop/probs-balance-payments-deficit
Structural Challenges of the TC Economy

TC GDP growth is out of balance, with high consumption and growth primarily driven by services exports, not by investment. TC GDP growth accelerated in 2017 reaching 5.4 percent compared with 3.6 percent in 2016. Although private investment picked it up in 2017, its contribution to growth has remained very weak, as is also the case for ‘public’ investment (Figure 2). Total investment as a share of GDP has declined from about 20 percent in 2011 to around 15 percent now. Meanwhile, total consumption has remained very high, above 70 percent of GDP. Exports of services (tourism and higher education) continue to be drivers of growth (Figure 2), explaining why services drive growth from the production side (Figure 3).

The TC economy is not making the most of its people, particularly women. Although the unemployment rate declined to 5.8 percent in 2017, down from 6.4 percent in 2016, labor force participation at 51.2 percent remains very low compared with the EU average of 73 percent. Female labor force participation is only 39 percent compared with a male participation rate of 62.4 percent. In addition, at 7.8 percent, the female unemployment rate is higher than the male unemployment rate of 4.6 percent.

Employment growth has slowed, and most new jobs are being created in the low-productivity services sector, both ‘public’ and private. Employment growth in the TC economy stood at 2.2 percent in 2017, down from 5 percent in 2016 (Figure 4). The TC job market created in net 2,612 jobs in 2017 compared with a net creation of 5,576 jobs in 2016. The services sector, both ‘public’ and private, continues to be the driver of employment growth. However, this sector is also a low-productivity sector, with labor productivity growth declining in recent years mostly in the ‘public’ services sector (Figure 5). Contrary to the ‘public’ sector, where wages are increasing, the low-productivity private services sector translates into low wage growth, and therefore low capacity to absorb a prolonged economic shock.
Low investment and job creation primarily in low-productivity sectors have resulted in declining aggregate labor productivity growth, unlike prior to 2011. As a result, the TC economy is no longer a high-income economy. Thanks to relatively high annual average investment of about 21 percent of GDP between 2004 and 2011, aggregate productivity increased at about 2.2 percent per year, higher than in the EU and in the Republic of Cyprus (RoC). Post-2011, total investment as a share of GDP contracted to about 14 percent of GDP. ‘Public’ investment also contracted from an average of 5 percent of GDP to about 2.6 percent.\footnote{The TCc was only able to spend 39 percent of the allocated investment funds in 2015, which is low by international comparison. The reason is that projects are often insufficiently prepared and therefore fail at the approval stage, or encounter delays in implementation. The benefits of improved infrastructure take too long to materialize because of poor investment planning and delays in project implementation. At the same time, current budget procedures cannot guarantee that projects with the highest returns for the TC economy are selected for financing. This results in lost opportunities to enhance ‘public’ services and improve the business environment.} Shrinking investment combined with job creation in the low-productivity ‘public’ and private services sector have resulted in declining aggregate productivity growth (Figure 6). Consequently, the TC’s income per capita has been falling since 2011, widening the gap with the RoC and the rest of Europe. This has meant that, since 2015, the TC economy was no longer categorized as a high-income economy.

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\includegraphics[width=\textwidth]{figure6.png}
\caption{Aggregate productivity has declined compared with pre-2011}
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\end{figure}

Source: ‘State Planning Organization’, World Development Indicators, World Bank Staff.

Note: TC per capita income is calculated using the World Bank Atlas method to smooth the impact of fluctuations in exchange rates. GNI for an economy in US dollars for year $t$ is calculated on the basis of a conversion factor (“Atlas conversion factor”) computed for the period that covers years $t-2$, $t-1$, and $t$. Each year, the 3-year base period moves forward, including the target year for which GNI is computed and the two preceding years.

Figure 4: Employment growth has slowed down

Figure 5: Labor productivity growth in the services sector has declined

Source: ‘State Planning Organization’.

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Economic Impacts of the Depreciation

Impact on Consumer Price Index (CPI) inflation and domestic demand

CPI inflation in the TCc is more sensitive to exchange-rate fluctuations than in Turkey because of the high share of consumption that is imported. As a small economy, the TCc imports almost everything (consumption and investment goods, and inputs for agriculture). Total imports of goods as a share of GDP fluctuate at around 40 to 45 percent of GDP (Figure 8).12 As food and beverages, and energy products represent almost 30 percent of TC imports, headline inflation is driven by price increases in these basic goods (Figure 9).13

Our estimate shows that the exchange rate pass-through (ERPT) is higher in the TCc than in Turkey, and that it takes 4 to 5 months for the impact to be fully transmitted into price increases. We make use of a bivariate structural vector autoregression (SVAR) model to simulate the impact of an exchange-rate depreciation shock on inflation, both for the TCc and for Turkey.14 For each model, we use the inflation rate and the percentage change in the TL/US$ exchange rate. Our results through the Impulse Response Function (IRF) show that the inflation rate increases—more rapidly in case of the TCc—in response to a shock in the exchange rate of 1 percentage point. Results hold for both month-on-month inflation and for year-on-year inflation (Annex Figure 1 and Annex Figure 2). For month-on-month inflation, the inflation IRF becomes insignificant after 4 to 5 months for the TCc, which means that it takes 4 to 5 months for the impact of the shock to be fully transmitted into price increases. Our simulation also shows that with a 10-percentage-point TL depreciation, inflation in the TCc will increase by 2.13 percentage points for up to 5 months, while it increases only by 1.24 percentage points in Turkey (Table 1).

Figure 8: TC CPI inflation is more sensitive to exchange-rate fluctuations than Turkey
Figure 9: Headline inflation is driven by price increases of basic goods (food, beverages, energy)


12 Note that the TC BOP does not record imports of services, but only net exports of services.
13 Calculations are based on 2008 base year weights for the months before 2017 and 2015 base year weights for the months from 2017. Food inflation reflects the first sub-group, foods and non-alcoholic beverages; energy inflation the fourth (housing, water, electricity, gas and other fuels) and seventh sub-groups (transport) in the consumer price basket.
14 For further details on the model and the identification strategy, see the first paragraph of Box 2.
Table 1: Exchange-rate pass-through is higher in the TCc than in Turkey\textsuperscript{15}

<table>
<thead>
<tr>
<th>Months following a shock</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
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</thead>
<tbody>
<tr>
<td>TCC</td>
<td>1.29</td>
<td>1.70</td>
<td>1.93</td>
<td>2.04</td>
<td>2.10</td>
<td>2.13</td>
</tr>
<tr>
<td>Turkey</td>
<td>0.58</td>
<td>0.95</td>
<td>1.12</td>
<td>1.20</td>
<td>1.23</td>
<td>1.24</td>
</tr>
</tbody>
</table>

\textit{Source:} World Bank staff estimates.

\textit{Note:} The table shows an estimate of cumulated exchange-rate pass-through inflation in the TCc and in Turkey. The effects on a given month is the ratio of a cumulated IRF of inflation to a cumulate IRF of exchange rate change to a shock of a 10-percentage-point increase in the exchange rate.

Combining both our own simulation and the information collected during interviews with key counterparts in the field, annual inflation—which stood at 15.1 percent in 2017—is projected to reach 24.5 percent in 2018 and gradually decline in the medium term. The TL depreciation has more than tripled inflation from about 12 percent y-o-y in January 2018 to about 38 percent y-o-y in October. Over the first 10 months of 2018, inflation reached 20 percent, while it stood at 15.1 percent in 2017. Because exchange-rate depreciation fully translates into domestic prices after one quarter, we expect annual inflation to reach 24.5 percent in 2018. Back in 2001, inflation also spiked to 67 percent from 53 percent in 2000. Going forward, inflation is expected to remain high but gradually decline to 20 percent as the TL is expected to stabilize (Table 3).

Private consumption and investment are expected to fall in 2018, reflecting rising inflation and interest rates. In 2017, the contribution of private investment to GDP growth increased, while the contribution of private consumption was moderate (Figure 2). Before the Turkish Central Bank raised its policy rate from 17.75 to 24.0 percent in September, loans were provided at an interest rate of at least 20 percent. With the rising policy rate in Turkey, market rates are expected to increase in the TCc, reducing credit growth both to households and firms. Combined with higher inflation, private consumption and investment are expected to decline in 2018. Going forward, private consumption is expected to pick up, reflecting both salary increases in the ‘public’ sector and the expected stabilization of the currency. Investment is expected to continue to decline as interest rates will remain high (Table 3).

\textsuperscript{15} The size of our estimate of the ERPT for Turkey is not easily comparable with existing estimates. Several factors including the methodology, the definition used to calculate the ERPT, the magnitude of the exchange rate shock could explain differences in estimates. For instance, the Central Bank of Turkey recently estimated the ERPT over the business cycle and according to perceptions of the persistence of an exchange rate changes (temporary vs permanent). The study found that the ERPT tends to be higher than historical average of around 15 percent reaching 25 percent during booms (output-gap positive) and lower than 10 percent in downturn. Also, when markets expect a persistent depreciation, the ERPT is substantially higher (http://www.tcmb.gov.tr/wps/wcm/connect/blog/en/main+menu/analyses/exchange+rate+pass+through). However, the absence of a detailed discussion on the methodology makes it hard for the comparison with our estimate.
Box 2: Explaining the SVAR model and identification strategy

1. **On the exchange rate pass-through**

For the TCc and for Turkey, we make use of a bivariate SVAR:16 (i) a model with the month-on-month inflation rate and the month-on-month percentage change of the TL/US$; (ii) and a model with the monthly inflation rate year-on-year, and the same for the exchange rate. For (i) the period of estimation is February 2003 to September 2018, while for (ii) the period is January 2004 to September 2018. We chose these periods to avoid a break in the Turkish inflation series due to a change of the yearly basis of the CPI, which occurred in 2003. We also chose the CPI inflation rate instead of the index in level because the TCc has changed its yearly basis many times, with the most recent change in 2015. The model can be extended to include other price indices, such as the import price index or the producers’ price index (PPI), The ERPT for the PPI would be more informative for the supply side, as the TCc also imports a significant amount of its production inputs. The estimate is limited for CPI inflation as data on imports price or producer price are not available for the TCc. The common problem when estimating a SVAR is to identify shocks of the structural form of the model from the reduced estimated form. Innovations from the reduced form are usually not orthogonal. A common approach is to impose short-run restrictions or long-term restrictions based on economic theory. For the TC SVAR model, we impose two sets of constraints. As the currency is totally exogeneous to the TC economy, we assume that TC inflation does not affect the exchange rate, so coefficients of the inflation equation on the exchange rate and its lags are set to zero. In addition, we imposed the IRF of the exchange rate to a shock on TC inflation equal to zero at all times. For the model for Turkey, as shocks to the exchange rate are both endogenous and exogenous, we only impose a short-run restriction by assuming that the exchange rate reacts with a lag on the Turkish inflation rate shock. To estimate each model, we chose the appropriate number of lags using minimum criteria information (AIC and SBIC)17 and each model is stationary. In 2006, the Central Bank of Turkey officially adopted an inflation targeting regime that may have introduced a structural break on the inflation rate series. As a robustness check, we reduced the sample starting in 2006 and the results and conclusions remain unchanged.

2. **On the exchange-rate impact on GDP**

We followed the same approach as in the case of inflation. Here we used annual GDP and exchange-rate data from 1977 to 2017 to keep any long-term cointegration relationship between the two variables. We imposed the exchange rate not to respond to a shock on the TC GDP and coefficients of the GDP equation on the exchange rate, and its lags are set to zero. We also chose the appropriate number of lags using minimum criteria information (AIC and SBIC) and the model is stationary.

Source: World Bank staff.

Impact on input prices, and on agriculture and manufacturing

Input prices increase because of currency depreciation, raising production costs for firms. This can be expected to cause a decline in agricultural and manufacturing production in 2018. Depreciation causes input prices in TL to increase (Figure 10). For instance, rising prices of petroleum products led KIBTEK18 to increase electricity tariffs—a key production input for manufacturing—by about 50 percent between February and June 2018. The price of barley, which constitutes 50 percent of animal feed, also spiked. Those producers with limited access to finance due to high interest rates are forced to buy fewer inputs than before and their production is likely to fall as a consequence. In addition, the bad weather conditions experienced in 2018 are likely to exacerbate the decline in agricultural production. We therefore project production in agriculture to fall in 2018 but recover subsequently (Table 3).

17 AIC stands for Akaike Information Criterion, SBIC stands for Bayesian Information Criterion.
18 KIBTEK stands for Kıbrıs Türk Elektrik Kurumu, the agency in charge of the distribution of electrical power in the TCc.
Impact on external demand

With the depreciation, the export volume of goods is expected to fall in 2018, but the volume of imports is likely to fall further. Two factors are expected to constrain the export of goods—mainly agricultural and agribusiness products: a fall in production (due to the rising costs of inputs and limited access to finance to buy the same amount of inputs) and a slowdown in demand from Turkey. Both factors contributed to the 26 percent decline in the export volume in 2001. The import volume, which fell by 31 percent in 2001, is expected to decline further due to the spike in import prices resulting from the currency depreciation. In 2017, real exports increased by only 1.2 percent. During the first half of 2018, the volume of exports of citrus and raki products, which together represent about 40 to 43 percent of export value, declined by only about 4 percent (Annex Table 1). With most of the depreciation occurring in the second half of 2018, we project that imports will fall by about 2 percent and exports by about 1 percent in 2018. In the medium term, both exports and imports are expected to recover, but at a faster pace for imports (Table 3).

Tourism exports are expected to continue to expand and drive growth in 2018 and beyond. Real growth of tourism exports reached about 19 percent in 2017, thanks to a record increase in overnight stays of about 25.2 percent. Countries other than Turkey contributed about 17.4 percentage points to this increase, equivalent to an increase of about 70 percent. Following the 2001 currency depreciation, real net tourism exports contracted by about 50 percent as Turkey went into recession. In the present context, things are rather different: people including tourists can now cross the Green Line. The number of crossings to the TCc in the first 9 months of 2018 increased by about 46 percent relative to the same period in 2017 (Table 2) and have almost doubled since August (Annex Figure 3). Overnight stays from Turkish tourists over the same period also increased by about 18.5 percent (Table 2). Spending (hotel, restaurant, and retail sales) by these visitors is expected to increase tourism receipts. With the currency depreciation, we project a more dynamic and expanding tourism sector through to the end of the year and into the medium term (Table 3).

19 Turkey’s GDP growth is expected to slow down from 7.4 percent in 2017 to 3.7 percent in 2018, and then 2.3 percent in 2019, according to the World Bank’s forecast.
20 The TC tourism model is however oriented toward quantity rather than quality. The sector has been the main beneficiary of the incentive system to reward hotel expansion and tourism agencies. These costly incentives do not meet citizens’ expectations, who complain about the lack of transparency in the concession of incentives and their weak impact on the needs of the broader population.
21 Though Turkey still accounts for more than 50 percent of TC tourism exports.
22 With the TL depreciation, Turkish tourists may prefer the TCc destination as a substitute, given that other destinations have become more expensive. Also, because of the short distance, Turkish tourists may prefer the TCc destination instead of other countries with a different currency.
Unlike the 2001 crisis, exports of higher education have become one of the TCc’s main drivers of growth.\textsuperscript{23} With the TL depreciation, enrolment growth of foreign students has slowed. As a result, higher education exports are expected to slow. In 2001, the impact of the TL depreciation on the higher education sector was not as relevant for GDP growth, as the sector was not as developed and was not an engine of growth. In 2017, higher education real exports increased by 12 percent, thanks to an increase in foreign student enrolment of 12.85 percent. For the 2017/18 academic year, the number of foreign students increased by 13.40 percent to reach 87,607, of which 64 percent were Turkish. As the academic and calendar years do not coincide, part of the related increase in exports was recorded for the last quarter of 2017, and the rest recorded in 2018. With the currency depreciation, foreign student enrolment increased by just 3 percent in the current 2018/19 academic year reaching 90,438 students (Figure 11).\textsuperscript{24} This reflects a 2 percent decline in students from Turkey and a slowdown in enrolment growth of students from other countries from 32 percent in 2017/18 to only 12 percent in 2018/19.\textsuperscript{25} We therefore project a slowdown of higher education export growth in 2018 and the following years (Table 3).

\begin{table}[h]
\centering
\begin{tabular}{lrrr}
\hline
\multicolumn{4}{c}{Table 2: Increasing number of overnight stays and crossings over the Green Line will support tourism} \\
\hline
 & Jan-Sept.2017 & Jan-Sept.2018 & \% change \\
\hline
Overnight stays & 3,168,570 & 3,444,362 & 8.7 \\
  Turkey & 1,669,545 & 1,978,229 & 18.5 \\
  Other foreign & 1,499,025 & 1,466,133 & -2.2 \\
\hline
Crossings over the Green Line & 2,539,575 & 3,711,689 & 46.2 \\
\hline
\end{tabular}
\end{table}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure11}
\caption{After a steady increase in foreign students, numbers are stalling in 2018/19}
\end{figure}

\textit{Source: ‘State Planning Organization’}.

\textsuperscript{23} Over the past decade, foreign student numbers have nearly tripled, but this rapid expansion was achieved at the cost of quality education.

\textsuperscript{24} According to recent statistics on higher education enrolments published by the TC administration.

\textsuperscript{25} The decline in Turkish student numbers is due to low income growth in Turkish, while a slowdown in enrolment growth of students from other countries (Central Asia, the Middle East and Africa) is the result of increasing living costs in the TCc.
Impact on overall GDP growth

With the TL depreciation, GDP growth, which reached 5.4 percent in 2017, is expected to decline to about 2.5 percent in 2018 and slightly rebound thereafter. To assess the impact of a depreciation shock on GDP, we made use of another bivariate SVAR model for the TC economy, using the annual average TL/US$ rate and annual TC GDP. IRFs (Figure 12) suggest that a 1 percent depreciation shock causes GDP to decline by about 0.02 percent in the year of the shock, while a depreciation shock of 50 percent translates into a 1 percent decline in GDP, which will continue for up to 2 years. This decline results from less consumption due to high inflation. In 2001, following the depreciation shock of about 100 percent and the subsequent economic recession in Turkey, TC GDP contracted by 5.4 percent. This year, we anticipate a depreciation of about 30 percent. Also, contrary to 2001, we expect tourism exports to continue expanding, together with higher education exports, which are expected to increase, albeit at a slower pace. We therefore project GDP growth to slow from 5.4 percent in 2017 to about 2.5 percent in 2018, while going forward an expected pick-up in consumption, and continued expansion of tourism and higher education exports will help to keep the economy growing (Table 3).

Impact on current account, fiscal balance and financing

The current account before grants is expected to remain in surplus. In 2001, the current account deficit before grants improved from 13 percent of GDP in 2000 to 7.4 percent, thanks to a decline in imports of about 9 percentage points of GDP. In recent years, higher education and tourism exports have been behind the strong improvement of the current account deficit (as shown in Figure 13 for exports of goods and services). As tourism and higher education exports are expected to continue growing, the current account before grants is expected to remain positive as in 2017 (Figure 13). Grants from Turkey will help the current account surplus increase further (Table 3). High exports of tourism and higher education have increased the stock of foreign reserves, which now cover more than 15 months of goods’ imports. The stock of foreign reserves is expected to further increase.

**Source:** World Bank staff.

**Note:** The charts show impulse response functions to a shock of a 1-percentage-point increase in the TL/US$ annual average exchange rate. A positive response of the exchange rate stands for a depreciation of the TL.
The TL depreciation is expected to increase fiscal pressures, requiring higher domestic financing by the TC administration. Fiscal space in the TCc is very limited. Although the fiscal deficit has significantly narrowed in recent years due to declining budget support from Turkey, the deficit in 2017 after grants was 1.5 percent of GDP. Excluding grants, it stood at 6.4 percent of GDP (Figure 14). In the TCc, ‘public’ wages, pensions and scholarships are adjusted every 6 months by half the inflation rate observed over the previous 6 months. With high inflation expected in the second half of 2018, the wage bill, pensions and transfers are expected to further increase in 2019. In addition, imports of fuel, subsidies and support to farmers are expected to increase, resulting in an increase of the fiscal deficit. Because of the expected decline in budget support from Turkey, the subsequent increase in the fiscal deficit will require higher domestic financing, resulting in an increase in domestic debt (Table 3).

The TC administration will need to both mobilize domestic revenue and reduce inefficient spending if it is to contain the fiscal deficit. In 2001, the fiscal deficit after grants increased from 13.2 percent of GDP to 16 percent, and then jumped to 24 percent in 2002, entirely financed by budget support from Turkey. However, budget support from Turkey is not expected to increase. To avoid accumulation of domestic debt, the TC administration will therefore need to diversify its sources of revenue and reduce inefficient spending. For instance, a reform of the incentive system would help to capitalize on forgone revenue and save on inefficient subsidies.

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27 The budget support successively increased from 6.6 percent of GDP in 2000 to 13.6 percent in 2001, and then to 21.7 percent in 2002.
**Impact on the balance sheets of the administration, firms and households**

The ‘public’ sector, with a large amount of debt denominated in foreign currency, is the most vulnerable sector. The TC administration contracts most of its external debt and part of its domestic debt in foreign currency. The ‘public’ debt denominated in forex in 2016 was evaluated at about 105 percent of GDP, up from about 92 percent in 2012. A 2014 World Bank report shows that the net foreign currency financial position deteriorates by 10.4 percent of GDP with a depreciation in real terms of 10 percent caused by the revaluation of debt denominated in foreign currency.

**Firms in the non-financial sectors and households also face significant risks due to the TL depreciation.** According to the same World Bank report, firms’ and households’ balance sheet positions and cash flows appear imbalanced between their forex assets and liabilities. Depreciation raises debt-servicing obligations in forex, hurting firms with a currency mismatch (income in TL, expenditure in forex), resulting to a potential knock-on effect on the banking sector (e.g., increased non-performing loans, or NPLs). Mortgages and car loans, at about 35 percent of total consumer loans as of July 2018, are mostly denominated in forex and the ability of borrowers to repay these loans is reduced by the depreciation, increasing the possibility of foreclosures.

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28 The primary deficit—the deficit before interest payments—and the fiscal deficit are almost identical because the TCc pays very little interest, and only on its domestic debt.
Table 3: The TC economic outlook is one of a slowdown in growth

<table>
<thead>
<tr>
<th>Real economy</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018f</th>
<th>2019f</th>
<th>2020f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP, percent change</td>
<td>4.0</td>
<td>3.6</td>
<td>5.4</td>
<td>2.5</td>
<td>2.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Household consumption, percent change</td>
<td>-7.2</td>
<td>6.0</td>
<td>0.7</td>
<td>-3.9</td>
<td>1.8</td>
<td>2.0</td>
</tr>
<tr>
<td>'Public' consumption, percent change</td>
<td>-5.5</td>
<td>-2.0</td>
<td>-1.9</td>
<td>-0.9</td>
<td>0.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Investment, percent change</td>
<td>21.4</td>
<td>7.5</td>
<td>26.5</td>
<td>-10.6</td>
<td>-10.1</td>
<td>-6.8</td>
</tr>
<tr>
<td>Exports of goods, percent change</td>
<td>3.0</td>
<td>-10.0</td>
<td>0.1</td>
<td>-0.8</td>
<td>1.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Net exports of tourism, percent change</td>
<td>15.1</td>
<td>7.5</td>
<td>18.9</td>
<td>13.0</td>
<td>12.4</td>
<td>11.0</td>
</tr>
<tr>
<td>Net exports of education, percent change</td>
<td>20.9</td>
<td>10.7</td>
<td>12.1</td>
<td>7.8</td>
<td>2.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Imports of goods, percent volume change</td>
<td>24.2</td>
<td>16.0</td>
<td>2.1</td>
<td>-2.0</td>
<td>4.5</td>
<td>5.3</td>
</tr>
<tr>
<td>Real GDP at factor costs, percent change</td>
<td>5.9</td>
<td>3.0</td>
<td>6.1</td>
<td>2.5</td>
<td>2.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Agriculture, percent change</td>
<td>14.5</td>
<td>-7.3</td>
<td>4.9</td>
<td>-4.9</td>
<td>2.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Industry, percent change</td>
<td>19.5</td>
<td>7.3</td>
<td>4.4</td>
<td>-1.9</td>
<td>2.7</td>
<td>3.0</td>
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<tr>
<td>Services, percent change</td>
<td>3.1</td>
<td>3.7</td>
<td>6.5</td>
<td>4.0</td>
<td>2.9</td>
<td>3.0</td>
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<td>CPI (pa), percent change</td>
<td>4.1</td>
<td>8.3</td>
<td>15.1</td>
<td>24.4</td>
<td>22.3</td>
<td>19.5</td>
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<td>Fiscal accounts, Central Administration</td>
<td></td>
<td></td>
<td></td>
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<td>Revenues, percent GDP</td>
<td>33.9</td>
<td>34.1</td>
<td>33.0</td>
<td>33.5</td>
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<td>Expenditures, percent GDP</td>
<td>37.6</td>
<td>35.9</td>
<td>34.5</td>
<td>36.3</td>
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<td>38.4</td>
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<tr>
<td>Fiscal Balance, percent GDP</td>
<td>-3.7</td>
<td>-1.7</td>
<td>-1.5</td>
<td>-2.8</td>
<td>-5.0</td>
<td>-4.5</td>
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<tr>
<td>excluding foreign aid, percent GDP</td>
<td>-9.1</td>
<td>-6.1</td>
<td>-6.4</td>
<td>-7.7</td>
<td>-9.9</td>
<td>-9.5</td>
</tr>
<tr>
<td>Financing, percent GDP</td>
<td>3.7</td>
<td>1.7</td>
<td>1.5</td>
<td>2.8</td>
<td>5.0</td>
<td>4.5</td>
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<tr>
<td>External, percent GDP</td>
<td>2.7</td>
<td>1.9</td>
<td>1.5</td>
<td>1.2</td>
<td>0.9</td>
<td>0.7</td>
</tr>
<tr>
<td>Internal, percent GDP</td>
<td>1.0</td>
<td>-0.2</td>
<td>0.0</td>
<td>1.6</td>
<td>4.1</td>
<td>3.8</td>
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<td>'Public' and 'public' guarantees debt, percent GDP</td>
<td>149.8</td>
<td>147.9</td>
<td>145.7</td>
<td>148.5</td>
<td>153.6</td>
<td>158.1</td>
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<td>Internal, percent GDP</td>
<td>50.0</td>
<td>48.5</td>
<td>48.5</td>
<td>50.1</td>
<td>54.2</td>
<td>58.1</td>
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<td>Balance of payments</td>
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<tr>
<td>Current account balance, percent GDP</td>
<td>7.2</td>
<td>7.5</td>
<td>7.4</td>
<td>8.2</td>
<td>8.4</td>
<td>8.8</td>
</tr>
<tr>
<td>Excl. foreign grants, percent GDP</td>
<td>1.9</td>
<td>3.1</td>
<td>2.5</td>
<td>3.4</td>
<td>3.5</td>
<td>3.9</td>
</tr>
<tr>
<td>Net merchandise exports, percent GDP</td>
<td>-36.9</td>
<td>-37.8</td>
<td>-42.0</td>
<td>-43.3</td>
<td>-44.2</td>
<td>-44.6</td>
</tr>
<tr>
<td>Net services exports and transfers, percent GDP</td>
<td>44.1</td>
<td>45.3</td>
<td>49.4</td>
<td>51.5</td>
<td>53.4</td>
<td>55.0</td>
</tr>
</tbody>
</table>


Note: Projections are based on the following assumptions. In 2017, the exchange rate was TL 3.65/US$. The average exchange rate from January to October is TL 4.68/US$, which is a depreciation of about 28.2 percent compared with the 2017 average. After the shock in August, when the exchange rate reached TL 6.68/US$, the Turkish Central Bank raised its benchmark interest rate on September by 625 basis points from 17.75 to 24 percent; tensions between Turkey and the US have eased as the American pastor jailed in Turkey was released on October 12. So, the Turkish lira has been appreciating and was at TL 5.55/US$ on October 19. Because of these developments, we assume that until the end of the FY, the average annual exchange rate in 2018 will be around TL 4.75/US$. This assumption means the Turkish lira will depreciate again by about 1.5 percent. The total depreciation will be therefore 30 percent in 2018. Because we assume that the end of year rate will be above TL 5.00/US$, we project that the currency will appreciate over the year, but slightly depreciate compared with the 2018 average to reach TL 5.25/US$ and then remain stable in 2020.
Impact on banking sector balance sheets

The private banking system in aggregate appears to be relatively insulated from an immediate currency depreciation shock. Individual impact may differ, however, depending on each individual bank’s forex position. Based on publicly available data for the first half of 2018, the World Bank team ran a first simulation to assess an immediate impact of the depreciation on capital adequacy ratios (CAR) through forex positions. The results show that even at TL 8.00/US$, the impact on the banking system is limited, as the CAR remains above 15 percent thanks to a forex long position (assets at TL 17.1 billion are higher than liabilities at TL 16.2 billion). In addition, most banks’ borrowings are domestic, making the likelihood of a liquidity shock lower. The high level of forex deposits of about 60 percent also provides a cushion, as depositors may worry less about their savings losing value because of the depreciation.

However, in the medium to longer term, the TL depreciation could result in a significant increase in NPLs (for loans denominated in forex), which could affect the stability of the private banking system. The World Bank team also performed a medium-term assessment of the depreciation on the CAR through increased NPLs due to corporate defaults. The results show that only a significant increase in NPLs will have a severe impact. In the three scenarios (NPLs rising from actual 5.5 to 10 percent; up to 15 percent or up to 20 percent), the private banking system shows strong resilience to absorb the losses, except in the third scenario in which the CAR falls below 12 percent. Given that forex loans account for about 50 percent of the loans portfolio of banks, concentrated in working capital loans and consumer loans (69 and 22 percent of total forex loans, respectively), the likelihood of a significant increase in the NPL ratio in the medium to longer term is considerable.

The ‘public’ banking system appears vulnerable. According to a TC regulation, NPLs do not include non-serviced ‘public’ debt, which is at odds with the international definition of NPLs. If these ‘public’ loans are accounted for, the actual NPL ratio of 5.5 percent will be much higher. The impact of the depreciation through additional shock factors (rising NPLs in the private sector, for instance) will be more severe.

Risks to the Outlook

The absence of a credible policy response in Turkey could trigger a vicious cycle for the Turkish economy. Additional stress on the Turkish economy could worsen the impact on the TC economy. The economic impact previously assessed assumes a soft landing, with the Turkish authorities implementing a credible policy response to stabilize the currency. External financing pressures also warrant tight monetary policy, private sector deleveraging and a strong debt restructuring framework, and countercyclical fiscal policy to support households over a period of slowdown. The absence of these measures could spell a more severe correction to Turkish economic growth. Such a scenario as in the 2001 depreciation crisis could worsen the impact on the TC economy through a contraction of the tourism and higher education sectors, both drivers of TC economic growth.

Further depreciation would also increase TC domestic vulnerabilities. If TC firms become unable to service their debts, this could hurt the weakest banks in the TC. Action by the administration would be needed in such a situation to restore confidence. Further TL depreciation would also lead to more domestic price increases, hurting consumption, production and TC economic growth.

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29 Individual impacts may differ depending on each individual bank’s position. The simulation was not run on individual bank data. Therefore, the private banking sector may still be vulnerable to the vulnerability of individual banks, due to the concentration of forex assets or liabilities, or maturity and capital structure mismatches.

30 Particularly, as for 2016, there is one ‘public’ loan of TL 3 billion contracted from a ‘public’ bank and another TL 1.7 billion loan contracted from a ‘public’ non-banking financial institution that are not serviced (http://www.kktc.gov.tr/media/1782/07.2018.kktc-ekonomik-goesterge-raporu.pdf) and might significantly erode their capital.
Conclusion and Policy Recommendations

The depreciation of the Turkish lira impacts the TC economy on several dimensions. As a small economy with high imports, the TC economy is highly vulnerable to currency depreciation. Weak macroeconomic resilience of the economy—overheating due to high consumption and weak investment, low labor force participation, declining productivity and weak regulation—all serve to worsen the impact of the depreciation. The results include: double-digit inflation that hurts households and producers; a slowing down of consumption and production; a deterioration of the ‘public’ sector’s and firms’ balance sheets; and increased vulnerabilities in the banking system. Further TL depreciation could trigger a vicious cycle in Turkey with a potential to magnify the impact on the TC economy. Inefficient policy responses have made things worse, such as the blanket wage increases for ‘public’ sector employees and fuel subsidies (both benefiting the rich more than the poor), putting greater pressure on the budget and requiring greater fiscal consolidation.

Short-term policy recommendations call for a strong commitment from the TC administration to face the immediate impact. Such policies could include: (i) simplifying import procedures—which seems to be underway—and reducing inefficient tariffs (of a magnitude that does not hurt fiscal sustainability) to reduce the impact of the depreciation on prices; (ii) cutting red tape and improving insolvency, contract enforcement and loan recovery to allow ‘exporters’ to benefit from the depreciation and lower trade costs; (iii) a fiscal consolidation that improves spending efficiency and domestic revenue mobilization to face a decline in financing from Turkey, with a progressive reform of the incentive system being the first step in capitalizing on forgone revenue and savings from inefficient subsidies; and (iv) tailoring solutions to borrowers’ forex positions (e.g., borrowers of forex mortgages with an income in forex are not as adversely hit) to help contain vulnerabilities in the banking system.

In the medium term, the TCc needs to rethink its engine of growth to achieve a sustainable high-income status. It also needs to improve the TC economy’s resilience to ensure shared prosperity. (i) Achieving sustainable high-income status requires an economic vision with a medium-term strategy supported by a coherent structural reform agenda. For instance, improved management of investment projects would raise investment and economic growth, while a better business environment and higher quality of human capital would boost competition and productivity. (ii) Improving resilience to shocks can be achieved through: a more frequent household survey that helps identify poor and vulnerable households, and the establishment of a means test system so that cash transfer programs can be set up to mitigate the impact of the depreciation on the poor; strengthened financial monitoring and improved data collection to help anticipate and mitigate shocks; and an effective labor employment agency to help the unemployed find jobs faster after a shock.

The recent macroeconomic developments related to the impact of the TL depreciation carry special significance for TC LCBs. About half of LCBs’ revenues come from the central administration’s budget. With the TL depreciation, the significant fiscal pressures that this now creates for the central administration will obviously have implications on LCBs’ budgets, and service delivery at the local level could potentially be impacted. Therefore, it has become critically important to assess the financial condition of the 28 TC LCBs. This is the subject of the second half of this report, to which we now turn.
Financial Situation of Local Community Bodies in the TCc

Introduction

The TCc has 28 designated Local Community Bodies (LCBs). These are territorial subdivisions and thus include both urban and rural areas. Most of them are small. The largest, Nicosia (Lefkosa), has a population of about 60,000. Their primary functions involve urban infrastructure; e.g., water supply, sanitation, local roads and bridges, and solid waste management, along with the disposition of septic wastes, the regulation of dumpsites, pest control and the operation of cemeteries and slaughterhouses.

The financial situation of LCBs appears precarious, apparent in their growing stock of arrears. This is not immediately visible in local budget execution reports, however, which report only expenditure obligations that have been paid. It is instead evident in a growing stock of arrears, particularly to contractors and suppliers.

The deteriorating financial situation of LCBs carries two possible adverse implications. First, it suggests that LCBs may be increasingly unable to provide the basic infrastructure services that are critical to TC economic growth and the wellbeing of its people. Second, it presents a growing fiscal risk to the central administration. At some point in the not-too-distant future, the stock of LCB arrears may become so large that the central administration could come under intense pressure to provide a bailout. Given the central administration’s current fiscal constraints, explained in the previous macroeconomic section, this would be highly inopportune.

This report examines the increasingly fragile condition of the LCBs’ finances. It goes on to examine the reasons that have led to the current situation, including poor fiscal management, and exogenous constraints on revenues and expenditures management. The report examines proposed amendments to local regulations, the extent to which these amendments could address identified shortcomings, and then suggests additional measures to enhance financial outcomes for LCBs. The report then concludes and provides recommendations.

Local Finances Are in a Precarious State

Roughly half of LCBs’ revenues are derived from transfers from the central administration. The principal transfer, the so-called ‘state contribution’ (devlet katkısı) constituted about 42 percent of LCBs’ revenues in 2017 (Figure 16). This state contribution is distributed among LCBs largely on the basis of their population size. The amount to be distributed in a given year is determined as a percentage of the central administration’s projected domestic revenues. The current percentage is 9.25 percent.

Figure 16: The central administration transfer constitutes the main source of LCBs’ revenues
The largest source of LCBs own-source revenues is a charge for drinking water and sewerage and represents only a small fraction of LCBs’ revenues. As shown in Figure 16, this source accounts for only about 15 percent of LCBs’ revenues. At present, LCBs are permitted to set the level of these tariffs at their own discretion, subject only to pro-forma central approval. But LCBs tend to set them at below cost-recovery levels.

Charges for solid waste management (temizlik resmi) and street cleaning (saglik resmi) contribute a further 4 percent. The level of these fees is set by the central administration. The regulation governing the solid waste management fee, for example, sets out the level of fees to be charged to various categories of users, such as housing units, offices, shops, etc. The rates are denominated in Turkish lira, rendering them vulnerable to declines in the real value of the lira over time. As a result, the level of these fees, particularly for residential customers, is far lower than it was when the regulations were originally issued.

LCBs are also assigned two broad-based taxes but their yields are not substantial. In 2017, the yield of the two taxes combined was only 24 per capita. The occupations tax for instance is imposed on both legal (corporate) and physical persons, including employees of the central administration and the self-employed. Despite its broad base, its annual yield is only €7 per capita.

The ability of LCBs to supply their mandated services may be in jeopardy. The costs of purchasing bulk water, for example, have sharply increased with the completion of the TC Water Supply Project bringing water from Turkey (from TL 0.25 per ton to TL 2.30 per ton). To recover these increased input costs, the price of water to consumers was increased and this has in turn affected revenue collection rates. Famagusta reports that the collection rate is now 81 percent (down from 90 percent), Lapta (which has installed some prepaid meters) reports a 65 percent collection rate, while in Nicosia the collection rate is estimated at 80 percent.

LCBs suffer from significant financial shortfalls between the cost of providing wastewater services and the revenues that are generated. Only about half the population is currently connected to sewerage systems. In LCBs where wastewater treatment plants exist (e.g., in Nicosia and Famagusta), there are significant financing issues. For example, the Nicosia treatment plant reportedly loses nearly TL 1.00 on every cubic meter of water it processes and officials at that LCB alleged in 2018 that they are currently close to €1 million in arrears for waste water treatment. Similar costs and arrears exist in Famagusta, which is thought to have €600,000 in arrears and is adding to them at a rate of €30,000 per month.

There are similar financial shortfalls in the solid waste management sector. Although LCBs manage to provide twice-weekly solid waste collection in major cities, they are unable to finance transfer and disposal services, which are increasingly provided by the central administration. But even with this top-up arrangement, solid waste collection is still a money-losing venture. Currently, LCBs levy fees that are supposed to cover collection, transfer and disposal of solid waste, as well as street cleaning. But in Nicosia, for instance, the costs of personnel, fuel and maintenance for solid waste collection and transfer alone are reported to be about TL 4.4 million per year. Even if all the estimated 35,000 households in Nicosia paid the fee, the potential TL 4.2 million in revenue would be insufficient to cover these costs. Similarly, Lapta estimates a loss of TL 2 million per year for its solid waste management services. The situation is likely worse in the more outlying LCBs, where greater distances between villages increase the costs of collection and transfer to the landfill.

The financial problems of each of these sectors are reflected in the worsening financial condition of the LCBs overall. This deterioration is not captured in financial reports. This is because LCBs accounts are kept on a cash, rather than an accrual basis, where reported expenditures are roughly equal to reported revenues at the end of each year. But initial indications are that LCBs are not paying their bills. Instead, they seem to be running up significant arrears to contractors and suppliers (see Box 3 for a history of LCBs’ arrears).
Box 3: The history of LCBs’ arrears

LCBs are not required to report the amounts of their unpaid bills. As a result, accurate data on the current stock of arrears are not (yet) available. The TCc has, however, experienced a previous arrears crisis, for which data do exist.

Over the first part of this decade, many LCBs failed to make the required payments to the central tax office for pension fund and insurance fund contributions on behalf of their employees. By the end of 2015, the total stock of these arrears had reached TL 342 million, equivalent to 3.4 percent of GDP. Nicosia alone accounted for nearly half (48 percent) of the total stock of arrears. That amount, at TL 166 million, was equal to twice its annual revenues.

The central administration responded by amending the regulations on LCBs. The regulations now allow the central administration to deduct the amounts owed to the various central agencies from the transfers it would normally make to the LCBs. While this has succeeded in halting the accumulation of new arrears, it has not resolved the status of the existing arrears.

A proposed amendment to the local finances’ regulation would require LCBs to initiate the restructuring of their arrears to the ‘public’ sector. LCBs would be required to notify the ‘Ministry of Labor’ and the ‘Ministry of Finance’ of their intention to restructure their debt and would have up to January 1, 2020, to reach agreement with those ‘ministries’ on a restructuring plan, including a repayment schedule. The amendment would authorize the central administration to deduct the resulting debt service from central administration transfers to the LCBs. This proposed regulation has not yet been enacted.

Source: World Bank staff.

Box 4: LCBs are failing in their responsibilities to support economic actors in the TCc

LCBs affect economic development in the TCc through their role in land use management, building control and service delivery in industrial zones. Unfortunately, several actors report that LCBs are falling short in these respects. Famagusta, for example, is reportedly failing to coordinate services around historic sites that attract a significant number of visitors. Similar complaints are raised in industrial zones. LCBs must also take some responsibility for TCc’s poor ranking in Doing Business, given the 40-day processing time for requesting and giving planning consent, and the 30-day building construction approval process.

Source: World Bank staff.
How Has This Happened?

Inadequate fiscal management

Part of the problem is of the LCBs’ own making. LCBs have only rudimentary ‘public’ financial management (PFM), which is not conducive to sound, sustainable local finances. Prevailing practices and tools for budget preparation, execution, reporting and control vary among LCBs, reflecting differences in size and institutional capabilities. Nevertheless, important weaknesses in local PFM—particularly the lack of sound revenue forecasting, expenditure controls, and independent monitoring and auditing—are common to all LCBs and certainly contribute to the recurrent fiscal imbalances experienced by many of them.

The process for preparing LCB budgets lacks a mechanism for sound revenue forecasting and effective spending controls. Own-source revenues are projected by a simple extrapolation of past trends, with no consideration given to the macroeconomic outlook. Contributions from the central administration budget are not forecast but are instead confirmed once the central budget is approved—a practice that often leads to delays in the approval of local budgets. As budget execution is recorded on a cash basis, it is difficult for LCBs to assess the extent of expenses actually incurred by the local administration in undertaking activities and operations. Expenditure allocations instead essentially update the execution figures from the preceding year, using the official inflation forecasts elaborated by the ‘State Planning Organization’. This procedure imposes an inertia at the level of budgeted expenditures.

There is little central administration oversight of local budget preparation or execution. The central administration does review LCBs’ budgets before they go into effect. If it determines that revenue and expenditure projections are implausible (based on historic trends) it sends the budget back for correction. But the regulation on LCBs grants virtually no authority to central administration agencies to request the information necessary to monitor the condition of local finances, for instance requesting the data on arrears. Similarly, there are no regular, independent audits and inspections of LCB budgets that can ascertain compliance with legal statutes and detect unreported operations and activities that impact on fiscal performance. Audits by the ‘Court of Accounts’ are often conducted several years after a budget cycle ends and hence cannot help to establish controls in real time. Inspections by the central administration are infrequent and there are insufficient personnel to carry them out.

Weaknesses in the local tax administration

Part of the problem also lies with the weaknesses of the local tax administration. The occupations tax for instance suffers from administrative problems. Discovery is by self-declaration: firms and the self-employed are required to declare their existence and then provide the required data on profits or income to the LCB taxing administration. As a result, taxes may still be under-assessed or not paid at all.

Exogenous constraints on revenues

There are also exogenous factors that contribute to the financial difficulties of LCBs. Some of these factors adversely affect LCBs’ ability to generate sufficient revenues.

The most important of these are central restrictions on local occupations tax rates. The centrally-imposed ceiling on the occupations tax are very low. The rate on corporations, joint ventures, limited partnerships and the self-employed is a very low 0.2 percent of profits. The rate on employees, including LCB employees and private sector firms, is 0.2 percent of gross income. Similarly, other tax rates decided at the central administration level are extremely low.

The regulation allows LCBs to impose higher rates on other categories of taxes, but they do not. This regulation has never been acted upon, and these taxes are imposed at the minimum rate.
Exogenous constraints on expenditure management

In addition to constraints on their ability to raise sufficient revenue, exogenous factors also contribute to inefficient expenditure management. These constraints largely stem from the limitations that LCBs face in controlling spending on salaries.

Non-discretionary spending on personnel account for about half of LCBs’ combined budget. Wages and salaries, including social security contributions, accounted for nearly half (49 percent) of total LCB expenditures in 2017 (Figure 17). In Nicosia, personnel expenses consumed a staggering three-quarters of the budget.

Due to data constraints, it is difficult to provide evidence of overstaffing. The proportion of the budget that an LCB spends on wages is, in part, a reflection of its staffing model, i.e., whether the provision of services is undertaken by an LCB’s own departments or contracted out to private companies. Nicosia, for example, employs 825 staff to serve a population of around 60,000. Famagusta employs only 384 staff to serve a population of nearly 40,000. But Nicosia relies on employees to provide services, while Famagusta contracts out. Anecdotal evidence suggests that some LCBs have set up off-budget agencies where they locate staff, in an attempt to circumvent the legislative restrictions discussed below.

But it is clear that local wage bills are hard to control. Staffing levels, for instance, can be difficult to reduce. Existing personnel regulations recognize three categories of local staff: (i) civil servants, who hold open-ended contracts and perform managerial tasks; (ii) contracted staff, who perform professional and administrative tasks and have term contracts; and (iii) workers, who also hold term contracts and typically perform blue-collar jobs. Civil servants have strong de jure job security provided by the regulation on LCB personnel. Their employment is permanent, unless a case of under-performance or illegal behavior can be filed against an individual employee. Although contracted workers are hired on term contracts, their jobs are de facto protected because they often perform tasks essential for the normal operation of the local administration. Both categories of municipal employees are largely unionized and actively engage in collective bargaining on basic salaries and working conditions. As such, LCBs can only alter the staffing levels of the third category, the workers.

LCBs themselves have only limited control of the level of individual wages. The salaries of civil servants are essentially determined at the central level, in conjunction with adjustments in the wages of civil servants at the central level. Meanwhile, the wages of low wage workers are affected by changes in the minimum wage.
Central administration attempts to limit local staffing levels through regulation do not appear to be enforced by the LCBs. The regulation sets a limit on the number of civil servants an LCB may employ, with specific ceilings for various positions depending on the population under the jurisdiction of the LCB. The regulation also establishes ratios between the number of civil servants and other types of staff. However, in practice, these ratios do not seem to be monitored or enforced. Instead, political events and structural factors have played a role in determining the actual ratios. For instance, after a labor conflict in Nicosia, most employees were ‘upgraded’ in terms of their contractual status. Currently, the personnel are nearly 50:50 split between civil servants and contracted staff, with not a single worker. Famagusta, where the seasonality of tourism implies variations in service provision requirements, has a very different personnel structure: civil servants are just 15 percent, contractual staff are 50 percent, and workers are 35 percent.

A ceiling on personnel expenditure introduced in the regulation on municipalities has not been effective in reducing LCB wage bills. Given the sizable wage bills at the local level, in 2015 a new ‘fiscal rule’ was introduced in the legislation: personnel expenses should not exceed 50 percent of total revenue recorded in the preceding year—or 55 percent in the case of small-size LCBs—and a hiring freeze must be imposed until those ceilings are met. Deadlines for the achievement of the ceiling have been rescheduled twice.

The recent adjustment in the minimum wage is likely to increase the share of personnel expenses in total expenditures in 2018. In March 2018, the central administration announced a TL 190 increase in the minimum wage, to TL 2,364. This was further increased to TL 2,620 effective September 1, equivalent to a total increase of over 20 percent. As LCBs must increase their salary structure accordingly, their actual wage bills in 2018 are expected to be much larger than the planned figures when the budgets were prepared.

It is conceivable, nevertheless, that LCBs could reduce their wage bills voluntarily. While civil servants are difficult to dismiss, their numbers could be reduced through attrition (i.e., waiting for them to retire). The contracts of contractual staff could be allowed to lapse. Workers could be laid off. Subject to the limitations imposed by the minimum wage, the wages of workers could also be reduced.

**Will the Proposed Regulatory Amendments Help?**

The central administration has currently proposed amendments to the regulations, and a brief assessment of these amendments suggests that they would improve the fiscal prospects of LCBs to some degree. These proposals are explained below. However, while certainly a step in the right direction, a more critical problem remains, namely the current regulations do not require LCBs to include arrears in their debt calculations.

A local services tax would replace former separate charges for solid waste management, street lighting and pest control. The new tax would be levied on every residence and work place. While the central administration would continue to control the level of the tax, it would be expressed as a percentage of the minimum wage rather than denominated in Turkish lira, thus shielding it from inflation. Specific ceilings are set out in an annex to the proposal and differentiate between types of users. For example, the service tax per house would be allowed to range from 10 to 100 percent of the minimum wage. This represents a significant increase over current rates. Taken together, the current charges for cleaning, lighting and pest control range from TL 38 to TL 430. Under these amendments (given the current minimum wage) the new local service charge would range from TL 262 to TL 2,620, roughly six times the current range.

The ceiling on the rate of the occupations tax would be partially removed. While the rate on corporations would continue to be fixed at 0.2 percent of profits, proposed amendments to the regulation would remove the current ceiling on the rate on other types of taxpayers. This amendment effectively allows LCBs to set their own rates for non-corporate taxpayers, subject to central administration approval. The amendment would also improve enforcement, in two
ways. First it would require the central tax department to provide the LCBs with the relevant data on corporate and individual profits. Second, it provides that if an employer fails to pay the occupations tax owed by his/her employees, the central tax administration and social insurance agencies will inform the LCB of the names of those employees and the amounts they owe.

The proposed amendments would modify the existing debt ceiling. At present, the local regulation limits the amount that municipalities can borrow in any given year to 20 percent of their annual revenues. To obtain a loan approval, a LCB is required to submit a request to the debt management committee (DMC). The amendment would make two changes. First, rather than controlling new debt, the new ceiling would place a limit on the total stock of municipal debt, including the proposed new borrowing. Second, it would express the ceiling as a percentage of central administration transfer (specifically the devlet katkısı), rather than as a percentage of total municipal revenues. The maximum maturity of debt would continue to be limited to the term of the ‘mayor’. Any exceptions would require high level approval.

These proposed amendments are undoubtedly improvements. An LCB’s total stock of debt is a better indicator of its debt servicing capacity than the amount of its proposed new borrowing. Existing debt must be serviced. Using the value of the central administration’s contribution, rather than total LCB revenues, removes the chance that LCBs will inflate the amount of own-source revenues to qualify for further debt. But this may not be sufficient, for several reasons. First, a debt-to-revenue ratio, taken alone, is not a sufficient indicator of debt servicing capacity. With interest rates in double digits, even a small stock of debt may be difficult to service. To address this problem, some countries impose two ceilings: one on the debt-to-revenue ratio and another on the debt service-to-revenue ratio.

But that is not the only problem, or even the most important one. The critical problem is that the current regulations do not require LCBs to include arrears in their debt calculation. The current cash-based LCB income statements do not reveal annual deficits. Unpaid expenditure obligations go unreported. Nor do current regulations require LCBs to report their existing stock of arrears—either the old arrears to the tax authorities and the social insurance funds, or the more recent arrears to contractors and staff. As a result, the information provided to the DMC has the potential to grossly understate a municipality’s debt servicing capacity.

What More Needs to Be Done?

The central administration could take several steps to increase the own-source revenues of LCBs. The central administration could encourage local communities to increase the rate of the occupations tax on employees. As previously discussed, the proposed amendments would remove the existing ceiling on the occupations tax on employees, allowing LCBs to set the rate subject to central administration approval. There is a strong case for increasing the rate above the current inadequate 0.2 percent. It is true that the burden of such an increase would fall primarily on employees in formal organizations, leaving workers in the informal sector largely untouched. But there are practical grounds for doing so. The income of informal sector workers (as well as the profits of small enterprises) can be extremely difficult to determine.

But there is also a strong case for abandoning the locally-administered occupations tax altogether and giving LCBs a share of the central personal income tax. Many European countries use a different approach altogether for taxing local income: they simply give local governments a share of the central personal income tax (PIT) that is raised in their respective municipalities. In Poland, for example, the central government administers PIT. Their municipalities are entitled to 37 percent of PIT collected within their jurisdictions. Intermediate tiers of subnational governments, the districts and provinces, are entitled to 10 and 1.6 percent of PIT, respectively. As shown in Figure 18, this arrangement generates significant local revenues in many other economies in Europe. There may also be a case for eliminating certain local windfall taxes (see Box 5).
Figure 18: Local PIT can be a significant source of revenues for local administrations

Source: International Monetary Fund.

Box 5: How to treat local windfall taxes

Five LCBs in the TCc generate extraordinary revenues from tax bases that are peculiar to their jurisdictions. These include local airport taxes, taxes on the TCc’s principal oil depot and port fees. There has been some discussion about diverting these revenues into an earmarked fund that would be used to assist LCBs that confront unusually high costs of service provision.

Parts of this proposal bear serious consideration. It would make sense to deprive the five LCBs of these extraordinary revenue sources: the amounts they generate bear no relationship to the costs of the services that these jurisdictions provide. But earmarking the taxes for distribution to high-cost LCBs may also be inadvisable. There is no reason to think that the revenues generated by these windfall taxes would equal the amount required to compensate high-cost LCBs in the years to come, however “high-cost” may be defined. Instead, it may make more sense to reassign these taxes to the central administration’s budget. High-cost LCBs could then be assisted through modification in the general transfer formula, such as the addition of a density or land area variable, as discussed in later in Box 6.

Source: World Bank staff.

Increasing the rate of other taxes could be another option. The current regulation allows for annual increases of other tax rates up to the rate of inflation, but an adjustment based on the recent inflation rate would not be sufficient to bring the basic rate up to a reasonable level (in 2017, the inflation rate was 15.1 percent). A larger one-time increase could be considered.

The burden of fiscal adjustment should not fall entirely on local taxpayers through own-source revenue enhancement by LCBs. LCBs need to reduce expenditures as well. One obvious target is the wage bill. In principle, the central administration could force LCBs to reduce personnel spending by enforcing the existing ceilings on staffing levels and wage spending (as a percentage of total revenue). Although the ceiling on the number of civil servants may be enforceable, the ceilings on other categories of staff, as well as the overall ceiling on wage spending, are easily evaded. Contractual staff and workers can be hired as contractors and their wages are classified as goods and services. Efforts to reduce staffing levels are more likely to succeed when they are done voluntarily.
The central administration could also rein in LCBs’ propensity to over-budget revenues by toughening its approach to budget reviews. It could, for example, systematically reject any budget that implies a major increase in revenues over the level of inflation. It could also assist LCBs to improve the efficiency of specific services. Technical support and funding for leak detection and repair could increase water revenues and reduce water losses arising from leaks and illegal connections. Technical support for route optimization could reduce the costs of solid waste management.

The system for assessing borrowing requests could be improved. The proposed amendments would change the criteria for evaluating LCB borrowing requests. The new ceiling would be based on the total stock of LCB debt. But “debt” is not defined in the regulation and could be easily interpreted to refer only to contractual debt, ignoring arrears. The latter represent a major claim on revenues, as well as an indicator of financial probity, and should be considered. As previously discussed, LCBs are not required to report their arrears to the central administration. They may be reluctant to do so. But the regulations should be amended to require LCBs to report arrears when requesting borrowing authorizations. The definition of debt should be expanded to include them.
Box 6: The equalization issue

This note is largely concerned with the fiscal condition of LCBs in aggregate. But fiscal conditions can vary among individual jurisdictions. At present, variations in local per capita revenues are fairly modest, as shown in graphic below. (Note that the calculation of per capita revenues uses 2011 population figures.) This is due to the large scale of central transfers (relative to local own-source revenues) and the fact that the transfer is based entirely on population.

There is little variation in per capita revenue across LCBs

![Variations in per capita revenues (Turkish lira), 2016](chart)

*Source: Ministry of Interior*. Is there a case for more equalization? Maybe so. The unit costs of services can vary among LCBs. The costs, per household, of collecting garbage in a dense city such as Lefkosa, for example, are far less than the costs in Lapta, an LCB with a large geographic area and many remote villages to serve. Thus ‘equality’ in per capita revenue terms does not necessarily mean equality in terms of ability to provide a given quality of service. (It should be noted that the de-control of local taxes and fees will widen disparities among LCBs, favoring those, such as Lefkosa, that have strong tax bases.)

To reflect the higher costs of delivering services in low-density municipalities, some economies in Eastern Europe add additional variables to their transfer distribution formulas. In Albania, for example, 80 percent of the transfer to municipalities is distributed on the basis of population. Another 15 percent is distributed on the basis of population density, with sparsely populated municipalities receiving a greater share. The remaining 5 percent is distributed according to the number of school children in each jurisdiction. But one should avoid the temptation to add too many variables to the distribution formula. Some countries’ formulas attempt to capture variations in the costs of providing every single service provided by local administrations (including administration), as well as variations in each local administration’s ability to generate own-source revenues. In practice, the weights assigned to each factor tend to be arbitrary and the data to operationalize such formulas are often not available. The TCC should consider adding a density factor to the transfer distribution formula. Land area would be a good candidate, for example. But additional elaborations should be avoided.

*Source: World Bank staff.*
Conclusion

**The strained fiscal situation of LCBs carries adverse implications.** It may jeopardize their ability to provide key infrastructure services. It also presents a growing fiscal risk to the central administration in the form of increasing pressure to provide a bailout.

**The central administration has a role to play in responding to fiscal risks being created at the local level in facilitating revenue mobilization and limiting expenditures growth.** To increase local revenues, the central administration could start by enacting the proposed local services charge and considering a one-time increase in the basic rate of other taxes. To encourage spending reductions, the central administration could toughen its approach to reviewing local budgets. It could also assist LCBs in improving the efficiency of specific services, such as water supply and solid waste management. In principle, the central administration could double down on its efforts to limit staffing levels and overall wage spending, although these provisions have proven difficult to enforce.

**Using their assigned fiscal roles and responsibilities, LCBs too can help to limit growing fiscal risks.** To increase revenues, LCBs could: (i) increase the rates of current charges for solid waste management, street lighting, and pest control (and the proposed local services charge) to the maximum allowed by regulation; (ii) increase water and sewerage tariffs sufficiently to cover both operating costs and capital improvements; (iii) increase the rate of the occupations tax (pending its replacement a shared PIT); and (iv) increase the basic rate of other taxes to the maximum permitted by existing regulations.

**By the same token, they could reduce expenditures and initiate a stock-taking exercise for arrears.** Expenditures growth can be limited by reducing staffing levels, particularly those in the ‘workers’ category. They could also rein in their own propensity to over-budget by adopting realistic estimates of revenues. It would be advisable to do a stock-take of arrears and report them, as a first step toward better management of arrears.

**But politicians are typically reluctant to raise taxes on their constituents or dismiss staff.** They may be reluctant to adopt realistic budgets if it means foregoing popular ‘public’ works projects. LCBs enjoy a relatively high degree of autonomy in the TCc. Now the challenge is to compel them to use that autonomy to improve their fiscal situation.

**The central administration can encourage this by strictly enforcing a hard budget constraint.** Over time, the ability of LCBs to meet their expenditure commitments will be limited by their access to resources. Staff and private suppliers will not tolerate going unpaid indefinitely. In the past, LCBs have managed to avoid their obligations to the tax and social insurance authorities by failing to make required payments. But this option is now closed. The central administration is permitted to deduct LCB obligations to the tax office and social insurance funds (as well as debt service on centrally guaranteed loans and money owed to state water company) from transfers. In some economies, municipalities can postpone the “day of reckoning” by borrowing. But this option is not available to LCBs in the TCc. Private banks will not lend without a central administration guarantee. A critical test of the central administration’s commitment to this policy will be the way it ultimately resolves the status of the existing stock of arrears to the tax and social insurance authorities.
Annex Figure 1: TC monthly inflation spikes more than Turkish inflation in response to an exchange rate shock

Source: World Bank staff.

Note: The charts show impulse response functions to a shock of a percentage point increase in the percentage change of the TL/US$ exchange rate. Inflation is change in the CPI and exchange rate is expressed as month over month percent change. A positive response of the exchange rate stands for a depreciation of the TL.
Annex Figure 2: TC inflation yoy spikes more than Turkish inflation in response to an exchange rate shock

Source: World Bank staff.

Note: the charts show impulse response functions to a shock of a percentage point increase in the percent change of the TL/US$ exchange rate. Inflation is monthly change in the CPI yoy and exchange rate is expressed as yoy percent change. A positive response of the exchange rate stands for a depreciation of the TL.
Annex Table 1: Exports statistics 1H18 vs 1H17

<table>
<thead>
<tr>
<th></th>
<th>2017H1 Million</th>
<th>2018H1 Million</th>
<th>2017H1 Quantity (million)</th>
<th>2018H1 Quantity (million)</th>
<th>Percentage change (yoy)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citrus (kg)</td>
<td>18.83 $US</td>
<td>18.31 $US</td>
<td>78.06</td>
<td>64.43</td>
<td>-2.7% -17.5%</td>
</tr>
<tr>
<td>Dairy products (kg)</td>
<td>22.67 $US</td>
<td>25.22 $US</td>
<td>6.22</td>
<td>6.46</td>
<td>11.2% 3.9%</td>
</tr>
<tr>
<td>Raki (a type of alcoholic beverage) (Lt)</td>
<td>6.92 $US</td>
<td>6.15 $US</td>
<td>0.80</td>
<td>0.64</td>
<td>-11.1% -20.0%</td>
</tr>
<tr>
<td>Scraps (kg)</td>
<td>2.28 $US</td>
<td>4.20 $US</td>
<td>12.73</td>
<td>19.75</td>
<td>84.3% 55.2%</td>
</tr>
<tr>
<td>Juice concentrates (kg)</td>
<td>1.01 $US</td>
<td>1.60 $US</td>
<td>0.60</td>
<td>0.73</td>
<td>58.6% 21.2%</td>
</tr>
<tr>
<td>Grand Total</td>
<td>59.91 $US</td>
<td>63.80 $US</td>
<td>6.5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Annex Figure 3: Crossings over the Green Line are substantially increasing

Source: ‘State Planning Organization’.