# CURRENCY AND EQUIVALENTS UNITS

| Currency Unit = TL (Turkish Lira) | until December 31, 2004  
| Currency Unit = YTL (New Turkish Lira) | from January 1, 2005  
| 1 YTL = 1,000,000 TL  
| 1 US Dollar ($) = 12900 YTL, as of April 9, 2008 |

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# FISCAL YEAR

July 1 – June 30

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# ABBREVIATIONS AND ACRONYMS

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>BEEPS</td>
<td>Business Environment and Enterprise Performance Survey</td>
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<td>BIP</td>
<td>Border Inspection Posts</td>
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<td>BRS</td>
<td>Banking Regulation and Supervision Agency</td>
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<td>CAD</td>
<td>Current Account Deficit</td>
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<td>CAP</td>
<td>Common Agricultural Policy</td>
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<td>CCOS</td>
<td>The Committee on the Challenges to Modern Society</td>
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<td>CEM</td>
<td>Country Economic Memorandum</td>
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<td>DAF</td>
<td>East Africa Project</td>
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<td>DAF</td>
<td>Development Agencies</td>
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<td>DOKAP</td>
<td>East Black Sea Regional Development Plan</td>
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<td>DSI</td>
<td>General Directorate of State Hydraulic Works</td>
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<td>EBRD</td>
<td>European Bank of Reconstruction and Development</td>
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<td>EPA</td>
<td>Environment Protection Agency</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FSAP</td>
<td>Financial Sector Assessment Program</td>
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<td>GAP</td>
<td>South East Anatolia Project</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>CNF</td>
<td>Cross National Projects</td>
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<td>HACEP</td>
<td>Hazard Analysis and Critical Control Points</td>
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<td>HRM</td>
<td>Human Resource Management</td>
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<td>IC</td>
<td>Investment Climate Assessment</td>
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<td>ICT</td>
<td>Information and Communication Technologies</td>
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<td>ILO</td>
<td>International Labor Organization</td>
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1. Turkey’s public policy program aims at improving the quality of life of its people. The country seeks to double the nominal per capita income of its population by 2013. It wants this rapid growth to be inclusive of all segments of society, regions, and economic sectors—especially through improved labor market performance leading to more and better jobs in the economy. At the same time, the authorities want to improve the quality of public services which they see as an important complement to economic growth in improving quality of life. They also believe that the potentially negative environmental consequences of the period of rapid growth ahead need to be managed so that the positive welfare gains from higher per capita income levels do not become eroded by environmental nuisances.

2. This Country Economic Memorandum (CEM), prepared in collaboration with the Turkish authorities, summarizes recent accomplishments in achieving high growth and analyzes remaining public policy challenges and options available to the authorities to meet these challenges.

3. Turkey has succeeded in restoring macroeconomic stability and rapid growth. It now wants to converge in terms of per capita income with wealthier countries—especially members of the European Union (EU). The Turkish economy began recovering from a crisis in 2001 and grew at 7.5 percent per year on average during 2002-2006. The Government’s commitment to sound economic policies assisted strong growth—within an extraordinarily benign global economic environment at the time. The consolidation of fiscal balances, progress in reducing inflation, improved resilience of the economy, and broad-based structural reforms, have placed Turkey in a better position to sustain high growth—including attracting large capital inflows. Moreover, favorable demographic trends will increase the share of working-age population in total population, which could expand output if currently unutilized labor is absorbed in the coming years.

4. The authorities are committed to continue reforming the economy consistent with their policy objectives of doubling income per capita. The Government’s medium-term program, covering the period 2007-2013, outlines the structural reforms to be implemented to sustain economic development—which will help Turkey in closing the per capita income gap with EU countries, making growth more inclusive, and improving the quality of public services, while also protecting the environment. Turkey also made public its program for harmonizing its legislation with the EU in its “Program for Alignment with the Acquis (2007-2013)”. This time bound harmonization program, adopted in 2007, seeks to strengthen Turkey’s regulatory and policy framework.

5. Ambitious reforms over a long period could be more easily sustained if the resulting growth is inclusive. Public support for the reform efforts will be stronger if it delivers more and better jobs and if the resulting growth spreads across regions, sectors, and social groups.
6. In addition, certain dimensions of public sector governance are instrumental in improving quality of life and promoting competitiveness in Turkey including, for example, food safety and environmental protection. Further strengthening of the legal framework and institutions fighting corruption could improve the investment climate, the efficiency of the public sector, and popular support to further reforms.

Ensuring Sustainability of Fast Growth

7. Continued macroeconomic stability is a necessary (but not sufficient) condition for sustainable growth. Turkey has recently established macroeconomic stability, through disciplined fiscal and monetary policies and fundamental first generation reforms, with the help of a conducive global environment. However, challenges remain, especially as the economy exploited a large portion of unused production capacities and growth has failed to create enough jobs to reduce the still high unemployment rate.

8. More investment especially in tradable sectors will assist in sustaining high growth. An analysis of the required investment to gross domestic product (GDP) ratios to maintain a given growth rate reveals the order of magnitude of the challenge. During 1997-2006, annual total factor productivity (TFP) growth averaged 1.3 percent. In the absence of a substantial increase in this rate, for example to 2.5 percent; sustaining a 7 percent annual growth rate over the 2007-2014 period would require the investment to GDP ratio to increase from its current 24 percent level to above 30 percent. The composition of investment also matters, and the recent shift towards investment in tradable goods bodes well for sustainability of growth. Large investments will be necessary but larger shares of the funding for these investments will need to come from domestic savings and foreign savings in the form of foreign direct investment (FDI)—not from debt instruments—to ease current account pressures and risks.

9. Turkey’s high current account deficit (CAD) and the persistence of inflation create risks to macroeconomic stability. Strong fiscal discipline and monetary policy have reduced chronic inflation to below 10 percent in 2005. Public debt has also been reduced and its sustainability has improved. Accordingly, the resilience of the Turkish economy to shocks has improved as demonstrated by the rapid recovery from turmoil in international markets in the summer of 2006 and, more recently, in the summer-autumn of 2007. The remaining vulnerabilities include that (a) the CAD increased to 8.1 percent of gross national product (GNP) in 2006 – although it is estimated to have narrowed slightly in 2007; (b) inflation started to pick up in 2006

Figure 1: Current Account and FDI (Average 2002-2006)

increasing to about 10 percent—against a target of 5 percent; and (c) high inflation and the large CAD prevent domestic interest rates from falling—which puts pressure on fiscal balances and sustainability of public debt.

10. **The external deficit has widened faster than predicted.** Turkey’s CAD in 2006 was about 3 percentage points higher than would have been predicted through comparison with current account trends in other middle-income countries. This larger-than-expected widening of the CAD partly reflects strong growth and pent-up domestic demand, and partly the increase in the price of imported energy. Moreover, Turkey’s exports have become more intensive in imported intermediate goods and raw materials.

11. **External debt sustainability could be increased by reducing the CAD through improved trade competitiveness and an increase in domestic savings to match the investment levels required for high growth.** Turkey’s external debt as a share of GDP is likely to increase if the CAD remains at 2005 levels. The narrowing of the deficit would ideally come from an increase in the savings rate. Although Turkey’s savings rate, at 18 percent of GDP, is comparable, for instance, to the average of new EU members, it is well below the savings rates of other fast-growing emerging economies, such as Korea and Chile, where savings rates hover around 30 percent. Better mobilization of domestic savings, trade competitiveness, attracting higher FDI and sustained fiscal consolidation, will all help reduce the CAD without decreasing investment. Exchange rate depreciation would have a limited impact in addressing external balances given the low price elasticity of Turkey’s foreign trade. Depreciation would also have adverse valuation effects on the stock of external debt as well as on inflation and interest rates. If oil prices remain significantly higher than historical averages, preserving sustainability would require even stronger improvements in competitiveness and more efficient energy use.

12. **FDI-friendly policies and structural reforms, such as energy, transport and labor market reforms, that improve competitiveness in the tradable goods sectors would improve external sustainability.** Despite significant improvement in 2005-06, net FDI to Turkey remains low relative to comparator countries including most of the new EU members (Figure 1). Moreover, FDI in Turkey has flowed mostly to the services sector as opposed to manufacturing which has received large shares of FDI in the new EU Member States. High investment in the non-tradable goods sectors temporarily boosts domestic demand but does not improve significantly productive capacity in exporting and import-competing sectors. By contrast, private sector investment in tradable goods sectors contributes to reducing the CAD. Although the investment mix in Turkey has improved in the current expansion, policy measures aimed at increasing the attractiveness of manufacturing to domestic and foreign investors—such as addressing the high energy costs, poor transport infrastructure, limited labor market flexibility—are important.

**Productivity and Competitiveness**

13. **The sustainability of growth would be enhanced by improving productivity and competitiveness.** Productivity gains have helped keep unit labor costs of Turkish firms broadly competitive, despite rising labor costs and currency appreciation. Most sectors have maintained exports as a share of GDP despite the real exchange rate appreciation since 2002 and the more than doubling of manufacturing wages in USD terms since 2001. Real wages are now high compared to relevant competitors, especially new EU member states, but due to increases
in productivity unit labor costs remain competitive across sub-sectors of manufacturing. However, productivity growth has reflected to a large extent an increase in capacity utilization, which had plummeted during the crisis. Thus, sustaining productivity growth will prove increasingly challenging. As firms are back to normal capacity, focusing on efficiency gains will be important.

14. **More efficient reallocation of labor and capital to both highly productive incumbents and surviving entrants may increase productivity.** Entry and exit among small firms in Turkey has been vibrant but surviving entrants tend not to grow much. Moreover, most of the productivity growth in Turkey (70 percent) comes from general improvements in productivity within existing firms rather than through reallocation of labor and capital across firms—through the creation of new, more productive firms and exit of less productive firms as well as reallocation from less productive to more productive firms. Slow growth of successful entrants and sluggish reallocation of labor and capital across firms may reflect potential problems in product market competition, inflexible labor and capital markets and firms’ low capacity to innovate including adopting new technologies. Although firm entry and exit conditions appear to be working well, lower costs of business registration, a more streamlined system for acquiring licenses for operating businesses and more expedient exit of firms could further foster contestability and dynamism, and thus growth. Enabling the most productive incumbents and the most successful entrants to grow will require reforms in labor and financial markets.

15. **Turkish firms do not seem to be taking sufficient advantage of available knowledge in the world.** Evidence indicates that Turkey lags behind fast growing emerging markets and some new EU members in acquiring new technologies, use of general purpose technology, licensing new technologies and introduction of new products and patenting. Furthermore, despite the recent surge, FDI in Turkey is low compared to most new member states and is directed mostly to services, limiting the spillovers to tradable sectors. For example, in 2005, only about 2.7 percent of Turkish firms established a joint venture with foreign firms—the FDI modality that leads to highest levels of technology transfer, in contrast to 6.1 percent in the Czech Republic. Thus, Turkey could sustain faster growth, by promoting adoption of new technologies and increasing output per worker through a higher capital/labor ratio.

16. **Sustaining high productivity growth will benefit from further improvements to the business environment and labor force skills.** The growth of new firms—and their contribution to productivity growth—would benefit from more flexibility in the use of labor and better access to financial markets. Moreover, the rapid growth of credit has been allocated mainly to consumers while firms’ access to capital remains limited by legal and institutional constraints such as a deficient framework for using movable assets as collateral. More reliable access to energy would improve competitiveness and could be achieved through a policy mix of privatization, regulation, and investments in industry segments that remain owned by the state. Reducing the presence of State Owned Enterprises (SOEs) in other sectors will also help Turkey’s competitiveness, due to the higher labor productivity growth of private manufacturing firms. In addition, efficiency gains could be realized if improvements were made with regard to customs clearance, state aid, and the frequent use of anti-dumping measures. Finally, as labor in Turkey becomes more expensive, upgrading the skills of the labor force becomes critical to sustaining competitiveness.
Public Sector Governance

17. The functioning of the public sector is an important determinant of public support to the reform program and a key element of the investment climate. Improvements in the fight against corruption, the judiciary, and civil service would be beneficial to the Government’s objective of improving the quality of life in Turkey.

18. Progress in creating an institutional framework to control corruption has been notable but more could be achieved. Surveys of firms and households suggest that corruption levels in Turkey are comparable to those in many new EU member countries (Figure 2). Moreover, such surveys also show a marked decline in areas like the frequency of firm-level bribery. One challenge is to consolidate the progress made so far. In particular, the scope of confidentiality in declarations of information may impede the effectiveness of public oversight. Other priorities include the approval of the new Law on the Turkish Court of Accounts (TCA) and the provision of adequate resources to the newly created Ethics Board. Laws governing key areas of openness and accountability fall far short of the standards being set by the new members of the EU. In this regard, key challenges include: (a) improve the system of asset monitoring; (b) strengthen the enforcement of laws that regulate conflict of interest for officials; (c) clarify and effectively implement the Law on the Right to Information; and, (d) address the excessive immunities of some high-level officials.

19. In addition to improving judicial independence, the authorities may also wish to focus on restructuring the court system and its management. Reforms to ensure the full independence of the judiciary are advisable. Judges and prosecutors are currently administratively attached to the Ministry of Justice, which still maintains significant influence over the recruitment, promotion and training of judiciary. Well trained judges, an improved infrastructure, and alternative dispute resolution systems will help improve judicial performance. Better court management, including the increase of support personnel and modernized case management systems, would help increase the efficiency of the court proceedings and reduce backlogs. The enactment of the revised code of civil procedures would be an important step in reducing the duration of cases. Finally, improving continuing legal education, including a strengthened role for the Justice Academy, would facilitate such an intensive period of legal reform.
20. **Civil service reform will strengthen public sector governance and efficiency.** The Government has prepared a draft Law on Public Personnel pursuing a number of objectives including improving efficiency in staffing and performance of duties, eliminating discrepancies in remuneration across similar positions, making it easier to manage a fiscally sound wage bill and providing competitive opportunities for entry into the public administration. The draft law introduces mandatory evaluation of individual civil servants as well as an element of performance-related pay —prudently kept at moderate levels. Successful implementation of the draft law reform would contribute to a more responsive public sector—a detailed analysis of the draft law can be found in the World Bank Public Expenditure Review (PER), 2006. In the past two decades, most Organization for Economic Cooperation and Development (OECD) countries have introduced reforms to increase efficiency and productivity in their civil services, notably by adapting some management tools inspired from the private sector.

**Inclusiveness**

21. **The government aims for the economy to create more and better formal sector jobs.** The challenge is multifaceted in that employment rates are low while unemployment rates are high—including especially for young people and women—and about half of the jobs are in the informal sector. Despite some moderate improvement, the employment rate, at 45.9 percent, is 18.5 percentage points below the EU-27 average for 2006. The rapidly growing youth population would be an opportunity for Turkey to reap a “demographic dividend”, if employment of young people could be improved so as to benefit from their productive potential. But the employment rate for those aged 15-24 remains well below the national employment rate while an additional concern is that another 40 percent in this age group are neither in the labor force nor in school. Employment is also particularly low for young women, especially with low educational attainment.

22. **More flexible labor market regulation, coupled with more effective social protection through labor market programs, could significantly improve labor market outcomes.** Reducing payroll taxes could be aimed at creating jobs. Turkey’s taxes on labor are among the highest in the OECD zone. However, reducing payroll taxes is unlikely to create sufficient number of jobs by itself. A comprehensive package of labor market and social security reforms will be necessary. Moreover, to be fiscally sustainable, it is critical that labor tax cuts go in tandem with social security reforms and/or increased tax revenues from other sources, and/or reduced fiscal expenditures in other areas.

23. **Reducing the tax wedge on labor, at a reasonably low cost—as one element of a comprehensive reform—could have a substantial impact on employment if targeted to low-wage workers.** The pass-through to actual wages from lowering the labor taxes is weakest for low wages. Hence the employment gain from cutting labor taxes—for a given level of forgone revenue—would be greatest any cuts are targeted to minimum wage earners. A reduction in social security contributions will thus have a stronger employment impact if targeted to low-wage workers than if the cuts are made across the board. Existing regional employment incentives seem to have had an impact on employment but subsidized job creation has come at a very high cost—as only a small fraction of subsidized jobs would not have been created in the absence of the program. The high estimated cost of piece-meal incentives underscores the importance of comprehensive labor market reforms to permanently remove obstacles to job creation.

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1 Data source is Statistical Office of the European Communities (Eurostat) which covers population aged 15-64. According to Turkish Statistical Institute (TURKSTAT), which publishes employment statistics for those aged 15+, employment rate was 43.2 percent in 2006.
Regional disparities in Turkey are large and there is no clear evidence of convergence in per capita income across regions—despite recent rapid growth. Turkey’s regional development disparities are significantly larger than in EU15 countries and comparable to the level of disparities prevailing in several new EU members—as examples of comparator countries. Regional disparities run largely along the east–west axis. “Lagging” regions (Eastern Anatolia, Southeastern Anatolia and Black Sea) account for 40 percent of land area, 30 percent of population, but less than 20 percent of the economy’s income, and their per capita GDP is only 60 percent of the national average (Figure 3). Inter-regional disparities have remained over time.

Differences in labor productivity are a key determinant of regional disparities. Differences in productivity account for 88 percent of the total difference in GDP per capita between lagging and advanced regions. This reflects the wide differences in the economic structure of the East and the West, with a large, traditional, and poorly productive agricultural sector predominating in lagging regions. Agricultural productivity in lagging regions is about one third of the level prevailing in advanced regions, while this gap is also evident in services (39 percent), and industry (45 percent).

A meaningful reduction of income disparities implies a significant change in the economic structure of lagging regions. As agricultural productivity grows in the East, employment in the sector is likely to decline, to be replaced by growth in manufacturing and services. Labor migration—from rural areas to urban areas, and from poorer regions to richer ones—will also occur and is likely to reduce income disparities.

The evidence available suggests that the regions with higher schooling rates grow faster than other regions. Empirical analysis was conducted for this study for the 26 Nomenclature of Territorial Units for Statistics (NUTS) regions and 81 provinces of Turkey for the period 1989-2001. The results of the study suggest that, while the size of public investment in a region does not affect its growth performance, its composition does. Public investment in social sectors is positively associated with regional growth. Similarly, the role of public sector incentives in generating regional growth is found to be insignificant—a result consistent with the finding of limited cost-effectiveness of regional incentives in generating new jobs.

Well-calibrated public policies can sustain growth over time and make growth more inclusive. The first is the provision of education, which through enhancing skills, productivity, and adaptability, is conducive to long-term economic growth. The second is building macro-level infrastructure—power and telecommunications lines, highways, railroads, port and airport facilities. International experience suggests that the right sort of infrastructure can provide a necessary if not sufficient condition for economic growth. In areas
where inappropriate transport infrastructure constitutes a bottleneck, for example in accessing markets, for example, developing such infrastructure is likely to have a beneficial economic impact. The government could also coordinate and facilitate the development proposals of private investors and public entities. The design and implementation of successful policies to accompany the transformation of lagging regions cuts across sectors and levels of government. There is a need for an improved mechanism for inter-sectoral and central-local coordination. Although not all experiences with regional development agencies (DAs) are positive, well designed structures could provide an improved coordination mechanism. Turkish authorities have recently started working on the new Development Agencies structure.

29. **Increasing rural competitiveness through for example improving food safety standards can also help make growth more inclusive.** Lack of a strong legal and institutional framework in food safety standards has implications for both Turkey’s competitiveness and growth, and living standards. Health hazards related to unsafe food cause high economic costs because of (a) income foregone due to limited competitiveness of food products on national and international food markets, (b) diseases and deaths, and (c) costs of medical treatment. The unfavorable food safety status in Turkey seems basically related to hygiene practices in the food chain but also in households. Efforts to improve food safety needs to be based on a good analysis of incidence of food borne diseases, analysis of their causes, and targeted measures to reduce hazards. Creating awareness, education, training, and preventive measures throughout the supply chains will most likely be the most important elements of an improved foods safety policy. While food safety improvements first and foremost require investments into upgrading food supply chain facilities, potential investment support programs and the enforcement of standards and is a key public sector role. Bridging the food safety regulatory gap with the EU will be crucial for enhancing competitiveness and hence for supporting growth and rural employment in the longer run.

**Environmental Protection**

30. **A particularly important area in managing a period of large investments and rapid growth is environmental protection.** Upgrading environmental quality to EU norms will provide substantial benefits to the Turkish society in terms of reduced occurrence of illnesses, a better living environment, more recreational opportunities and protection of its valuable biodiversity. There are major priorities for improvements in the areas of water supply, solid waste management, improvements in air quality and more effective nature conservation.

31. **The costs of upgrading environmental quality to EU levels can be significantly reduced by pursuing effective public policies.** Relevant reforms include: increasing the accountability of municipalities (as providers of municipal services such as water supply, wastewater and solid waste management), reconsidering the central government support scheme, promote new models of Public Private Partnership (PPP) possibly based on output based support to private supporters and actively engage in training Small and Medium Scale Enterprises (SMEs) in the case of industrial pollution. Strengthening environmental governance and upgrading the human resources will also prove to be essential in carrying out the necessary reforms.
Turkey aims to converge with the per capita income levels of advanced countries and is now in a favorable position to do so. In the aftermath of the 2001 crisis, an ambitious reform program coupled with tight monetary and fiscal policies helped Turkey’s growth rates to reach an average of 7.5 percent in 2002-06—making it one of the fastest growing OECD countries. Fiscal discipline has been the cornerstone of the strong economic performance. Commitment to achieving price stability brought inflation to single digit levels for the first time in three decades. The improved credibility of the economic program led to a decline in the interest rates and substantially improved the debt dynamics. As a result, Turkey’s economy became more resilient to shocks as was evidenced by the response to the May-June 2006 and August 2007 global market turmoil. With stronger fundamentals and a less vulnerable economy in place, the challenge ahead is to secure employment-generating and shared growth. Deepening the reform process in the years ahead will help sustain the high growth rates and support convergence of Turkey’s per capita income to the EU average. This will not only require commitment by the government to the reform process, it will also call for complementary private sector actions.

A majority of the reforms that are on Turkey’s medium term agenda are second generation reforms. First generation reforms which usually follow financial crises have an immediate impact and have high public visibility. Second generation reforms, on the other hand, have medium-to-long term impact, have low public visibility and are more complex. While Turkey’s economic reforms in the recent years have featured a mix of both first and second generation reforms, a bulk of what is typically characterized as second generation reforms (such as for example, labor market reform, social security reform and judicial reform) still dominates the future reform agenda.

Sustaining high and employment generating growth will require consolidating the gains achieved so far. This brings the need for deepening the reform process, by complementing the past reform efforts with more complex second generation reforms, and ensuring its inclusiveness. The need to sustain high growth over a long period of time raises three simultaneous challenges:

- **Managing the macroeconomic risks.** Existing vulnerabilities stemming from current account imbalances and persistent inflation may pose risks especially in a less favorable global environment in the future. As further explained in this CEM, skillful and prudent macroeconomic management will be required to sustain high growth.

- **Ensuring inclusiveness, as is needed for continued support for the reforms.** To garner support for “hard” reforms, growth will have to be inclusive, with tangible benefits for the population as a whole and the most vulnerable in particular. Growth will thus need to be backed by stronger employment
generation than in the 2002-06 period and it will also need to trickle down to the backward regions and the rural sector. Fast-paced structural reforms to promote competitiveness and to improve the labor market performance will be the key to ensure inclusiveness. A stronger policy and institutional framework for regional development will promote a regionally more balanced growth.

- **Further strengthening public sector governance and institutions.** The challenge of improving public sector governance encompasses a broad agenda supporting Turkey’s long-term development goals. Cross-cutting reforms such as judicial sector reform, anticorruption efforts and civil service reform are key elements of an improved public sector governance structure. At the same time, strong governance in individual sectors such as environmental protection and food safety standards will be instrumental in improving the living standards in Turkey.

4. **Aware of the challenges ahead, the Government has committed to a comprehensive structural reform program over the medium term.** Turkey’s medium term development program, covering the period 2007-2013, outlines the structural reforms to be implemented to bolster Turkey’s economic development. At the same time, these reforms will help Turkey prepare for membership of the EU—a simultaneous challenge for Turkey, as EU accession will promote growth and social development in many different ways.

5. **EU reforms will support Turkey’s development and convergence of living standards to the EU average.** Main expected benefits include:
   - Strengthening of the regulatory and policy framework as a result of the adoption of the EU Acquis—thus making Turkey a better place to invest and fostering the absorption of superior know-how;
   - Providing significant net benefits down the road to Turkey’s farmers as a result of better access to EU agricultural markets and the Common Agricultural Policy (CAP);
   - Promoting social cohesion and regional development.

6. **Above all, by strengthening the investment climate, EU accession will create more employment opportunities for Turkey’s rapidly growing labor force, while labor mobility will eventually deliver further welfare gains.** The Government is firmly committed to pursuing the EU accession agenda, regardless of the pace of negotiations, because it is essential for meeting Turkey’s long-term development goals. Hence, many of the reforms required for final accession to the EU are justified on their own merit in contributing to Turkey’s development goals, whatever the length of the accession process.

7. **Because of the multifaceted reform agenda to be addressed and the complexity of implementation, this study covers a selected set of issues towards the goal of sustaining high growth with inclusiveness and further improving public sector governance.** There are two volumes in the study. Volume I provides the overall framework and a shorter version of the analysis and policy recommendations in each subject, while Volume 2 provides the full analysis, findings and policy options for each of the subjects. The selected set of topics covered in the report are: the macroeconomics of sustaining high growth; promoting competitiveness;
selected horizontal issues in strengthening governance (anti-corruption, judicial reform, and civil service reform); the interrelated subjects of promoting employment and managing migration; options for designing effective regional development policies and institutions; and policy requirements in two selected sectors—environmental protection and food safety standards. Future CEMs might address additional issues critical for Turkey’s reform agenda, such as energy, industrial and enterprise policy, education and training, and science and research, including any sector-specific governance challenges within those areas. Such issues will also have an increasing importance for moving towards innovation-based growth and ensuring Turkey’s competitiveness in higher value-added sectors.

8. Following the completion of this report, TURKSTAT released the long-awaited revision to GDP data on March 8, 2008. The main reason for this revision was to account for the structural changes in the economy since 1987 and to harmonize Turkey’s GDP estimates with the European System of Accounts (ESA 95). TURKSTAT plans to complete full alignment with the ESA-95 by 2011. The recent revision updates the base year to 1998 from 1987, and includes both changes in methodology and coverage. With this revision, historical GDP series – both in real and nominal terms – as well as key macroeconomic ratios of Turkey have changed significantly. Nevertheless, these changes have not been reflected in this report since the revision was announced after the report had been completed. As a result, revision of the analyses would have delayed the dissemination of the report considerably. Furthermore, key findings and policy recommendations presented in this report are unlikely to have changed as a result of revision. This is due to the fact that analyses in the report are not based on the levels of key variables – but rather on their trends, which have remained broadly unchanged. The GDP revision will be reflected in future World Bank documents on Turkey. Annex I provides an overview of the GDP revision.
9. Turkey has restored macroeconomic stability and has greatly improved the resilience of its economy. Since 2001, the Turkish economy has bounced back from a sharp crisis and entered a period of high growth and significant structural transformation. Annual growth averaged 7.5 percent and output increased by more than 40 percent in 2002-2006. This positive performance is due in great part to the government’s sustained commitment to sound economic policies as well as a benign international economy. Strong fiscal discipline and tight monetary policies helped lower inflation and inflationary expectations and improve debt sustainability. Substantial progress has also been achieved in restructuring the financial sector, improving the business environment, and reforming the public sector. Sound policies, a favorable international environment and the prospects of EU accession have helped Turkey expand its export capacity and attract large capital inflows. Vulnerabilities remain, as demonstrated by the impact on Turkey of the May-June 2006 turmoil in international markets. Even so, the episode also demonstrated the economy’s resilience to economic shocks, while the authorities’ response by tightening monetary policy and maintaining fiscal discipline demonstrated a firm commitment to macroeconomic stability.

10. However, challenges remain.

- Achieving income convergence with advanced countries will require a sustained period of high economic growth. The 7.5 percent annual average growth rate achieved during the last five years of recovery may exceed show the sustainable growth level of potential output once the output gap has been closed. Therefore, the outlook for growth depends on the ability to increase the level of investment—as well as its efficiency—above the historical averages and on achieving stronger employment generation combined with higher labor productivity.

- After reaching 6.3 percent of GNP in 2005, the CAD-to-GNP ratio further increased to 8.1 percent in 2006 and remained high at an estimated 7.8 percent in 2007. Turkey’s large CAD poses a risk to the sustainability of high growth—although the quality of its financing has improved, with an increase in the share of FDI and other non-debt creating sources to above 50 percent.

- Inflation started to pick up in 2006, jumping to a level of about 10 percent by the end of the year, which was significantly higher than the official target of 5 percent. Annual inflation at 8.4 percent at end-2007 was more than double the 4 percent target. Bringing inflation close enough to the targeted level of 4 percent in 2008 seems challenging.

- Turkey has been one of the main beneficiaries of the ample capital flows directed to emerging markets over the past few years. Large capital flows will support growth but may also generate macroeconomic imbalances.
The Challenge of Sustaining High Growth

11. Contrary to other emerging countries, Turkey experienced little income convergence over the past decades but is now in a better position to achieve it. Turkey's growth over the last decades has been volatile and below that observed in other emerging countries. Slow labor productivity growth and declining labor utilization prevented Turkey from realizing its growth potential. The consolidation of the fiscal balances, the reduction in inflation, the improvements in macroeconomic stability, and the wide range of structural reforms put Turkey in a better position to accelerate growth on a sustained basis.

12. Higher and more efficient investment will be important to sustain high growth rates. Sustaining growth rates of 7 percent will necessitate the investment to GDP ratio to increase above 30 percent, under the assumption that the TFP growth rates are not going to increase drastically from the last decade's average of 1.3 percent. China, by comparison, invests more than 40 percent of GDP. Raising Turkey's investment rate to above 30 percent range will require not only a significant increase in the national saving rate but also sustaining sizeable CAD for prolonged periods. The efficiency of investment also greatly matters for sustaining high GDP growth: TFP growth lower than 2 percent would require even higher investment ratios in order to achieve meaningful convergence, hence making external balance more difficult to sustain.

13. The composition of investment also matters for growth sustainability. High investment does not necessarily lead to higher growth if it is concentrated in the non-traded goods sectors. Such investment boosts domestic demand—and temporarily also employment—but has little impact on productive capacity in exporting and import-competing sectors. It eventually leads to even larger CAD and growing foreign debt. By contrast, private sector investment in productive capital in tradable goods sectors improves the sustainability of the CAD as it can contribute to its reduction in the future. A significant shift in the composition of investment towards tradable sectors has taken place since 2001 (Figure 4). This trend, if continued, bodes well for the sustainability of growth.

14. Equally important is human capital formation. Turkey under-invests in human capital (especially as regards education and training of women) and underutilizes the human capital it has—especially the existing potential female labor supply. Turkey's unemployment rate of about 10 percent, while too high, is not unusual by the standards of the EU. However, what is unusual is the very low employment rate. In most countries, at least half of the working age population is employed.

Figure 4: Composition of Investment (Percent of GNP)

Source: State Planning Organization (SPO), Staff Calculations
The average for the EU-25 was 64 percent in 2006, while in Turkey only 46 percent of the working age population had jobs. Even worse, about one out of four Turkish women was employed in 2006, compared to 56 percent in the EU-25. Improving the employment content of growth, through comprehensive labor market reforms (see World Bank, 2006, Labor Market Study) is a prerequisite for sustained high growth.

External Sustainability

15. The challenge for Turkey is how to sustain the large CAD associated with fast growth. Looking forward, this challenge becomes even more important as the scope for easy growth that comes with economic recovery has been exhausted and investment rates need to go up significantly—requiring higher domestic and foreign savings to finance it. To this end, understanding the driving forces behind the large CAD over the recent years is important for assessing the sustainability of such levels in the future.

16. Turkey’s external deficit in 2006 was at par with the average deficit in the new EU members. To some extent, the widening of the CAD in recent years can be seen as a natural phenomenon for a catching up economy, following the current account reversal that occurred as a result of the financial crisis of 2001. Still, such levels leave the country exposed to global market turbulences.

17. However, the good news is that while growth has gone hand in hand with a growing overall trade imbalance, exports have displayed substantial increases over the last five years. Total exports tripled between 2000 and 2006 in dollar terms. Turkey’s export growth has been faster than in most comparator countries in recent years (new EU members, Cohesion Countries, China, Brazil, Korea and Thailand). Among the comparator countries analyzed, only China has experienced much higher export growth rates than those observed in Turkey. The composition of exports have also continuously changed towards more high tech products, such as automobile, electrical and electronic equipment and machinery since 2001, boding well for the sustainability of future export growth.
18. Similar to previous cycles in Turkey, fast economic growth has also tended to rely on a rapidly growing flow of imports. Much of this growth has been reflected in imports of capital goods, as well as in raw materials. Annual imports increased by 28 percent on average after 2001. Despite the strong domestic demand and real appreciation, growth of consumption goods imports has not been excessive in recent years. Consumption goods imports in proportion of total non-energy imports have even slightly declined to 14.6 percent in 2006, from 15.3 percent in 2000. Capital goods imports are also heavily concentrated on machinery, accounting for more than 70 percent of Turkey’s capital goods imports. Access to technology embodied in imported capital goods is essential for higher productivity growth in the future.

19. The evolution of the CAD in Turkey has been largely influenced by oil price developments. After surging to 6.7 percent of GNP in 2004, the non-oil merchandise trade deficit remained stable in 2005-2007. By contrast, the total trade deficit had showed a steady deterioration in the period 2001-2006 before it slightly improved in 2007. Turkey appears indeed to exhibit a relatively greater dependency on oil compared to other middle-income countries and therefore, is relatively more exposed to continuously elevated oil prices.

20. Better savings mobilization will help to sustain high growth. The savings and investment pattern in Turkey is broadly similar to that observed in the new EU Member States (Figures 6 and 7). However, savings rates in Turkey remains far below those seen in other fast-growing emerging economies, such as Korea and Thailand, where CAD has been kept at lower levels. As in other countries that previously joined the EU, while the accession process and the reform efforts are encouraging investment, faster growth and expected convergence of incomes to the EU

![Figure 6: Gross National Savings Rate](image)


![Figure 7: Gross Investment Rate](image)

Source: World Bank databases, IMF.
average may lead to a decline in savings. In Turkey this trend may be exacerbated by relative lack of financial depth to mobilize savings, and by ample bank liquidity and strong growth of consumer credit, as observed in 2003-05. Better mobilization of domestic savings, and continuing ability to attract foreign savings in the form of FDI, would be needed in order to hedge surrounding risks due to still high, and growing, foreign debt. At the same time, a sustained fiscal consolidation effort will be important to maintain a strong contribution of the public sector to domestic savings mobilization.

21. Preserving external debt sustainability will require a reduction in the CAD. Projections of the net external debt to GDP ratio have been made assuming the non-interest non-oil current account balance would remain at its 2005 level (0.3 percent of GDP), and using two different assumptions (base- and low-case) about Turkey’s growth and the external environment. In both cases, if the (non-interest non-oil) current account balance remained at 2005 values, external debt to GDP is likely to increase (Figure 8 – which also shows a sensitivity of the base case to a change in the oil price only).

22. In this sense, the CAD will not be sustainable. If, in addition, net FDI inflows are assumed to remain at an elevated 3 percent of GDP over the years 2008-2015, the present level of the CAD would be sustainable. Such a sustained FDI inflow would not be unheard of among countries in the process of accession to the EU, and in fact most new EU members averaged FDI inflows above 3 percent of GDP from 1998-2005. In the low case scenario, the CAD would need to decline by about 4.8 percentage points of GDP to ensure a stable external debt ratio. In the base case scenario, the needed adjustment to the current account is 2.6 percentage points – although, should oil prices remain at USD 76.5 pb in 2008-15 the required adjustment in the base case scenario would be closer to 4 percentage points.

23. Exchange rate depreciation would have a limited overall impact on external sustainability. Taking into account the estimated foreign trade elasticities a 10 percent depreciation of the real effective exchange rate would result in a decrease in the current account balance of only around half of one percentage point of GDP. This limited impact is largely due to the low price elasticity of imports of intermediate goods, which account for the lion’s share of all Turkish imports. In addition, the exchange rate depreciation would have adverse valuation effects on the stock of external debt, thus raising the primary current surplus required for debt sustainability.
24. Structural reforms and FDI-friendly policies that improve competitiveness are key to ensuring external sustainability in the long-term. Continued improvement of the business climate and structural reforms would not only facilitate the needed FDI inflows but would also positively affect the competitiveness of the Turkish economy, hence reinforcing further its long-term external sustainability.

Taming Persistent Inflation

25. The Central Bank has adopted a formal (explicit) inflation targeting regime but inflation exceeded targets by far in 2006 and exhibits persistence. Reaching the historically low level of 7.7 percent end-year rate in 2005, inflation started to pick up in April 2006, after exhibiting noticeable inertia in the preceding months due to strong domestic demand and persistence in services inflation. Furthermore, the depreciation of the exchange rate following the market turmoil in May-June passed through to inflation, which ended at 9.7 percent in 2006, well above the target of 5 percent. Annual inflation at 8.4 percent in 2007 was more than double the 4 percent target. Bringing inflation close enough to the targeted level of 4 percent in 2008 seems challenging.

26. Exchange rate volatility, especially in the presence of a sizeable CAD, is likely to hinder inflation targeting due to “pass-through effects”. Experience shows that inflation targeting in emerging market economies is vulnerable to capital flow reversals that lead to exchange rate depreciation and higher inflation, thus prompting higher interest rates in order to keep inflation on track. Turkey is particularly vulnerable to this risk due to the large CAD that may prompt exchange rate corrections associated with capital flow reversals.

27. Exchange rate pass-through on inflation remains significant in Turkey, especially in the non-tradable goods sectors. There is some evidence that exchange rate pass-through on inflation has declined after the introduction of floating exchange rate regime—a welcome development for continuing disinflation. However, the level of pass-through is still significant, with one percent increase in exchange rate resulting in 0.58 percent increase in CPI inflation. Exchange rate pass-through is also higher for non-tradable goods prices (0.60) compared to tradable goods (0.50). This is likely to reflect the difference in market competition in the two sectors, as exchange rate pass-through is facilitated in markets for non-tradable goods and services shielded from foreign competition, which makes it easier for uncompetitive practices to prevail. Similarly, empirical evidence indicates faster transition of changes in exchange rate and broad money supply to non-tradable prices.

28. Reducing inflation to the target level of 4 percent in 2008-09 would not only require continuous monetary and fiscal discipline but also ambitious structural reforms in product and services markets. In a base line scenario, inflation is projected to gradually decline to 6 percent in 2008, while the target level of 4 percent seems to be attainable only after 2009. Moreover, an increase in energy prices or acceleration of the growth rate would raise the inflation to the levels of 6-9 percent in 2008-2009. Policies that promote competition and improve productivity in sheltered non-tradable goods markets, and reforms that reduce the cost of key inputs (such as electricity), would greatly help meet the inflation targets without sacrifice on the growth front.
Managing Large Capital Flows

29. Large capital inflows will support growth but may also generate macroeconomic imbalances. Turkey has already been one of the main beneficiaries of the ample capital flows directed to emerging markets over the past few years and—although international investment portfolios may undergo some rebalancing in the future—is likely to remain an attractive destination over the medium term. Capital inflows will play a key role in the financing of growth, but they can also initiate trouble by leading to exchange rate misalignment; encouraging bank lending booms that result in a decline in loan quality; or igniting asset-market booms that set the stage for disruptive busts.

30. Although there is no perfect solution to the challenges that capital movements pose in emerging market economies, a number of partially effective measures might be adopted. Experience suggests three complementary ways of managing the consequences of large capital flows: (i) sterilized intervention; (ii) tightening of financial regulation; and (iii) fiscal adjustment. Exposure to the impact of capital flows could also be mitigated by tax policies or capital controls, but such measures raise the cost of finance, hinder investment, and are difficult to combine with a commitment to market-friendly reforms.

31. Whether sterilized intervention is appropriate and efficient hinges on a judgment about why the exchange rate is moving in the first place. If the movement in the exchange rate reflects an extraneous, passing increase in market volatility, then sterilized intervention to ensure adequate market liquidity and orderly conditions will be appropriate. If, on the other hand, the movement in the exchange rate is not extraneous but reflects an intensification of domestic inflation, then sterilized intervention alone will be futile and counterproductive. In practice, drawing this distinction is often extremely difficult.

32. Tightening regulations affecting the banks and markets on the receiving end of capital inflows can ease the burden on monetary policy. This technique has the strength of addressing some of the corollary problems specifically associated with capital inflows—such as lending booms and the resulting deterioration in the average quality of bank loans. Turkey’s framework of bank regulation, supervision, and intervention has been improved but issues still remain. In the near future, key outstanding issues for the Banking Regulation and Supervision Agency (BRSA) include further strengthening of consolidated supervision; and further improving the capacity to supervise banks’ risk management techniques and models. There also remain limits on the independence of the BRSA. In view of the rapid credit expansion, stronger accumulation of general loan loss reserves by banks would help curb the risks.

33. Maintaining a tight fiscal policy is a key option for addressing the challenge of capital inflows. Fiscal consolidation reduces domestic demand, hence mitigating the expansionary impact of capital inflows. Turkey has implemented an ambitious fiscal consolidation since 2001 but a continuous effort remains important over the medium term to improve the quality of public expenditures. The declining structural primary surplus in 2004-2006 indicates that the fiscal stance has turned pro-cyclical—a potentially unwelcome development at a time of broadening external current account imbalances (World Bank, 2006, PER). A preferable option would be for the structural primary surplus to be maintained unchanged during years of robust growth—a policy that would be reflected in an increasing actual primary surplus in proportion to GDP.
34. Working toward more credible policies, deeper and more robust financial markets, and a more stable and diversified economy is the optimal long-run solution to the challenges of large and volatile capital flows. The broader process of structural reform can contribute to mitigating risks while enabling the benefits from capital inflows. In addition, by increasing the flexibility of the economy it may attenuate the real exchange rate response to capital inflows—by, inter alia, raising the elasticity of supply of non-traded goods, in turn attenuating the inflationary effects of shifts in capital flows. Building deeper financial markets, more efficient fiscal procedures, and stronger policy institutions, not to mention completing the lengthy process of economic restructuring, is a long-term endeavor.

Key Risks and Mitigating Factors

35. Although the resilience of the economy has greatly improved, Turkey remains vulnerable to the risk of a sudden stop to capital flows causing a severe economic downturn. Rising external debt, dollarization and rapid domestic credit expansion are still a source of vulnerability. External debt has increased particularly due to increase in private sector borrowing. The heavy reliance of the corporate sector on external borrowing increases its exposure to exchange rate risks. On the other hand, public sector external debt has declined in terms of GNP since 2001. Also, loans denominated in foreign exchange still account for around a third of all loans extended by domestic banks to corporate sector. The share of bank deposits denominated in foreign currency has been decreasing in recent years but its level is still high. Domestic credit growth has also been particularly fast in recent years, especially in the areas of consumer finance, housing, and credit cards. The expansion of lending activities increases credit and – through maturity mismatches – interest rate risk.

36. Public debt sustainability has improved but risks remain. The net public debt to GNP ratio fell from a high of 90.5 percent in 2001 to 45 percent in 2006. The ratio is projected to continue declining in the period 2007-2012, assuming an average primary surplus of 5 percent of GNP, sustained growth, stable exchange rates and favorable external environment. However, sensitivity analyses of the public debt dynamics demonstrate the importance of commitment to sound economic policies. In the case of a combined shock of fiscal loosening, interest rates increase and growth rate decline in 2007-2008, the net public debt ratio would reverse its declining trend.

37. A much stronger banking sector helps mitigate external risks. The financial soundness indicators of the Turkish banking sector have broadly improved, as documented in the recent Financial Sector Assessment Program (FSAP) (2006). The increased resilience of the banking sector was also demonstrated during the market turmoil of May-June 2006. Exchange rate risk has decreased as banks are increasingly making use of hedging instruments. Interest rate risk stemming from banks’ holdings of securities has also decreased as the banks increasingly shifted their asset composition towards lending to the private sector and government securities with flexible interest rates. However, a different source of interest rate risk has been increasing as a result of the maturity mismatch between the assets (increasingly long-term loans for housing, etc) and the liabilities (mainly short-term deposits). Although the shift towards lending to the private corporate and household sectors is a healthy sign for investment and growth, assessing the true quality of the loan portfolio may prove to be particularly difficult in the case of rapid credit growth, highlighting the importance of continued vigilant supervision of the banking sector.
3. PROMOTING PRODUCTIVITY AND COMPETITIVENESS

38. The sustainability of high growth will eventually depend on the capacity of the Turkish economy to maintain and further improve its competitiveness. Sustaining rapid growth will be more challenging within a context of fast globalizing international markets and stiffer competition from low-cost producers—especially from China and India in traditional sectors, such as textiles and clothing, but also in more technologically advanced sectors. Improving competitiveness will contribute towards attracting larger FDI inflows to finance the CAD, especially in export-oriented sectors, as pressures on Turkish exporters may intensify with continued exchange rate appreciation. Indeed, exchange rate appreciation, if excessive, may deny some of Turkey’s low-cost competitive advantages, possibly discouraging export-oriented FDI. Maintaining a fast pace of productivity growth will thus be all the more important to preserve competitiveness.

39. Turkey has substantially integrated its private sector into the global economy over the past decade and boasts important success stories. The customs union with the EU, which became effective in 1996, marked an important shift in Turkey’s trade policy and many Turkish firms have successfully expanded into the global economy. Exports grew on average 10 percent per year in real terms over the past decade. Revealed comparative advantages have shifted across sectors, but few sectors have lost exports as a share of GDP despite the appreciation of the real exchange rate since 2002. The automobile sector in Turkey is a celebrated success story of global integration. The industry includes about 15 large assembly firms that rely not only on imported parts, but also on a large number of domestic SMEs. Ten of those are foreign owned or joint ventures with large foreign manufacturers operating under licenses. Automotive exports in proportion to GDP have grown strongly, accompanied by substantial, albeit smaller, imports of parts and components (Figure 9).

40. Turkey has lost some competitiveness due to growing wages, but productivity gains have partly offset the growth in labor costs and currency appreciation. Manufacturing wages have more than doubled in USD terms since 2001 after being depressed by the crisis. Before 2003 nominal wages were effectively tied to the USD, but since inflation has come down, labor costs appear to be priced in local currency, and as the Turkish lira has appreciated, Turkish labor has become less competitive. Wages are thus now high compared to some competitors in new EU member states. However, when taking the productivity of Turkish firms into account, unit labor costs remain competitive in the manufacturing sector (Figure 9).

41. The immediate post-crisis period offered an opportunity to increase productivity and growth by utilizing idle capacity, but sustaining high growth will not be so easy. Early in the recovery period improved capacity utilization allowed firms to expand and keep unit labor costs from rising without fundamentally

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2 This section draws on a recently completed Turkey Investment Climate Study, carried out by the World Bank and The Economic Policy Research Foundation of Turkey (TEPAV), which analyzes the dynamics of Turkish manufacturing firms’ productivity and employment on the basis of local and international firm-level data.
changing production technology and capacity. In 2002 and 2003, increased capacity utilization added more than 10 percentage points of productivity growth in manufacturing. Since 2003, when capacity utilization reached 79 percent, the growth has mostly been sustained by an expansion of the productive capacity of the Turkish economy. As firms are back to normal capacity, it becomes more difficult to continue high growth, and attention needs to be shifted to efficiency gains, greater employment growth, and faster accumulation of capital.

42. Analysis of productivity gains through firm dynamics points to the importance of a more efficient reallocation of labor and capital to both highly productive incumbents and surviving entrants. Entry and exit among small firms in Turkey has been vibrant, but surviving entrants tend not to grow much. Their limited growth may be a result of rigidities in the use of labor, inadequate access to capital, some distortions to competition and firms’ low capacity to innovate and adopt technologies. As a result, and as it is common in non-transition countries, most of the productivity growth in Turkey (70 percent) comes from general improvements in productivity within existing firms rather than through reallocation across firms (for example through the creation of new, more productive firms, exit of less productive firms, and reallocation from less productive to more productive firms). Net entry of new firms contributes to productivity growth because exiting firms have very low productivity, but the productivity of entering firms does not initially outperform that of incumbent firms. The lower initial productivity of new firms (compared to incumbents) may reflect the cost of marketing, building capacity, and getting established in the market—areas where start ups may require attention and better support.

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3 For a complete analysis of firms’ dynamics, see Turkey Investment Climate Assessment (ICA) (2007).
43. **Turkish firms do not seem to be taking sufficient advantage of available knowledge in the world.** Evidence indicates that Turkey lags behind fast growing emerging markets and some new EU members in acquiring new technologies, use of general purpose technology, licensing new technologies and introduction of new products and patenting. Furthermore, despite the recent surge, FDI in Turkey is low compared to most new member states and is directed mostly to services, limiting the spillovers to tradable sector. For example, in 2005, only about 2.7 percent of Turkish firms established a joint venture with foreign firms—the FDI modality that leads to highest levels of technology transfer, as opposed to 6.1 percent in Czech Republic. Thus, Turkey could sustain faster growth, by promoting adoption of new technologies and increasing output per worker through a higher ratio of capital per worker.4

44. **Evidence from firm level data confirms that external financing helps firms grow, but it also points towards inefficiencies in the allocation of credit.** Turkish firms with higher leverage grow faster. Moreover, exports as a share of sales are positively related to leverage. However, tangibility (collateral value as a share of debt) has a negative relationship with leverage suggesting that collateral is not effectively used in Turkey. Finally, more profitable firms borrow less again suggesting that financial intermediaries are not very sophisticated in allocating funds where they are best applied.

45. **Improved allocation of capital requires deepening financial intermediation.** Turkey's financial sector is developing rapidly but is still well behind comparator countries. Since the 2001 crisis credit to the private sector doubled to 30 percent of GDP, but half of the growth has gone to consumer credit, and inadequacies remain in the Turkish credit market, where financial reporting is underdeveloped—except for listed companies, credit information on firms is scarce, and use of collateral is inefficient. In particular, movable collateral (as opposed to land and buildings) suffers from legal impediments and inadequate collateral registration. Improving those institutional underpinnings is likely to support greater access to finance for firms in Turkey.

46. **Better and more reliable access to energy can offer an important advantage over lower cost producers.** In addition to inadequate reliability, electricity prices for industrial users are 30 percent higher than the OECD average, largely owing to cross-subsidies and uncompetitive market structures. As with the liberalization of the telecom sector that has allowed better services at lower costs, similar opportunities exist through the pending liberalization of the energy sector. A well-coordinated mix of privatizations, regulation, and continued investments in segments that remain public would be important elements of reforms in the electricity sector.

47. **Non-tariff barriers that may hamper efficiency gains are still present in an otherwise largely open trade regime.** Despite progress in aligning with the EU acquis, import customs clearance is still relatively slow in Turkey. Moreover, Turkey has remained a fairly frequent user of anti-dumping measures since the tariff regime was liberalized in 1996 (World Bank, 2006 CEM). Such measures protect inefficient domestic industries while increasing the cost of inputs for firms that use the goods that the measures are targeting. State aid is also an issue as it disrupts a level playing field and usually is in favor of uncompetitive firms. The state aid regime is in the

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4 An in-depth discussion of firms’ capacity to—and policies aimed at promoting—innovation and adoption of new technologies and quality standards are included in the Turkey ICA and in the previous Turkey CEM.
process of becoming more transparent as creating a new institutional structure for monitoring state aid remains a priority on the government’s agenda.

48. Informality remains widespread, and establishing a more leveled playing field represents an opportunity to strengthen competitiveness. Firms with low productivity enjoy tax and regulatory advantages by remaining informal or semi-informal and by recording only part of their activities. Improving incentives for formalization through streamlined entry and licensing procedures as well as tax reforms that ensure equal application of taxes across all firms can help establish a level playing field and thereby improve competitiveness.

49. The presence of SOEs in the productive sphere of the economy continues to be substantial and steady efforts to privatize these entities will help Turkey gain competitiveness. The Government substantially accelerated its long-standing privatization program in 2005 and 2006, but it remains an unfinished agenda, as SOEs still employ 226,000 personnel in 2006. A continued strong privatization program will help strengthen productivity and create a level and more competitive playing field in the private sector.\(^5\) One way of increasing strategic investor interest, following the EU experience, is to reduce the uncertainty about environmental liabilities of state-owned large manufacturing and energy generation enterprises.

50. As labor in Turkey becomes more expensive, upgrading the skills of the labor force becomes critical to sustaining competitiveness, especially in high-value added sectors. Despite notable progress, education in Turkey lags behind comparator countries in Europe and other fast growing emerging economies. These inadequacies of the primary and secondary education provision are reflected in the poor Program for International Student Assessment (PISA) scores achieved by Turkish pupils, which were below the average OECD scores for mathematics, reading literacy, science and problem solving in 2003. At the same time, continuous diversification and growth of successful sectors, such as the automotive and Information and Communication Technologies (ICT) sectors, will require highly skilled labor. It is therefore imperative that the skills of the labor force be upgraded to match the needs of highly productive sectors. Turkey would therefore benefit from improving the quality of education at all levels, placing more emphasis on job mismatch and arranging its curriculum accordingly to promote supply of skilled labor force needed by the growing modern sectors in the economy.\(^6\)

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\(^6\) See World Bank: 2006 CEFA, 2006 Education Sector Study, 2006 PER.
4. IMPROVING PUBLIC SECTOR GOVERNANCE

51. The public sector governance agenda is of crucial importance for a strong investment climate conducive to growth and job creation, and thus for meeting Turkey’s long-term development challenges. The Government’s medium-term program includes “increasing quality and effectiveness of public services” as one of the key development themes. Turkey would also benefit from a strong public administration that is more apt to implement the EU acquis. Particularly, the justice sector will play a critical role in adapting to EU requirements and standards. The challenge of improving public sector governance encompasses a broad agenda, essential for Turkey’s long term development. Aware of the governance challenges, the Government has initiated a comprehensive public administration reform process. Focus areas reviewed here include efforts to control public sector corruption, efforts to reform and modernize the judiciary and the systems and incentives in civil service in the context of OECD experience.

Controlling Corruption

52. Surveys of firms and households suggest that corruption levels in Turkey are not unlike those in many EU member countries. The BEEPS showed a marked decline in the frequency of firm-level bribery in many areas between 2002 and 2005, a pattern echoed in other surveys. (Figure 10) The European Bank of Reconstruction and Development (EBRD)-World Bank Life in Transition Survey (LITS) suggests that unofficial payments in Turkey would be about as frequent as in the new members of the EU, and for higher education and medical treatments at public health facilities less frequent. The two areas where respondents in Turkey report unofficial payments to be more frequent than in the EU were for obtaining unemployment benefits and in interactions with the road police.

53. Progress in creating and strengthening the institutions of oversight has been notable, though there remains room for improvement. In addition to the

![Figure 10: Bribe Frequency According to Firms, 2005](image-url)

Source: BEEPS
Note: EU members includes Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, Slovenia, Greece, Germany, Ireland, Portugal, and Spain.
courts and prosecutors, many other governmental bodies serve roles in the field of anticorruption, including the Inspection Boards (IBs) of each ministry and agency. Such a decentralized system is not unique to Turkey, although the need for permission by the head of the governmental agency before launching an investigation in that agency weakens its effectiveness. The system of audits has been strengthened, but the new Law on the TCA has yet to be approved—which will empower the TCA to audit entire general government and to carry out financial and performance audits. While the creation of the Ethics Board is a positive step, its potential as a body for preventing and controlling corruption is severely hindered by several factors. Most importantly, the Board lacks technical resources and is under funded, while its purview is limited to executive agencies only (excluding the courts, universities, the military, and Members of Parliament). Moreover, the fact that assets declarations are considered confidential makes them ineffective. Finally, the Financial Crimes Inspection Board (MASAK) focuses its activities on drug smuggling and fraud other than cases of laundering of public sector corruption proceeds.

54. **Turkey’s progress could be consolidated by making government more open and high level officials more accountable.** Evaluations of the laws governing four key areas of openness and accountability—including the systems for monitoring assets, for resolving and preventing conflicts of interest, for ensuring free access to government information, and for ensuring properly bounded immunities for high-level officials—reveals that Turkey’s legislation in several of these areas falls short of the standards being set by the new members of the EU (Figure 11).

55. **Key challenges are as follows:**

- Turkey’s system of asset monitoring has several weaknesses compared to those of many of the new members of the EU: they are confidential, infrequent and cover such a large number of officials as to be unworkable. In the context of a system of enforcement that is highly decentralized, these features result in a system that provides little deterrent to corrupt behavior.
- Several laws regulate conflict of interest for officials of various levels, but practical enforcement is weakened because there is no requirement for a full disclosure of interests, other than the subset that may appear in the assets disclosures, and even those are kept confidential.
• The Law on the Right to Information enacted in 2003 is an essential component of anticorruption, but its implementation encounters wide variation across governmental bodies, while shortcomings in the legislation include broad categories of exemption and a lack of clarity over the tests used to override non-disclosure.

• While all countries have immunities for some high level officials, Turkey is unusual both for the breadth of officials covered by immunity and for the lack of clarity in the procedures for removing immunity.

Judicial Reform

56. Despite positive business perceptions of the judiciary, there is room and desire for improvements. According to business surveys, the business community views the functioning of judiciary as less of a problem for doing business in Turkey compared than in the EU8 countries. Notwithstanding this positive assessment, there is no room for complacency because in many critical areas the business community’s perceptions lag behind those in older EU members. Reforms in the Turkish judicial system’s human resources, infrastructure, and alternative dispute resolution systems would help move towards such higher standards.

57. Strengthening the independence of judiciary in Turkey is an integral part of judicial reform. Although the assessments by firms of the independence of the Turkish judiciary are in line with those of the new members of the EU, they remain short of the norm among older members of the EU. Article 140/6 of the Constitution, which attaches the judges and prosecutors administratively to the Ministry of Justice, is seen as the main impediment to judicial independence. In addition, the Ministry of Justice retains a significant influence over the recruitment, promotion and training of the judiciary. Several new EU members have carried out reforms to address similar concerns.

58. In many countries, judicial reform efforts focus on restructuring the court system and its management. To enhance the performance of the judiciary, judicial reforms aim, first, to create sufficient human resources and physical infrastructure available to the current court system. Second, judicial reform programs typically address the efficient management of these resources. Finally, judicial reforms identify bottleneck and structural issues in the system and try to address them by creating specialized courts, different appeal structures, or alternative dispute resolution mechanisms. By deploying

![Figure 12: Assessments by Firms of Judicial Independence](image-url)

Notes: The survey question read: “Is the judiciary in your country independent from political influence of government, citizens, or firms? (1 = no—heavily influenced, 7 = yes—entirely independent).”
efforts in these three different categories, judicial reforms aim to improve typical measures of judicial efficiency such as lower case backlog, shorter duration of cases, and improved access to justice, and better popular assessment of judicial quality.

59. **Improving continuing legal education is a pre-requisite during an intensive period of legal reform.** While Turkey is overhauling all areas of law, there are concerns that the current level of programs for continuing education is not sufficient. Additional training programs for judges and prosecutors, and better coordination of existing programs, would strengthen the system. In particular, the role of the Justice Academy could be enforced and increased to the level of an institution in charge with: (i) the pre-service training for judges and prosecutors; (ii) the in-service training for judges and prosecutors; and (iii) the initial and continuous training for court clerks and other court personnel. Moreover, the number of judges, prosecutors and qualified assistant judicial personnel currently falls short of EU standards.

60. **Better court management could lead to enhanced judicial efficiency.** Key steps to increase the efficiency of the court proceedings and reduce backlogs include: (i) modernizing the current case management system; (ii) increasing the number and the quality of the judicial support personnel so that judges and prosecutors spend less time on administrative tasks and focus on cases at hand; and (iii) streamlining civil and criminal procedural rules. Enhanced monitoring of judicial efficiency and proactive correction of problems would greatly help Turkey achieve its judicial reform goals. The introduction of mediation as an alternative dispute resolution mechanism and establishment of its institutional set-up will also be important in the long run in making the judicial system more efficient.

61. **Enactment of the revised code of civil procedures is important for reducing the duration of cases.** Under the current draft code, a new procedure for pre-examination of cases by judges is envisaged that will significantly reduce the delay in collection of evidence and scheduling of hearings. The new draft gives more powers to judges to speed up the court proceedings. Measures are envisaged to eliminate delays caused by bad faith parties. Elimination of the differentiation of rules between international and domestic arbitration is also sought. The enactment of this new civil procedural code will lead to significant efficiency gains for the judiciary.

62. **It would be crucial for Turkey to continue its successful judicial reform programs and deepen its efforts to increase the independence, efficiency, accountability of judiciary and the overall capacity to meet rising demands of economic growth.** As a result of the reforms carried out since 2002, the performance of Turkish courts has improved significantly. These improvements contribute to better service delivery, favorable business environment, and implementation of the EU legislation. At the same time, economic growth and expansion of market interactions will only bring added pressure on the courts. Deepening the existing judicial reform efforts can help Turkey stay ahead of these pressures, expanding the economy by allowing entrepreneurs to engage in contracts with confidence they will be enforced, to extend credit with confidence it will be repaid. By strengthening the independence of the judiciary, while building comprehensive training programs, increased human resources, incremental changes to the structure of the courts, emphasis on court management, and the development of alternative dispute resolution mechanisms, Turkey will be able to meet the best international standards for judicial efficiency and quality.
Comparative Civil Service Reforms—Issues of Relevance for Turkey

63. The draft Law on public personnel, which aims to overhaul the public personnel regime, is yet to be adopted and implemented. Turkey is pursuing several goals and challenges with regard to civil service reform through the draft public personnel law. Key priorities include: (i) a more efficient allocation of human resources to meet future staffing requirements—both in terms of numbers and skills composition; (ii) developing the potential and strengthening the motivation of civil servants; and, (iii) establishing incentives for good individual performance and addressing unequal salary scales across the civil service which often undermine staff motivation. A new draft Law on Public Personnel, which is under preparation, provides for a number of innovations, whose successful implementation would address many of the current weaknesses in the functioning of the civil service (also see World Bank, 2006 PER for a more detailed discussion).

64. In the past two decades, most OECD countries have introduced reforms to increase efficiency and productivity in their civil services, notably by adapting some management tools inspired from the private sector. The main trend has been a shift towards a results-oriented approach, with implications for budgetary planning, and with a growing focus on measuring organizational and staff performance. New approaches to human resources management (HRM) have been introduced, including in many cases separate arrangements for the senior civil service, with the aim of changing to a performance-oriented mentality. A growing trend is also observable towards reforms aimed at increasing staffing flexibility, notably in career-based civil service systems. In the past decade, several OECD countries with career systems have increased the number of posts open to external competition and decentralized human resource policies to line ministries. Another option tested for increasing staffing flexibility has been to limit the scope of the civil service to staff exercising core policy-making and regulatory functions, thereby divesting personnel engaged in service delivery from the legal civil servant status.
5. PROMOTING EMPLOYMENT AND MANAGING MIGRATION

65. Broad access to productive jobs is essential for achieving the objective of inclusive growth and help Turkey converge faster to average EU and OECD income levels. Labor market reform could address the issue of creating more and better jobs. This part of the study addresses selected issues pertaining to employment generation and labor markets in Turkey namely migration, youth employment, and the impact of labor taxes on employment.

66. Turkey faces a twin “jobs deficit” – low employment rates and high informality. In 2006, the employment picture has seen moderate improvement, with the unemployment rate at 9.9 percent, down from 10.3 percent in 2005. These gains notwithstanding, jobs remain a priority issue for Turkey, as the employment rate is 18.5 percentage points below the EU-27 average for 2006, while about one-half of Turkey’s employed labor force is “informal”.

67. International migration is also likely to be determined by employment prospects in the domestic labor market as well as the demographic trends. Comparison of employment prospects in the domestic labor market and in EU labor markets will be most relevant for young people since they are the most likely to move in search of better jobs. The large numbers of young men and women that will be entering the work force in coming years will undoubtedly add pressure in the labor market but they also present an opportunity for Turkey to reap a “demographic dividend” through their productive potential.

Managing Migration: Patterns and Prospects

68. Migration from Turkey has been stable in the past decade. The percentage of Turkish workers who are in developed countries is close to 6 percent of the total labor force. This is broadly comparable to the corresponding share from other comparison source countries (Figure 13). Furthermore, Turkish migration did not grow faster than the labor force between 1990 and 2000 despite economic crises and a low employment ratio. In view of the rapid increase in enrolment ratios in higher
education, from 13 to 23 percent over the past decade, creating high-quality jobs for the educated young people is particularly important—otherwise a “brain drain” could seriously impair Turkey’s long-term development prospects.

69. Understanding the determinants of migration patterns from Turkey is important in order to support a better-informed debate and appropriate policy design. Based on a “gravity model,” some key factors of international migration have been identified. Growing population of the source countries increases migration, but also higher age dependency ratios in destination countries act as “pull” factors for migrant workers. Relative economic conditions are important drivers for migration: If the source country grows at a rate that is 3 percent faster than the destination country, the migration level is expected to be 10 percent lower, confirming the importance of economic convergence (or the lack of it) as a driver of migration. Differences in economic stability of origin and destination countries, measured by inflation levels, appear to also affect international migration. Labor market performance also matters: the higher the labor participation in origin countries, the lower the migration while high labor force participation in destination countries encourages migration.

70. More specifically, if Turkey continues to grow rapidly and sustains moderate inflation, migration pressures would subside. If GDP per capita in Turkey were to double from USD 6,320 to USD 12,640, or from 18 to 36 percent of per capita GDP in Germany (the most important destination country for Turkish migrants), migration level would be predicted to decline by over 27 percent compared to its current levels. Moreover, if lower inflation in Turkey is sustained, migration levels to Germany would be expected to decline by about 24 percent, reflecting more stable economic conditions.

71. On the other hand, overall demographic trends suggest that for the attraction of migrating from Turkey to Germany (and, indeed, other aging EU countries) will increase. The population of Turkey is projected to reach 87 million in 2020, from the current level of 73 million, while the population of EU27 is projected to roughly remain constant. While population increases will play some role, the most important impact will come from differences in how the dependency ratios evolve in Turkey and EU countries. In 2020, the dependency ratios in Turkey and Germany are expected to be 0.47 and 0.53 respectively (down from 0.56 in Turkey and up from 0.47 in Germany in 2000), reflecting the increasing working-age population in Turkey and the rapid aging in Germany and most other EU countries (Figure 14). This decline in Turkey and the parallel increase in Germany will create significant upward pressure on the migration flows.
72. **On balance, two strong forces will be working against each other in influencing migration patterns.** On one hand, the recently favorable economic developments in Turkey, are subduing the “push” pressures for migration. Rapid economic growth in Southern European countries, such as Spain, Portugal and Greece, brought a similar decline in their emigration levels, and, eventually these countries became destinations for migrants. On the other hand, the relatively faster increasing population in Turkey and, especially, the changes in dependency ratios will add considerable pressures for out-migration to those EU countries that are aging quickly. Whether the “push” factors of migration will weaken over the next decade or so greatly depends on the conditions in the Turkish labor market. The level and quality of employment opportunities—especially for youth (discussed below)—and the regional disparities in labor markets, are highly relevant for migration patterns. Labor market reforms that impact these dimensions and create more and better quality jobs will certainly help ease migration pressures.

**Promoting Youth Employment**

73. **The rapidly growing youth population would be an opportunity for Turkey to reap a “demographic dividend” through their productive potential if labor market outcomes for young people could be improved.** In 2006, the employment rate for those aged 15-24 was 30.9 percent, well below the national employment rate of 45.9 percent which, in itself, is far lower than employment rates in the EU (Eurostat). But an additional concern is that another 40 percent in this age group are neither in the labor force nor in school. Labor market indicators are particularly poor for young women, especially with low educational attainment. Education is very highly correlated with labor force participation and employment among Turkish women.

74. **Education eventually pays off in terms of better employment outcomes but the transition from school to work is unusually long, especially for the well-educated.** Unemployment rates for the 20-24 year age group actually increase with education, reaching 32 per cent for those with tertiary education (Figure 15). Eventually, unemployment rates get lower for the better-educated compared to other groups, but this does not take place until young people are in their late 20s and 30s, thus potentially discouraging investment in post-secondary education.
75. **Improving employment outcomes for young people will require challenging reforms in education and in the labor market.** However, this will pay off in economic and social terms, as well as reducing pressures for out-migration. The difficulties experienced by young people in entering the labor market reflect deficiencies in the education system in terms of access, equity, quality, and relevance. The high unemployment rates for educated workers are likely to indicate a mismatch between the skills provided by their schooling and labor market needs. The restrictive labor market regulations and institutions also play a role, since they do not ensure broad access to jobs, especially good quality jobs.

76. **The Impact of Labor Taxes on Employment**

76. **One factor behind poor labor market performance if the fact that Turkey’s taxes on labor are among the highest in the OECD zone.** Combined employer-employee contributions to finance pensions and disability insurance, health insurance, unemployment benefits, and workers’ compensation represent 36.5-42 percent of gross wages. This tax wedge is especially high for low-wage workers with children, employment of which may be particularly sensitive to high non wage costs. In view of Turkey’s high tax wedge, which can be expected to reduce employment especially in the formal sector, the possibility of reducing payroll taxes has provoked considerable policy debate. The new government program (announced by the Prime Minister in August 2007) includes the reduction of taxes on employment as one of the policies to be pursued in 2008.

77. **Reducing payroll taxes is not a universal remedy for job creation and has to be part of a coordinated package of labor market and social security reforms.** More flexible labor market regulation, coupled with more effective social protection through retraining and active and passive labor market programs (protecting workers not jobs), are critical for creating more and better jobs as Turkey continues to open up to the global economy (see World Bank, 2006 Labor Market Study). However, to improve the effectiveness of reforms, it is important to understand what the employment gain would be if labor costs in the formal sector were decreased as a result of a reduction in the tax wedge. This obviously has important implications not only for the labor market but, also, for the fiscal position of the social security funds. Moreover, it has implications for the cost-effectiveness of various subsidy schemes of social security contributions to promote employment in less developed regions—actually covering as many as 49 of Turkey’s 81 provinces.

78. **The “pass through” of labor taxes on wages is significant, but is also strongly correlated with wage levels.** In the case of a mean-wage worker in manufacturing, it is estimated that a 1 percentage point reduction in labor taxes will reduce labor costs by 0.30 percent, with the remaining 0.70 percent passed through to the employee in increased wages. Assuming a mean employment elasticity rate of 0.50 implies that the employment gain will be 0.15 percent. A key finding, however, is that the pass through—and hence the potential incidence of labor tax cuts on employment—is strongly correlated with wage levels. Where wages are high, essentially the total effect of a tax reduction is further increases in wages, so that the employment gains are modest. But at lower wages the pass through declines as well and the impact of tax cuts on labor costs and employment becomes significant.
79. **A reduction in social security contributions would thus have a somewhat stronger impact on employment when it is targeted on low-wage workers than when it is instituted across the board.** The elasticity and pass-through calculations were used to calculate the employment effects of two tax reform scenarios: (i) an across-the-board reduction of 7 percentage points in employer social insurance contributions; and, (ii) a targeted reduction of the same magnitude for new hires under the age of 30. Because of the pass-through differences, the employment impact of the targeted cut is greater than the across-the-board cut (84,200 vs. 70,200 new jobs). Neither scenario leads to a major decrease in the overall unemployment rate—about three-tenths of a percentage point.

80. **To be fiscally sustainable, labor tax cuts would need to go in tandem with social security reforms.** In any event, in the scenarios studied the employment gains of a contribution cut would not be large enough to compensate for decreased social insurance revenues from the reduced rates. Not surprisingly, the targeted cuts would have a smaller negative impact on fund balances so that the “across the board” reduction would initially increase the pension fund deficit by 0.74 percent of GDP per year, compared to an increase of about 0.20 percent for the targeted cuts. This differential impact reflects the greater efficiency of selective as opposed to across-the-board tax reductions. However, to be fiscally neutral, any reform would need to include an increase in tax revenues from other sources.

81. **Existing regional employment incentives seem to have some impact on employment.** Three different laws currently provide subsidies to firms in less developed provinces—including for employer social security contributions; employee personal income taxes; electricity consumption; and land. Employers in the eligible provinces have qualified on the basis of meeting new job creation thresholds, either by opening new establishments or by expanding employment in existing ones. An empirical model has been used to estimate Social Security Institution (SSK) registered employment in a province as a function of whether the regional incentives program is in force, the time period, and provincial variables that cover province-specific effects. Estimates of the relative employment gains between January 2004 and April 2005 due to the incentives under Law 5084 range from 4.1 percent to 12.7 percent, with the mid-point at around 8.2 percent. However, the size of the calculated impacts should be interpreted as upper-bound estimates because the employment gains: (i) include both new jobs created as well as the formalization of previously informal jobs; (ii) do not capture any shift of existing jobs from non-subsidized to subsidized provinces; and, (iii) do not account for jobs that would have been created without the regional incentives program.

82. **However, subsidized job creation comes at a high cost that potentially undermines the rationale of the incentives.** What casts doubt on the effectiveness of regional employment incentives is that, according to the results of the econometric modeling, somewhere between 47 percent and 81 percent of the subsidized jobs under Law 5084 would have been created without the regional incentives program. As a result, the cost-effectiveness of the subsidies is less favorable when the net employment effect is considered. The estimated mid-range cost per job-month is YTL 441, which is 80 percent of the total labor cost of employing a minimum-wage worker. So while the regional subsidies do appear to have contributed to some net new job creation, these jobs were created at substantial cost.
The policy and institutional framework for regional development plays an important role in contributing to a more equal sharing of the benefits of high growth. By strengthening the policy framework and the institutional structure of regional development Turkey could address the issue of wide regional discrepancies.

Regional disparities in Turkey are large and persistent. Turkey suffers of large regional development disparities: these are significantly larger than in EU15 countries, and at the high end of disparities prevailing in new EU members (Figure 16). As in much of the EU, regional income disparities in Turkey have stayed more or less constant over the last few years (Figure 16 b). Regional disparities run largely along the east-west axis. “Advanced” regions (those with an average income per capita higher than the 75 percent of the national average) include Marmara, Aegean, Mediterranean and Central Anatolia, while the remaining three regions, Eastern Anatolia, Southeastern Anatolia and Black Sea, are classified as “lagging”.

This is a cause of concern for three reasons. First, disparities in regional economic development are reflected in disparities in household income, with relatively high concentrations of poverty in the East. Second, the absence of economic growth in the East could spur additional migration to the large cities of the West, contributing to urban congestion. Third, the absence of growth in the East may reflect a bias in the allocation of investment capital, suggesting that the East harbors unexploited investment opportunities which could benefit Turkey as a whole, thus a contributing factor to overall income convergence.
Factors Underlying Regional Disparities and the Challenge

86. Overall, there is no clear evidence of convergence in per capita income across regions in Turkey over 1980-2000. While disparities among individual provinces appear to have decreased, disparities between the lagging region as a whole and the advanced region as a whole have increased or remained constant. Absolute convergence is found only in the productivity of labor. Conditional convergence (which measures convergence after taking differences in initial conditions into account) is found in one study. The studies also find that regional inequality tends to increase when the national economy is growing rapidly.

87. Differences in labor productivity are the key determinants of regional disparities as they account for 88 percent of differences in per capita regional incomes. Differences in unit effort (average hours per employee) and activity rates follow, each with a contribution a little over 20 percent. Employment rates are actually higher in lagging regions, probably due to hidden unemployment in agriculture, and therefore contribute negatively to income disparities (-33 percent).

88. Variations in labor productivity reflect the predominance of low productivity agriculture in the East. The findings of a decomposition analysis are largely explained by wide differences in the economic structure of the lagging and advanced regions, i.e., the composition of output and employment. In the lagging region, agriculture accounts for almost 30 percent of GDP and 60 percent of employment. Even discounting a likely high hidden unemployment in agriculture, this represents a significant difference from the advanced regions, in which the figures are respectively 12 percent and 27 percent. Agriculture is at the same time the least productive source of employment in the lagging region. This is partly due to strong climatic disadvantages. More specifically, agricultural productivity in the East is about one third of the level prevailing in the West. The gap is somewhat less pronounced in services (39 percent), and industry (45 percent).

89. Raising the level of output per capita in lagging regions even half-way to the levels currently enjoyed by advanced regions, would be a momentous task. The scale of the task can be illustrated by analyzing the conditions under which the per capita GDP gap prevailing in 2000 could be cut in half by the year 2013 (the end year of the current national development plan); that is, per capita GDP in lagging regions be increased from 50 percent to 75 percent of per capita income in advanced regions. At the “baseline” employment rate (55 percent) in lagging regions, a 7 percent annual rate of productivity growth would be required to cut in half per capita income disparities by the end of the current national development plan, assuming the labor force remains in situ. This
is significantly higher than the average annual rate of productivity growth in Turkey as a whole over the period 1991-2003. Slower rates of productivity growth would need to be compensated by fairly large increases in rates of employment (Figure 17). For example, if productivity grows at 4 percent per year, the end-of-period employment rate would need to increase to 80 percent to reduce the gap by half.

**Options for Strengthening Regional Policies**

90. **A meaningful reduction of income disparities will probably require a significant change in the economic structure of lagging regions.** Bridging the existing productivity gaps between advanced and lagging regions will require a significant reduction in the employment and GDP shares of agriculture, and reallocation of resources to non-farm rural development activities in rural areas, and to industry and services in urban areas.

91. **Empirical analysis conducted in this study points to some key factors affecting long-term regional income disparities:**

- There is strong evidence that human capital matters for regional growth. The regions with higher schooling rates (i.e. quantity of human capital accumulation) tend to grow significantly faster than other regions.
- While the size of the public investment in a region does not impact its growth performance, its composition does. The results point to two findings, although they should be interpreted with caution: (i) public investment skewed towards social spending has a positive association with regional growth performance, while, (ii) public investment skewed towards the primary sector has a negative association with regional growth performance.
- Similarly, the role of incentives in generating regional growth is found to be insignificant—a finding consistent with the finding of limited cost-effectiveness of regional development incentives in generating new jobs discussed earlier as well as the international literature on state aid. The reasons might be the possible short-term duration of the impacts (firms may leave the lagging regions once the incentive expires), the absence of any broader impact on the regional economy (if benefiting firms operate as industrial enclaves) and the tendency of such firms to be highly capital intensive and therefore generate little employment.

92. **Large integrated infrastructure programs have also had limited results.** Starting with South East Anatolia Project (GAP) in the 1960s, during subsequent planning periods, several regional development plans were designed and (partly) implemented. Arguably regional plans have had the merit of focusing planning efforts on relatively large geographical areas, spanning far beyond the jurisdictions of individual provinces, and attempting to address their common development challenges. The original model has been constrained by a focus on a limited number of sectors and a fairly centralized governance structure. The gradual transformation of GAP into a multi-sector, dual-management (national and local) project signals a change in the underlying development model, which is confirmed by the more integrated approach followed by more recent plans (for example, Eastern Anatolia Project (DAP),
Eastern Black Sea Regional Development Plan (DOKAP)). The future viability of the regional plan model is open to question though, on account of the limited administrative capacity of local executing agencies, of the prevailing governance structure (which appears still fairly centralized), and of funding uncertainties.

93. **The Government is now experimenting with regional development agencies.** The Law on the Establishment, Co-ordination and Duties of DAs at NUTS II level (entered into force in February 2006) sanctions, for the first time in Turkish history, the institutionalization of a regional level of governance. In purely administrative terms, the rationale for the establishment of DAs is the creation of structures legally entitled to manage EU-cofinanced development programs spanning the jurisdictions of multiple provinces, thereby replacing -but only after a yet unspecified “transition process”-the temporary system used at present, which is based on Service Unions. As of end-2007, only two DAs were actually established, and the secondary legislation required for their full functioning is still in the process of being formulated. In May 2007, the Council of State issued an injunction on the implementation of the regulation on the working principles of DAs and also referred the case to the Constitutional Court on the basis that some articles of the Law no.5449 are unconstitutional. While the Court’s decision, rendered in November 2007, annulled certain provisions affecting the appointment of staff and tax exemptions, it left the remainder of the law intact. The authorities are now free to establish new DAs and permit the existing agencies to fully operate.

94. **The Government is also considering a “growth poles” strategy.** Within the 9th National Development Plan, the Government has indicated its intention to focus development efforts, within less developed regions, on “centres with high growth potential” – an approach unofficially labelled as the “growth poles strategy.” The rationale is to support the development of urban areas that could divert migration from eastern rural areas, away from the conventional destinations in Western Turkey (in particular Istanbul and Izmir). Official documents indicate that the strategy will focus on 12 poles, accounting for some 20 percent of total 2001 population, and with per capita income of 66 percent of the national average in 2001.

95. **The international literature suggests that, in a market economy such as Turkey’s, the location of labor and capital is largely determined by private economic forces.** Therefore, it is important to recognize market forces as the primary determinant of the location of economic activity in government’s efforts to influence the location of economic activity. The literature—and Turkey’s own experience—also suggests that some of the traditional instruments used by governments to influence the location of economic growth are not particularly effective. Firm-specific investment incentives have a mixed track record. The evidence suggests that such incentives can affect investors’ location decisions, if the incentives are large enough. But they do not guarantee that the resulting investments will have broader multiplier effects on the regional economy or that the investors will remain once the incentives expire.

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7 Service unions, established by the Local Authority Unions Law (amended in 2005) consist of an association of provincial and municipal administrations for the joint provision of services over multiple jurisdictions; hence they can be used as management structures for the implementation of regional development programs.
96. There are nevertheless key roles for the public sector in regional development.

- The first is the provision of education. Education, by enhancing skills, productivity, and adaptability, is conducive to long-term economic growth. Other things being equal, this suggests that investment in education is an effective means of stimulating growth in poorer regions. It should be recognized that education can also increase the propensity of people to move. Nevertheless, the development of a critical mass of educated workers in the larger urban areas of the East could improve this area’s attractiveness to investors.

- Governments also play a key role in the provision of infrastructure. Building macro-level infrastructure—power and telecommunications lines, highways, railroads, port and airport facilities—in depressed regions is a time-honored approach to regional development. Although much of the existing literature and the analysis carried out under this CEM do not provide any evidence that physical infrastructure stimulates regional growth, some recent studies argue that under certain conditions public infrastructure investments contribute significantly to productivity growth. The right sort of infrastructure investment can provide a necessary if not sufficient condition for economic growth. What is important is to identify such investments that would exhibit comparatively high economic rates of return.

- Another key role for government is to coordinate and facilitate the development proposals of private investor and public entities. The design and implementation of successful policies to accompany the transformation of lagging regions cuts across sectors and levels of government. The establishment of partnerships among public and private stakeholders alike is needed, to orient and govern this process. This process needs to aim at bridging the gap between knowledge on the constraints to, and opportunities for, regional development (typically more available locally); and the funds required to finance public investments (often provided centrally).

97. Under the existing institutional structure of the Turkish public sector, it would be difficult to take charge of the third role above. Turkish public sector is highly centralized, with most spending decisions taken by ministries headquartered in Ankara. Local governments have relatively few functional responsibilities and limited bargaining power. At the same time, national sectoral ministries tend to operate in sectoral stovepipes, without considering the wider economic development implications of their actions or possible synergies with other sectors.

98. The current planning system offers a place to start. Turkey has a system of multi-level development planning spanning different levels of government and aimed at different objectives. The 9th National Development Plan stipulates that an overarching regional development strategy will be prepared at the national level. While SPO has primary responsibility for regional plans, there are a number of other planning instruments, at other territorial levels, that affect regional development outcomes. At lower levels of jurisdictions, Provincial Development and Provincial Territorial Plans (and more recently, strategic planning for Special Provincial Administrations and larger Municipalities) are intended to guide the selection of projects at a more micro level.

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99. The proposed DAs could also provide a venue and mechanism for inter-sectoral and central-local coordination. Such a role, for example, is played by regional DAs in England. The private sector (represented both in the DAs’ Development Council and Executive Board) could provide an important input through its knowledge of where the market development opportunities are, what are the constraints to seizing them, and what are the priority public investments that would help removing those constraints. However, how large a role DAs should play in regional development is still an open question. Current legislation limits the authority of the DAs. The preparation of regional development strategies are envisaged to be led by SPO. The financial power of DAs is also limited. With an estimated average annual budget of some €19 million per agency, DAs will have only a small financial role in regional development. The effectiveness of DAs will instead crucially depend on the active participation of local stakeholders and the technical/administrative capacity of their staff. These assets may be in short supply in some of the regions with limited traditions of public participatory processes and insufficient experience in decentralized management of development programs.
Overview

100. Improving environmental quality and protecting the environment are major challenges facing a rapidly growing country such as Turkey irrespective of its status with respect to EU accession. As a modern industrializing country, Turkey faces new and growing challenges to improve its water and air quality, to reduce the damages to its valuable natural land and coastal resources and to leave future generations of Turks with a legacy of a clean environment. These objectives have been looked at recently in the context of EU membership, but they are relevant irrespective of whether Turkey gains accession to the EU. In the present circumstances, it is advised that focus will be on prioritizing measures that provide the greatest benefits to the Turkish people that recognize the strong fiscal constraints under which the public sector is operating and that are conscious of the limitations and potentials of the private sector to invest in and pay for environmental improvements.

101. Upgrading environmental quality to EU norms will provide substantial benefits to the Turkish society but will also entail significant costs. Turkey will gain from such upgrading in terms of reduced occurrence of illnesses, a better living environment, more recreational opportunities and protection of its valuable biodiversity. The cost of this, however, will depend on the policies that are pursued. Countering the effects of rapid urbanization and industrialization on the environment will require both significant investment outlays and reforms in governance. One estimate of the potential costs of such actions was provided in the government’s program to meet the upgrading that would be required under the conditions of the Environmental Acquis. These costs were estimated at €59 billion over the period 2007 to 2023. It is important to note, however, that the actual costs can be lower than this figure. With appropriate policies, the costs of upgrading environmental quality in Turkey to EU or similar levels can be reduced considerably. Given the magnitude of the figure, it will be critical to develop a program that is cost effective and that sequences the investments in an affordable way, taking into account the available resources and public willingness to pay for the improvements (which will also grow as the country becomes richer).

Table 1: Estimated Benefits in Turkey of Compliance with the Environmental Directives

<table>
<thead>
<tr>
<th>Directives Relating to</th>
<th>Present Value of Costs</th>
<th>Present Value of Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water Supply and Waste Water</td>
<td>23,000 – 32,000</td>
<td>9,600 - 37,000</td>
</tr>
<tr>
<td>Air and Industrial Pollution</td>
<td>9,999</td>
<td>&gt;23,310</td>
</tr>
<tr>
<td>Waste</td>
<td>6,581</td>
<td>890-19,980</td>
</tr>
</tbody>
</table>

Sources: UCES, World Bank, ECOTEC et al, 2001 adjusted for inflation for the benefits. Both benefits and costs are discounted at 4 percent in real terms.

10 The government’s cost figures are undiscounted, so no advantage arises from delaying investments. It would be better to present the costs with a real discount rate.
102. **In determining priorities a useful point of departure is to look at the relative benefits and costs in different environmental areas.** As part of the assessment of the value of the EU program, an assessment was made of the benefits of attaining EU standards in different areas (ECOTEC et al., 2001). The results of the estimation for Turkey are given in Table 1, where the benefits are compared to the cost figures as given in the Government of Turkey’s UCES study. The exercise is only possible for a few areas, namely air, drinking water, wastewater and solid waste.

103. **While the data on the benefits are subject to considerable uncertainties, the table nevertheless reveals some useful findings.** First, investments in water supply and reduction in air pollution are probably justified in terms of net benefits (particularly, as will be shown below, the cost estimates are likely to be on the high side). Second, investments in wastewater are very unlikely to be justifiable given the measurable benefits. Of course this does not mean that all individual projects for wastewater treatment have negative net benefits; some almost certainly will be of high priority. But it does mean that as a program, the net benefits are likely to be negative. Third, in the case of solid waste, an overly ambitious program, the economic rationale for undertaking investments will depend on the specifics of each project.¹¹

**State of Water, Wastewater and Solid Waste Management**

104. **Access to drinking water has greatly improved but reaching acceptable water quality standards continues to be a challenge.** The Government intends to improve drinking water quality and monitoring thereof in line with the EU Drinking Water Directive. Given that in 2004, only about 45 percent of the water supplied for drinking and utilization purposes was treated, this will be a stretch. In prioritizing Central Government contributions to the water sector, the Government could take into account the fact that drinking water infrastructure may be less difficult to fund through user financing than wastewater infrastructure.

105. **In wastewater treatment, the gap between EU level treatment and current conditions in Turkey is large but the benefits of large investment efforts are not so clear.** Thus a phased approach is required, giving higher priority to settlements with larger environmental impact. In Turkey, the overall rate of connection to sewer systems in municipalities was 87 percent in 2004 (an increase from 78 percent in 2002, still low relative to that found in other European countries). Wastewater from only 44 percent of all municipal households is treated at secondary or advanced level. In view of the high costs and relatively low average benefits of wastewater treatment (however with high benefits in some cases), Turkey is advised to develop a careful program with high priority given to those locations where the benefits are significant. This will be the case in larger settlements (unit costs fall due to economies of scale) and in coastal areas where tourism is an important industry.

106. **The key problem with household waste is not collection but disposal thereafter while collection and disposal of hazardous waste is major problem.** Only an estimated 29 percent of the municipality-collected waste is disposed of on sanitary landfills. Only a fraction of hazardous waste is managed adequately.

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¹¹ Benefits from the waste directives arise largely from the Landfill Directive, which reduces methane emissions as well as amounts of waste that has to be disposed. The benefit range is so wide because the benefits depend on how much recycling takes place and how much incineration is carried out. The higher the recycling and the fewer amounts incinerated the greater the benefits.
and often illegally disposed of on land or water bodies. Contaminated sites constitute a significant problem for public health, the environment, and economic development. Municipal and industrial waste dump sites and illegal waste dump sites make up about 80 percent of contaminated sites. Along with enforcement measures to prevent the generation of new contaminated sites, the Government is advised to establish an inventory and a risk-based strategy for remediating the existing sites.

107. **Significant progress in terms of harmonization with the EU acquis has been achieved in solid waste management but implementation remains an issue.** Several regulations—including on Solid Waste Control, Medical Waste Control, Hazardous Waste Control, and Solid Pollution Control—were recently revised to be in harmony with the EU acquis. The effectiveness of implementation of these regulations is hampered by the limitations in number and capacity of waste management facilities. European experience showed that stricter enforcement and cost of incineration led to adoption of cleaner technologies, which in turn, rendered some of the treatment facilities financially unviable. As a result, a phased approach taking account of other changes in environmental regulations and demand for services is recommended.

108. **Improvements to the institutional framework for water and wastewater management are also recommended.** At present, multiple institutions have responsibilities in the water supply and waste management sector. Separate institutional mandates for the management of water quality and water quantity with little coordination are no longer feasible in the face of increasing and conflicting demands for water for municipal, industrial and agricultural purposes and of increased pollution sources. International experience suggests it is more effective to have one central authority that has planning, licensing, regulating functions in water resource management, which is also in charge of collecting, processing, and analyzing data. The establishment of such an authority – a central Integrated Water Resource Management (Department – is recommended. In considering institutional arrangements for river basin level management the benefits and costs of new bureaucratic structures should be carefully examined.

**Cost and Financing of Water, Wastewater and Solid Waste Programs**

109. **The current system of municipal financing is one where municipalities heavily rely on central government subsidies, but the government is keen to reform the sector.** A substantial share of the sizeable investments in water and wastewater services has been covered by subsidies in the form of central budget transfers to DSI and Iller Bank, or by Treasury Guarantees and on-lending to municipalities. These investments were often highly inefficient, costing more than double compared to international norms. A three-pillar reform agenda may be considered to reduce municipalities’ dependence on Central Government subsidies:

- Improving governance;
- Improving the efficiency and financing schemes of investments through broader application of user charges; and
- Raising operational efficiency.

Improving governance at the municipal and central government levels. Municipalities and their utilities have long depended on the Central Government to subsidize sector investment and operations and on consumers to pay high tariffs to service providers with little accountability. Steps in three directions can help change this model of governance.

- Establishing municipalities’ accountability for service provision and placing their performance under monitoring of service quality and of the tariffs charged. Performance audits by an appropriate agency would also be helpful.
- Discontinuing the present wide-spread use of water supply, wastewater and waste revenues to fund other municipal activities to raise accountability of municipal councils, promote more efficient use of resources and assure sound finances of the sector;
- Municipalities may explore a greater use of public-private partnerships to operate the publicly owned systems, while small municipalities would create regional associations to achieve economies of scale and ensuring the sustainability of operations. In waste management, regional landfills are often a cost effective solution.

Turkey’s increased coverage of water supply and wastewater collection can be achieved at lower cost if investment efficiency is improved. Key factors are appropriate design parameters and dependable central government funding that results in timely construction periods and avoids high risk premiums charged by contractors and equipment suppliers. The recent establishment at İller Bank of a project appraisal unit is encouraging. This unit will carry out financial analyses and examine borrowing municipalities’ ability to service debt. To further raise investment efficiency it is proposed to provide all financing from State Hydraulic Works (DSİ) and İller Bank on the basis of loans with positive real interest rates to redress incentives to invest only in those works that can justify the payment of debt service.

Raising tariffs alone would not resolve municipalities’ financial difficulties. Water tariffs vary significantly among municipalities and in some cases they are relatively high. Hence a decision on whether or not to raise tariffs to help finance environmental investments in infrastructure would best be based on each municipality’s specific conditions. Key considerations are affordability and the possibility that higher tariffs could lead to lower collection rates or, in case of waste, to a diversion to illegal out-of-sight wild dumps.

Increasing operating efficiency and sustainability. Operating efficiency is particularly low in the water supply sector where non-revenue water (NRW, formerly called “unaccounted-for water) (due to leakages or lack of metering) averages 50 percent of water production. Reducing unaccounted water would ensure that municipalities will have an incentive to invest more in maintenance and demand management which will lengthen the useful life of existing assets. Yard-stick regulation would help—recording connection rates for water supply and wastewater services, continuity and safety of services, NRW, and the share of wastewater that is treated. Assuming that the level of NRW could be reduced from the present average of 50 percent to 30 percent, the sector’s internal cash generation from operations could grow from the present annual level of USD 750 million to USD 1,350 million.
New models of public-private partnership (PPP) and appropriate design of subsidy schemes would help raise operating efficiency. Examples include joint public-private ownership companies and schemes where the public sector finances investments operated by the private sector. In smaller municipalities and in low income peri-urban areas where effective connection rates must go up, subsidies may be justified. But subsidy payments to service providers would be better made against proof of services rendered (Output Based Aid or OBA)—such as additional connections made, water supplied, or wastewater treated—rather than to the inputs (such as physical investment costs), which is now the case in Turkey. The replicability of OBA-model for small-scale private operators in Turkey depends on the central government’s ability to provide the OBA subsidies in case the poorest municipalities cannot pay tariffs sufficient to cover the OBA-entrepreneur’s total costs.

Industrial Pollution Control

The main industrial pollution issues are in line with the focus of the EU directives. The overall costs of aligning with these directives are high and will cause difficulties for some sections of the Turkish industry. Currently, manufacturing sector contributes significantly to environmental pollution. The Government has already implemented two projects in textiles and petrochemicals to pilot under the Integrated Pollution Prevention and Control directive. However, more generally lack of sufficient data and knowledge on the requirements as well as financial constraints constitute limitations for implementation. It is recommended that the Government work closely with the industrial sector associations to develop industrial sector plans for meeting the requirements of these directives. It would be most advantageous if these plans aimed not only at estimating costs, but also at identifying barriers that each industrial sector faces in meeting the requirements, and at the policy measures to help them overcome such barriers. Furthermore, it needs to be noted that the exceptionally large share of SMEs in Turkey makes it even harder to handle difficulties in improving industrial performance to meet directives, such as lack of awareness/knowledge of the environmental legislation and tools to meet the requirements, lack of competence etc.

As in the EU, in Turkey the thrust of industrial pollution control policy has been command and control, but it could be significantly strengthened and complemented with other instruments. A firm legislative basis and an institutional structure to monitor and enforce compliance is the basis of any industrial pollution control or prevention strategy. While command and control measures remain the mainstay of environmental regulation in all advanced industrialized countries, an increasing role is being given to market based or economic instruments. These take the form of charges and fees against amounts emitted, or permit that polluters must hold but that they can buy or sell, depending on how efficient they are at reducing emissions. Turkey also would be advised to move further to a mixed system of regulation, in which economic instruments and standards work together, along with other factors, such as education, awareness raising and moral suasion. With regards to economic instruments, Turkey’s experience in applying these to environmental policy making has been very limited and the MEF’s capacity to design and implement them is thin. As a favorable step, the 2006 Law provides for increased use of economic instruments. However, the government could increase its capacity to develop such instruments.
117. As Turkey proceeds with the privatization of a large number of state-owned enterprises, it is advised to do so in a manner that makes the environmental liabilities fully transparent. Applying international best practice in the privatization of state-owned enterprises holds the promise of both economic and environmental benefits for Turkey. Key elements include:

- Making environmental due diligence (audits) an integral part in the privatization of all high and medium risk industrial enterprises.
- Assigning environmental liabilities, with guidelines for defining the extent of remediation activities, preferably using a risk assessment approach,
- Making phased compliance and remediation plans an integral part of privatization agreements and developing guidelines for their monitoring and enforcement.
- Involving MEF in the privatization process to provide specialized technical input and oversight.

Nature Protection

118. Because of the importance of Turkey’s biodiversity, improving nature protection will prove particularly challenging, despite advances made in recent years. Turkey is one of the most biologically diverse countries in Europe. It has already taken the first steps to develop and introduce principles of nature conservation, which are consistent with emerging global best practices. Also some progress has been made in aligning national legislation with the *acquis* on nature protection. However, there are still significant gaps in transposition, implementation and enforcement. Specifically, only around 1.6 percent of Turkey’s land area is formally protected under World Conservation Union protected area categories and many of these areas lack comprehensive management plans or the institutional capacity for management. Furthermore, of MEF’s staff of more than 4,500, fewer than 2 percent have any formal training in biology, botany, or ecology. Yet these skills are essential to understand how complex ecosystems operate so they can be better managed. These skills also need to be complemented by skills in economics, the social sciences, archeology, and participatory planning, to best capture the potential of protected areas in the planning and management process. Coordination among institutions involved in nature protection could also be improved.

119. Further programs to protect Turkey’s biodiversity are advised to be structured around the implementation of the EU habitats and birds directives. These two directives are highly relevant to protecting Turkey’s biodiversity and are advised to be implemented irrespective of its EU obligations. Turkey will have three significant challenges resulting from the implementation of these two directives. Actions recommended include:

- Substantially increase the area with formally protected status;
- Identify critical natural habitats which fall outside of formally protected areas, and put in place the incentives and management structures for non-state management of these sites, using tools such as the CAP and its agri-environment programs;
- Fully incorporate nature protection in other sectoral policies and legislation; and
- Significantly increase MEF institutional capacity and skills needed to plan and manage protected areas.
Environmental Governance

120. **Unlike Turkey, most if not all EU member states have developed organizational structures to achieve separation of environment policy from the regulatory functions.** In Turkey environmental policy functions are carried out at the central level, led by the MEF. Regulatory responsibilities partly overlap, as they are shared by Central MEF, provincial governorates, which house MEF’s provincial directorates (PDEFs), and municipalities. The benefit of separating policy and regulatory functions is that it helps manage conflicts of interest and allows decentralization of regulatory functions where possible. One of the common solutions in other EU countries has been to establish an environment protection agency (EPA) to coordinate environment regulatory functions and to report to the European Environment Agency in a coordinated manner. It is encouraging that the Government is considering establishing an EPA as part of its efforts to improve environmental management.

121. **While some progress has been noted in recent years, key shortcomings of environmental permitting practices remain.** Permits are still issued for emissions into individual environmental media, such as air and water, rather than in an integrated manner, especially for large enterprises that will be subject to the EU Integrated Pollution Prevention and Control (IPPC) Directive. Integrated permits have the key advantage of preventing cross-media transformation of pollution. Turkey has initiated the process of introducing IPPC permits, but there is still a long way to go in terms of capacity building and legislation development. In addition, regulatory flaws (coupled with weaknesses in enforcement) have resulted in some polluting enterprises, such as thermal power plants, operating without permit and emitting pollutants at levels that constitute significant health hazards.

122. **SMEs face numerous and sometimes overlapping permitting requirements.** MEF has nevertheless announced plans to introduce a one-stop procedure for all environment permits for SMEs. It may also consider developing fully standardized permits or even eliminating permit requirements for enterprises that are not heavy polluters and have uniform operations.

123. **Environmental inspection is one of the key weaknesses in Turkey’s environmental management system.** In certain areas, there is lack of clarity as to which institution, MEF, PDEF or metropolitan municipality, is in charge of inspection. Experience shows that inspection, like other regulatory functions, is best delegated to the lowest administrative level that is closest to enterprises to be inspected. Regarding capacity, increasing the number of environmental inspectors, and providing training in integrated permitting and inspection would be very advisable. Finally, coordination and data flow between Central MEF and PDEFs could be improved. MEF intends to establish a centralized database with permitting and compliance information so as to be able to gauge trends and aid inspection planning.

124. **Enforcement is another weak link in the regulatory system that the Government intends to address.** Enforcement authority is mainly held by Central MEF and Governorates. Better enforcement will involve the implementation of the tougher sanctions for non-compliance introduced by the Amended Law on Environment. This necessitates not only an improved staff capacity (staff numbers and skills) but also political
will. The latter in turn depends on popular demands for better cleaner environment. This demand will continue to grow as the economy continues to grow and as the public raises its awareness about the link between the environmental pollution and the public health issues. For effective enforcement, it is crucial that environmental decision making is transparent, information is shared with the public and public participation is encouraged.
8. AN INTEGRATED FOOD SAFETY POLICY TO IMPROVE COMPETITIVENESS

125. Lack of strong legal and institutional framework in food safety standards has implications on both Turkey’s competitiveness and growth, and living environment. Health hazards related to unsafe food cause high economic costs, because of the income foregone due to the limited competitiveness of the food products on the national and international food markets, diseases and deaths, and costs of medical treatment. Food safety has become a stand-alone policy field in all countries seeking enhanced international (particularly European) trade integration.

126. The food safety status in Turkey is unfavorable and the public sector has a key role in upgrading the standards. The unsatisfactory food safety seems basically related to hygiene practices in the food chain but also in households. Efforts to improve food safety are advised to be based on a good analysis of incidence of food borne diseases, analysis of their causes, and targeted measures to reduce hazards. Creating awareness, education, training, and preventive measures throughout the supply chains will most likely be the most important elements of an improved foods safety policy. While food safety improvements first and foremost require investments into upgrading food supply chain facilities, potential investment support programs and the enforcement of standards and requirements are among the most important incentives to be provided by the public sector.

127. The short- to medium-term compliance costs for producers and processors are high, but the medium- to long-term costs of non-compliance might be higher. Bridging the food safety regulatory gap is crucial for enhancing competitiveness and hence for supporting growth and rural employment in the longer run in three ways: by counterbalancing a potential erosion of domestic market shares, by helping to offset a potential future decline of market support to producers, and by boosting competitive advantages through addressing limiting factors. Furthermore, an EU approximation perspective further increases the importance of food safety on the domestic policy agenda.

128. Supporting the food sector’s adaptation towards better coping with competitive pressures will require mobilization of significant resources. Accession to the EU will give the Turkish food processors the opportunity to supply a Single Market of over 600 million consumers. This will generate an increase in demand that holds the promise of significant growth for the Turkish agricultural and food sectors (World Bank, 2006 CEM). However, benefits will not unfold fully unless competitive bottlenecks are addressed in advance:

- The agri-food sector is dominated by (semi-)subsistence farms and by small and medium-sized processors who face technology and capacity utilization problems.
- Cooperation between the agricultural sector and the food industry remains weak, which is detrimental to the improvement of food safety across the food chain.
• The food-processing establishments are largely unprepared to meet the EU hygiene and public health standards.

129. **The assessment of related funding needs, however, requires a more detailed evaluation of costs associated with a national food safety improvement program.** A high priority is given to the improvement of the capacity, processes, and funding mechanisms in the control and inspection; capacity upgrades and accreditation in the laboratory system; and to the establishment of incentives for upgrading of the private sector performance in handling food safety and quality.

130. **Consolidation of Turkey’s multifaceted structure in overseeing and implementing food safety would help to improve effectiveness.** Ministry of Agriculture and Rural Affairs (MARA) is the main decision maker in the food safety, veterinary, and phytosanitary matters, but other institutions, such as the Ministry of Health and the MEF also have roles. In addition to these institutions, part of the legal enforcement is the responsibility of the municipalities under the Ministry of Interior. Sometimes coordination difficulties appear within MARA between general directorates as well as between central and provincial units. In a medium- to longer-term perspective, the establishment of an independent food safety agency could represent the ideal approach to streamline the present inter-institutional intricacies. For coordination purposes, Turkey may consider the following best practice in the EU Member States so as to enable “from farm to fork” coordination on food safety matters. In a short- to medium-term perspective, on the other hand, continued reform within MARA and better coordination between its central and local bodies is recommended to enhance the effectiveness of its food safety policy. Particular emphasis should be given to the modalities of separating the functional responsibilities for risk assessment, communication and management and policy making, implementation and evaluation. A planned restructuring of MARA, as part of the public administration reform process, envisages shaping the division of responsibilities between central and provincial units, although the exact timing is not set.

131. **Capacity improvements are recommended both in (i) human resources and (ii) laboratory infrastructure.** Strengthening of human capacities in the domestic control and inspection administration is crucial for improving food safety policy outcomes. The EC judges that current staffing and financial resources do not adequately cover the high number of food enterprises (around 40,000) and farms (over 3 million). Given the high degree of informality in the Turkish food sector, well trained and well equipped personnel are highly needed. Equally important is the further development of laboratory infrastructure and their equipment with adequate analytical tools and know-how. The currently available number of laboratories is relatively small given the size of Turkey’s territory and its agro-food sector. In addition, an improved definition of a mechanism providing adequate financial resources for official controls (facilitating imposing most inspection fees on private operators) is recommended.

132. **Turkey faces a pronounced challenge coming from the illegal movement of foods across its borders.** The involvement of a high number of agencies impedes on the required legislative alignment in import measures with practices applied and expected by Turkey’s European trading partners. The institutional structure for border controls is being reinforced but further extension efforts may still be needed. The physical conditions
at Turkish customs are generally not appropriate for the entry of agricultural and food products. The customs entry ports for perishable agricultural products, food and fishery products are recommended to be redesigned and their infrastructure reinforced. The problem is being addressed through the recent construction of Border Inspection Posts (BIPs), benefiting from EU support. In addition, the introduction of the Hazard Analysis and Critical Control Points (HACCP) by the private sector complements official controls.

133. **Even if private operators take over certain control or certification functions, the public sector would be advised to ensure strong monitoring and enforcement capacities.** European best practice shows that specific tasks pertaining to certification or official controls are transferred to private bodies. Delegation is conditional upon the latter operating in accordance with clearly established standards and disposing of adequate expertise, equipment and infrastructure. In such event, the public sector is advised to preserve and exert core functions for the control system to function adequately. It could set the rules and procedures for accrediting private bodies (for example, laboratories). It could organize audits and inspections of these control or certification bodies. Finally, it could take action against processors, traders or farmers if delegated control bodies report non-compliance. All these public actions require adequate resources to be developed.
On March 8, 2008, TURKSTAT introduced a fourth revision to Turkey’s GDP series and updated the base year to 1998 from 1987. TURKSTAT has been compiling national accounts data since 1929. GDP using the production and expenditure approaches has been estimated both in nominal and real terms based on the concepts of the 1968 System of National Accounts (SNA) since 1972. The data have been published at a quarterly frequency since 1987. The national income accounts data from 1923 onwards were revised based on data in 1948, 1968 and 1987.

The main reason for the latest revision was to reflect structural changes in the economy since 1987 in national accounts statistics. Another reason was to harmonize Turkey’s GDP estimates with the European System of Accounts (ESA 95). This work was initiated in 2004 and completed in March, 2008. TURKSTAT plans to complete full alignment with the ESA-95 by 2011.

With this revision, the authorities aimed at (a) improving the measurement of Turkey’s economic activities; (b) enhancing international comparability of Turkey’s statistics; and (c) meeting data requirements of international institutions.

The new series embody improvements in both methodology – such as introduction of the benchmarking system, changes in the measurement of financial intermediation services, introduction of chain index method – and coverage – such as inclusion of some additional sectors: leasing, factoring, private pension funds and non-
profit financial intermediation, to name a few. The historical revision is also due to improvements in data sources and statistical techniques. This revision has brought significant changes to GDP series both in real and nominal terms for the last nine years, as well as for the first three quarters of 2007 (Table A.1). The revised series maintain the trend of real GDP growth but adjust nominal GDP levels upwards by about 32 percent on average.

5. The recent revision to national income data has resulted in significant changes in Turkey’s key macroeconomic indicators – although their trends have remained broadly unchanged (Table A.2). For instance, the revised GDP data also show that the CAD-to-GDP ratio increased substantially, while the public debt-to-GDP ratio was on a sharply declining path in the period 2002-2006. Nevertheless, with the revision, shares of expenditure components in GDP have changed considerably. To illustrate, the revised data show an increase in the domestic savings-to-GDP ratio in 2006 – compared to a 1.5 percentage point of GDP decline implied by the old series. A similar difference can also be observed in the gross investment-to-GDP ratio in 2006.

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<th>Table A.2: Key Economic Indicators of Turkey</th>
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<td>Real GDP growth rate</td>
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<td>Gross investment (%GDP)</td>
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<td>Foreign direct investment</td>
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Source: TURKSTAT, Turkish Treasury, CBRT, Staff calculations.

6. Data changes associated with the recent GDP revision have not been reflected in this CEM since the revision was announced after the report had been completed. As a result, revision of the analyses would have delayed the dissemination of the report considerably. Furthermore, key findings and policy recommendations presented in the report are unlikely to have changed as a result of revision. This is due to the fact that analyses in the report are not based on the levels of key variables – but rather on their trends, which have remained broadly unchanged as discussed above.

7. The GDP revision will be reflected in future World Bank documents on Turkey.