



# Comments on “Turkey: Country Economic Memorandum”

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# Introduction

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- The report emphasizes among others three issues that are considered to be of prime importance: (i) income convergence, (ii) labor market reform, and (iii) sustainability of macroeconomic policies.



# Introduction

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- First, accelerated income convergence is essential for enhancing the prospects for Turkey's eventual EU membership.
- The report emphasizes that as of 2004 per capita income in Turkey equaled 29.1 percent of EU25s per capita income level.
- Furthermore, per capita income in the richest provinces in Turkey were 6.9 times higher than in the poorest provinces.
- Both figures need improvement for enhancing the prospects for Turkey's eventual EU membership.



# Introduction

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- Second, the employment rate in Turkey is around 43.5 percent. This rate is very low by international standards. Comparable levels in the EU are around 63 percent. EU aims to increase it to 70 percent by 2010.
- A major challenge facing Turkey is to increase the employment rate.
- In the context of free mobility of labor, the EU member countries will be more at ease with Turkey's application if it is creating jobs for its citizens and does not have a large pool of unemployed workers.



# Introduction

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- Third, although actions to stabilize the economy through IMF programs since 2001 proved successful, it is still too early to determine to what extent the rebound in economic activity reflects a transition to sustainable growth. The main problems concern the sustainability in fiscal policy and the sustainability of the current account.



# Introduction

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- Thus, Turkey over the coming years has to continue to implement the current sound macroeconomic policies, and it also has to broaden the scope of structural reforms in a number of priority areas including labor markets, public sector governance, and commercial judiciary. In addition it needs to support productivity enhancing and technology creating activities, and competition in product and factor markets particularly in services and network industries.



# Income Convergence

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- To study issues related with income convergence with the EU countries consider the identity defining per capita income.

$$\frac{GDP}{population} = \frac{GDP}{employment} \times \frac{employment}{working\ age\ population} \times \frac{working\ age\ population}{population}$$



# Share of Population in the Working Age to Total Population

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- Note that the time path of the ratio of working age population to overall population over time is largely determined by demographic factors that presumably move slowly.
- The share of population in the working age in total population is about 70.7 percent by 2004. It is expected to change over time but only marginally.



# Employment Rate

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- Employment rate depends among others on gender, location (rural and urban), education, and age. But most important variables affecting the employment rate are output levels and labor market flexibility. Increases in output and labor market flexibility increases the employment rate in the economy.



# Employment Rate

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- A major characteristic of the Turkish labor market is its extreme flexibility. The labor market is flexible mainly because of the country's formidable informal sector, whose wage-setting mechanism is quite different from that of the formal sector.
- The informal sector is largely free from most types of labor regulations, and it does not pay most taxes and related charges. Because wages in the informal sector are determined by demand and supply conditions, the informal sector itself is flexible.



# Employment Rate

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- By contrast, the formal sector observes labor regulations, and it pays all taxes and related charges such as social security contributions and payments to various funds. Thus this sector is not as flexible as the informal sector.



# Employment Rate

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- It should be emphasized that the current system of formal and informal sectors is unsustainable.
- It leads to complaints by firms in the formal sector. It does and will also lead to complaints from EU firms in the future due to unfair competition practices by Turkish firms in the informal sector.
- Since foreign owned firms comply strictly with the formal regulatory and tax rules, possibly more completely than most domestic firms, Turkey needs to eliminate unfair competition from the informal economy, if it wants to increase FDI inflows.
- Finally, lax enforcement of rules may lead the economic units to believe that they can avoid the rule of law.



# Employment Rate

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- To increase the employment opportunities over time, Turkey has to preserve the flexibility of the labor market and achieve a relatively high but sustainable growth rate of GDP over the next decades.
- Turkey can no longer sustain the flexibility of the labor market through the lax enforcement of laws on taxation and social security, because of the above mentioned considerations.



# Employment Rate

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- The report emphasizes that labor market flexibility can be increased in the formal sector by decreasing the tax wedge on labor income, and by introducing more flexible job security rules. Such rules will encourage employment creation, especially in the formal sector. But this change in policy needs to be complemented with improved unemployment insurance system and active labor market programs.

# Determinants of Labor

## Productivity

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- Turning to labor productivity we note that it depends on capital-to-labor ratio, labor quality (human capital) and total factor productivity (TFP). The percentage contribution of the three sources of growth to productivity growth during 1990-2003 were (i) 54 percent from growth in the amount of capital per worker in the economy (capital deepening), (ii) 19 percent from improvements in labor quality, and (iii) 27 percent from total factor productivity (TFP) growth.



# Physical Capital Formation

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- To increase the amount of capital per worker, Turkey has to increase not only its investment ratio, but also its domestic savings rate, because too much reliance on foreign savings over considerably long periods of time may lead to problems of solvency and to problems of sustainability of the current account.



# Human Capital Formation

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- The report discusses ways of increasing human capital formation in Chapter 6. This requires that the country increases the proportion of the adult population with primary, secondary, and higher education, and also the quality of education at each of these levels. Turkish labor needs to acquire the skills for the knowledge-driven economy (problems solving, stating relationships between events, making complex inferences, and continuous learning)



# Determinants of Total Factor Productivity Growth

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- The report emphasizes that reforms in product markets discussed in Chapter 3, policies geared towards improving innovation capacity and labor skills discussed in Chapter 6 as well as infrastructure discussed in Chapter 7 are important for promoting faster growth of TFP across sectors. In addition, horizontal reforms that promote financial sector development as discussed in Chapter 5 will contribute to TFP growth.



# Determinants of Total Factor Productivity Growth

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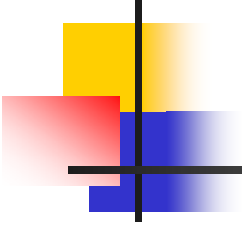
- It has been shown by various economists that instability in macroeconomic policies negatively influences the TFP, and that trade liberalization and budget surplus positively affect the TFP.



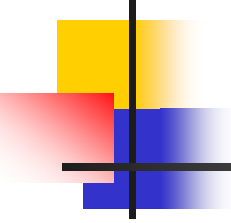
# Income Convergence

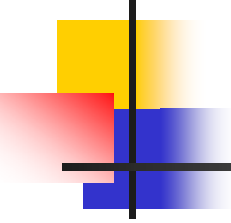
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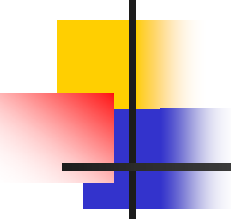
- Thus, to increase the growth rate of its GDP the country has to (a) increase not only its investment ratio but also its domestic savings rate; (b) increase its investment in human capital formation; (c) follow outward-oriented and prudent macroeconomic policies; (d) increase the flexibility in the labor market; (e) improve infrastructure; (f) increase competition in the economy, and (g) improve innovation capacity.
- The pursuit of these policies, however, should not jeopardize the sustainability of fiscal policy nor the sustainability of the current account.



*Many thanks...*

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- These remarks have been rather general. In the remaining time I will consider one of the policy areas analyzed in the report in some detail.
  - It is the elimination of technical barriers to trade in trade of industrial goods with the EU.

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- The elimination of technical barriers to trade is very lengthy and complex process. Harmonization of technical legislation within the context of the Turkey – EU customs union consists of two phases:
    - (1) Adaptation of the EU's technical legislation into the Turkish one
    - (2) Establishment of the quality infrastructure such as accreditation, standardization, metrology, test, certification and inspection bodies and a market surveillance system similar to that of the EU.

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- In the following I will discuss first the EU approach to elimination of technical barriers to trade, and then consider briefly what was achieved during the last ten years in Turkey regarding the elimination of technical barriers to trade, and lastly discuss what the report emphasizes.

# EU Approach to Technical Barriers to Trade



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- In the EU the traded products are divided into regulated and non-regulated commodities.
  - The regulated products are those whose commercialization is governed by the regulations of member states, and the non-regulated products are those for which no regulations have an impact on commercialization.
  - The regulated products are further divided into commodities under the harmonized sphere and those under the non-harmonized sphere.



# EU Approach to Technical Barriers to Trade

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- Products under the harmonized sphere are covered by European rules for the harmonization of regulations and mandatory specifications.
- Commodities under the non-harmonized sphere are governed by national rules.



# EU Approach to Technical Barriers to Trade

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- The EU policy to elimination of technical barriers to trade has two approaches:

(1) Enforcement of the Mutual Recognition Principle (MRP), and

(2) Harmonization of technical regulations.



# EU Approach to Technical Barriers to Trade

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- The mutual recognition principle (MRP) is considered the first line of defense against technical barriers in the regulated non-harmonized sphere.
- The basic EU approach under the MRP has been to promote the idea that products manufactured and tested in accordance with a partner country's regulations could offer levels of protection equivalent to those provided by corresponding domestic rules and procedures. Mutual recognition, in other words, reflects the existence of ex ante trust between the trading partners.

# EU Approach to Technical Barriers to Trade



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- Mutual Recognition Agreements (MRAs) have been advocated by the EU with its relations with third countries. MRAs seek to facilitate trade while safeguarding the health, safety, and environmental objectives of each party. Each party is free to set its health, consumer protection, environmental, or other regulations at whatever level it deems necessary, as long as they comply with international obligations. These obligations require that each side have full confidence that the certification process on the other side can wholly satisfy its requirements.



# EU Approach to Technical Barriers to Trade

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- The EU legislation on harmonizing technical specifications has followed two distinct approaches, the old approach and the new approach. The old approach was based on the idea that the EU would become a unified economic area functioning like a single national economy. It dealt with the content-of-standards issue via negotiated harmonization, and it sought adoption of a single standard that laid out in detail technical regulations for single products or groups of products. The regulations were implemented by the directives of the European Council, and the designated bodies in EU nations performed the conformity assessments.



# EU Approach to Technical Barriers to Trade

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- Under the new approach, only “essential requirements” are indicated. This approach gives manufacturers greater freedom on how they satisfy those requirements by dispensing with the “old” type of exhaustively detailed directives. Directives under the new approach provide for more flexibility by using the support of the established standardization bodies—CEN, and the national standard bodies. The standardization work is easier to update and involves greater participation from industry.



# EU Approach to Technical Barriers to Trade

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- Under the new approach, the European Council issues a directive that lays down “essential requirements”. So far, 28 directives have been adopted on the basis of this approach. 23 of these directives require the affixing of the CE (Conformité Européene) marking. Once a new approach directive has been issued, member states must conform their national laws and regulations to it. The European Commission is empowered to determine whether the national measures are equivalent to the “essential requirements.” The Council refers the task of formulating detailed standards meeting the essential requirements to CEN, and European Telecommunications Standards Institute.



# EU Approach to Technical Barriers to Trade

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- For products regulated by the new Approach directives, a CE (Conformité Européene) marking confirms conformity with the essential requirements of the directives and is required for a product to be placed on the internal market. The CE marking indicates not only that the product has been manufactured in conformity with the requirements of the directive, but also that the manufacturer has followed all the prescribed procedures for conformity assessment. It ensures free access to all of the EU.



# EU Approach to Technical Barriers to Trade

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- The final stage of implementation of the new approach system consists of market surveillance procedures that develop a common approach to enforcement. Market surveillance consists of the control that the relevant authorities in the member states are required to carry out to ensure that the criteria for CE marking have been satisfied—after the products have been placed on the market

# Turkish Policies and Approaches



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The Association Council Decision 2/97 listed the areas in which Turkey had to align its legislation. In addition Turkey as a member of a customs union with the EU had to align its national quality infrastructure with the European one.

- Law 4703 on the Preparation and Implementation of Technical Legislation on Products entered into force in January 2002

# Turkish Policies and Approaches



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- As a secondary legislation, four regulations entered into force during 2002, namely on
  - (1) market surveillance
  - (2) use and affixing of the CE conformity mark
  - (3) working principles and procedures for the conformity assessment bodies and notified bodies
  - (4) notification procedures between Turkey and the EU for technical regulations and standards which apply to the non-harmonized regulated area

# Turkish Policies and Approaches



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- Furthermore, Turkey adopted all of the 23 new approach directives that require affixing the CE conformity marking, and 18 of the directives have entered into force up to the present time.
- In addition, Turkey has advanced the harmonization of its technical legislation both on a sectoral (vertical) basis and at a horizontal level. At the same time, it has started to establish and revise the necessary structures on conformity assessment and market surveillance to align with that of the EU.

# Turkish Policies and Approaches



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But problems were faced in the establishment of quality infrastructure on an equal level to that of the EU. These problems can be summarized as follows:

- (1) The need to completely develop market surveillance structure in Turkey

# Turkish Policies and Approaches



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(2) A lack of multilateral agreements signed between Turkish Accreditation Body (TURKAK) and European National Accreditation Bodies, and refusal of the EU to accept Turkey's application for the appointment of notified bodies for the harmonized new approach directives. Turkey has to complete the process leading to TURKAK's international recognition.

# Turkish Policies and Approaches



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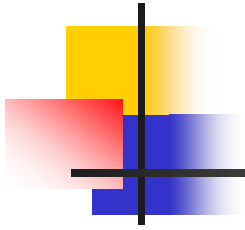
- (3) Need to recognize tests and standards for products originating in countries with which the EU has signed mutual recognition agreements (MRAs); and the need to sign parallel mutual recognition agreements with EU partners and countries with which the EU has signed MRAs.
- (4) Need to align some sector specific legislations with the Acquis (pharmaceuticals and chemicals), and need to adopt food safety and foodstuff legislation.

# Turkish Policies and Approaches



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- As a result of these problems, Turkish products have not been allowed to enter into free circulation in the EU and the aim of realizing the elimination of technical barriers to trade between Turkey and the EU has not been achieved until now.



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*Many thanks...*