

CHAPTER 2. PUBLIC FINANCE MANAGEMENT ON THE WAY TO THE EU

2.1 *Improving the quality of fiscal adjustment remains a key challenge on the way to EU membership.* Turkey's newly achieved macroeconomic stability hinges crucially on the strong fiscal adjustment, however, sustainability of the adjustment can only be ensured by improving the quality of adjustment. Aiming for a higher quality of fiscal adjustment would call for action on many fronts and in particular: (i) structural fiscal reforms that yield efficiency gains in public expenditures, by determining the low value programs that should be retrenched, in order to make appropriate room in the budget for growth-enhancing public expenditures and lower taxes; (ii) tax reforms that broaden the tax bases while reducing distortions and inequities associated with the existing system. This chapter discusses the patterns of fiscal adjustment; benchmarks the public expenditure allocations and structure of fiscal revenues in international comparison; and points to broad directions for expenditure reforms in view of improving fiscal sustainability.¹² It provides an assessment of debt dynamics and sustainability in the face of surrounding risks. The issue of fiscal dominance, in the context of the upcoming introduction of formal inflation targeting, is also addressed.

2.1. QUALITY OF FISCAL ADJUSTMENT AND THE SIZE OF GOVERNMENT

2.2 *Turkey has gone through an impressive fiscal adjustment during 1999-2004.* In the aftermath of the 1999 and 2001 crises, Turkey had to generate a sizeable primary surplus to reduce its public debt stock. Turkey's fiscal position improved dramatically between 1999 and 2004, as it is reflected in the improvements in the primary balance of the Consolidated General Government (CGG), from a surplus of 0.5 percent of GDP in 1999 to a surplus of 5.9 percent in 2004.¹³ The CGG borrowing requirement decreased by 7.1 percentage points of GDP between 1999 and 2004, driven by the larger primary surplus and the gradual reduction in interest payments on public debt—from a peak of 25.4 percent of GDP in 2001 to 13.5 percent in 2004.

2.3 *Turkey's public sector—comprising the general government plus the state owned enterprises (SOEs)—achieved even a bigger fiscal consolidation.* Over 1999-2004, fiscal adjustment at the level of the public sector amounted to close to 9 percent of

¹² Turkey's public expenditures and options for expenditure reforms will be discussed in the upcoming Public Expenditure Review of the World Bank. The status of expenditure management reforms will also be discussed in this study.

¹³ See Annex 2.1 of the main report for a detailed description of data sources and methodology.

GDP, from a primary deficit of 1.6 percent of GDP in 1999 to a primary surplus of 6.9 percent in 2004.¹⁴ The improvement in the financial situation of the SOEs was mainly generated by a close to 2 percentage points of GDP reduction in their investment expenditures, and 1 percentage point cut in their personnel compensation. With the privatization of profitable SOEs, like Turk Telekom and Tupras, the contribution of the SOEs to the primary surplus will decrease. However, revenue losses for the consolidated budget will be mitigated by corporate tax receipts from privatized SOEs. International experience suggests that additional tax receipts may offset foregone fiscal revenues from profitable SOEs as a result of growing business activity in liberalized sectors. In addition, with privatization revenues used to pay down public debt, there will be room for expenditure savings as a result of lower interest payments on the public debt stock.

2.4 *Fiscal consolidation came primarily from the revenue side, with heavy reliance on indirect taxes:* Despite the partial shift in the adjustment pattern since 2002, Turkey's focus for achieving fiscal consolidation has been on revenue-increasing measures rather than expenditure rationalization. While primary revenues increased by 4.8 percent of GDP, primary expenditures declined by only 0.6 percent of GDP between 1999 and 2004. Thus, *90 percent* of the 5.4 percentage points of GDP increase in the CGG surplus from 1999 to 2004 came from revenue-increasing measures. The increase in tax revenue was mainly generated by higher indirect taxes. Indirect tax revenues increased from 11.7 percent of GDP in 1999 to 15.7 percent of GDP in 2004. In addition, non-interest expenditures reflect no major changes during 2000-2004, with expenditures for personnel, goods and services and current transfers largely unaffected by fiscal consolidation. It should be noted, however, that initiatives have been taken to prevent wasting in expenditures, improve spending quality, and set expenditure priorities—for example by setting recruitment limits and eliminating low-priority investment projects from the investment program. These measures have supported a better control of expenditure growth than in the past.

2.5 *Fiscal adjustment has been impeded by a growing social security deficit, which reached 3.8 percent in 2004:*¹⁵ Turkey's fiscal situation would have been much better if Turkey had managed not to expand the social security deficit after the 1999 reform. Although the 1999 reform resulted in a one-off benefit in 2000, the fiscal *balance* of the system started to deteriorate mainly due to ad-hoc policy reversals such as above-inflation benefit increases, amnesties for contribution arrears, and implementation delays due to legal bottlenecks. Given the favorable demographic profile of Turkey, the currently high deficits (compared to other emerging market countries) pose a bigger challenge in the long run considering that the number of elderly will start to increase as the demographic shift starts to kick in.

¹⁴ The IMF's Stand-By Arrangement (SBA) program target of 6.5 percent GNP primary surplus for 2005-2007, includes primary surplus of the SOEs together with the general government. The general government data used are from the State Planning Organization (SPO).

¹⁵ The deficit of the social security institutions do not include payments made on behalf of the consolidated budget since those expenditures are treated as part of the consolidated budget expenditures.

2.6 Continued commitment to overhaul of the social security system is key for achieving long-term sustainability. The new social security reform package initiated by the government envisages separating pensions, health and social assistance functions and unification of the social security institutions for increased efficiency and transparency. While enactment of the draft legislation on the pensions and health components is still pending, the complementary institutional law and the social assistance law are still under preparation. On the pension front (for issues in health care reform see chapter 9), the reform introduces parametric changes including the retirement age, replacement rate, valorization rate and pension indexation. A significant improvement included in the draft law is that Emekli Sandığı contributions will be based on the total remuneration (as opposed to the existing base of only salaries). In addition, Bağ-Kur income steps will be removed and contributors will be allowed to declare their own earnings level. With the help of the reform, pension system deficit currently at 3.5 percent of GDP is expected to decline by 1 percent below the baseline projection of “no reform” by 2020.¹⁶ However, the beneficial impact of these measures is expected to be rather limited over the medium run, thus creating little fiscal space for growth-enhancing expenditures. Moreover, long-run financial sustainability will be secured under a high level of payroll taxes by international standards, which is an impediment to job creation in the formal labor market (see chapter 4). More ambitious reforms would be needed to generate medium-term savings and also create room for a reduction in payroll taxes in the future.

(a) The expenditure side

2.7 Turkey’s primary expenditures are still at the low end of EU countries but much higher than in other emerging economies. At 32.7 percent of GDP, primary expenditures compare favorably with the average size of government in cohesion countries and new EU members, but are considerably higher than in other comparable emerging economies (Figure 2.1).

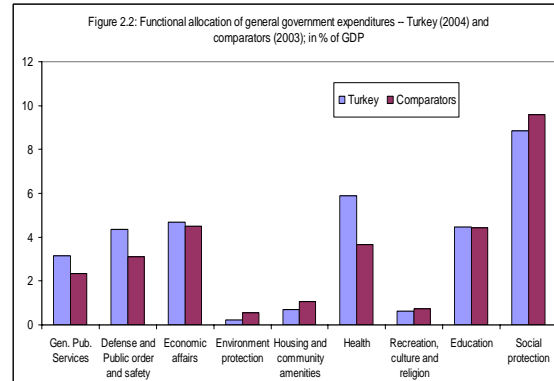
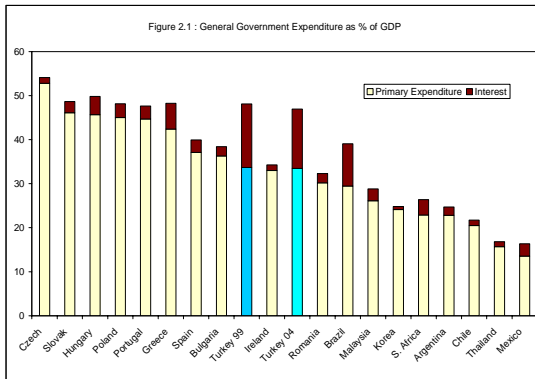
2.8 Expenditure pressures are being felt in some Government functions. International comparisons point to the following expenditure patterns (Figure 2.2):

- Turkey’s public expenditure for the provision of public goods (general public services, defense, public order and safety) is relatively high in international comparison.
- Expenditure on health care is relatively high—also in per capita terms and including out-of-pocket private spending (see chapter 9).
- Expenditure on social protection is high, especially in view of Turkey’s favorable demographics.
- Expenditure on education is in line with comparators but may need to increase in the future.

¹⁶ The deficit of the pension system does not include the health-related deficits as well as the payments made on behalf of the consolidated budget.

- Expenditure on environmental protection is comparatively low and may need to increase on the way to the EU.
- Expenditure on economic affairs (comprising mainly investment in infrastructure and various subsidies) is broadly in line with average levels in comparator countries.

Allocating expenditure to functions most critical for growth and social protection, while enhancing expenditure efficiency, is a key precondition for accelerated convergence and improved social inclusion.



2.9 Increased expenditure pressures in education should be expected in the near future— This will be due to three factors: (i) postponement of the expenditures, including education investments and maintenance of the existing capital stock, during the recent years of fiscal adjustment; (ii) fast growing school-age population; (iii) the increase in the proportion of youth entering and completing secondary education; and (iv) the need to improve the quality of education towards catching up with the human capital in EU. In order to expand access to primary and secondary education, promote equity in educational opportunity, and improve the quality of education (with the ultimate goal of increasing the employability of young graduates), Turkey needs to devote sufficient public resources to education while at the same time improving the distribution and efficiency of available resources. The recent Education Sector Study of the World Bank finds for example, that among the recommended policy options for education reform, expanding access to early childhood education and using information and communication technology to integrate new curriculum into classroom practice have high estimated cost impacts, particularly due to additional investment requirements. In addition, estimates suggest for example that solely the construction of new classrooms that will be required to reduce the number of students per class to 30 in primary education in 2006 is at 0.2 percent of GNP.

2.10 —but should go in tandem with improved efficiency of spending. Public expenditure on education in percent of GDP is similar to other EU countries and comparable to emerging economies, but educational attainment in Turkey is still lagging behind with respect to these comparators. This suggests some potential for efficiency improvements. Reforming the curricula at all levels; better targeting of public schooling

efforts to groups really in need; better management of teacher's wage bill; could be examples of focus areas where efficiency gains could generate resources for new investments.

2.11 ***The Government wage bill has been bypassed by fiscal consolidation.*** Since 1999, total compensation for General Government employees has been relatively stable, at around 10 percent of GDP. Although civilian public sector employment is not exceptionally high by international standards, average compensation is. Linking wage increases to inflation has not proven enough to contain the growth in the wage bill, probably because other forms of compensation have provided room for increases in personnel costs. Slower growth in average compensation would have created considerable room for fiscal savings. For example, had the ratio of average compensation to per capita GDP remained constant at its average level in 1999-2000, the wage bill of consolidated budget agencies would have fallen by about 1 percentage point.

2.12 ***The wage bill in economic affairs and security is oversized by international comparison.*** A functional breakdown of the wage bill indicates that the wage bill in economic affairs and security is oversized with respect to a comparator group of new EU members, cohesion countries and emerging economies. In particular, the share of personnel expenditures on economic affairs is twice as high.¹⁷

2.13 ***Moving to a simpler compensation system would contribute to containing pressures in the wage bill.*** In 2004, about 32 percent of personnel compensation in consolidated budget agencies was composed of various allowances, compensations, and ***rewards*** on top of the basic salary of employees. Overtime pay represented 6.5 percent of total compensation. In addition, many allowances are exempt from income tax. Unlike wages, the system of allowances and overtime pay is quite complicated and seems to offer substantial opportunities for discretion. This may be distorting incentives, but further analysis is warranted. The Government is already addressing some of the deficiencies of the system in its civil service reform efforts.

2.14 ***The brunt of the fiscal adjustment on the expenditure side fell on the investment budget.*** The impressive fiscal adjustment in 2001-2004 was unbalanced in that the investment budget was cut sharply, particularly in 2003-2004.¹⁸ The total public investment level (inclusive of local administrations investment), stood at 4.7 percent of GNP in 2004, ***which*** is down from 6.8 percent of GNP in 2000, with infrastructure investment being hit the hardest. In 2001-2002, fiscal adjustment fell primarily on public investment by SOEs while investment by the consolidated budget increased. In 2003-2004 however, the cut was predominantly from the investment budgets of both the

¹⁷ There is an oversized wage bill especially in the rural agencies budget. Between 1999 and 2004, budget allocations for recurrent expenditures (excluding agricultural transfers) have been on average 70 percent of the consolidated budget. As much as 90 percent of recurrent spending of rural agencies is allocated for salaries alone. Therefore, there is limited funding for logistical and operational spending, which is extremely vital for effective service delivery. There is room for fiscal savings in rationalizing the personnel in rural agencies.

¹⁸ The rationalization of the existing public investment stock in 2001 has played an important role in the earlier part of the adjustment.

consolidated budget agencies and SOEs. Rationalization of the public investment program in 2001 has been quite effective in reducing average completion times of projects and reduced allocations from the budget in 2003-2004 put pressure on the PIP for further rationalization.¹⁹

2.15 *Ensuring appropriate allocations for operation and maintenance of public capital is an important requirement for improving the quality of services and restricting the cost of the projects.* As a result of fiscal adjustment, total maintenance expenditures declined in tandem with cuts in the investment budget—although available data do not allow reliable tracking of appropriations for maintenance in the budget. The transportation sector, as well as the social sectors—especially education and health—were subject to a reduction in their maintenance allowances during this period.²⁰ Such reductions in O&M expenses should be avoided since they are not sustainable while they reduce the contribution of public capital to efficiency and growth. Moreover, inappropriate maintenance and accelerated decay of capital goods may unduly burden the investment program in the future.

2.16 *Expenditure pressures in investment will only rise further as alignment with the EU accelerates.* Although in its Preliminary National Development Plan the government recognizes pressing infrastructure needs, much needs to be done towards faster convergence with EU. When additional investment requirements are added, for example for alignment with the environmental acquis or the need for substantial education investment, effectiveness of investment spending and better project selection and monitoring is even more urgently needed. The reduction in completion times is welcome but alone does not certainly assure the rationalization of the PIP. Structural measures are bound to complement the rationalization of the investment stock, by enhancing the management of the public investments.

2.17 *There are several potential measures towards reaching a more effective investment program.* In the recent past, volatility of annual investment allocations has hampered implementation in line with strategic priorities, total costs and average completion times of projects. In order to close the quality gap in infrastructure, and improve the quality of its investments, Turkey needs to (i) utilize the newly introduced medium-term expenditure framework; (ii) as part of the ongoing introduction of performance-based budgeting, strengthen the consistency of investment and recurrent budgets to facilitate the achievement of sectoral policy objectives; (iii) improve the PIP management by strengthening the project selection process as well as monitoring and evaluation of ongoing projects and, (iv) promote private sector participation in infrastructure.

¹⁹ In 2005 investment spending by consolidated budget agencies went slightly up, reversing recent trends, from 1.8 percent of GDP in 2004 to an estimated 2.1 percent of GDP.

²⁰ Evidence of lower than expected capacity utilization and shorter than planned economic life of some projects points to problematic maintenance, especially in the road network, where indicators of physical condition point to deteriorating quality—see chapter 7 (Figure 7.3; volume II). However, the relative roles of inadequate budget allocations and lack of appropriate incentives/culture for maintenance seems difficult to establish.

2.18 *Trade offs in expenditure allocations would need to be combined with expenditure reforms to meet Turkey's development challenges.* As public expenditures are already high compared to other emerging economies and some new EU members there is little room for Turkey to further increase expenditure in order to meet pressing development challenges—such as in education and in infrastructure for less-developed regions, or in areas where alignment with the EU Acquis entails a cost (for example in environmental protection). Expenditure should also be contained in order to make room for lower taxes in the long run while preserving a sound fiscal framework. Policy would thus need to focus on trade offs in expenditure allocations, possibly by reducing spending in functional areas where it appears to be oversized in international comparison, and by implementing reforms that improve the efficiency of expenditure programs in areas where expenditure pressures are being felt—such as health care, education, social protection. Horizontal reforms, focused on the modernization of civil service pay and employment system and the careful formulation of the investment program, would also help contain pressures on the wage bill and investment spending and thus better control public expenditure in specific functional areas.

(b) *The Revenue side*

2.19 *Fiscal revenues have increased to levels comparable to EU countries and much higher than in emerging market economies.* In most EU cohesion countries and new EU members the tax burden has remained constant, or has even decreased in percentage of GDP, as a result of initiatives to contain the increase in the size of Government. But contrary to this trend, and as a result of the pattern of fiscal adjustment since 1999, fiscal revenues in Turkey stood at 40 percent of GDP in 2004, a level that is now similar to EU countries—despite the smaller size of Turkey's welfare system. With a fiscal burden higher than in other emerging economies any further increase taxes would risk compromising prospects for growth.

2.20 *The balance between direct and indirect taxes is considerably out of line with comparator countries but reducing the burden of indirect taxes would call for careful study and long-term design.* The composition of revenues has shifted markedly toward indirect taxation over the last few years. However, options for reform in the short-to-medium term remain limited because revenue cuts in one area must—given the continued need to achieve large primary surpluses—be offset by gains in another. Substitution of direct for indirect taxes would not be advisable. When pervasive informality is present, as in Turkey, reliance on indirect taxes appears to be a reasonable way of ensuring some degree of compliance of those who would have otherwise escaped taxes altogether. This tends to alleviate the distributional consequences of indirect taxes. In addition, indirect taxes uniformly levied on consumption offer advantages on efficiency grounds: (i) they are relatively neutral towards saving and investment decisions; (ii) they do not distort incentives to work. Hence, all else equal, a tax mix relying more on indirect taxes may be more conducive to growth. Fiscal space for lower indirect taxation will have to be created over the long term from three main sources: (i) Continuous fiscal discipline to reduce the level of the debt ratio and create room for a lower primary surplus in percent of GDP; (ii)

better control of primary expenditures in low-value programs; (iii) tax base broadening and reduction in the size of the informal sector.

2.21 ***The tax landscape is changing fast.*** The authorities are currently in the process of reviewing and rewriting each of the major income tax laws. A new regime for capital income taxation will subject interest and capital gains, including on previously exempt government securities, to final withholding at 15 percent. Moreover, the 2006 budget and draft legislation to amend the existing CIT and PIT laws incorporate significant reforms of the Corporate Income Tax and the Personal Income Tax: (i) a reduction of the CIT rate from 30 to 20 percent, with a parallel elimination of the Investment Tax Allowance (ITA); and, (ii) a reduction of the top personal income tax rate from 40 to 35 percent, accompanied by a reduction in the number of tax brackets from 5 to 4 and a unification of the tax regimes for wage and non-wage income. The CIT tax reforms have the potential to promote investment on a sound basis and stimulate job creation, especially in the formal sector, while the PIT reform will improve the efficiency of the tax system and reduce costs of tax collection.

Further reform priorities for the Personal Income Tax (PIT) include: (i) replacing the costly and potentially inequitable VAT-based consumption credit either with a standard deduction or a non-refundable credit, which are more pro-poor systems, and (ii) introducing explicit reduction for spouse and children.

2.22 ***Further reform initiatives for the Corporate Income Tax (CIT) could include:*** (i) ***avoiding*** regional and sectoral incentives; (ii) incorporating dividends into a new regime for capital income taxation, where a first step would be to include dividends in the base for the new harmonized capital income tax to be launched in 2006; and (iii) progressively phasing out the double taxation of dividends.

2.2. PUBLIC DEBT SUSTAINABILITY

2.23 ***Despite the significant improvements, debt reduction is still a challenge.*** The level of Turkey's debt still remains high, especially when compared with EU member states and candidate states. In 2004, Turkey's significantly reduced gross debt level, at 77.4 percent of GDP (63.5 percent in net terms; 80 percent in gross terms as a share of GDP, as defined in ESA 95),²¹ was much higher than all of the new member states (EU-8) which are below the 60 percent "Maastricht threshold" and EU-15 average.²² In addition, the Maastricht criteria may not be strong enough to ensure a sound fiscal framework in the face of Turkey's vulnerabilities: First, the sustainability of a given debt-to-GDP ratio depends not only on its level, but also on the composition of the public debt portfolio, in particular with regard to maturity. Despite recent improvements, the average maturity of Turkey's public debt remains much lower compared to EU-8, and especially

²¹ The Treasury definition of gross debt differs from the ESA95 definition. For a more detailed description of the latter, see Box 2.5 in Volume 2 of this study.

²² In 2004, gross public debt in proportion to GDP was, on average, 31.3 percent in EU-8 and 64.7 percent in EU-15—although significant disparities persist within the EU-15 group.

EU-15 countries, making refinancing more challenging, but also posing important liquidity risks that should be hedged by a lower debt ratio. Second, Turkey's public debt ratio remains higher than in other comparable emerging economies, with a similar or slightly higher sovereign debt ranking. On average, the debt-to-GDP ratio of these comparators is below the Maastricht benchmark.²³

2.24 *In a base-case scenario, sound macroeconomic fundamentals will lead to a further reduction in the debt ratio over the medium term.* In a baseline estimation, underpinned by the base-case growth scenario presented in chapter 1, the net debt-to-GNP level will continue to decline, falling below 60 percent in 2005 (74.5 percent in gross terms) and further below 50 percent in 2008 (60.2 percent in gross terms).

2.25 *Debt dynamics have considerably improved but credible policies that maintain a robust fiscal framework will play a key role in building further confidence—* To illustrate potential risks for debt sustainability, a downside scenario can be formulated where the political will to continue the fiscal program falters and the primary surplus does not exceed 3 percent of GNP in 2006-08. As a result, real interest rates could be in the 20 percent range, i.e., well above the projected program path, with growth falling to 3 percent per year. A reversal in the strong growth pattern and deterioration in the public debt dynamics could lead to capital account outflows and exchange rate instability which would exacerbate the impact on the debt burden. Under these hypothetical conditions, the public debt burden could begin to rise and the currently declining path of the debt to GNP ratio could be interrupted.

2.26 *—especially as the way to the EU may be lengthy.* The relatively appreciated real exchange rate and large current account deficit constitute a potential risk Turkey will need to cope with throughout the EU accession process. (A 20 percent depreciated nominal exchange rate compared to the program level at end-2005 would imply a 4 percent increase in the debt-to-GNP level). EU accession negotiations may boost capital inflows, providing relief from balance-of-payments pressures and contributing to some real exchange rate appreciation as also assumed in the base- and high-case scenarios discussed in the previous chapter. However, Turkey might also be exposed to capital flow reversals, in case the EU accession process were to occasionally stumble, with potentially destabilizing effects on the exchange rate, interest rates, debt dynamics, and the overall macroeconomic framework.

2.27 *Maintaining a high primary surplus becomes increasingly more important for debt reduction.* An analysis of the breakdown of the reduction in debt-to-GNP ratios shows that in the medium term the importance of maintaining a high primary surplus increases. At the same time, a high growth rate plays a significant role, while as the economy stabilizes more permanently the impact of reduced interest rate and inflation dies off. Therefore, preserving a tight fiscal stance as needed to accelerate the reduction of the debt ratio, and using projected large privatization proceeds to further reduce public

²³ Comparators include (by increasing S&P's sovereign debt rating): Brazil, Philippines, Ukraine, South Africa, Thailand, Tunisia, Mexico, Kazakhstan, Russian Federation, Egypt, India, Morocco, and Colombia. On average, the public debt-to-GDP ratio of these countries was 46.1 percent in 2003.

debt, would be the best course to mitigate surrounding risks while making needed fiscal room for growth-enhancing expenditures and lower taxes.