

CHAPTER I SOURCES OF FISCAL CONSOLIDATION AND THE QUALITY OF FISCAL ADJUSTMENT

1.1 *Improving the quality of fiscal adjustment is a key challenge.* The Turkish economy in the 1990s has been characterized by persistent fiscal imbalances and fiscal dominance, a pattern that contributed to growth volatility, chronic inflation, and continuous macroeconomic instability. As high public sector borrowing requirements became unsustainable and structural problems mounted, it became inevitable for Turkey to embark on an ambitious reform program aiming at macroeconomic stability and fundamental restructuring of the economy following the 2001 financial crisis. The analysis in this chapter focuses on the quality and sustainability of the strong fiscal adjustment achieved so far, since maintaining hard-won macroeconomic stability is a prerequisite for promoting faster growth on a sustained basis. At the same time, the analysis benchmarks Turkey's size and composition of public expenditures and fiscal revenues in international comparison, as achieving an efficient allocation of expenditures and an efficient distribution of the tax burden are key preconditions for fast growth.

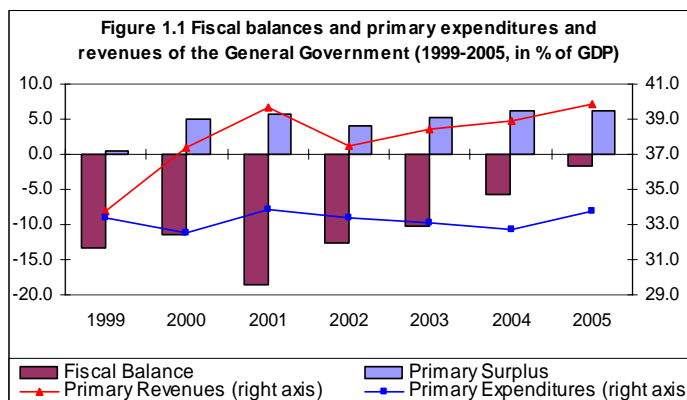
1.2 The first section reviews the patterns of fiscal consolidation since 1999 and examines shifts in the focus of fiscal adjustment. Section two benchmarks public expenditure allocations at the general government level in international comparison. Section three reviews trends in tax revenue mobilization and contribution to fiscal consolidation, as well as major tax initiatives taken recently. The fourth section completes the analysis of fiscal adjustment by estimating discretionary changes in the primary budget balance separately from changes due to cyclical automatic stabilizers. Despite possible limitations—due to the difficulty in estimating tax elasticities in the face of frequent changes in taxes—this analysis provides a more accurate view of the fiscal consolidation effort.

A. PATTERNS OF FISCAL ADJUSTMENT IN TURKEY

1.3 *Turkey has gone through an impressive fiscal adjustment during 1999-2005—* In the aftermath of the 2000 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 2005, as reflected in the improvements in the primary balance of the Consolidated General Government (CGG), from a negligible primary surplus of 0.5

percent of GDP in 1999 to a surplus of 6.1 percent in 2005 (Figure 1.1).¹ (See Box 1.1 for the conversion from the SPO-based consolidated general government primary surplus to IMF program definition of public sector primary surplus). The CGG borrowing requirement excluding privatization proceeds decreased by 11.8 percentage points of GDP between 1999 and 2005, driven by the increase in the primary surplus and the decline of interest payments on public debt. Turkey’s public sector—comprising the consolidated general government plus the State Owned Enterprises (SOEs)—achieved an even larger fiscal consolidation in 1999-2005, from a primary deficit of 1.6 percent of GDP in 1999 to a primary surplus of 6.9 percent in 2005.²

1.4 —*which was largely revenue-driven.* Fiscal adjustment at the CGG level was mainly driven by a substantial tax effort achieved from 1999 to 2001 and maintained thereafter (Figure 1.1). By contrast, primary expenditure has hovered at around 33-34 percent, without any noticeable reduction during the period.



Source: World Bank staff calculations

1.5 *Reflecting a sound fiscal framework, interest payments on public debt have declined significantly.* Strong fiscal adjustment helped Turkey reduce its gross public debt in proportion to GDP ratio to 72 percent in 2005 from 108 percent in 2001 (with the net debt ratio declining, during the same period, to 55.8 percent from 90.5 percent). Declining debt ratios and lower interest rates—thanks to receding inflation and stronger confidence in the ability of the Government to restore macroeconomic stability—have led

¹ While Annex I presents detailed data sources and methodology, it should be noted that the definition of general government used in this report includes the (i) consolidated budget, (ii) social security institutions (SSI), (iii) a subset of budgetary and extra budgetary funds (EBFs), (iv) local administrations, and (v) off-budget revolving funds created by public entities. The analysis does not include the revenues and expenditures of the Central Bank and other public depository institutions, 36 non-financial state economic enterprises (SOEs), nine regulatory and supervisory agencies, and 45 out of a total of 50 special budget institutions listed in the Public Financial Management and Control Law (PFMC). Special budget institutions refer to 50 public entities established as affiliated or related to a ministry to provide certain public services. These special budget institutions receive revenues and are authorized to spend them. The analysis includes the net subsidies and transfers between these institutions and the consolidated budget.

² The IMF’s Stand-By Arrangement (SBA) program target of 6.5 percent of GNP primary surplus for 2005-2007, includes primary surplus of a subset of SOEs together with the general government. The primary surplus data for the SOEs provided in Table 1.1 are from IMF staff reports.

to sharp declines in interest payments on public debt: Interest payments, which had peaked at 25.4 percent of GDP in 2001, up from 14.6 percent in 1999, declined to 9.6 percent of GDP in 2005. However, interest payments still represented the equivalent of 28 percent of total primary expenditures of CGG in 2005.

Box 1.1. Conversion between SPO definition of CGG primary surplus to IMF's program definition of public sector primary surplus:

The backbone of the Government's Stand-By Arrangements (SBA) with the IMF has been continued and strong fiscal discipline monitored through program definition of the public sector primary balance. A detailed definition of the program primary surplus methodology can be found in the Fiscal Targets annex of the April 2005 SBA with Turkey.

The objective of the IMF methodology is not to monitor the consolidated public sector revenues and expenditures according to Government Financial Statistics (GFS) definition and the underlying primary surplus, but rather to focus on the fiscal balance measured through the primary surplus. Moreover, the program definition also does not account the revenues and expenditures that are not of continues and regular nature.

In order to reach the program definition of the public sector primary surplus the following adjustments should be made to the SPO definition of the primary surplus.

Table: Public Sector Primary Surplus; conversion from the SPO to the IMF Program definition

(% of GDP)	1999	2000	2001	2002	2003	2004	2005
Primary Surplus (SPO definition of CGG)	0.5	4.9	5.8	4.1	5.4	6.2	6.1
Adjustments on revenues							
(-) CB profit	0.1	0.2	0.3	1.1	0.0		
(-) Transfer of special revenues							
(-) Dividend revenues from state banks						0.3	0.3
(+) Tax arrears interest				0.1			0.1
(-) Revaluation difference			0.5	0.0	0.0		
(-) Minting coins revenues							0.1
(+) Support Price Stabilization Fund repayment	0.0	0.0	0.0	0.0			
(+) Interest revenues of SSIs	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Adjustments on expenditures							
(-) Retirement Bonus				0.1			
(+) Mandatory Savings	0.7	0.5					
(-) expenditures due to privatization activities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(+) Privatization Fund net lending	0.1	0.1	0.1	0.1	0.1	0.0	0.1
(+) Defense Fund net lending	(0.0)	0.0	(0.0)	0.1	0.0	(0.0)	0.0
(+) Mass Housing Fund net lending	(0.0)	0.0	(0.0)				
(+) Interest expenditures of SSIs	0.1	0.1	0.0				
(-) Risk Account					0.3	0.1	0.0
Program Adjusted General Government primary Surplus	(0.4)	4.1	5.0	3.0	5.6	6.0	5.8
SOEs primary surplus (program definition)	(2.1)	(1.5)	0.1	1.1	0.7	1.1	0.8
Program adjusted public sector primary surplus	(2.5)	2.6	5.1	4.2	6.3	7.1	6.6

Source: World Bank staff

1.6 *At the same time, fiscal transparency and accountability have considerably improved (see chapter 5).* Turkey has aligned, to a great extent, its legislation of public procurement, financial management and financial control with international standards. A public procurement agency and a risk management unit for public debt (under the

General Directorate of Public Finance in the Treasury) have been established; most of the extra budgetary funds have been integrated into the budget; the so called “duty losses” of state banks (obligations to state banks and SOEs due to quasi-fiscal policies) have been accounted in a more transparent manner while generation of new duty losses without an appropriation in the budget have been legally prohibited. More importantly, a new Public Financial Management and Control Law (PFMC) has been enacted as of December 2003. The PFMC Law aims at establishing a public financial management and control system compatible with international standards and EU norms. It extends the scope of the budget; provides budgetary unity, increase effectiveness, fiscal transparency, and accountability during the process of preparation and implementations of budgets; ensures transparency in financial management; and restores the balance between authorizations and responsibilities in the spending process by establishing an efficient accountability mechanism. Therefore, a more transparent and close management of the fiscal stance is now achieved and quasi-fiscal activities are much harder to undertake.

1.7 Actions reflected in the consolidated budget (CB) and extra-budgetary funds (EBFs) contributed most to fiscal adjustment at the General Government level.

Actions reflected in the consolidated budget (Central Government budget, accounting for 57 percent of CGG expenditures in 2005) by itself created a fiscal adjustment of more than 6 percentage point of GDP (Table 1.1). With the primary surplus of 9.9 percent of GDP, the CB more than doubled its primary surplus compared to 1999. Controlling the extensive off-budget activities of the past by eliminating the earmarked revenue system through the closure of numerous Extra-budgetary Funds (EBFs) contributed to fiscal consolidation. Abolishment of all budgetary funds, with the exception of the Support Price Stabilization Fund (DFIF), and all but five extra budgetary Funds (i.e., the Social Solidarity Fund, the Defense Fund, the Promotion Fund, SDIF and the Privatization Fund) improved fiscal discipline and brought the deficit of the EBFs to a small surplus in 2005.³

Table 1.1: Institutional breakdown of Consolidated General Government Primary Balance

(% of GDP)	1999	2000	2001	2002	2003	2004	2005
Consolidated Budget	3.8	6.2	6.2	6.7	8.9	9.2	9.9
SSIs	-3.0	-1.9	-2.6	-3.1	-3.8	-3.8	-4.1
Local Administrations	0.3	0.5	0.7	0.1	-0.2	0.1	-0.3
Revolving funds	0.0	0.1	0.1	0.2	0.3	0.4	0.3
EBFs	-0.6	-0.3	0.8	-0.2	-0.2	-0.2	0.0
Unemployment Insurance	0.0	0.3	0.6	0.3	0.4	0.4	0.3
Total Primary Surplus	0.5	4.9	5.8	4.1	5.4	6.2	6.1
<i>Memo Item:</i>							
SOEs	-2.1	-1.5	0.1	1.1	0.7	1.1	0.2

Source: World Bank staff calculations based on SPO data

³ The number of EBFs has been reduced in 2000 and 2001, and the related earmarked revenue system was abolished in 2004.

1.8 ***Further fiscal adjustment has been impeded by a growing social security deficit, which reached 4.1 percent of GDP in 2005.***⁴ The fiscal situation would have been much better if Turkey had managed to contain the social security deficit after the 1999 reform. The overall deficit of the Social Security Institutions (SSIs) increased from 1.9 percent of GDP in 2000 to 4.1 percent in 2005. Given the favorable demographic profile of Turkey, the currently high deficits 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. As further explained in chapter 3, in the absence of the social security reform enacted in June 2006, the projected deficit of the system could have reached 6.7 percent of GDP over the long term.

1.9 ***Recently enacted social security reform will help contain the deficits over the long term.*** With the help of the recent reform the pension system deficit is expected to decline by 1 percent below the baseline projection of “no reform” by 2020 (chapter 3). 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. As further explained in Chapter 3, more ambitious steps will be needed to ensure financial sustainability if payroll taxes were to be lowered in the future in order to facilitate formalization and job creation.

1.10 ***The primary balance of State-Owned Enterprises has significantly improved since 1999.*** The SOEs covered under the IMF program generated a deficit of 2.1 percent of GDP in 1999 but their fiscal situation improved substantially, resulting in a surplus of 0.15 percent of GDP in 2005 (Table 1.1).⁵ This improvement was mainly an outcome of reductions of close to 2 percentage points of GDP in their investment expenditures, and 1 percentage point cut in their personnel compensation. The personnel retrenchment of the SOEs has been supported by the PFPSAL program.

1.11 ***With the privatization of profitable SOEs, like Turk Telekom and Tupras, the contribution of the SOEs to the public sector primary surplus will decrease, but foregone revenues may be offset from other sources such as increased tax receipts.*** These SOEs were also helping the fiscal position of the consolidated budget through their net transfer to the budget. In 2005, the net transfer from the SOEs to the budget was YTL 0.8 billion or 0.17 percent of GDP.⁶ 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

⁴ The deficit of the social security institutions does not include payments made on behalf of the consolidated budget since those expenditures are treated as part of the consolidated budget expenditures. Therefore the deficit of 4.1 percent of GDP is consistent with the more commonly used definition, (including payments made on behalf of the consolidated budget) which corresponds to 4.8 percent of GNP in 2005.

⁵ The number of SOEs covered in the program was eight in 1999, and this number increased to 26 in 2005.

⁶ The transfers from SOEs to the budget include: Dividend payments of YTL 2.13 billion and Treasury levy of YTL 0.17 billion. Transfers from the budget to SOEs include capital transfers of YTL 0.9 billion and “duty loss” payments of YTL 0.57 billion. Net transfers from SOEs to the budget amount thus to YTL 0.8 billion.

privatization revenues used to pay down public debt, there should be room for expenditure savings as a result of lower interest payments on the public debt stock.

1.12 *Fiscal adjustment at the general government level was mainly revenue-driven in 1999-2001.* As shown in Figure 1.1 and Tables 1.1 and 1.2, the effort of fiscal consolidation until 2001 reflects predominantly an increase in general government revenues, excluding SSI, and an improvement in the primary balance of the SOEs—the latter up until 2002.⁷ During 1999-2001 primary revenues increased by 5.9 percentage points of GDP, driven by an increase in indirect taxes of 3.2 percentage points of GDP (Table 1.2). By contrast, primary expenditure of the general government remained almost constant in percent of GDP.

Table 1.2: Fiscal Consolidation in Turkey, 1999-2005 and sub-periods¹

(differences between years in % of GDP)	1999-2005	1999-2001	2001-2005
Taxes	3.1	3.9	-0.8
Direct	-2.4	0.7	-3.1
Indirect	5.1	3.2	1.9
Wealth	0.4	0.0	0.4
Non-Tax Revenues	0.4	-0.2	0.6
Factor Incomes	2.2	1.5	0.7
Interest revenues	1.1	0.3	0.8
Social Funds	1.6	1.0	0.5
Total Revenues	7.2	6.2	1.0
Primary Revenues	6.1	5.9	0.2
Current Expenditures	-0.3	-0.2	0.0
of which personnel	-1.7	-0.5	-1.2
Investment Expenditures	-0.6	0.3	-0.9
Transfer Expenditures	-3.6	11.3	-14.9
Current Transfers	-3.0	11.4	-14.4
of which interest payments	-5.0	10.8	-15.8
Capital Transfers	-0.6	-0.1	-0.6
Primary Expenditures	0.4	0.5	-0.1
Borrowing Requirement	-12.5	4.3	-16.8
Primary Surplus	5.7	5.3	0.3

¹ Changes, between the years indicated, in percent of GDP

Source: SPO and World Bank Staff estimates

1.13 *Starting in 2001 fiscal consolidation was more balanced on the revenue and expenditure sides.* In 2001-2005 total primary revenues decreased by 0.8 percentage

⁷ Although tax revenues in percent of GDP have peaked in 2001, for the whole 1999-2004 period, this partly reflects the sharp drop in GDP in this crisis year. For this same reason, expenditure items appear also artificially inflated in 2001 when measured in percent of GDP.

points which was mainly due to a decrease in the direct tax collection. A 3.1 percentage point decrease in direct taxes was partially off-set by close to 2 percentage points increase in indirect taxes. Primary expenditures, on the other hand, stayed almost constant although there has been a significant reduction in investment expenditures. A reduction in personnel expenditures was also noted in 2005. The fiscal space created in these two expenditure areas was completely offset by the increase in the social security deficit.

1.14 ***Overall, fiscal consolidation since 1999 has come primarily from the revenue side, with heavy reliance on indirect taxes, although initiatives have been taken to improve the quality and limit the growth of spending.*** 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. From 1999 to 2005, *almost 100 percent* of the 6.1 percentage points of GDP increase in the CGG primary surplus came from revenue-increasing measures—especially from higher indirect taxes. Indirect tax revenues increased from 11.7 percent of GDP in 1999 to 16.7 percent of GDP in 2005. In contrast to primary revenues, non-interest expenditures reflect no major changes during the period due to increase in social security transfers, despite the downsizing of investment and reduced expenditures for personnel in 2005. It should be noted, however, that initiatives have been taken to prevent low productivity expenditures, improve spending quality, and set expenditure priorities—for example, annual budget ceilings are set to recruitments in the public sector to better control the wage bill (with priority to education, health care, and justice), while non-priority investment projects have been excluded from the investment program. Although more steps are needed, as further explained below, these measures have supported a better control of expenditure growth than in the past.

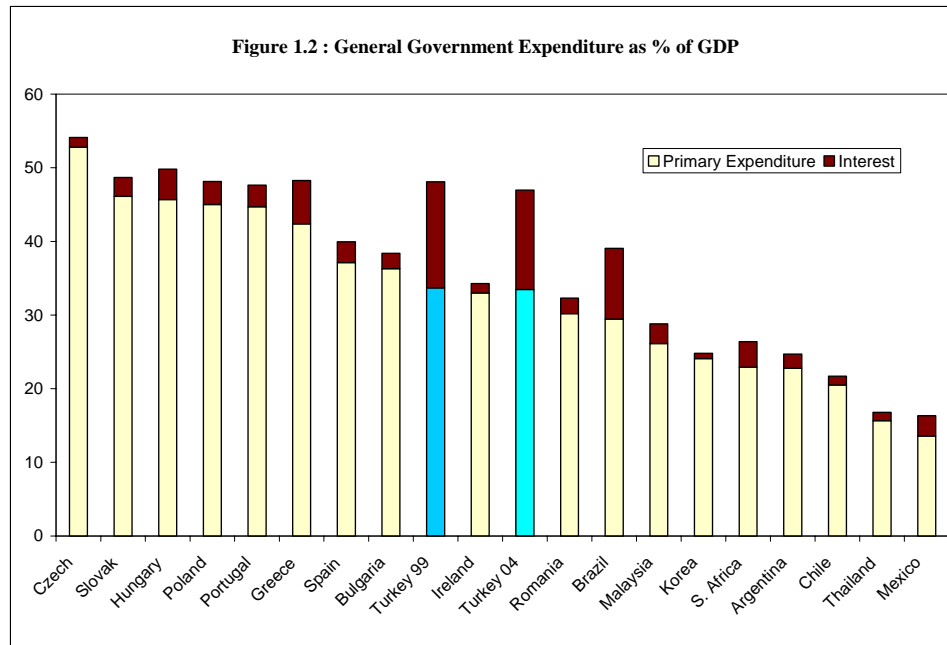
B. THE SIZE OF GOVERNMENT AND COMPOSITION OF EXPENDITURES IN INTERNATIONAL COMPARISON⁸

1.15 ***Turkey's primary expenditures are still at the low end of EU countries—*** Turkey's public expenditure allocations have been benchmarked against a set of countries comprising cohesion EU countries, new EU members, and emerging market economies. Reflecting still high interest payments on public debt, total expenditures of the Consolidated General Government (CGG) are among the highest of the comparison group (Figure 1.2). However, at 32.7 percent of GDP in 2004, primary expenditure is much lower, and compares favorably with the average size of government seen in cohesion countries of the EU and new EU members—although Turkey's primary expenditure in percent of GDP is at par with Ireland's and higher than Romania's.

1.16 ***—but much higher than in other emerging economies.*** Primary expenditure in the comparison group of emerging economies (excluding Mexico where available data do

⁸ In this section expenditure data for Turkey refer to 2004 rather than 2005 as comparable international data could not be collected for more recent years than 2003 or 2004. The changes in expenditure shares between 2004 and 2005 are not significant.

not capture properly spending by sub national governments) represented 23 percent of GDP in 2003, about ten percentage points of GDP lower than in Turkey. As primary expenditure was only marginally reduced in percent of GDP between 1999 and 2004, Turkey's relative position remained stable within the benchmark group.



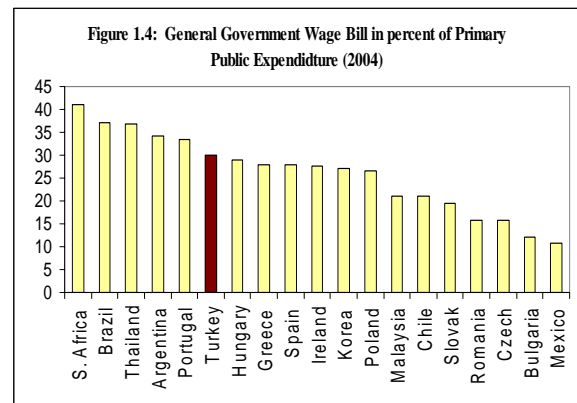
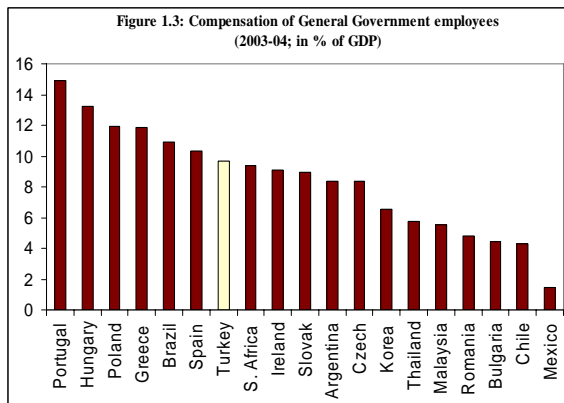
Source: World Bank staff calculations

B.1. Public expenditure by economic category⁹

1.17 *The Government wage bill is high compared to other emerging economies and some new EU members.* At 10 per cent of GDP in 2004, Turkey's expenditure on wages and salaries at the level of the General Government is relatively high. It is still lower than in Southern EU countries (Greece, Portugal, Spain) or in some new EU members with a tradition of bloated public service (Poland, Hungary—see Figure 1.3). However, personnel compensation is significantly higher than in other fast-growing emerging economies (Chile, Korea, Malaysia, Thailand) or in some new and acceding EU countries that have streamlined the public sector (Czech Republic, Bulgaria, Romania). At 30 percent of total General Government primary expenditure in 2004, up from 28.6 percent in 2000, the wage bill represents a large fraction of public spending by international

⁹ This section briefly examines, in international comparison, Turkey's expenditures for personnel compensation, current transfers, and public investment at the CGG level. These three categories comprised the bulk (75.4 percent) of primary CGG expenditures in 2004, or the equivalent of 24.6 percent of GDP. Remaining primary expenditures (the equivalent of 8 percent of GDP) are allocated for purchases of goods and services (7.3 percent of GDP) and capital transfers. The bulk of purchases of goods and services are allocated to health (3.8 percent of GDP) and Defense, Public order and safety (1.8 percent of GDP combined). A detailed cross-classification (i.e., economic and functional) of CGG expenditures is provided in Annex I.

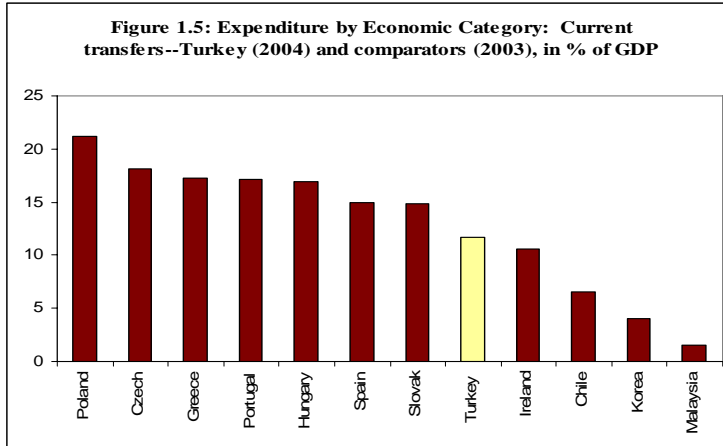
comparison (Figure 1.4). This imparts rigidity in the budget at a time when more fiscal space is needed.



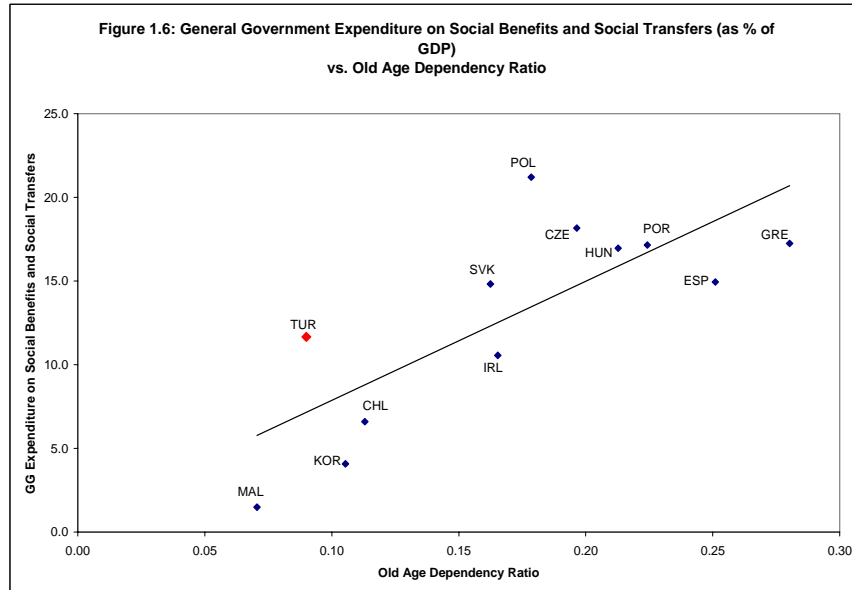
Source: World Bank staff calculations

1.18 *Expenditures for current transfers, mainly comprising social benefits, are oversized by international standards, in view of Turkey’s favorable demographics.* At 11.7 percent of GDP in 2004, expenditure on current transfers is lower than in most EU comparator countries (15 percent and up, with the exception of Ireland), but higher than emerging market economies such as Chile, Korea and Malaysia (Figure 1.5). Current transfers in their majority (8.5 percent of GDP) are for social protection, so that spending in this category is better analyzed in the context of the age distribution of population. Given that Turkey has a very young population and the lowest old age dependency ratio among a selected group of comparators, its social protection expenditures are oversized by international comparison (Figure 1.6). In addition, the proportion of Turkey’s population aged 65 and over to the labor force will increase by 10 percentage points between 2000 and 2020, according to OECD projections.¹⁰ Therefore, despite the current favorable demographic situation, in the future, Turkey is likely to face an upward pressure on social spending in order to expand the social safety net.

¹⁰ OECD Fact book 2005 – ISBN 92-64-01869-7 – © OECD 2005. See Section “Population and migration - demographic trends - ageing societies”.

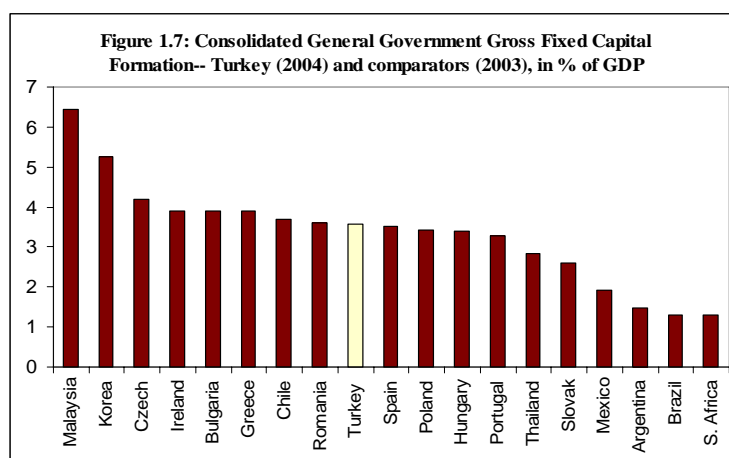


Source: World Bank staff calculations



Source: World Bank staff calculations

1.19 Turkey's domestic investment level is close to the average of comparator countries. Despite significant downsizing since 2001, public investment remains comparable to levels seen in other EU members, and higher than in other emerging economies (with the exception of Malaysia and Korea—see Figure 1.7). Although infrastructure gaps in Turkey may be larger than in cohesion countries or in some new EU members, careful consideration should be given to increasing the size of the PIP based on sound cost/benefit assessment of investment projects. The large portfolio of frozen projects suggests that the PIP has been oversized in the past, including with projects of questionable priority. Issues in the management of the public investment program are reviewed in chapter 2.



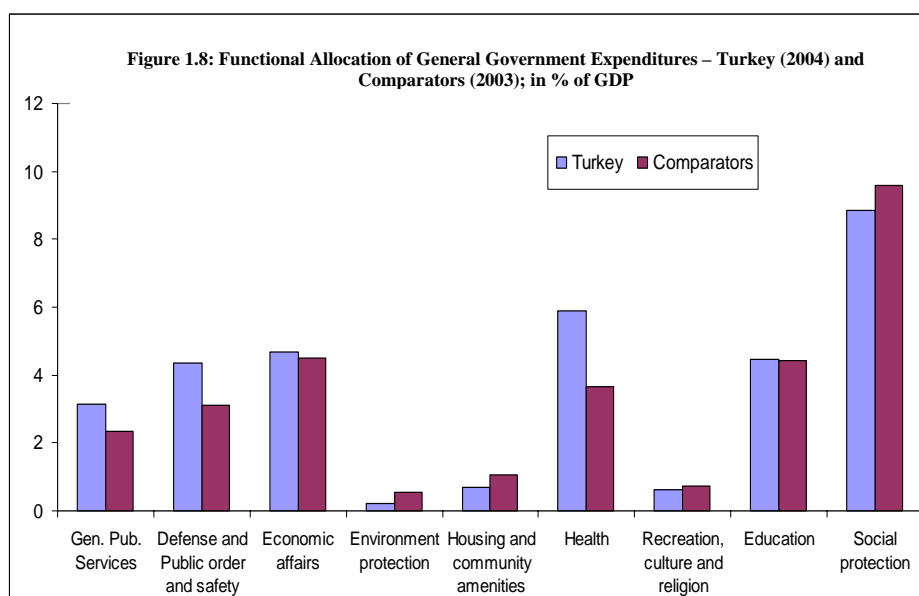
Source: World Bank staff calculations

B.2. Public Expenditure by Government function

1.20 *Implementation of functional classification of expenditures is very recent in Turkey.* Turkey initiated the GFS 2001 consistent functional classification for the consolidated budget institutions in 2004, and rest of the general government institutions started implementing the GFS classification with the 2006 budget. Although there have been some partial efforts to estimate the functional classification of social sector expenditures, an official functional breakdown of the general government expenditures is not available for 1999-2005.¹¹ The cross functional and economic classification for 2003 and 2004 used in this study is a first attempt to estimate the general government functional expenditures. Completing a functional classification of expenditures for past years will help analyze more accurately the sectoral impact of the fiscal adjustment. Turkey's functional distribution of consolidated general government expenditure has been benchmarked against a set of comparators for which a similar functional classification is available.¹² The main findings are summarized below (also see Figure 1.8) and further detailed in chapter 3 for specific sectors such as education, social protection, and health care:

¹¹ General Government social expenditures first initiated under the PEIR 2001 study of the World Bank. The coverage has been expanded under the PFPSAL program.

¹² Comparators include: Russia, Portugal, Greece, Czech Republic, Spain, Ireland, S. Africa, Romania, Malaysia, Mexico, Thailand, Brazil, and Chile. Turkey's size of government, as measured by primary expenditure in percent of GDP (32.6 percent in 2004), was broadly comparable to the average of these countries (30 percent of GDP in 2003).



Source: World Bank staff calculations

1.21 ***Expenditure for the provision of public goods (general public services, defense, public order and safety) is relatively high in international comparison.*** Spending levels in general public services and in defense and public order and safety are above the average of comparator countries by 0.8 and 1.2 percentage points of GDP respectively.

1.22 ***Expenditure on economic affairs (comprising mainly investment in infrastructure and various subsidies) is broadly in line with average levels in comparator countries.*** As already mentioned, this mainly reflects drastic downsizing of the investment budget and continuing reform of subsidies to agriculture since 1999.

1.23 ***Expenditure on health care is relatively high in international comparison.*** At 5.9 percent of GDP in 2004 (including Hospital Revolving Funds), CGG expenditure on health care is 2.2 percentage points of GDP higher than in the average of comparator countries. Public expenditure on health care depends of course on many factors, such as the structure of the health care system, demographics, and per capita GDP. Further analysis in this area is provided in chapter 3.

1.24 ***Expenditure on education is in line with comparators but educational attainment remains weak.*** Turkey spends more on education than other emerging economies with similar educational attainment. 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. As in other countries experiencing educational gaps, public expenditure on education would need to increase in the future to promote the closing of these gaps. This would be a pre-requisite for faster long-term growth (World Bank, 2006 CEM). However, in view of current levels of public spending, existing educational gaps also

suggest potential for efficiency improvements that should go in tandem with increases in the level of education expenditures. Options in this direction are reviewed in chapter 3.

1.25 *Expenditure on social protection is high by international comparison in view of Turkey's favorable demographics.* As noted earlier, although Turkey's expenditure in percent of GDP is on par with the average of comparator countries, favorable demographics suggest considerable room for savings through more ambitious pension reform.

1.26 *Expenditure on environmental protection is comparatively low and may need to increase on the way to the EU.* Alignment with the EU Acquis on environmental protection will place a burden on public expenditure for control of air pollution, quality of water supply, wastewater and waste management. Although considerable uncertainty surrounds the cost estimates of necessary investments, it should be noted that costs of meeting the Acquis requirements will also depend on policy choices and reforms in infrastructure services with environmental externalities, while there is considerable room for participation of the private sector.¹³

1.27 *Downsizing low-value expenditure programs, to make room for growth-enhancing expenditures and lower taxes, would deserve particular attention in the years ahead.* Turkey has accomplished a remarkable effort of fiscal consolidation since 1999 but improving the quality of fiscal adjustment will be a key challenge on the way to the EU. This is important for a number of reasons: (i) international experience suggests that the quality of fiscal adjustment is a key factor for sustainability and is closely associated with stronger growth performance;¹⁴ (ii) expenditure pressures are likely to be felt over the medium term, either as a result of past policy commitments—such as in education and access to universal health insurance (see chapter 4), or owing to a still pending reform agenda (such as in civil service pay); (iii) infrastructure investment may need to increase in less developed regions to alleviate persistence of regional disparities, while maintenance needs to be scaled up (see chapter 2); (iv) Government will have to make room in later stages of EU accession for expenditures in areas such as environmental protection where harmonization with the EU Acquis is costly—even though the cost will be, to some extent, offset by EU pre-accession funds; (v) civil service pay for highly qualified personnel may also need to increase to support the EU accession process.

1.28 *Trade offs in expenditure allocations would need to be considered 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.

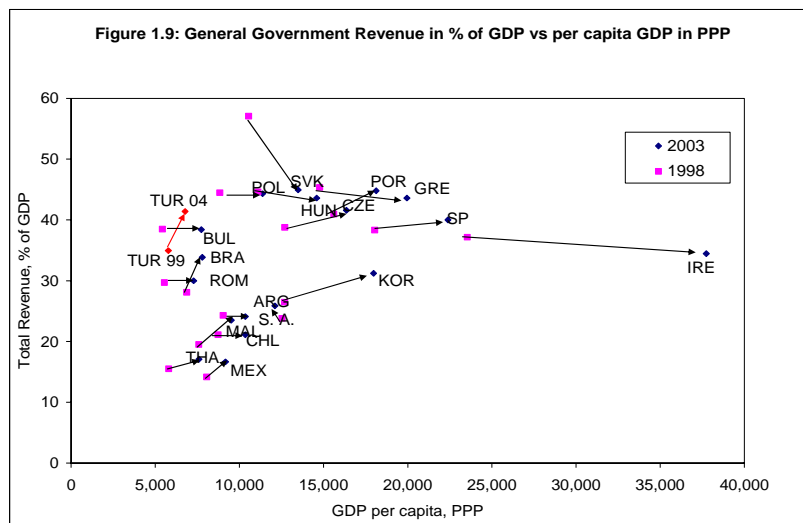
¹³ Markandya, A. 2005. "Turkey on the Path of to the Accession: The Environmental Acquis" p. 295 - 309 in "Turkey. Economic Reforms & Accession to the European Union", *co publication of the World Bank and the Centre for Economic Policy Research*

¹⁴ A. Alesina and R. Peroti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", IMF Staff Papers, 1997; A. Alesina and S. Ardagna, "Tales of Fiscal Adjustment", Economic Policy, 1998; R. Peroti, "Fiscal Consolidation in Europe: Composition Matters", American Economic Review, 1996.

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 (such as general public services and defense, public order and safety). At the same time, reforms should be implemented with the aim of improving the efficiency of expenditure programs in areas where expenditure pressures are being felt—such as health care, education, social protection (see chapter 3). *Horizontal* reforms, focused on the modernization of civil service pay and employment system, and the rationalization of the investment program would also help contain expenditure pressures on the wage bill and investment spending and thus better control public expenditure across functional areas. Incorporation of tax expenditures into the budget allocation process would also support their rationalization, help avoid duplication with direct expenditure programs, and support tax base broadening. Reform options in these horizontal areas are reviewed in chapter 2.

C. THE REVENUE SIDE

1.29 *As a result of revenue-driven fiscal adjustment, general government 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 fiscal 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 (Figure 1.9). But contrary to this trend, and as a result of the pattern of fiscal adjustment since 1999, general government revenues in Turkey stood at 40 percent of GDP in 2005, a level that is now similar to EU countries.¹⁵ The increase in the fiscal burden in 1999-2005 was the largest among the comparator countries—similar only to Brazil.

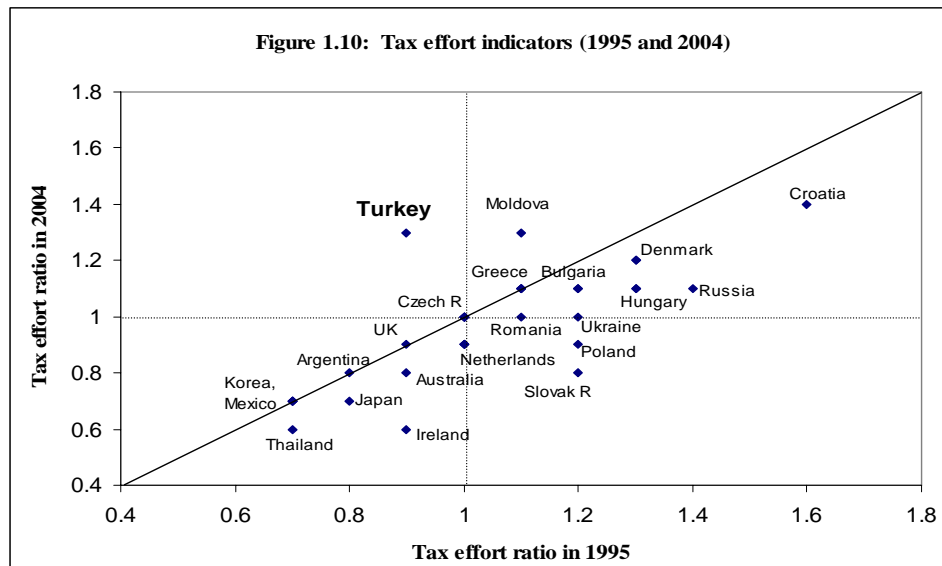


Source: World Bank staff calculations

¹⁵ General government revenues include tax revenues, social security contributions, factor income (mainly revenues from SOE's), and interest income.

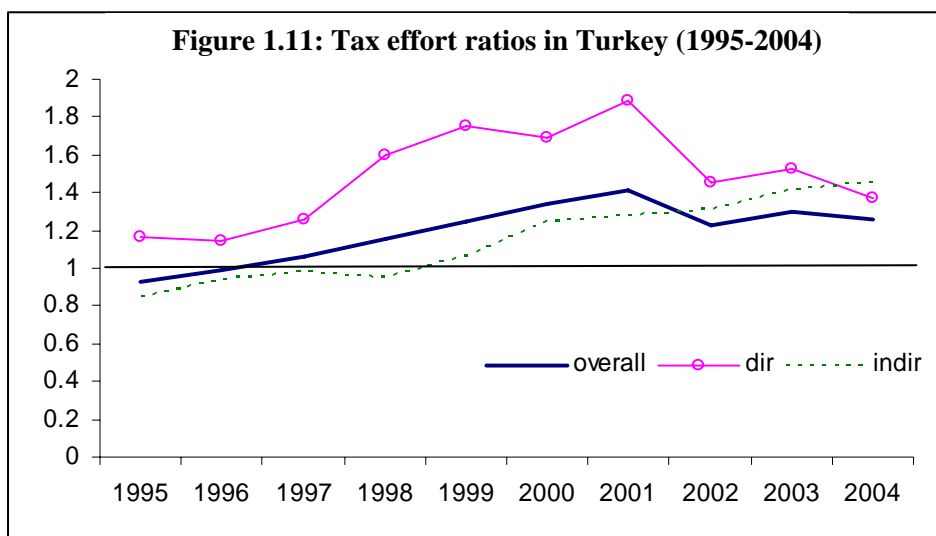
1.30 *The tax effort in Turkey is largely above the average of comparator countries.* Tax revenues (including social security contributions) have increased to 31.7 percent of GDP in 2004, from 27.1 percent in 1999 and 19.7 percent in 1995. Whether or not this fiscal performance is above the expected norm can be judged by accounting for factors that affect tax performance across countries. A formal analysis of tax performance across countries in the period 1995-2004 confirms that differences in per capita income, the share of agriculture in GDP, and openness to trade, are consistent factors accounting for international variations in tax ratios (see Annex IV). Accounting for such determinants of tax performance, the estimated “tax effort ratio” in Turkey was 1.3 in 2004, indicating an actual tax ratio of about 30 percent higher than expected based on international experience.¹⁶ Turkey’s tax effort was one of the highest among comparators, mainly OECD countries and emerging economies, equal to that of Moldova and surpassed only by Croatia (Figure 1.10).

1.31 *The tax effort has been on the rise, with recently opposing trends between direct and indirect taxes.* The tax effort ratio was less than potential in 1995, at an estimated level of 0.9 (Figure 1.10). It has steadily increased since then and reached its peak in 2001, initially boosted by above-potential direct tax collections and, later, by a strong indirect tax effort (Figure 1.11). The overall tax effort has stabilized since 2002 at around 1.3, on the back of a slightly lower direct tax effort while, at the same time, the indirect tax effort has kept increasing reflecting the introduction of special consumption taxes and a heavy reliance on excises.



Source: World Bank staff calculations

¹⁶ Tax effort is measured by comparing the actual tax ratio of a country with that predicted by using a panel regression. An index of one means the country’s tax effort is at the expected level, given the structural factors of the country. In that case the country is using its taxable capacity at level consistent with the average of the other countries in the sample. See annex IV for the calculations. A tax effort ratio above one potentially indicates excessive taxation, which may have a negative incidence on efficiency and growth for many reasons (capital is mobile; labor and sales could go to the informal market, etc).



Source: World Bank staff calculations

1.32 High actual tax ratios and estimated tax effort suggest limited room for further revenue mobilization in the coming years. The high estimated tax effort ratios should not be interpreted as indicating limited room for broadening tax bases, strengthening tax compliance, and improving tax administration—all priority areas of fiscal policy in Turkey, especially in view of the extensive informal economy. However, in most comparator countries the tax effort ratio is close to one—on average, an estimated 0.9 in the 8 new EU members in 2004. The high tax effort ratio tends thus to suggest that the tax burden in Turkey is overstretched, most likely reflecting high and multiple tax rates, given Turkey’s level of development and economic structure. There is thus very limited room for further revenue mobilization through higher tax rates or new taxes in the years ahead. With a fiscal burden higher than in other emerging economies, further increases in tax rates would risk hindering competitiveness, bolstering informality, and eventually compromising growth. There is, however, considerable room for broadening the tax bases, as explained in World Bank 2006 (CEM) and in chapter 2 (see section on tax expenditures). Tax base broadening would create room for lowering the tax rates in the future.

1.33 The composition of revenues has shifted markedly toward indirect taxation over the last few years. Hikes in excise rates along with buoyant VAT collections in the post-crisis years combined to increase indirect tax revenues from 11.6 percent of GNP in 1999 to 16.7 percent of GNP in 2005. During the same period, personal income tax (PIT) revenue fell from 6.5 percent of GNP in 2001 to only 4.9 percent GNP in 2005, while corporate income tax (CIT) revenue remained broadly stable. As a result of these trends, Turkey is one of the countries with the heaviest reliance on indirect taxes among OECD countries, with indirect taxes representing 52 percent of tax revenues, against 36.5 percent on average in the OECD (Table 1.3).

Table 1.3. Revenue Breakdown for selected OECD Countries

General Government (in percent of GDP)	2003								
	Taxes & SS	Taxes	Income Tax	PIT	CIT	VAT	Excises	Imp Duty	SS
Austria	43.0	28.3	12.9	10.4	2.3	9.5	2.7	0.0	14.7
Belgium	45.2	30.6	16.5	13.4	3.0	12.2	2.2	0.3	14.6
Canada	33.6	28.6	15.6	11.8	0.3	0.2	4.9
Czech Republic	36.5	21.3	9.6	4.9	4.7	8.4	2.5	1.3	15.2
Denmark	48.7	47.1	28.8	26.0	2.8	17.8	4.0	...	1.7
Finland	44.8	32.6	17.5	14.0	3.5	14.0	4.3	0.0	12.2
France	43.4	26.8	10.3	8.1	2.2	14.2	2.5	0.0	16.6
Germany	40.3	22.8	10.3	7.7	2.6	0.7	17.5
Greece	36.1	23.2	8.3	4.9	3.3	11.9	3.2	0.0	12.9
Hungary	39.1	26.4	9.3	7.1	2.2	13.2	3.3	1.1	12.7
Ireland	29.6	25.0	11.9	7.0	3.8	9.1	2.0	1.4	4.6
Italy	42.6	29.8	13.2	10.8	2.3	11.7	2.5	0.0	12.9
Netherlands	38.7	24.2	10.1	6.9	3.2	10.7	1.3	1.3	14.5
Norway	43.4	33.4	19.3	11.2	4.3	14.4	1.7	0.1	9.9
Poland	36.6	22.5	6.3	4.1	2.2	12.8	3.9	1.0	14.1
Portugal	36.9	25.1	9.1	5.9	3.2	14.8	3.3	0.2	11.8
Slovak Republic	31.2	18.8	7.0	3.4	2.8	9.3	...	1.4	12.4
Spain	35.8	23.0	10.2	6.9	3.3	10.3	2.6	0.0	12.8
Sweden	50.2	35.8	18.1	16.0	2.1	17.1	3.3	0.0	14.4
United Kingdom	36.1	28.9	13.2	10.4	2.8	10.5	3.5	0.0	7.3
United States	25.5	18.5	10.8	8.9	2.0	10.0	1.6	0.2	7.0
Turkey (2004)	30.3	23.3	7.3	5.0	2.3	8.0	7.7	0.3	7.0
OECD average:	39.1	27.4	12.9	9.5	2.9	11.8	2.5	0.7	11.7

Source: OECD and World Bank staff calculations

1.34 *High excises, narrow tax bases, and high labor income taxes are main features of the tax system.* While international comparisons of tax ratios need to be interpreted with care, three features of the tax structure in Turkey are especially noteworthy:

- *A very heavy reliance on excises*, which account for nearly one-third of all tax receipts and raise at least twice as much, relative to GDP, as in any other country in the sample.¹⁷ Heavy reliance on excises is of concern as it may encourage activity in the informal sector, which would further undermine the tax bases and impede efficiency for the economy as a whole. Reducing this high level of excise taxation does not appear, however, to be seen as a priority: the 2005 budget included several excise increases in order to attain the primary surplus target while meeting spending needs.¹⁸

¹⁷ This appears to mainly reflect high rates on ‘traditional’ excisable goods: around half is from petroleum products alone—indeed, at about \$8/gallon, pump prices for gasoline are about the highest in Europe. In addition, the taxes on “luxury goods” raise revenue of about 0.1 percent of GDP.

¹⁸ Of course excises need to be raised to ensure that negative externalities are fully offset. While a systematic international comparison of specific excises would be appropriate, cursory evidence suggests that excises in Turkey are comparatively high. For example, super gasoline prices in 2005 were 20 percent higher than in Poland and 50 percent higher than in Romania. In the 2006 budget, while total tax revenues

- ***Low receipts from, and reliance on, income taxation.*** Although the PIT yield in percent of GDP is significantly lower than the OECD average, the top marginal rate was a substantial 40 percent in 2005 for non-wage earners (planned to be reduced to 35 percent in 2006). One reason for this pattern may be the existence of a large informal sector. Similarly, Corporate Income Tax (CIT) revenues are somewhat lower than the OECD average, despite the fact that the CIT rate in 2004 was a substantial 33 percent (though reduced in 2005 to 30 percent).¹⁹ This indicates that the base of the tax is narrow, owing to substantial tax expenditures as further discussed below.
- ***A high tax wedge on labor income.*** When the PIT, employer and employee social security contributions, and the stamp duty on wages are combined, total payments to the government out of labor income can approach 43 percent of the labor cost for some workers (see World Bank 2006). Indeed, according to the OECD's *Taxing Wages* study, Turkey emerges as the country with the highest labor tax wedge for the married "average production worker" with a non-working spouse and two children. High labor income taxation impedes employment generation, particularly in the formal labor market.

1.35 ***Reliance on indirect taxation may have a regressive incidence on income distribution but offers some advantages that should be taken into account in the design of the tax system.*** Reliance on indirect taxes is often criticized on equity grounds, as the tax burden is indiscriminately distributed across all income groups. Nevertheless, given pervasive informality, in the short term, 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. Moreover, indirect taxes offer a more symmetrical treatment of labor, transfer, and capital income, thus meeting some criteria for horizontal taxpayer equity better than income taxes that discriminate against some types of income or are subject to considerable evasion. These factors tend 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 distort relatively less incentives to work. Hence, all else equal, a tax mix relying more on indirect taxes may be more conducive to growth. Caveats apply, however, to these considerations, if greater reliance on indirect taxes is accompanied by proliferation of special regimes and exemptions, which may boost tax evasion and feed informality, thus being counterproductive for growth (see chapter 2, section D for more information about tax expenditures related to the VAT regime in Turkey).

1.36 ***Reducing the burden of indirect taxes would call for careful study and long-term design.*** Although the balance between direct and indirect taxation in Turkey is considerably out of line with that in comparator countries, options are limited in the short to medium term because revenue cuts in one area must—given the continued

are estimated to increase by 11 percent, the increase in SCT on Petroleum and Natural Gas is lower, estimated at 3 percent.

¹⁹ Further reduction in the CIT rate to 20% has been initiated starting from January 2006.

macroeconomic need to achieve large primary surpluses—be offset by gains in another. If excises and VAT collections are cut, then income taxes will likely need to be raised. However, such a substitution of direct for indirect taxes would not be advisable in view of the above-mentioned considerations regarding the efficiency benefits of indirect taxes and their equity-improving incidence when significant informality is present, as in the case of Turkey. Appropriate fiscal space for lower indirect taxation will thus have to be created over the long term. Fiscal space could come 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. The analysis that follows presents options for income tax reform with the aim of improving efficiency and broadening the tax base. Eventually, these initiatives will also facilitate a shift in the balance of the tax burden between direct and indirect taxation.

1.37 ***The tax landscape is changing fast***— The authorities are currently in the process of reviewing and rewriting each of their major tax laws, also following commitments taken in the last Stand-By Arrangement with the IMF. The authorities eliminated stamp duties on financial transactions in 2004, and in April 2005 announced their intention to eliminate the two remaining financial intermediation taxes—the Banking and Insurance Transaction Tax (BITT) in 2006 and Resource Utilization Support Fund (RUSF)—if conditions permitted, within the program period. A new regime for capital income taxation was to be introduced as from 2006, subjecting interest and capital gains, including on previously exempt government securities, to final withholding at 15 percent. This would move Turkey closer to an explicit “*dual income tax*” (DIT) model of the sort employed in the Nordic countries. Labor would remain subject to progressive taxation, while capital income would be subject to a flat and relatively modest rate—in recognition of the futility of trying to tax a highly mobile base like capital.

1.38 ***—but sometimes without sufficient attention to tax neutrality and tax equity considerations.*** Further to the recent financial market turmoil, in an attempt to improve the attractiveness of domestic Government bonds to investors, the authorities waved the 15 percent withholding tax for non-resident investors, while for domestic investors the rate was lowered to 10 percent. For domestic investors, the 15 percent withholding tax on deposits and repos will remain in place. The tax exemption for all derivative instruments will remain in place indefinitely. These initiatives will undo the simplification and elimination of asset-specific distortions that the withholding tax regime was supposed to achieve. As for offering different tax treatment to non-residents, despite the temporary boost to the attractiveness of government bonds, this will also create tax loopholes and incentives for residents to misreport their investments, thus putting the domestic tax base at risk. A better option, perhaps over the longer run, would be to apply a common tax across investors and then work on building a broader array of tax treaties that would carve out particular exceptions for non-residents.

1.39 ***The 2006 budget and draft legislation to amend the existing PIT and CIT laws initiated significant reforms of the Corporate Income Tax and the Personal Income Tax.*** They include: (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 for non-wage earners, 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.²⁰ As a result of tax base broadening, due to the elimination of the ITA, ongoing tax administration reforms, and broader strengthening of the CIT code (regarding, for example, transfer pricing and thin capitalization),²¹ the Government does not expect a significant impact of these measures on CIT collections, and stands ready to take offsetting expenditure measures if necessary to keep the primary surplus on target. The CIT tax reforms have the potential to promote investment on a sound basis and stimulate job creation in the formal sector. The PIT reform will improve the efficiency of the tax system, as the dual tax system for wages and non wage income created complication and incentives for income recharacterization, and was unduly generous to highly paid wage earners. Unifying the rate schedules is consistent with movement towards a Dual Income Tax system. The CIT legislation has been put into force, while only the PIT legislation concerning the tax brackets and tax rates has been implemented.

1.40 *Reduced VAT rates introduced recently are of questionable effectiveness and not supportive of base broadening efforts.* As part of its tax initiatives the Government announced in March 2006 reduced VAT rates on textiles, clothing, and some leather products. These measures are intended to help domestic producers face competition from cheaper imports and also to provide incentives for better formalization in these sectors where informal activity is particularly important.²² However, the instrument used is not appropriate for the goal pursued, as reduced VAT rates on textiles and clothing, if anything, will boost consumption and imports and thus intensify competition faced by domestic producers. In addition, multiple VAT rates and exemptions (see chapter 2, section D) increase the complexity of the tax system, create more opportunities for misreporting and misclassification for tax purposes, and thus work against efforts of strengthening tax compliance.

1.41 *Initiatives in the years ahead should focus on tax-base broadening.* Two goals should be pursued with appropriate prioritization: (i) In the short term, promoting tax rationalization, with the aim of reducing the distortions associated with a given level of the tax burden and broadening the tax bases; (ii) Over the medium term, making fiscal room for lower taxes, by taking advantage of the reduction in the debt ratio and pursuing public expenditure reforms aimed at containing expenditure pressures.

²⁰ By the new reform, it is also planned to reduce the lowest tax rate for income components other than wages from 20 percent to 15. The highest and the lowest tax rates on wages will be maintained at 35 percent and 15 percent respectively, thus effectively unifying the two tax schedules.

²¹ “Thin capitalization” occurs when multinational firms are able to shift profit across jurisdictions for tax purposes by increasing the amount of debt financing in jurisdictions with high tax rates in order to benefit from the deductibility of interest from the corporate tax base.

²² Authorities argue that the rate reduction will also tame incentives to use forged documents to get fictitious rebates in VAT refund system, thus helping improve compliance in the short term.

D. STRUCTURAL AND CYCLICAL COMPONENTS OF THE BUDGET BALANCE

1.42 *Structural budget balances convey useful information about the fiscal stance prevailing in an economy and the extent of fiscal adjustment.* Government budgets can significantly be affected from growth cycles. For example, during economic contractions, there will be a reduction in tax revenues and an increase in unemployment benefits and other social protection expenditures. By contrast, during economic expansions, there will be an increase in tax revenues and a decrease in unemployment benefits and related expenditures. Therefore, an analysis aiming at measuring fiscal stance and the extent of fiscal adjustment has to distinguish between structural and cyclical parts of the budget.

1.43 *Changes in the structural deficit can contribute to the assessment of the sustainability of fiscal adjustment in the medium term by identifying the impact of the growth cycle on the budget.* Short-term improvements in the budget, due to robust economic growth, may be reversed when growth slows down and should therefore not be seen as an underlying improvement in public finances. Relaxing fiscal discipline by interpreting a cyclical improvement in budget balance as permanent at a time when the economy expands may create unsustainable budget deficit and debt stock in the medium term. In a similar way, to interpret a cyclical increase in the budget deficit as permanent when the economy contracts and taking measures to reduce the deficit may exacerbate the slow down.

1.44 *The sustainability of Turkey's strong fiscal performance depends on how much of the achievement was due to policy-induced changes as opposed to cyclical improvements stemming from robust growth.* It would also depend on whether the policy-induced changes are sustainable themselves over the medium term. The lack of major restraint in non-interest expenditures can raise questions as to the sustainability of the adjustment as discussed earlier. This section aims to address only the first issue above related to the cyclicity of the observed fiscal adjustment.

1.45 *The basic methodology for estimating structural budget balance mainly consists of two steps; measuring the potential output and linking the related budget items, revenues and expenditures, to the cycle.* The methodology used in this study and its alternatives are discussed in detail in the Annex III. Because long time series data is not available at general government level, estimations relied on consolidated budget figures. Estimated tax elasticities were then used to adjust tax revenues for the cycles in economic activity. These adjusted tax revenues were then used to calculate structural budget balances both at the consolidated budget level and general government level.²³ On the expenditure side, no adjustments were made for the impact of cycles in economic activity. The main budget expenditure item sensitive to the cycle is unemployment

²³ The consolidated budget accounts for more than 85 percent of the total tax revenues at the general government level. Therefore using the elasticities estimated for the consolidated budget also for the general government is a reasonable assumption.

insurance. It should be noted that unemployment insurance is a recent development in Turkey with very little insurance payments to unemployed so far and is also out of the coverage of the consolidated budget.

1.46 *Tax elasticities in Turkey are close to the OECD average.* Table 1.4 compares our elasticity estimates for Personal Income Tax (PIT) and Corporate Income Tax (CIT) in Turkey with existing estimates for OECD countries. Following standard practice, the elasticity of indirect taxes is taken as unity. Indirect taxes are assumed to increase one to one with the income growth, as they are not expected to be progressive or regressive. Therefore, income elasticities have been estimated only for PIT and CIT (see Annex III). The estimated elasticities are close to the OECD averages. The fact that the elasticities are greater than one reflects the progressivity of taxes in Turkey, as in most OECD countries.

Table 1.4: Output Elasticity of Taxes ⁽¹⁾

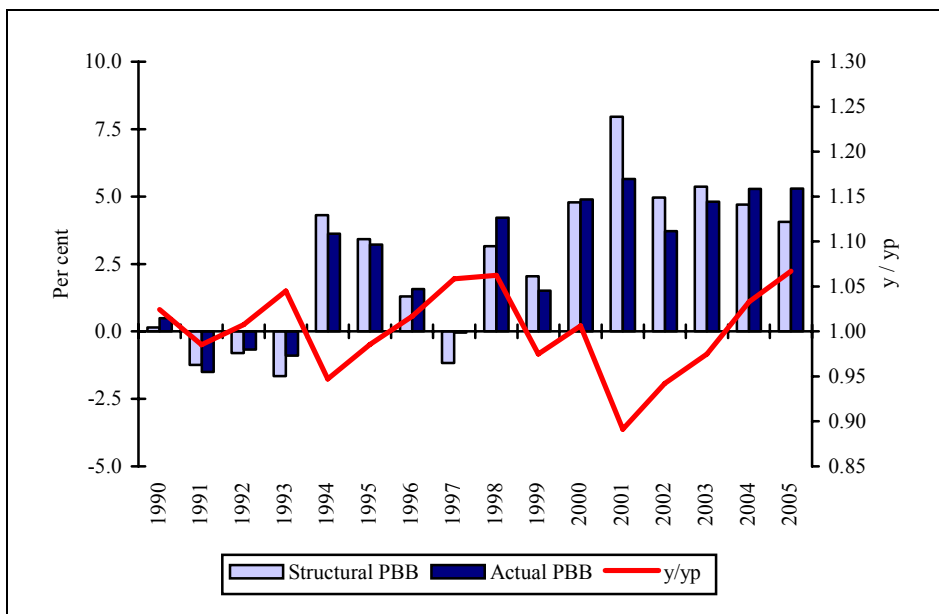
	Income Tax	Corporate tax
United States	1.3	1.5
Japan	1.2	1.6
Germany	1.6	1.5
France	1.2	1.6
Italy	1.8	1.1
United Kingdom	1.2	1.7
Canada	1.1	1.5
Australia	1.0	1.4
Austria	1.3	1.7
Belgium	1.1	1.6
Denmark	1.0	1.6
Finland	0.9	1.6
Greece	1.7	1.1
Ireland	1.4	1.3
Netherlands	1.7	1.5
New Zealand	0.9	1.4
Norway	1.0	1.4
Portugal	1.5	1.2
Spain	1.9	1.2
Sweden	0.9	1.8
Average	1.3	1.5
Turkey ⁽²⁾	1.5	1.6

(1): Elasticities for all countries except Turkey are taken from the study “Girouard, N. and C. André (2005), Measuring Cyclically-Adjusted Budget Balances for OECD Countries, Economics Department Working Papers, No. 434.

(2): World Bank staff estimations

1.47 *Estimated structural primary budget balances indicate a strong consolidated budget performance from 2000 onwards.*²⁴ Using the elasticities given in Table 1.4, structural budget balances were first calculated for the consolidated budget. The structural primary budget balances were close to zero or in deficit of 1-2 percent of potential GDP in the early 1990s (Figure 1.12). Although budget performance improved after the crisis in 1994, this did not last long as the government eased fiscal discipline soon after a short-term recovery from the crisis. At the end of the 1990s, the fiscal imbalances were unsustainable and therefore a substantial fiscal adjustment was a necessity. The government initiated a significant fiscal adjustment in 1998 and this adjustment was further strengthened after the crisis in 2001. The structural primary budget surplus for the consolidated budget was consistently above 5 percent during this period with a peak in 2001 where the fiscal measures taken led to very high budget surplus in proportion to GNP. Similar conclusions follow from the analysis of changes in the structural overall balance of the consolidated budget (Figure 1.13).

Figure: 1. 12. Actual and Structural Primary Budget Balances for Consolidated Budget

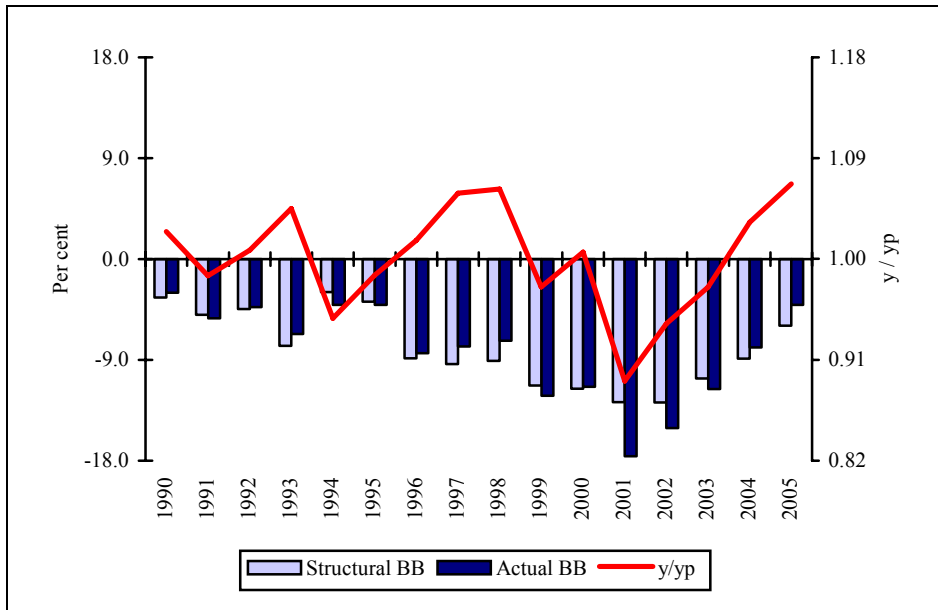


Note: Structural budget balances are percent of potential GNP, while actual budget balances are percent of actual GNP.

Source: World Bank staff calculations

²⁴ Note: Privatization revenues are excluded from the calculations as they represent one-off asset sale revenues and are not steady revenue sources.

Figure: 1. 13. Actual and Structural Budget Balances for Consolidated Budget



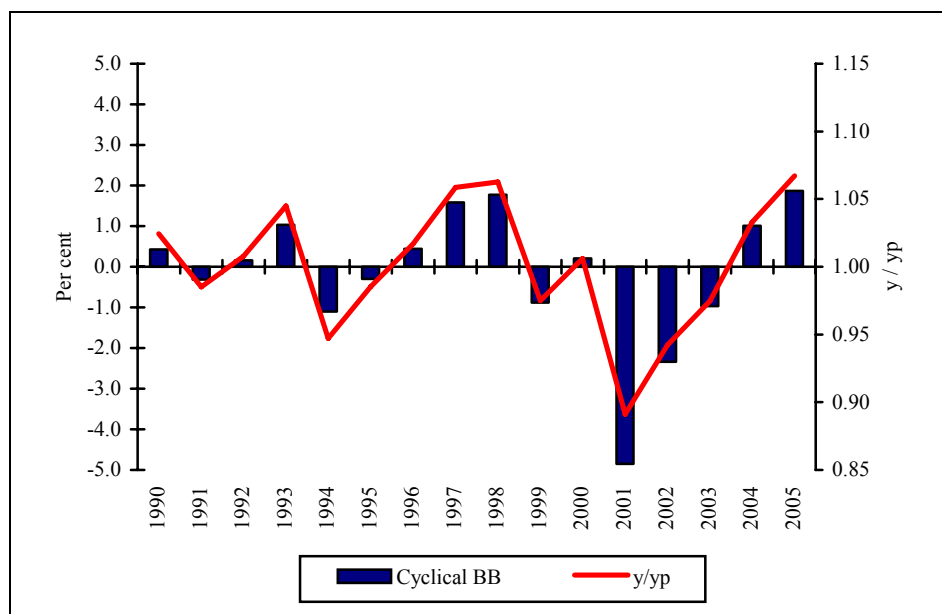
Note: Structural budget balances are percent of potential GNP, while actual budget balances are percent of actual GNP.

Source: World Bank staff calculations

1.48 *A significant part of the large primary fiscal surplus in 2004 and 2005 reflects a contribution from strong growth.* The estimations show that the negative cyclical budget balances due to output being lower than potential vanished and the cyclical component of the consolidated budget balance was significantly positive, up to 1.9 percent in 2005 (Figure 1.14). The growth rate was at historic highs and, as suggested by the estimations, the output was above potential both in 2004 and 2005. The contribution of the cycle to the performance of the primary budget balance has reached substantial levels as of 2005.²⁵ This indicates that the current fiscal performance can be significantly undermined in case of a slowdown in growth.

²⁵ This is so despite the fact that automatic stabilizers in Turkey are rather weak compared to other countries. This reflects the large share of agriculture (which does not pay taxes) and the informal economy, and also the large share of indirect taxes which are less cyclical compared to direct taxes.

Figure: 1.14 Cyclical Budget Balance for Consolidated Budget



Source: World Bank staff calculations

1.49 *Changes in the structural budget balance are a useful indicator of whether fiscal policy dampens or amplifies the cycle.* Table 1.5 compares the changes in output gap and structural fiscal balances from the previous year. A positive association of the changes in the structural fiscal balances with the changes in the output gap implies a counter-cyclical fiscal stance: It shows that fiscal adjustments are taking off steam from an overheating economy or, inversely, supporting a flagging economic activity. By contrast, a negative association implies a pro-cyclical fiscal stance with a magnifying effect on the cycle.

1.50 *Measured at the level of the consolidated budget, the fiscal stance has often turned pro-cyclical.* The analysis of the changes in the output gap and structural fiscal balances in the Table 1.5 shows that the fiscal stance was mostly pro-cyclical before 2001 and this was particularly the case in the first half of 1990s. In this context, it can be claimed that pro-cyclical fiscal stimulus has exacerbated the growth cycles. Although the pattern seemed to be changing in 2002-2003, with a positive correlation as the government maintained a surplus throughout the initial years of the recovery, the weakening in the structural primary balances in 2004-2005 indicates that the fiscal stance has become pro-cyclical again.

Table 1.5: Fiscal Stance and the Output Gap⁽¹⁾ (Consolidated Budget)

	Change from the Previous Year (Percentage points)		
	Output gap (actual/potential)	Structural Primary Budget Balance (% of Potential GNP)	Structural Budget Balance (% of Potential GNP)
1990	4.4	-0.4	-0.5
1991	-3.9	-1.4	-1.5
1992	2.3	0.4	0.5
1993	3.7	-0.9	-3.3
1994	-9.8	6.0	4.8
1995	3.8	-0.9	-0.9
1996	3.1	-2.1	-5.1
1997	4.2	-2.5	-0.5
1998	0.4	4.3	0.3
1999	-8.8	-1.1	-2.2
2000	3.1	2.7	-0.3
2001	-11.5	3.2	-1.2
2002	5.1	-3.0	0.0
2003	3.3	0.4	2.2
2004	5.8	-0.7	1.7
2005	3.4	-0.6	2.9

(1): Bold figures in the table shows pro-cyclical fiscal policy periods while unbolded ones show counter-cyclical fiscal policy periods.

Source: World Bank staff calculations

1.51 *The estimated structural primary budget balance confirms that fiscal performance was also strong at the general government level.*²⁶ Structural budget balances for the general government have also been calculated using the same tax elasticities estimated for the consolidated budget. However, in the case of general government, social security contributions are also adjusted for the cycle. The estimated elasticity of 0.82 indicates that social security contributions are regressive. Social security contributions are usually levied at a flat rate up to a ceiling and this makes them moderately regressive. The elasticity of 0.82 is close to the average of OECD countries (Table 1.6). The estimated structural primary balance of the general government was, on average, about 6 percent for the period of 2000-2005 (Figure 1.15). The overall structural deficit of the general government has declined substantially after 2001 with the help of high primary surpluses and declining real interest rates. The structural deficit declined from a peak of 14 percent in 2001 to about 6 percent in 2005 (Figure 1.16).

²⁶ Note: Privatization revenues are excluded from the calculations as they represent one-off asset sale revenues and are not steady revenue sources.

Table 1.6: Output Elasticity of Social Security Contributions ⁽¹⁾

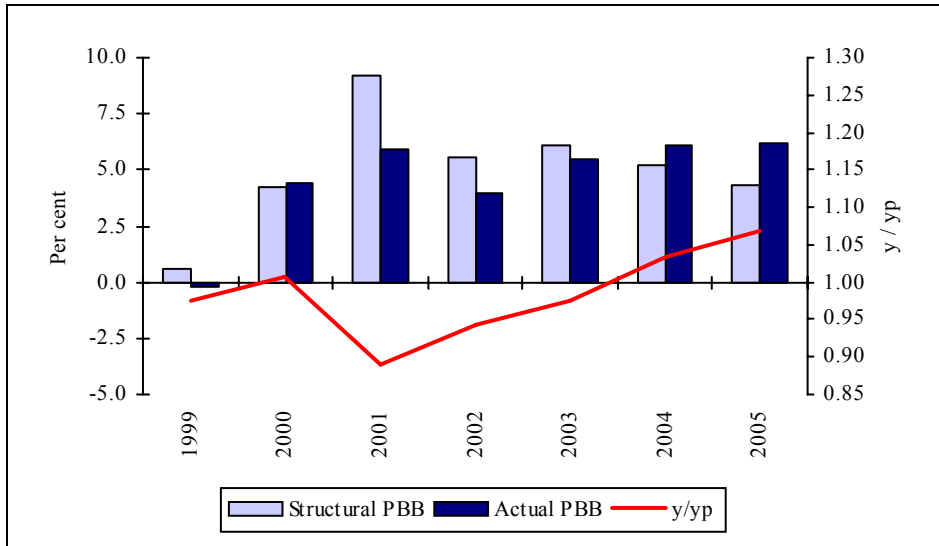
Social Security Contributions	
United States	0.6
Japan	0.5
Germany	0.5
France	0.8
Italy	0.9
United Kingdom	0.9
Canada	0.6
Australia	-
Austria	0.6
Belgium	0.8
Denmark	0.7
Finland	0.6
Greece	0.8
Ireland	0.9
Netherlands	0.6
New Zealand	-
Norway	0.8
Portugal	0.9
Spain	0.7
Sweden	0.7
Average	0.7
Turkey ⁽²⁾	0.8

(1): Elasticities for all countries except Turkey are taken from the study “Girouard, N. and C. André (2005), Measuring Cyclically-Adjusted Budget Balances for OECD Countries, Economics Department Working Papers, No. 434.

(2): World Bank staff estimation

1.52 *However, measured at the General Government level, the fiscal stance has not been uniform since 2000 and has turned somewhat pro-cyclical more recently.* Despite strong performance over those years, the structural primary surplus increased during 1999-2003, but has declined by 1.8 percentage points of potential GDP since then. Similar to the case of the consolidated budget, Table 1.7 compares the annual changes in output gap and structural fiscal balances at the general government level. The analysis confirms that fiscal policy turned pro-cyclical in 2001-2002 and in 2004-2005, with a negative association of the changes in the structural fiscal balances with changes in the output gap.

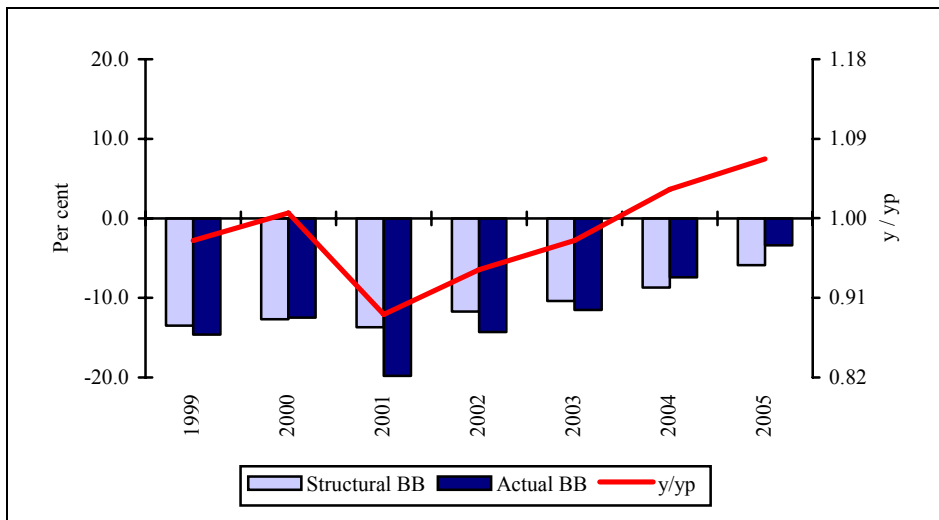
Figure: 1.15. Actual and Structural Primary Budget Balances for General Government



Note: Structural budget balances are percent of potential GNP, while actual budget balances are percent of actual GNP.

Source: World Bank staff calculations

Figure: 1.16. Actual and Structural Budget Balances for General Government



Note: Structural budget balances are percent of potential GNP, while actual budget balances are percent of actual GNP.

Source: World Bank staff calculations

1.53 The pro-cyclicality of the fiscal stance during the first period is a reflection of the adjustment to the crisis. In 2001-2002, pro-cyclicality reflected the necessary fiscal adjustment to the crisis, despite a sharp contraction in economic activity. However, as many of the one-off, revenue raising measures vanished in 2002, structural budget balances deteriorated although growth was recovering. This pattern of fiscal adjustment contributed to the pro-cyclical stance of fiscal policy in 2002.

1.54 *Since 2004, the decline in the structural budget balances indicates an easing in the fiscal stance attributable to fiscal imbalances of a more fundamental nature.* This weakening in the structural primary balances mainly reflects the decline in the structural primary balances of the consolidated budget, social security institutions and local administrations. The structural primary balances of the consolidated budget declined by 0.7 percent of the potential GNP in 2004-2005.²⁷ The structural primary balances of the social security institutions weakened by 1.2 percent of potential GNP in the period 2004-2005 and by 0.7 percent of potential GNP in 2005 alone. The long-awaited amnesty for premium collections must have contributed to this outcome. It is expected that the recently enacted social security reform will slowly contribute to the reversal of this trend over the coming years (see chapter 3). Similarly, the structural primary balances of the local administrations fell by 0.6 percent of potential GNP in 2005 but the overall decline over 2004-2005 was only 0.4 percent of potential GNP due to a small improvement in 2004. The pro-cyclicality in the last period is likely to have had a magnifying effect on the growth cycle.

Table 1.7: Fiscal Stance and the Output Gap⁽¹⁾ (General Government)

	Change from the Previous Year (Percentage points)		
	Output gap (actual/potential)	Structural Primary Budget Balance (% of Potential GNP)	Structural Budget Balance (% of Potential GNP)
2000	3.1	3.7	0.8
2001	-11.5	5.0	-0.9
2002	5.1	-3.7	2.0
2003	3.3	0.6	1.3
2004	5.8	-0.9	1.7
2005	3.4	-0.9	2.8

(1): Bold figures in the table shows pro-cyclical fiscal policy periods while unbolded ones show counter-cyclical fiscal policy periods.

Source: World Bank staff calculations

1.55 *The findings are robust to alternative modeling assumptions.* The impact of the growth cycle on the structural balances has also been tested by a comparative analysis due to its importance. The results do not change much with respect to changes in the estimated elasticities or to the calculation method of potential output. The cyclical part of the general government budget was recalculated by setting all tax elasticities to unity in order to see if higher tax elasticities overstate the impact of the cycle and by estimating potential output with a different methodology in order to test robustness of the results with respect to the estimation of the cycle.²⁸ The results do not change significantly and even under the most conservative assumptions the estimated cyclical part is substantial in 2004 and 2005 (Table 1.8).

²⁷ The consolidated budget figures here are defined within a context of general government, which requires some adjustments in the data. Therefore the figures presented here may differ from the ones given in the previous section.

²⁸ To estimate potential output, the actual output time series was “filtered” to remove cyclical fluctuations using a Hodrick-Presscott filter.

Table 1.8: General Government Cyclical Budget in % of GDP

	1999	2000	2001	2002	2003	2004	2005
Potential output is estimated by production function							
Cyclical Budget $\alpha^{CIT}=1.57 \alpha^{PIT}=1.50 \alpha^{SSC}=0.82$	-0.8	0.2	-4.0	-1.8	-0.8	1.1	2.2
Cyclical Budget $\alpha^{CIT}=1.0 \alpha^{PIT}=1.0 \alpha^{SSC}=1.0$	-0.7	0.2	-3.5	-1.6	-0.7	1.0	2.1
Potential output is estimated by alternative method (Hodrick-Presscott filter)							
Cyclical Budget $\alpha^{CIT}=1.57 \alpha^{PIT}=1.50 \alpha^{SSC}=0.82$	-0.5	0.6	-3.8	-2.0	-1.3	0.8	2.2
Cyclical Budget $\alpha^{CIT}=1.0 \alpha^{PIT}=1.0 \alpha^{SSC}=1.0$	-0.4	0.5	-3.3	-1.8	-1.1	0.7	2.1

Source: World Bank staff calculations

1.56 Moving forward, the observed robust growth rates may weaken, together with the positive contribution of the cyclical component, triggering a decline in the primary surplus. The widening current account deficit, higher interest rates as a result of higher than expected inflation and exchange rate depreciation, can trigger a slowdown in growth. The operation of automatic fiscal stabilizers would limit the size and/or duration of any growth slowdown, so that their impact on the primary fiscal surplus would normally be welcome. However, even under a soft landing scenario, a declining primary surplus may have secondary unwanted effects on the economy, ranging from a deterioration of debt dynamics, to even higher real interest rates, and a non-negligible effect on market sentiment.

1.57 To avoid a pro-cyclical fiscal stance, the structural primary surplus should be maintained unchanged during years of robust growth. This would call for saving fiscal revenue over performance due to robust growth—a policy that would be reflected in an increasing *actual* primary surplus in proportion to GDP, owing to the cyclically buoyant fiscal revenues. Maintaining a constant *structural* primary surplus would provide insurance that the reduction of the debt ratio would continue even in case of a temporary growth slowdown. An alternative option would be to introduce an *expenditure cap* as a complementary policy goal if the actual (as opposed to the structural) primary fiscal surplus were to continue to be targeted. Under this option, robust fiscal revenues in years of strong growth would be reflected in a higher actual primary fiscal surplus rather than higher expenditure, which would work counter-cyclically. By contrast, the primary fiscal surplus target would still have to be preserved in cases of slower growth, thus making the functioning of fiscal stabilizers “asymmetric”. In view of the positive output gap, the decline in the structural primary surplus in 2004 and 2005, the widening deficit of the external current account, and the need to ensure that the debt ratio continues to fall despite higher interest rates, some withdrawal of fiscal stimulus would seem appropriate in the 2007 budget.