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ENHANCING TURKEY'S GROWTH PROSPECTS BY IMPROVING FORMAL SECTOR BUSINESS CONDITIONS

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by **Rauf Gönenç, Willi Leibfritz, Gökhan Yılmaz**

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ABSTRACT

Enhancing Turkey's growth prospects by improving formal sector business conditions

Turkey's business sector has achieved high growth over the past few years and – on average – has coped well with increased competition. However, some labour-intensive sectors lost competitiveness prior to the currency depreciation in mid-2006 and faced employment losses, raising political pressure for interventionist policies. This paper argues that the government should resist such pressure and instead follow a broad-based strategy to improve framework conditions for firms, irrespective of their size, sector and legal status. Overcoming the duality between the formal and informal sectors should be the central point of this strategy. In particular, the cost of labour should be reduced and regulatory hurdles in labour and product markets should be minimised, to help formal firms to remain competitive and increase employment. This would also make it easier for the many small and medium-sized firms to move into the formal sector, thereby raising productivity through economies of scale. This would increase the growth potential of the whole economy, broaden the tax base and level the playing field for doing business in Turkey, not only for the wide variety of domestic firms but also for foreign investors.

This Working Paper relates to the 2006 OECD Economic Survey of Turkey (www.oecd.org/eco/surveys/turkey).

JEL Classification: K20; L11; L16; L60

Keywords: Turkey; regulatory reform; informal economy; industrial competitiveness

RÉSUMÉ

Accélérer la croissance en Turquie en améliorant les conditions d'activité dans le secteur formel

Ces dernières années, le secteur des entreprises de la Turquie a affiché une croissance élevée et, en moyenne, s'est bien comporté face à une concurrence plus vive. Mais la compétitivité de certains secteurs à forte intensité de main-d'œuvre a baissé avant la dépréciation de la monnaie intervenue au milieu de l'année 2006, et l'emploi du secteur formel a reculé, augmentant les pressions politiques favorables à des mesures interventionnistes. Nous soutenons dans ce document que les autorités devraient résister à ces pressions et opter pour une stratégie globale d'amélioration des conditions-cadres offertes à toutes les entreprises, indépendamment de la taille, du secteur d'activité et du statut juridique de ces dernières. Cette stratégie devrait d'abord et avant tout viser à estomper la dichotomie entre secteur formel et secteur informel. Il faudrait en particulier réduire le coût du travail et atténuer le plus possible les obstacles présents sur le marché du travail et les marchés de produits, afin d'aider les entreprises du secteur formel à rester concurrentielles et embaucher davantage. Grâce à une telle politique, les nombreuses petites et moyennes entreprises pourraient aussi plus facilement rejoindre le secteur formel, ce qui augmenterait la productivité par le jeu des économies d'échelle. Toute l'économie verrait son potentiel de croissance augmenter, l'assiette fiscale s'élargirait et les entreprises – des firmes nationales les plus diverses aux investisseurs étrangers – pourraient opérer à conditions égales en Turquie.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de la Turquie 2006 (www.oecd.org/eco/etudes/turquie).

Classification JEL : K20; L11; L16; L60

Mots clés : Turquie; réforme réglementaire; économie informelle; compétitivité industrielle

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ENHANCING TURKEY'S GROWTH PROSPECTS BY IMPROVING FORMAL SECTOR BUSINESS CONDITIONS

by Rauf Gönenç, Willi Leibfritz, Gökhan Yılmaz¹

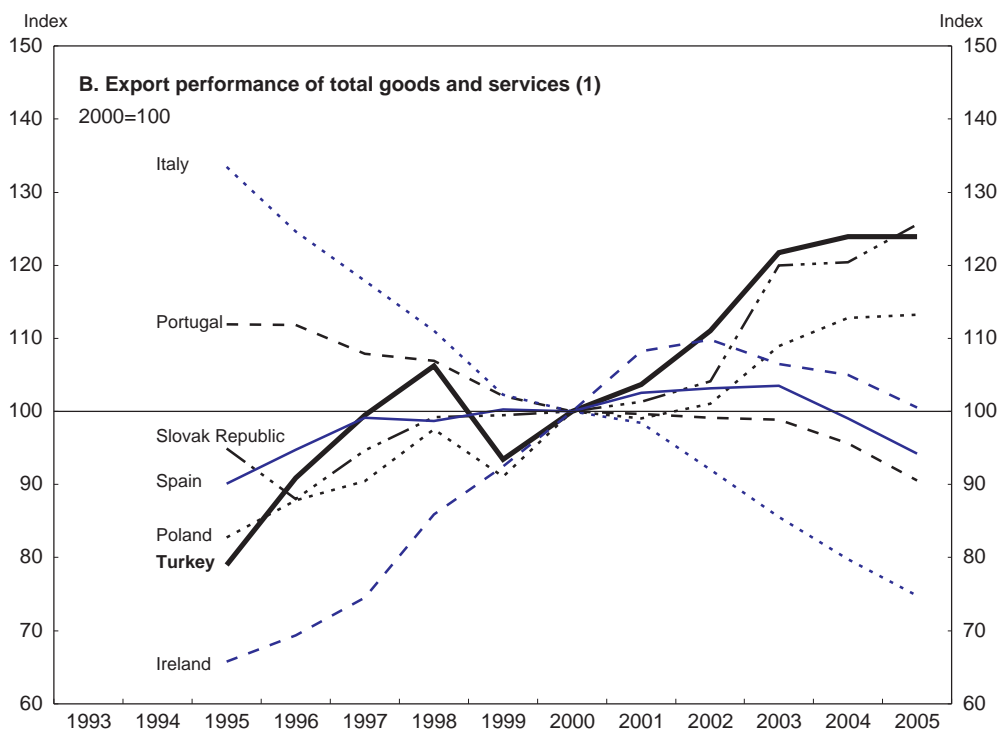
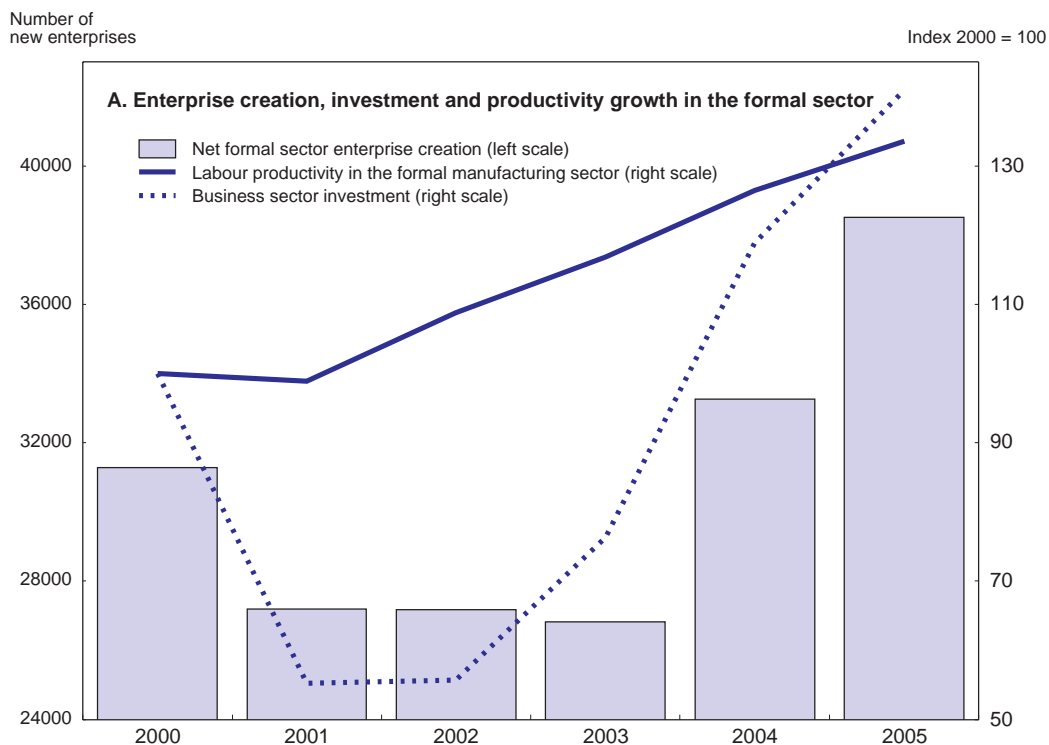
A dynamic business sector facing new challenges

1. The early liberalisation reforms of the 1980s which put an end to protectionism and state dirigisme considerably strengthened Turkish enterprises.² As a result, over the past two decades the private business sector has, on average, shown considerable strength in spite of political instability, severe macroeconomic shocks, regulatory and institutional uncertainties and resulting increases in risk premia and capital costs. The macroeconomic stabilisation and structural reforms which followed the 2001 crisis have also considerably helped. The credibility of the new macroeconomic institutions and of the market-enhancing structural reforms (backed by the strong international anchors of reform programmes agreed with the IMF and the convergence agenda with the EU *acquis*³) created a more supportive and predictable environment for the business sector. New enterprise creation has picked up, private investment has soared and business sector productivity has accelerated above trend (Figure 1, Panel A)

2. These reforms, together with the real depreciation of the exchange rate in the 2001 crisis led to a rapid increase in exports, which outstripped export market growth by a cumulative 30% between 2000 and 2005. Turkey thus achieved – together with Ireland and the Slovak Republic – one of the largest gains in export market shares among all OECD countries during this period (Figure 1, Panel B).

-
1. The authors are economists working in the Economics Department of the OECD. The paper is based on work originally prepared for the *Economic Survey of Turkey* published in October 2006 under the authority of the Economic and Development Review Committee (EDRC). The authors would like to thank Anne-Marie Brook, Ugur Ciplak, Jean-Philippe Cotis, Andrew Dean, Jorgen Elmeskov and Val Koromzay for comments and contributions on earlier drafts, as well as Lutécia Daniel for technical assistance and Nadine Dufour and Lillie Kee for technical preparation.
 2. See *Turkey: OECD Review of Regulatory Reform*, 2002.
 3. See OECD Economic Survey of Turkey, 2004.

Figure 1. Recent business sector performance



1. Growth of exports divided by growth of export markets.
Source: TURKSTAT, OECD Analytical Database and Economic Outlook 79.

3. However, in the period of stabilisation that followed the 2001 crisis Turkish businesses have also faced important new challenges:

- *Strong real currency appreciation.* The real effective exchange rate against the average of trading partners appreciated by 2.5% in 2004 and, by a further 14.5% over 2005. Part of the increase in the real effective exchange rate (as measured by relative unit labour costs) was due to sharp increases in the minimum wage in 2004. This strong pace of real appreciation weakened the competitiveness of many business activities. In the first half of 2006, this trend was interrupted, with the nominal exchange rate depreciating again and the real exchange rate depreciating by around 20% between end-February and end-June - more than offsetting the earlier appreciation, before regaining strength in the second half of the year and approaching its level before the turmoil.
- *Rising competition from low-cost countries.* Increased competition from China, India and other Asian countries is threatening the labour intensive segments of Turkish industry. In particular, the textile, clothing and leather industries, which represent one third of total manufacturing exports and employment, are heavily affected.

4. The rising pressures on competitiveness are reflected in the export performance of the economy. Market gains slowed after 2003, and in 2005 and early 2006 Turkey has, on average, only just been able to preserve earlier gains, with market share losses in some sectors and gains in others. Import penetration has also accelerated. Domestic producers of many consumer goods and industrial inputs have faced growing import competition and the trade deficit has increased. The share of imported consumer goods in total private consumption is estimated to have grown from 5.5% in 2001 to 8.5% in 2005, while the use of intermediate inputs in total industrial production also increased significantly.

5. Evaluated with the standard OECD indicator of competitiveness,⁴ the Turkish business sector came under pressure through 2004-2005, although not enough to fully offset the strong competitive gains generated by the sharp currency depreciation and real wage falls of 2000-2001 (Figure 2). The indicator then improved again in the first half of 2006, as a result of the exchange-rate depreciation and moderate real wage growth. Compared to other OECD countries, Turkey has faced the sharpest fluctuations in its competitiveness over the past decade and particularly in the past five years.

Performance differs across sectors and firms

a) Sectors

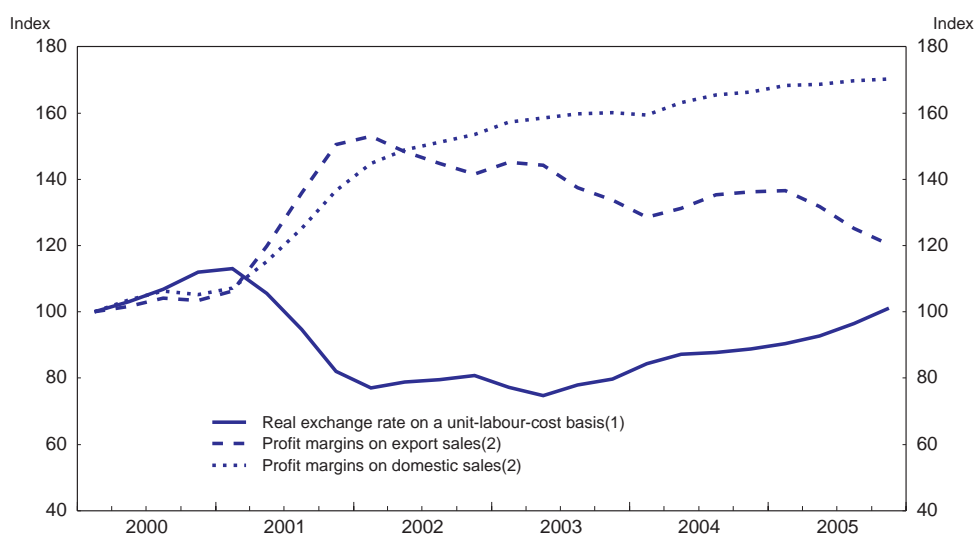
6. The intensity of international competition varies across business sectors and has resulted in uneven pressures on firms' prices and profits. Notably, the exposure of manufacturers to competition from low-wage Asian countries depends on their sector of activity. These differences have caused the competitive position of different business activities to diverge.

4. The *relative unit labour costs adjusted for the exchange rate* (or, in other words, the *real exchange rate calculated on a relative unit labour cost basis*) published bi-annually by the OECD.

7. To map these differences in competitive pressure, the development of profit margins and their principal determinants has been analysed for exports and domestic sales and for total sales of a range of manufacturing sectors (the methodology and findings is described in Annex A1).⁵ The main findings are:

- Over the 2000–05 period Turkish firms experienced a significant squeeze in their profit margins on export sales while profits continued to increase on domestic sales although at a decelerating rate (Figure 2), subsequently picking up after the currency depreciation in early-mid 2006.
- The profitability of different sectors diverged strongly in this period of exchange rate fluctuations. The inter-sectoral divergence has been wider in export markets than in domestic markets. Turkish firms in labour-intensive industries are more exposed to competition from low-wage countries in their export markets than in the domestic market. However, they may face more intense competition at home in the future.
- The profit squeeze was strongest in industries which suffered from a fall in output prices as these firms were not able to raise productivity or cut wages sufficiently to protect their profit margins. By contrast, the more successful industries faced less pressure on prices (due to product specialisation, high demand, and/or less competition from low wage countries) and also achieved more wage restraint, as their more skilled labour force was less affected by the sharp increase in minimum wages, so that their profit margins remained larger.⁶

Figure 2. The real exchange rate and profit margins in domestic and export markets
2000Q1=100



1. An increase shows appreciation.

2. The estimation methodology of profit margins on domestic and export sales is summarised in Annex A1.

Source: OECD.

5. All sectors of the economy - tradable and non-tradable activities, manufacturing and service sectors - should have been ideally covered but data availability (the price, wage and productivity data required for calculations) imposed the restriction of the analysis to manufacturing.

6. The analysis included two further elements which affected the competitiveness of enterprises: energy and credit costs. Results suggest that energy costs had a non-negligible but limited impact on estimated profitability. In contrast, the high variation of credit costs (which soared in periods of currency depreciation and declined in periods of appreciation) has partially off-set both the positive impacts of depreciation and the negative impacts of appreciation. Interest rates played a countercyclical role in the evolution of profitability. See Annex A1.

8. As a result of these differences in the determinants of their profitability in the past five years, sectors can be placed into three groups according to the extent of their profit squeeze and their price, productivity and cost performance: *i) The highly-competitive sectors*: which experienced no profit squeeze as they maintained or increased output prices, and achieved relatively high labour productivity growth and moderate wage growth;⁷ *ii) The declining sectors*: which, in contrast, suffered from a pronounced profit squeeze as they under-performed in terms of price, productivity, and wage cost developments;⁸ and *iii) The intermediary sectors*: which had a more mixed performance, by combining good and bad performances along various dimensions of competitiveness or achieving only average performance in all of them.⁹ Figure 3 illustrates this clustering by comparing the post-2000 profitability, export, output and employment performance of firms in six representative sectors.¹⁰ The car and electronics industries represent the highly competitive sector, textiles and clothing the declining sector, and food and plastics the intermediary sector.

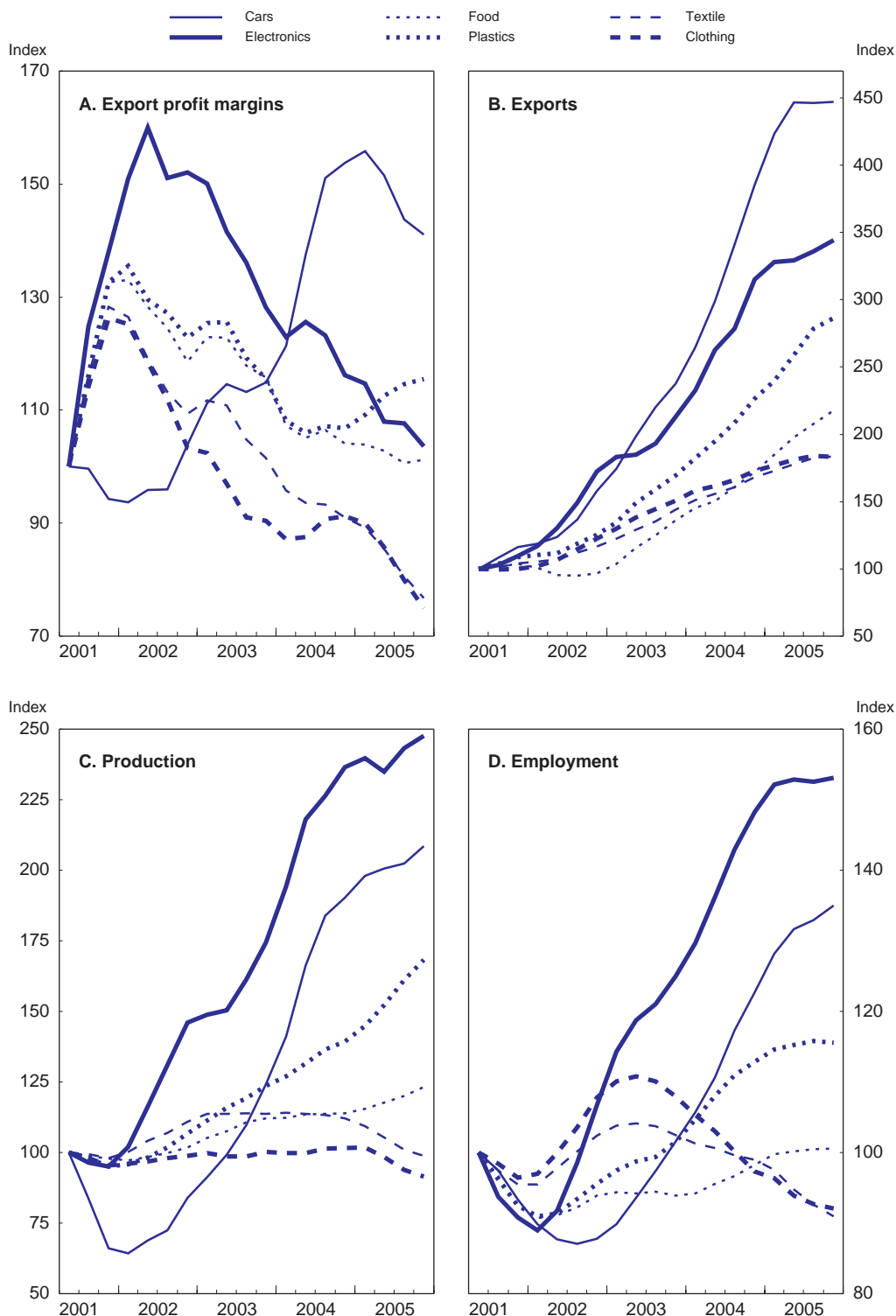
7. Or in at least two of them, together with average performance in the third. Highly competitive sectors include consumer electronics, industrial machinery, steel and car manufacturing.

8. Textile, clothing and leather industries are in this situation. While improvements have been observed in their performance in certain years, they are overall experiencing a declining trend.

9. Plastics, electrical equipment, metal product and furniture manufacturing are in this category.

10. Annex A1 offers more detail on the distinct performances of individual sectors.

Figure 3. Recent performance in some representative sectors
2001Q2=100

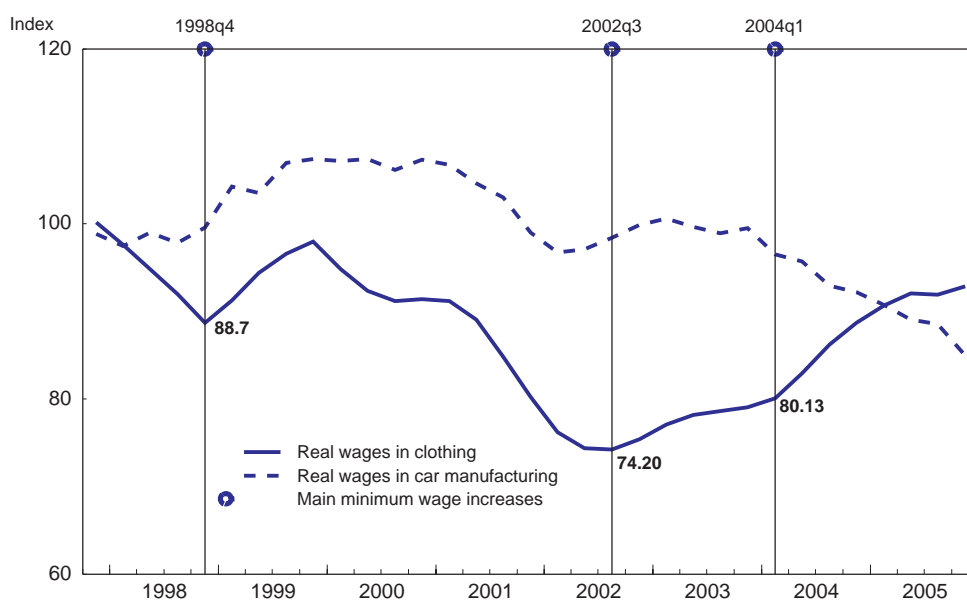


Note: Highly competitive sectors are shown with thick lines, declining sectors with dashed lines and intermediary sectors with dotted lines.
Source: OECD.

Problems of the declining sectors...

9. The declining sectors have suffered from a fall in output prices, low productivity growth and rising wage costs. Price declines appear to be largely due to Asian competition and are particularly steep in low quality products. At the same time, the large increases in the minimum wage in the 2000s had a big impact on the wage costs of these sectors as they employ many minimum wage earners. Therefore, and paradoxically, real wages have on average increased more in the declining sectors than in the highly competitive sectors (Figure 4).

Figure 4. Minimum wage increases and wage growth in a declining and in a highly competitive sector
1997q4=100¹

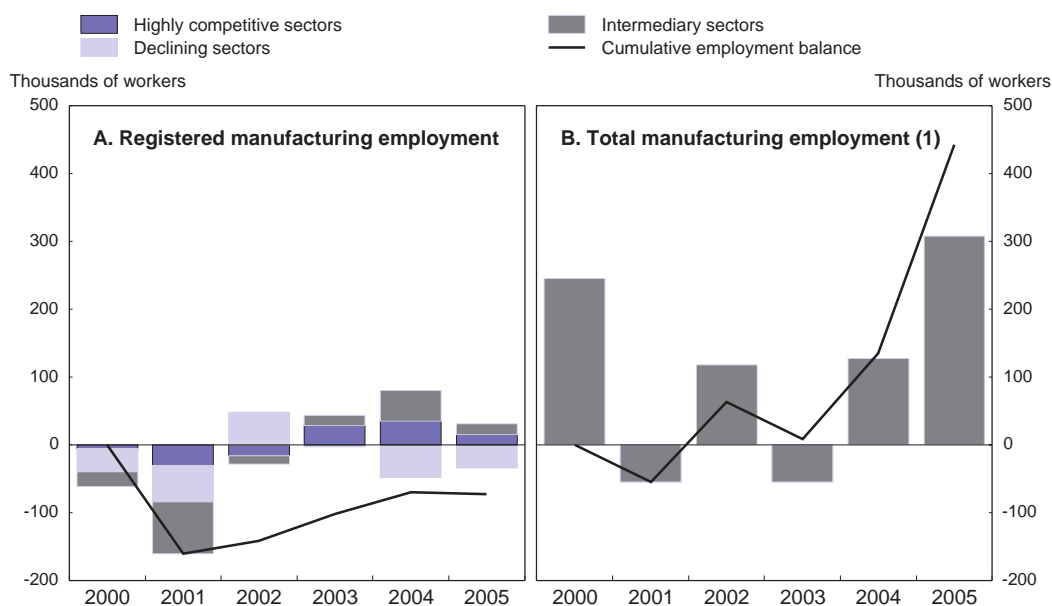


1. Four quarter moving averages.
Source: OECD on basis of TURKSTAT.

... have been accompanied by employment losses in the formal economy

10. The declining activities have a very large share in total employment (36% of total manufacturing employment in 2003) while the highly competitive sectors are smaller (13% of manufacturing employment) and intermediary sectors represent the bulk of employment at 50% of the total. While many new jobs have been created in the highly competitive and intermediary activities over the past five years, their growth has not been sufficient to absorb those losing their jobs in the declining sectors plus new labour force entrants. In particular, there has been insufficient job growth in the formal sector - reflecting firms' efforts to preserve employment by shifting it to or creating it in the informal sector. Indeed, registered employment figures indicate net employment losses in formal manufacturing between 2000 and 2005, whereas the entire manufacturing sector (including unregistered activities) recorded net employment gains (Figure 5). Even using the total economy (manufacturing plus services) figures, net employment gains have been insufficient to absorb the workers who have lost their jobs in the declining sectors as well as the many workers leaving agriculture and the new entrants in the labour force which – despite a fall in labour force participation - continues to grow as Turkey has a relatively young population.

Figure 5. Employment shifts from declining to growing manufacturing sectors
Year-on-year and cumulated change in employment

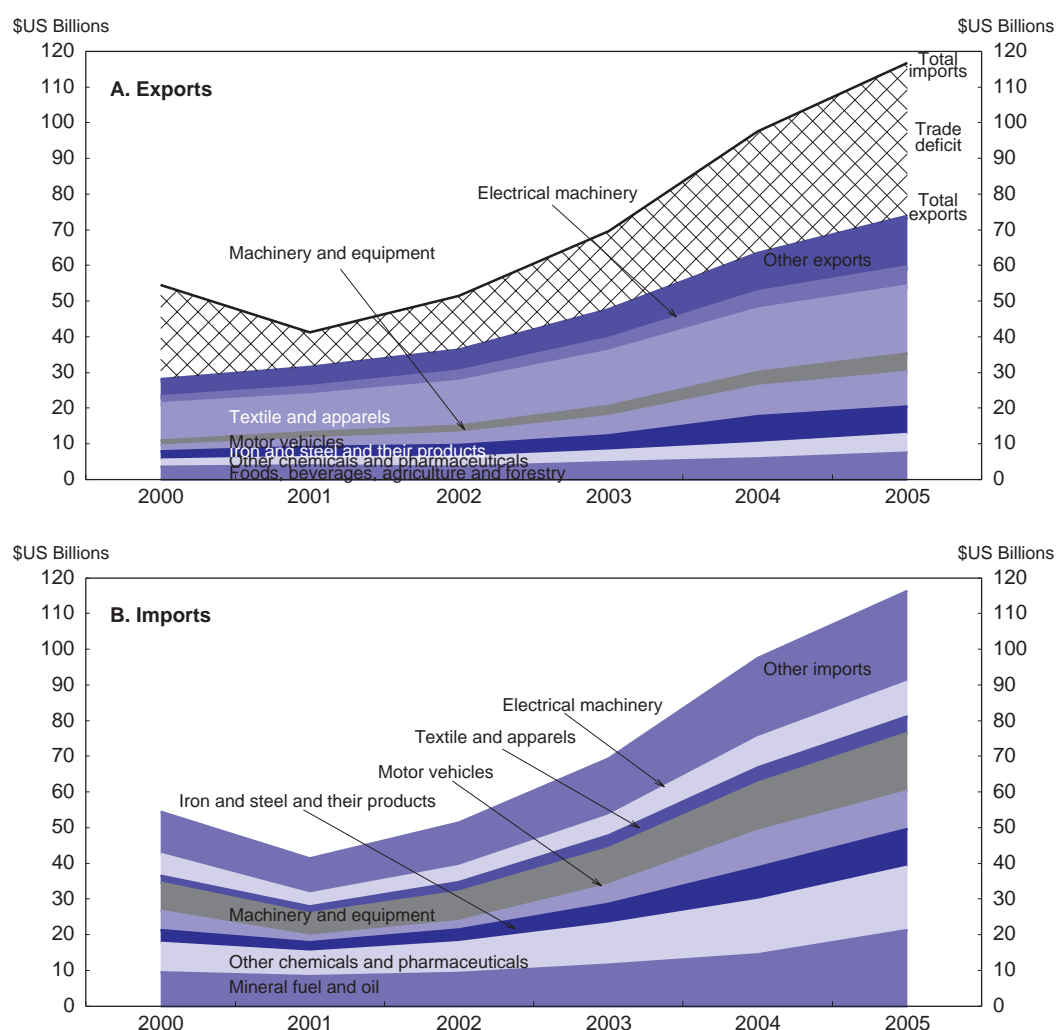


1. Total manufacturing employment (including part of unregistered employment) is based on Household Labour Force Surveys which do not provide their distribution according to manufacturing sub-sectors. Source: Manufacturing Output and Employment and Quarterly Labour Force Surveys, TURKSTAT.

... and a deterioration in the trade balance

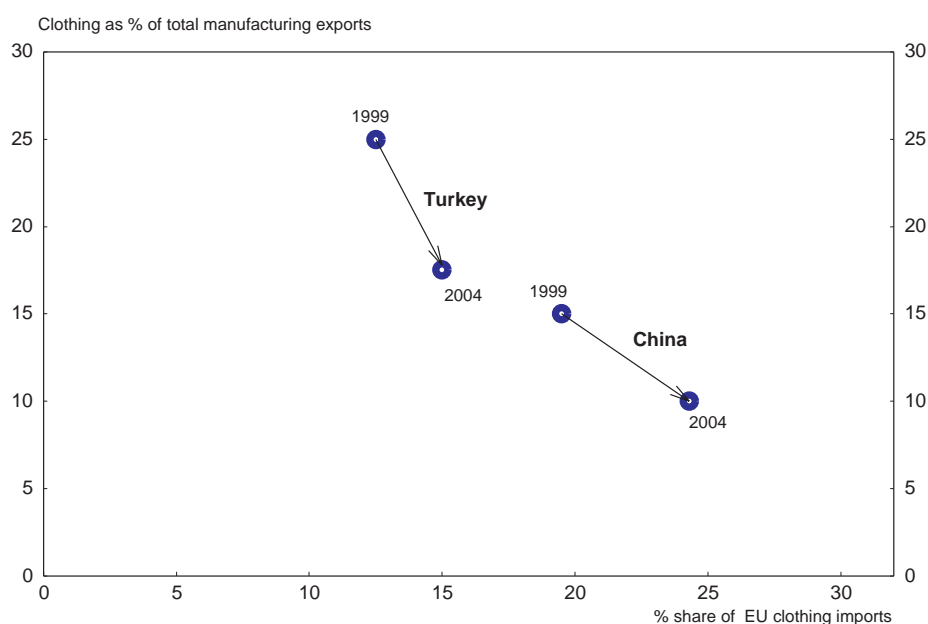
11. The trade specialisation of Turkey is evolving as a result of these developments and the trade balance is directly affected. Imports of low-technology consumer goods and industrial inputs more competitively produced by low-wage countries are on a strong rise. These shifts, together with a surge of imports due to strong domestic demand have contributed to the deterioration of the trade balance since 2003¹¹ (Figure 6).

11. The increase of oil and gas prices has also contributed to this deterioration of the trade balance. Turkey imports most of its energy needs in form of fossil fuels and the imported energy bill increased by USD 7 billion (1.9% of GDP) in 2005. Only part of this inflated energy bill was offset by increased exports to energy producers. Turkey's imports from its four main crude oil providers (Iran, Russia, Saudi Arabia and Libya) increased by 69% in 2005 but its exports to them increased by only 23%.

Figure 6. Shift of specialisation towards medium technology and the trade balance, 2000-2005

Source: TURKSTAT.

12. At the same time, competition from low-wage countries is spreading to medium-technology areas. While Turkey has changed its trade specialisation to more sophisticated products it has remained exposed to competition from China which has developed its trade in a rather parallel way (Figure 7). A comparison with other low-wage countries would probably reveal a similar picture (see also Figure A1.2 in Annex 1). At the same time the geographical proximity of Turkey to European Union markets permit Turkish manufacturers to interact more closely with customers and reduce their delivery times. Manufacturers are increasingly taking advantage of this by specialising in demand-responsive, customised, higher value-added products.

Figure 7. Turkey and China in the European clothing market

Source: Economic Policy Research Institute, Ankara.

b) Firms

13. Not only different sectors but also different types of firms cope unevenly with competitive pressures. The Turkish business sector is indeed particularly heterogeneous and firms' resources (assets) and framework conditions appear to cluster them into three groups:

- *Small-sized firms have traditionally* compensated a thin resource base - and low productivity - with significant latitude to operate outside the regulatory and tax framework. However these firms are now increasingly squeezed by domestic and international competition and their "equilibrium" appears less sustainable (Box 1);
- *Medium-sized firms* have grown particularly well in the recent period, helped by their vibrant entrepreneurship, their growing physical and human capital base and their escaping - at least partly - the burdens of the formal framework. However, they cannot continue to grow at full potential in such semi-formality (Box 2);
- *Large-size firms* in the formal sector have a robust physical and human capital base, are well connected to international markets and partners, and increase their productivity at a high pace. However, they are severely constrained by the burdens of the formal regulatory framework. Should this framework be significantly reformed, they would grow at an even higher pace (Box 3).

Box 1. Strengths and handicaps of small firms

Small-sized enterprises (SSEs) comprising the self-employed and the so-called “micro” enterprises are an important feature of the Turkish business sector. They operate for the most part informally (Table 1). It is estimated that although less than 10% of value-added is generated in this sector, these firms make up more than 30% of total manufacturing employment and 95% of the total number of manufacturing firms. These enterprises are found in large numbers in all manufacturing and service activities and many have no other regular employees than their family members. They are particularly numerous in clothing, metal working and food industries. In services, they are widespread in retail trade, construction and transportation.

Table 1. Informal employment in manufacturing and service sectors
Percentage share of unregistered workers in each sector

	Total economy	Agriculture, forestry hunting and fishing	Manufacturing	Construction	Wholesale and retail trade, restaurants and hotels	Transportation, communication and storage	Finance, insurance, real estate and business service
1988	58.1	93.5	23.9	56.2	37.5	34.5	9.8
1989	58.7	92.2	26.3	56.7	39.2	34.9	8.4
1990	55.6	90.3	23.5	52.8	34.5	28.4	8.1
1991	51.2	79.8	24.5	59.2	32.5	21.6	6.6
1992	49.2	78.8	27.1	55.6	32.1	19.5	8.2
1993	47.5	78.0	24.5	52.2	31.5	19.7	9.3
1994	45.7	70.2	27.3	55.2	47.5	19.7	9.9
1995	49.2	78.0	25.2	57.8	34.3	22.6	9.3
1996	52.7	88.4	23.0	58.0	31.5	20.0	11.3
1997	51.6	89.2	21.6	60.8	30.3	23.6	8.9
1998	50.3	88.5	20.7	53.1	29.0	25.5	8.0
1999	52.1	89.3	25.6	60.4	33.1	29.8	10.4
2000	50.6	88.6	26.4	65.5	37.1	31.4	13.8
2001	52.9	91.8	27.2	61.7	39.5	33.1	16.2
2002	52.1	90.2	31.7	61.5	42.7	34.0	18.9
2003	51.7	91.2	30.7	63.8	42.2	33.9	20.1
2004	53.0	90.0	31.3	66.5	44.4	38.8	20.6
2005	50.1	88.2	32.0	64.3	43.8	39.0	21.6

Source: TURKSTAT, Household Labour Force Survey.

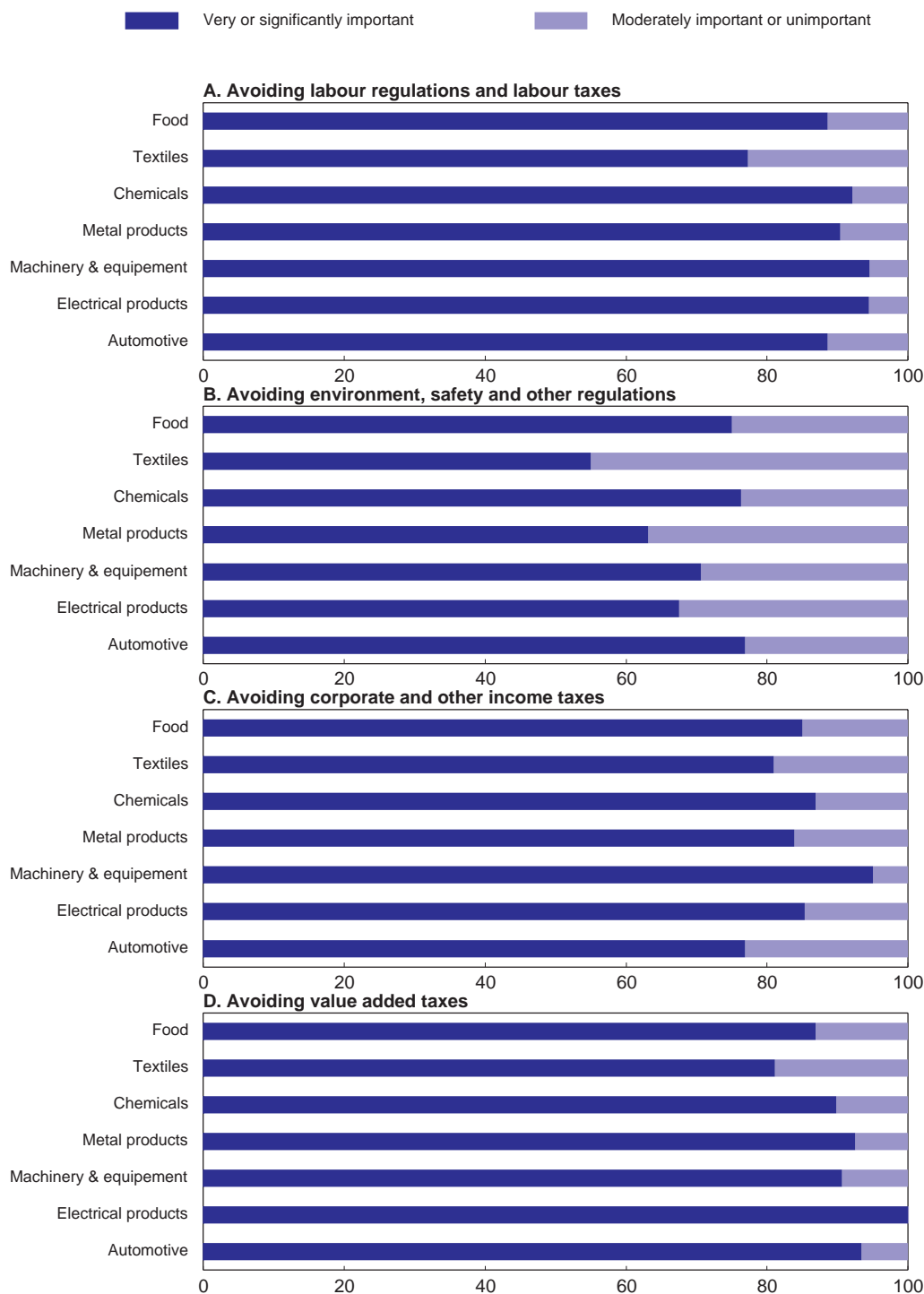
The core strengths of SSEs are their very low operating costs and very high flexibility. They enter and exit markets at little cost and adjust employment quasi-spontaneously. Few of them are formally registered, pay taxes, or are bound by regulations for market entry, physical settlement, environment and safety, and can therefore avoid minimum wage rules, social security obligations and other regulatory costs (Figure 8). Even if a minority of them, notably those settled in the “Organised Industrial Zones” can be considered as “half-formal”, because they register some proportion of their sales, revenues and employment,¹ most of them remain entirely informal.

The biggest handicap of the SSEs in Turkey is their weak equity base and their low physical and human capital stock which pulls their productivity well below industry averages. Essentially, these firms allow low-skilled workers to participate in the economic activity but they face direct competition from imports from low-wage-countries while not being able to reduce wages to such low levels. In some sectors, such as retail trade and construction, they also face more intense competition from larger domestic firms which have much higher productivity.

Data on the entry, exit and employment performance of micro enterprises is limited and biased by massive informality. Yet, according to the partial and anecdotal evidence available, it seems that many micro-firms have recently exited business and reduced employment, in both tradable and non-tradable activities, pointing to important structural handicaps (Figure 9).

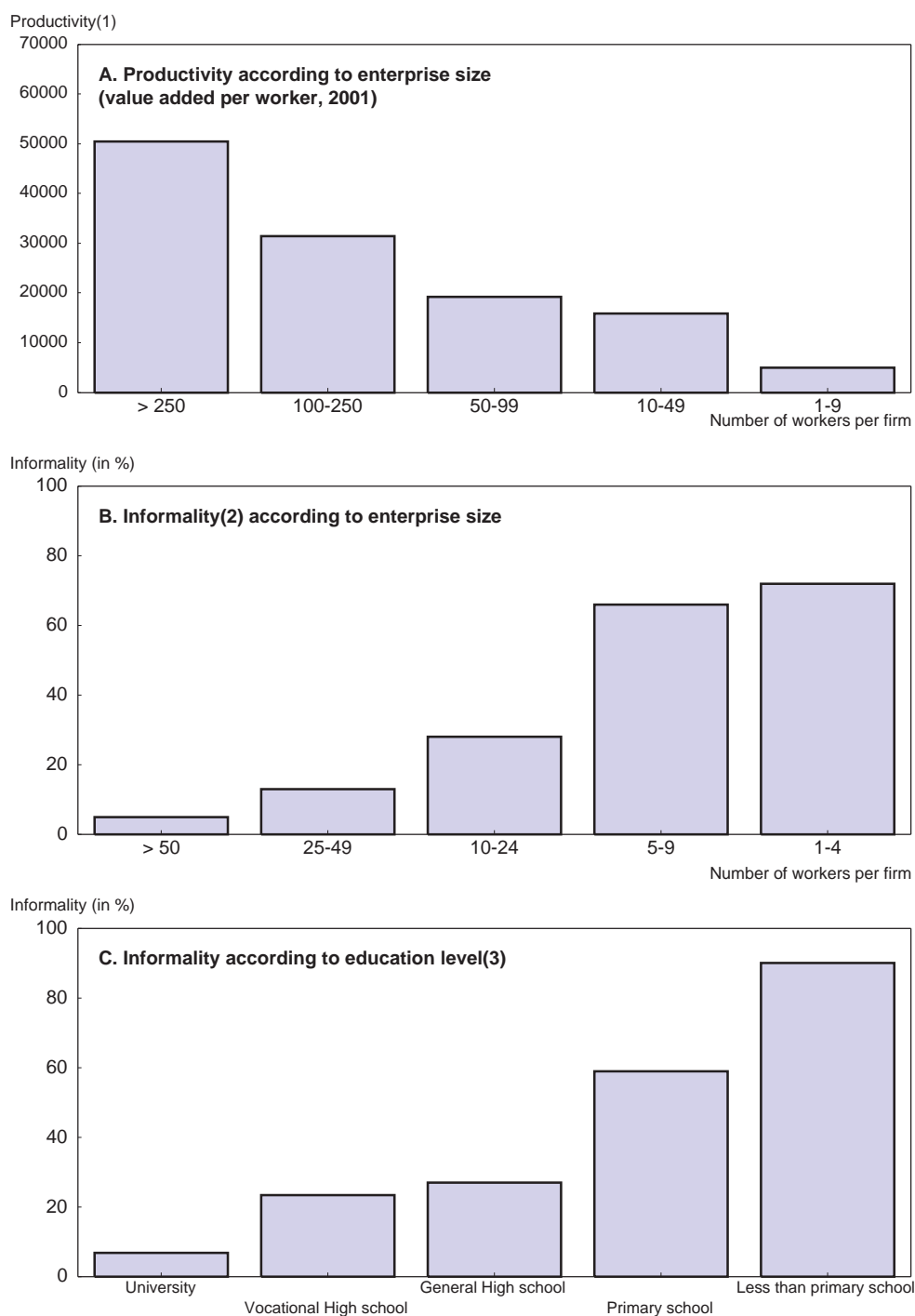
1. In the international literature “small firms” are those employing between 10-49 persons. However, in the Turkish context even firms employing less than 10 persons may be considered as “small firms” if they register part of their activities, pay social security contributions for some of their employees, and pay some taxes (in opposition to fully informal “micro-scale” firms).

Figure 8. The 'advantages' of informality
Percentage of total respondents



Source: World Bank/TEPAV ICA Survey, 2005.

Figure 9. Micro enterprises' structural handicaps

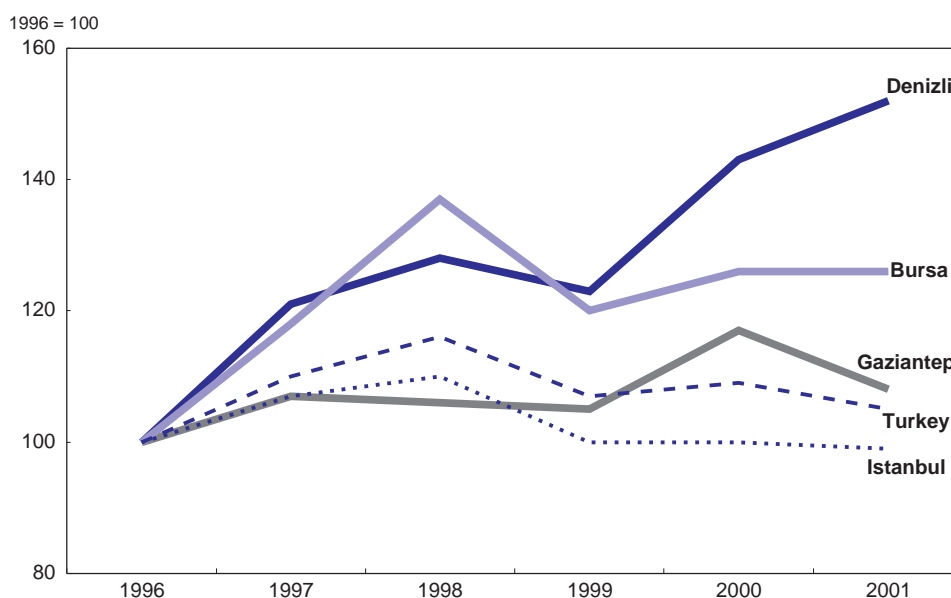


1. Value added in euros per workers, current exchange rates.
 2. Percentage of workers not declared to social security institutions.
 3. Percentage of workers in each education group not declared to social security institutions.
- Source: TURKSTAT and Turkan (2005).

Box 2. Strengths and handicaps of medium-sized firms

Medium-sized enterprises (MSEs) have been the most dynamic component of the Turkish business sector over the past decade.¹ Enterprises employing between 10 and 249 employees represented 34% of manufacturing employment and 35% of manufacturing value added in 2000, and these figures must have increased since that year. One of the distinct features of these firms is that they are mostly owned and run by families (most of them of the first generation) and that – while being registered – they only partly comply with official regulations, thus permitting them to partly escape the rigidities and costs of the regulatory and tax system. These firms operate in all manufacturing and service activities, and particularly in the tradable sectors such as textiles, clothing, metal working, machinery, food, and furniture Annex A3 summarises some recent surveys on the competitive position of medium-sized enterprises in comparison to both large- and small-size firms. They have grown in the traditional industrial centres of Turkey (Istanbul, Izmir and Bursa) but also, and more typically, in a range of Anatolian towns which have achieved industrial growth (such as Denizli, Gaziantep, Eskisehir, Kayseri – scattered through many different regions of Turkey). spectacular “Organised industrial zones” established in these towns have provided the infrastructure for this development.² Due to their propensity to nurture a large population of high-growth firms these towns have been dubbed “Anatolian Tigers” (Figure 10).

Figure 10. 'Anatolian Tigers'
Growth of manufacturing employment in high growth towns

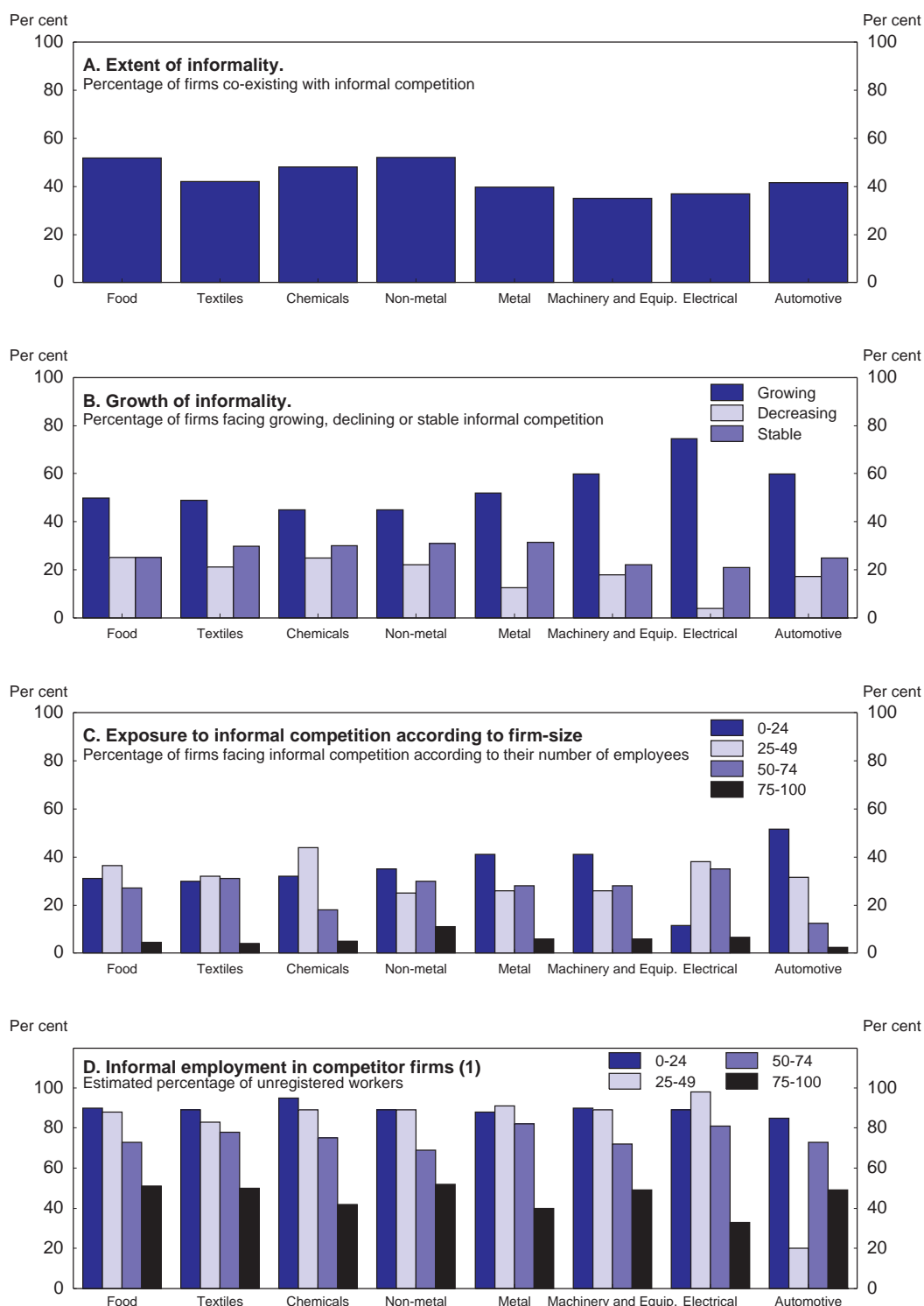


Note: 'Anatolian Tiger' cities are shown with thick lines.
Source: TURKSTAT.

The strength of these MSEs is their outstanding entrepreneurial spirit and their generally decent engineering and technical capabilities. Their equity-based capital structures have also made them less vulnerable to financial shocks in the past. After the 2000-2001 crisis, as the domestic market contracted and currency depreciated, many of them sharply accelerated their opening to global markets,³ not only by increasing exports but also by diversifying their sources of know-how and technology. In particular, they began imitating commercially successful international designs at much lower cost.⁴ Many of them consider now *any domestic and international market accessible via internet*, whatever its location and distance, as an opportunity for doing business, but also as a source of potential competition. Their strategies appear to be increasingly shaped by such an open, pro-competitive mindset.⁵ Many medium-sized firms also aim to develop their own know-how and technology base, and their size, in order to exploit economies of scale. However, financial and human capital constraints often tend to limit their options.

These firms generally use special arrangements to avoid the full burdens of formality. A popular avenue is to employ their workers under sub-contracting contracts, outside company payrolls. This allows enterprises to remain below critical thresholds for the application of regulations concerning employment protection and other workplace rules.⁶ Such avoidance is often achieved with the consent of workers who consider such flexibility a requirement for the survival of the firm.

Figure 11. The extent of informality among medium-sized firms



1. According to the size (number of employees) of respondents.
Source: World Bank/TEPAN ICA Survey, 2005.

Semi-formal firms usually do not hire high-skilled managers. Even if they would be prepared to pay a high salary, high-skilled managers are normally reluctant to take on the reputational and other risks of running a semi-formal entity. Firm owners would also rather avoid too much exposure to outsiders who may acquire sensitive information and prefer to deal with family members. Many firms thus miss out on access to state-of-the-art technical and managerial knowledge. Enhancing the knowledge base of these enterprises including managerial skill, foreign language education and information technology know-how would improve the growth potential of these firms. Medium-sized firms also seem to derive other financial gains from semi-formality by only partial compliance with the environmental and health-and-safety rules. Direct data is of course missing on the informal practices of medium-sized firms, but a recent joint survey by the World Bank and the Turkish Economic Policy Research Institute (TEPAV) appeared to corroborate the wide reach of these practices⁷ (Figure 11).

-
1. There are two statistical definitions of a medium-sized firm: 50-150 employees (Turkish) and 50-250 employees (international) both of which show strong growth in the past decade. In Turkish circumstances, many firms employing between 10-49 employees would also qualify as medium-sized firms if they demonstrate a robust capital base and operational stability.
 2. "Organised Industrial Zones" provide physical facilities at low cost and offer standard energy, transportation and logistical services.
 3. Dynamic medium-sized firms' performance has not been thoroughly analysed, as information about them is limited. A long-time observer has recently offered a number of observations on ongoing changes in their behaviour. See Bozkurt (2006).
 4. Without necessarily infringing the existing intellectual property rights. They often duplicate the basic designs of the models, and the inputs and materials utilised, rather than directly counterfeiting.
 5. These enterprises seem to form a new constituency for policymakers. As a difference from traditional SMEs - which are interested primarily in trade protection and subsidies - they know that they can only prosper through global competition and favour an open, rule-based and level-playing business environment. These new expectations are reflected in their professional and trade organisations' pro-reform policy positions.
 6. Firms employing less than 30 employees are not subject to employment protection legislation – but remain liable to severance payments - and firms employing less than 50 employees are exempt from obligations to hire "socially assisted" employees (handicapped, ex-convicts etc.) and to provide mandated health, recreational and social facilities.
 7. This 2005 ICA survey only covered registered businesses of a minimum size. 800 firms employing 10-to-100 workers were asked about the formal and informal business practices they face in their immediate competitive environment. The OECD Secretariat is grateful to the World Bank and to the Economic Policy Research Institute for sharing the detailed findings of this survey.

Box 3. Strengths and handicaps of formal sector firms

The formal sector in Turkey is characterised by mainly large-size enterprises which employ well-trained entrepreneurs, managers and workers, and are well-equipped to modernise, invest and cut costs. The share of large-sized firms is smaller than in other OECD countries but they have been performing well over the past decade and have grown at an above-average pace. Large-size manufacturing firms employing more than 250 workers accounted for around 60% of manufacturing output and 30% of manufacturing employment in 2003. In addition to their good growth performance, the profitability of large firms has been better than in the rest of the economy and further improved in the recent period.¹ The key strength of these firms is their high level of productivity which comes close to international standards, and contrasts with their relatively low labour costs in international comparison.² The automotive industry epitomises the recent performance of the large-size formal sector. Car assembly facilities have been able to achieve international quality and productivity standards at relatively low cost. A larger share of car industry investment and production in Europe has consequently shifted to Turkey.³ An important source of strength of formal sector firms is their close ties with multinational firms, which encompass equity investments but also marketing, licensing and technology transfer agreements. Such ties are being developed with European, North American and Asian partners, frequently via joint-ventures. Firms with foreign investors in their equity capital realised more than 40% of the total sales of the top 500 companies in 2005 and nearly 20% of the sales of the next 500.⁴

In contrast to their strengths, formal sector businesses face handicaps which can be binding constraints for their competitive performance and growth. Despite recent reductions in corporate tax rates, the Turkish regulatory framework is out of line with international best practices and is very costly and rigid. If these handicaps could be alleviated, these businesses could grow more rapidly and employ a higher proportion of the labour force at a higher level of productivity.

1. According to the Turkish Central Bank's Enterprise Balance Sheet database the profit margins of large firms increased from an

average of 3.1% in 2002 to 4.6% in 2004, while they remained stable at 2.3% for medium-sized firms, and declined from 0.1% to – 0.7% for small firms.

2. Domestic and foreign formal sector firms have access to high-quality human capital trained in prime Turkish and international universities. This helps them to absorb international management, technical, and finance know-how. A 2002 study by McKinsey of 11 manufacturing and service sectors found that formal-sector firms reach around 70% of the benchmark productivity level of US counterparts.
3. According to data from the International Organisation of Motor Vehicle Manufacturers, Turkey's automotive output increased from 298 000 vehicles in 1999 to 823 000 in 2004 (a 176% increase), while it decreased from 16 900 000 to 16 854 000 in EU-15 (a decrease of 0.4%) and from 2 544 000 to 1 680 000 in Central and Eastern Europe (a decrease of 34%).
4. Istanbul Chamber of Industry (ISO) "Top 1 000 Corporations" database.

Policies to cope with increased competition

While there is political pressure for interventionist policies...

14. As the textile, clothing and leather sectors represent as much as one third of total manufacturing export and employment, the competitive pressures that they face led to an important policy debate in Turkey. In recent years, prior to the recent lira depreciation, industry representatives incessantly complained about the "unsustainable squeeze" arising from the combination of fierce competition from low-cost countries and strong currency appreciation. These sectors, together with tourism sector representatives, have become vocal advocates of special support from government. In response to these pressures, the government reduced the value-added tax (VAT) rate on textile products from the standard 18% to a preferential 8%, starting from March 2006.¹² However, introducing preferential rates for certain products distorts resource allocation across sectors and complicates the VAT system. Furthermore, as the VAT is a consumption tax which taxes imports similarly to domestically produced goods, it is not clear how this measure helps domestic firms to better cope with foreign competition. On the other hand, the reduction of the VAT rate on textile products may reduce tax fraud. Indeed, the Ministry of Finance estimated that because of lower fraud the net fiscal impact of this measure could even be positive. But if this proves to be true, it may rather be an argument for improving tax administration.

15. An *Experts Group* of the State Planning Organisation created for the preparation of the 9th Development Plan 2007-2013 acknowledged the pressures faced by the sectors exposed to low-cost country competition but refrained from advocating trade protection and subsidisation measures. It stated that "Public policies can help reduce the costs of adjustment in the sectors under stress, but should do it without hindering the process of adjustment".¹³ To this effect the group made three proposals: *i*) innovative firms in the declining sectors which prove their capacity to upgrade themselves could be granted incentives; *ii*) measures under consideration to enhance the competitiveness of the industry in general (such as reductions in taxes and social security contributions) could first be introduced in these sectors, provided that they are also rapidly generalised to the entire industry; *iii*) the established physical capital base of declining firms should not be liquidated with fire-sales to less advanced countries but can be delocalised under enterprises' own control toward special enterprise zones benefiting from free-trade agreements with the United States in Egypt, Jordan, Israel and the occupied territories."¹⁴ This discussion indicates that the government is under considerable political pressure to support declining sectors. International experience has shown, however, that subsidies are generally not effective and introduce new distortions and risk hampering the growth potential of the economy. Instead, as outlined in the next section,

12. Tourism sector enterprises also requested VAT exemptions for services sold to foreign tourists - on the ground that these are export sales. The Ministry of Finance rejected this request for fiscal and administrative reasons.

13. See SPO and TEPAV (2006).

14. See SPO and TEPAV (2006).

a broader-based strategy which improves general framework conditions for doing business would more effectively help firms to cope with increased competition and strengthen their growth potential.

... a strategy of simplification of the regulatory framework is needed

16. Efficient product and labour markets facilitate the reallocation of resources to their most productive uses and the continuous upgrading of products in line with changing demand. However, as discussed above, Turkish firms are currently operating under quite different regulatory frameworks. While large firms face the full burden of the formal regulatory environment, small and medium sized enterprises totally or partly escape it, but face the difficulties of operating outside full formality. While this reduces their costs and provides some flexibility to survive under demanding conditions, it also deprives them of potential productivity gains through economies of scale and access to other critical resources. This reduces the overall capacity of the Turkish economy to cope with competitive pressures.

17. The opportunity cost of having a large part of business activities “trapped” in the informal or semi-informal sector has increased with the stabilisation of the Turkish economy. Interest rates have declined, borrowing opportunities have increased, and many domestic and international equity investors are eager to invest in promising companies. More FDI and joint-venture candidates are also approaching the Turkish market, while new technologies become available from various international and domestic sources. The *unrealised gains* of the small-and-medium-sized enterprises which cannot seize these opportunities because of their informal or semi-formal status suggest a need for a strategy to break this ceiling.

18. What is needed is a simple, low-cost, unified, pro-competitive and pro-growth regulatory framework for all sectors and firms. Such a framework would help improve the performance and growth of formal firms and facilitate the move of informal firms into the formal economy. Although many micro-firms possess a genuine entrepreneurial drive and interesting business niches, their generally low level of productivity makes it difficult for them to register as they would be unable to afford the costly minimum wage and social security contribution obligations. Improving enforcement alone is no solution as many would be forced to exit, with net output and employment losses for the economy. With less costly regulations, however, many of the currently informal or semi-informal firms would have a good chance of survival in the formal sector.

19. The following sub-sections discuss the main policy areas which should be addressed to achieve this low-cost unification of the framework conditions for the business sector. Policies are closely inter-related. Reducing tax distortions – including by cutting labour taxes – , easing labour market regulations, improving competition in product markets and facilitating access to bank and equity financing, as discussed below, would help achieve this comprehensive upgrading of business conditions

The tax reform is on track but weaknesses remain

The corporate tax rate has been reduced...

20. The corporate tax environment has in the past been characterised by relatively high standard tax rates and an excessive number of exemptions and loopholes providing incentives for tax planning and affecting investment decisions. The complexity of the tax system has created wide inequalities both between informal and formal firms as well as *within* the formal sector, as the effective corporate tax burden has fallen on a small population of contributors.¹⁵ This highly opaque environment has led to very low

15. The Ministry of Finance found in 2004 that in the Istanbul metropolitan area - where most Turkish formal businesses are registered - only 352 firms (4.2% of local corporate taxpayers) paid 87.8% of all corporate income tax collected. When the Ministry reviewed in detail the tax declarations of 670 enterprises in 2005

public and business sector confidence in the integrity of the corporate tax system. Recent tax reform has improved the situation although weaknesses still remain:

- The reduction of the standard corporate rate from 30% to 20% in June 2006 has reduced the effective average and marginal tax rates of firms. The effective average corporate tax rate is now close to the level in other low-tax European countries (such as Hungary, Poland and Slovakia) and significantly lower than in most other European countries (with a few exceptions like Ireland, Latvia, Lithuania and Cyprus) (Figure 12). Without the recent cut in the statutory tax rate the effective average and marginal tax rates would have increased above their 2005 levels as the 40% investment allowance was eliminated at the end of 2005. Overall, and particularly after the recent reform, the Turkish corporate income tax appears to be attractive enough for domestic and international investment. The focus should now be on other policies which affect business environment and job creation, such as labour costs and regulatory hurdles as discussed below.
- The authorities have been reluctant to offer *ad hoc* tax holidays to potential foreign investors and this seems sensible, not only because of the fiscal costs but also because it would create new distortions within the business sector.¹⁶ Concerning transparency, tax expenditures started to be reported from 2006 but the coverage of reporting should be further improved and other state aid should be made transparent.¹⁷
- The government introduced an incentive package in 2004 for investment in less-developed regions (in 36 provinces among 81 where yearly GDP per capita was less than USD 1 500 in 2001, plus 13 others), offering newly created firms employing more than 30 workers and old firms increasing their employment by at least 20%, 80 to 100% exemption from workers' personal income taxes (capped by the minimum wage), 80 to 100% exemption from employers' social security contributions, and a Treasury subsidy of 20% on their electricity bill.¹⁸ An extension of this measure to more provinces was envisaged in 2006 but was not implemented because of fiscal constraints.
- Since 2004, all enterprises in Turkey can also deduct 40% of eligible R&D investment from their taxable income, and enterprises established in designated sites near Universities and co-operating with them ("Technoparks") are exempt from corporate taxes for their software and R&D sales. Such firms' research and engineering personnel are also exempt from personal income taxes. The

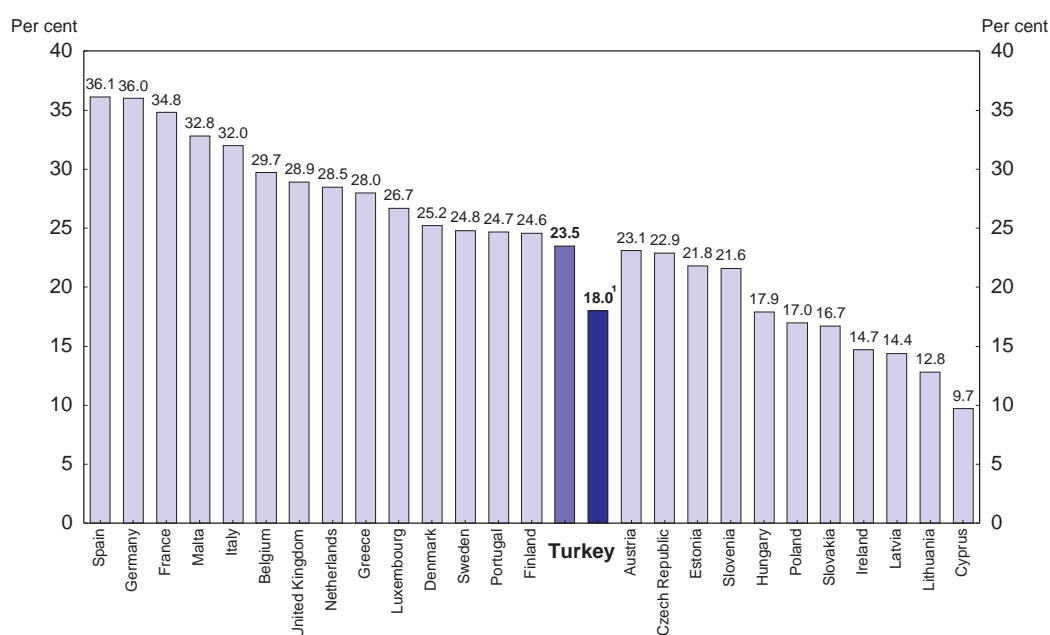
it found that they had declared a total taxable income of YTL 420 million (€ 270 million) for the year, whereas their actual taxable revenues had reached YTL 2.87 billion (€ 1.8 billion), a rate of understatement of 700%. See Milliyet (2006).

16. As experienced with the Hyundai case in 2004-05. This company ran, as many others, a "contest" for tax concessions and free land between Eastern and South-Eastern European countries to select its site for a 12 000 (3 000 direct and 9 000 indirect) job-creating investment. Turkish authorities, evoking their fiscal constraints and the need to preserve a level-playing field between international and domestic investors, stopped bidding and lost the project, although non-tax factors probably also played a role in the company's decision to build its new factory in the Czech Republic.
17. State aid to enterprises is not regularly reported and is not monitored by a specialised agency as is the best practice in other OECD countries.
18. After a strong early response to these incentives, which also involved partial re-location of some labour- and energy-intensive manufacturing between provinces, their impact seems to have declined. In mid-2006, 33 000 enterprises employing a total of 150 000 workers (less than 1% of total labour force) were operating under these incentives.

generosity of these incentives and their potentially distorting impacts on competition would justify an evaluation of their costs and benefits and of their specific provisions.¹⁹

- A withholding tax of 15% on revenues of financial assets held by domestic and foreign investors was introduced in early 2006, to replace the previously declaration-based system. When capital outflows accelerated and the Turkish Lira weakened toward mid-2006 these taxes were eliminated for foreign investors, and reduced to 10% for domestic investors. Investment in TL Treasury bonds and equity securities benefit from these exemptions while taxes remain in place for bank deposits and repo accounts.
- Tax administration has been delegated to a semi-autonomous agency and is now organised according to functional lines (and not according to tax types as before). As is the case in all large-scale tax administration restructurings the transformation is taking time and weaknesses remain. Active co-operation has begun between the tax administration and the banking system to chase tax evaders. This project is in an early phase of implementation and should be backed with safeguards preserving privacy and confidence in the banking system - along OECD best-practices.

Figure 12. International comparison of the effective average tax rates in 2005



1. After 2006 reform.

Source: Zentrum für Europäische Wirtschaftsforschung, Mannheim and *OECD Economic Survey of Turkey, 2006*.

19. In addition to tax expenditures, R&D activities of small-and-medium-sized enterprises are supported with the technology transfer services of the Small-and-Medium-Sized Enterprises Agency (KOSGEB), which have been on offer for several years. The number of beneficiary enterprises remains limited and a more demand-driven provision of such services were recently advocated (including by the *OECD Economic Survey of Turkey, 2004*). KOSGEB has recently taken initiatives to become a catalyst for the overall modernisation efforts of enterprises, notably by acting as a partner for the preparation of strategic business plans inspired by Basel II principles. It estimates that around 10 000 enterprises could be involved.

... the indirect “tax burden” on the informal economy also declined

21. A main reason for firms not to register in the formal economy is to evade taxes. The losers of this tax evasion are – besides the government - the law-abiding firms and workers who dutifully pay taxes but see their prices and wages bid down by the competition from tax evaders. However, even if the informal sector does not directly pay taxes, some of its activities are taxed indirectly. Given the flexibility of prices and wages it is often unclear who finally bears the tax burden (tax incidence). Tax shifting from the formal sector to the informal sector can occur through higher output prices or lower input prices. For example, the money which is earned in the informal sector and spent on purchases from the formal sector bears the VAT and other indirect taxes. Also, if informal firms sell intermediate goods to the formal sector these sales are finally taxed as the purchasers cannot claim VAT tax credits on these inputs.

22. In the high inflation environment that previously existed in Turkey, the so-called inflation tax was another way of taxing the underground economy (Box 4). However, with lower inflation – which is clearly positive for the whole economy - the inflation tax has been reduced. As the informal sector holds relatively large cash balances to finance its transactions and these balances are now less eroded by inflation, it benefits more from disinflation than the formal sector. This also underlines the importance of policies to facilitate the entry of informal firms into the formal sector and also to improve tax enforcement.

Box 4. The inflation tax

With the so-called inflation tax, governments absorb real resources from the private sector by running fiscal deficits and financing these by printing money and thus creating inflation. As inflation reduces real cash balances of the private sector so that it can buy less while the government can buy more, resources are shifted to the government sector in a similar way as if public purchases would be financed by ordinary taxes. The real amount of goods and services which the government obtains by increasing the nominal money stock is the so-called “seigniorage”. Seigniorage is defined as:

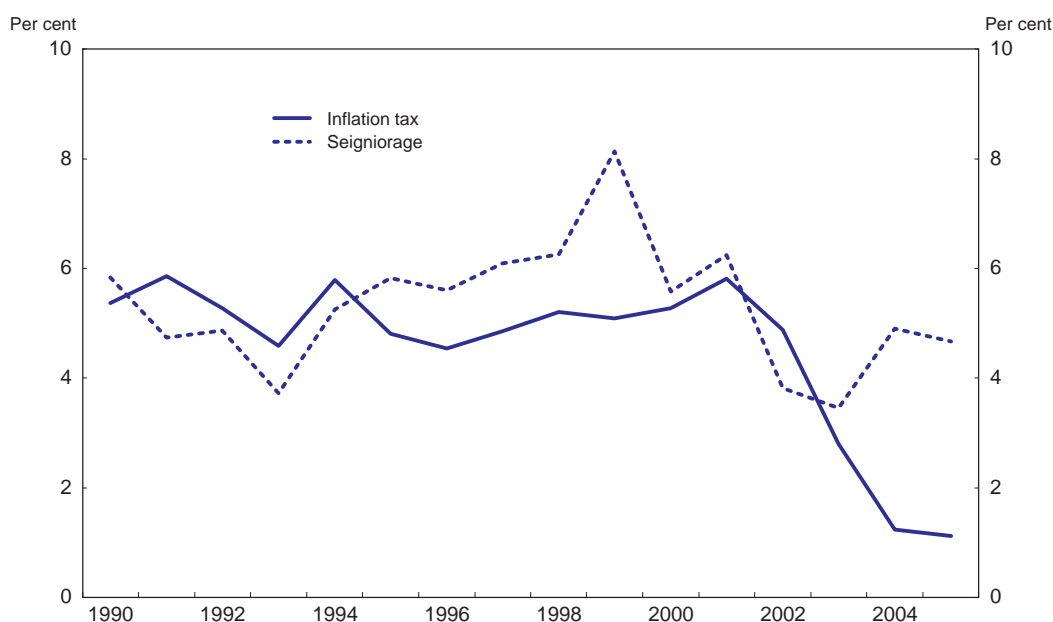
$$\frac{(M_t - M_{t-1})}{P_t} = \pi_t m_{t-1} + (m_t - m_{t-1})$$

where M is the nominal and m is the real money stock, P is the price level and π is the inflation rate defined as $\frac{P_t - P_{t-1}}{P_t}$. The seigniorage thus has two sources. The first (the first term in the formula) is the so-called inflation tax

which is the (real) amount of resources which the private sector must give to the government to hold its real money stock constant in the face of rising prices. The second term (the change in the real money stock), reflects the desire of the private sector to alter its real money holdings. Figure 13 presents the development of the total seigniorage and of the inflation tax component for Turkey. A feature of the inflation tax is that it is not only paid by the formal sector but also by the informal sector. In fact, as cash balances are generally larger in the informal sector it tends to be particularly burdened by the inflation tax.

In the past, Turkish governments used this “source of government financing” to a large extent so that the size of the (ordinary) tax level understates the true burden which the government put on the private economy. In recent years with the reduction of inflation the inflation tax has declined significantly. Turkey is thus making progress in creating a more normal environment where government spending is financed by ordinary taxes rather than by inflation. While the lowering of inflation is clearly positive for the economy as a whole, a side effect is that the reduction of the inflation tax has reduced the burden on the underground economy.

Figure 13. Seigniorage and inflation tax in Turkey
% of real GDP



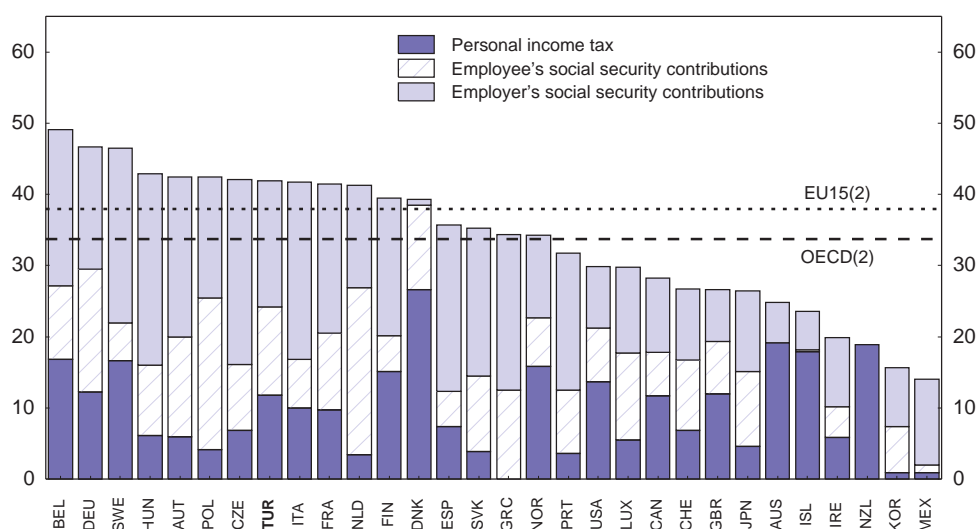
Source: OECD Secretariat calculations.

The large tax wedge on labour should be reduced

23. High taxes on labour income, mainly in the form of social security contributions, push up the cost of employing a worker formally. In recent years most other OECD countries have tended to reduce the tax wedge on labour, while in Turkey it increased. As a result, Turkey is among the OECD countries with the highest average tax wedge²⁰ (Figure 14). This large gap between the effective employment costs of workers and their net income creates strong incentives to work informally.

24. A formalisation strategy will require a reduction in these rates. Even more than income taxes, the high rate of social security contributions contributes to the size of the wedge. Due to the exceptional extent of informality in the economy, which keeps fiscal revenues from social security contributions at a very low 7% of GDP (versus nearly 15% of GDP in other countries with high social security contribution rates), the fiscal cost of cutting social security contributions may be relatively limited and their claw-back effect would be expected to be larger than in other countries.²¹

Figure 14. Average tax wedges on labour, international comparison⁽¹⁾
As per cent of gross labour costs, 2005



1. For a single individual without children at the income level of 67% of the average production worker, or estimated wage levels of the average production worker.

2. Weighted average using 2000 GDP and PPP.

Source: OECD, Taxing Wages, 2005.

20. Turkey has at present a “tax rebate to wage earners” scheme which is not taken into account in the calculation of the tax wedge because it is not a standard deduction in the tax system. The government plans to restructure it as a standard deduction, the labour tax wedge may then decline by about 3-4 percentage points.

21. Social security contributions collected from the private sector (excluding payments made on behalf of civil servants) amounted to about 5% of GDP in 2005. If, social security contribution rates were halved, direct fiscal costs would therefore amount to less than 3% of GDP. If following such a drastic cut informal employment could be reduced by 15% in the first year and an additional 15% in the second, a claw back effect of 1% of GDP in the first year and a further 1% of GDP in the second year could be expected. If, better control and enforcement of wage declarations accompanied this measure – since more accurate wage reporting would become more legitimate and better accepted after such cuts, against massive underreporting at present whereby the majority of private sector employees are declared as minimum wage earners – the reform could nearly fund itself. In all instances, given the crucial importance of this reform its funding deserves fiscal precedence.

Labour market regulations should be considerably simplified

25. Turkish labour market regulations remain rigid despite two legislative revisions in the past decade. The convergence of the Labour Code with OECD best practices is thus a key requirement:

- For *temporary employment* Turkey has the most rigid code of OECD by a significant margin. “Temporary”, “interim” and “agency” work contracts are authorised only in limited circumstances and there are strict limits to the number of times they can be renewed. “Agency work”, whereby an enterprise makes temporary use of another firm’s workforce, was made significantly more difficult by the Labour Code amendment of 2003 (Figure 15).
- Regulations concerning *permanent employment* are not the most rigid in the OECD, but remain far from being flexible. They are characterised by relatively long notice periods for the termination of employment, and a particularly costly severance payment regime. Various amendments to the Labour Code in 2002 and 2003 did not alter these provisions, even if they raised the “enterprise size threshold” for the application of employment protection from 10 to 30 workers. All enterprises remain obliged to pay the high severance payments. Other employment-related rules apply to enterprises employing more than 50 workers, such as the requirement to hire 6% of their workforce from “socially assisted” groups (ex-convicts, handicapped people, victims of terrorist acts), the requirement to hire a certain number of lawyers, physicians and nurses, and the requirement to establish social and recreational facilities. In these circumstances many enterprises ensure that their total number of (formal) employees remains below the relevant threshold (30 or 50 employees) in order to avoid compliance with these additional rules.²²
- *Severance payments* represent a very significant employment cost for formal sector firms. The law prescribes one month of compensation at the latest wage level for each year of service, which can be further increased under collective agreements. This rate of severance payment is the highest in the OECD (Table 2). Moreover, severance payments are payable even in the case of certain voluntary departures (such as retirement). Many Turkish enterprises have a huge off-balance-sheet liability in the form of such obligations which, according to certain analysts, would make many of them insolvent in case of large employment adjustments. If compulsory severance payments were included in the labour tax wedge the wedge would increase by 8 percentage points,²³ making it the highest tax wedge in the OECD by a wide margin (See Turkey’s position in Figure 13 above, without this element). Many firms circumvent this rule by firing workers and re-hiring them before they have been employed for 12 months, after which they become eligible for severance payments. However, those that play by the rules face growing liabilities. In 1999 formal unemployment insurance was introduced, with contribution and benefit rules inspired by standard practices in the European Union.²⁴ This was motivated by an intention to replace the severance payment system. However, the severance payment regime was maintained and formal

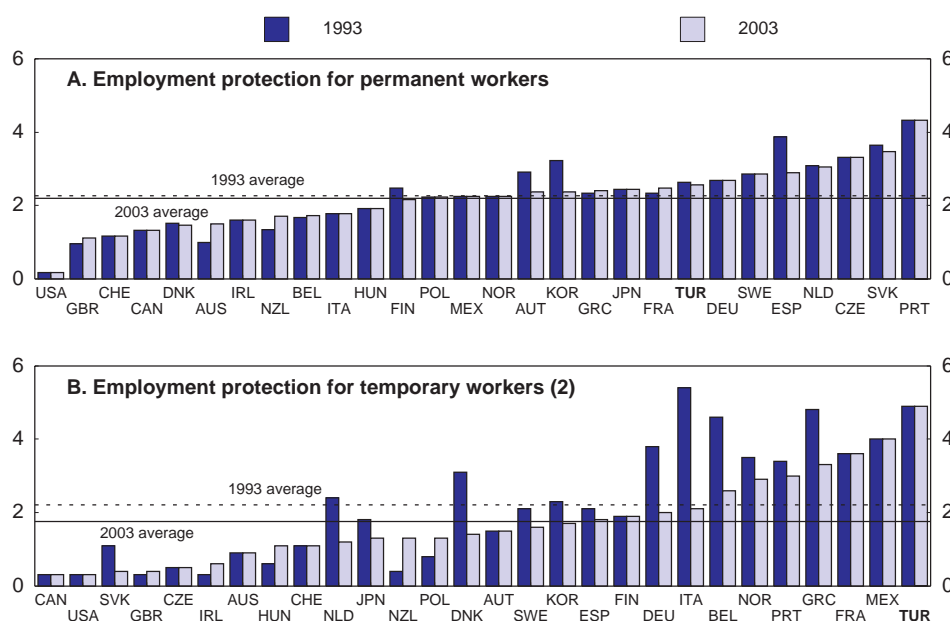
22. The size distribution of enterprises in Turkey confirms the existence of these thresholds for the registered part of their employees.

23. 8% of the wage bill is the provision that an enterprise would have to set aside in order to fund the severance payment liability that it incurs by employing a worker for one more month.

24. A minimum contribution period of 600 days is required for unemployment benefits amounting to 50% of the last wage during six months.

sector enterprises found themselves paying both high unemployment insurance premia (amounting to 3% of the wage bill) and hefty severance payments.²⁵

Figure 15. Employment protection regulations, Turkey vs. OECD countries, 1993-2003⁽¹⁾



1. 0-6 scale from least to most restrictive.

2. The figure for Spain is different from the one reported in *Employment Outlook (2004)* due to a re-assessment of regulation in this area.

Source: Brandt, N., Burniaux, J., and Duval, R., 'Assessing the OECD Jobs Strategy: Past Developments and Reforms', OECD Economics Department Working Paper, 2005.

25. Enterprise provisions to fund severance payment obligations amount to 8% of gross wages (one month of salary per year of seniority) while the unemployment insurance premium is 3%. On the other hand severance benefits are made available not only at unemployment, but also at retirement. If policymakers want to converge the economic incentive properties of the two schemes, severance payments at retirement would need to be eliminated and unemployment insurance premia would need to be made "experience dependent" - e.g. the premia paid by firms firing a higher proportion of their workers would need to be raised. Large funds have already been accumulated in the Unemployment Fund. Fully replacing severance payments with unemployment insurance should now be a policy objective.

Table 2. Severance payments in OECD countries
Severance pay for no-fault individual dismissals by tenure categories, in 2003

	Severance pay in monthly salaries after		
	9 months	4 years	20 years
Australia	0.0	1.0	1.0
Canada	0.0	0.4	2.1
Czech Republic	1.0	1.0	1.0
Denmark	0.0	0.0	1.5
France	0.0	0.6	4.0
Greece	0.3	1.0	5.9
Ireland	0.0	0.4	1.9
Japan	0.4	1.4	2.9
Portugal	3.0	4.0	20.0
Slovak Republic	1.0	1.0	1.0
Spain	0.5	2.6	12.0
Switzerland	0.0	0.0	2.5
Turkey	0.0	4.0	20.0
United Kingdom	0.0	0.5	2.4

Source: OECD.

The minimum wage should not be an obstacle to formal employment

26. The high cost of legal employment also stems from the high level of the legal minimum wage. In 2005, the gross monthly minimum wage in Turkey averaged € 364, lower than in Spain (€ 491), but significantly higher than in Poland (€ 183), Slovakia (€ 167), Estonia (€ 159), Bulgaria (€ 120) and Romania (€ 69). The level of the minimum wage as a percentage of the formal sector average wage was 38% in Turkey, against 39% in Slovakia, 40% in Bulgaria, 37% in Hungary, 35% in Poland, 34% in Estonia, 30% in Spain and 29% in Romania.²⁶ The ratio would be higher if lower wages in the informal sector were taken into consideration. The high minimum wage magnifies the negative impact of the labour tax wedge on employment in the formal sector, as the formal wage costs of low-skilled workers can easily exceed their productivity levels.²⁷ Among OECD countries Turkey has the second-highest labour costs for minimum wage earners relative to formal sector median wage workers, and this ratio has sharply increased as a result of successive minimum wage increases over the past five years (Table 3). These developments have undoubtedly contributed to employment losses in the formal sector.

26. 2004 figures for countries other than Turkey (data from “Minimum Wages in Europe”. European Industrial Relations Observatory, 2006).

27. The estimated annual value added per worker was about USD 5 300 in small size informal manufacturing firms in 2005 (OECD Secretariat estimation), while the yearly effective employment costs of a minimum wage earner was about USD 5 800.

Table 3. Minimum labour costs in OECD countries
Ratio of employers' labour costs¹ for minimum wage workers relative to formal sector median wage workers

	1997	2000	2004
Mexico	0.23	0.21	0.19
Korea	0.22	0.23	0.27
Spain	0.33	0.31	0.29
United States	0.38	0.36	0.31
Japan	0.31	0.31	0.32
Czech Republic	0.22	0.30	0.37
Slovak Republic	-	0.43	0.39
Ireland	-	0.40	0.39
Poland	0.45	0.41	0.40
Canada	0.44	0.44	0.41
Portugal	0.43	0.46	0.44
United Kingdom	-	0.42	0.44
Hungary	0.25	0.27	0.45
Belgium	0.50	0.48	0.45
New Zealand	0.45	0.44	0.47
Greece	0.52	0.50	0.49
Netherlands	0.48	0.50	0.51
France	0.55	0.55	0.54
Luxembourg	0.55	0.52	0.54
Turkey	0.42	0.39	0.57
Australia	0.59	0.57	0.58

Note: - = Not applicable.

1. Gross wage payment plus employers' mandatory social security contributions, as proxied by employers' contribution rates for a single worker with no children earning 67% of the average production worker's earnings level.

Source: OECD Employment Outlook, 2006.

27. The level of the minimum wage is particularly high when the uneven distribution of productivity across firms, sectors and regions is taken into consideration. Indeed, the minimum wage/median wage ratio would be much higher if median wages were calculated on an economy-wide basis, *i.e.* by also taking into account the informal sector. The employment cost of a minimum wage earner appears to be *above* average labour productivity in small size informal manufacturing firms, suggesting that the ratio between labour costs of minimum wage earners, and average wages in the total economy would be even higher. This gap between actual productivity and the mandatory minimum wage is even wider at the regional level. According to available estimates, the ratio of the minimum wage to regional GDP per capita was around 20-30% in western regions in 2001 but peaked at 150-160% in the poorest regions of the East. These ratios must have increased since 2001 but they cannot be calculated as regional GDP per capita has not been published since that date. But given the high labour cost of minimum wage earners it is not surprising that only an infinitesimal minority of workers in the poor Eastern provinces are employed in the formal sector, and then mainly by municipalities and state-owned enterprises. Employing workers legally in the lower productivity areas is difficult as long as this gap between wage costs and productivity persists.

28. In Turkey (as well as in some other OECD countries), the increase in the minimum wage has been justified by the social policy objective to alleviate poverty. However, if it pushes labour costs of low-skilled workers above their productivity level it doesn't serve that purpose as unemployment increases and/or jobs are only created in the informal sector where wages are lower and social security is not provided. Other countries inside and outside the OECD have implemented other policies to mitigate

poverty which take better account of the equity-efficiency trade-off of minimum wages (OECD *Economic Outlook* 2006 and Box 5).

29. In Turkey, formal employment of low-skilled labour would be stimulated by reducing the minimum wage. As this may be politically difficult, as a second best solution, the future increase in the minimum wage should be limited so that it falls as a ratio of the average wage. Furthermore, harmonising the real minimum wage across regions (so that the nominal minimum wage falls in regions where living costs are lower) would improve efficiency as more formal jobs would be created in poorer regions. Such a policy would thus take equity concerns into account at the same time.

Box 5. The political discussion about the appropriate minimum wage in other emerging countries

Other countries have explored new ways to support low-skilled and low-income individuals, without pricing them out of the labour market. An interesting recent policy discussion took place in Singapore, an economy which is often hailed as a success model for emerging countries.¹ In Singapore there is no national minimum wage and the lowest-paid workers earn around SGD (Singapore dollars) 750 (USD 460 or € 380 per month).² This amounts to about 50% of the average wage while the same ratio is 48% in Turkey. Charged with investigating ways of assisting low wage workers, a recent Ministerial Committee concluded that the best way to help low wage workers would be not to increase the minimum wage, but to increase opportunities for upward mobility. Interestingly, employers rather than unions had proposed the introduction of a minimum wage “to protect low wage workers from cost competition by employers, to enhance the image of jobs, and help attract/retain workers”. The committee rejected this proposal on the following grounds: “When wages are propped up artificially through a minimum wage, then some companies in Singapore would lose their competitiveness and relocate to other countries. We will end up with more job losses and higher unemployment. Rather, we should pursue initiatives such as job re-creation, whereby the jobs become more productive and thus can pay more”. Instead, the Singaporean government’s approach is to promote higher wages through increased productivity of low skill workers, backed by policies such as: training programs for low wage workers (in particular, English language, Information Technology literacy and numeracy training); the expansion of the Workforce Skills Qualification System (to promote productivity gains); a focus on workfare rather than welfare (to ensure strong worker incentives to participate in the workforce); and affordable education and pre-school education for low income households (to ensure that low wage workers have help to look after their dependents if they work).

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1. See “Report of the Ministerial Committee on Low Wage Workers”, <http://www.mom.gov.sg/MCLWW>.
 2. Some domestic workers from Indonesia or the Philippines earn as little as USD 150 – 200 per month.

Improving access to external financing is becoming more important

30. Access to efficient capital markets is becoming more important in all segments of the business sector. In particular, informal and semi-formal firms face costs in terms of diseconomies of small scale as (full or partial) informality puts a “*glass ceiling*” on their access to capital markets and therefore on their investment capacity:

- As informal and semi-formal firms’ *financial accounts* understate the true dimensions of their activities - *i.e.* the actual volume of their sales, assets, profits, employment and capital - firms have difficulty getting full support and services from properly supervised banks. Turkish banks, subject to looser regulations in the past, used to provide informal and semi-formal firms with a

limited amount of credit through a system of informal books and bilateral information. But stricter bank regulations are making this more difficult.²⁸

- The peculiarities of their *governance structure* also make it difficult for these firms to raise funds from equity investors (as discussed in more detail in Annex A3). Semi-informality is also a hindrance in their communication with other partners such as joint-venture candidates, technology suppliers and new customers. Large international customers prefer to deal with suppliers with a clear governance structure and financial basis that they can document and rate.

31. In order to draw on the new funding sources arising in financial markets, firms should upgrade their governance and financial reporting processes. Policy reforms can back these efforts. Capital markets laws already impose more rigorous financial reporting, external audit and governance standards on “publicly held” companies (those with more than 250 shareholders and those listed on the stock exchange). To extend similarly demanding standards to “closely-held” companies (the category to which the vast majority of medium-sized enterprises belong), draft revisions to the Turkish Commercial Code (TCC) propose more rigorous financial reporting and external audit rules for all companies.²⁹ These initiatives are well-intentioned but should ensure that compliance costs do not outweigh the benefits of stricter regulation or create new incentives to operate informally. The adaptation of regulatory requirements to the circumstances of smaller, privately held firms may be necessary. Authorities should also encourage pension and mutual funds to consider pro-actively exercising their shareholder rights and encourage private sector organisations, including self-regulatory organisations (SROs) to help diffuse good governance practices among enterprises and investors on voluntary grounds.³⁰

Product market regulations should be eased

32. Firms playing to the rules are exposed to a plethora of product market regulations which remain more detailed than in other OECD countries despite the simplification efforts undertaken in the 2000s (Figure 16). The complexity of regulations increases entry costs and creates room for government bureaucracy to exert discretionary power over business creation, a recipe for fostering competition distortions and, according to some cross-country studies, increases the scope for corruption.³¹ These risks are compounded by the complexities of the laws governing the conduct of business and create unpredictabilities in the commercial justice system.³² These shortcomings are more taxing for foreign firms

28. Basel II Banking Supervision Rules vary the capital adequacy requirements for commercial loans according to the financial and governance transparency of borrowers. These rules will apply in Turkey from 2007. See Annex A3.

29. The proposed regime allows for alignment with simpler, “SME-specific” reporting rules which may in the future be developed by the International Accounting Standards Board.

30. These questions are discussed in more detail and recommendations will be issued in OECD, “Corporate Governance in Turkey: A Pilot Study” (OECD, 2006).

31. Djankov *et al.* (2002) found a strong statistical correlation between the complexity of product market regulations and the extent of corruption across countries.

32. It has been asserted, and confirmed in several recent cases, that the sources of law are particularly disparate in Turkey so that parties to a commercial case can always hope to find a legal provision backing their argument - including from the Constitution which contains sectoral prescriptions. They can therefore expect to have unfavourable justice decisions reversed by some higher Court. This explains the snowballing of appeal cases, the average processing time of which increased from 152 days in 2002 to 202 days in 2003. Cases in the Administrative Court of Appeal (Danistay) also grew spectacularly: For 87 000 pending cases at the beginning of the year, 68 000 new cases were open in 2005 and only 58 000 cases were solved by the end of the year. Judicial enforcement proceedings also reached high numbers: 3 million actions were resolved in 2003 and 4.4 million proceedings were pending at the end of the year.

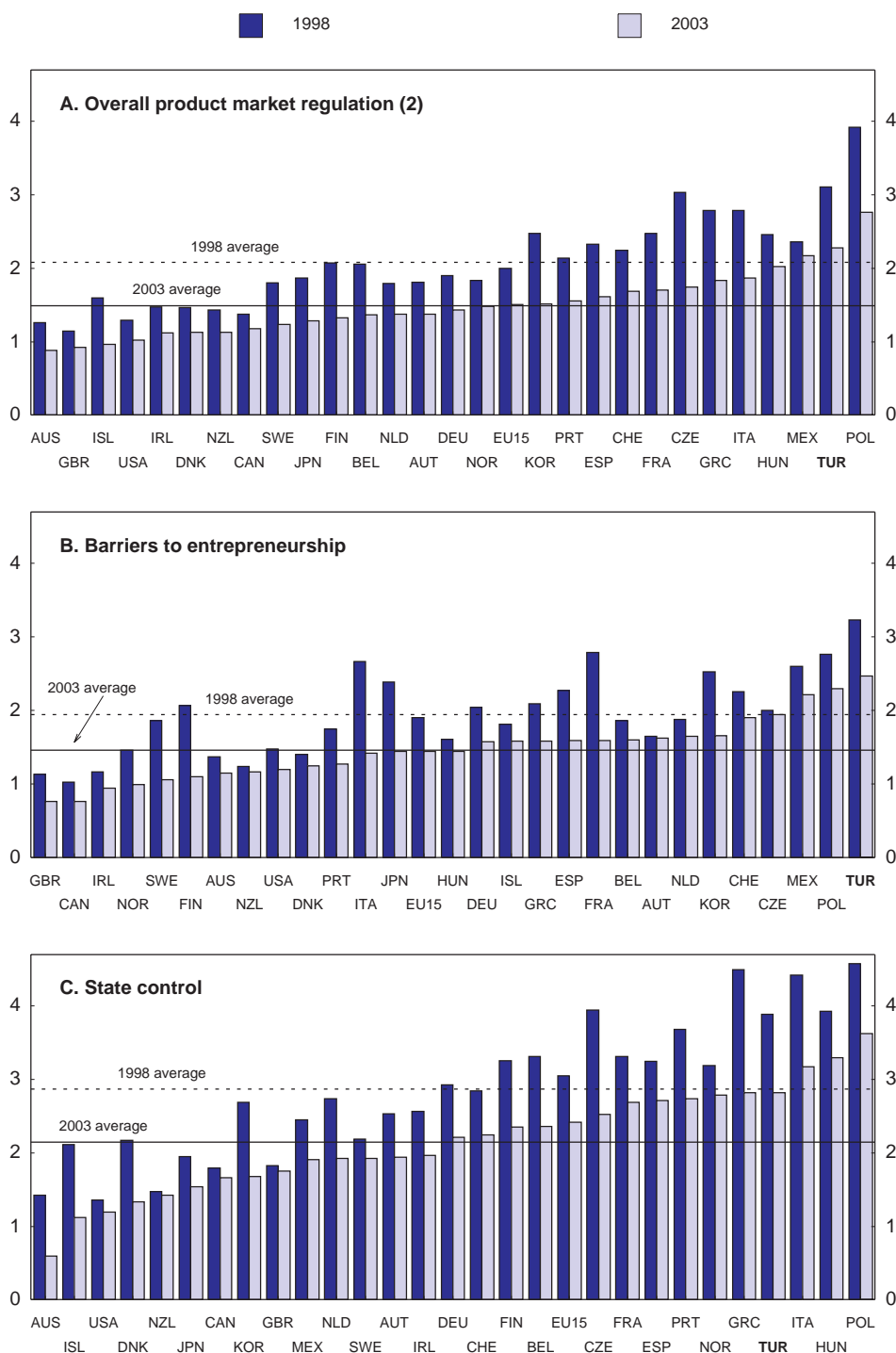
which have difficulty coping with them. Empirical studies show that countries with relatively strict product market regulations tend to receive less FDI.³³ In contrast, domestic firms are more accustomed to operating in this setting and have developed resources to cope with it, such as increasing their influence in the political and media spheres to further their interests. Nonetheless, despite the streamlining of administrative procedures for firm creation in 2003, a comprehensive simplification of the legal rules governing business-making is needed and the commercial justice system should be reinforced to provide a streamlined framework.³⁴

Commercial courts received around 95 000 new cases in 2003, decided half of them and the average processing time of a commercial case reached 417 days at the end of the year. In this litigation-intensive environment, the application of regulations to large-size domestic and international businesses gave rise to a number of well-known judicial stalemates - some of which are still pending. See Dutz *et al.* (2005).

33. See Nicoletti *et al.*, 2003.

34. In January 2006, the Turkish Association of Industrialists and Businessmen (TUSIAD) issued a statement on the reform of the justice system. Among many other points it has been stated that: *i) An independent judiciary is imperative for reform.* The structure of High Council of Judges and Prosecutors should be changed, the Secretariat of this Council should be separated from the Ministry of Justice; *ii) The practice of retrospective unilateral actions of the state should be abandoned.* They alienate local and foreign investors and diminish public confidence in the legal system; *iii) Financial, personnel and training problems of the judiciary should be solved.* In addition to increased financial compensation for judges and prosecutors, the training of key and office personnel is crucial” (TUSIAD, 2006).

Figure 16. Product market regulations, Turkey vs. OECD countries, 1998-2003¹



1. Sorted by 2003 values. The scale of indicators is 0-6 from least to most restrictive.
 2. The overall product market regulation index is a compound of 16 low-level indicators aggregated into three intermediary-level indicators on 'barriers to entrepreneurship', 'state control' and 'barriers to trade and investment'.
 Source: Conway, P., V. Janod, and G. Nicoletti, "Product Market Regulation in OECD Countries, 1998 to 2003", OECD Economics Department Working Paper, 2005.

33. A topical issue is the regulation of market entry in retail trade. Further restructuring is needed to increase productivity and reduce the massive informality in this sector, and to contribute to greater price-competition in the entire economy. The development of large-size retailers is promising, as evidenced by the increase of their market share from 30% in 2002 to 37% in 2005.³⁵ Unfortunately, certain legislative initiatives now aim to make hypermarkets' market entry more difficult. A draft law proposes to submit the opening of new large-size retail facilities to local and central administrative authorisations, to constrain their working days and hours, and regulate their prices and discounts. This draft law is based on laws in certain other OECD countries which, in order to slowdown the exit of less efficient operators, unduly held back the modernisation and productivity of their retail trade at large economic costs.³⁶ Given the importance of this sector in furthering price competition and overcoming duality, it is important to provide it with open and predictable framework conditions. More domestic and international investment in distribution should therefore be encouraged.³⁷

Infrastructure should be made less costly through more competition

34. Turkish firms also have to pay high energy costs reflecting the stranded costs of past investments in the energy sector, high energy taxes and various supervisory shortcomings.³⁸ Telecommunication tariffs are also very high (Figure 17). As a consequence, a large proportion of enterprises consider infrastructure utilities as a major bottleneck in their doing business.³⁹ The recent pro-competitive regulations of the energy and telecommunication sectors should be fully enforced according to a clear calendar, and through co-operation between sectoral regulators and the Competition Authority. The prices and the quality of services should be closely monitored and made transparent to the business sector and to the general public.⁴⁰

35. There were around 2 000 supermarkets and hypermarkets in Turkey in 1998 and 5 500 in 2005, while the number of smaller grocery stores (without mentioning the numerous open-air retailers) fell from 37 000 in 1998 to 31 000 in 2005. See TEPAV (2005a).

36. See O. Boylaud (2000).

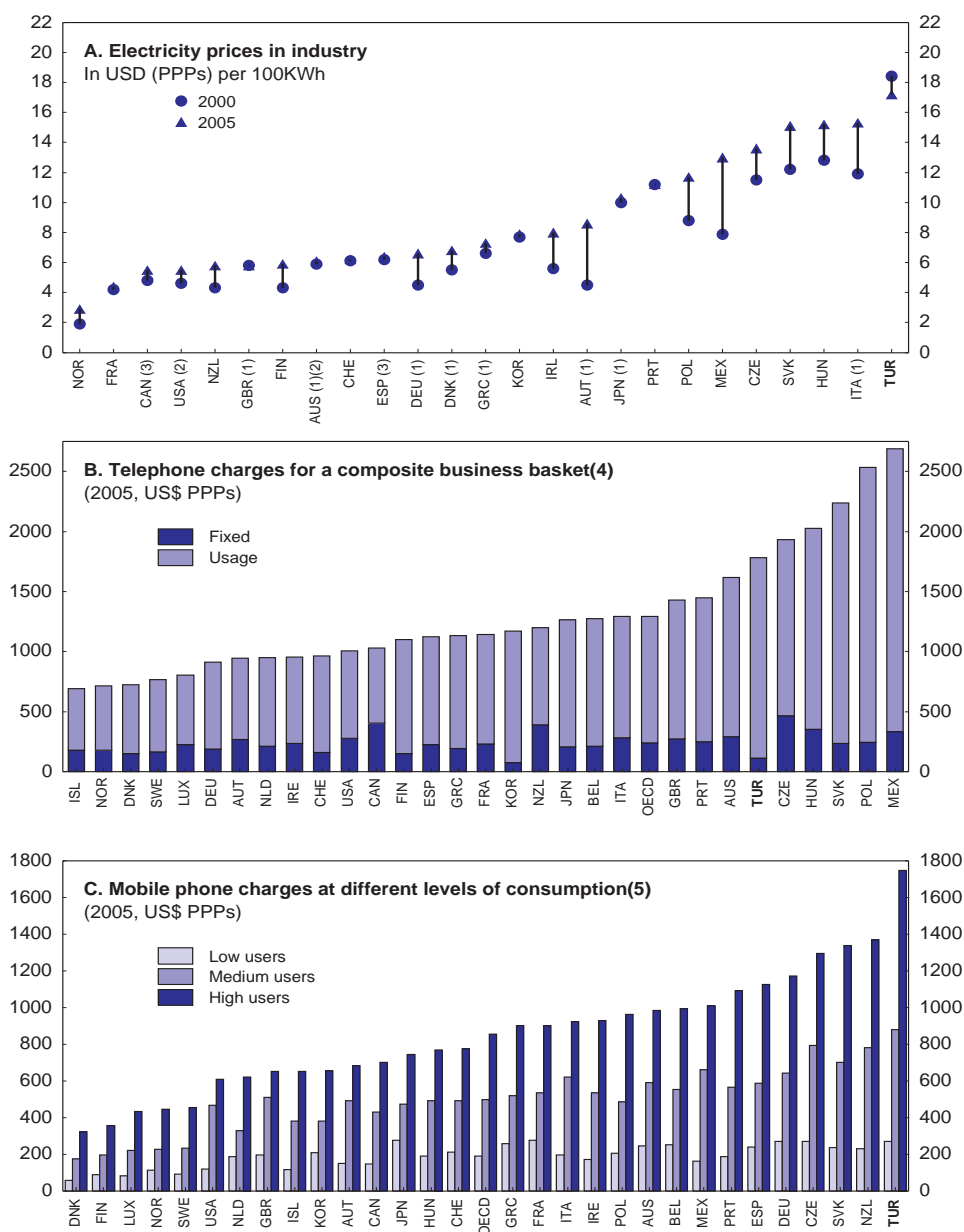
37. A straining development affected the international furniture retailer IKEA which opened two facilities in Turkey in 2005 and 2006, met massive consumer interest and rapidly gained market share. Its imports then were made subject to new and cumbersome procedures, hampering its procurement. Encouraged by its early successes, this retailer had started direct procurement with high-quality local manufacturers in Turkey.

38. The high "loss ratios" in the Turkish electricity distribution grid - reflecting both technically lost and illegally used electricity - are around 15% and increase the energy fees paid by legal users.

39. According to the *Business Environment* (BEEPS) survey of the World Bank in 2005 23% of Turkish enterprises considered energy service provision, 20% the telecommunication service provision and 21% the transportation services as serious problems for doing business; against 11%, 12% and 14% respectively in the eight new EU-accession countries.

40. At current exchange rates, Turkey remains the third most expensive OECD country after Japan and Italy for electricity prices for industry. For household consumers, electricity prices are moderate in comparison to other OECD countries, hinting at cross-subsidies from industrial to household users. The authorities control most energy prices, notably the electricity tariffs for end-users, and have not increased them since November 2002 in spite of rises in international oil and gas prices. They decreased electricity tariffs for industry in 2003. Deficits are building up in the electricity system as a result of this price repression. These deficits are not fiscally sustainable if structural reforms do not reduce costs in the energy chain.

Figure 17. High infrastructure costs



1. Data for 2004.
 2. Excluding taxes.
 3. Data for 2003.
 4. Excluding VAT.
 5. Including VAT.
 Source: AIE, Energy prices and Taxes and OECD, Communications Outlook database.

Privatisation should be backed with sound corporate governance

35. Ongoing privatisations are increasing the size of the formal private sector. After delaying for more than a decade, large-size privatisations only began in 2004-2005. *Turk Telekom* (telecommunications incumbent), *Tupras* (main oil refiner) and the *Mersin port* (one of the major export ports - its privatisation has not yet been entirely completed) have been sold to foreign and domestic controlling investors (Table 4). Plans for the privatisation of three large public banks have advanced more slowly but appear to be in progress. Twenty-five per cent of the equity of *Vakifbank* (the Bank of Foundations) was sold to stock market investors in July 2005, a financial adviser was hired for the privatisation of *Halkbank* (Bank of SMEs), while the privatisation of *Ziraatbank* (the Bank of Agriculture, the largest bank in Turkey) should in principle follow on the basis of these two privatisation experiences. The government plans to publish a banking sector privatisation strategy and timetable in the near future.

36. As these privatised companies are major suppliers of goods and services to other businesses and their performance matters for the competitiveness of the economy as a whole, it must be ensured that they remain subject to strict competition policy, more consistently than when they were under state ownership.⁴¹ These privatisations may also be a step towards the creation of truly *publicly-owned*⁴² corporations in Turkey: although most privatisations have resulted in controlling ownership of privatised entities by either domestic or foreign players, a non-negligible portion of their equity is likely to remain in the hands of stock market investors. Less concentrated ownership structures should permit the emergence of active minority holders and facilitate the diffusion of international corporate governance standards in Turkey, provided that the rights of minority shareholders are fully enforced.⁴³

41. This is particularly important for Turk Telekom which has a dominant position in fixed line telecommunications and basic internet services, for TUPRAS which is the main supplier of refined oil, and for cement factories which have strong regional market power. Post-privatisation competitive surveillance of Turk Telekom and cement factories has already raised controversies. Some “learning” process in the enforcement of competition rules in these large industries must be recognised, while performance outcomes (price and quality of services) should be closely monitored.

42. The so-called “Berle-and-Means” corporations with dispersed equity and no dominant owners do not exist in Turkey (A. Berle et C. Means, *The Modern Corporation and Private Property*, New York, 1932).

43. *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (2005) represent what OECD governments agree as the core elements of a good corporate governance regime for SOEs (before privatisations).

Table 4. Major privatisations in 2005 and 2006

Privatised company	Area of activity	Date of privatisation	Employment in company (before privatisation)	Total (notional) market value of the company on the basis of its privatisation price (USD)	Percentage of equity sold to the new controlling investor	Percentage of equity issued on or already in the stock market	Percentage of the equity still owned by the government
Turk Telekom	Telecommunications (incumbent fixed-line operator / GSM-AVEA)	14 November 2005	54 000	11.9 billion	55	-	45
Tupras	Petroleum Refining	26 January 2006	4 302	8.12 billion	51	49	Nil
Tupras (Sale Channelled through Istanbul Stock Exchange)	Petroleum Refining	4 March 2005	4 330	3.1 billion	14.76	49	36%
Istanbul/Ataturk Airport (Operating rights for 15.5 years)	Airport Operations	July 2005	-	3 billion	Transfer of Operational Rights / BOT Scheme	-	-
Erdemir	Iron & Steel	27 February 2006	14 414	6 billion	49.29	47	Nil
Vakifbank	Banking / Financial Services	November 2005	7 164	5.1 billion	(25.18% Initial Public Offering)	16	58.45
Mersin Port (Operating rights for 36 years) (*)	Seaport Operations	12 August 2005	1 336	755 million	Transfer of Operational Rights	-	=
Motor Vehicle Inspection Stations (*)	Public Service Concession Agreement (for 20 years)	20 December 2004	-	613.5 million	Concession Rights	-	=
Eti Alüminyum	Bauxite/Aluminium Production	29 July 2005	2 212	305 million	99.99	-	Nil
Petkim	Petro-chemicals	April-December 2005	3 761	809.8 million	34.57 (Secondary Public Offering)	4.1	61.32
Başak Sigorta & Başak Emeklilik	Insurance / Retirement Fund (Occupational Pensions)	16 May 2006	469	473 million	56.67	-	43.33 (Indirectly-through agriculture sales co-operatives)
Istanbul Hilton Hotel	Tourism/Hotel Business	15 November 2005	-	255.5 million	Asset Sale	-	-
THY/Turkish Airlines	Air Transport / passenger carrier	16-18 May 2006	10 928	723 million	28.75% (public offering)	25.5	46.43
Ataköy Group of Companies	Tourism	28 February 2005	568	199.1 million	Various Stakes	-	Nil

(*) The privatisation process of the Mersin port and of the Motor Vehicle Inspection Services have not yet been completed.

Conclusion: Regulatory simplification is the key to enhancing competitiveness and growth

37. Enhancing the growth potential of the economy under growing competition from low-wage countries requires a broad-based strategy of improving framework conditions for all types of firms. Reducing labour market regulations and labour costs, improving competition in product markets and improving infrastructure would not only enhance the productivity of firms in the formal sector, but would also facilitate the creation of new firms and the move of the large population of informal firms into the formal sector.

38. A strategy of *regulatory simplification and formalisation* would help replace the distinctly *layered* regulatory and tax framework with a unified, low-cost, level-playing and much more flexible formal framework. The resulting streamlined business environment would stimulate the productivity and competitiveness of *large-size, dynamic medium-size and micro-scale firms* alike, and would facilitate resource shifts between these groups according to their true underlying efficiencies rather than according to their uneven exposure to legal and tax liabilities:

- i) It would reduce the heavy regulatory burden on formal-sector firms – particularly in the areas of costly product and labour market regulations,
- ii) It would help informal micro operators to become normal business firms – enhancing their capacity to build-up physical and human capital,
- iii) It would break the glass ceiling that is currently impeding the performance of dynamic medium-sized firms – by permitting them to expand and by giving them access to the funding, technology and marketing resources that they need.

39. The main pillars of this suggested approach are summarised in Box 6.

Box 6. A comprehensive strategy to raise competitiveness and growth based on regulatory simplification and formalisation

The first priority

Reducing labour costs and regulations for formal employment

- Labour taxes: substantially reduce social security contribution rates (for example by halving them). This measure should be a fiscal priority and can be partly funded through reductions in pension costs (as discussed in the *OECD Economic Survey of Turkey 2006*).
- The minimum wage: limit the growth of the minimum wage so that it falls as a ratio of the average wage; harmonise the real minimum wage across regions so that the minimum wage costs are reduced in regions where productivity and living costs are lower.
- Labour regulations: liberalise labour market regulations for both *permanent* and *temporary* contracts; and permit standard unemployment insurance to fully replace the severance payment system.

Other important reforms

Ease regulations in product markets

- Review and simplify sectoral licences and minimise local government authorisations for doing business,

thereby reducing the room for discretionary influence on businesses by administrative authorities.

- Reduce the complexity and the overlaps in the legal framework for doing business, in particular by reducing potential conflicts between different sources of law.
- Reinforce the commercial justice system on the basis of this simplified framework.

Ease access to capital markets

- Enhance the financial transparency of small-and-medium-sized firms by adopting and enforcing the new draft provisions of the Turkish Commercial Code but reducing compliance costs to a strict minimum.
- Facilitate the funding of publicly-owned companies through compulsory transparency and other governance standards and by encouraging companies to fully implement the Corporate Governance Principles.
- Align with OECD good practices of institutional investment by amending the relevant laws and encouraging private sector organisations to raise awareness and provide training on investment best practices.

Improve infrastructure and make it less costly through more competition

- Fully implement the new sectoral regulations for energy, telecommunications and transportation, through co-operation between sectoral regulators and the competition authority.
- Make available low-cost broadband services across the entire territory.

Improve knowledge base

- Promote basic management education for the owners of micro- and small-and-medium-sized enterprises.
- Promote basic information technology and internet education.

Ensure effectiveness of investment incentives

- Resist pressures for sectoral subsidies.
- Increase transparency about state aid and its economic impacts.

Improve the efficiency of the tax system

- Simplify and consolidate the indirect tax structure.
- Continue to eliminate tax exemptions.
- Assess the efficiency of tax incentives for research-and-development and technoparks.
- Continue to improve tax administration and auditing.

Annex A1

An Analysis of the Evolution and Determinants of Profitability in Turkish Manufacturing Industry, 1998-2005

40. The profit margins of seventeen manufacturing sectors have been analysed for the period between 1998 and 2005 at aggregate and sectoral levels by drawing on the standard methodology of calculation of unit labor costs. The analysis also includes additional elements and represents an extended version of the standard approach.⁴⁴

- Sectoral disaggregation permits the reporting of significant differences in the evolution of the unit labour costs and prices in different sectors.⁴⁵ This provides a proxy for the difficult-to-calculate and unpublished *sectoral relative unit labour costs* (i.e. *sectoral real exchange rates on a ULC* basis).
- The analysis also broadens the standard unit labour cost approach by taking into account unit capital and unit energy costs. As capital and energy costs differ significantly in Turkey from competitor countries, both in level and trend, their inclusion enhances the monitoring of competitiveness.⁴⁶
- The methodology also permits to evaluate the specific contributions of individual determinants of profit margins by distinguishing the estimated impact of changes in output prices, real wages, labour productivity, relative capital costs and relative energy costs. These contributions have been estimated for different time periods, at aggregate and sectoral levels.

Two models have been utilised:

44. A more detailed exposition of this analysis and its results are presented in: R. Gönenç and G. Yılmaz, “The evolution and determinants of profitability in Turkish Manufacturing Industry, 1998–2006”, Central Bank of the Republic of Turkey Research Document, 2007.

45. Data average out performance differences between firms *within sectors*. Also, the competitive performance of very small firms which usually account for a limited share of output but a sizeable share of employment is not fully reflected. This limited coverage is due both to *i)* many firms’ not accurately reporting their actual output and employment levels, and *ii)* their falling below the minimum size thresholds in Surveys. The Quarterly Manufacturing Output and Employment Surveys of the State Statistical Institute provide generally good quality data, but exclude enterprises employing less than 10 workers. In contrast, Quarterly Household Labour Force Surveys and Quarterly Sectoral GDP data from National Accounts provide a fuller coverage of the business sector, but at the expense of data precision and quality. Since this analysis focuses on *changes in* rather than *levels of* productivity (as *changes* of productivity bear on the profitability indicator), the Manufacturing Output and Employment Survey has been utilised.

46. *Interest rates* and *energy costs* varied strongly between 1998 and 2005, as a result of fluctuations in *credit* and *currency* markets, and changing *energy taxes*. The weight of debt service (interest) in total enterprise costs was estimated using the Turkish Central Bank’s sectoral balance sheets database. The measure of “interest rates for real sector credits” published by the Central Bank was used to estimate the rates of change in capital costs. For energy costs, sector-specific energy intensity matrixes from the State Planning Organisation were used to estimate sector-specific cost weights and the “wholesale energy price index” of the Central Bank was used to estimate the rates of change in energy costs.

Simple Model

EPMI: Index of Export Profit Margins

$$(EPMI) = (EXPr) / (ULC)$$

EXPr: Index of Export Prices⁴⁷

ULC: Index of Unit Labor Costs

$$ULC = (Wn * PWH) / (IP)$$

Wn: Index of Nominal Wages per Worked Hour

PWH: Index of Worked Hours

IP: Index of Industrial Production

$$(EPMI) = (EXPr * IP) / (Wn * PWH) \quad (1)$$

To estimate the contribution of individual factors to export profit margins, a logarithmic differentiation of equation (1) was used:

$$d(EPMI) / EPMI = (d(EXPr) / EXPr) + (d(IP) / IP) - (d(Wn) / Wn) - (d(PWH) / PWH) \quad (2)$$

DPMI: Index of Profit Margins on Domestic Sales has been calculated by substituting export prices with producer prices in the same formula.

Extended Model

A second model included *unit capital* and *unit energy costs*. In this model, instead of estimating export and domestic profit margins separately, a general profit margins index (GPMI) was calculated. In GPMI, *composite price index* is constructed by weighting export prices and producer prices by the shares of the export and domestic sales in total output in each sector:

$$(GPMI) = (WPr) / \{0.5 * ULC + a * UCC + b * UEC\} \quad (3)$$

WPr: Weighted Price index

UCC: Index of interest rates for real sector credits

UEC: Index of Unit Energy Costs

a: Coefficient of sectoral unit capital costs.

b: Coefficient of sectoral unit energy costs.

41. The main findings for the period 1998-2005 are:

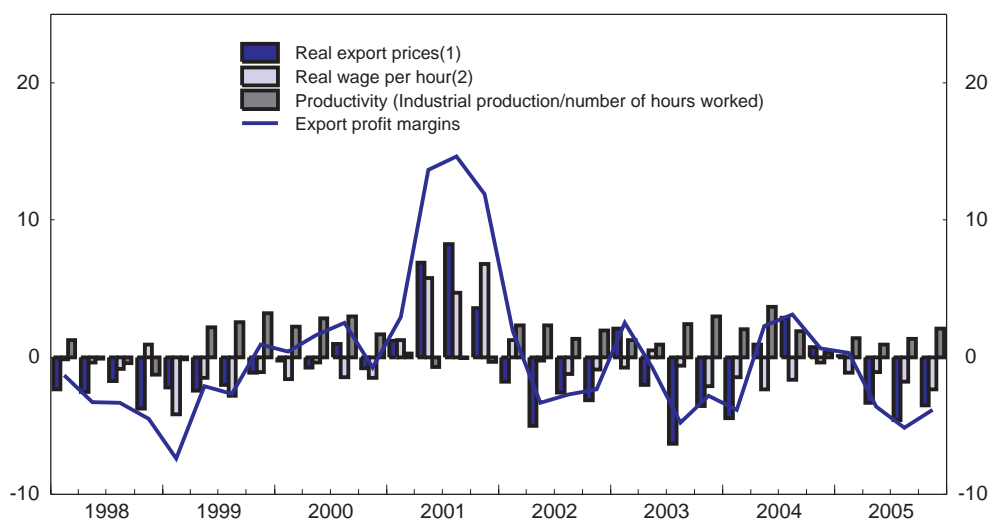
- The estimated profit margins of the manufacturing industry as a whole closely tracks the real exchange rate on a unit labour cost basis, confirming the relevance of the standard competitiveness indicator. Correlations between profit margins and the real exchange rate are particularly strong in export sales while, in domestic markets, profitability grows with depreciation but diminishes less with appreciation - there is an asymmetry in the pass through from the exchange rate to domestic prices and profits.⁴⁸ As a result, the main outcome of the recent period's strong real currency appreciation has been a sharp erosion in export profits.

47. The export prices of manufacturers depend both on the level of international prices (reflecting the unit labour cost performance of trade competitors) and domestic manufacturers' ability to earn a product differentiation rent over international prices. The second and third factors (labour productivity and wages) together determine unit labour costs at the domestic level. The ratio of export price growth and unit labour cost growth provide a proxy for export profit margins.

48. This observation appears consistent with available estimations of exchange-rate pass-through to domestic prices.

- Three phases in the evolution of competitiveness must be distinguished: a) the period preceding the 2000-2001 crisis which saw a regular erosion in the aggregate profitability of the business sector, mainly due to the pressures of real currency appreciation (1998-2000), b) in the crisis years 2001-2002, *sharp* real currency depreciation and *sharp* real wage declines permitted a spectacular restoration of profitability, and c) in the post-crisis reform period, structural changes in industry on the one hand and strong real currency appreciation on the other hand generated mixed competitiveness outcomes (2003-2005). The nominal and real depreciation of the currency in May-June 2006 must have helped manufacturers improve their margins (before a partial re-appreciation of through the summer) but the needed statistical data is not yet available to document these most recent developments.
- The profitability of domestic and international sales, after evolving in parallel until the crisis years have diverged in the post-crisis stabilisation period. While profit margins on domestic sales continued to expand exports margins have been compressed under apparently stronger price competition in international markets and strong real currency appreciation.
- Estimated export profit margins for the manufacturing industry as a whole appeared above their 1999 level at the end of 2005 while domestic margins attained even higher levels.
- Individual sectors' profitability has increasingly diverged and this divergence is deeper in export markets than in the domestic market. The divergence of sectoral profitabilities reflects mainly weakening sectors' losing their margins more severely in export markets than at home, while sectors which succeeded to preserve their profitability achieved a comparable performance in foreign and domestic markets.
- The contributions of changes in *prices*, *wages* and *productivity* reveal that divergences in the profitability performances are first and foremost due to sectors' uneven ability to preserve and increase their *prices* against the pressures of international competition. *Labour productivity growth* also diverges across sectors, as do their paces of *real wage growth*. Figure A1.1 displays these contributions to export profit margins in the manufacturing industry as a whole. The same decomposition for individual sectors is provided in the background Research Document which presents more detailed findings.⁴⁹.
- As a result of these differences in the determinants of their margins, manufacturing sectors cluster in three groups:

Figure A1.1. Contributions to export profit margins in manufacturing industry (1998-2005)
 Percentage change in real profit margins and estimated contributions of real prices, real wages and productivity



Note: for the decomposition formula of contributions, please refer to the text.

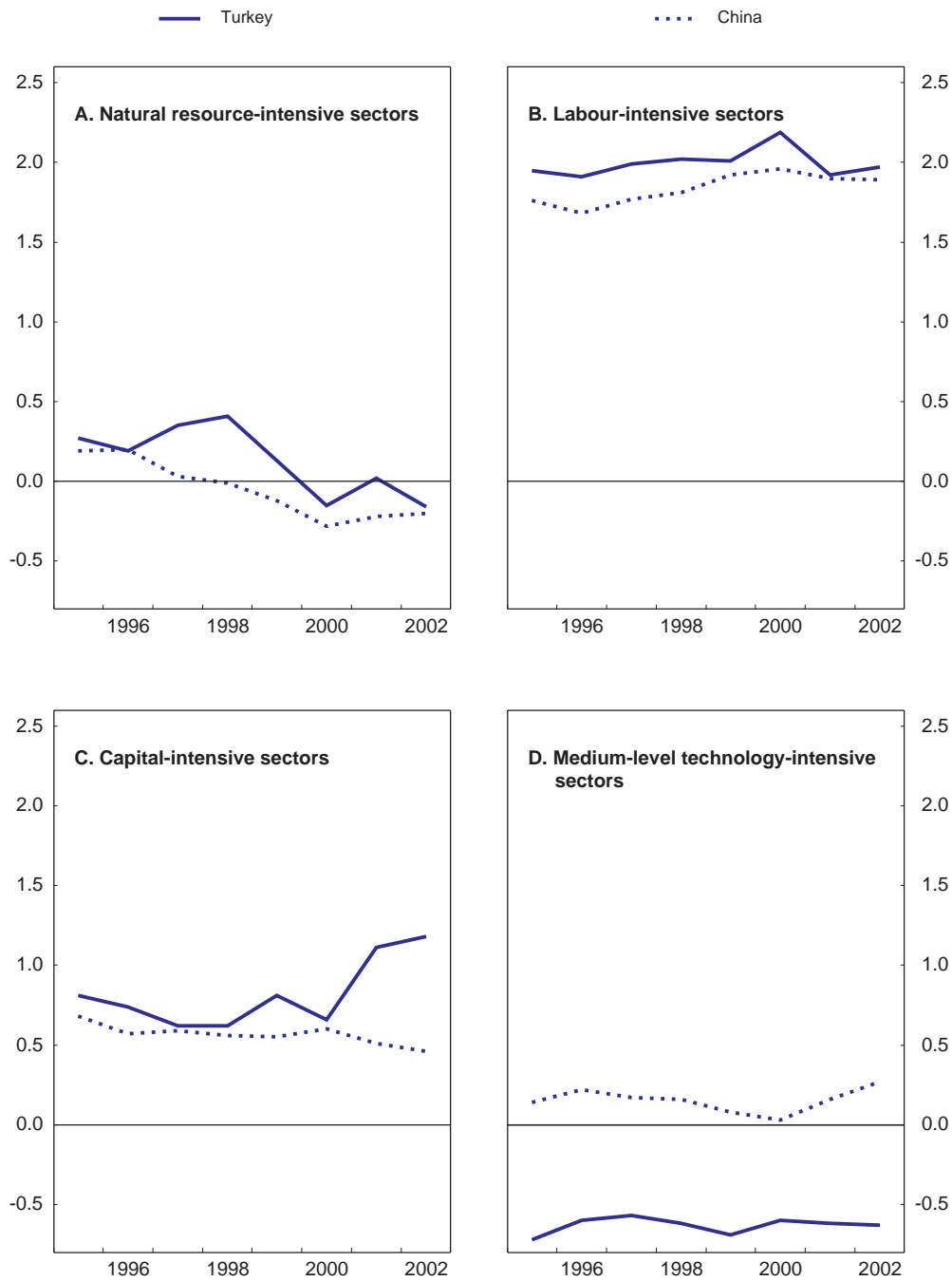
1. Real price increases contribute positively.
2. Real wage increases contribute negatively.

Source: OECD.

- i) Sectors which do consistently well along the three determinants of competitiveness⁵⁰ and, as a result, cope successfully with the pressures of appreciation. These sectors include electronics, industrial machinery, steel and car manufacturing (highly-competitive sectors).
- ii) Sectors which, in contrast, tend to under-perform in all three dimensions and consequently face a severe deterioration in their competitiveness. Textile, clothing and leather industries are in this situation (declining sectors); and
- iii) Sectors with a mixed performance, either because they combine good and bad performances in different determinants of competitiveness or achieve only average performance in all of them. Several industries such as plastics, electrical equipment, metal product and furniture manufacturing are in this case. They have resisted generally well to the pressures of appreciation to date but remain vulnerable (intermediary sectors). To illustrate the continuing pressures from international competition, Figure A1.2 shows Turkey's continuing exposition to competition from China.

50. Or in at least two of them, together with an average performance in the third.

Figure A1.2. Revealed comparative advantages¹: Turkey vs China



1. The “Revealed Comparative Advantage” (RCA) indicator proposed by Wollrath (1991) was compiled for China and Turkey for the period 1995-2002. It is defined as $RCA = [(X_{ij}/X_{it}) / (X_{nj}/X_{nt})] / [(M_{ij}/M_{it}) / (M_{nj}/M_{nt})]$ with X=exports, M=imports, i=country, j=product, n=all countries and t= all products.

Source: Seymen and Simsek (2006).

Table A1.1. Performances of individual sectors

Sectors	Performance
<i>Highly competitive sectors</i>	
Car manufacturers	Firms have achieved remarkable wage moderation over the past two years despite a successful pickup in their prices and profits.
Electronic goods	Manufacturers have achieved significant wage moderation under strong downward pressures on prices and profits.
Steel	The sector benefited from exceptional price and profitability increases (due to excess demand in international markets) but avoided wage drifts.
<i>Intermediary sectors</i>	
Electrical machines	In response to growing import competition from China producers have shifted to higher value-added products.
Metal products	Firms have not stopped developing their international activity in spite of narrowing export profit margins.
Furniture	Manufacturers responded to a sharp loss of competitiveness by accelerating productivity gains and by shifting to higher value-added products.
Plastics	Manufacturers reacted to a sharp fall in international prices with very strong productivity gains.
<i>Declining sectors</i>	
Textiles	In spite of steep price declines and mediocre productivity gains, firms were effectively forced to grant above-average wage increases, due to large increases in the minimum wage.
Clothing	Protection measures against Chinese exports in OECD markets in 2005 permitted some restoration in margins, without however slowing down sharp employment adjustments.
Leather manufacturing	Producers recently improved their product differentiation and pricing power. A pickup of exports ensued but employment adjustments continue.

42. The *extended* model confirms these broad trends and provides additional insights. When capital and energy costs are taken into account : a) the erosion of competitiveness becomes less sharp in the pre-crisis period 1998–2000; b) the recovery of competitiveness appears less startling during crisis years; c) estimated performance improves in the post-crisis reform and stabilisation period. The details of this decomposition are provided in the background Research Document.

- Changes in *interest rates* have a non-negligible influence.⁵¹ In the past credit costs soared in Turkey in periods of macroeconomic strain and currency depreciation, and declined in periods of macroeconomic stabilisation and currency appreciation. The variation of capital costs partially offsets the impact of the exchange rate fluctuations on competitiveness. Notably, the decline of capital costs in the most recent post-crisis stabilisation period has made an important positive contribution.

51. Their share in total enterprise costs is limited but their high variance ensures that they play an important role. The decline of real interest rates before 2000-2001 helped to offset the pressures of currency appreciation, their subsequent sharp increase during the crisis moderated the (otherwise) stronger surge in profitability.

- *Energy costs* also showed a high variation and affected profit margins.⁵² However, the estimated effect of energy costs appears more limited than the estimated effect of interest rates.

52. The variation of energy costs is high because of the high share of imported fuels in total energy consumption, the fluctuations in exchange rates, and the high variation of energy taxes. Discretionary political control of electricity prices has also made them subject to cycles of price repression, followed by frequently abrupt adjustments.

*Annex A2***Surveys on the competitive strengths
and weaknesses of firms of different sizes**

43. In 2002, The Istanbul Chamber of Industry (ISO) surveyed 500 enterprises of different sizes across Turkey and asked them to evaluate their strengths and weaknesses in the face of international competition. Large, small and medium-sized firms were investigated separately and the findings are summarised below. The results of the Survey are interesting, also because they reveal how quickly the international competitive scene is changing and how much perceptions about different players' strengths and weaknesses may prove elusive:

- Enterprises of all sizes considered themselves to be in a generally favourable position vis-à-vis their trade competitors. This positive assessment was systematic across all parameters of performance, including price competitiveness, quality of products and response-time-to-market of production facilities.
- Competition from low-wage countries was not on the radar screen of enterprises in 2002. Only very large enterprises saw Chinese and Indian firms as their direct competitors.
- The Turkish Lira was undervalued at the time of the Survey. Enterprises of all sizes saw their price competitiveness as solidly established - a perception challenged by subsequent developments.
- Enterprises had precise views on their weaknesses *vis-à-vis* trade competition. Firms of all sizes wanted to move away from pure price competition and saw technical upgrading, product differentiation and marketing muscle as key priorities.
- Medium-sized firms were particularly confident about their competitive strengths. The share of firms claiming to have a competitive advantage over both EU and non-EU competitors was highest among medium-sized firms.
- Large-size firms identified their main competitive handicap as infrastructure costs. These included energy, water and infrastructure tariffs. In all other areas, from labour costs to management performance, the majority of large firms found that they were matching international competition.
- Small firms found that they were lagging competition in the areas of information technology, research-and-development, international brand image and infrastructure costs.
- Medium-sized firms felt that their two main handicaps were their limited research-and-development capability and their high infrastructure costs.

44. The State Statistical Institute carried out a similar Survey on the innovation and technological activities of firms of different sizes during 2002-2004. It found that:

- Large firms (>250 employees) were more engaged in innovative projects, around 55% of them reporting innovative investments, both in manufacturing and service sectors.
- Small firms (10-49 employees) were less engaged in innovative activities, in a proportion of 37% in manufacturing and 25% in services.
- Medium-sized enterprises (employing between 50-250 employees) ranked themselves between the two groups, with a proportion of 40% innovators among manufacturing firms and 31% in services.
- *Highly competitive sectors* such as automotive and electronics are prominent innovators, with respective proportions of 60 and 81% of firms engaged in innovative projects.
- *Declining sectors* such as textiles and clothing have a narrower, yet non-negligible percentage of innovative firms.
- The *intermediary sectors* of metal products, food, furniture and machinery-equipment also seem to maintain an innovative drive with 30 to 50% of firms reporting technological innovation projects.

*Annex A3***Dynamic medium-sized enterprises' access to credit and equity capital**

45. Dynamic medium-sized enterprises have made limited use of formal banking and financial services to date - even if they have taken full advantage of government-subsidised credit.⁵³ They are funded to a large extent by own-equity and inter-enterprise trade credit, which serve as the main financing channel of this sector in Turkey.⁵⁴ The “participation banks” have also gained some market share in the working-capital and export financing of dynamic enterprises.⁵⁵

46. These enterprises now also need standard banking and financial services. In particular, the demand for and potential supply of medium-to-long-term investment credit⁵⁶ is expected to develop rapidly. Enterprises' investment for modernisation and long-term asset-building increase demand for such funding, and the decline of real interest rates makes such funding more attractive. Recent entries of prime international banks have also stimulated the supply of a new financial products to the enterprises.⁵⁷

47. To fully benefit from this supportive environment, medium-sized enterprises need to improve their corporate governance and financial reporting practices. Banks' new credit allocation procedures, resulting from both their modernisation strategies and new banking laws, are expected to force borrowers to provide more transparent and reliable financial accounts. Implementation of the “Basel II” prudential rules in Turkey from 2007 is expected to change the way banks allocate capital to risks and change banks' need for information about their loan customers. Each bank has to decide between a “standardised” approach (resorting to external credit rating) or an “internal ratings-based (IRB)” approach for all its lending business. Whether their bank adopts the standardised approach or the IRB approach, borrowers of all sizes will have to be able to: a) deliver either to banks or external credit assessment institutions high

53. Such as Halk Bank and Eximbank. Halk Bank granted subsidised loans to small-and-medium sized businesses. After the 2001 crisis these loans were drastically reduced and their costs became closer to market rates, the bank is now in the process of being privatised. Eximbank continues to extend working capital loans and guarantees to exporters.

54. Inter-enterprise credits are bi-lateral and information-intensive credit channels between trade partners. Cascades of trade credits, notably in form of trade bills and pre-dated checks are re-cycled by their holders according to the credibility of their issuers. Entirely informal, they are not subject to any intermediation taxes.

55. Participation banks provide funding inspired by “islamic” principles, such as no-interest lending (but claiming a share of the profit earned in the operations that they finance).

56. Long-term investment loans were traditionally provided by two special financial institutions sponsored by the World Bank: the Turkish Industrial Development Bank (TSKB) and the Industrial Investment Bank (SYB).

57. As an example, the first product innovation launched after the take-over of 50% of the up-market *Turkiye Ekonomi Bankasi* (TEB) by *Banque Nationale de Paris* in 2005 was the introduction of a new “SME-credit package”.

quality financial statements and b) demonstrate – through good corporate governance and independent audits of financial statements - that there are good reasons for relying on such financial statements. (If they do not comply with these requirements their credit demands will fall into a significantly higher risk category (akin to non-collateralised household loans), and may be may rejected or imply higher costs.⁵⁸ Standard business plans also need to be prepared and shared with long-term lenders.

48. In 2005 most Turkish firms - unless compelled to do so under capital market laws because they had offered securities to the public - remained reluctant to publish financial statements audited by an external, independent auditor. Furthermore, only around 3-4% of registered firms are thought to have standard business plans. If produced along best practices, a *business plan* represents a formalisation of the enterprise's strategic, managerial and financial outlook, set out in the following: *i) the description of the business* setting out the products and the legal structures of the business; *ii) the marketing plan* reviewing customers and competitors and pricing strategies; *iii) the financial plan* a balance sheet, an income statement and cash flow projections.⁵⁹ Privately held firms in Turkey rarely develop such formal descriptions and plans.

49. Medium-to-long term credit has nevertheless picked up in form of export loans provided by foreign suppliers of capital goods. The improvement in Turkey's credit risk and trend currency appreciation reduced both the service costs and the face value of foreign-currency loans during 2004-2005. Total foreign currency debt of non-financial firms increased from USD 11 billion in 2002 to USD 15 billion in 2003, USD 23 billion in 2004 and USD 28 billion in 2005 (8% of GDP). As dynamic, medium-sized firms (and more generally the non-financial sector) are not subject to any prudential borrowing regulations - while banks and financial firms are - they need to voluntarily adopt strategies and practices to carefully manage their exposure and risks.

50. A similar change of scene is also happening in the equity-funding of enterprises. The main new avenues of development are: *i) venture-capital and private equity*: the emerging domestic and international interest in this area remains still marginal in practice; *ii) merger, acquisition and other equity participations* by non-financial domestic and international firms, which are on the rise;⁶⁰ and *iii) initial and secondary public offerings (IPOs and SPOs)* on the stock market, which are slowly picking up.⁶¹ Medium-sized firms are likely to need more such equity funding in the future.⁶²

51. Both creditors and equity investors in these firms will expect more transparency and more reliable corporate governance, to protect their interests as lenders and minority investors. Publicly held companies (*e.g.* companies with more than 250 shareholders as well as companies listed on the Istanbul Stock Exchange) are subject to more rigorous financial reporting standards and must have their annual

58. The implications of the "Basel II" rules for the Turkish commercial loan market were reviewed in the OECD Economic Survey of Turkey 2004.

59. See, OECD, "A Framework for the Development and Financing of Dynamic Small and Medium Sized Enterprises in Turkey", OECD Center for Private Sector Development, Istanbul, 2005.

60. Merger and acquisition investments (excluding privatisation purchases) were estimated at USD 113 million in 2003, USD 1.2 billion in 2004 and USD 12.1 billion in 2005 (around 3% of GDP). Thirty-three among the 92 acquisition deals recorded in 2005 were by foreign investors.

61. Initial Public Offerings (IPOs) and Secondary Public Offerings (SPOs) in the Istanbul Stock Exchange (ISE) rose from USD 11 and 89 million respectively in 2003 to USD 613 and 701 million in 2004 and to USD 1.75 and 1.39 billion in 2005 (nearly 1% of GDP together in 2005). Fourteen medium-sized firms were listed in the Second Market of ISE in 2005.

62. Potential underwriters and intermediaries anticipate an acceleration of industrial restructurings involving outside equity injections. See for example: ISI Emerging Markets, "Deal Watch Turkey", 2006.

financial statements audited by independent, external auditors. There were 625 publicly held companies at the end of 2005, including 303 listed companies. The Capital Markets Board of Turkey (CMB) has also issued voluntary corporate governance principles, inspired by the OECD Principles of Corporate Governance. While a number of listed firms demonstrate a willingness to gradually align with such standards, overall compliance remains uneven in some key areas, including disclosure about major participations in other companies, significant direct shareholders, significant related party transactions and the quality of auditor oversight and supervision of financial statements. Prevailing corporate governance practices reflect in many firms the dominance of controlling owners who generally limit the capital share of third party investors. As a consequence the latter generally have not, to date, played an active role in enforcing their shareholder rights. The protection of minority investors rests primarily upon a public enforcement model, with the CMB playing a leading role in enforcing the relevant laws.

52. The asymmetry between controlling and minority owners is likely amplified in closely-held corporations. A recent study of corporate governance in Turkey concluded that, in general, “family control is valued more than efficiency...it is not really accepted that assets belong to the company and not to controlling parties...and tax concerns do not favour transparency”.⁶³ More recently, draft revisions to the Turkish Commercial Code (TCC) have aimed at extending comprehensive financial reporting standards (based on International Accounting Standards Board (IASB)’s International Financial Reporting Standards (IFRS) to all companies, irrespective of their size and status. On balance, the potential advantages of implementing IFRS in Turkey at this time are significant, and so the proposed reform is supported. This ambitious proposal, however, could present some concerns about compliance costs and compliance capabilities for small firms unless, for example, a phased-in approach or streamlined reporting framework for the smallest firms is also implemented. The Turkish Accounting Standards Board, which under the proposed amendments would be granted the authority to set national accounting standards consistent with IFRS, expects to be able to introduce IFRS-compatible standards for small firms at about the same time as the relevant, proposed amendments to the TCC come into effect. It will be important for the authorities to ensure that an appropriate financial reporting framework for small firms is introduced and that small firms have the right incentives, resources and support to implement the new standards, in order to ensure that this proposed amendment does not create an additional incentive to operate informally.

53. Under the authority of its Steering Group on Corporate Governance, OECD conducted a Pilot Study of corporate governance in Turkey in 2005-2006.⁶⁴ The study focused on publicly held companies and evaluated the extent to which the OECD Corporate Governance Principles have been implemented by the authorities and the private sector. While noting that the overall corporate governance outlook for publicly held companies is positive, the study stresses the importance of implementing certain key reforms, including: a) proposed reforms to the company law provisions in the TCC, and b) amending the laws governing pension and mutual funds to facilitate the exercise of their rights as shareholders. The study also comments favourably on public and private sector initiatives to diffuse knowledge about the benefits of international good practices throughout the business community, including through new self-regulatory organisations (SROs) that could conduct research and offer training.

54. The collateral regime is also in need of improvement. Movable asset registries exist only for vehicles, boats, intellectual property and trademarks. As a result, small firms cannot easily pledge most of their assets, notably their equipment and other movables. On the other hand, few cadastres have automated their processes and computerised records, making it costly to use land as collateral. The collateral requirements for formal sources of credits are also very high (about 200%) and personal guarantees are

63. See Institute of International Finance (2005).

64. See OECD (2006).

often required for corporate borrowing. Improving the collateral regime would both strengthen lenders' protection and reduce the costs of borrowers.

55. Lenders also have fragmented and limited information about small firms' repayment behavior. Turkey has two credit information registries, one managed by the Central Bank and another managed by a private bureau, but the information available about the credit and repayment history of small-size borrowers is thin. Phasing in Basel II regulations in 2007, which is likely to result in more published credit ratings of firms as well as increasing banks' demand for more nuanced and reliable data about small firms' repayment behaviour, is expected to stimulate this activity.

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