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Aspects of Fiscal Policy in Turkey

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Aspects of Fiscal Policy in Turkey

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Abstract: This report studies the aspects of fiscal policy in post -1980 Turkey. The 1990s had been a period of acute deterioration of the public sector balances with increased indebtedness and the rising interest burden. On the other hand, the post-2001 period witnessed a significant narrowing of the fiscal budget deficits. This is often hailed as a discriminatory success of the Turkish Republic, during when the European economies suffer from a public debt crisis. Currently Turkey stands as the largest candidate country which certainly comprises differences with the EU Member States and to other candidate countries. Yet, the Turkish experience in economic policy making in the neo-liberal era should provide repercussions for the European geography, especially in the aftermath of the global financial crisis of 2008-9.

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1. Introduction

For many developing economies, the 1980's has been a period of external shocks with faltering export demand, high and volatile real interest rates and depletion of funds for external finance. By 1980, many developing country governments were used to rely on external sources for financing their fiscal operations. Under such conditions, constraints to growth were thought to originate from the two gaps of "savings-investment" and "foreign exchange". With the darkening external environment, however, most developing countries found themselves in a position where they had to extract resources from the internal markets to sustain their fiscal targets. That in turn meant domestic debt accumulation, and the emergence of the so-called "fiscal constraint" as the *third gap* limiting the growth prospects (Bacha, 1990; Taylor, 1994).

In comparison to many developing nations, Turkey experienced relatively modest sizes of accumulated fiscal debt by 1996. However, two additional factors increased the gravity of the problem: one was the realization by fiscal authorities that continued seignorage extraction through monetization was no longer feasible; that is, the Treasury had almost fully exploited the Laffer curve (Yeldan, 1997; Selcuk, 1997). Thus, the deficit had to be increasingly financed by domestic sources through bond issues at very high real rates of interest to cover the risk premia. Secondly, the maturity of the domestic debt was very short which gave way to an intensive Ponzi financing mode of debt management. These factors combined led to excessively high interest rates, crowded out private investors, and caused significant strain on the domestic markets.

Turkey experienced a severe economic and political crisis in November 2000 and again in February 2001. The crisis erupted when Turkey was following an *exchange-rate based disinflation programme* led and engineered by the IMF. Over 2001 the real GDP contracted by 7.4 percent in real terms and the currency lost 51 percent of its value against the major foreign monies. The burden of adjustment fell disproportionately on the laboring classes as the rate of unemployment rose steadily by 2 percentage points in 2001 and then

another 3 percentage points in 2002. Real wages fall abruptly by 20 percent upon impact in 2001 and could not recover for a long time.

Following the crisis, Turkey has implemented an orthodox strategy of raising interest rates and maintaining an overvalued exchange rate. Following a logic that the successful achievements of the fiscal and monetary targets would enhance the “credibility” of the economy, this strategy was designed to set the macroeconomic policy agenda in Turkey to rely mainly on two pillars: (1) fiscal austerity that targets a 6.5 percent surplus for the public sector in its primary budget as a ratio to the gross domestic product; and (2) a contractionary monetary policy (through an *independent* central bank) that exclusively aims at price stability (via inflation targeting). Thus, in a nutshell the Turkish government was charged to maintain *dual* targets: a *primary surplus* target in fiscal balances; and an *inflation-targeting* central bank whose sole mandate is to maintain price stability, divorced from all other concerns of macroeconomic aggregates —hence the terms in the title: *macroeconomics under twin-targeting*.

Spanning over a planning horizon 2001 to 2007, the primary surplus target was regarded necessary by the fiscal authorities to reduce the massive debt burden and the fragilities it imposed on the financial and the real commodity markets. The government was forced to follow a contractionary fiscal policy, and promised to satisfy the customary IMF demands: reduce subsidies to agriculture, privatize, and reduce the role of public sector in economic activity. Needless to assert, the mentioned fiscal policy administration has had important implications on both the macroeconomic environment and the microeconomic mechanisms of resource allocation, employment, and tax incidence of the Turkish economy.

The 2000s meant an era of profound shifts in the social and economic spheres of the Republic of Turkey. Following the crises of November 2000 and February 2001, the political arena had witnessed the rise into power of the *Justice and Development Party* (AKP) – an implicit coalition of diverse Islamic movements. Shortly after the AKP took



office it was observed to abandon its populist discourse as an anti-IMF and anti-liberal reactionary movement and turned into fully adopting the neo-liberal policies that aim at entrusting national resources and economic future of the country directly to speculative foreign capital and non-fettered dynamics of the market forces (ISSA, 2005; Cizre and Yeldan, 2005).

The distinguishing feature of the series of AKP Governments over the post 2003 period was that they had deliberately adopted the mission of executing the neo-liberal project under the discourse of “strong government” without confronting any strong popular opposition. Over this period, Turkey continued to specialise in standard technologies and low labour cost production in line with export-based growth strategy, all within the international division of labour. On the macro-economic policy side, a significant shift towards “speculative-led growth” have been realized, where “macroeconomics” has become almost synonymous with “monetary policy” (at the expense of fiscal policy). Furthermore, monetary policy has often taken the exclusive form of inflation targeting whereby an “independent” Central Bank of the Republic of Turkey (CBRT) has the objective of attaining price stability at a low rate of inflation by using the policy interest rate as the major instrument. All these changes can be placed within the concept of *financialization*, i.e. an overall *ascendance of finance over the real economy, industry in particular*.

In this report we will study the aspects of fiscal policy in post -1980 Turkey. Since Turkey has started its long-standing relationship with the EU in 1959 (with the application to join the European Economic Community), the association has definitely had impacts on the stance of the economic policy making. Currently Turkey stands as the largest candidate country which certainly comprises differences with the EU Member States and to other candidate countries. Yet, the Turkish experience in economic policy making in the neo-liberal era should provide repercussions for the European geography, especially in the aftermath of the global financial crisis of 2008-9.

This paper starts with providing a broad overview of the state of the macroeconomic environment and the public sector balances in Turkey over the post-liberalization period. Here, we particularly emphasize the elements of the post-2001 crisis adjustment programme. Next we focus on the budgetary equilibrium and study the fragilities and macro perspectives of the consolidated budget, and study in depth the fiscal balances and the conditions before and after the 2001 crisis. Finally we provide some concluding remarks.

2. Fiscal Policy at a Glance: from 1990s to 2010s.

2.1. Turkish Experience in 1990s: Deterioration of Fiscal Balances

The structural adjustment program of 1980 marks the start of Turkish integration with the world economy. This initial step was followed by trade liberalization in 1984, the liberalization of the capital account in 1989 and recognition of the full convertibility of the Turkish Lira in 1990. Thus, Turkish economy has functioned under the conditions of a fully open, globalized economy throughout the 1990s. As in any other developing economy that has gone through these phases of liberalization/globalization process, the main motives behind the integration with the evolving world financial system were to increase saving, credit supply and investment, attain a reduction in the national interest rate bringing it closer to the international level, and restore growth and stability. Yet, the results turned out to be completely opposite to the expectations.

A major consequence of capital account liberalization in developing countries has been greater exposure to speculative attacks and sudden outflows of short-term capital movements. With the eradication of the government's ability to use independent monetary, exchange rate and interest rate policies as major macro-policy instruments, these economies have been forced into cycles of speculative capital-led growth and trapped with high real interest rates, appreciated currency and persistent balance of payment

difficulties.¹ Table 1 provides the real GDP growth rates² of the Turkish economy through 1990s, from which we can trace the mini boom-and-bust cycles. Here, each boom followed by a bust triggered by major external crises throughout the 1990s.

At a first glance from Table 1, one can observe that the Turkish growth experience throughout 1990s had been on a fluctuating trend, starting at 9.4 percent in 1990, decreasing to 0.3 percent in 1991 and even reaching -6.1 percent during the crisis of 1994. Correlated with output fluctuation are the cyclical variations of consumption and investment. The level of public expenditure, that declined 20 percent in 1988 for instance, did not recover until 1996–1997. Further, private investment was not on a sustainable path. The peak of private capital accumulation in 1993 at 38.8 percent was immediately followed by the contraction of 1994, when it plummeted to a rate of -9.6 percent growth. Thus, one can easily agree that the overall expansion of both private and public capital accumulation could not be sustained throughout the 1990s.

Such observations have been concurrent with the deteriorating fiscal panorama of the Turkish economy throughout the decade. As a sign of vulnerability, the public sector borrowing requirement (PSBR) stood around 7.0 percent on average between 1990 and 1999 and continued to rise thereafter reaching to 12.1 percent in 2001. The explanation is that, while government revenues increased to 24.2 percent of GDP in 1999 from an initial level of 14.2 percent of GDP in 1990, the ratio of public expenditures rose to 35.9 percent from a level of 17.2 percent during the same period. Nevertheless, with the advent of full-fledged financial liberalization, the government had the opportunity of bypassing much of its liquidity constraint problems. The circumstances of the world economy implied that

¹ Adelman and Yeldan (2000) discuss the elimination of independent macroeconomic policies under external liberalization. Grabel (1995) shows that the growth performance of developing economies tends to more and more follow speculation-led patterns. In the context of the Turkish economy, Yeldan (2006); Boratav, Yeldan and Köse (2002), and Ekinci (1998) discuss how the central bank lost its control over the exchange rate and the interest rate policies, and how these variables effectively turned into *exogenous* parameters, usually set under the chaotic conditions of international finance capital. See also Turkey Country Report as a part of Working Package 2.

² Based on the old GDP series, 1987 base year.

international finance was repressed, and financing of the PSBR relied exclusively on the issues of GDIs to the internal market – especially to the domestic banking sector. In 1989, just before the liberalization of the capital account was completed, domestic debt was only 6.3 percent of GDP. It then grew rapidly and had reached 29.3 percent of GDP by 1999 and to 69.2 percent by 2001. Meanwhile, interest payments on the outstanding debt stock became progressively the largest item on the expenditure side of the public accounts. The real interest rate on GDIs remained above 20 percent during the decade. Fiscal authorities were trapped to such extent that the targeted expenditures on interest on outstanding debt could not be controlled by the end of the decade. As a ratio to GDP, interest payments on outstanding (domestic) debt reached to 21.2 percent in 2002. Table 1 also depicts a summary of the deterioration of the fiscal balances throughout 1990s.

<Table 1 about here>

Soon the public sector was caught in a *Ponzi-finance* scheme, concerned uniquely with short-term management of debt.³ In this regard, the central budget lost its instrumental role in development of social infrastructure and achievement of long-term growth. Budgeting has rather become trapped by the dictates of debt-rollover under a borrowing scheme with very high interest rates. In this vein, the fiscal debt management not only acted as an income transfer mechanism to rentier classes, but it has also significantly constrained the social role of the state. The share of public investment on education in government's consolidated budget decreased from its level of 13.2 percent in 1990 to 7.9 percent in 1999, while the share of interest payments increased to 56.6 percent from 24.6 percent in the same period.

³ See Akyüz and Boratav (2002); Boratav, Yeldan and Köse (2002); Metin-Özcan, Voyvoda and Yeldan (2001), and Cizre-Sakallıoğlu and Yeldan (2000) for a thorough overview of the post-1990 Turkish macroeconomic history. For the deterioration of fiscal balances refer to San (2002); Özatay (2000); Türel (1999), and Selçuk and Rantanen (1996).

It would be extraordinary if investment could actually increase in the context of this structural adjustment program. High rates of interest have attracted short-term foreign capital into the Turkish economic system. Such inflows, on the one hand, enabled financing of the accelerated expenditures of the public sector, and also provided a relaxation of the items of aggregate demand, reducing cost of imports and enlarging the volume of consumption. However, the simultaneous appreciation of the Lira and the rising current-account deficits signalled and sudden drainage of the funds brought the end of each of these mini growth cycles throughout the decade.

In sum, the post-1990 liberalization period signalled an environment where accumulation, distribution and growth patterns depended exclusively on the movements of speculative, short-term capital, stimulated by a combination of high real interest rate and an appreciated Lira. This macro policy mix meant that the pressure on PSBR experienced short-term relieves, but the economy had already become addicted to short-term foreign finance to generate growth. Figure 1 depicts the financial arbitrage⁴ that the Turkish economy was offering to the world financial markets since mid-1992. As the figure reveals, in order to sustain the economic performance, Turkey had to offer real interest rates as high as 100.0 percent in January 1996, 60.0 percent in December 1998 and 80.0 percent in March 2001.

<Figure 1 about here>

After a decade of volatile growth, persistently high rates of inflation, deteriorated fiscal performance, and rapidly increasing debt burden, Turkey initiated the last round of the continuous chain of stabilization attempts in December 1999. Closely backed and supervised by the IMF, the program utterly relied on a nominally pegged exchange rate

⁴ Financial arbitrage here is calculated as the end result of the process of initially converting the foreign currency into Turkish Lira, earning the interest at the rate offered in the domestic economy and then re-converting back to foreign currency at the prevailing exchange rate.

system for disinflation and a targeted set of austerity measures and structural reforms to restore fiscal balance. Yet, just eleven months after launching the program, Turkey went through the first sign of a severe financial crisis in November 2000 and experienced the major strike in February 2001. Government soon surrendered, floated the exchange rate and effectively declared the end of the program. The stock market, and the Lira went into a downward spiral and GDP shrank with the worst performance of the Turkish economy since World War II.⁵

2.2. The Post-2001 Crisis Adjustments

Pillars of the IMF-Backed Adjustment Program

In response to the crisis, and in order to reinvigorate the now-stalled free market reforms, a new *Stand-by* agreement was signed with the IMF. The IMF has been involved with the macro management of the Turkish economy both prior and after the crisis, and provided financial assistance of \$20.4 billion, net, between 1999 and 2003. Following the crisis, Turkey has implemented an orthodox strategy of raising interest rates and maintaining an overvalued exchange rate. The government was forced to follow a contractionary fiscal policy, and promised to satisfy the customary IMF demands: reduce subsidies to agriculture, privatize, and reduce the role of public sector in economic activity.

The IMF program in Turkey relied mainly on two pillars: (1) fiscal austerity that targeted a 6.5 percent surplus for the public sector in its primary budget⁶ as a ratio to the gross domestic product; and (2) a contractionary monetary policy (through an *independent* central bank) that exclusively aimed at price stability (via inflation targeting). Thus, in a nutshell, the Turkish government was charged to maintain *dual* targets: a *primary surplus*

⁵ The underlying elements of the disinflation program and the crisis are discussed in detail in Akyüz and Boratav (2002); Alper and Öniş (2003); Ertuğrul and Yeldan (2003); and Yeldan (2002).

⁶ *i.e.*, balance on non-interest expenditures and aggregate public revenues. The primary surplus target of the *central government budget* was set 5 percent to the GNP.

target in fiscal balances (at 6.5 percent to the GDP); and an *inflation-targeting* central bank⁷ whose sole mandate is to maintain price stability and is divorced from all other concerns of macroeconomic aggregates. Yet the main motivation behind the agreement has been the reduction of fiscal repression in the commodity and asset markets. This in turn, has been claimed to be the result of high cost of servicing of public debt, whose net value reached 90.9 percent of GDP in 2001. Thus, the program primarily aimed at providing a signal of confidence to the domestic and international community, suggesting that the Turkish fiscal authorities have achieved the proper mix of stabilization measures. The primary surplus was identified as the crucial indicator of this confidence game. According to the program's officially stated rationale, as the non-interest expenditures of the public sector are reduced and the primary-surplus target of 6.5 percent of GDP is attained, the real interest rate would fall, private consumption and investment would be stimulated and growth would be fuelled. In the meantime, projections by the fiscal authority forecast a reduction in the outstanding net stock of debt as a ratio to GDP. Specifically, the formally stated targets are 69.4 percent of GDP for 2004 and 63.9 percent of GDP for 2006.

According to the logic of the program, successful achievement of the fiscal and monetary targets would enhance "credibility" of the Turkish government ensuring reduction in the country risk perception. This would enable reductions in the rate of interest that would then stimulate private consumption and fixed investments, paving the way to sustained growth. Thus, it is alleged that what is being implemented is actually an *expansionary* program of *fiscal contraction*.

Conventional Vision of Fiscal Sustainability and Solvency

The adjustment program has defined a public sector that is committed to a fiscal policy of facilitating a smooth roll-over of the government's debt through primary fiscal surpluses. Therefore the concept of fiscal sustainability and the conditions of government solvency

⁷ The target was set at 5 percent on consumer price inflation for 2006, and 4 percent for 2007 and 2008.

has become a major topic of discussion with regard to the post-2001 adjustment program. At this point, it becomes important to discuss the concept of fiscal sustainability, the theoretical basis and the relevant elements of the conventional fiscal programming model that has been applied in Turkey as well as a sizeable number of developing economies under the auspices of the IMF. This discussion is also important to elaborate on fiscal policy alternatives of which would allow rational debt management, public expenditure on infrastructure, investment patterns and growth.

The theoretical literature emphasizes the intertemporal budget constraint as well as the flow budget constraint of the government and focus on fiscal policy alternatives differentiating the ones that can be continued into distant future without threatening government solvency. Yet, on the level of empirical policy analysis, the term fiscal sustainability remains highly controversial and the controversy reveals itself in the various studies where each author develops its own definition of fiscal sustainability and derives conclusions accordingly.

The analytical dimension starts with a current period flow budget constraint of the government. In its simplest form, for a closed economy that is exempt from monetary treatment, this constraint can be written as:

$$B_{t+1} = (1+r_t)B_t + D_t$$

where B_t is the outstanding debt stock, r_t is the interest rate in the current period on the accumulated stock of debt, and D_t is the deficit (current period expenditures net of the current period revenues of the government). The current debt stock can be written

$$B_t = -\sum_{j=0}^{\infty} \frac{1}{\prod_{k=0}^j (1+r_{t+k})} D_{t+j} + \lim_{T \rightarrow \infty} \frac{1}{\prod_{k=0}^T (1+r_{t+k})} B_{t+T+1}$$

According to the equation above, it is possible for the government to rollover its debt each period in full, borrowing continuously to cover both the principal and the interest payments. Under those conditions the present value of the terminal debt stock (second term in equation above) becomes positive. However, the only way for the government to run this Ponzi debt scheme is that at least one of the lenders in the economy runs a Ponzi credit scheme. However, under the conventional theory, this would violate the necessary transversality condition in the lender's optimization problem. So, a government attempting to play a Ponzi game will not find any rational individual willing to hold its liabilities. Therefore, a sustainable fiscal policy implies that the current value of debt stock, B_t , equates to the present value of the future primary surpluses.

However, given the analytical properties of the present value budget constraint (PVBC) approach, the policy implications derived turn out to be quite impractical. The PVBC does not rule out either large deficits or high debt-to-GDP ratios; it simply constraints the government debt to grow no faster than the interest rate in the economy. So, for instance, a growing economy with a relatively low interest rate, the debt stock could be tending to zero asymptotically, but would still be regarded as unsustainable. Moreover, permanent primary deficits are incompatible with the PVBC, whereas permanent overall deficits are. Moreover, there are far too many ways in which fiscal policies can comply with a budget constraint encompassing infinite periods, and for practical purposes the PVBC approach turns out to be not that useful.

Thus, rather than using the *impractical* PVBC approach, policy advisers have mostly relied on methods that depend on practical indicators and usually set a constant debt-to-GDP ratio as a benchmark state for sustainable fiscal policies. It has been then, frequently the primary deficit (surplus) that is used as the key macroeconomic policy variable indicating a sustainable fiscal policy. If the primary target generates a constant, rather than ever increasing debt-to-GDP ratio, given the projection on the real interest rate and the growth rate of the economy, then debt is considered sustainable. For its exclusive reliance on a

limited set of macroeconomic indicators, the method is referred to as the “accounting approach.”

It was a broad version of this accounting approach that was followed by the Turkish fiscal authority on the Public Debt Management Report, as reported by the Undersecretariat of Treasury, February 2004 and is summarized in the equation below:

$$b_t = d_t - m_t - pri_t + \left[\frac{(1 + r_t^d)}{(1 + g_t)} \right] b_{t-1}^d + \left[\frac{(1 + r_t^f)}{(1 + g_t)} \right] (1 + \Delta rer_t) b_{t-1}^f$$

Here, b_t gives the ratio of the net stock of public debt to GDP, b_t^d representing the domestic, b_t^f representing its foreign components. d_t stands for the primary deficit as a ratio to GDP, r_t^d gives the interest rate on Turkish Lira denominated and r_t^f gives the real interest rate on foreign currency denominated portion of the public debt; m_t and pri_t represent seigniorage and privatization revenues, respectively; g_t is the real growth rate of the economy and Δrer_t is the change in the real exchange rate (TL/\$). According to the equation above, given the projection on revenues from seigniorage and privatization, the debt-to-GDP ratio, b_t , will be lower; (i) the lower the real interest rates, r_t^d and r_t^f , (ii) the higher the growth rate, g_t , of the economy, (iii) the greater the appreciation of the real exchange rate.

Based for the most part on a version of the approach above, many researchers and financial rating agencies routinely conducted series of programming exercises to monitor the Turkish fiscal sustainability and its debt burden in the short-to-medium run. However, in an open economy subject to inflationary pressures, with a floating exchange rate regime, and with the interest rate determined by international market conditions, the only policy tool left for the government to control the pace of debt-rollover is determined to be the primary surplus. Yet, the stock of public debt for the next period as a ratio to GDP, b_t is still endogenous since the growth rate of the economy is endogenous and it is the

international market determines the values of the real exchange rate and the expenditure on interest payments.

Thus, such exercises are doomed to be restricted to a partial-adjustment framework, and often do not go beyond an accounting check between the projected real rate of growth of GDP, the interest rate, the exchange rate and the primary surplus ratio. In fact, the crucial critique of this partial adjustment framework is that they take no account of the repercussion effects of the fiscal policy itself on the macroeconomy at large, through interest rates, saving–investment gap, and the current account balance.⁸

Yet, the macro and fiscal balances of the Turkish economy during the successful implementation of the program disclosed that the primary surplus cannot be the only variable to achieve a set of targets that are dependent on a number of macro-variables whose values are determined by the dynamics of the economy. In a series of studies Voyvoda and Yeldan (2005 a,b) investigated the effects of the IMF-led austerity program for the Turkish economy. These studies also assessed fiscal policy alternatives of debt management, of public expenditures on the productive factors of the economy, and of economic growth and the welfare of future generations. The results indicated that the program targets were relatively sensitive to (exogenous) foreign capital inflow shocks, and the fiscal austerity program based on the primary-surplus objective could succeed in constraining the explosive dynamics of debt accumulation only under much favorable circumstances of growth and foreign capital inflows.

Macroeconomic Performance under Post-Crisis Adjustment

The post-2001 growth had indeed been high. Annual rate of growth of real GNP averaged 7.8 percent over 2002-6. Growth, while rapid, had very unique characteristics. *Firstly*, it was mainly driven by a massive inflow of foreign finance capital which in turn was lured by significantly high rates of return offered domestically; hence, it was *speculative-led* in

⁸ See also a critique by Creel and Kamber (2004).



nature (*a la* Grabel, 1995). The main mechanism has been that the high rates of interest prevailing in the Turkish asset markets attracted short term finance capital, and in return, the relative abundance of foreign exchange led to overvaluation of the *Lira*. Cheapened foreign exchange costs led to an import boom both in consumption and investment goods. Clearly, achievement of the fiscal contraction under severe entrenchment of public non-interest expenditures was a welcome event boosting the hungry expectations of the financial arbitrageurs (See Table 2).

The *second* characteristic of the post-2001 era was its *jobless-growth* patterns. Rapid rates of growth were accompanied by high rates of unemployment and low participation rates. The rate of unemployment rose to above 10 percent after the 2001 crisis, and despite rapid growth, has not come down to its pre-crisis levels (of 6.5 percent in 2000). Furthermore, together with persistent *open* unemployment, *disguised* unemployment has also risen. According to TURKSTAT data, “*persons not looking for a job, but ready for employment if offered a job*” has increased from 1,060 thousand workers in 2001, to 1,936 thousands by 2006, bringing the *total* (open + disguised) unemployment ratio to 15.5 percent.

<Table 2 about here>

In Table 2 we distinguish the different phases of the post 2001 macroeconomic developments of the Turkish economy. The post crisis adjustments bring the average rate of growth to 5.88 percent over 2003-8. The crisis hit Turkey with a decline of the real GDP by 4.82 percent. After the surges in 2010 and 2011, GDP growth receded to 2.12 percent and 4 percent in 2012 and 2013, respectively, as Turkey became part of the culminating great recession. With the exception of 2009, investment expenditures claimed about 20 percent of the gross domestic product. The distinct feature of the episode was the decline in savings. Private savings decline secularly over the period and fell below 10 percent

mark by 2013. The consequent development was the expansion of the current account deficit and the accompanied rise of the foreign debt.

Together with rapid growth, dis-inflation has been hailed as another area of “success” for the AKP government. The Central Bank has started to follow an open inflation targeting framework since January 2006. The Bank’s mandate was to set a “point” target of 5 percent inflation of the consumer prices. Inflation rate, both in consumer and producer prices, has, in fact, been brought under control by 2004. Producer price inflation receded to less than 3 percent in late 2005. After the turbulence of the asset markets in May-July 2006, inflation again accelerated to above 10 percent and could only be brought under control gradually to 9.6 percent towards the end of 2006.

Despite the positive achievements on the dis-inflation front, rates of interest remained slow to adjust. The real rate of interest on the government debt instruments for instance remained above 10 percent over most of the post-crisis period and generated heavy pressures against the fiscal authority in meeting its debt obligations. (See Figure 2). The persistence of the real interest rates, on the other hand, had also been conducive in attracting heavy flows of short term speculative finance capital over 2003 and 2008. This pattern continued into the 2010s at an even stronger rate.

<Figure 2 about here>

It is known that the availability of cheap foreign exchange and the consequent appreciation of the *Lira*, were the factors behind the rapid rise of the per capita GDP valued in US\$ terms. From 3,500\$ in 2001/02 per capita GDP rise to more than 10,000\$ mark in 2010. Yet, due to the fall in the real price of dollar, much of this expansion was exaggerated and came to a halt with the real depreciation of the *Lira* under conditions of the global recession.

Inertia of the real rate of interest is also enigmatic from the successful macroeconomic performance achieved thus far on the fiscal front. Even though one traces a decline in the general plateau of the real interest rates, the Turkish interest charges are observed to remain significantly higher than those prevailing in most emerging market economies. The credit interest rate, in particular, has been stagnant at the rate 16 percent despite the deceleration of price inflation until the 2006 May-July turbulence. Since then the credit interest rates accelerated to 23.5 percent in 2006. The financial chaos that erupted in the housing and sub-prime credit markets of the US in 2008, had necessitated for the CBRT to maintain high rates of interest against threats of contagion. So Turkey has been by now severely constrained in maintaining significantly high rates of interest into the next decade of the 2000s.

2.3. The `IMF Program`, EU Impact and Beyond

The rapid increase of private sector debt —both by the financial and non-financial sectors alike, reveals the true essence of the IMF-engineered adjustment mechanisms following the currency and banking crises of February 2001. The underlying characteristics of the Turkish post-crisis adjustments ultimately relied on maintaining high real rates of interest in anticipation of increased foreign capital inflow into the domestic economy. Coupled with an overall contractionary fiscal policy, the programme found the main source of expansion in speculative inflows of foreign finance. The aforementioned elements of this adjustment path were clearly stated, in fact, in the Turkey Country Report prepared by the IMF staff in late 2001. Table 3 below makes a reference to that 2001 report which had laid out the macroeconomic targets of the post-crisis adjustment path as envisaged by the IMF. It is very illuminating to note that the targets of the 2001 IMF Report encompassing 2002 through 2006 have eventually become the official targets of both governments over that period. The targeted rate of real GNP growth, for instance, was persistently set at 5.0 percent for each coming year, despite the observed rapid expansion of the economy in

rates often exceeding 7.0 percent in the preceding year. This choice was clearly no coincidence. Likewise, the inflation targets of the “independent” central bank each year followed the path envisaged in the 2001 IMF Report, beginning with 20 percent of 2003 to 5 percent in 2006 (Note that the Turkish CB has declared the onset of its official inflation targeting monetary regime in January 1, 2006).

<Table 3 about here>

The very sanctimonious primary surplus target of the public sector at 6.5 percent as a ratio to the GNP clearly finds its origins in the aforementioned report. In addition, as the onset of the 2001 crisis has significantly transformed both the institutions and the policy environment of the Turkish economy, one can also relate the basis of austerity in fiscal policy to Maastricht Treaty of 1997 and the Stability and Growth Pact of 1998.

Turkey was declared as a candidate country for EU membership in the Helsinki European Council of December 1999. Subsequently, Turkey was asked to prepare a national programme for the adoption of the *acquis*, as a response to the Accession Partnership Document. According to the Council’s decision on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Republic of Turkey (8 March 2001), the main short term priorities and objectives included (i) Ensuring the implementation of the anti-inflationary structural reform programme supported by the IMF and (ii) Proceeding the implementation of the financial sector reform to guarantee the transparency and surveillance.

For the adoption of the EU *acquis*, Turkish government announced the first national programme in March 2001. Accordingly, the programme highlighted the importance of structural reforms including the budget law, tax reform, transparency, privatisation and restructuring of the state-owned banks on the fiscal policy front. Regarding the Economic and Monetary Union, it was stated in the first national program that the mission of the

CBRT and provisions regarding its independence would be re-evaluated in order to harmonise it with the EU Central Bank system. In May 2001, with the Law Amending CBRT Law No. 4651, price stability was determined as the primary target of the CBRT and the independence of the bank was strengthened.

The second national programme, which had the main target of enhancing the market economy and increasing its competitiveness was announced in 2003. The programme defined the main objectives of fiscal policy as to reach a functional budget structure by permanently decreasing public deficits, to ensure the sustainability of debt stock and thus to contribute to the formation of a sustainable growth environment, and to support the efforts towards disinflation. In accordance with these main objectives, continuing to implement a tight fiscal policy and fiscal discipline have been emphasized. The programme also highlighted the importance of reducing state intervention in the market by privatisation, transferring the market regulation function to the independent regulatory agencies and removing the macroeconomic uncertainty. Consequently, a number of regulatory agencies were established in sectors like energy and telecommunication. The second national programme also gave importance to the convergence to the EU system of taxing financial instruments.

All that being said on the fiscal policy front, what remains noteworthy of the stability programme of 2001 is the IMF's choice of a very high and persistent *real* interest rate targeted at 18 percent throughout the programming horizon. The real interest rate target is persistently kept at its very high level despite the falling trajectory of the inflation rate. In comparison of the Figure 1 above where the realized rates of inflation and interest were disclosed, the persistence of the high level of real interest rate against falling inflation rates seem to find a resonance in the adjustment path assumed by the IMF staff in the immediate post-2001 crisis. It is clear that the main adjustment mechanism of the post-crisis IMF programme was embedded in maintaining a significantly high rate of real interest. The high interest rates attracted short term finance capital; and the relative



abundance of foreign exchange led to overvaluation of the *Lira*. Cheapened foreign exchange costs led to an import boom both in consumption and investment goods. Achievement of the fiscal contraction under severe entrenchment of public non-interest expenditures, in turn, was a welcome event further boosting the hungry expectations of the financial arbiters.

In sum, contrary to the traditional stabilization packages that aimed at increasing interest rates *to constrain the domestic demand*, the new orthodoxy aimed at maintaining high interest rates for the purpose of *attracting speculative foreign capital* from the international financial markets. The end results in the Turkish context were the shrinkage of the public sector in a *speculative-led growth* environment; and the consequent deterioration of education and health infrastructure which necessitate increased public funds urgently. Furthermore, as the domestic industry intensified its import dependence, it was forced toward adaptation of increasingly capital-intensive, foreign technologies with adverse consequences on domestic employment.

High rates of interest were conducive in generating a high inflow of hot money finance to the Turkish financial markets. The most direct effect of the surge in foreign finance capital over this period was felt in the foreign exchange market. The over-abundance of foreign exchange supplied by the foreign financial arbitrageurs seeking positive yields led significant pressures for the Turkish Lira to appreciate. As the Turkish Central Bank has restricted its monetary policies only to the control of price inflation, and left the value of the domestic currency to the speculative decisions of the market forces, the *Lira* appreciated by as much as 40 percent in real terms against the US\$ and by 25 percent against Euro (in producer price parity conditions).

As also had been discussed in the above pages, a key attribute of the post-2001 Turkish economy was that monetary policy was substituted for fiscal policy. Policy targets such as primary fiscal balance ratios to the GDP; inflation targets along with a determined stance on unfettered, free mobility of capital flows and flexible floating exchange rates were part

of this episode. In fact the *real exchange rate* had become the key variable to provide the link and bring forth the required adjustments.

The behaviour of the bilateral real exchange rate over 2003-2015 *vis-à-vis* the US dollar is tabulated below in Figure 3. This is calculated with the purchasing power parity approach, using the producer price inflation rates as the deflators.

<Figure 3 about here>

The overall assessment that comes from the real exchange rate adjustments is that as of January 2015, the real value of the US dollar lies about 30 percent below its value in January 2003. The nominal currency depreciation is clearly visible after the onset of the great recession, 2008-onwards. The post-2014 adjustments had been particularly steep.

It has to be noted that this particular adjustments of the exchange rate both in nominal and real magnitudes were instrumental in shifting the burden of the global crisis from the domestic demand contraction to the asset markets. On the other hand, the continued volatility of the exchange rate had severely worsened expectations and limited the scope of the real sectors in setting forth the investment demand. The wild fluctuations of the exchange rate may easily turn into a mixed blessing, increasing risk premia and reduced market confidence.

It is mainly this observation of the structuralist approach for the developing economies to argue forward to maintain a *stable and competitive real exchange rate* (SCRER) (see, *e.g.*, Frenkel and Taylor 2006; Galindo and Ros, 2005, Frenkel and Ros, 2006; Frenkel and Rapetti, 2006). They argue that the real exchange rate can affect employment, and the economy more generally, through a number of channels: (1) By affecting the level of aggregate demand (*the macroeconomic channel*); (2) By affecting the cost of labor relative to other goods and thereby affecting the amount of labor hired per unit of output (*the labor intensity channel*); and by affecting employment through its impact on investment and



economic growth (*the development channel*) (Frenkel and Ros, pp. 634-637). While the size and even direction of these channel effects might differ from country to country, in many countries, including countries in Latin America, maintaining a competitive and stable real exchange rate is likely to have a positive employment impact though some combination of these effects.

The gist of the structuralist case for SCRER rests on a recent (and unfortunately not well understood and appreciated) paper by Taylor (2004). Resting his arguments on the system of social accounting identities, Taylor argues that the exchange rate cannot be regarded as a simple “price” determined by temporary macro equilibrium conditions. The mainstream case for exchange rate determination rests on the well-celebrated Mundell and Fleming model where the model rests on an assumed duality between reserves (fixed exchange rate system) *versus* flexible exchange rate adjustments. The orthodox mainstream model, according to Taylor, presupposes that a balance of payments *exists* with a potential disequilibrium that has to be cleared. This, however, is a false presumption. The exchange rate is not an “independent” price and has no fundamentals such as a given real rate of return (or a trade deficit) that can make it *self-stabilizing*. In Taylor’s (2004, p.212) words, “... *the balance of payments is at most an accumulation rule for net foreign assets and has no independent status as an equilibrium condition. The Mundell-Fleming duality is irrelevant, and in temporary equilibrium, the exchange rate does not depend on how a country operates its monetary (especially international reserve) policy*”. Accordingly, the exchange rate “*has to evolve over time subject to rules based on expectations about its values in the future. (Yet), in a world of shifting and perhaps unstable expectations, no simple dynamic theory (of foreign exchange markets) is likely to emerge*” (p.223).

The literature has no shortage of stochastic models where expectations play a role in macro equilibrium. The standard arbitrage arguments as stated in the uncovered interest parity (UIP) theorems imply that the expected rate of depreciation of the spot exchange

rate, $\dot{\varepsilon}^{EXP}$ is an increasing function of the gap between the domestic and foreign rates of interest, i and i^* .

Consider the *no-arbitrage* condition of the UIP:

$$1 + i_t = \frac{(1 + i_t^*)}{\varepsilon_t} \varepsilon_{t+k}^{EXP}$$

Re-arranging,

$$i_t = i_t^* + \frac{\varepsilon_{t+k}^{EXP} - \varepsilon_t}{\varepsilon_t}$$

where the second term on the right gives the k-period ahead expected rate of depreciation of the spot rate. As for the direction of the expected adjustments on the ε_t one must distinguish between an “operational” view and the “speculative” view (Frenkel and Taylor, 2006). Considering myopic perfect foresight, the expected change of ε_t will be equal to the observed change and hence a lower domestic interest rate will lead to an appreciation over time. Thus, $\dot{\varepsilon} \equiv \frac{d\varepsilon}{dt} < 0$ for $i < i^*$. This prognostication is what Frenkel and Taylor 2006, p.6) terms the *operational* view of the Wall-Street arbitrageurs and contrast it with the *speculative* view which states that the exchange rate will *depreciate* when the national interest rate falls short of the foreign rate.

In a practical setting, the fact that the foreign exchange market can be in *equilibrium* in the sense of meeting the demand for foreign exchange with its supply in the spot market, and yet its level might still be “*mis-aligned*” with respect to overall macro equilibrium has been recently claimed in Edwards (2006 and 2001). Accordingly, the exchange rate is regarded as *mis-aligned* if its realized value exhibits a persistent departure from its long run equilibrium trend (Edwards, 2001, p.6). The long run equilibrating value, in turn, is taken to be that rate which, for a given set of “structural fundamentals” is compatible with

simultaneous achievement of internal and external equilibrium⁹. It is clear that such an assessment has to go beyond the simple PPP calculations, which are wrought with issues of the choice of a relevant price index and a proper base year.

The preceding discussions clearly underscore that the real world behaviour of exchange rates is quite complex and the focus of the inflation targeting regime for floating exchange rates (in expectation of dropping it from the policy agenda altogether) is a *mirage*. This view of exchange rates helps to explain why many believe that there are no viable alternatives to inflation targeting as a mode of central bank policy.

In the Turkish context, the behaviour of the real exchange rate signify a rise in import demand with consequent expansion of the current account deficit. The current account deficit has reached to 10.0 percent to the GDP in 2012, after when the CBRT decided to act to keep this ratio below the 6.0 percent threshold with a resort to unconventional measures to combat financial instabilities associated with external debt financing. In fact, a significant detrimental nature of hot money led financing of the current account deficit was its foreign debt intensity. As reported in Table 2, the stock of external debt has increased by a total of \$270 billion over the end of 2002 to the end of 2013. Despite this rapid increase, the *burden* of external debt as a ratio to the GNP was maintained at roughly 45 percent to the GDP. This is due to both the rapid expansion of the GNP and the unprecedented appreciation of the Lira over the period. The appreciation of the Turkish *Lira* has disguised much of the fragility associated with both the level and the external debt induced financing of the current account deficits. Under conditions of the floating foreign exchange regime, this observation reveals a persistent fragility for the Turkish external markets, as a possible depreciation of the *Lira* in the days to come may severely worsen the current account financing possibilities. This persistent external fragility is

⁹ See also Fischer (2001) on the formal statement of the problem within the context of a finer classification of the exchange rate systems.

actually one of the main reasons why Turkey had been hit the hardest among the emerging market economies in the post 2014 turbulence.

3. Patterns of Fiscal Policy in Turkey

3.1. Tax Reforms and Determinants of Tax Revenues

Tax burden, defined as the ratio of all *tax* revenues to GDP, increased from 11.4 percent in 1990 secularly to exceed 20 percent by 2006, and stabilized around 22 percent in 2012. Together with the non-tax revenues, the aggregate revenue of the public sector is about a quarter of the GDP. Most of this increase was due to the rise in taxes on goods from 3.5 percent in 1990 to 7.8 percent in 2006, and to 8 percent by 2012 (See Table 4). If account is taken of the taxes on foreign trade, we see that their share was 3.6 percent in 2006 to reach 3.9 percent in 2012. Special taxes on consumption amounted to 5.1 percent of GDP in 2012.

The ratio of direct income taxes to GDP was 5.0 percent in 1990 and remained at that plateau to modestly reach 6 percent by 2012, marking clear difficulties that the tax administrations had to deal with, when the tax base could not have been expanded further due to the increased political competition and the fragile macro environment over the 1990s. A further major factor that led to the erosion of the tax base in Turkey is due to the informalisation of economic activities, especially in labor markets. Informalisation of the labor markets is witnessed in the fact that according to the TurkStat's estimations, around 40 percent of the existing labor employment is known to be working under conditions of no social coverage and their incomes are often under-reported by their employers. In addition, agricultural activities remain to be outside the formal tax base of the ministry of finance.

Between 1990 and 2000, revenues from direct taxes increased following the increase in the GDP. A major reason for this development was the rapid increases in the wages and salaries just before and after the crucial elections in 1989. 1989 elections marked the end

of the military regime in Turkey which had been introduced with the military intervention of 1980. Following 1989, political competition had increased severely and Turkey entered a new wave of *populism* with the agricultural public support programme and civilian salaries serving as the main instruments of this episode (Cizre-Sakallioglu and Yeldan, 2000). The expansion in the fiscal transfers was financed mainly from the domestic banking sector, which in turn, was able to attract foreign hot money inflows in an unregulated capital account. This foreign-debt-driven and hot-money-led expansion soon reached its limits by mid-1990s and soon after 1995, however, direct tax revenues stagnated in real terms all through 2010, with only marginal gains in 2011 and 2012. In what follows, the major source of tax revenues after 1995 came from *indirect* taxation, as the share of indirect taxes in the total rose from 53 percent in 1990, to as much as 66.8 percent by 2012.

<Table 4 about here>

In 1996 Turkey signed the *Customs Union* protocol with the European Union. As a result, following 1996 Turkey and the EU member states had agreed to have duty-free trade in their commerce. But more importantly, with this maneuver Turkey adopted the common tariff system of the EU against the third parties, thus in fact the tariff rates in certain products had even gone up.¹⁰ In fact, Turkish import protection was quite liberal by the time of the CU sign up. Turkey had initiated and completed much of its commodity trade liberalization during the 1980s, especially for the manufactured products. Thus, during the course of the post-1996 re-structuring there was little room for re-adjustments of the tariff rates for much of the manufactured items, and import protection continued mainly for the agricultural products due to specialized treatments and granted exceptions (see Togan, 2010).

¹⁰ See Mercenier and Yeldan (1997) for a detailed account and macroeconomic evaluation of the CU agreement.



We witness that over the post 1996 era taxes on foreign trade increased their role in the overall tax revenues. Their share in GDP was around 3-4 percent range all through 2000s (making about a fifth of the aggregate tax revenues) and made a significant contribution to the increasing tax resource base of the Turkish economy. This is all the more remarkable, however; in the view of the fact that with the CU agreement, imports destined for Turkey originating from European Union member countries increased rapidly. Together with this *volume effect*, trade revenues were observed to keep pace with the rise in the overall GDP. Thus, beginning from the second half of the 1990s, the government had to increasingly rely on indirect taxation, as its tax administration capacity could not be expanded by increasing the direct income tax base. The fragile conditions of the Turkish political system, coupled with an ineffective and overburdened tax inspection system, inhibited the conditions for expanding into politically unpopular moves of extending the tax coverage. The indirect taxation scheme was further extended in 2002 with the advent of the *Special Consumption Tax* (SCT). In 2003, SCT replaced motor vehicles purchase taxes and the so-called “additional tax” and consumption tax on petrol. Note that besides consumption of petrol and transactions involving motor vehicles, SCT now applies also to transactions involving all durable consumer goods and alcoholic as well as non-alcoholic beverages. If we take into account *all* budgetary revenues, including tax as well as non-tax revenues, funds and annexed budget revenues, the ratio of aggregate fiscal revenues to GDP, i.e. the “tax burden”, equals 10 percent in 1990 and 25 percent in 2012. As a ratio to the GDP, special and non-tax revenues reached a peak of 4 percent in mid 2000s and are diminishing since then. Note that this item is also referred as “extra-budgetary” funds or revenues because governments were not required by the law neither to include them on their budget nor to search the approval of the parliament to raise them.

We observe from Table 4 above that taxes on income roughly maintained their share in GDP between 5.9 percent in 1990 to 6 percent in 2012. These apply mainly to personal and corporate income. The first component (income taxes) has not changed much over the

period analysed, going from 3.8 percent in 1990 to 4.0 percent of GDP. The share of corporate income taxes increased marginally from 1.2 percent to 2.0 percent. Wider automation of the inspection systems, and measures such as introduction and unification of the personal and tax identification numbers; utilization of web-designed regulation systems through e-invoice, e-reporting and e-collections had enabled much of the expanded ground on advancement of the tax coverage.

Taxes on goods and services included a number of indirect taxes levied on a multitude of transactions. They amount to 3.4 percent of GDP in 1990 and to 8 percent in 2012. This increase is explained mainly by the increases in value added taxes, consumption tax on petrol and by a number of new taxes introduced in 1999 and 2001. The increase of 1.3 percentage points came in 2003 due to the rise of revenues stemming from the newly introduced special consumption taxes (SCT).

The increasing contribution of indirect taxation to the tax burden in the Turkish economy is explained mainly by its relative ease and effectiveness in reaching taxable expenditures. Urgency in raising tax monies, together with the pressing need to finance domestic debt, led governments to increase taxes levied on economic transactions. However, the rise in the indirect taxes provided incentives to operate outside the legal framework in order to avoid to pay these taxes and this resulted, not surprisingly, in important tax losses. This process led, in turn, to new increases in indirect tax revenues by governments. Furthermore, such a heavy reliance has negative effects on equity since indirect taxes concern more incomes of persons who affect an important part of their income to consumption.

As far as the evolution of *non-tax* revenues is concerned, the share of the annexed budget revenues diminishes as well as the share of special revenues and funds (extra-budgetary revenues). The average share for this last variable over the first half of the 1990 is 14.4 percent -with a peak of 19.3 percent in 1993 – and equals 4.4 percent in 2012. We also observe an increase in the share of non-tax revenues in budgetary revenues, with this

share being equal to 10 percent at the end of the period, explained partly by the revenues accruing to state property.

3.2. Structure of Expenditures

All these developments led to a sharp decrease in the disposable income of the public sector over the 1990s reaching its minimum during the 2001 crisis. The public sector borrowing requirement (PSBR) as a ratio of GDP stood around 10 percent on the average over 1990-1995. This ratio rose sharply in 1993, just before the financial crisis of 1994 (12.0 percent). Even though there were some improvements in the borrowing requirements of the public sector under the 1994/1995 crisis management, the PSBR rose again to an alarming rate of 15.5 percent in 1999. From Table 1 it can be read that over the period 1995-2000, the public disposable income declined by 22 percent *in real terms*. Such a decline had clearly devastating effects and generated strong pressures on the PSBR with culminating pressures leading to the 2001 crisis.

Under these conditions the fragility of the domestic asset markets gave way to high rates of real interest. Interest payments on public debt increased very rapidly. From 1990 to 1995, the share of interest expenditures on domestic debt in aggregate GDP increased by 300 percent. By the end of 1995 this ratio stood at 9 percent. In the second half of the decade, interest costs rose to as much as 21 percent during the crisis of 2001, and bounced back to 14.8 percent in 2003. The debt servicing costs in terms of interest expenditures could only be brought under control after 2006.

One can contrast these magnitudes, for instance, with the aggregate value added of the agricultural sector, whose share within the GDP is just only 15 percent. Thus, interest payments reach almost to aggregate agricultural value added, a sector which accounts for about a third of the active labor force. Interest burden necessarily claims a big share of the budget revenues. In fact, a comparison of the interest costs as a ratio of aggregate tax revenues –targeted and realized—disclose the structural constraints over the Turkish

fiscal policy openly: Interest expenditures as a ratio of tax revenues reached 103.3 percent in 2001, and 77.1 percent in 2002. Under the crisis management targets, interest expenditures were fixed as 88.1 percent of the tax revenues in 2000, and 109 percent in 2001.

Thus, even though interest costs continued to claim an increasing portion of tax revenues over the 1990's, none of the governments showed the political will to tackle the problem of debt re-consolidation directly. Under conditions of maintaining the debt turnover via only primary surpluses, the fiscal authority has been deprived of any viable funds to sustain public services on health, education, protection of the environment, and provision of social infrastructure.

All of these meant a heavy toll on the needed public investments on health, education and public infrastructure. Within total expenditures, public investments' share has fallen from 12.9 percent in 1990, to 5.1 percent in 2003. As a ratio to the GDP, public investments stood at less than 2.0 percent during 2000s.

3.3. Taxation Policy in 2000s

Over the post-2001 crisis era Turkish fiscal position improved significantly. The budget deficit has narrowed down to less than 2 percent as a ratio the GDP and the PSBR turned even negative by 2007; only to deteriorate once again in the immediate aftermath of the 2009 global crisis. Public sector had improved its indebtedness secularly over this period. The non-financial gross public debt has fallen from its peak of 80 percent in 2001, to below 40 percent by 2012 (See Figure 4).

<Figure 4 about here>

Budget deficits of the central government largely remained contained over the late 2000s (See Figure 4). Deterioration during the 2008/09 crisis was mostly recovered by 2010. However, this relative improvement should not mask the fact that the increases in public revenues came mainly from the value added tax (VAT) and once-off privatization of public assets. Figure 5 narrates the recent developments in the tax base as a ratio to the GDP.

<Figure 5 about here>

These efforts were the result of a strong performance by the fiscal authority in maintaining a significant rise of the primary surplus, especially at the central government level. It has to be noted, however, that much of this recovery came at the expense of significant contraction in public investments, and in social infrastructure as mentioned above.

Current taxation system is tabulated in Table 5. In principle, the two major components of the direct taxes were on personal incomes and the corporate sector. The income tax system had been revised many times over the last decade. Most recently, income taxes were levied in six brackets (20 percent, 25 percent, 30 percent, 35 percent, 40 percent, 45 percent) between 1999-2004. In December of 2004 the highest income bracket had been abolished and the marginal tax rate has been reduced to 40 percent. Then again in 2006 the tax brackets had been reduced to four distinct levels together with marginally lower four rates. In the meantime, the then existing procedure of granting 5 percentage point reduction to wage earners had been eliminated and the income tax rates had been uniform for all income sources. Similarly the corporate income taxation procedures have changed and were simplified by 2006. The corporate taxation system was initially instated in 1949 and was reformed many times since then. The 2006 revisions were mostly directed to extend the coverage with a thorough simplification of the taxation procedures, especially for the global investors (See Table 6).

<Table 5 about here>

<Table 6 about here>

Yet, the most visible aspect of the Turkish taxation system continues to be the usage of the VAT and the special consumption taxation. As indirect taxes, the VAT system has significant role in resource mobilization and fiscal revenue generation. As pointed out above pages the share of indirect taxes in total tax revenues in Turkey has increased steadily since 1990s and reached to a peak of 69 percent by 2006. An important part of indirect taxation is based on revenues raised through the application of VAT introduced in 1985. VAT revenues levied on domestic transactions and imports amounted to 24.8 percent of total tax revenues in 1985, 27.2 percent in 1990, 32.7 percent in 1995 and 32.1 percent in 2003. They have comprised about 34 percent of the total tax revenues through 2010s.

3.4. Fiscal Response to 2008-9 Crisis

Following the 2001-crisis, Turkey implemented two successive stand-by arrangements: the 18th stand-by arrangement (2002-05), and the 19th stand-by arrangement (2005-08). During this period, in addition to the reports prepared for the IMF and the national programmes submitted to the European Commission, starting from 2006 the three-year medium term programs have been the instruments to follow the stance of the fiscal policy making in Turkey. The first of these medium-term programs targeted a 5 percent primary surplus/GDP ratio for the period 2006-8 and also set a target of balanced budget for 2008. However, during the election year of 2007, both due to decline in growth rate and the rise in noninterest expenditures, the target of 5 percent primary surplus/GDP ratio could not be attained. In fact, the overall budget deficit increased to 1.6 percent of GDP. Thus, while the global crisis was reaching Turkey, fiscal policies were already loosened and budget

deficit was on the rise (Uygur, 2010). The several fiscal stimulus packages announced later in 2008 and 2009 further deteriorated the fiscal balances (Table 4).

Uygur (2010) categorizes the Turkish response to the global crisis under five headings: (i) measures to Promote Consumption Spending, mainly relying on reductions in consumption tax rates; (ii) measures to promote employment, including reductions in social security premiums, payments for the unemployed and short-term employment programmes; (iii) measures to promote investment, which mainly included tax exemptions; and (iv) measures to promote SMEs' production and exports, comprising credits with no interest and cuts in taxes. It is estimated that as a ratio to the GDP, the fiscal costs of the overall stimulus package were on the order of 0.91 percent in 2008, 3.15 percent in 2009, and 1.56 percent in 2010 (Yeldan, 2011).

An overall comparison of the aggregate level of fiscal stimuli across Turkey and other G20 emerging market economies reveal that the size of the Turkish packages had been relatively small (See Table 7). Part of this problem stems from the fact that the Turkish fiscal balances were relatively more fragile at the onset of the crisis. Thus the government seems to have been severely constrained and had relatively less room for maneuver towards intervention. A comparison of the Turkish fiscal stimuli as estimated by the IMF staff reveals that Turkish fiscal stimulus measures had fared significantly dismal as compared to the global average of the emerging market economies. Turkey had relatively high fiscal deficits, where the sources of employment-generating fiscal measures had been significantly at the low end.

<Table 7 about here>

4. Concluding Observations

The fiscal performance of the Turkish economy over the last two decades varied. The 1990s had been a period of acute deterioration of the public sector balances with

increased indebtedness and the rising interest burden. A series of failing attempts on broadening the tax base and to curtail public expenditures led to the eruption of the 2001 crisis, during when Turkey was following and IMF-led adjustment programme. The post-crisis era witnessed a significant narrowing of the fiscal budget deficits, especially with respect to the central government administration. Public sector borrowing requirement narrowed considerably and it currently stands at less than 2 percent to the GDP. This is often hailed as a discriminatory success of the Turkish Republic, during when the European economies suffer from a public debt crisis.

Yet, a closer inspection of the sources of tax revenues indicates that the existing tax system in Turkey is quite regressive, with a heavy reliance on the indirect taxes (value added taxes and consumption taxes). These have a close association with the growth performance of the economy and do not provide the warranted counter-cyclicality as expected from a sound tax system based on progressive income taxation. Furthermore, the severe cutbacks of the non-interest public expenditures had taken their toll on public investments on social infrastructure, as well as on regional and per capita income distribution.

Given the acuteness of the perceived dilemmas on disinflation and fiscal credibility, the resolution of the current impasse will surely necessitate a more tolerant view over the programmed targets (on both inflation and the primary surplus ratio) as well as a coherent and a mutually supportive macro policy design. Furthermore, there is a clear case for the acute need to design viable policies to diminish the exposure of the domestic economy (in particular of the financial markets) to short term, speculative foreign capital. This, in turn, may necessitate implementation of capital management techniques to gear inflows towards longer maturities and imposition of a financial tax to raise fiscal revenues.

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Tables and Figures:

Table 1. Selected Indicators of the Public Sector in Turkey, 1988-2001

	1988	1989	1990	1992	1994	1996	1997	1998	1999	2000	2001
<i>GDP Growth Rate (%) (Real GDP, 1987 prices)</i>	1.5	1.6	9.4	6.4	-6.1	7.1	8.3	3.9	-6.1	6.3	-9.5
As a Ratio to GNP (%)											
Current Account Balance	1.3	0.7	-1.3	-0.5	1.5	-1.0	-1.0	0.7	-0.4	-3.7	1.9
Public Disposable Income	10.1	9.9	10.2	8.6	7.9	6.3	8.9	7.0	5.0	5.9	2.5
Public Savings	5.1	3.6	2.6	-0.6	-0.1	-1.1	0.8	-1.4	-5.0	-3.4	-7.1
Public Investment (Including Stock Changes)	6.3	5.5	6.5	5.1	2.7	4.0	5.0	5.2	5.0	5.2	4.1
Public Sector Borrowing Requirement (PSBR)	3.6	4.0	5.5	7.9	4.6	6.5	5.8	7.1	11.6	8.9	12.1
Net Borrowing											
Domestic	3.5	4.6	5.7	7.9	6.5	9.4	8.0	8.9	11.2	6.9	14.7
Foreign	1.6	0.6	0.7	1.2	-0.8	-0.9	-0.7	-0.7	1.4	2.6	-1.6
Stock of GDI's	5.7	6.3	6.1	11.7	14.0	18.5	20.2	21.9	29.3	29.0	69.2
New Net Domestic Borrowing/Domestic Debt Stock	41.7	48.5	40.7	67.2	53.1	57.8	52.4	49.5	49.3	37.1	70.2
Consolidated Budget Interest Payments on Accumulated Stock of											
Domestic Debt	2.4	2.2	2.4	2.8	6.0	8.9	6.7	10.5	12.6	15.0	21.2
Foreign Debt	1.4	1.4	1.1	0.9	1.7	1.1	1.0	1.0	1.1	1.3	2.0
Primary Balance	0.6	0.2	0.4	-0.5	2.8	1.3	0.1	3.3	1.4	4.0	4.7
Macroeconomic Prices											
Annual Inflation Rate (WPI) ^a	53.7	67.5	58.4	60.6	86.8	73.1	79.1	81.9	56.9	57.0	47.9
Nominal depreciation of the TL/US\$	66.0	49.3	23.0	65.2	170.4	77.5	86.8	71.7	61.6	48.5	96.5
Nominal Interest Rate on GDIs ^b		53.9	49.7	74.6	109.9	135.2	110.7	102.0	94.0	36.6	75.9
<i>Sources: SPO Main Economic Indicators; TURKSTAT</i>											
a. Change in whole sale prices, year averages.											
b. Weighted average of interest on government debt instruments (GDIs).											

Table 2. Turkish Economy over the 2000s

	Economic Crisis	Post Crisis Adjustment and Growth	Global Crisis	Patterns of Recovery Under the Great Recession			
	2001-2002	2003-2008	2009	2010	2011	2012	2013
Macro Aggregates							
GDP per capita (US\$)	3,548	10,444	8,561	10,003	10,428	10,459	10,807
GDP real rate of growth (%)	2.41	5.88	-4.82	9.15	8.77	2.12	4.00
As % of GDP							
Consumption Exp.	70.12	69.84	71.46	71.69	71.18	70.19	70.87
Investment Exp.	14.63	21.78	14.93	19.52	23.55	20.13	20.62
Private Savings	25.1	16.90	18.00	12.30	10.7	11.6	9.7
Budget Balance	-10.5	-3.25	-5.5	-3.6	-1.4	-2.1	-1.2
Non-Interest (Primary) Budget Balance	4.23	4.60	0.05	0.75	1.88	1.34	2.02
Public Domestic Debt Stock	38.49	35.50	34.64	32.11	28.42	27.28	25.81
Internalization							
Exports of Goods (bn \$)	31.60	84.79	109.64	120.91	143.39	163.22	163.37
Imports of Goods (bn \$)	49.15	132.54	134.49	177.31	232.53	228.55	243.39
Current Account Balance (bn \$)	-2.26	-26.16	-13.40	-45.42	-75.08	-48.49	-65.07
Current Account Balance (% of GDP)	-1.43	-4.75	-2.27	-6.30	-9.70	-6.17	-7.40
Total External Debt (bn \$)	120.57	202.67	268.93	291.91	303.91	339.04	389.5
Total External Debt (% of GDP)	52.88	39.91	43.76	39.85	39.34	43.07	47.29
Macro Prices							
Consumer Prices (yearly % change)	33.13	11.81	6.50	6.40	10.40	6.16	7.32
Rael Interest Rate ^a	5.35 ^a	11.80 ^a	0.01	0.01	-0.02	-0.44	-0.74
Index of Real Exchange Rate (TL/\$) (2001=100)	..	88.70	87.70	79.37	89.29	86.21	87.72
<i>Sources: TURKSTAT, Min of Development data bases; CBRT electronic data dissemination system.</i>							
a. GDI interest rate for 2001-2002 and 2003-2008; CBRT Policy Rate (One-week Repo Rate) for post-2009. All deflated by the CPI.							

Table 3. The IMF Program: Macro Variables and Price Targets						
		2002	2003	2004	2005	2006
Macro Variables						
GNP Growth Rate		3.0	5.0	5.0	5.0	5.0
Public Sector Primary Balance		6.5	6.5	6.5	6.5	6.3
Debt Stock of the Public Sector / GNP (%)		81.3	73.3	69.4	66.5	63.9
Macro Prices						
Inflation Rate (%)		35.0	20.0	12.0	8.0	5.0
Nominal Interest rate on Domestic Debt (%)		69.9	46.0	32.4	27.4	23.9
Ex-ante Real Interest Rate on Domestic Debt (%)		25.6	21.7	18.2	18.0	18.0
<i>Source: Report on Public Debt Management, Undersecretariat of Treasury, April 2003</i>						

Table 4. General Equilibrium of the Central Government									
	1990	1995	2000	2005		2009	2010	2011	2012
Real Values (Fixed 1980 Prices, Billions TL)^a									
<i>Tax Revenues</i>	1,431.9	1,694.2	2,406.5	2,775.8		2,862.1	3,232.6	3,670.0	3,745.7
<i>Direct</i>	611.5	692.6	942.1	853.2		947.5	927.5	1,097.8	1,150.0
<i>Indirect</i>	820.4	1,001.5	1,464.3	1,922.6		1,914.7	2,305.1	2,572.3	2,595.7
<i>Factor Revenues</i>	311.9	336.7	353.9	721.3		679.6	613.5	603.8	635.3
<i>Current Transfers</i>	-627.7	-1,091.7	-2,000.0	-1,564.8		-1,771.0	-1,649.1	-1,658.4	-1,748.5
<i>Public Disposable Income</i>	1,250.9	954.9	791.6	1,816.2		1,686.2	2,151.8	2,756.2	2,726.9
<i>Public Consumption</i>	926.9	961.6	1,255.5	1,384.7		1,822.5	1,886.2	2,053.6	2,257.7
<i>Public Savings</i>	324.0	-6.7	-463.9	431.5		-136.2	265.5	702.5	469.1
<i>Public Investment</i>	-798.5	-382.6	-702.9	-610.8		-714.6	-696.1	-783.3	-856.7
<i>Public Sav-Inv Balance</i>	-474.4	-389.3	-1,166.8	-179.3		-850.9	-430.5	-80.8	-387.6
As Ratio to GDP (%)									
<i>Tax Revenues</i>	11.6%	12.7%	17.8%	18.0%		17.7%	18.8%	19.3%	19.5%
<i>Direct</i>	5.0%	5.2%	7.0%	5.5%		5.9%	5.4%	5.8%	6.0%
<i>Indirect</i>	6.7%	7.5%	10.8%	12.5%		11.8%	13.4%	13.5%	13.5%
<i>Factor Revenues</i>	2.5%	2.5%	2.6%	4.7%		4.2%	3.6%	3.2%	3.3%
<i>Current Transfers</i>	-5.1%	-8.2%	-14.8%	-10.2%		-11.0%	-9.6%	-8.7%	-9.1%
<i>Public Disposable Income</i>	10.2%	7.1%	5.9%	11.8%		10.4%	12.5%	14.5%	14.2%
<i>Public Savings</i>	2.6%	-0.1%	-3.4%	2.8%		-0.8%	1.5%	3.7%	2.4%
<i>Public Investment</i>	-6.5%	-2.9%	-5.2%	-4.0%		-4.4%	-4.1%	-4.1%	-4.5%
<i>Public Sav-Inv Balance</i>	-3.9%	-2.9%	-8.6%	-1.2%		-5.3%	-2.5%	-0.4%	-2.0%
<i>PSBR (net)</i>	5.5%	3.7%	8.9%	-0.1%		5.1%	2.4%	0.1%	1.7%
<i>Sources: SPO Main Economic Indicators ; Undersecretariat of Treasury, Treasury Statistics.</i>									
^a / Deflated by the Wholesale Price Index, (1980=100)									

Table 5. Turkey: Chart of Principal Taxes		
Taxes	Details	Percentage
Corporate income tax	Increase in net worth	20 percent
Advance corporate income tax	Net taxable income	0.2
Individual income tax		15-35 percent (all sources of income including salary income)
Value Added Tax - VAT	Sales value	
. General		0.18
. Certain products and services		0.08
. Certain products		0.01
Banking & Insurance Transaction Tax		
. General		0.05
. Interbank deposit transactions		0.01
. Repossessions		0.01
. Money market transactions between banks and brokers		0.01
. Sale of government bonds and t-bills		0.01
. Sale of foreign currency		0
Stamp Duty		
(where stamp duties are payable, the amount of stamp duty payable on each document is limited to TRY 1.487,397,70 for 2013)	Value specified in the documents	Generally at 0.948 percent (0.189 percent for rental contracts, 0.759 percent for salaries)
Gift and Inheritance Tax	Value	1-30 percent
Customs Duties	Value	Various
Transfer of real estate	Sales value	2 percent, each buyer and seller
Special Consumption Tax		

.Petroleum products	Per liter, kilogram, etc.	Specific
. Vehicles	Value and engine size	1 to 130 percent (*) 25 percent - 65.25 percent and lump-sum 6.7 percent - 25 percent
. Alcoholic beverages & tobacco products . Certain luxury goods	Value, retail sale price for tobacco products Value	
Special Communication Tax	Service fee	
. Mobile telecommunication services		0.25
. Radio & television broadcasting services through satellite or cable		0.15
. Wired, non-wired and mobile internet service providing facility		0.05
. Other telecommunication services		0.15
Lottery taxes (national lottery, horse racing, toto, lotto, etc.)	Various	Specific and ad valorem at 10 percent
Motor Vehicle Tax	Model, engine, weight	Certain amounts revised each year
Major municipal & local taxes		
Real estate taxes	Tax value	
. Buildings		0.1 - 0.4 percent
. Land		0.1 - 0.6 percent
Entertainment tax	Per tariff, gross profit	Specific, 0-20 percent and ad valorem at 10 percent
Communication tax	Fee	0.01
Electricity and gas consumption tax	Sales value	1-5 percent
Environment protection tax	Per flat and business premises	Certain amounts revised each year
* Only the percentage tax rate is applied provided that it is not less than the tax calculated by using the minimum lump-sum tax amounts.		
Source: Ministry of Finance		

Table 6.

Structure and Net Tax Burden on Corporate Incomes				
Taxation Structure and Taxes Incurred	Subject Corporates		Global Investors²	
	2005	2006	2005	2006
Corporate Income	100	100	100	100
Corporate Income Tax Rate	30	20	30	20
After Tax (net) Profits	70	80	70	80
Pre-Tax (%10 x net profits) ¹	7	8	7	8
Tax Base (1/2 of distributed profits is excepted)	35	40	--	--
Total Taxes Paid	7	6	7	8
Accrued Tax Burden	44%	34%	37%	28%
<p>Source: Deloitte, 2007 Turkey Fiscal Report available at: www.deloitte.com/dtt/cda/doc/content/tr-tr_tax_KVK_300107.pdf</p> <p>1) Pre Taxation rate had been increased to 15% in July 2007.</p> <p>2) Double taxation procedures had not been taken into account.</p>				

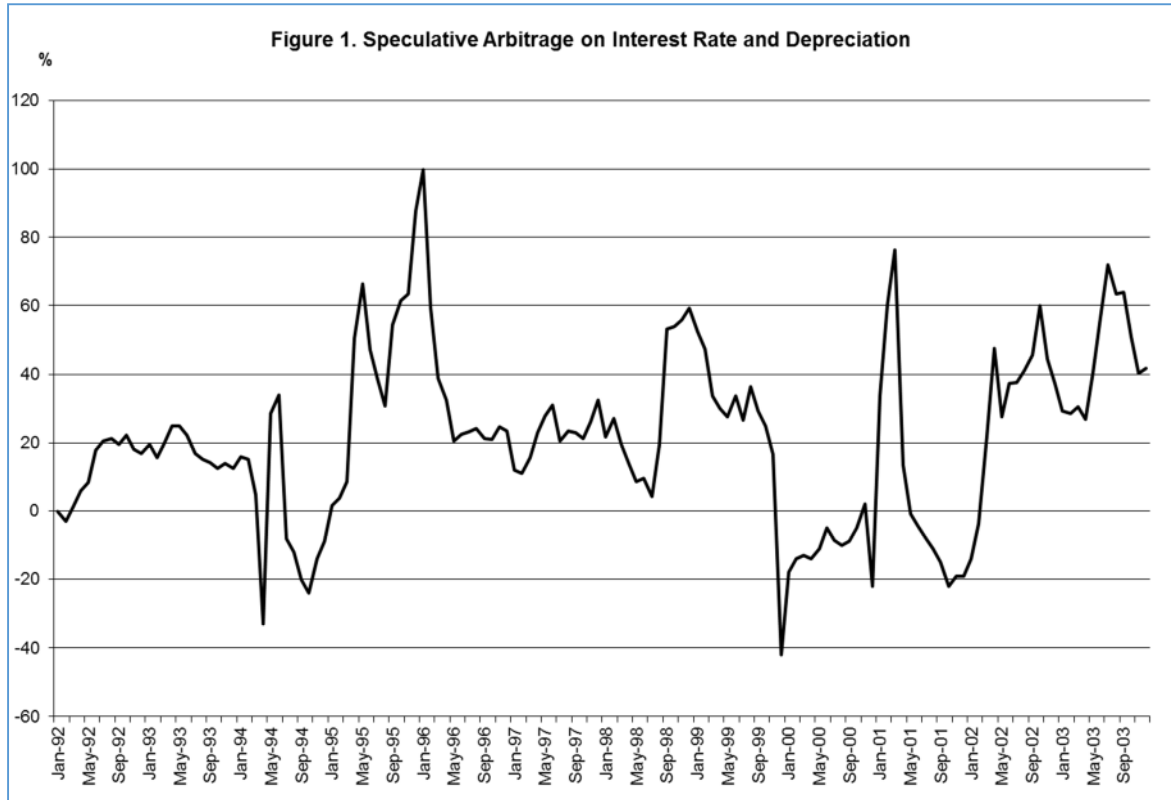
Table 7.

G-20 Countries: Fiscal Expansion as % of GDP

	2009			2010		
	of which			of which		
	overall balance	crisis related discretionary measures	other factors	overall balance	crisis related discretionary measures	other factors
GDP weighted average	-5.5	-2.0	-3.5	-5.5	-1.6	-3.8
Advanced G-20	-5.9	-1.9	-4.0	-6.2	-1.6	-4.5
UK	-8.9	-1.6	-7.4	-10.6	0.0	-10.7
USA	-5.6	-2.0	-3.6	-5.6	-1.8	-3.9
Emerging Market G-20	-5.0	-2.2	-2.8	-4.4	-1.6	-2.8
Argentina	-1.1	-1.6	0.4	0.7	0.0	0.7
Brasil	-0.7	-0.6	0.0	1.2	-0.6	1.8
Korea	-6.7	-3.6	-3.0	-7.8	-4.7	-3.1
Mexico	-2.8	-1.5	-1.0	-2.6	-1.0	-1.6
Turkey	-3.7	-0.8	-2.9	-3.3	-0.3	-3.0
Weighted average incl financial support	-7.0	-2.0	-4.9	-5.8	-1.6	-4.2

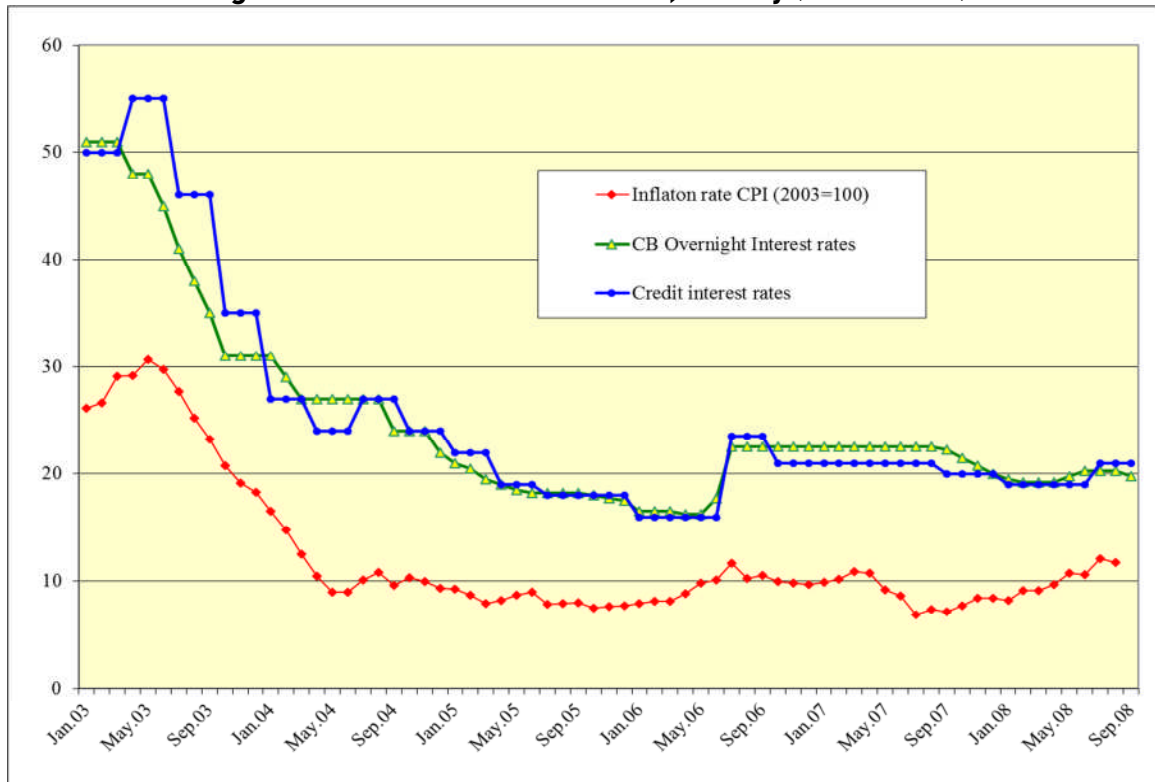
Figures reflect the budgetary cost of crisis-related discretionary measures in each year compared to 2007, based on measures announced through mid-July. They do not include (i) acquisition of assets (including financial sector support) or (ii) measures that were planned before the crisis.

Source: IMF Staff Position Note 30 July 2009, SPN/09/21



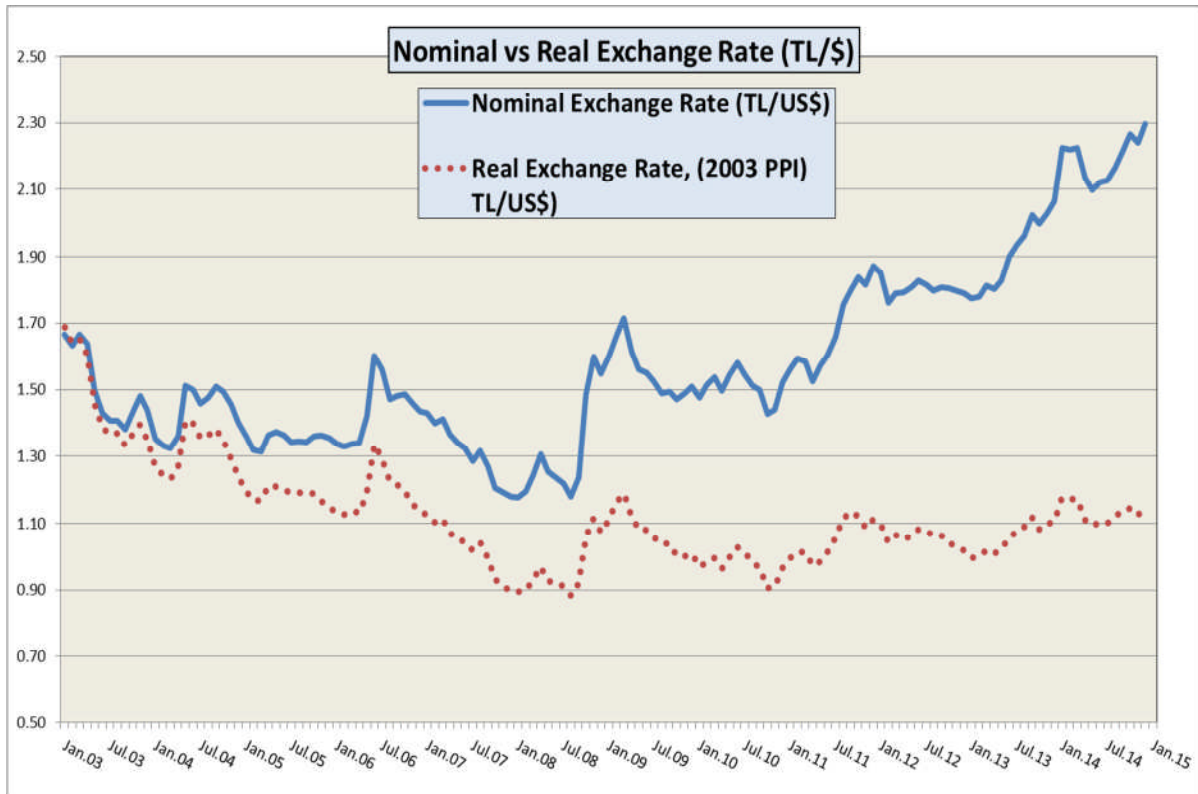
Source: Figure 2, Yeldan (2006)

Figure 2. Macroeconomic Prices, Turkey (2003-2008)

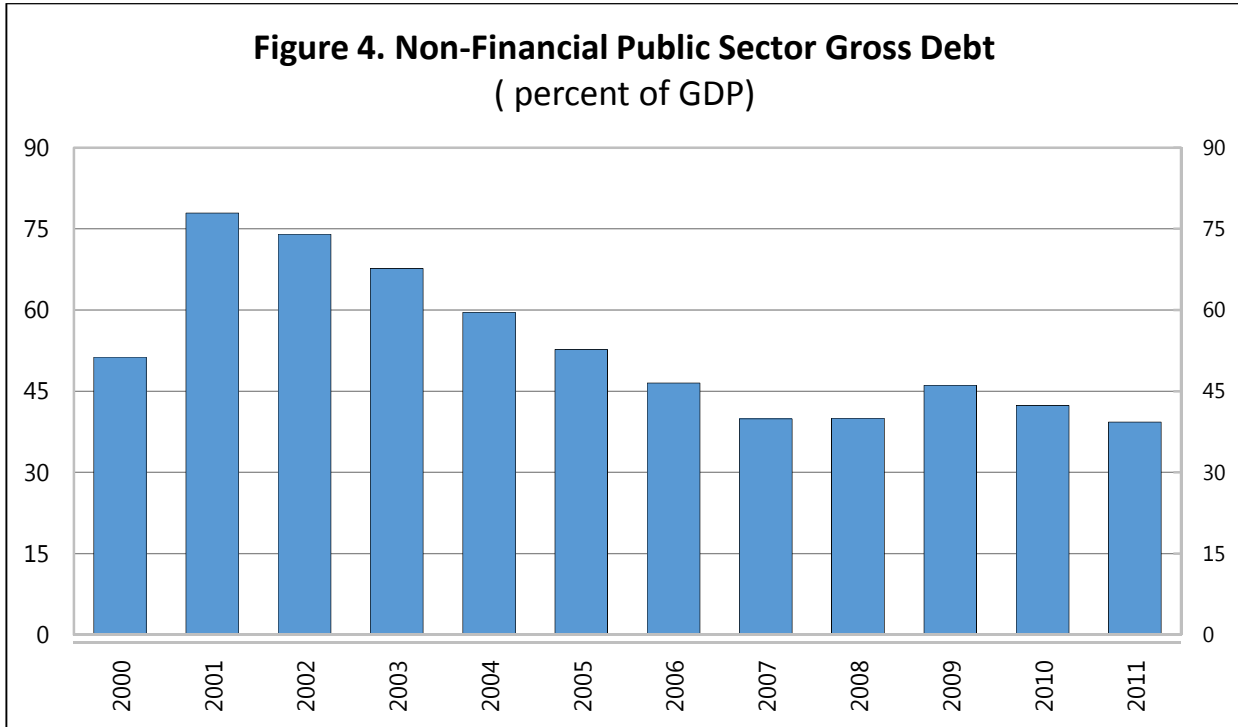


Source: CBRT

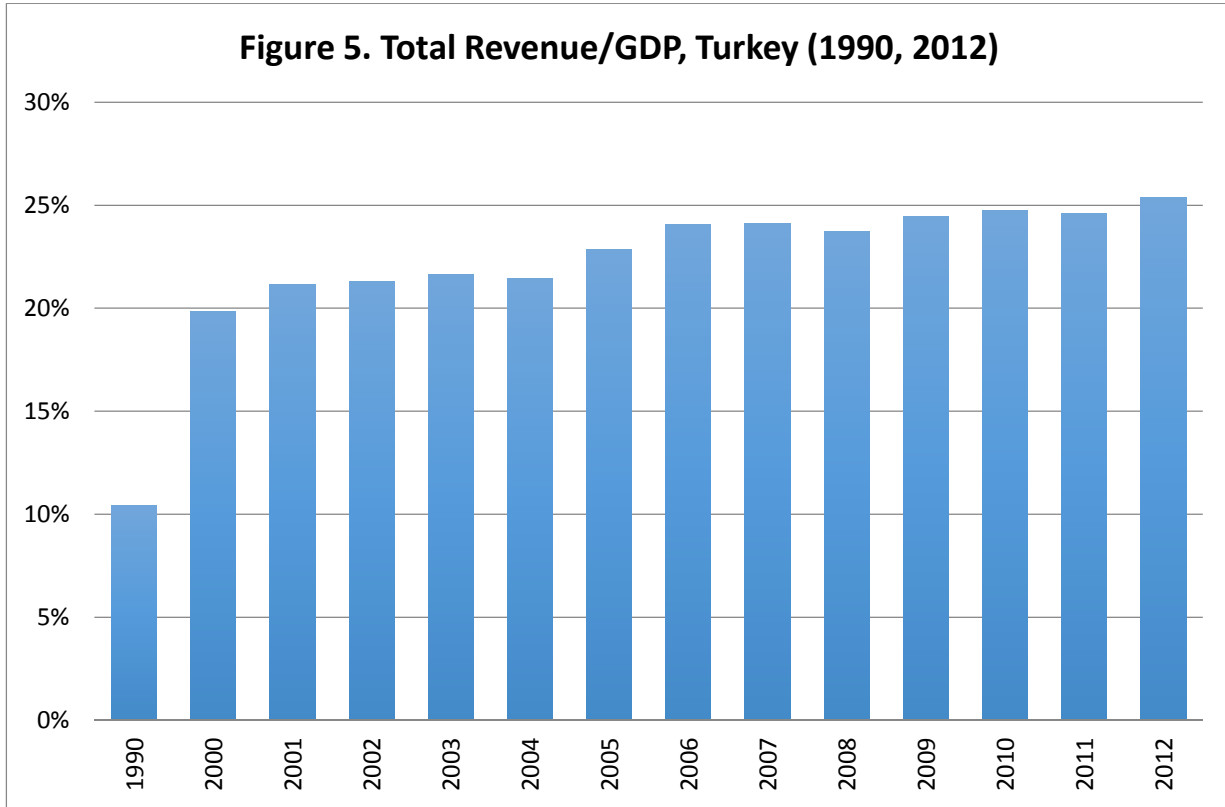
Figure 3. Exchange Rate, Turkey (2003-2008)



Source: CBRT



Source: Undersecretariat of Treasury



Source: Undersecretariat of Treasury

Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?

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