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REFORMING TURKEY'S PUBLIC EXPENDITURE MANAGEMENT

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By Rauf Gönenç, Willi Leibfritz and Erdal Yilmaz

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ABSTRACT/RÉSUMÉ

Reforming Turkey's Public Expenditure Management

Fiscal imbalances were a main cause for chronic high inflation and macroeconomic instability before the 2000/2001 crisis. Fiscal consolidation is the cornerstone of post-crisis stabilization. It has been quite successful over the past three years as sizeable primary surpluses have been sustained and the fall in interest rates has reduced the interest cost of public debt. Fiscal targets have been achieved chiefly by raising revenues which has increased the tax burden; greater emphasis should now be placed on the control of public expenditure. At the same time, core public services such as education, justice, infrastructure and rural development will need to be upgraded. Social security costs may also rise with the planned shift to universal health insurance, and the ambitious administrative decentralization project could cause upward pressure on local spending. Far-reaching rationalization of public expenditures is therefore required to meet the quantitative fiscal targets while achieving the intended improvement in public governance. Turkey has made important steps in this direction with new fiscal laws and regulations but an integrated strategy is necessary to harness their full benefits.

This Working Paper relates to the 2004 OECD Economic Survey of Turkey (www.oecd.org/eco/surveys/turkey).

JEL Classification: E62, H1, H4, H5, H7.

Keywords: Turkey, government expenditure, public sector efficiency, budget systems, intergovernmental relations, new public management.

Réformer la gestion des dépenses budgétaires en Turquie

Les déséquilibres fiscaux ont été une cause majeure de l'inflation forte et de l'instabilité macroéconomique avant la crise de 2000/2001. La consolidation budgétaire a été au cœur de la stabilisation après la crise. Elle a été mise en œuvre depuis trois ans avec des excédents primaires larges, et la baisse des taux d'intérêt a réduit le coût du service de la dette publique. Les objectifs budgétaires ont été atteints principalement par une hausse des revenus, augmentant la pression fiscale, et plus d'attention devra être accordée à l'avenir au contrôle des dépenses. En même temps des services publics majeurs comme l'éducation, la justice, les infrastructures et le développement rural devront être améliorés. Les dépenses de sécurité sociale pourraient aussi augmenter avec le passage annoncé à la couverture médicale universelle, et l'ambitieux projet de décentralisation administrative pourrait accroître les dépenses locales. Une forte rationalisation des dépenses devient donc nécessaire pour atteindre les objectifs quantitatifs de la politique budgétaire tout en améliorant la qualité de la gouvernance publique. La Turquie a fait d'importants pas dans cette direction avec de nouvelles lois et réglementations budgétaires mais une stratégie intégrée est nécessaire pour recueillir pleinement leurs fruits.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de la Turquie, 2004 (www.oecd.org/eco/etudes/turquie).

Classification JEL : E62, H1, H4, H5, H7.

Mots clés : La Turquie, dépenses gouvernementales ; l'efficacité du secteur public ; système budgétaire ; système de dépenses publiques ; relations intergouvernementales ; nouveau système de gestion publique.

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REFORMING TURKEY'S PUBLIC EXPENDITURE MANAGEMENT

By Rauf Gönenç, Willi Leibfritz and Erdal Yilmaz¹

1. The rapid increase in government expenditures and debt has been the main cause of persistent inflation and vulnerability of the economy during the past decades, and the recent improvement of fiscal discipline has played a key role in the recovery from the 2001 crisis. The challenge now is to prevent the repetition of the pre-crisis fiscal drifts by putting in place more effective budget institutions, and by upgrading the quality of spending by directing resources to areas essential for economic growth. Beyond aggregate fiscal consolidation, enhancing the quality of spending is a matter of urgency in Turkey as the present weaknesses of core public goods and institutions appear to be hindering the investment and employment potential of the economy.

2. Important efforts addressing these challenges to the public finance system have been launched since 2001, including the programmes in co-operation with the International Monetary Fund, the World Bank and the National Plan of Convergence with the European Union *acquis*. The proper co-ordination and sequencing of these projects is a demanding task. On top of these efforts to upgrade public expenditure institutions, the government has launched a far-reaching governance reform. A range of draft laws being discussed in Parliament under the aegis of a "Public Administration Framework Law" aim to achieve, first, a thorough administrative decentralisation, and, second, a separation of public funding from public delivery of social services. The reform, if implemented, will be applicable from 2005 and involve the transfer of a significant share of central government spending authority to *special provincial administrations* and *municipalities*. Given Turkey's traditionally highly centralised public finances these reforms represent a major step forward in improving public sector efficiency and responsiveness. However, to avoid any conflict with demanding fiscal consolidation objectives, they must be backed by a strong national policy framework enforcing rigorous spending ceilings and strict service standards across the territory.

3. This document examines the current transformation of the public expenditure system. It first reviews recent trends and pressures in public spending and identifies the expenditure management practices which failed to contain the fiscal drift of the past decade and failed to provide public services and institutions at an acceptable level of quality (Section I). It then reviews the present efforts to strengthen

1. This paper was originally prepared for the *OECD Economic Survey of Turkey* published in December 2004 under the authority of the Economic and Development Review Committee of the OECD. Rauf Gönenç is Head of Turkey/Slovakia Desk, Willi Leibfritz is Head of Division in OECD's Economics Department and Erdal Yilmaz had been seconded from the Research Department of the Central Bank of Turkey. The authors are indebted to Anne-Marie Brook, Luiz de Mello, Andrew Dean, Jorgen Elmeskov, Mike Feiner, Isabelle Joumard, Val Koromzay and Peter Walkenhorst for useful inputs and many colleagues in the Ministry of Finance, the State Planning Organisation and the Undersecretariat of Treasury in Ankara, and the research foundation TESEV in Istanbul for valuable contributions. Thanks to Brooke Malkin for careful technical assistance and to Nadine Dufour and Chrystyna Harpluk for effective support in preparing the document.

public services with new spending management institutions (Section II). The concluding section provides policy recommendations.

Pressures and shortfalls in public expenditures

The drift of expenditures in the past decade...

4. Up to the mid-1990s Turkey had one of the lowest shares of general government expenditures and tax revenues in GDP in the OECD area (Figure 1),² and this was perceived as one of the causes of the insufficient quality of public services and institutions. Less than one decade later, Turkey's tax revenues and primary expenditures as a percentage of GDP are not far from OECD averages and the ratio of total public spending to GDP, because of the heavy source cost of public debt, was one of the highest in the OECD. In contrast, neither GDP per capita nor the quality of public services and institutions had converged toward OECD levels. Six factors were behind this explosion of public expenditures:

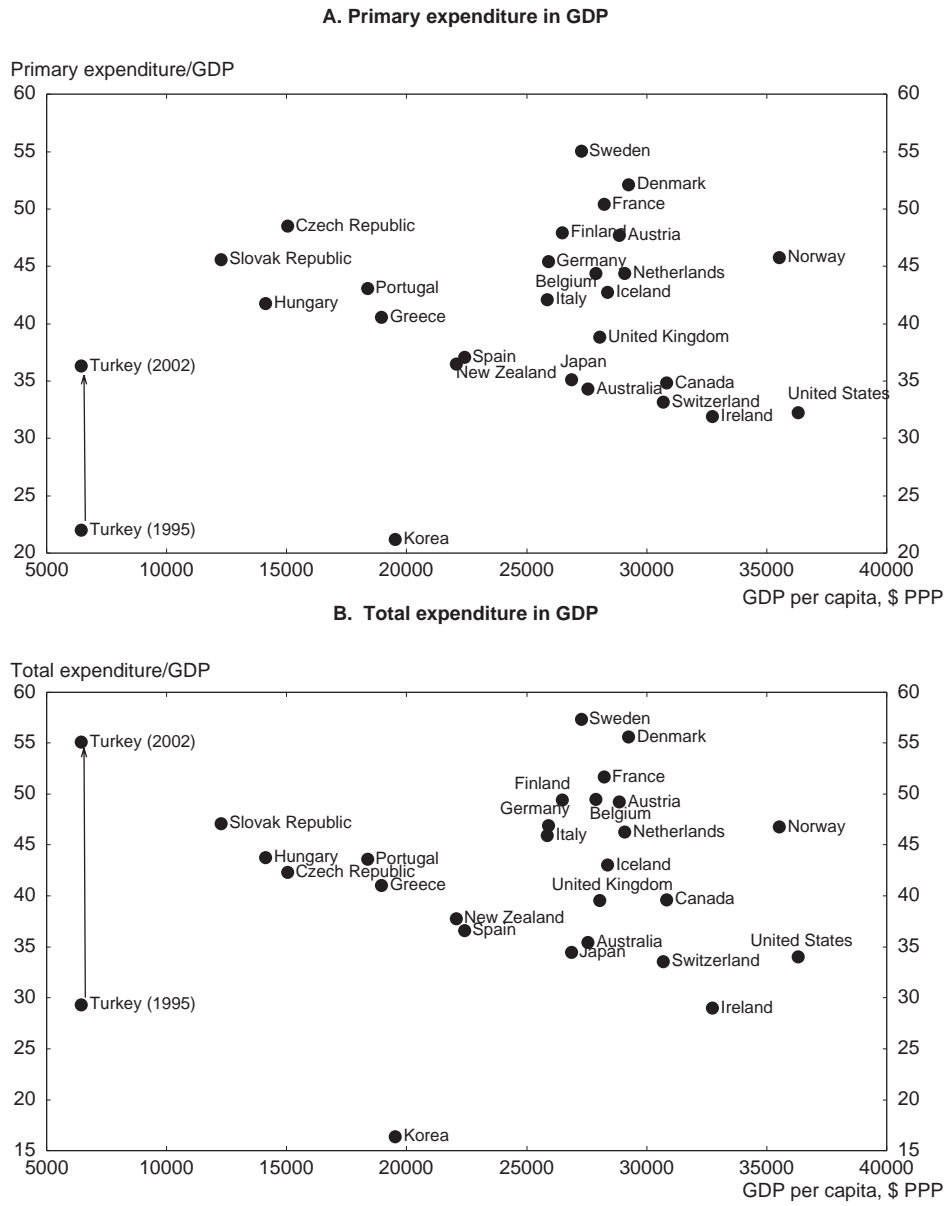
- i) Primary expenditures soared by 8 percentage points of GDP from 1995 to 2003. There were increases across all primary spending items, most notably in the government wage bill, in transfers to social security institutions, and, until 1999, in transfers to agriculture – including via off-budget channels. The increase in primary spending during this period was therefore mainly due to policy efforts to increase or protect the income level of various social groups (Figure 2).
- ii) Transfers to social security institutions concerned both the pension and health legs. Pressures arose from generous provisions for retirement granted in earlier years³ and swift growth of health expenditures in spite of the rationing of health services in many parts of the country (Figure 3).
- iii) Infrastructure investment was also subject to upward pressures, driven by real infrastructure needs but also escalating demands by local interest groups which became more influential in the context of successive anticipated elections. However, infrastructure investment was curbed in the past two years as the only non-mandatory item remaining available in the budget for spending cuts.
- iv) The largest drifts in public finances occurred outside the general government sector, in quasi-fiscal activities. In the second half of 1990s, both public and private banks operating under treasury guarantees engaged in aggressive deposit taking, took excessive risks and extended unsound loans without adequate regulatory supervision. Public banks augmented politically-driven lending and many private banks⁴ channeled funds to related parties and to assets of dubious quality. The 2000 currency crisis revealed massive open positions and unfunded liabilities, which amounted to nearly 40 per cent of GDP. The government assumed these losses and as a result the stock of public debt increased sharply (Figure 4).

2. State-owned corporations were large employers and had a large weight in the economy but they are not in the general government sector.

3. Under rules in force until 2002, any participant could retire after 25 years of contributions. This permitted many individuals to “retire” in their mid-40s.

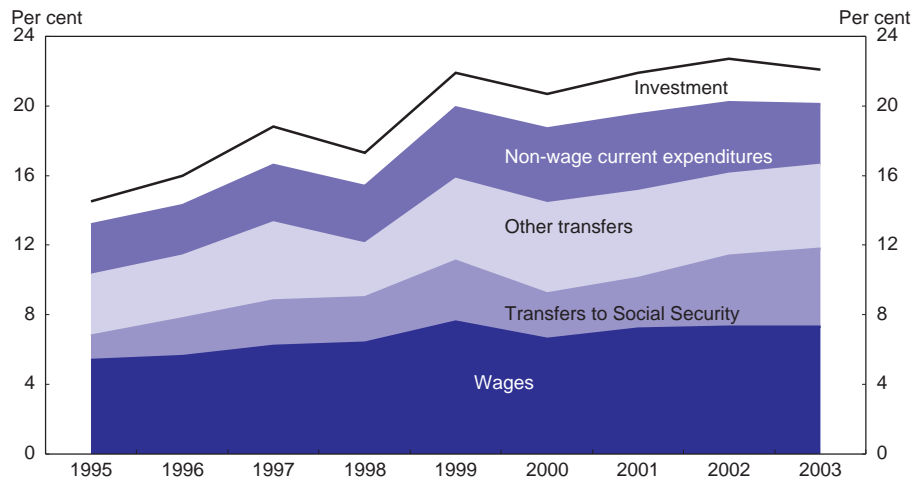
4. Notably small banks which were created in large numbers in the 1990s after the liberalisation of capital movements.

Figure 1. Primary and total public expenditures, international comparison 2002, for Turkey 1995 and 2002



Source: OECD.

Figure 2. Components of primary expenditure¹
Share of GDP



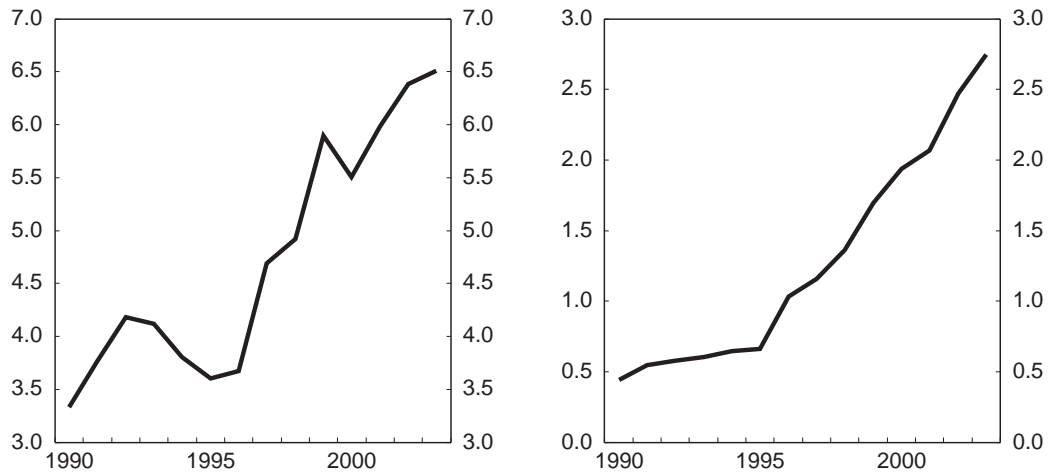
1. On a consolidated government basis.

Source: General Directorate of Public Accounts, MOF.

Figure 3. The growth of social security and health spending¹
Per cent of GDP

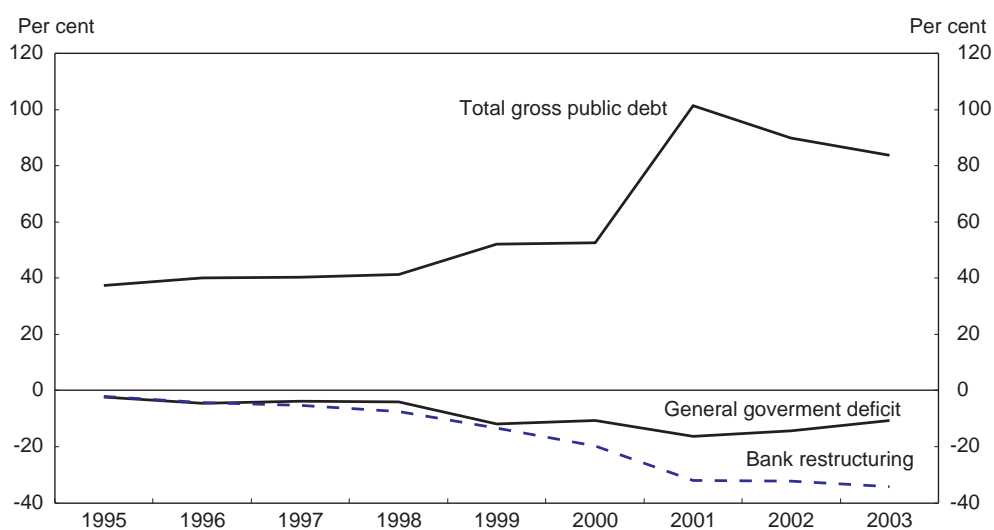
A. Pension disbursements

B. Social security health spending



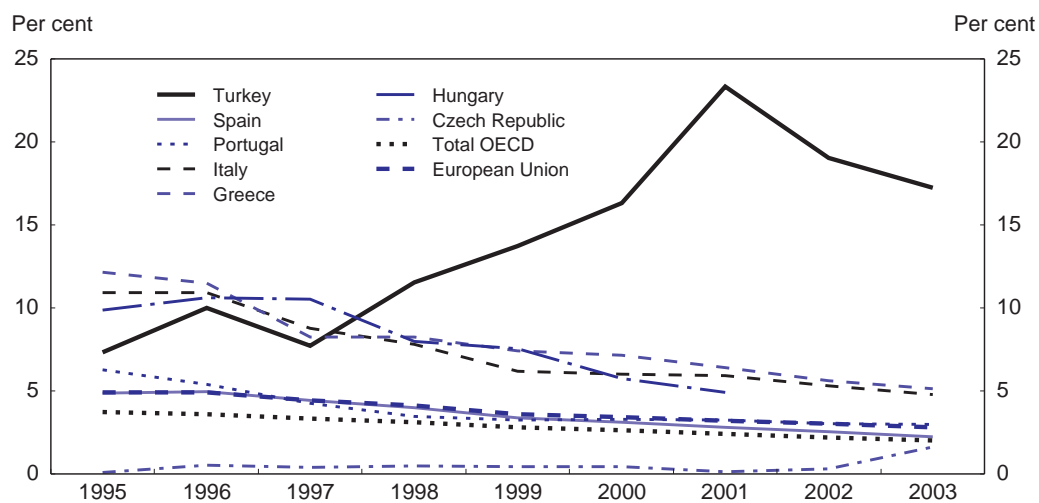
Source: Undersecretariat of Treasury and OECD.

Figure 4. Components of public debt growth
As a share of GDP



Source: Undersecretariat of Treasury, SPO, OECD.

Figure 5. The explosion of government interest expenditures
Per cent of GDP



Source: OECD.

- v) The maturity and currency composition of the debt stock made it highly vulnerable to interest and exchange rate fluctuations. After the 2000-2001 crisis and following massive multilateral borrowing, the foreign currency component of debt rose to around 40 per cent, and the share of short-term and floating interest-rate debt increased to 45 per cent. Such a composition made the service costs difficult to predict and stabilise. The rising level of debt, together with successive shocks on interest and exchange rates, led to sharp increases in interest expenditures (Figure 5).
- vi) Turkey also faced exceptional spending needs in the 1990s. Severe earthquakes in August and November 1999 were onerous and their fiscal cost, estimated at around 3 per cent of GDP, was mainly borne by the government -- although international aid helped.⁵ Also, security and defense expenditures related to the fight against terrorism, which had increased strongly in the Eastern provinces in the 1990s but subsequently come under control after 1999, put exceptional claims on public resources.

Further pressures are looming

5. The fiscally costly bailing out of banks will hopefully be a single event after the fundamental banking reform of 2001, and interest expenditures should come down as confidence improves. However, the other drivers of spending remain pressing and need to be addressed:

- The government wage bill will remain exposed to some pressure. Employment has been reduced in state-owned corporations in recent years, and this trend should continue, but general government employment might increase following decentralisation reforms. Even if total employment is kept under control, wage pressures may persist in the medium-term. Private sector wages declined more rapidly than public sector wages in real terms after the 2000-2001 crisis, but over the longer term, wages of university-educated and skilled civil servants lagged behind their private sector counterparts. In particular, the EU negotiation and accession process will increase the need for highly qualified and adequately paid civil servants. A catching-up of the wages of highly qualified civil servants may be required in the future, at least for high performing employees (Figure 6 and Box 1).
- Social security institutions remain exposed to medium- and long-term pressures although demographic developments are more favorable than in many other countries. There is an exceptionally large difference between the age structure of the population and the ratio between pensioners and contributors. Cash balances of the pay-as-you-go pension system were temporarily restored following the parametric changes effected in 1999, but there is a need to accumulate reserves for subsequent years.⁶ Pressures are also continuous to make pensions grow in line with wages, in spite of government efforts to limit indexation to inflation⁷ (Figure 7).

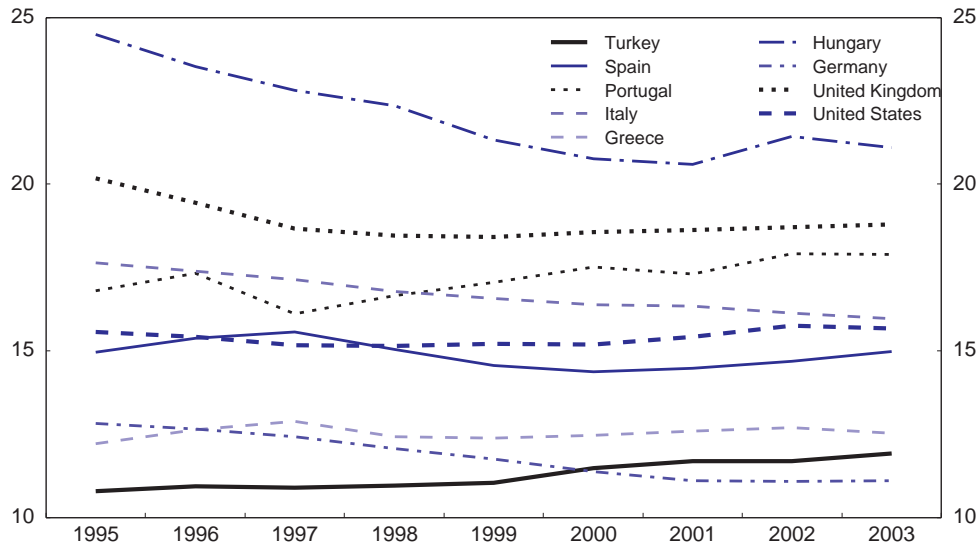
5. Total fiscal and private costs of these earthquakes were higher at close 5 per cent of GDP. See *OECD Economic Survey of Turkey, 2001*.

6. A large gap between “demographic” and “systemic” dependency ratios, due to the high share of unregistered workers not contributing to social security hinders the attainment of this objective.

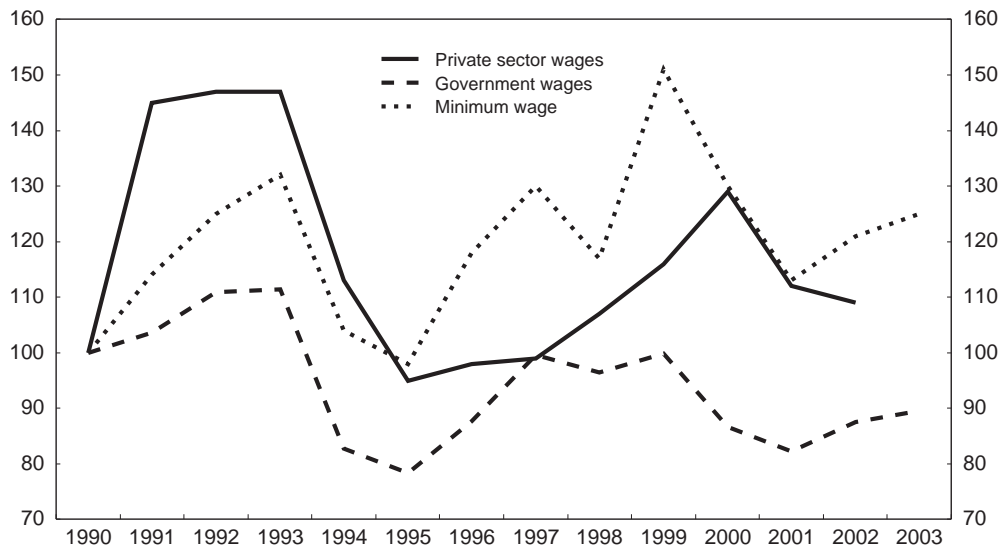
7. A law adopted in 1999 prescribed the adjustment of pensions to inflation in six-monthly intervals but several additional increases have been granted since that date.

Figure 6. Pressures on the government wage bill

**A. Government employment as a percentage of total employment:
International comparison**



**B. Real wage growth in the private and public sectors
(1990 = 100)**



Source: OECD.

Box 1. Public sector employment and wages

Central government employs 1 600 000 workers in 2003, without including state economic enterprises (400 000), military personnel (200 000) and local government workers (205 000). Main government employers are the Ministry of Education (640 000 employees, 40 per cent of the total), the Ministry of Health (230 000 employees), the General Directorate of Public Security (190 000 employees) and Public Universities (150 000 employees). All included, public sector employment amounted to around 2.5 million in 2004, or 12 per cent of total employment.

Public sector employment includes *civil servants* with life-time contracts (1 850 000 in 2004, 74 per cent of the total) and unionised *workers* with practically sheltered positions (400 000, 16 per cent). Employees with fixed-term contracts have a marginal weight in most ministries. Employment is rigid quantitatively, the main source of adjustment being the seasoned practice of “not filling” available budget positions and making use of natural attrition of those leaving for retirement. In 2003, 25 per cent of all available budget positions were vacant (1 600 000 workers for 2 100 000 budget positions). In spite of such restraint, central government employment increased by 30 per cent between 1990 and 2002 (from 1 240 000 to 1 600 000), an annual growth rate of 2.4 per cent.

The wage system for *civil servants* is also relatively rigid, with a “scale and coefficient” system determining the grade and wage points of each individual. There are statutory starting levels according to education and automatic steps according to seniority. The envelope for total civil service pay is subject to budget constraints and since the grade structure is demographically determined, wage coefficients are a residual. In contrast, for public sector *workers*, powerful unions negotiate high levels and rapid growth rates of wages, less subject to budget constraints as they are generally paid by off-budget state economic enterprises – even if wage growth in this sector has remained below inflation in the past three years. The result is a very compressed wage structure between university-educated civil servants and low-skilled workers. The ratio of the highest to the lowest wages for civil servants has been estimated at 7 in 2004, considerably below internationally observed averages of around 12-13. There is practically no room for performance-based pay in this employment system. It is likely that significant reforms to public sector employment arrangements will be required in order to lift the overall effectiveness of the public sector.

Table 1. Composition and growth of central government employment
1990-2003

	1990	1995	2000	2003
Ministry of Education	485 692	527 079	578 931	637 192
Ministry of Health	156 521	192 325	211 102	227 056
General Directorate of Security (Police)	107 553	150 770	181 078	192 462
Universities	86 306	114 664	135 151	148 548
Ministry of Justice	56 472	56 927	59 535	58 545
Ministry of Defence	20 600	20 966	26 197	22 038
Others	324 362	334 018	319 870	312 480
Total central government	1 237 506	1 396 749	1 511 864	1 598 321

Source: Turkish authorities.

Table 2. Total public employment in 2004

Total public sector	2 518 427
Consolidated budget - Total	1 865 819
Civil servants	1 663 517
Contracted employees	14 620
Workers	187 682
Local administration – Total	205 220
Municipalities – Total	200 481
Civil servants	92 740
Contracted employees	1 041
Workers	106 700
Social security institutions – Total	77 080
Civil servants	73 063
Contracted employees	289
Workers	3 728
State economic enterprises – Total	339 824
Treasury portfolio (total)	260 892
Civil servants	7 356
Contracted employees	104 472
Workers	149 064
Privatisation portfolio (total)	78 932
Civil servants	1 254
Contracted employees	10 509
Workers	67 169
State banks ¹ - Total	30 484
Civil servants	175
Contracted employees	423
Workers	29 886

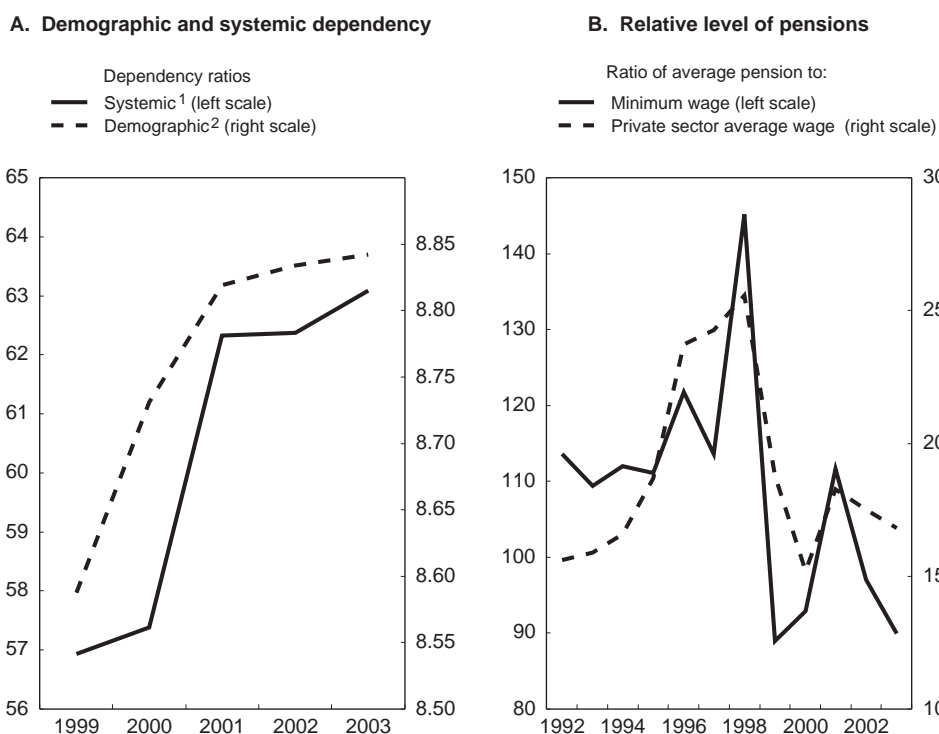
1. State Banks include Ziraat Bank and Halk Bank. Vakıflar, which has a semi-private status, is not included.

Source: Turkish authorities.

- Pressures will continue to bear on health spending as in all OECD countries, but with an additional catch-up potential. There is room for short-term rationalisation in health spending, and the government is presently making use of it, but medium-term trends are upward, notably with the planned introduction of universal health insurance. More generally the population's average health status needs improvement and claims for better health services are expected to mount.⁸ Health spending per capita is expected to converge toward levels in comparable countries (Figure 8).

8. Government preparations for a universal health insurance system reflects these pressures. See below.

Figure 7. Pressures on the pension system



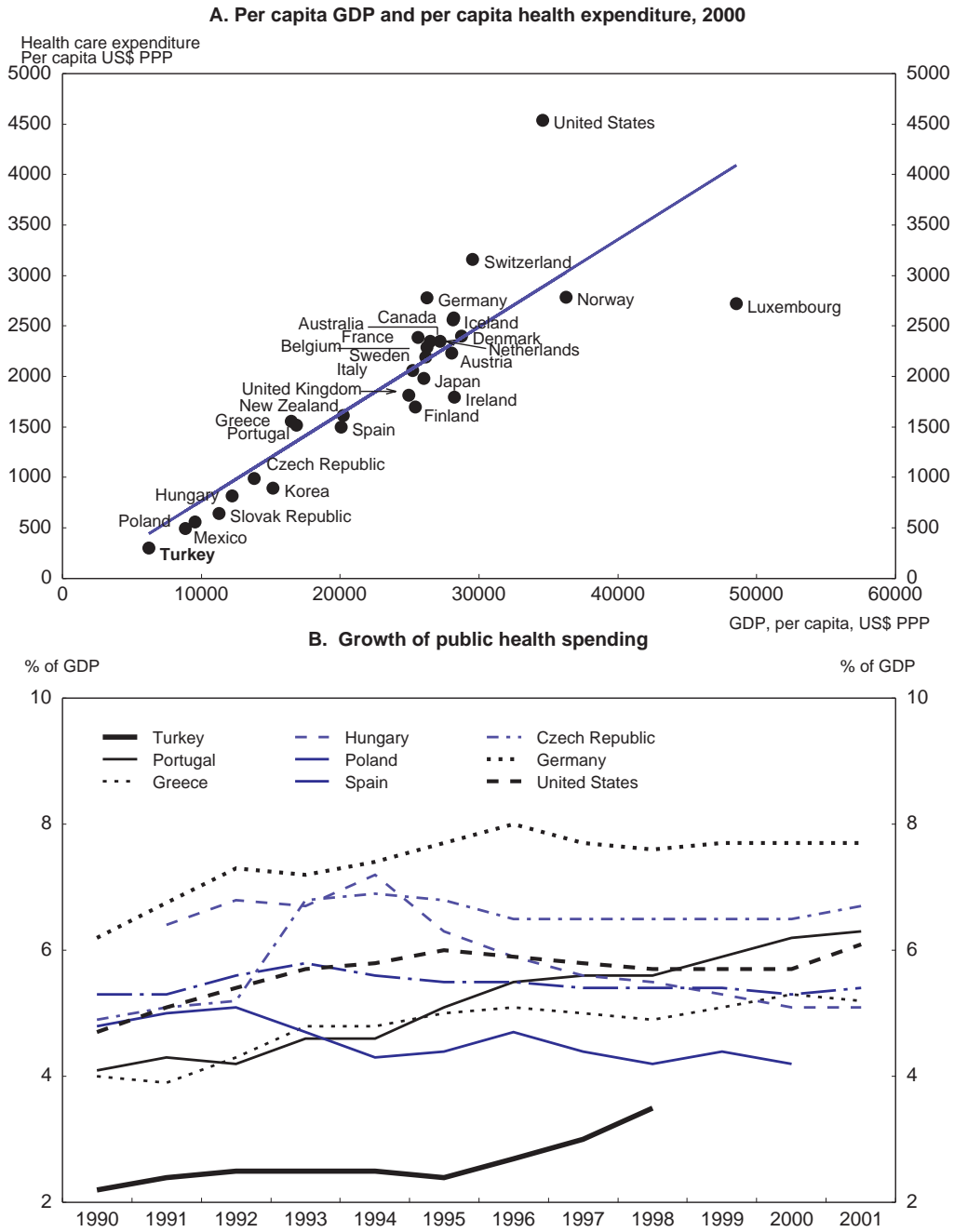
1. Systemic dependency ratio = pensioners/contributors * 100.
2. Demographic dependency ratio = population aged > 65 / aged 15-64 * 100.

Source: SPO, Treasury and OECD.

- More public spending will be needed on education, even though more private funding will also be necessary at the tertiary level. First, the growth rate of the school-age population is still high. Second, educational enrollment lags comparable countries as Turkey has not yet achieved the leap forward that other countries have completed in high school education and its population growth is still very high. The enrolment of girls in primary education also needs to improve.⁹ Lastly, the upgrading of the quality of teachers, educational material and school facilities will claim additional resources. The high unemployment rate of educated youth hints, among other factors, at quality problems in secondary and tertiary education which will need to be addressed (Figure 9).

9. A recent study by UNICEF has shown that up to 600 000 school-age girls are currently out of school. Practical needs of families (help needed in the household or farm) or their inability to pay for (limited) school expenditures is often the reason. In response the Turkish government and UNICEF have launched a campaign, partially based on some financial support to families, aiming to reduce the number by half by the end of 2005.

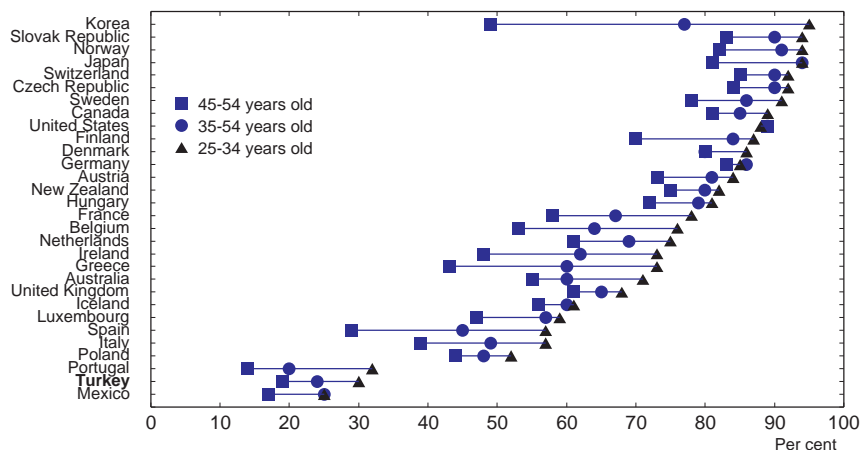
Figure 8. Pressures on the health system



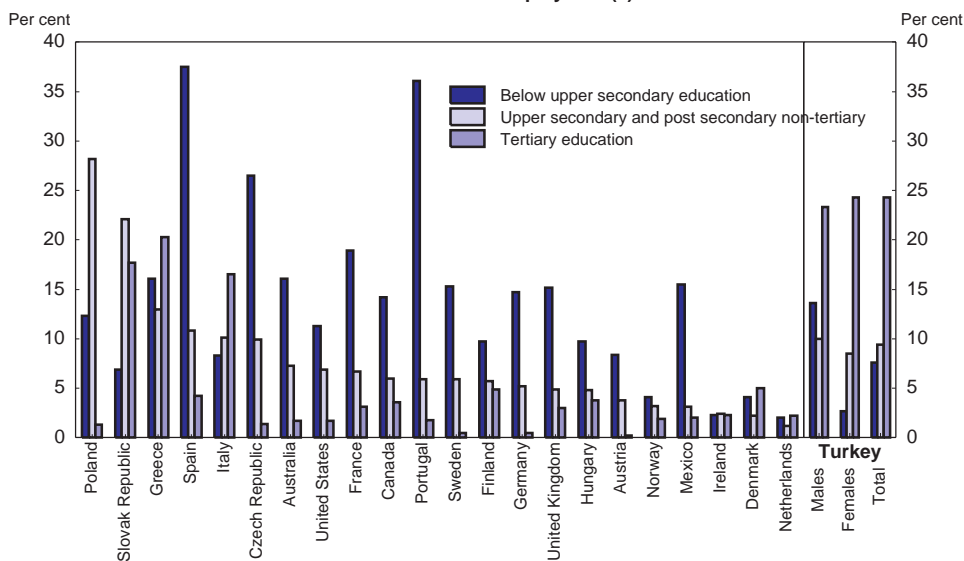
Source: OECD Health Data 2003.

Figure 9. Pressures on the educational system
Per cent in 2001

A. Share of the population with at least an upper-secondary qualification



B. Youth unemployment(1)



1. The unemployment rate of those below 25, according to educational background. The unemployment rate of poorly educated females is low in Turkey because of lower labour market participation.

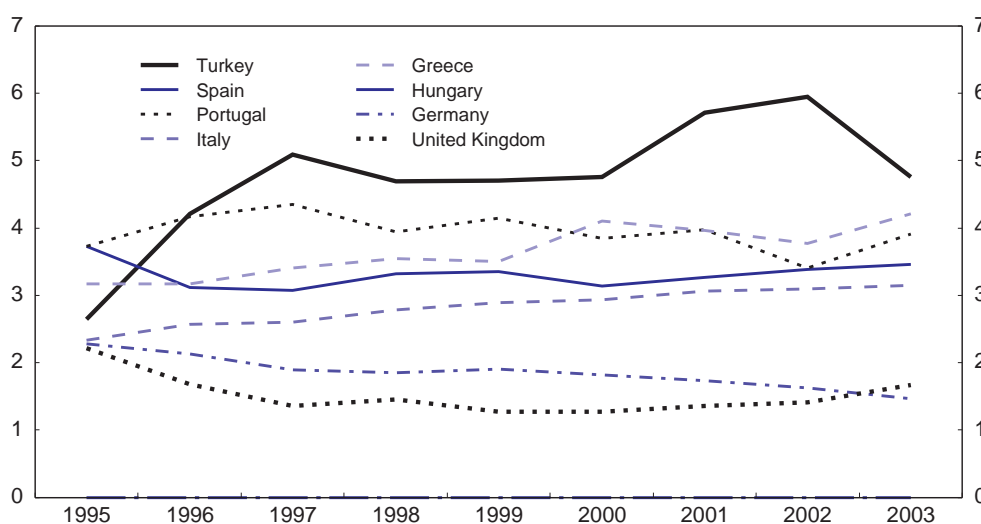
Source: OECD.

- The future path of government infrastructure investment is not determined as such spending is exposed to both upward pressures and saving opportunities. In international comparisons the government investment level is high, partly reflecting the low level of the stock¹⁰ (Figure 10). Infrastructure development and maintenance needs are indeed large. On the other hand, there is

10. Turkish *general government* investment series for the period 2000-2003 were estimated and appear well above levels reported in the *central* government budget.

also evidence of less necessary items in the existing project portfolio, that the government has begun to cut. Also, more recourse to private investment in energy, water and other infrastructures may diminish the need for direct public funding in the future. By contrast, the requirements of regional development will likely require massive additional infrastructure investment in the less developed eastern and southeastern regions.

Figure 10. Government investment: international comparison
Per cent of GDP



Source: OECD.

- Defense expenditures have remained stable at 4-5 per cent of GDP.¹¹ Reportedly, certain defense-related projects have been postponed to support the fiscal stabilisation effort. Turkey spends more on defense than comparable countries (See Figure 14 below).
- The natural catastrophe risks remain high. Notably, the Istanbul metropolitan area is exposed to a serious geological risk and the recently introduced (government-guaranteed) earthquake insurance scheme only partially provisions against this hazard (Box 2). Meanwhile, the Law on Catastrophes provides extensive government coverage.
- There are also other contingent liabilities borne by the government. Although the recent strengthening of the prudential supervision system for banks and the capping of deposit guarantees reduced government exposure, it nevertheless remains non-negligible in case of macroeconomic and systemic strain. Treasury exposure via long-term purchase contracts in Build-Operate-Transfer (BOT) and Build-Own-Operate (BOO) agreements guaranteed by the government also need to be measured.¹² Many debt-funded municipal infrastructure projects also operate under explicit and implicit state guarantees.

11. Total defence expenditures in general government terms, *e.g.* including the budget of the Ministry of Defence, spending from the extra-budgetary Defence Fund, and other related expenditures are not systematically computed.

12. The contingent fiscal costs of these guarantees are discussed below.

Box 2. Fiscal risks from earthquakes

Earthquakes in August and November 1999 devastated north-western Turkey, with a severe human toll of more than 18 000, plus 50 000 injured and 600 000 homeless. The extensive physical damage, which was re-estimated at US\$ 10.2 billion,¹ was largely absorbed by the public sector which re-built physical infrastructure, government buildings and private houses. The Natural Catastrophe Law requires the government to re-build decent housing for citizens who have lost their homes in natural catastrophes. Emergency aid and debt relief for injured families and businesses added to fiscal costs. The total budget cost between August 1999 and December 2002 amounted to US\$ 6.4 billion, or 3 per cent of GDP.²

To mitigate the contingent fiscal costs arising from the probability of other seismic shocks,³ a Compulsory Earthquake Insurance Scheme was put in place in 2000. The scheme is a state-owned legal entity,⁴ managed under contract by the Turkish Reinsurance Corporation. All registered residential dwellings across the territory (those located within municipal boundaries - excluding houses in small villages) must be insured by owners. The scheme divides Turkey into five risk zones, with the yearly mandatory premium for a private house ranging from US\$ 50 in highest risk regions to US\$ 10 in lowest risk regions. Premia are differentiated following rating categories based on hazard zone and quality of buildings.⁵ In case of earthquake damage, coverage is guaranteed up to a maximum of US\$ 45 000 per policy. To induce building owners to participate, the government mandated its deed offices to register only transactions effected on insured buildings, required municipalities to deliver water and gas supplies only to insured dwellings and decreed that the blanket coverage provided by the Natural Catastrophe Law would not be applicable anymore to potentially insurable, but uninsured, buildings.

Participation in the scheme soared in the beginning but then stalled somewhat. The number of policies reached 2 430 000 in 2001, covering 16 per cent of the country's housing stock. In the Istanbul area coverage reached 32 per cent. Certain policies have not been renewed subsequently and in 2003 15 per cent of insurable buildings in Turkey and slightly below 30 per cent in the Istanbul area were in the scheme. Slowing participation is probably due primarily to poor enforcement of the rules although increased budget constraints of households may also be playing a role.

The utilisation of the scheme in two recent earthquakes in 2002 and 2003 illustrates some difficulties of implementation. From 2000 to 2003, fifty earthquakes occurred in Turkey and the scheme paid total damages of US\$ 7 million to 4 200 beneficiaries. In two serious earthquakes with human toll however, in Afyon (Aegean region) in 2002 and Bingol (in the East) in 2003, the government waived the strictest provision of the Decree instituting compulsory insurance, declaring all citizens eligible for government support, insured or not. While the difficulty of excluding victims in such straining circumstances is common to all compulsory insurance schemes, waiving the rules creates moral hazard and reduces the incentives for participation. Thus it is imperative to enforce participation *ex ante*, to make sure that all potential victims are insured.⁶ Payouts to non-insured victims in the 2002 and 2003 earthquakes cost the Treasury an additional US\$ 200 million, dwarfing disbursements from the insurance scheme.

Authorities intend to root the scheme in a new Law, instead of the 2000 government Decree, in order to advance enforcement. Since the Earthquake and Natural Catastrophe Insurance Institution (DASK) announced that its total coverage capacity attained US\$ 1 billion in 2003, a lift in enforcement would provide the Treasury with significant additional cushion against earthquake risks (up to US\$ 6-7 billion in theory). Yet the sad fact is that the fiscal costs of a serious earthquake in a densely populated region are likely to be significantly higher. Notably, government buildings and physical infrastructures are not covered by the scheme, as they are "pooled" in the government portfolio. More "macroeconomic" (aggregate public sector) coverage, through adapted risk-coverage instruments in international insurance and financial markets and international co-operation, may need to be sought.⁷

1. On the basis of detailed estimates published by the Natural Catastrophe Co-ordination Council of the Ministry of Construction and Public Works in August 2004. Private housing destruction was estimated at US\$ 4 billion, commercial building damage at US\$ 4.2 billion and infrastructure costs at US\$ 1.7 billion.

2. The OECD Economic Survey of Turkey of 2001 provided a detailed review of estimates by different institutions. The measurement of second round economic effects and opportunity costs diverge, but direct fiscal costs are less controversial. See also Akgiray et al. (2004) and Lenain (2004).

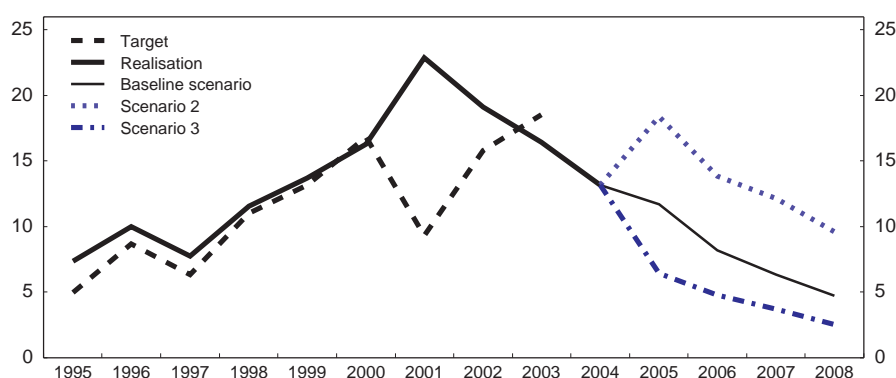
3. Notably in the demographic and economic heartland of Istanbul area. Forty-five per cent of the population lives in high-risk regions (Category 1) and 26 per cent in other threatened regions (Category 2). Dozens of earthquakes occur each year, with generally limited damage. In the last 100 years, 100 000 lives have been lost in earthquakes. For the future, risk estimates through

accepted methodologies appear to converge on a probability of 30 per cent for a serious earthquake (above degree 7.2 on the Richter scale) in the Istanbul area within 10 years, 50 per cent within 20 years and 65 per cent within 30 years. See Armijo and King (2000), "Seismic hazard in the Marmara Sea following the 17 August 1999 Izmit earthquake", *Nature*, 16 March.

4. Earthquake and Natural Catastrophe Insurance Institution (DASK) controlling the Turkish Catastrophe Insurance Pool (TCIP).
5. No coverage is provided for the contents of dwellings. Additional insurance for buildings and contents can be purchased from private insurers on voluntary basis.
6. The goal of achieving high participation, however, raises certain delicate registration and building quality issues, as 65 per cent of all buildings in Turkey (in number, and not in capacity or value) do not have building permits, and 30 per cent are on non-constructible areas. The coverage of these buildings by formal insurance would be administratively and technically difficult and would also distort the actuarial balances of the scheme and complicate international reinsurance. Special policies will be needed in the face of this problem, and resettlement will appear imperative in a number of cases, increasing the fiscal toll.
7. A recent review of international insurance coverage of large-scale disasters concluded: "Adequate financial response to risks ... exceeding the current financial capacity of the insurance industry and the government of a given country ... may only be provided via an international mechanism involving states as last resort capacity, and possibly the financial markets in the future." See Vignial-Denain (2004).

6. On the other hand, lower spending pressure should be expected in the service costs of public debt. After attaining a very high level in 2001, interest payments declined as a per cent of GDP following the reduction of the public debt to GDP ratio, strong primary surpluses, real currency appreciation and the drop of government risk premia. Assuming that fiscal discipline is fully maintained, real interest rates continue to converge to international levels, and the economy remains on its current growth path, the OECD Secretariat projects yearly savings in debt service costs up to 10 per cent of GDP by 2008 (Figure 11).¹³

Figure 11. Scenarios for service costs of public debt under different interest rate assumptions
Per cent of GDP



1. The baseline scenario is based on a decline in the nominal interest rate from 19.2 per cent in 2004 to 6.3 per cent in 2008.
2. Scenario 2 assumes a 50 per cent higher nominal interest rate over the baseline scenario in 2005 and a slower decline afterwards.
3. Scenario 3 assumes a 30 per cent lower interest rate in 2005 and a slightly more rapid decrease afterwards (reaching 4.1 per cent in 2008).

Source: OECD.

Shortcomings of traditional budget institutions

7. An absence of political will by successive coalition governments to reign in budget, off-budget and quasi-fiscal spending was behind the spectacular fiscal worsening of the past decade. Drifts were

13. *OECD Economic Survey of Turkey*, 2004.

facilitated by changes in the economic environment, notably the liberalisation of capital markets which permitted easy foreign exchange borrowing by budget and off-budget institutions and which also led to excessive risk-taking by banks. Public expenditure institutions were permissive to these drifts.

8. Relatively surprisingly for an OECD Member country, general government fiscal balances were not reported in national accounts until very recently. The “consolidated government budget”, the most comprehensive concept utilised by the Ministry of Finance and the Undersecretariat of Treasury in conjunctural fiscal management included the budgets of central government ministries and agencies, three extra-budgetary funds,¹⁴ the *budget transfers* to social security institutions and the *budget transfers* to local governments (without, however, integrating the *total revenues and expenditures* of social security institutions and local governments). In preparing the consolidated budget, the current expenditures, the capital expenditures, and the transfers to social security institutions were also handled separately, albeit through co-operation, respectively by the Ministry of Finance (MoF), the State Planning Organisation (SPO), and the Undersecretariat of Treasury (UT). SPO published a yearly estimate of all-encompassing general government balances for the purposes of its five-yearly development plans and annual programmes, but this was not part of the national accounts and had no adequate intra-annual frequency for macroeconomic management.¹⁵ In 2000, an *ad hoc* team of Treasury, SPO and MoF officials gathered as part of a World Bank project to produce more detailed but still tentative general government accounts for the period 1995-2000. The International Monetary Fund (IMF) has also established a monitoring system of the fiscal stance in *general government terms*,¹⁶ which does not aim at exhaustive general government accounting but focuses on the key and fiscally most risky components of public finances (Box 3).

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14. 61 extra-budgetary funds (XBFs) have been integrated into the central government budget in 2001, except three: the Defense, Social Solidarity and Privatisation. Other XBFs are managed outside the central government budget: the Promotion and Publicity Fund (for international tourism promotion), Saving Deposits and Insurance Fund (for banking guarantees) and the new Unemployment Insurance Fund.
15. The public sector balances compiled by SPO cover all accounts under the consolidated budget, social security institutions, state economic enterprises (in terms of net transfers to/from them), extra-budgetary funds, local authorities, the revolving funds of budgetary institutions and the new Unemployment Insurance Fund. This compilation is included in the so-called “General Economic Targets and Investments Report” approved by the High Planning Council (the economic sub-cabinet) and are presented to the Parliament together with the budget proposals during budget talks. It is also utilised in the Pre-Accession Economic Programmes submitted to the European Union. However, these general government balances are not included in national accounts.
16. Eight reviews under the Stand-By Arrangement have been effected on that basis by the IMF since May 2001.

Box 3. The IMF methodology of fiscal monitoring

The main pillar of the Stand-By Agreement with the IMF is compliance with rigorous fiscal benchmarks. To monitor the development of the fiscal position at general government level, a primary surplus objective is set as a performance criterion. A detailed fiscal monitoring methodology has been defined.¹ The objective of this methodology is not to put in place fully fledged general government accounting by systematically monitoring and reporting the *total revenues* and *total expenditures* of general government entities, but rather to monitor the bottom-line fiscal position through primary surplus of the consolidated government sector (CGS). The IMF's definition of primary surplus of the consolidated government differs slightly in terms of coverage and items from that used by Turkish authorities (the yearly compilation by SPO).

In the IMF methodology, the primary balance of the consolidated government sector covers the primary balances (primary revenues minus non-interest expenditures) of the central government, the three Extra Budgetary Funds covered in the "consolidated budget" (the Defense Fund, the Privatisation Fund and the Social Solidarity Fund), the Unemployment Insurance Fund, the Social Security Institutions, as well as the primary balances of the 27 State Economic Enterprises (SEEs).

The IMF's definition of **primary revenues** excludes:

- *Interest receipts* of the consolidated central government (including on tax arrears), of SEEs, and of the Unemployment Insurance Fund. The interest receipts of Extra-Budgetary Funds and Social Security Institutions remain included.
- *Profit transfers* of the Central Bank of Turkey.²
- The *revaluation account*.
- *Proceeds* from the sale of assets of consolidated government (privatisation proceeds or transfers thereof). However, revenues from sales of immovable property below TL 500 trillion are included.

The IMF's definition of **primary expenditures** excludes:

- Payments related to *bank recapitalisation*, and to the restructuring of private and public banks.
- The *risk account*.

The floor on the primary balance will be adjusted upwards for any increase in revenues arising from changes in revenue sharing arrangements between the CGS and other elements of the public sector, including local authorities. In addition it will be adjusted downwards (upwards) by the officially projected profits (losses) from state economic enterprises that were included in the performance criterion but were not subsequently realized due to their privatisation.

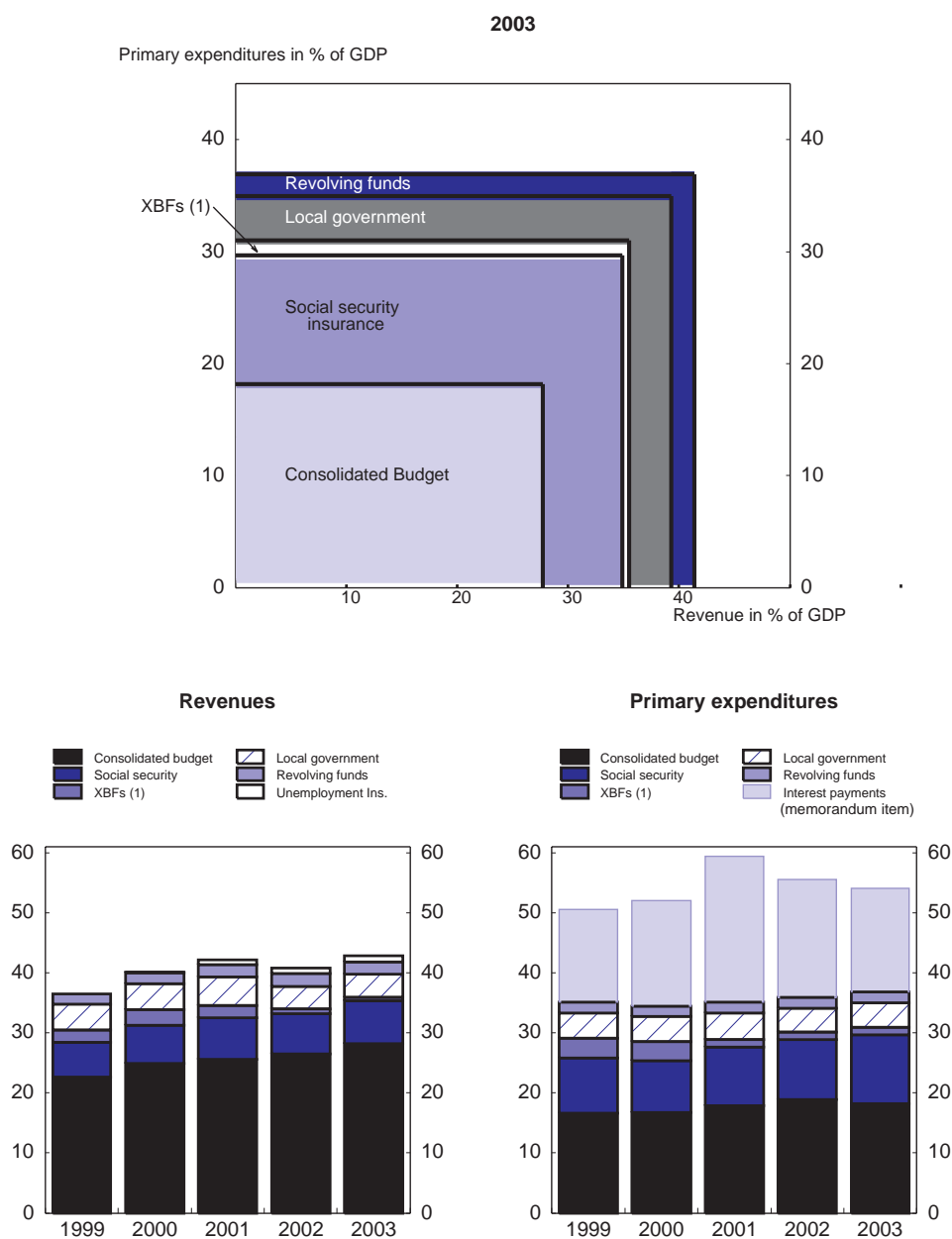
The IMF and Turkish government (SPO) methodologies give slightly different results. For 2003, the primary balance of the general government was estimated at 6.2 per cent of GNP by the IMF methodology and 6.4 per cent of GNP by the Turkish government methodology.

1. The most complete and updated exposition of this methodology is in the Letter of Intent of the Turkish government to the IMF of 2 April 2004.

2. Central Bank profits are included in the Turkish government methodology.

9. For the purposes of this Survey and on the basis of official data, the OECD Secretariat estimated the contribution of different government layers to general government accounts for the last five years. This estimation confirms that the "consolidated" budget generates only around 60 per cent of total government revenues and expenditures (Figure 12).

Figure 12. A construction of general government accounts
 Estimation by the OECD Secretariat



1. Extra-budgetary funds.

Source: OECD.

10. Quasi-fiscal activities have not been adequately tracked so far, either. While this is a familiar problem in other OECD countries as well, the omission has had more serious consequences in Turkey. Certain government-owned banks and enterprises which are formally in the corporate sector used to implement policy-driven spending. Quasi-fiscal activities came under better scrutiny after the agreement with the IMF in May 2001 and quasi-fiscal losses began to be explicitly capped, budgeted and reported. The amount of total duty losses of state-owned banks and state economic enterprises has been decreasing in real terms in the last three years. This sector should be monitored more systematically at the domestic

level, with a view to enforcing market-type corporate governance. In particular, large and recurrent losses of a small number of state economic enterprises must be closely watched and contained through governance changes and privatisations.¹⁷

11. The budget itself has been so far a historically-based document, carried forward with little adjustments year after year. It was run, until 2004, according to a law passed in 1927 and modelled according to the centralised and formalised French fiscal procedures of that time. Budget appropriations were extremely detailed and itemised and spending authorisations were handled by the officials of each ministry as well as by special budget officers appointed by the Ministry of Finance within each Ministry (“saymans”). Once the budget was voted, line ministries and spending agencies had limited discretion as to the utilisation of their appropriations. Budget codes followed administrative lines. An attempt, in the 1970s, to shift to programme-based budgeting did not succeed, as it was impossible to transcend administrative boundaries in preparing and implementing “programmes”. Programmes ended up converging with existing administrative lines. The lion’s share of allocations are pre-committed as wage bills for ministerial civil servants with life-time contracts, in social security and other social transfers granted as legal entitlements, and for the increasing interest costs of public debt. In 2003, approximately 85 per cent of the consolidated budget had such a *pre-committed* character, while around 10 per cent was dedicated to new capital investments.¹⁸

12. In the past and under such circumstances, policy initiatives implying sizeable spending needed to rely on sources other than the mainstream budget, deepening a functional divide between the official budget voted by the Parliament and catering to routine spending, and extra-budgetary (off-budget) funding channels utilised for government action. The standard example is the massive effort to increase road, irrigation, energy, telecommunications and public housing investments in the 1980s and 1990s, which were funded by large extra-budgetary funds.¹⁹ A more recent example is the ambitious government campaign to lengthen the duration of primary education from five to eight years. This decision was made in 1997 and swiftly implemented via a special budget programme partly provisioned by a World Bank loan. More than 1 per cent of GDP of new funding could be channelled annually to this project.²⁰ In this fragmented setting however, shaping an overall direction for expenditures under strategic prioritisation and transparent accounting was impossible.

17. The yearly losses of state economic enterprises belonging to the Privatisation Administration portfolio amounted to US\$ 600 million in 2003 (0.25 per cent of GDP), arising from the recurrent losses of four enterprises: Sumer Holding (consumer goods), EBK (meat and fish products), Divrigi (coal mining) and SEKA (paper mills). The Treasury portfolio also includes large loss-makers such as TCDD (railways) and TTK (coal mining).

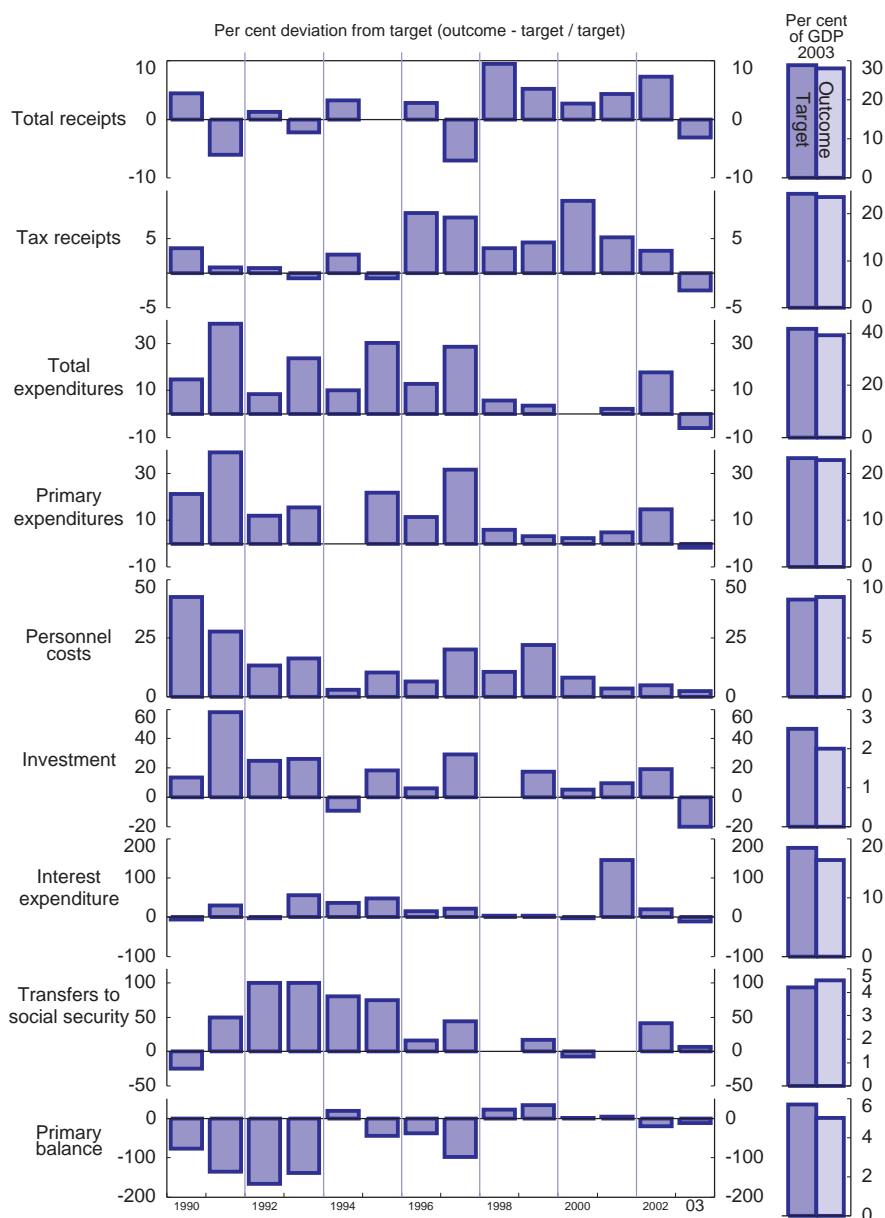
18. Investment expenditures were planned, co-ordinated and funded under the authority of the State Planning Organisation (SPO). SPO could achieve some resource re-allocation through this budget. However, only half of total public investments have been funded from central budget, the rest being carried out by public utility companies and municipalities.

19. Part of extra-budgetary funds for infrastructure and housing were integrated in the budget in 1993. The remaining funds were integrated in 2000 in form of special appropriation schemes, and will be entirely abolished in 2005. The public bank which financed collective housing investments was closed.

20. The special education levy was abolished in 2003. A quarter of the proceeds of the Advertisement Council continue to be earmarked for education spending.

13. Another problem is that governments often increased mandatory spending *over the course* of budget years. This happened recurrently between the mid-1990s and the early 2000s. As a result, original spending limits were frequently breached (Figure 13).²¹

Figure 13. Differences between central government budget targets and outcomes



Source: OECD.

21. This also happened in December 2003, when the government raised minimum wages and pensions by an unplanned 30 per cent, only one month after the adoption of the 2004 budget. In order to fund these increases without undermining the fiscal targets, indirect and excise taxes were augmented by 2 per cent of GDP and all discretionary budget appropriations (all appropriations except personnel, social security and interest expenses) were cut by 13 per cent.

14. These loopholes in the spending procedures prior to the 2000-2001 crisis were well-known by insiders, but their detrimental impact on public finances became fully visible at the occasion of the crisis. Analytical inquiries were then launched to analyse the sources of these drifts, and the factors which hampered the standard allocation, transparency, integrity and accountability of public expenditures. The most thorough research was launched by the non-profit Turkish Economic and Social Studies Foundation (Box 4).

Box 4. A fiscal transparency index

The Turkish Economic and Social Studies Foundation (TESEV) launched a set of projects on the status of fiscal management in Turkey, the need for improving fiscal transparency, and the main areas where international best practices could be adopted.

TESEV analysts started from the IMF Code on Fiscal Transparency, detailed further its four main criteria of fiscal transparency and established a reference framework to gauge fiscal institutions and practices. The framework encompasses: *i)* the transparency of boundaries between fiscal and non-fiscal organisations; *ii)* the accessibility of fiscal information; *iii)* the transparency of the budget preparation and approval cycle; *iv)* the effectiveness of budget implementation and control; *v)* the efficacy of Parliamentary auditing and surveillance; and *vi)* the administrative autonomy in the production of fiscal data.

Twenty-three experts from the public sector, academia and economic press were asked to use this framework to review and rate various dimensions of fiscal management, according to 108 different criteria. The index is compiled by averaging their judgments along each dimension, and scores by review groups (public servants, academics etc.) are published separately. The index was first computed in 2003, before the implementation of the Public Financial Management and Control Law, and scored a low 44 on a scale of 100 for the overall transparency of fiscal management. Assessments of professional groups did not differ significantly. Judgments along different dimensions were also broadly congruent and scores remained below 50 in all areas.

Future computations of this index will be useful to help monitor the progress of fiscal reforms, not only in terms of legal and regulatory measures but also of *actual implementation*. Areas with effective progress and those where progress is lacking can be identified. Regular publications of the index can help review the "performance" of the reform effort. In particular, the impacts of the laws introduced in the past two years can be systematically gauged. The Index could be detailed further in the future according to needs. Sub-central governments' fiscal practices and the quality of functional audits for core public services are potential candidates. The design and introduction of this index illustrates the role that civil society organisations may play in the improvement of fiscal transparency.

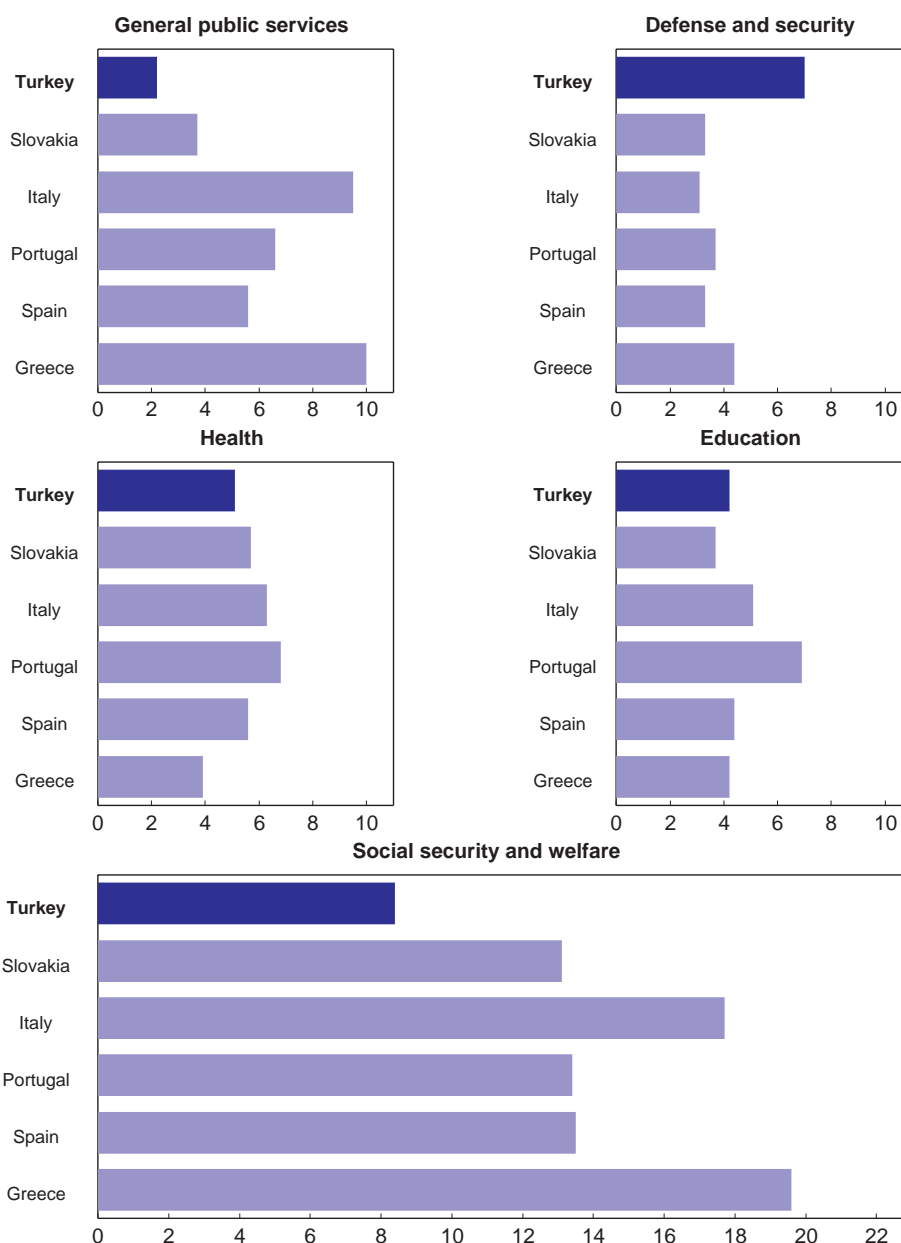
Failures in adequately resourcing core public services and institutions

15. In the past, the public expenditure management institutions lent themselves poorly to government deliberations on the strategic objectives of public spending, and to parliamentary and public consultations about them. No functional distribution of general government spending has ever been discussed or determined by the government and the Parliament in the past. The functional pattern of spending emerged only *ex post*, and always remained imperfectly known, as overall expenditures resulted from a multitude of non-co-ordinated spending initiatives by a variety of institutions. Functional budgeting started to be introduced in central government from 2004 (see below), and *general* government accounts compiled on functional lines will only be available from 2006. Figure 14, using various sources, presents a tentative *ex post* functional de-composition of recent general government spending.

16. It is not surprising in these circumstances that a number of key public institutions and services failed to be purposefully funded and effectively controlled. The quality of essential public services and their perception by the population appear highly unsatisfactory. While in many OECD countries the key

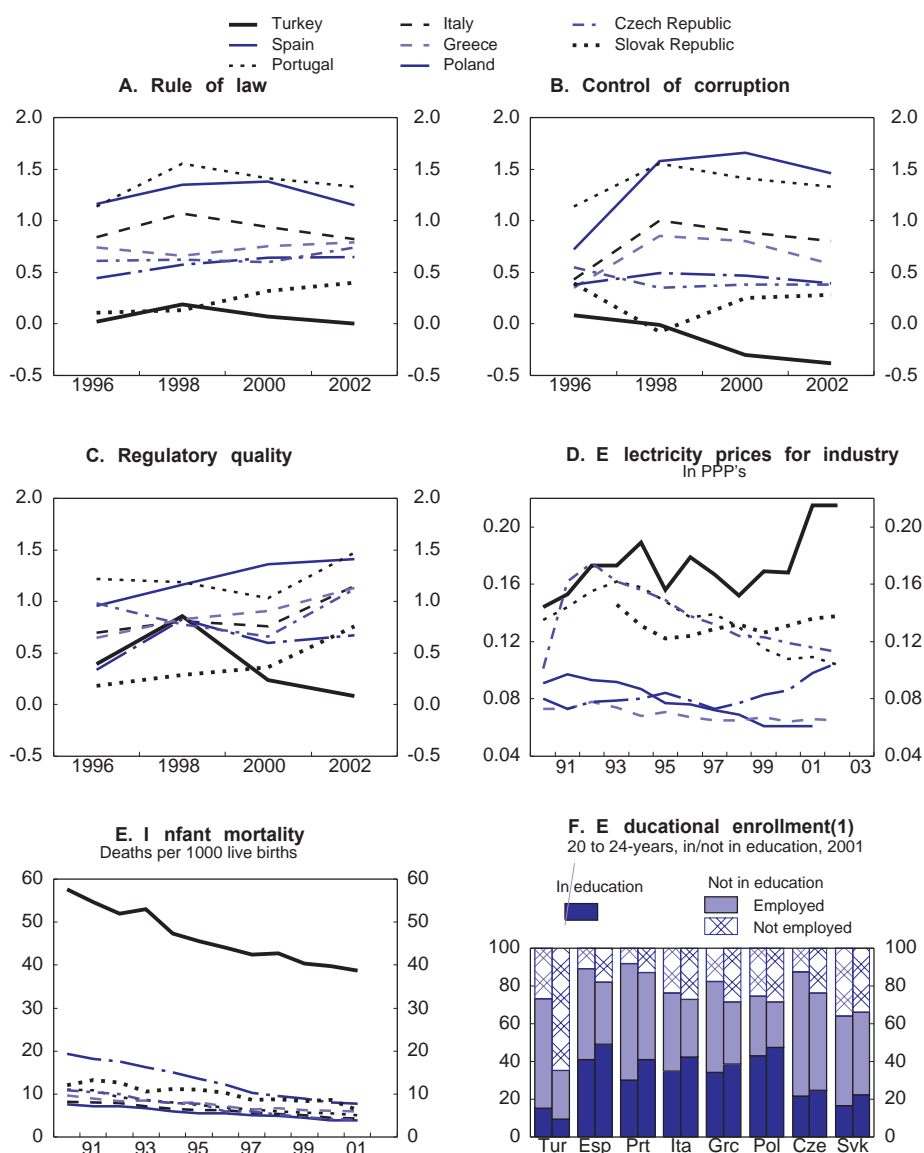
problem in public expenditure management is the effective control of aggregate spending, in the case of Turkey the provision of core public services and institutions at *adequate quality* has equally been a fundamental concern (Figure 15).

Figure 14. Ex post functional composition of general government expenditure in 2000¹
Per cent of GDP



1. 1999 for Turkey and Portugal.

Source: Government Financial Statistics, IMF and OECD estimates.

Figure 15. Indicators of shortcomings in core public services and institutions

1. The first bar represents men, the second bar represents women.

Source: World Bank Governance Indicators Project, 1996-2002 (2003) and OECD.

Law and rule enforcement

17. The legal infrastructure and rule enforcement environment have lagged behind the needs of economic development in Turkey. Entrepreneurship thrives in a dynamic market, but many individuals and enterprises, including those from abroad, seek to operate in a more coherent, efficient and predictable legal and judicial setting than that which Turkey has offered to date. The main obstacle noted by the business circles were administrative procedures and burdens, the improvement and simplification of which has been a primary agenda item for the government. This area has been regarded as a major impediment to attracting

FDI and as one of the reasons why Turkey could not ride the FDI wave of the late 1990s which brought significant financial and technological resources to the emerging market economies of Europe and Asia.²²

18. Formal legal and regulatory *rules* as well as their actual *enforcement* need to be improved and the government recognises this. The biggest problems are found in the administration of licensing regulations, land-planning and zoning decisions, environment protection regulations, tax accounting rules, corporate law and bankruptcy law. A long series of laws and regulations “sedimented” over time have created biases against free market entry, and competition - particularly in the heavily regulated sectors such as energy, telecommunications and transportation. The actual enforcement of rules is occasionally deficient, creating incentives to circumvent rules and regulations; and discouraging firms from operating in such an environment.²³

19. A thorough modernisation of the Turkish legal and regulatory environment and its methods of enforcement are in order. This requires not only major deregulation efforts but also additional resources and capabilities in the justice system, in line ministries, and in sectoral regulatory authorities. The relations between independent regulators, the competition authority and the existing ministries and administrative bodies need to be clarified. Against these needs, technical and human capital shortcomings and low wage levels in the justice system and line ministries appear to erode the motivation of the officials involved.²⁴

20. Shortcomings in the justice system have been particularly worrying. There are many indications that justice services are slower than required, that courts are not equipped with adequate physical facilities. Expert advice on specific issues is lacking, notably on commercial and regulatory matters. The government and the professional associations of the justice system recognise that important reforms are required, including simplification of legal codes, of the administrative rules governing justice, and of the specialisation and organisation of courts. Upgrading the professional training capacities for justice officials is recognised as an important requirement.²⁵

21. Such justice reforms raise important fiscal issues. First, providing adequate wages to the 7 200 judges is a permanent challenge. Judges are vested with prime responsibilities as the trustees of the third power, they should be independent from the executive branch, and their remunerations should be in line with those of skilled executives. Their salaries were once indexed on Parliamentarians’ revenues but then diverged downward.²⁶ Their office and transportation facilities should also be improved, notably with

22. They also discouraged potential participants in privatisation auctions. Privatisation auctions have often been undersubscribed because of legal and regulatory uncertainties surrounding future operations of privatised businesses. Administrative courts have cancelled the sale of the alcoholic arm of TEKEL (the tobacco monopoly) in 2003, and of TUPRAS (the largest oil refinery) in 2004.

23. Such a setting has been particularly discouraging for international investors with institutionalised corporate governance structures and skilled domestic entrepreneurs with sophisticated and long-term projects. This is confirmed by surveys by Transparency International (Transparency International, 2003), World Bank (World Bank, 2003) and World Economic Forum (World Economic Forum, 2003).

24. The existing amount and complexity of regulations appears to preserve the power base of individuals at various levels of hierarchy, who derive a number of advantages (including sources of income) that the nominal civil service salaries do not provide.

25. A Judicial Academy for judges was recently created. Judges are also exposed to various risks to their personal and family security and their office, transportation and home facilities need to be adequately protected.

26. A senior judge’s monthly net salary was TL 2.5 billion in mid-2004 (US\$ 1 700), the President of the Supreme Court earned TL 3.3 billion (US\$ 2 200), and a junior judge TL 1.3 billion (US\$ 850). By contrast, a Parliamentarian’s net monthly salary was TL 7.2 billion (US\$ 4 800) in 2004.

regard to security. By contrast, there is evidence of sizeable waste in the present organisation of the justice system: too many provincial court centers (“Adliyes”) occupy excessively large buildings with large operating expenses. The Ministry of Justice estimated that as many as 140 provincial court centers could be closed. Liquidating such centers face the usual obstacles against any administrative closures.

22. The Justice system receives relatively low central budget allocations (fluctuating around 0.8-1 per cent of GDP per year) but resorts to financing from large off-budget foundations and revolving funds. These are financed by optional or mandatory contributions by the users of the justice system. The role of off-budget sources’ in the financing of the justice system is now questioned on equity and fiscal transparency grounds, and the government has decided to integrate these revolving funds in the budget. However, it is not clear to what extent any “losses” can be compensated with increases in ordinary budget allocations. The future of the revenues of the main revolving fund of the Ministry of Justice (Isyurtları Kurumu), which is also in charge of production activities in prisons, remains an open question.²⁷

23. The intended modernisation of the *legal and judicial codes*, of methods of *administration of the justice system*, and of its physical and human infrastructures will require additional human, financial and material means. International co-operation in the process of convergence with the EU *acquis* may bring useful contributions in this area.²⁸ A clear justice reform strategy within a medium-term fiscal plan will be needed to provide a stable and purposeful framework to these efforts.

Education

24. Turkey has invested considerable resources over the past decades in the establishment of a public education system and spends around 4 per cent of GDP annually on public education. In spite of starting with a weak educational infrastructure it has achieved major strides in literacy and primary school enrollment. The quality of the overall education infrastructure has improved. Yet, sizeable inequalities remain and have increased in the recent period. Differences are visible in secondary education, between a large number of public general and vocational high schools which operate with limited means, and a small number of elite institutions employing high quality human and material resources.²⁹ The registration fees in private high schools are considerable and there are -- at times sizeable -- market-determined wage differences between public and private sector teachers.³⁰ Physical resources (school and classroom facilities, computer and internet access, other educational material) are also unequally available. The government now considers it a priority to reduce these sizeable inequalities in educational resources across regions and education levels.

27 Isyurtları Kurumu will not be closed down and will continue to run economic activities in prisons, but may lose its earmarked tax revenues which have represented to date its main revenue source.

28. Recent inquiries in the framework of the “Council for the Improvement of the Investment Environment” helped to identify the main biases and backed a new law on FDI which streamlined investment procedures. As confirmed by the latest Survey of the Association of Foreign Investors additional simplifications are nevertheless needed, on sectoral and practical grounds (YASED, 2004).

29. Some of the elite institutions are publicly-owned and offer free education to a small number of selected students, while many are private and access is rationed by high registration fees.

30. Many public sector teachers find it impossible to live on their nominal salaries alone, and take supplementary jobs or engage in private tutorships. Extra-curricular training became widespread in response to quality shortcomings in public education. In 2003, 88 per cent of successful candidates in university entrance examinations had attended extra-curricular courses, at a total private cost of TL 700 trillion (0.25 per cent of GDP).

25. The performances of high schools remain particularly dispersed.³¹ Differences in the quality of secondary education extend to subsequent labour market performance of students.³² Overall, the unemployment rate of high school graduates remains very high, at around 13 per cent, while this rate is only slightly lower for vocational school graduates at around 12 per cent. Unemployment rates are lower for workers with no education.³³ The overall weakness of public education remains in all instances undisputed.³⁴ There is consensus in society on the need for a fundamental reform.³⁵ The Ministry of Education declared in summer 2004 that a critical review is focusing on six main areas: *i*) Increasing *effective* enrollment rates;³⁶ *ii*) modernizing the curricula; *iii*) increasing the quality of teachers; *iv*) equipping schools with new technologies (notably computers); *v*) developing personal counseling for students; and *vi*) rehabilitating school buildings (against earthquake and other catastrophe risks).

26. Such far-reaching efforts will have fiscal implications. According to the Ministry of Education, *non-wage* current spending would need to rise (mainly for teaching material); wages will need to include a larger performance element,³⁷ and the investment budget for additional classrooms and building

31. As shown by recent tests and university entrance examinations. In university entrance tests in 2003, the rate of admission of high school graduates to the most demanded departments of universities ranged from 75 per cent for the graduates of the elite “science high schools” (3 150 graduates in 2003), to 11 per cent for the graduates of ordinary high schools (203 000 graduates), and to around 3 per cent for the graduates of “vocational high schools” (80 000 graduates in total). In the 2004 university entrance tests, regional differences also became very visible: low income eastern provinces could only place 5-6 per cent of their high school graduates in Universities.

32. See Gursel (2002).

33. This fact has inspired different explanations. One approach stresses the increase in the reservation wage of high school graduates, also invoking the self-selection bias of their (relatively higher income) families which can afford longer unemployment and search periods for their children. There is also a theory of rigid duality in the labour market where more skilled jobs are only available in the narrow upper segment. High school graduates would refuse taking jobs in the other segment, where vacancies are more numerous but subsequent chances of shifting to the main market are slimmer.

34. The weakness of secondary education in international comparison became visible when Turkey participated in international high school tests for the first time in 2000. 8 000 randomly selected students placed Turkey 31st among 38 countries in a range of secondary school level tests (the TIMSS system). Turkey also participated in the OECD’s comparative PISA tests for the first time in 2003, but results are not yet available. On the labour market impacts of shortcomings in general secondary education see Tansel (1999).

35. Results of university and high school entrance examinations for the academic year 2004/2005 published in Summer 2004 provoked a thorough public discomfort and debate in Turkey. 35 000 university candidates and 65 000 high school candidates just scored “nil” in these examinations. Many schools and regions fared poorly with a very low proportion of successful graduates while, in contrast, certain non-public schools in the low income areas of the country fared remarkably well.

36. The objective would be to raise enrolment rates toward target levels, for both boys and girls. Ministry officials recognise that primary school enrolment stays, at 92-95 per cent, below the official target of 100 per cent. According to a survey by UNICEF in 2003, in certain Turkish provinces, more than half of all girls aged seven to 13 do not attend school. The secondary enrolment rate of 60 per cent also needs to be further increased and its composition has to shift, with 60 per cent of students having to go to vocational schools.

37. Teachers’ wages are not at first sight low in Turkey if compared to the GDP per capita level. In primary education, a teacher with 15 years experience earn 2.12 times the GDP per capita in Turkey, against an OECD average of 1.31 (OECD, 2003). Many teachers get also overtime compensation, as the standard teaching time is shorter than actual workload. However, teachers also have a higher educational attainment

rehabilitation will need to increase.³⁸ By contrast, parent donations to individual schools and the revolving funds of the ministry, which represent important complementary sources of financing in the education system, may play a smaller role in the future, calling for larger top-ups from the budget.³⁹

27. The looming tension between resource needs and budget constraints call for a thorough review of budgeting methods and resource allocation in education. It justifies a shift to educational performance benchmarks, the utilisation of multi-year budgets at the level of the Ministry and in schools, and more school autonomy in exchange for higher performance accountability. In that regard, the stronger performance of private high schools in reducing costs and enhancing academic performance is being recognised across Turkey.⁴⁰ This may justify investigating not only the sources of excess costs and low performance in public schools, but also initiating reflection about separating financing from provision of services, by “purchasing” more services from private schools on a *per-student* basis, to develop competition and strengthen overall quality.⁴¹ Such a move would of course represent a departure from the *status quo*, and from prevailing understandings about desirable patterns of school organisation. It may also necessitate constitutional adjustments (see below) and would certainly require a particularly effective monitoring and auditing infrastructure to ensure the conformity of privately provided education to national rules and standards.⁴²

28. In tertiary education too, there are capacity bottlenecks and large quality differences between universities. Most universities are public and there are small-size elite institutions under private foundations, for a limited number of students.⁴³ The rapid built up of public enrollment capacity since 1990 could not be backed by adequate resources in the public system⁴⁴ and expenditure levels per student

than average working population and earn less than other *skilled* university graduates. Many teachers have second informal jobs which represent a distraction over their main duties.

38. The Ministry of Education budget was cut by 15 per cent in 2004 versus an increase of 12.5 per cent proposed by the State Planning Organisation.

39. These off-budget resources are questioned on equity grounds and there are complaints that “voluntary” parent donations have become in fact compulsory. In 2003, revolving fund revenues of public primary and secondary schools amounted to 0.34 per cent of GDP, versus 0.20 per cent in 1998. Government policy is to integrate the revolving funds in the budget and to reduce the weight of parent “donations”.

40. Experts recognise that certain private schools are more cost-effectively managed and obtain better results than the public sector counterparts. Evaluation studies controlling for student characteristics are, however, not available. In the 2004 University entrance examinations, some private high schools in Eastern provinces achieved remarkable success – without only catering to wealthy families – while public schools obtained very unsatisfactory results. One of the good performers, a private high-school in Urfa, is a corporate-type organisation holding a ISO 2000 quality certificate.

41. According to some observers, including in the Ministry of Education, better service and performance than presently offered ought to be available with the current TL 2.5 billion (US\$ 1 700 at current exchange rates) spent per student per year (average of public primary and secondary education).

42. Indeed, the Ministry of Education might be better positioned to fulfill such tasks, rather than centrally managing 650 000 teachers and tens of thousands of schools.

43. Twenty-three private universities enrol 3.9 per cent of all students – this proportion may approach 5 per cent in the years ahead.

44. The total number of students increased from 584 000 in 1989 to 1 568 000 in 2002. In the same period the number of teaching personnel increased from 28 000 to 65 000. Student/teacher ratios in undergraduate education average 35 but fall to 15 when distance education is excluded (and to 17 when graduate students are included). It varies from 12 in a prime private university, to 200 in a disadvantaged public university. This ratio is 8 in Germany, 10 in Poland, 16 in Greece and 20 in Korea. Average expenditure per student in

have stagnated or declined, notably for the most disadvantaged universities in remote regions.⁴⁵ The large proportion of students who are directed to distance (mail-based) education (35 per cent of total enrollment) receive an education with limited labour market relevance. While graduates of lower rated public universities face high unemployment rates,⁴⁶ graduates from elite universities receive a highly praised training and are in demand in the national and international labour market. However, fees in private universities are extremely high⁴⁷ and as their enrollment capacity is low Turkey remains the OECD country with the lowest share of student contributions in the financing of tertiary education. In public universities, registration fees are marginal; they constitute only 5 per cent of current costs.

29. However, universities generate growing revenues from their revolving funds, which they activated after the severe budget pressures of recent years. Their revolving funds generated revenues of TL 600 trillion in 2000 and 2.3 quadrillion in 2003 (US\$ 1.5 billion at current exchange rates), representing 70 per cent of government budget appropriations to universities in 2003. However, these off-budget sources are unevenly available to different universities⁴⁸ and face uncertainties for the future, as do revolving funds in other general government entities.⁴⁹

30. Student loans with low interest rates constitute another fiscal cost of higher education.⁵⁰ They help students finance housing and boarding needs and represent a non-negligible budget cost. They are difficult to allocate optimally -- students truly in need are difficult to identify-- while delinquency rates on loans are abnormally high, transforming them into *de facto* government grants.

31. The need to overhaul the public finance and governance system for universities is widely recognised.⁵¹ To overcome the presently severe under-resourcing, the weakness of education quality and accountability in several universities, the growing duality in the credibility of different universities in the labour market and the irrelevance of distance education, more purposeful resource allocation is needed. The process of “creating” universities and university departments in response to local demands without securing an adequate funding basis -- a practice which escalated in the 1990s -- cannot be sustained. Capacity growth in tertiary education should follow a strategic medium-term plan, within a clear fiscal framework.

Turkey decreased from US\$ 2 650 in 1993 to US\$ 2 000 in 1998 and was only US\$ 755 in public universities (The average spending in OECD countries is US\$ 5 900 per student).

45. See Yuksek Ogretim Kurulu (Higher Education Council), 2003.

46. When the graduates of distant education are included, the aggregate unemployment rate of university graduates is higher than that of high-school graduates (See Figure 9.B).

47. They match fee levels in the most expensive North American universities - at current exchange rates. At purchasing power parity rates, fees are easily double those in international universities.

48. The importance of revolving funds depends on universities' departmental structure. Universities including medical schools earn most of the revenues. Engineering departments also began to develop fee-earning co-operative research projects with enterprises.

49. Future governance structures and financial balances of university hospitals is under debate, and their status in the public hospital system will be further clarified. The Ministry of Finance also questioned universities' entitlement to accumulate reserves in revolving funds and occasionally transferred such reserves to the central budget.

50. Budget transfers to the Students' Loans and Boarding Institution (Yurt-Kur) doubled from approximately US\$ 100 million in 1998 to US\$ 200 million in 2002.

51. The Research, Planning on [and?] Co-ordination Council of the Ministry of Finance published a detailed study of the fiscal administration of the Turkish higher education system. See Kesik (2003).

32. As economic returns on tertiary education are mostly private, the role of student fees should be increased.⁵² Equity objectives can be pursued with scholarships, and student loans sponsored by the government and possibly managed by banks. Within a clarified fiscal framework, public universities should be given performance objectives taking into account their resource level and their students' background, and should be granted more managerial autonomy to pursue these objectives. Private (foundation) universities, which have a peripheral role in the system but a successful record so far,⁵³ could serve as real-life experiments on the benefits of academic and managerial autonomy under public supervision.⁵⁴

33. The fiscal reform of higher education appears well-suited for introducing new principles of public management to this human-capital-intensive environment. The combination of national long-term planning, strong quality control, accountable governance bodies, academic and managerial autonomy, performance-based budgeting, cost-based user fees, and direct public transfers to targeted social groups to promote equal access to services could produce inspiring results. The total amount of public resources dedicated to education in Turkey is below the level in other OECD countries as a share of GDP, and need to be increased, but the relevance of their direction, their efficiency of use, and their capacity to leverage private funding at the primary, secondary and tertiary levels need to be fundamentally improved.

Health

34. The health system shows similar features to those in the education system. Big efforts by the government over the past decades have helped to achieve important progress in public health and 5 per cent of GDP is spent annually in this area.⁵⁵ Yet the average health status of the population falls short of comparable countries. There is no formal universal health insurance but nearly the entire population has some access to public health facilities,⁵⁶ even if services remain severely rationed. Differences in health status and service availability across regions and population groups are wider than in other OECD countries (Figure 16).⁵⁷ There is also evidence of significant inefficiency and waste in the allocation of health spending in the two main cost items: *hospital expenditures* and *drug reimbursements*.⁵⁸ As in the

52. Some experts estimate that student registration fees in public universities could be rapidly raised from the existing level of 5 per cent of current expenditures to at least 25-30 per cent, if accompanied by an effective student loan system. See Kesik (2003).

53. Their successful record reflects in part the fact that they are "cream skimming" the student and faculty markets because of the severe resource constraints in public universities. They pay their faculty internationally competitive salaries. By doing this they reveal, rather than cause, the underresourcing problem in public universities.

54. The prestigious private foundation universities have credible boards of trustees. They are also overseen by the Higher Education Board.

55. The efforts of private foundations should also be recognised. For instance, the Foundation Against Tuberculosis has been instrumental in the eradication of this disease.

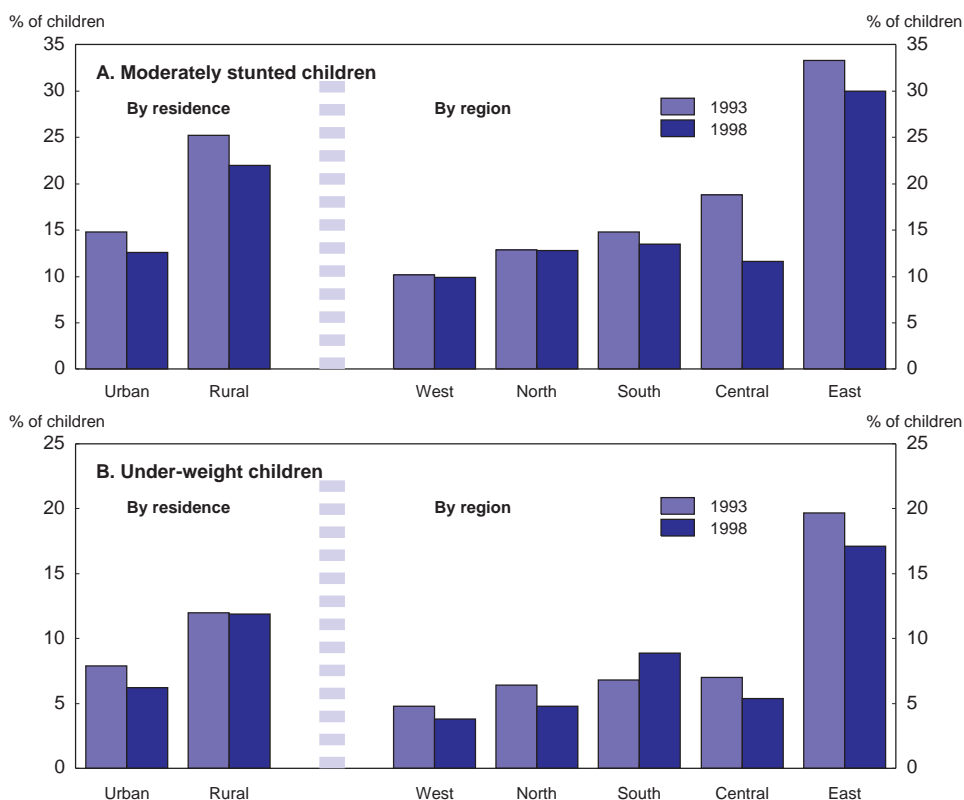
56. Either as social insurance beneficiaries, their dependants, or "green card" holders insured by the state.

57. Full medicalisation of pregnancy, a key objective of health policy for decades, has not been achieved across the territory. A new "Population and Health Survey, 2003" will be published in Autumn 2004 and present the latest information in this area. According to this Survey, around 50 per cent of pregnancies and around 50 per cent of births are medically attended in the Eastern regions. The average infant mortality rates which were six times above OECD averages at 35 per thousand during the 1980-1997 period are now below 30 per thousand. The maternal mortality which was above 100 per hundred thousand births during the 1980-1997 period is now at 70 per hundred thousand.

58. The Parliamentary Commission of Inquiry on Corruption and Irregularities in the Public Sector spotted the health system as an area suffering serious misspending and overbilling. See TBMM Yolsuzluklari

education system, private and commercial services proliferated in response to deficiencies in public services, but they are available to households with an ability to pay. Large wage differences developed between health professionals in the public sector and professionals engaged in commercial services.⁵⁹

Figure 16. Regional differences in health status¹



1. Prevalence of stunting and under-weight among children, classified by residence and regions.

Source: TDHS.

35. The public hospital sector is both fragmented and centralised. Ministry of Health hospitals, wage earners' insurance (SSK) hospitals and university hospitals are all funded from general government revenues, but are separately planned and governed, and service different user groups. Hospital budgets are detailed and itemised, while staff (physician and nurse) hiring decisions, employment relations and wage practices follow central rules.⁶⁰ Procurement practices are directed from the top in most cases. Hospital

Arastirma Komisyonu (National Assembly's Corruption Investigation Commission, 2003). Anomalies in the composition of expenditures are also observed: pharmaceutical reimbursements amount to 40 per cent of total spending versus 15 per cent in other OECD countries.

59. Public sector professionals may be allowed to take secondary jobs in the commercial sector but rules governing these part-time arrangements are controversial and change frequently.

60. The wages of public health personnel, who are included in the civil service pay system, remain below private sector counterparts. Hospital revolving funds top up revenues for certain categories of personnel. The public system had difficulties hiring specialists in less developed eastern regions -- where revolving fund revenues are also lower. The Ministry of Health now uses fixed term contracts outside the public pay scale in such regions, where a public sector specialist physician can be paid up to US\$ 2 700 per month

managers appear to have relatively limited discretion in resource allocation, with no room to arbitrage between personnel, capital and procurement spending, and no freedom to introduce innovative, performance-based spending of their budget. At the same time, preventive care has been marginalised in the system.⁶¹ Rigidities appear to prevail also in pharmaceutical purchases, which account for no less than 30 per cent of total public health spending, and suffer imperfections in the selection of reference (reimbursable) drugs, limited recourse to generic products, and distortions in price negotiations with the suppliers of patented and branded products.⁶²

36. Detailed plans were developed to streamline and rationalise the public health sector, in line with international best practices.⁶³ But little action has been taken to date. Reform plans have aimed at merging and co-ordinating different components of the public hospital system, in order to enhance the autonomy of hospital managers by reinforcing *ex ante* corporate governance and *ex post* supervision mechanisms, and to reform the competitive procurement of pharmaceuticals and medical aids. An effective initiative was the recent authorisation of the cross-procurement of hospital services. Through this implementation, SSK (wage earner), ES (civil servant) and Bag-Kur (self-employed) insurance fund members will be able to utilise the hospitals of the Ministry of Health and SSK. This decision, which applied from January 2004, is a step toward the separation of the financing and provision of hospital services. Transparency is also expected to increase in drug procurement, as a new Public Procurement Institution is authorised to review practices in this area.⁶⁴ Authorities should make sure, however, that the planned decentralisation of hospital ownership (to sub-central governments – see the Public Administration Framework Law below) does not conflict with the separation of financing and provision principle, by putting local governments in a position of being both funders and owners of local hospitals. In all circumstances, a period of transition will be needed to build administrative competence in sub-central governments on health management matters. Although a non-negligible 5 per cent of GDP is dedicated to public health, the direction and efficiency of these resources call for significant improvements.

Infrastructure

37. As in other catching-up economies, the government used to dedicate a sizeable proportion of GDP annually to infrastructure development.⁶⁵ This has helped to equip the country with basic transportation, energy, water and communication networks. These networks are considered reasonably developed compared to similar countries, but suffer important shortcomings in quality, technological

(approximately US\$ 3 700 with revolving fund revenues), against a salary of US\$ 700 for a specialist in western regions (approximately US\$ 1 700 with revolving fund revenues).

61. Representing 3 per cent of the Ministry of Health budget in 2002.
62. In 2004, press revelations about large price differentials between high-cost drugs for different public purchasers attracted public attention. Drug manufacturers invoked legitimate marketing and medical experimentation practices. An official investigation was launched following these revelations.
63. A detailed and reportedly consensual health sector reform plan was developed with technical support from the World Bank in the 1990s. Implementation units were also created in the Ministry of Health. Practical application could, however, not proceed. See World Bank (2003 a).
64. Possibly in co-operation between the Competition Authority. Only a limited part of pharmaceutical markets are serviced by multiple manufacturers (since many products are patented and branded). Competitive procurement may not follow standard auctions and negotiations. The Competition Authority can help Health Authorities to develop a best-practice procedure in the light of international experiences.
65. Total infrastructure investment has oscillated between 4 and 6 per cent of GDP in recent years – see Figure 10.

sophistication, and cost and price performance. Turkey offers at present some of the OECD's most expensive telecommunications, electricity and natural gas services for business users.⁶⁶

38. Budget constraints have limited new infrastructure investments since the mid-1990s. Financing constraints have motivated, notably in the energy and water sectors, growing recourse to Build-operate-transfer (BOT) and Build-own-operate (BOO) contracts, where private investors rapidly build up additional capacity in exchange for long-term purchase agreements at guaranteed prices.⁶⁷ Several reforms were introduced since 2001 in these sectors along the *EU acquis*, but implementation has lagged. The existence of large cross-subsidies from professional to household customers is a major factor hindering free entry and competitive pricing, even if recent laws and regulatory decisions aim at preventing such tariff-distorting transfers. Recent legislation that prohibits cross-subsidisation in state economic enterprises, Turk Telekom's recently introduced tariffs favouring business users, and the new Electricity Sector Reform and Strategy Plan prescribing a calendar for liberalisation are steps in the right direction.⁶⁸ Nevertheless, Turkey has not yet devised a successful overall strategy to engage private investment in infrastructures at satisfactory regulatory and pricing conditions.

39. A number of economically dubious infrastructure projects have been burdening the public investment portfolio. These projects were launched in response to political and other local pressures (construction of airports with limited use, launching of irrigation projects with particularly long completion periods etc.). Such drifts seem to have worsened in the 1990s. The total cost of the government's ongoing infrastructure project portfolio was estimated at TL 155 quadrillion (US\$ 100 billion) in 2002, while annual central budget appropriations were about TL 8 quadrillion (US\$ 5 billion), implying an average completion period of 12 years per project. This gap between project costs and annual appropriations was smaller a decade ago, and project completion periods were much shorter.⁶⁹

40. The State Planning Organisation (SPO) was charged, in the context of the 2001 stabilisation programme, with identifying the most dubious projects and those with the lowest prospects of completion. SPO prepared an "investment rationalisation program" proposing to freeze spending on such projects and to concentrate the limited resources on priority areas. The government followed these recommendations and the resulting narrowing of the project portfolio - in spite of an aggregate reduction in investment spending - was welcomed by many market participants.⁷⁰ As a result, average project completion period declined from 2002's 12 years to 8 years in 2004.

66. *OECD Economic Survey of Turkey*, 2004.

67. The full commercial details of these contracts were never published. They now come under criticism as providing unjustifiably high rates of return to private investors - because the reference cost levels they have been built on appear well above international standards. As the government has guaranteed minimum sale and price levels to BOO and BOT investors, the Treasury will top up the difference in case market demand and price projections fall below these thresholds.

68. The new and important law n° 4736 passed in 2002 prohibits the pricing of state economic enterprises' and public utilities' goods and services at below-cost levels, and therefore bans cross-subsidisation. The Telecommunications Authority implemented this principle in its regulation of Turk Telekom's monopolistic tariffs from 2004.

69. As short as 6 years in the 1980s. Like in other spending areas, spending drifts of the 1990s made the public investment portfolio less rational, with more than 3000 projects pursued concurrently. Some of them have no prospect of completion in the foreseeable future. The large-size irrigation projects in the Bafra and Carsamba plains in the Black Sea region are telling examples: They were launched in 1980 and are still being carried on.

70. No player in the market complained about detrimental cuts in economically significant areas.

41. The ongoing reforms of public procurement (see Box 12 below) should also play a role in improving returns from investment spending. Slack exists in physical construction costs which represent the largest share of government investment. The Ministry of Construction noted in August 2004 that Turkey suffered, until 2003, from exceptionally high construction costs by international comparison, in spite of lower wages.⁷¹ New procurement procedures putting an end to the practice of *ex post* price majorations after the granting of contracts should help reduce this abnormal wedge. The Ministry declared that, already in 2003, 1600 km of double-lane motorways were contracted at lower than usual costs.⁷² It is important to maintain good quality control over rapid and low-cost construction works in order to avoid quality losses, and to make savings long-lasting.⁷³

42. Turkey's infrastructure development policies need further clarification. Respective responsibilities of public and private investors in infrastructure funding, the social ("universal") service commitments of the state, the pricing principles for business and household users, the room for cross-subsidies and competitive price setting must be specified. Further private investment is desirable in telecommunications, electricity, natural gas and air transportation. This will require a supportive regulatory framework and the realisation of basic public investments of a public good character.⁷⁴ The role of central and sub-central governments in planning and funding these basic investments, the role of sectoral regulatory agencies in capacity planning, and the contributions of commercial suppliers should be clarified.

Agricultural services

43. Even though 34 per cent of the working age population is employed in the agricultural sector, agricultural production contributes only 12 per cent to Turkey's GDP. Hence, farming is a sector with a very low labour productivity. Moreover, the productivity of agricultural activities falls short of that in other OECD countries. Many farmers still rely on traditional production methods and have only limited access to modern agricultural know-how and technology. For example, the use of production-enhancing inputs, like chemical fertilizers and pesticides, and the degree of mechanisation are low.

44. The recent agricultural policy reforms have replaced input and production-linked subsidies by direct income support payments (DIS), which are, however, still subject to certain planting requirements. This partial decoupling of producer support makes the income transfers to the agricultural sector more transparent and has the potential to increase the *transfer efficiency*⁷⁵ of agricultural support, so that a larger share of the intended support actually reaches the farmer and is not absorbed by the up- or downstream sectors.⁷⁶ The policy reforms will tend to make agricultural production more market-oriented. Although deficiency payments for some products and livestock subsidies are still available, farmers will no longer have an incentive to base their production decisions on support for different crop or animal products. They

71. For example, in road construction, one km of highway costed US\$ 10 million to build, against an international reference price of US\$ 4 million.

72. Stagnation in construction markets which increased competition also helped.

73. Shortcomings in construction quality were reported after another "high speed" construction campaign, when replacement houses for the victims of the 1999 earthquakes were built.

74. For instance, the interconnection facilities between the Turkish and South Eastern European electricity grids to facilitate electricity trade, the intercity gas pipelines to facilitate the development of commercial gas demand and supply are such facilities of a public good character.

75. Support schemes' success in transferring resources to *intended* beneficiaries.

76. Nonetheless, concerns exist about the distributional impacts of the DIS system - *i.e.* its lack of focus on farmers truly in need. Farmland eligible for DIS was initially capped to 20 hectares per farmer but this was later raised to 50 and made practically the entire planted land eligible. It is estimated that around 50 per cent of DIS payments go presently to 15 per cent of farmers.

will receive a lump-sum payment based on acreage and decide on production patterns according to comparative advantage.⁷⁷

45. However, while the new agricultural support system will improve the efficiency of farming, it exposes farmers to a much larger degree of market risk than the previous regime. In this context, a well-functioning agricultural extension service is important to advise farmers on appropriate cropping patterns, to diffuse new farming methods and technologies, and to improve the marketing of products. Turkey has very favourable natural conditions to expand its output of labour-intensive, high value-added agricultural produce, such as fruit and vegetables, and could increase its exports of these products. Yet, there is a skill-deficit along the supply chain that impedes international competitiveness. Overcoming these deficiencies requires a fundamental upgrading of the rural development policy to enable farm advisers to respond to the new challenges in the more market-oriented agricultural sector.

Introduction of reforms to improve public spending efficiency

46. Fiscal stabilisation since 2001 was chiefly based on tax increases and only to a limited extent on spending reductions. Cuts were effected in the central government spending but, due to continuing pressures in other general government expenditure categories, notably in transfers to social security institutions, total primary spending could only be frozen as a share of GDP. To contain spending durably and sustainably, while remedying resource shortfalls in core public services, serious structural reforms are necessary.

47. Important reform initiatives to that effect were undertaken in parallel with the 2001 stabilisation. To make public expenditures more transparent and directed towards clear policy objectives, a number of projects have been introduced in co-operation with the International Monetary Fund, the World Bank and in the framework of the convergence programme with the European Union *acquis*. These are now at an early stage of implementation and require significant additional expertise in central economic agencies, in line ministries and sub-central layers of government. Their proper co-ordination will be important for exploiting synergies and harvesting their full benefits.

48. This section reviews these initiatives by summarising their *objectives*, identifying the *issues* that their enforcement raise in the present Turkish context, and formulating, in the light of other OECD countries' experiences, *recommendations* for successful implementation.

Integrating the general government accounts

49. A landmark Public Financial Management and Control Law was passed in December 2003 and will be applicable from the preparation of the 2006 budget. For the first time in the history of public finances in Turkey, it aims at consolidating *all* fiscal operations of the government in an integrated general government approach, from the preparation to the closing stages of the budget (Box 5 and Table 3).

77. During a transition period, deficiency payments and livestock subsidies will be maintained in a number of product markets where the shift to direct income support is estimated to risk undesirable disruptions of production.

Box 5. The new budgeting system

The central budget will remain the pivot of public finances and will be prepared according to a schedule common to other OECD countries. All extra-budgetary funds will be integrated in the central budget. A medium-term economic programme will be prepared by the State Planning Organisation and will cover macro policies, targets and main economic indicators in the context of development and strategic plans and general economic conditions. It will be adopted by the end of May 2005 by the Council of Ministers. A *medium term fiscal plan*, consistent with the medium term economic programmes will be prepared by the Ministry of Finance. It will include total revenue and total expenditure projections, budgetary targets and proposed budget appropriation ceilings for public administrations. It will be endorsed by 15 June 2005 by the High Planning Council. These documents will set the framework for the discussions and negotiations with line ministries and spending agencies, before political reconciliation in the Cabinet and the Parliament.

A rolling multi-yearly budget framework - for the two following years after the budget year - will accompany the budget law. The voted budget will be implemented through a unified treasury system and the closing accounts will be presented shortly after the end of the budget exercise. A detailed audit report will be submitted to the Parliament before closing the accounts.

The accounts of the social security institutions, extra-budgetary funds and local governments will be prepared, implemented and closed according to their respective laws, but will be co-ordinated with the central budget. Their provisional budgets will be communicated to the Parliament before the vote of the central budget. Integrated general government accounts will be published in three-monthly periods, together with a yearly report shortly after the end of the budget exercise. The State Audit Institution (Sayistay) will have authority to audit all general government accounts and bodies.

To align the accounts with Government Financial Statistics (GFS) standards, the budget codification system is being overhauled. Each spending item will be identified in institutional, administrative, economic and functional terms and budgets and budget reports will be compiled according to these different classifications. The new codification system will be gradually applied to all general government entities from 2006.

Table 3. The new budget preparation cycle

Budget preparation process	Target dates each year
Medium Term Economic Program prepared by the State Planning Organisation (SPO) adopted by The Council of Ministers and published in the Official Gazette.	End May
Medium Term Fiscal Plan prepared by the Ministry of Finance (MoF) adopted by the High Planning Council and published in the Official Gazette.	15 June
Prime Minister's Budget Call and MOF's Budget Preparation Guide published in the Official Gazette.	End June
SPO's Investment Circular and Investment Program Preparation Guide published in the Official Gazette.	End June
Public administrations submit their budget revenue and expenditure proposals to MOF.	End July
Public administrations submit their investment proposals to SPO.	End July
High Planning Council (Economic sub-cabinet) sets macroeconomic indicators and budgetary ceilings.	October (First week)
Central Government Budget Law Bill is submitted to the Turkish Grand National Assembly (Parliament).	17 October
Parliament's plenary debate and budget approval.	December
The Central Government Budget Law is published in the Official Gazette before the commencement of the fiscal year.	End December
Public investment program to be prepared by SPO in accordance with the Central Government Budget Law, adopted by the Council of Ministers, and published in the Official Gazette.	15 January

Source: Turkish government.

50. This new system modernises the budgeting process according to international standards. However, it is not immune to the difficulties common to all OECD countries in running public finances *on a general government basis* while the social security institutions and local governments continue to operate outside the central budget. The new system improves fiscal co-ordination between general government entities by mandating municipalities to communicate their yearly budget plans by the month of June of the previous year, and by requiring the social security institutions to submit three-yearly rolling provisional accounts. Implementation from 2005⁷⁸ will reveal the strengths and weaknesses of the new design. At this stage, and in the light of international experience, the following features which concern the management of expenditures truly on a *general government* basis may deserve close attention:

- Social security institutions and local governments will prepare their budgets based on the multi-yearly budget framework. However, they have no legal obligation to comply with any overriding fiscal rule (constraining total general government spending or deficits) other than budgetary limits on central government transfers to them and relatively flexible rules concerning their borrowing. Their budgets should be made fully compatible with the macroeconomic framework and the fiscal strategy adopted by the government. *Provisional multi-year general government accounts* integrating social security and local government budgets can be prepared as an input to central budget discussions.
- A multi-year spending ceiling path should be established, with individual ceilings for the central budget and other components, for both *primary* and *total expenditures*. All general government entities should be required to comply with these ceilings.
- The central government's audit institutions should be required to audit all general government finances with the same standards, and with adequate resources. The Public Financial Management and Control Law and the Public Administration Framework Laws (see below) rightly stress the importance of (internal and external) audits, but procedures for the external auditing of sub-central government levels are not clearly spelled-out. Also, when *investigations* are required, they should be swiftly implemented. The respective responsibilities of the four existing audit and inspection bodies⁷⁹ as regards *procedural* and *functional* audits and subsequent *inspection, investigation and prosecution* tasks in all general government entities (*i.e.* including social security institutions and local governments) have to be clarified. The government will submit a new draft law on the Court of Accounts to the Parliament to clarify these issues.

Setting medium-term strategic objectives

51. The Public Financial Management and Control Law prescribes the introduction of functional budgeting in all areas of public spending. The Government, the Parliament and the public will be provided with a clear description of the policy objectives pursued by expenditures for both *ex ante* deliberations on budget priorities and arbitrages, and *ex post* discussions on achievements (Box 6).

78. The provisions of Public Financial Management and Control Law will be implemented in the public administrations within the scope of the general government as of 1 January 2005. According to the provisions of the Law, the medium term programme prepared by the State Planning Organisation will be adopted by the end of May 2005 by the Council of Ministers, and the medium term fiscal plan prepared by the Ministry of Finance will be adopted by 15 June 2005 by the High Planning Council. The new budgetary instruments of the multi-year budget framework and performance-based budgets will be introduced in the central government budget from 2006.

79. The State Audit Institution (Sayistay), the Ministry of Finance Inspection Council, the President's Inspection Council, and the Prime Minister's Inspection Council.

Box 6 Multi-year functional budgeting

In addition to the traditional institutional, administrative and economic classifications, the central government budget will also be presented, starting with the 2006 budget, according to functional targets. Ministries and spending bodies will report their budget proposals and budget reports according to functional objectives, by consolidating individual spending programmes along specific targets. This functional allocation of resources will be presented in a multi-year framework and should shed light on the government's policy priorities.

The Public Financial Management and Control Law mandates the introduction of multi-year functional budgeting as an innovative practice for line ministries and other spending bodies and requests the leadership and co-operation of the State Planning Organisation (SPO) and of the Ministry of Finance (MoF) for its gradual implementation. The Article 9 of the Law declares:

- "In order to elaborate missions and visions for the future within the framework of development plans, programmes and relevant legislation; to determine strategic goals and measurable objectives; to measure performances according to predetermined indicators, and to monitor and evaluate this overall process, public administrations shall prepare strategic plans in a cooperative manner.
- In order to provide public services at the required level and quality, public administrations shall base their budgets and their programme and project-based resource allocations on strategic plans, annual goals and objectives, and performance indicators.
- The State Planning Organisation is authorised to determine the strategic planning calendar and the public administrations to be in charge of preparing strategic plans, and to set out the principles and procedures concerning the correspondence between (sectoral) strategic plans and (national) development plan and programmes.
- Public administrations shall prepare their budgets on a performance basis and in concordance with the mission, vision, strategic goals and objectives included in the strategic plans. The Ministry of Finance is authorised to define the procedures and principles on the compatibility of administration budgets with the performance indicators stated in strategic plans, and the activities to be carried out by these administrations or other issues of performance based budgeting.
- The performance indicators that shall be set by the Ministry of Finance, the State Planning Organisation and relevant public administrations shall be included in the budgets of these administrations. Performance audits shall be carried out in the framework of these indicators."

52. The introduction of functional and results-oriented budgeting will inevitably face the teething difficulties which are also found in other OECD countries. Because of the particularly large gaps between actual and desirable performances in core public services, and the constraints on technical expertise in spending and expenditure management agencies, the introduction of performance-based budgeting will raise additional challenges in Turkey. In particular:

- An assessment of the current quality and performances of core public services is indispensable. Any significant weaknesses in these core services and their sources must be diagnosed. These assessments should determine to what extent shortfalls in services are due to under-funding, underinvestment *or* inadequate organisation, weak personnel motivation, and improper management. Respective roles of resource (budget) constraints and allocative and technical inefficiencies should be established.

- The government and the Parliament should clarify their policy objectives in core public services. Long- and short-term performance objectives should be spelled out for Justice, Education, Social Security (including health and retirement insurance), Physical Infrastructure and Rural (Agricultural) Support systems. Building on OECD economies' experiences, authorities should seek to build the largest possible support among political parties and civil society organisations around these strategic objectives.
- Technical ministries and the State Planning Organisation should be asked to assess and propose options for institutional arrangements (based on international experiences) for the provision of core public services. Such background work for institutional designs should be carried out in consultation with all involved parties, across the political spectrum and in civil society.
- In each key service area, a multi-year fiscal strategy setting out functional targets and selected institutional arrangements should be formulated. The amount of fiscal resources dedicated to each area, and performance objectives – including norms of distribution across the territory-- should be determined. In each area, room for “premium” services (which can be offered with additional comfort features, possibly at additional user fees, and even commercially) must be clarified.⁸⁰
- Strategic planning and results-oriented budgeting should be introduced in all areas, but given constraints on resources, it will be necessary to start from high priority areas. The Public Financial Management and Control Law requires the State Planning Organisation (SPO) and the Ministry of Finance (MoF) to introduce pilot projects in selected areas. Not only central budget organisations, but also social security organisations and local governments should be authorised to initiate pilot projects. The results of pilot experiments should be widely publicised.
- Multi-year performance budgets can only be successfully implemented if human resources in service organisations are flexible and responsive enough to pursue performance objectives. At all hierarchical levels, employees should be trained, equipped and rewarded for performance and it should be possible to sanction lack of commitment. In the Turkish context, where concerns about favouritism in government employment are traditionally pervasive, the highest possible degree of transparency would help build support for flexible personnel management.
- Training will be needed in spending ministries, economic agencies, sub-central governments and audit organisations to truly and seriously shift to multi-yearly functional budgeting. Audit organisations will need to achieve a quantum leap in expertise, in order to produce functional audits. The new laws designate them as agents of change and coaching in the diffusion of results-oriented budgeting.

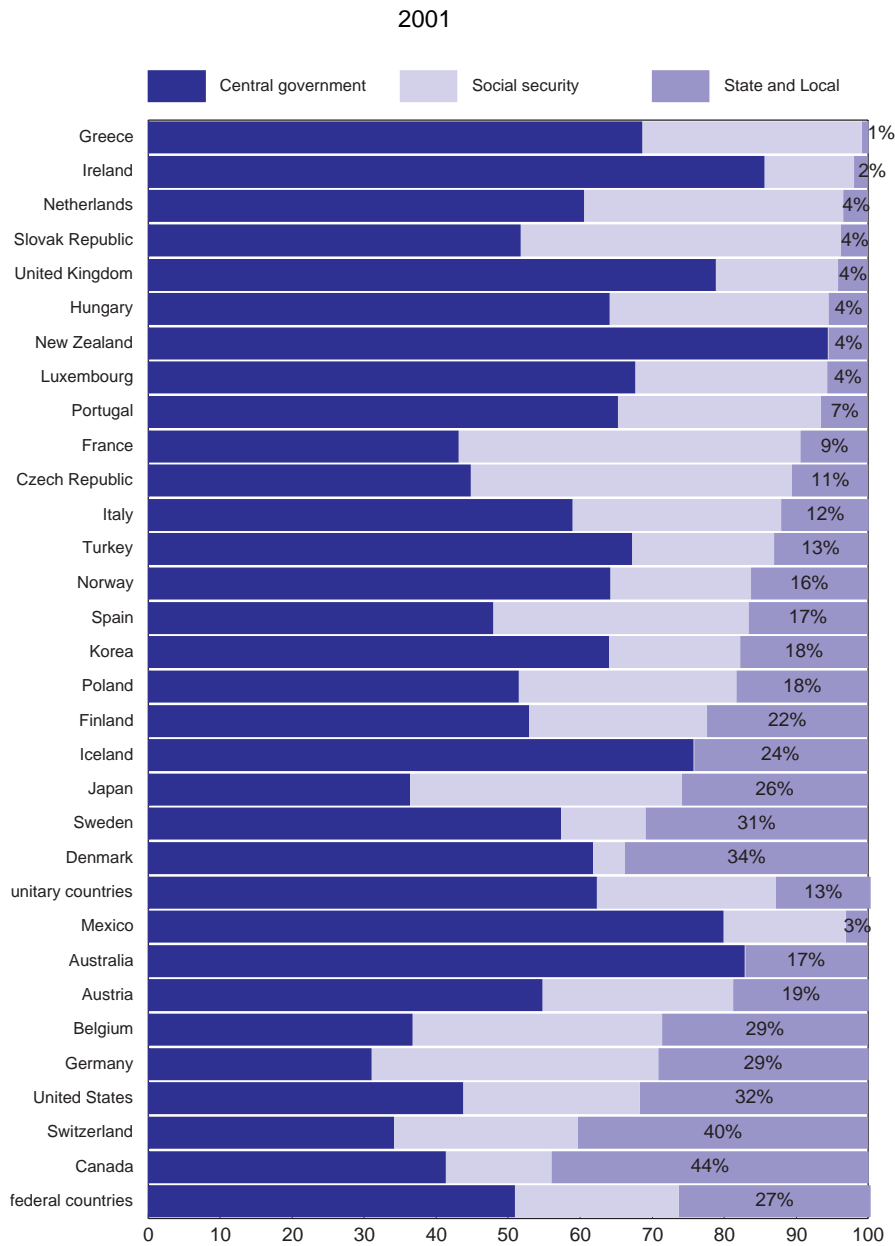
80. Safeguards should be taken against “exclusion” and “cream skimming”. This is important for reconciling the commercial dynamism of services with policy objectives. For instance in the education area, this may involve minimal enrolment quotas and loans for students from low-income families. Foundation Universities already set quotas and provide grants to such students on their own initiative provided that they fare sufficiently well in entrance examinations. In the health area, commercial providers are already requested by law to provide a minimum service capacity for “green card holders” (low income individuals lacking social insurance coverage).

Enhancing accountability

53. Turkey has a very centralised approach to the provision of public goods and services, with sub-central governments effecting only 9.5 per cent of total primary public spending (3.5 per cent of GDP). The share of local government tax receipts (including the automatic revenue sharing receipts from the central government) in total tax revenues (including social security) was around 13 per cent in 2001, which was equal to the average of unitary OECD countries (Figure 17). As local governments have no taxing powers, these figures overstate the degree of decentralisation. Moreover, revenue-sharing is effected according to straight demographic criteria (*i.e.* on a *per capita* basis), without taking into account local economic, social and physical conditions. Municipalities basically provide purely local services such as water distribution, waste management and land planning. They are also extremely fragmented, with 81 district administrations (prefectures) and 3 225 municipalities, with 62.5 per cent of municipalities having a population lower than 5 000 inhabitants. This combination of extreme centralisation and fragmentation was found to be a major source of inefficiency and lack of accountability in all the major reviews of the public sector in the past decade.⁸¹ A Framework Law to launch a thorough decentralisation process was passed by the Parliament in 2004. According to early estimations, it may imply the devolution of half of total public service spending responsibilities to sub-central layers, and has a potential to transform Turkey from one of the most centralised to one of the most decentralised OECD countries on the expenditure side (Box 7). Revenue-raising powers of local governments will likely remain limited at this stage of reforms (Boxes 8 and 5).

81. Three major reviews were the Public Administration Assessment (KAYA) project implemented by the Turkey and Middle East Public Administration Institute in the 1980s, the Study of the Experts Commission on Public Administration of the 8th National Development Plan in the late 1990s, the Public Administration Reform Review of the Turkish Union of Chambers of Industry (TOBB) in 2001, and the Background Report of the National Conference on Public Administration organised by the Ministry of Interior in 2002. The Turkish Association of Industrialists and Businessmen (TUSIAD) and the Turkish Foundation of Economic and Social Studies (TESEV) also continued internationally comparative background surveys on public administration reform. See for a review Canpolat (2002).

Figure 17. Percentage shares in total tax revenue by level of government



Source: OECD (2003), Revenue Statistics 1965-2002.

Box 7. Public Administration Framework Law

The *Public Administration Framework Law* was passed by Parliament in June 2004. It will come into force with implementation laws on *Special Provincial Administrations, Municipalities, Metropolitan Municipalities, Audit Institutions, Public Employment Regime, and Independent Regulatory Authorities*. The legislative package aims at a thorough transformation of public administration in Turkey.

A "Framework Law" is by itself an innovation in Turkey and will provide the basis for the implementation laws. A long preamble provides the background for the initiative and identifies a set of new principles for the public sector which, according to the preamble, is increasingly failing to fulfil its missions in a globalising economy, and in a democratising and diversifying society.

The draft law abundantly quotes the 1995 Charter of Local Governments of the Council of Europe as a main inspiration and benchmark. Following the principles of this Charter, and changing the traditional hierarchy of prerogatives between central and sub-central governments, it lists the central government's strategic and service responsibilities restrictively, and vests remaining public sector missions and responsibilities with sub-central governments. This feature of the Law was vetoed by the President in Summer 2004 and will be reconsidered by the Parliament.

The central government is charged with the core strategic missions of defining the principles and objectives of public services across the country, and co-ordinating and monitoring the services provided by other layers of government. It retains direct service responsibilities in the areas of justice, foreign relations, finance, treasury, foreign trade, market regulation, national infrastructure planning, education, religious services and social protection.

Sub-central governments' responsibilities are elaborated in the Framework Law and in respective Laws on Special Provincial Administrations, Municipalities and Metropolitan Municipalities (these are also sent to the Parliament.) Special Provincial Administrations, of which 81 already exist in the current public administration system, in order to co-ordinate and supervise central government duties in regions, are now vested with extremely large powers. Metropolitan municipalities will have larger responsibilities than ordinary municipalities. A minimum population size of 5 000 inhabitants will be required to operate a municipality.

A major innovation of the Framework Law is its insistence on the possibility of recourse, by sub-central governments, to service provision channels other than monopolistic public services.

The law also prescribes new principles for strategic planning, personnel management and audits across the entire public sector. All general government entities will create strategic planning and research units developing and monitoring their functional objectives and benchmarks. The employment of public servants will be governed by principles of merit, while civil servants above a given level will be considered political appointees and will change (or be confirmed at their position) at each change of government. Large *internal* audit functions will be developed in each organisation, with a mission to diffuse and advocate best management practices. *External* audits will only be effected by the State Audit Institution (Sayistay), instead of the four different audit and inspection organisations that now exist, including the powerful corps of the "Ministry of Finance Inspection Councils" and the President's and Prime Minister's "Inspection Councils". The organisation of the *investigation* function is not discussed in the Framework Law and may be dealt with in a subsequent law.

Funding criteria and channels for sub-central government layers following the devolution of service responsibilities are not discussed in the Framework Law. The government announced that this issue will be addressed in a special draft on sub-central finances which should be sent to the Parliament in 2004.

1. This feature of the Law was vetoed by the President in Summer 2004 and will be reconsidered by the Parliament.

Box 8. Fiscal decentralisation initiatives in the past

In Turkey's history there has generally been a strong centralist approach to fiscal management. A fundamental reform was implemented in 1981 with the aim of mobilizing more local resources for public services. It improved revenue sharing between the central government and municipalities by transferring a certain amount (first 5 per cent and later 6 per cent) of general budget tax revenues to local authorities. The Ministry of Finance transfers this amount to the Bank of the Provinces (İller Bankası) on a monthly basis and the bank distributes the revenue sharing to municipalities according to demographic criteria (on a *per capita* basis). The previous scheme which was in practice since 1948 (with some modifications), was more complex and municipalities received 45 per cent of property tax, 15 per cent of customs tax, 11 per cent of motor vehicle tax and traffic fines, 8 per cent of fuel consumption tax, 5 per cent of income tax and corporation tax, 2 per cent of excise taxes on cigarette, alcohol and tea, and 1 per cent of advertisement charges. In addition to the new revenue sharing system two funds, the Municipal Fund and the Local Government Fund were established to provide investment grants to smaller municipalities. The base of these funds was a fixed share of general budget tax revenues but they were distributed in the form of matching grants. Municipalities were also given more autonomy to raise their own revenues. While the new system improved resources for local governments the overall effect was limited. The ratio of municipal revenues to GDP which had declined from 1.4 per cent in 1967 to 0.9 per cent in 1980 increased to less than 5 per cent in the early 2000s. The allocation of resources was often unpredictable for the recipients. Besides the uncertainty related to economic boom-bust cycles such uncertainty also arose from the fact that the Bank of the Provinces has discretionary power to deduct any outstanding liabilities of the municipality from the revenue sharing. The deduction of such liabilities repayment (from outstanding debt redemption or outstanding compulsory payments to the central government such as pension payments and income tax) led to very low net transfers in some cases. Furthermore, the central government also tends to cut investment grants when there is pressure on the budget.

54. The framework law represents a major undertaking to transform the public finance system and has the potential to enhance public sector efficiency and responsiveness. Together with the Public Financial Management and Control Law, it opens the way to new principles of public sector management gaining ground in other OECD countries. These are based on medium-term strategic plans for service delivery; explicit quantitative benchmarks for service quality; clearly identifiable and accountable governance structures in service organisations; delivery of services at the most decentralised efficient scale available; full transparency of fiscal costs; *ex post* performance audits; and, wherever feasible, a *separation of service funding and from service supply* in order to reap the incentives and disciplines of market competition.

55. As experience in other countries shows, and the earlier review of shortcomings in the areas of justice, education and health care indicates, such changes have the potential to improve public resource allocation and the quality and cost efficiency of core public services. Functional objectives should be clarified and explicitly announced in all areas, service organisations should be set at most decentralised optimal scales; mergers and consolidations should be effected when necessary and identifiable and accountable governance structures should be put in place. At the same time, a rigorous fiscal, institutional and regulatory framework at the national level is essential for these reforms to deliver their promises. In the Turkish context certain issues require careful consideration:

- To enhance compatibility with national fiscal policy, e.g. with *general government* revenue and spending targets, sub-central governments should follow budget preparation, implementation and reporting cycles that are compatible with the national fiscal framework. Under the existing provisions of the Public Financial Management and Control Law, the Public Financing and Debt Management Law, and of the Public Administration Framework Law, sub-central governments prepare and adopt their own budgets and report them to the central government and Parliament (for information). They have discretion as to the management of their Treasury systems, but remain subject to centrally determined borrowing rules and *ex post* audits. As their main source of revenue is central government grants, and their borrowing is capped (harder caps for foreign

currency borrowing - see below) their fiscal stance and deficits are in principle constrained by central government policies. However, there are serious risks of drift in practice, notably for those municipalities which are still below their borrowing limits and those which are sufficiently large to ignore or breach borrowing caps (including through municipal corporations and arrear building). Risks will be particularly high in the early stages of spending devolution, as spending expectations from sub-central governments will be strong, and central government safeguards and financial information weak. It is essential that the provisions of the Public Financial Management and Control Law, the Public Financing and Debt Management Law and the Public Administration Framework Law are made fully consistent in spirit and letter. Financial and Administrative instruments should be used as appropriate to insure compliance with the national fiscal framework. Otherwise, there is a clear risk that fiscal decentralisation will lead to a weakening of fiscal discipline.

- *National strategic objectives for core public services and institutions* should prevail through decentralisation. The core services of justice and education will remain under central government control, but health, transportation, rural support and environmental protection are key areas which will be devolved to sub-central governments. The functional objectives, quality benchmarks (including citizen and user satisfaction measurements) and accessibility standards of these services must be clearly set and enforced before and after devolution. *Functional audits* of these services will be critically important and should be carried out at highest standards, in order to enhance the quality of services.⁸² Audit institutions should be thoroughly trained to carry out these reviews and should support both central and sub-central governments in shifting to best practices. Their reports should be widely publicised (Box 9). The central government should make the results of the services for which it retains responsibility, *i.e. justice and education*, transparent across (and comparable between) regional jurisdictions, making them more responsive to local needs and conditions, and publicising their respective performances.
- Attaining *optimal organisational scales* in the provision of services must be a prime consideration in the Turkish context.⁸³ The new Framework Law fixes a minimum size (of 5 000 inhabitants) for municipalities and prescribes mergers when this threshold is not attained, but given the recent strong political opposition to the closure of the 375 municipalities which went below their current minimum size (of 2 000 inhabitants),⁸⁴ these mergers will likely require a very strong political commitment by the government. Co-operative approaches for providing local public services (such as inter-municipality service unions) in order to help exploit economies of scale should be further developed. Devolution of spending responsibilities could be made conditional on the attainment of minimal service scales.
- The Public Administration Framework Law asserts the Special Provincial Administrations as the adequate (and new) sub-central layer for the provision of an unrestricted range of public services, including those implying higher scales of operations than at the municipal level. This provision should be actively enforced, including, when appropriate, mandatory transfers of responsibilities from municipalities to special provincial institutions. In areas where even higher scale co-ordination is needed at regional level, the newly envisaged “Regional Development Agencies” (RDAs) could play a useful role (Box 10).

82. The Framework Law stipulates that any deterioration in service quality should be detected by the Ministry of Interior and acknowledged by a Court. The Ministry of Interior can then take over responsibility for the provision of the service.

83. See, for a discussion of scale and service efficiency issues in present municipalities, Canpolat (2002).

84. Including an opposition and veto by the President in 2003.

- On the basis of the framework law the local tax system and the grant system have to be redesigned by providing more tax autonomy to local governments and improving their incentives for cost efficiency.

Box 9. The changing role of external audits

In the traditional Turkish budget management system, the auditing of the public accounts by the State Audit Institution (*Sayıstay*) is a legally well-powered and well-endowed function. It is dedicated to the verification of the conformity between the itemised budget law and actual spending, line by line. *Sayıstay* auditors built their competence and reputation on producing expenditure conformity reports based on audits effected in the provinces, where the spending by line ministries (handled by local budget officials appointed by the Ministry of Finance – the *saymans*) are consolidated. Yearly budget reports have been produced through a bottom-up synthesis of these reports.

In this system, line ministry spending is not analysed with regard to the sectoral responsibilities of each Ministry. A number of extra-budgetary funds with sectoral missions are also not subject to audits. The purpose of auditing is not to check the quality, efficiency and relevance of expenditures with regard to the public policy objectives pursued. Although its law requested *Sayıstay* to provide yearly reports to the Parliament on the adequacy of public spending “with the services and needs provided for by the budget”, these reports never gained prominence in the Parliamentary process and have been sidestepped. They stopped being produced in 1983. No reports are produced on the stock of public assets and liabilities either, although this is also requested by law. Finally, audits are effected only on a cash basis, excluding consumption of physical capital and disallowing any monitoring in accrual terms.

The new public expenditure management system vests auditing with greatly expanding missions. First, the consolidation of extra-budgetary and quasi-fiscal spending in the budget widens the scope of audits towards general government activities. Second, the planned shift toward results-oriented budgeting will shift the focus of audits from “conformity of spending with appropriations” to “compliance of policies with objectives”. Under this significant widening of the scope of audits, the degree of exposure of sub-central governments to central government audits will need to be fully clarified. A draft Law on State Audit Institution is now being prepared to describe and assign these new responsibilities and duties, and to spell out the new prerogatives of the State Audit Institution in the general government sector.

The successful shift of *Sayıstay* to these new functions will require a significant upgrading of its capacities, human resources and administrative organisation. A roadmap has been proposed by an experts group headed by the former head of Canada’s Supreme Audit Body, has been welcomed by Turkish specialists and *Sayıstay* insiders, and could be built on to undertake the necessary fortification.

Box 10. Regional development agencies

Regional Development Agencies (RDAs) will be created in the 26 newly created NUTS 2 regions,¹ in successive stages starting from the least developed regions that are currently using EU financial assistance. They will function as coordinator and leading organisations for regional economic development, infrastructure planning and local institution-building. RDAs are not mentioned in the Public Administration Framework Law but are congruent with its decentralisation objectives and will be created under special legislation. The State Planning Organisation is currently drafting a law in consultation with local and central business organisations, civil society organisations and governmental bodies.

RDAs are not conceived as an additional layer of government. They will be organised as private sector entities and will have governance bodies that are elected by central and local government and regional stakeholders. They will be exempt from the provisions of public employment and public procurement laws. Their budget will be established functionally, according to performance objectives. They will be staffed with contracted personnel and will be entitled to engage in any private and public projects facilitating regional economic development. They are expected to play an important role in all aspects of regional development including regional development planning, investment promotion, entrepreneurial development and regional infrastructure dimensions (integrating energy, transportation, industrial parks, rural development, education, research etc), either as leading or as supporting organisations.² They will lead regional “soft infrastructure” projects (such as technical diffusion centers, professional development fora, organisations to devise regional quality standards and trademarks etc.) They will co-operate with relevant foreign organisations.

The RDAs represent a promising form of public organisation, but government authorities should beware of the fiscal and other risks which might arise from their flexibility. Notably, their exemption from public employment and procurement laws should be carefully managed. To that effect, they should make full use of their strong and diversified corporate governance structures to put in place good *ex ante* controls, and they should be fully audited as general government entities for adequate *ex post* controls. Future functional audits of the new regional development system will be instrumental in gauging their relevance and contribution.

The first RDAs will be put in place in the least developed regions in Turkey with very high inactivity rates, and persisting socio-economic development problems. Relevant initiatives also exist in the more developed Western regions, including the one led by the non-profit Aegean Economic Development Foundation (EGEV). This body has engaged a set of regional consultation and development initiatives, around projects of local interest. These could later be formally co-ordinated and funded through an RDA. On the basis of such pilot experiences, and assuming their both positive and negative results are fully exploited, RDAs can emerge as a new and competitive institutional form channelling bottom-up collective action, and reversing the traditional top-down approach to regional development.

1. The creation of NUTS 2 (Nomenclature des Unités Territoriales Statistiques, level 2) regions was a requirement of the European Union for the distribution of pre-accession structural support funds.
2. In this regard, the special agency created to lead regional development initiatives in the framework of the large Southeastern Anatolian Project (GAP) is a relevant initiative. It includes energy development, irrigation and agricultural transformation dimensions. It is, however, highly specific and *ad hoc* to a mega project.

Box 11. Economic effects of fiscal decentralisation

Effects on efficiency, growth and equity: Fiscal decentralisation (FD) can increase economic efficiency and welfare. It will then also increase economic growth; at least until the higher equilibrium income level is reached. The main reason for this efficiency gain is that local governments usually know best what the most urgent needs are and can therefore target the provision of public goods and services to these needs. The better matching between supply and demand of public goods in decentralised fiscal systems (as compared to the single uniform level provided by a single central government) should lead to Pareto-superior levels of consumption in each jurisdiction. Furthermore in decentralised systems accountability may be higher as badly performing local governments are penalised by residents voting at local elections and/or by leaving the jurisdiction (voting by feet). In addition tax competition between jurisdictions protects tax payers from being exploited by local governments and bureaucrats which also increases efficiency (public choice school). But there are also counter arguments that too much FD reduces efficiency and growth. It is argued that excessive FD leads to higher costs arising from extra-co-ordination costs and the loss of economies of scale (as a single municipality or region may be too small to provide this good efficiently) and to an under-provision of public goods arising from external effects as the benefits are shared by other municipalities or regions which do not bear the costs. Depending on the specificities of public goods such problems may, however, be overcome at least in some cases by joint production of neighbouring local providers and/or by financial compensation between the provider and the users so that externalities are internalised. Where this is not possible a centralised provision is preferable. For example growth can be reduced if infrastructure projects with wide nation-wide externalities are too decentralised. There is also the view that tax competition between local governments may be harmful leading to a "race to the bottom" with the result of an under-provision of public goods. However, this view is not generally shared as infrastructure competition may prevent an excessive reduction in tax rates. Finally while in theory decentralised systems are more responsive to local citizens' preferences this may not be the case in practice. This is the case if local officials are not elected by local citizens or if there is only limited "voting with the feet" as citizens are too poor or housing markets are too rigid. Thus efficiency and growth can be reduced by excessive spending of sub-national governments on wrong expenditure items. Last but not least FD -- if not accompanied by appropriate fiscal equalisation -- may reduce growth by reinforcing regional inequalities. The lower level of public services in poorer regions could restrain their catching-up to higher income levels and increase migration to richer regions. On the other hand ill-designed fiscal equalisation systems could also reduce growth by implying high implicit tax rates for both the richer and the poorer regions which might reduce their incentives to adopt growth-enhancing policies.

Effects on corruption: FD can reduce corruption by enhancing transparency as local citizens become more aware of any wrongdoings of their officials. In addition the competition for political office increases responsibility and reduces corruption. FD is, however, no panacea for corruption. Corruption may result from proximity of local officers to private local interests, lack of service orientation and weaknesses in democratic institutions and internal bureaucratic controls.

Effects on macro-stabilisation and fiscal discipline: FD can improve fiscal discipline as local governments may follow a more prudent fiscal policy than central governments. But decentralised policy making can also cause macroeconomic co-ordination failures which increase cyclical volatility. Furthermore, without appropriate institutional regulations FD could weaken fiscal discipline and reduce growth.

Overall economic effects: Given these potential positive and negative effects of FD its overall net effect on the economy will depend on the circumstances. Among the various empirical studies some support the view that FD provides better public services, reduces corruption and increases economic growth but other studies produce ambiguous or negative results. This may be explained by different conditions in the various countries as well as measurement problems. What seems clear, however, is that an appropriate institutional and regulatory framework is required to reap the potential benefits of FD.

Source: For more details, see Joumard and Kongsrud (2003).

Using competition and market signals

56. Little utilisation of competition and market signals in the provision of public services has been to date an important area of weakness in the public expenditure management system. *De facto*, recourse to private supply and competition was only confined to the purchase of goods and services by government, and even this confined area was rigged with many imperfections (Box 12). The more fundamental opportunity of private competition in core public services such as education, health, energy, and telecommunications has not been directly addressed. Even if a large private sector has already developed in these areas for *privately funded* services, their role in the provision of *publicly funded* services has not been explicitly discussed.

Box 12. Public procurement reform

Public procurement practices have long been insufficiently transparent and competitive, and subject to suspicions of distortions and corruption. In the area of public works, for example, the widespread practice of *ex post* and *ad hoc* price adjustments (legally authorised in order to protect suppliers against unpredictable cost shocks in a volatile economic environment) gave way to abuses. *Ex ante* tendering and bidding became meaningless in many procurement areas, making public auctions ineffective in supplier selection. Projects usually faced massive cost overruns, and were frequently completed at many times initial tender prices.

A new Law on Public Procurement, based on EU best practices, was passed in 2002. It increases the transparency of procurement, sets explicit rules for the publicity of purchases, tightens competition provisions, and incorporates state economic enterprises and the revolving funds within its scope. It was welcome in the domestic and international market but was thoroughly revised in 2003 through long and stiff negotiations in the Parliament. The minimum contract size for the eligibility of a purchase under the new Law was increased, and public utility companies in oil and transportation sectors became exempt. Operational necessities in quasi-commercial activities were invoked to justify exclusions, but some observers mentioned the opposition of private interests to full competition in procurement. The government announced in 2004 that a special law would be prepared to enforce competitive procurement in the utility sectors. The 2003 Public Procurement Law is in all instances an important progress toward real and transparent auctions and competitive procurement in eligible areas. A Public Procurement Institution (KIK) was created under the Law, to handle complaints concerning the application of the law. This institution began to report publicly on its activities and interventions in 2004.

57. The Public Administration Framework Law states that public authorities, and notably sub-central governments with new service responsibilities, will be authorised to use private providers for more efficient service supply. However, the option of using private providers is always mentioned among a range of non-governmental supply sources such as universities and professional organisations. The specific dynamism that commercial players generate is not directly invoked. As a result, the room for regulations to minimise risks of rent-creation, cream-skimming and user exclusion by “for-profit” suppliers is not directly

addressed either. The questionable experience of the Build-operate-transfer (BOT) and Build-own-operate (BOO) contracts in the energy and water sectors in the 1990s, which have been forms of public service concessions to private providers under weak regulatory frameworks (see above), may explain the present reluctance and discomfort of policymakers in this area. Private provision of publicly funded services may also raise legal challenges, as the Constitution seems to not currently permit such sub-contracting.⁸⁵ This may require a Constitutional clarification or change in the future. Nonetheless, the magnitude of the stakes, the need for better services and the opportunities that commercial and non-profit suppliers may offer, would justify a more proactive approach by the government in this area. In particular:

- The government may explore if and in which areas private competitive providers could contribute to the provision of public services and add to the quality and cost efficiency of services. On the basis of international experience, regulatory principles that help to align public policy and private commercial objectives can be outlined.
- Conditions for fair and sustainable competition between public, private non-profit and private commercial providers in the provision of public services, under conditions of equal access to public funding could be explored.
- The room for introducing user fees in public services, to reduce superfluous and excess utilisation without jeopardising universal access and public service obligations should be explored. User fees may be introduced for “premium services” (*i.e.* services provided above minimum quality levels), whenever they are provided by public service organisations (such as special comfort services in public hospitals).
- The Public Financial Management and Control Law prescribes that “revolving funds” should be liquidated by 2007. These are common in many public agencies and sell services in return for fees.⁸⁶ The Public Administration Framework Law is also highly critical of revolving funds; explaining that they have degenerated into indirect tax collectors, hindering service access and distorting competition on private markets. Even if the government intends to preserve room for public service pricing directly within the budget, the negative view of fee-generating funds may deserve reconsideration, as these funds may also facilitate market orientation, corporatisation and personnel motivation in public organisations, *if adequately regulated and properly managed*.
- Policies to preserve the quality and financial robustness of private providers, and the continuity and availability of services of public interest across the territory must be specified, in the light of international experience. Turkey’s own record with local private hospitals, private intercity bus transportation, and (the limited number of cases in) local private electricity and gas provision is also relevant.

85. The Constitution states that “public services should be provided by employing civil servants” (Article 28). Long and difficult discussions in the Parliament on the draft Public Administration Framework Law in early 2004 demonstrated the absence of a commonly shared understanding of this matter. The costs, benefits and regulatory needs of private supply of publicly funded services were not addressed. Several parliamentarians equated private supply with the elimination of public service responsibilities. The regulatory needs of the separation of *public funding from public provision* was not addressed.

86. A total of 1 440 “revolving funds” were operated in public universities, hospitals and service organisations as of May 2004, selling various (research, care, etc.) services for a fee, and generating extra-budgetary income for their organisation.

- The planned introduction of Regulatory Impact Assessment⁸⁷ (RIA) is commendable. This is expected to pre-empt unintended consequences from new laws and regulations, notably on free market entry and fair competition. The extension of this approach to existing laws and regulations could also be advisable. Notably, a reassessment of the set of laws and regulations affecting land use, site development, property rights, and construction in urban and rural areas would give guidance on highly needed policy measures to facilitate long-term private investment and foreign direct investments in this sector. The implementation of measures against earthquake and other natural catastrophe risks would also be facilitated.

Managing public debt and liabilities

58. Good management of the public debt stock and other contingent liabilities is also essential for fiscal sustainability. Lessons from the past decade motivated two fundamental measures to rationalise debt management. First, the Public Financing and Debt Management Law of 2002 considerably tightens debt management, by subjecting all central government borrowing and guarantees to strict rules (annual borrowing is capped by the central government budget deficit target) and imposes reporting requirements (three-monthly and annual reports will be issued on all debt and guarantees, their composition and their costs). This should make the performance of debt management more transparent. The law also subjects all *foreign borrowing* by general government and quasi-fiscal entities (including state-owned enterprises, municipalities and municipal corporations) to formal authorisation by the Treasury (even when no Treasury guarantee is required and granted). Secondly, new policies in banking, including in the governance of public banks and the prudential regulation of private banks have brought the surveillance of the banking sector much closer to international and European standards. The government also capped the public guarantees on banking deposits.⁸⁸ These measures are important steps forward in the containment of public liabilities, but further attention should be granted to:

- *Domestic borrowing by sub-central and quasi-fiscal entities.* The *external* debt of local governments and quasi-fiscal bodies is included in the quarterly published external debt stock, but not the non-guaranteed *domestic* debt held by local banks and investors. At present, such domestic borrowing by municipalities and state economic enterprises is not directly constrained and is only subject to some relatively soft constraints. Municipal borrowing is, in principle, capped in proportion to their annual revenues, whereas state economic enterprises can borrow without approval by their supervisory agencies - either the Undersecretariat of Treasury or the Privatisation Administration - provided that they fulfil their regulatory obligation to inform their designated supervisory agency before and after borrowing. These provisions are insufficient to contain the risks of drift in actual borrowing and arrears building. The central government remains the *de facto* guarantor of last resort.

87. Technical co-operation is ongoing between the Turkish government and the OECD in order to initiate regulatory impact assessment studies on new pieces of legislation from 2005.

88. The cap is TL 50 billion (US\$34 000) per account. This represents 90 per cent of all bank accounts but only 40 per cent of all deposits in 2004.

- *Formal treasury guarantees* are made transparent but are not capped by a fiscal rule.⁸⁹ Their total amount is reported, and this represents major progress, but the economic liability they represent for the Treasury on the basis of their riskiness is not added to direct public debt so as to produce a total outstanding amount of public liabilities. Similarly, the implicit pension debt (the discounted value of future pension balances) is not reported among fiscal liabilities, despite being recommended by the IMF's Government Financial Statistics Methodology. Although Turkey is not the only OECD country with such missing elements in the calculation of its total public liabilities, progress in these areas would contribute to the intended high quality of debt transparency.
- The *prudential surveillance* of public and private banks, including of those banks presently under the control of the Saving Deposits Insurance Fund (SDIF), should be rigorously enforced and enhanced. The intended strengthening of the regulatory framework for banking supervision is expected to more firmly limit government exposure in this area.
- Further action may be desirable to contain the *contingent liabilities* arising from BOT and BOO contracts, including at the municipal level; and from the legal and *de facto* government exposure to the financial risks arising from natural catastrophe risks.

Social security reform

59. A major parametric reform of the pension system was enacted in August 1999 in the wage earners' (SSK) and self-employed (Bağ-Kur) pension funds but not yet in the civil servants' fund (ES) – in the latter fund the only parametric change concerned the increase of the retirement age. The reforms to the other two funds: (i) increased the minimum contribution period before retirement; (ii) reduced benefits paid by extending the reference period for the calculation of replacement rates to the entire work history; and (iii) reduced the benefit collection period through an increase of the retirement age. The minimum retirement age was increased to 58/60 for women/men with a transition period for the current contributors. The benefits at retirement will be calculated according to the years of service before and after the reform. However, with the exception of the increase in retirement age, the new provisions are not applicable to the civil servants' pension fund where deficits are high and benefits are calculated on the very latest period of work history. In 2003, legislation to address issues concerning institutional strengthening and improved collection for private sector social security institutions (SSK and Bağ-Kur) was enacted. The legislation addresses the problem of the large outstanding stock of contribution arrears of SSK and Bağ-Kur that contribute to the deterioration of the financial position of these institutions. A new system of penalties and interest that reflects the government's borrowing cost was introduced.⁹⁰ While the past stock of arrears remained unchanged, to ease the application of the new system, those who were in arrears were offered the opportunity to restructure according to the amount of arrears and their capacity to pay.

89. Each year's budget will state the maximum amount of formal guarantees that the Treasury can provide.

90. The legislation states that monthly Treasury bill rates would be applied to the outstanding stock of arrears reflecting the Treasury's cost of financing the deficit of social security institutions as a result of uncollected premiums.

60. Those are significant measures in the area of social security. However, the government recognises that a more comprehensive and radical approach is required to address the financial imbalances and institutional inefficiencies in the system. To this end, an “Urgent Action Plan” has been outlined, to unify the three social security institutions, to establish universal health insurance, and to consolidate all social assistance functions into one institution. Prior to the introduction of this reform, a *White Paper on Social Policies* was prepared through co-operation between central economic agencies (the Ministry of Finance, the State Planning Organisation and the Undersecretariat of Treasury) and spending agencies (the Ministry of Labour and Social Affairs, the Ministry of Health and the Social Solidarity Fund) for public review and debate. It provided a comprehensive account of the fiscal costs of these policies and the results actually obtained. It outlined reform options, with fiscal implications and impacts on services. This White Paper can play an important role in informing the debate and advocating the required reforms.

61. The government plans to fully *separate* the health and social assistance functions from retirement insurance, and to *unify* the three existing social security institutions under a single organisation to increase the transparency and efficiency of the pension system. Additional changes to the basic parameters of retirement insurance will also be introduced in order to enhance long-run sustainability. A simulation model developed by the World Bank is being used to assess the fiscal outcomes from various parametric options and macroeconomic scenarios.

62. In the health leg, the main thrust of the reform agenda concerns the introduction of a *universal health insurance system*. The objective is to extend health insurance to the entire population through a single health insurance institution, instead of the existing system with multiple payer institutions.⁹¹ It is clear from other OECD countries’ experiences, and from tentative simulations on Turkey, that the introduction of universal health insurance would increase public health costs *if service supply is not reformed*. However, given the depth of current inefficiencies in the health sector, reforms rationalising primary care, and generating competition in hospital services and drug purchases, should be able to generate important savings. Also, if universal insurance is introduced step by step, by cautiously defining the basic coverage package, the fiscal costs of planned reforms can be minimised.

91. These include the central-budget funded “green card” system financing low-income individuals’ health care costs. This system faces difficulties in establishing actual eligibility and reaching the most deserving potential beneficiaries.

Summary policy recommendations

Box 13. Priorities for improving the quality and cost-efficiency of public spending

- Fully implement the provisions of the Public Financial Management and Control Law according to the planned schedule.
- Set and enforce a multi-year aggregate and primary spending ceiling for the central government.
- Monitor fiscal performance according to total and primary spending targets, as well as total and primary balance targets.
- Fully implement the provisions of the Public Financing and Debt Management Law. Include all general government liabilities in regular reporting.
- Reform the public employment and pay system to back flexible, result-oriented budgeting.
- Enforce co-ordination rules with social security institutions and sub-central governments to insure their compliance with the general government fiscal framework.
- Implement a cost and performance audit for core public services (Justice, Education, Health Care, Infrastructure Development and Agricultural Support.)
- Set performance objectives for core public services, on a multi-year perspective and realistically taking into account present performances and resource levels. Fund these services on a multi-year basis according to the objectives set. Audit results against objectives.
- Create room for private and competitive provision of publicly funded services. Implement pilot projects and analyse and publicise their outcomes.
- Introduce user fees for public services, notably for premium (comfort and private-return enhancing) services, without jeopardising access of low income groups to core services.
- Implement the Public Administration Framework Law step by step, mitigating the risks associated with fiscal decentralisation:
 - Use, as appropriate, financial and administrative instruments to assure sub-central governments' compliance with the national fiscal framework.
 - Reduce pressures on the central government to increase grants, or take over debt and other liabilities when local governments face financial troubles.
 - Reconsider, and if needed redefine, the respective service responsibilities of Special Provincial Administrations, Metropolitan Municipalities and Ordinary Municipalities, according to optimal scales of service supply.
 - Tackle the existing fragmentation of local government units through compulsory amalgamation and, when appropriate, through inter-municipal service unions. Use administrative and financial means (incentives) to facilitate amalgamation.
 - Define minimum quality standards for services devolved to sub-central governments. Audit and publicise their performances. Put in place rapid response mechanisms to deal with cases of underperformance.
 - Raise local government taxing powers to make them financially accountable to local constituencies.
- Upgrade the public audit infrastructure as the core institution of the new public expenditure management system. Strengthen its organisation for sectoral and thematic tasks, and build up human capital for state-of-the-art functional and results-oriented audits at all government levels.
- Recreate the yearly synthesis report of the State Audit Institution to the Parliament as the core public document monitoring the functioning of the new public expenditure management system.

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