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The Turkish Business Climate

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Executive Summary

This Policy Brief analyzes Turkey's recent past and current business climate in the face of political, social, and economic trends in the country. Positing Turkey as being on the verge of attaining its potential as one of Europe's most dynamic economies, the article discusses both challenges and recommendations for the future. As the EU's largest and perhaps most complicated accession candidate, furthering liberalization is crucial to Turkey's business prospects.

At the turn of the 19th century, the Ottoman Empire was called the “sick man of Europe.” Modern Turkey, the state that emerged from the ruins of the Ottoman Empire in the wake of WWI, has struggled over the years to modernize and attain the standards of living enjoyed by those in the West. Progress over the years has been erratic, with bursts of growth interrupted by severe economic crises and periods of great political instability.

Turkey’s potential has long been recognized by the international community but the country has not lived up to expectations for a number of reasons. Political conflicts and instability created a sense of immobility, limiting the potential of the economy. Structural problems such as high inflation, exchange rate instability, high unemployment, and income inequality that needed urgent attention were not always adequately addressed. Over time, their reemergence has caused delays and interruptions in many long-awaited economic and political reforms.¹

Even as late as the 1990s, the country was still struggling to achieve political stability combined with sustained economic growth. Between 1994 and 2003, Turkish economic growth averaged a mere 2.8 % and the economy experienced several severe crises. Despite this inauspicious start, Turkey appears to be on the verge of attaining its potential as one of Europe’s most dynamic economies. Currently, the country is engaged on several fronts to restructure its economy and to carry out the remaining socio-economic and political reforms to qualify for membership in the European Union (EU). In this regard Turkey is not only the EU’s largest accession candidate, but also the most challenging. Turkey’s economic potential, the youth of its population (27.2% aged below 14), and its geostrategic importance are the strengths which are unrivalled among other candidate members.

On the other hand, the country’s chronically higher than average rate of inflation, patchy human rights record, lagging governance structures, and incomplete economic liberalization are serious weaknesses the country must overcome to move the accession talks forward. Progress in these areas is critical in attaining sustained economic growth over the next decade and thus completing the transition to a more developed country status capable of achieving high sustained rates of market growth.

BUSINESS CLIMATE OVERVIEW

The business climate in Turkey has experienced dramatic shifts over the years. In recent years, Turkey has experienced several economic and financial crises (1994, 1999, and 2001). The crises were primarily due to political instability, weak regulation, poor macroeconomic management, or a combination of all. More recently, progress in these areas has led to a dramatic improvement in the country’s economic importance and its attraction for foreign investors.

THE ECONOMIC DIMENSION

Gross Domestic Product (GDP) grew by 7% per year on average during 2002-2006, driven almost entirely by the private sector. Optimism in the business sector led to

1. Yilmaz Argüden, “An Overview of the Turkish Economy: Outlook and Current Perspectives,” Middle East Institute *Policy Brief*, December 2007.



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expansion of the capital stock and private fixed investments grew on average 24% annually between 2002 and 2006. These investments helped firms expand capacity and improve labor productivity. However, growth slowed to around 5% in 2007, and clearly a number of macroeconomic risks and structural impediments remain.

The government has launched its own ambitious 2007-2012 economic plan that aims to tackle some of these challenges. The difficulty, as usual, will be in the implementation. Areas where further structural reforms and actions are necessary to create an environment for high sustained economic expansion include:²

Dependence on capital inflows and foreign investor sentiment. Despite strong foreign direct investment (FDI), Turkey's high current account deficit makes it vulnerable to rising risk aversion of global investors and to external shocks in general. Foreign ownership in the local bond and equity markets has dramatically risen in the last two years to around \$85-90 billion from \$50 billion in 2005 and \$28 billion in 2004. The country's large current account deficit is gradually stabilizing at below 8% of GDP but is expected to remain a key macroeconomic risk over the medium term.

Growing corporate debt and foreign exchange risk. While public sector debt has declined over recent years, private sector foreign debt has more than doubled over the last three years, amounting to around \$138 billion in 2007. Moreover, the corporate sector's net short foreign exchange position has increased from \$40 billion at the end of 2006 to almost \$60 billion at the end of Q3 2007, making the Turkish corporate sector more vulnerable to a sudden depreciation of the Turkish lira.

High unemployment and low labor force participation. Despite the high rate of economic growth in the last five years, the Turkish economy has failed to create jobs to reduce the unemployment rate below 10%. The estimated labor force participation rate is only around 48% compared with an average rate of 71.5% for the EU economies, and has declined significantly in recent years. The 2001 crisis and the decline in agricultural employment have been determining factors. Initiatives aimed at improving the investment climate and increasing the productivity of the private sector are necessary to increase employment in the medium term, particularly in the small and medium-sized enterprise sector. Finally, the abnormally high dependency rate per worker—stemming from a high unemployment / low labor participation rate combined with a long run trend of the labor force expanding at a lower rate than that of the adult population — will, unless reversed, place great stress on the country's social security system.

Approximately one in three workers in urban areas and three in four in rural areas are not registered with the social security system.

Large informal economy. The informal economy, estimated to be about 40% of the economy, remains a huge problem. Approximately one in three workers in urban areas and three in four in rural areas are not registered with the social security system. It significantly impacts the government's revenues and the overall productivity of the Turkish private sector. Measures such as reducing administrative barriers and improving the tax regime to reduce informality, coupled with measures to improve the country's overall business environment would help to reduce the gaps in the economy, maintain rapid growth, and increase (formal) employment.

As part of its process of economic reform and liberalization, Turkey has historically turned to the International Monetary Fund (IMF) for advice and financial assistance. The current IMF stand-by program (Turkey's 19th) has provided a powerful incentive (and useful domestic political tool) for the government to put in place solid macroeconomic policies and advance with reforms. The program is due to expire in May 2008 and is currently under discussion for renewal and extension. If an agreement can be reached between Turkey and the Fund, prospects for progress would be greatly increased in such important key areas as social security, key privatizations, energy policy, and tax reform.

2. "Turkey: Reform Agenda Needs a Kickstart," Deutsche Bank Research, November 8, 2007.

THE POLITICAL DIMENSION

There is reason for optimism on the political front. First, despite Turkey's chronic political instability, its political system is not necessarily ill-suited to the successful implementation of solid economic reforms and successful macroeconomic policies. The centralized structure of the Turkish political system (unicameral parliamentary system, centralized bureaucracy) should make it possible to pursue disciplined economic policies and even push through wide-ranging reforms. The problem is that Turkey suffered from a high degree of political fragmentation in the past, despite institutional centralization.

A large number of political parties often resulted in the formation of shaky coalitions. With no strong consensus, the result was often weak and incoherent macro-policies and slow structural reform. Empirical analysis shows that the more fragmented — numerically and ideologically — a coalition government, the less stability-oriented economic policies will be. *Ceteris paribus* single party governments are more conducive to stability-oriented economic policies. This is largely what differentiates the current Justice and Development Party (AKP) government with its majority from previous government capitulations. Widespread political support for EU accession and considerable consensus with regard to economic consolidation should create major incentives for the AKP to continue with its reform programs.

Unfortunately things have not progressed as one might have hoped. Uncertainty has emerged as a result of a recent decision by the Constitutional Court to institute proceedings against the AKP. The Court's decision was based on an indictment prepared by the chief prosecutor of the Court of Appeal alleging that the party had become the focal point of activity against the secular order of the republic. The prosecutor also demands that 71 leading present and past members of the Justice and Development Party, including President 'Abdullah Gul and Prime Minister Recep Tayyip Erdogan, be banned from politics for five years.

The damage done to Turkey's development by the judicial challenge to a freely-elected and popular government can be contained, but it cannot be eliminated entirely. Foreign investors have long complained of the arbitrary nature of Turkish justice. Now domestic realization of its inadequacy may prompt fundamental reform, especially of the role of prosecutors. This would be the best outcome of an unnecessary crisis which may well dominate the rest of 2008.

On the EU front, the EU froze eight chapters (out of 35 total chapters required for accession) in December 2006. Accession talks have continued at a modest pace, with four chapters in process and another two chapters potentially to be commenced shortly. Despite the government's published "national action plan" (to implement the full range of EU-related laws by 2013) there has not been much concrete progress to date. The current AKP government was expected to capitalize on the favorable environment created after its sweeping victory in the July 2007 elections by carrying out broad based political reforms.

The EU is particularly concerned about Article 301 of the reformed Turkish Penal Code, which continues to limit freedom of expression by criminalizing remarks that are perceived to insult "Turkishness," Turkey, or its institutions. The article has been used by the judiciary to prosecute journalists, writers, and academics for their views, mainly on the Kurdish issue and the mass murder of Ottoman Armenians in 1915-17.

Unfortunately, little if anything has been done in this or other areas of importance. Specifically, in mid-December 2007 the European Council, which comprises the heads of state and government of the EU's 27 member states, warned that long-awaited reforms in the areas of freedom of expression and religion should not be delayed any further. Al-

The centralized structure of the Turkish political system (unicameral parliamentary system, centralized bureaucracy) should make it possible to pursue disciplined economic policies and even push through wide-ranging reforms.

though during the meeting Turkey was discussed as an enlargement candidate along with Croatia, the conclusions omitted any specific reference to “accession” or “membership” as the final goal of Turkey’s negotiations with the EU. In response, the Turkish Ministry of Foreign Affairs released a firmly-worded statement to the effect that turning a cold shoulder on Turkey would not only effect Turkey-EU relations, but also bilateral relations (meaning those with France and Germany).

Recent controversial plans to ease restrictions on the wearing of Islamic headscarves have not helped Turkey-EU relations either. Easing restrictions on headscarves has been portrayed by the Turkish government as a step toward greater civil and religious freedom. However, the EU believes there is an urgent need for Turkey to introduce other long-awaited political reforms, with the slow pace of progress over the past year creating uncertainty over the future pace of EU membership negotiations. Although Turkey’s EU accession bid and economic reform will remain priorities for the government, there is a risk that more vocal opposition to Turkish membership could hamper progress on both fronts.

Finally, one concern expressed by businesses, especially foreign firms, is that the AKP government, with its Islamist roots and the climate created by its rule and the appointments it has made, have and will to a greater extent increase the influence of Islamists and of religious ideas in public affairs and social and cultural life. In fact, little Islamization has occurred following the AKP ascendancy in 2002 with some of the larger “Islamic companies” seeking more modern images.

Some mainstream entrepreneurs have lent their support to the AKP government. The same is true — to a greater or lesser extent — of the whole of the mainstream media. However, this does not signal a fundamental ideological conversion. Media ownership and the influence of the various media groups have changed little. This year, the television channel TGRT, formerly regarded as Islamic-conservative, was sold to a new owner backed by investors who include Rupert Murdoch’s News Corporation.

The “Islamic banks” have been allowed to call themselves “participation banks” and to offer a fuller range of banking services, and are now regulated by the banking watchdog. In effect, they have become more like normal banks—a change also reflected in their advertising and decor of their branches. One such institution, Bank Asya, has been floated on the stock exchange. These developments owe as much to IMF-sponsored banking reforms as they do to AKP support. The participation banks still account for only about 3% of total banking system assets. Plans for an “Islamic” government bond appear to have been shelved.

All in all, AKP rule has not witnessed a shift in the center of gravity in the business community towards supporters of Islamist ideas or Islamic-conservative norms. The AKP has undoubtedly kept its friends, made new ones, and won a measure of acceptance across the ideological divide. In general, however, Western and mainstream Turkish capital seem to have fared better than “Islamic capital”, the hey-day of which may turn out to have pre-dated the AKP rather than followed it.

In sum, the AKP enjoys support from many businessmen. However, its support will erode quickly, especially if it is seen to be pursuing a more Islamist model of society.

The recent slow-down in the economy combined with increased political uncertainty has prompted a number of pessimistic forecasts for 2008:

- The Economist Intelligence Unit (EIU) expects moderate domestic demand growth to continue, but average import growth is forecast to marginally outpace exports to weakening demand in the

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Table 1
Table: Governance Comparisons: Turkey and Greece

	2006	2005	2004	2003	2002	2000	1998	1996	% Change 1998-2006
Voice and Accountability									
<u>Turkey</u>									
Estimate (-2.5 to + 2.5)	-0.19	-0.06	-0.09	-0.14	-0.26	-0.51	-0.66	-0.38	
Percentile Rank (0-100)	43.30	48.10	48.10	43.80	42.80	33.20	30.30	35.90	20.61
<u>Greece</u>									
Estimate (-2.5 to + 2.5)	1.05	1.11	1.14	1.02	1.05	1.04	1.13	0.73	
Percentile Rank (0-100)	81.30	84.10	84.60	77.40	79.80	80.80	85.60	69.40	17.15
Political Stability									
<u>Turkey</u>									
Estimate (-2.5 to + 2.5)	-0.65	-0.57	-0.87	-0.80	-1.01	-1.00	-1.09	-1.48	
Percentile Rank (0-100)	25.50	29.30	20.70	23.60	18.30	16.30	14.40	8.70	193.10
<u>Greece</u>									
Estimate (-2.5 to + 2.5)	0.48	0.45	0.40	0.58	0.68	0.69	0.32	0.37	
Percentile Rank (0-100)	63.00	62.00	60.10	63.50	68.80	69.70	56.70	55.80	12.90
Government Effectiveness									
<u>Turkey</u>									
Estimate (-2.5 to + 2.5)	0.23	0.21	0.07	0.11	0.00	-0.06	-0.22	-0.18	
Percentile Rank (0-100)	64.00	61.10	59.20	61.10	59.20	54.00	48.80	52.60	21.67
<u>Greece</u>									
Estimate (-2.5 to + 2.5)	0.62	0.66	0.81	0.84	0.89	0.73	0.87	0.79	
Percentile Rank (0-100)	71.10	73.50	76.80	77.70	79.60	76.30	79.60	78.20	-9.08
Regulatory Quality									
<u>Turkey</u>									
Estimate (-2.5 to + 2.5)	0.21	0.16	0.08	0.12	0.08	0.22	0.68	0.58	
Percentile Rank (0-100)	57.60	58.50	58.00	58.00	56.60	60.50	73.20	69.30	-16.88
<u>Greece</u>									
Estimate (-2.5 to + 2.5)	0.79	0.86	0.87	1.05	1.01	0.89	0.84	0.77	
Percentile Rank (0-100)	73.20	76.10	76.60	80.50	80.50	79.50	79.50	78.50	-6.75
Rule of Law									
<u>Turkey</u>									
Estimate (-2.5 to + 2.5)	0.08	0.08	0.09	0.00	-0.16	-0.06	-0.06	-0.01	
Percentile Rank (0-100)	55.70	55.20	57.10	52.90	50.00	51.90	54.30	55.20	0.91
<u>Greece</u>									
Estimate (-2.5 to + 2.5)	0.64	0.65	0.81	0.75	0.69	0.81	0.68	0.90	
Percentile Rank (0-100)	67.60	67.60	73.80	72.40	69.50	76.20	71.00	81.00	-16.54
Control of Corruption									
<u>Turkey</u>									
Estimate (-2.5 to + 2.5)	0.06	-0.05	-0.20	-0.24	-0.43	-0.19	-0.24	0.01	
Percentile Rank (0-100)	58.70	55.30	51.90	50.50	41.30	51.50	50.00	57.80	1.56
<u>Greece</u>									
Estimate (-2.5 to + 2.5)	0.39	0.40	0.55	0.58	0.56	0.72	0.68	0.38	
Percentile Rank (0-100)	68.90	67.00	70.90	71.40	72.30	75.30	73.30	68.40	0.73

Source: Compiled from: World Bank, Governance Matters 2007: Worldwide Governance Indicators, 1996-2006
http://info.worldbank.org/governance/wgi2007/sc_country.asp

euro area.

- 2008 GDP growth estimate: 3.7% (EIU), 4.9% (UniCredit), 5.5% (IMF).
- 2008 Year-end CPI Projections: 6-6.5% (EIU), 6-7% (Raiffeisen).
- 2008 Projected current account deficit: 7.5-8.0% #GDP (EIU), 7.4% (OECD).

Raiffeisen sees uncertainty in fiscal policy: any fiscal loosening will impact inflation. Finally, in April 2008 the country's perceived economic and political instability resulted in Standard and Poor's Rating Services revising the country's rating outlook from "stable" to "negative."

PROGRESS AT IMPROVING THE BUSINESS CLIMATE³

Many of the country's political problems simply reflect longer-term problems plaguing the country's governance structures. World Bank data on the main components of governance: (a) voice and accountability, (b) political stability, (c) government effectiveness, (d) regulatory quality, (e) rule of law, and (f) control of corruption (Table 1) show that Turkey lags considerably behind EU member Greece except in the area of government effectiveness. As of 2006 Turkey ranked in the 64th percentile worldwide (up from the 52.6 percentile in 1996). Greece, on the other hand, still leads, falling in the 71.1 percentile (down from 78.2 in 1996).

Turkey's progress has been greatest in the area of political stability, but even as late as 2006 the country ranked only in the 25th percentile (up from 8.7 in 1996). Little improvement has occurred in the critical area of corruption, with the country fluctuating in the 50-60 percentile since 1996. The same pattern took place with regard to improvements in the rule of law. On the other hand, the country has experienced improvements in voice and accountability, though it is still only ranked in the 43rd percentile. Unfortunately for the economy, Turkey's major governance regression has been in the area of regulatory quality where the country fell from the 73rd percentile in 1998 to the 57th in 2006.

Within the macroeconomic context noted above, Turkey's progress at reforming specific aspects of the economy has been mixed. The overall picture has not been bright, with Turkey's economic freedom in the decline through most of the 1995-2007 period (Table 2). On a scale of 0 (no freedom) to 100 (complete freedom), Turkey's composite score declined from 61.3 in 1995 to 59.3 in 2007. It should be noted however that the last few years under the AKP government have been promising with aggregate economic freedom increasing from 50.9 in 2003 to 59.3 in 2007.

Table 2
Turkey: Trends in Economic Freedom

Year	Average Score	Regulation	Trade	Fiscal	Government	Monetary	Investment	Financial	Property Rights	Corruption	Labor
2007	59.3	67.4	76.0	79.4	69.9	70.2	50	50	50	35.0	45.4
2006	58.5	65.9	76.0	78.7	72.7	64.7	50	50	50	32.0	44.6
2005	50.3	30	71.0	76.9	62.3	53.8	50	30	50	31.0	47.6
2004	51.7	30	69.2	73.8	64.6	46.1	50	50	50	32.0	
2003	50.9	30	66.6	76.4	53.9	42.9	50	50	50	36.0	
2002	53.0	30	74.6	76.8	66.8	41.0	50	50	50	38.0	
2001	63.4	50	88.0	78.0	78.1	36.4	70	50	70	50	
2000	66.2	50	90.0	78.2	85.6	31.8	70	70	70	50	
1999	63.2	50	89.4	71.4	66.0	31.8	70	70	70	50	
1998	64.2	50	88.8	72.3	75.0	31.8	70	70	70	50	
1997	63.8	50	92.8	71.5	69.7	29.8	70	70	70	50	
1996	59.8	70	90.0	62.9	66.4	28.9	70	70	70	10	
1995	61.3	70	89.8	63.0	71.1	38.2	70	70	70	10	

Source: Heritage House, Index of Economic Freedom, various issues.

3. Draws on: Index of Economic Freedom, 2008 (Washington: Heritage House, 2008), pp. 373-74.

A similar picture emerges with regulation, where the country's score dropped from 70 in 1995 to 30 in 2005 only to jump to 67.4 in 2007, regaining most of the lost ground over the period. Unfortunately, in some key areas such as property rights, investment freedom, and financial markets little real progress has been made over the years.

GENERAL BUSINESS FREEDOM

Within the main categories of economic freedom, progress has been encouraging in several key areas.⁴ In particular, the overall freedom to start, operate, and close a business has improved considerably and the whole process is relatively well protected by Turkey's regulatory environment. Starting a business takes an average of six days (Table 3) compared to the world average of 43 days. Obtaining a business license requires more than the global average of 19 procedures, but less than the world average of 234 days, and costs are relatively low. On the other hand, bankruptcy proceedings can be burdensome and lengthy.

TRADE-GLOBALIZATION

Turkey has made some progress in trade liberalization, but more work needs to follow. The country's weighted tariff rate was 1.6% in 2005. Service market access barriers, prohibitive tariffs for agriculture and food products, import taxes, restrictive import licensing requirements for food and agriculture products, non-transparent and arbitrary standards and regulation, export promotion programs, weak enforcement of intellectual property rights, and corruption add to the cost of trade.

Table 3
Turkey: Business Climate

Year	Over-All Ease of Doing Business (rank)	Starting a Business				
		Rank	Procedures (number)	Time (days)	Cost (% income per capita)	Minimum Capital
2004	..	..	13	38	36.8	31.6
2005	..	..	6	6	26.0	25.0
2006	..	..	6	6	27.4	20.9
2007	65	40	6	6	26.5	18.7
2008	57	43	6	6	20.7	16.2

Year	Rank	Dealing with Licenses		
		Procedures (number)	Time (days)	Cost (% income per capita)
2004	..	..	..	..
2005	..	..	..	..
2006	..	25	188	448.6
2007	126	25	188	400.8
2008	128	25	188	369.9

Year	Rank	Employing Workers					
		Difficulty of Hiring Index	Rigidity of Hours Index	Difficulty of Firing Index	Rigidity of Employment Index	Nonwage Labor Cost (% of Salary)	Firing Costs weeks of wages
2004	..	44	40	30	38	..	95
2005	..	44	40	30	38	..	95
2006	..	56	40	30	42	22	95
2007	138	56	40	30	42	22	95
2008	136	56	40	30	42	22	95

Source: Compiled from: Doing Business 2008 (Washington: World Bank, 2007)

Table 3 (contd)
Turkey: Business Climate

Year	Rank	Registering Property		
		Procedures (number)	Time (days)	Cost (% Property Value)
2004	..	..	..	..
2005	..	6	6	3.0
2006	..	6	6	3.1
2007	30	6	6	3.1
2008	31	6	6	3.1

Year	Rank	Getting Credit			
		Legal Rights Index	Credit Information Index	Public Registry Coverage (% Adults)	Private Bureau Coverage (% Adults)
2004	..	..	4	1.0	0.4
2005	..	3	5	3.2	30.0
2006	..	3	5	4.9	27.6
2007	62	3	5	6.7	not available
2008	68	3	5	10.3	2.7

Year	Rank	Protecting Investors			
		Disclosure Index	Director Liability Index	Shareholder Suits Index	Investor Protection Index
2004	..	..	..	..	..
2005	..	..	..	..	..
2006	..	8	4	4	5.3
2007	62	8	4	4	5.3
2008	64	8	4	4	5.3

Source: Compiled from: Doing Business 2008 (Washington: World Bank, 2007)

Turkey also has failed to become integrated into the global economy to the extent of some of its neighbors (Table 4). If anything, the country has suffered a significant decline relative to other nations in becoming more globalized, with its globalization ranking declining each year from 2004-2007. While Greece suffered a similar fate, that

4. Draws on: Index of Economic Freedom, 2008 (Washington: Heritage House, 2008), pp. 373-74.

Table 3 (cont'd)
Turkey: Business Climate

Paying Taxes							
Year	Rank	Payments (numbers)	Time (hours)	Profit Tax (%)	Labor Tax and Contribution (%)	Other Taxes (%)	Total Tax Rate (% Profit)
2004	..	..	..	..	..	..	..
2005	..	..	..	..	..	..	..
2006	..	15	254	..	..	..	53.0
2007	85	15	254	..	..	..	53.0
2008	54	15	223	15.9	24.5	4.7	45.1

Trading Across Borders							
Year	Rank	Documents for Export (number)	Time for Export (days)	Cost to Export (US\$ per Container)	Documents for Import (number)	Time for Import (days)	Cost to Import (US\$ per Container)
2004	..	..	..	..	..	..	..
2005	..	..	..	..	..	..	..
2006	..	8	20	513	13	25	795
2007	73	8	20	513	13	25	795
2008	56	7	14	865	8	15	1013

Enforcing Contracts				
Year	Rank	Procedures (number)	Time (days)	Cost (% debt)
2004	..	37	420	18.8
2005	..	37	420	18.8
2006	..	37	420	18.8
2007	36	37	420	18.8
2008	34	36	420	18.8

Closing a Business				
Year	Rank	Time (years)	Cost (% of estate)	Recovery Rate (cents on the dollar)
2004	..	3.3	15	11.0
2005	..	3.3	15	0.0
2006	..	3.3	15	11.0
2007	114	3.3	15	19.0
2008	112	3.3	15	20.3

Source: Compiled from: Doing Business 2008 (Washington: World Bank, 2007)

country was still ranked considerably above Turkey (45th versus 65th) in 2007.

TAXES/FISCAL BURDEN

Recent years also have seen improvement in the tax area, with the country implementing lower tax rates. The top income tax rate is 35%, down from 40%, and the top corporate tax rate is 20%, down from 30%. Other taxes include a value added tax (VAT), a property tax, and a tax on interest. Currently, overall tax revenue is around 24% of GDP.

Total government expenditures, including consumption and transfer payments, are moderate. Government expenditures currently account for around 32.5% GDP. The ratio of public debt to GDP has been declining since 2001. Deregulation and privatization have reduced somewhat the role of the public sector.

As noted, inflation is high, averaging 9.2% between 2004 and 2006. Unstable prices have introduced an element of uncertainty, adding risk to long-term investments. On the other hand, the government still sets prices for many agricultural products and pharmaceuticals and influences prices through regulation, subsidies, and state-owned utili-

Table 4
Turkey: Patterns of Relative Globalization

Country	2007		2006		2005		2004		2003	Percent change 2003-07
	Ranking	Change	Ranking	Change	Ranking	Change	Ranking	Change		
Globalization Summary Score										
Turkey	65	-8	57	-1	56	-1	55	-2	53	-22.6
Greece	45	-13	32	-2	29	-1	28	-2	26	-73.1
Israel	21	-6	15	2	17	5	22	-3	19	-10.5
Romania	36	-6	30	5	35	4	39	1	40	10.0
Economic Dimension										
Turkey	51		47		49		53		38	-34.2
Greece	68		56		55		31		41	-65.9
Israel	25		20		19		62		32	21.9
Romania	29		11		34		38		44	34.1
Personal Dimension										
Turkey	66		57		54		49		58	-13.8
Greece	33		22		23		21		15	-120.0
Israel	12		9		9		7		20	40.0
Romania	37		30		26		37		28	-32.1
Technological Dimension										
Turkey	43		37		39		38		41	-4.9
Greece	35		33		32		30		28	-25.0
Israel	19		17		16		19		20	5.0
Romania	42		36		57		41		53	20.8
Political Dimension										
Turkey	58		51		47		52		35	-65.7
Greece	21		12		9		15		30	30.0
Israel	50		40		46		44		58	13.8
Romania	35		28		56		30		55	36.4

Source: Foreign Policy Index of Globalization, various issues

ties and enterprises. Municipalities fix ceilings on the retail price of bread.

PROPERTY RIGHTS

Property rights are generally enforced but the courts are overburdened and slow and judges are not well trained for commercial cases. The judiciary is subject to government influence. The intellectual property rights regime has improved, but insufficient protection of confidential pharmaceutical testing data and high levels of piracy and counterfeiting of copyrighted and trademarked materials remain concerns.

CORRUPTION

Corruption is perceived as significant. Turkey ranks 60 out of 163 countries in Transparency International's Corruption Perceptions index for 2006. An independent public procurement board has the power to void contracts. The judicial system is viewed as susceptible to external influence and somewhat biased against outsiders.

ASSESSING TURKEY'S STRENGTHS AND WEAKNESSES

Drawing on many of the elements discussed above, the World Economic Forum (WEF) has compiled a detailed assessment of the relative strengths and weaknesses of 131 countries around the world (Table 5). In the WEF framework, business competitiveness involves high attainment in a broad set of twelve areas: (1) institutions, (2) infrastructure, (3) macroeconomic stability, (4) health and primary education, (5) higher education and training, (6) goods and market efficiency, (7) labor market efficiency, (8) financial market sophistication, (9) technical readiness, (10) market size, (11) business sophistication, and (12) innovation. Each of these areas will affect Turkey's business climate with 1 through 8.

One of Turkey's greatest macroeconomic weakness has been the government's inability to control inflation.

GENERAL CONSIDERATIONS

As noted above, Turkey has lagged in improving governance structures. Its strength in this area is the ethical behavior of firms, but even here it ranks only 40th out of 131. In contrast the country is weak in a whole spectrum of areas.

The country's infrastructure also has a number of deficiencies with quality of electricity supply (74th) and the quality of overall infrastructure (59th) presenting the greatest challenges. Turkey has one of the world's fastest growing electricity markets. Gross consumption growth has averaged some 7% in each of the past four years. With per capita consumption well below Western European levels, the surge could continue for many years. However, supply is rising much slower than demand. Under various projections, regular power cuts will become inevitable in 2008, 2010, or 2011. New investments are therefore urgently needed. However, the state has in principle withdrawn from new investment in power generation since 2001. Compounding the problem, the private sector has been cautious about investing on a purely commercial basis without official purchase and price guarantees.

As noted, one of Turkey's greatest macroeconomic weaknesses has been the government's inability to control inflation. Traditionally, Turkish inflations have been demand related with expansive money supplies accounting for most of the increases in price. Thus inflation rates in the 70% range experienced in the 1990s were easily brought down by standard monetary policies. In recent years inflation appears to be more cost driven. For this type of inflation to abate, there has to be either acceleration in productivity or a fall in commodity prices or some combination of both. Most experts anticipate inflation will remain in the 8-10% range over the next several years.

Turkey suffers from several severe weaknesses in its labor markets. Some examples include the country's low standing in: cooperation in labor-employer relations (93rd), rigidity of employment (89th), flexibility of wage determination (88th), hiring and firing practices (88th), and pay and productivity (83rd).

Inflexible employment regulations hinder overall productivity growth. The non-salary cost of employing a worker is high and the rigidity of hiring and firing a worker creates a risk aversion for companies that would otherwise employ more people and grow. Turkish labor market regulations remain rigid despite two legislative revisions in the past decade. The convergence of the Turkey's Labor Code with OECD best practices is thus a key requirement for eventual EU membership.

With respect to temporary employment, Turkey has the most rigid code of the OECD by a significant margin. "Temporary," "interim," and "agency" work contracts are authorized only in limited circumstances, and there are strict limits to the number of times they can be renewed. "Agency work," whereby an enterprise makes temporary use of another firm's workforce was made significantly more difficult by the Labor Code amendment of 2003.

Table 5
Turkey: Business Environment -- Major Strengths and Weaknesses

Category	Ranking/131	Areas of Strength	Ranking/131	Areas of Weakness
Institutions				
	40	Ethical behavior of firms	100	Business costs of terrorism
	49	Favoritism in decisions of government officials	91	Efficacy of corporate boards
	50	Judicial independence	80	Burden of government regulation
			76	Organized crime
			70	Wastefulness of government spending
			69	Intellectual property protection
			63	Efficiency of legal framework
			62	Strength of auditing and reporting standards
			59	Transparency of government policymaking
			58	Property rights
			58	Business costs of crime and violence
			56	Public trust of politicians
			56	Protection of minority shareholders' interests
			54	Diversion of public funds
			52	Reliability of public services
Infrastructure				
	25	Available seat kilometers	83	Quality of port infrastructure
	49	Quality of transport infrastructure	74	Quality of electricity supply
	50	Quality of roads	67	Quality of railroad infrastructure
			59	Quality of overall infrastructure
			51	Telephone lines
Macroeconomic Stability				
	41	Government surplus/deficit	111	Inflation
			90	Government debt
			76	Interest rate spread
			53	National savings rate
Health and Primary Education				
	1	HIV prevalence	85	Infant mortality
	16	Business impact of HIV/AIDS	82	Malaria incidence
	39	Business impact of malaria	81	Education expenditure
	41	Business impact of tuberculosis	80	Quality of primary education
	48	Tuberculosis incidence	80	Primary enrollment
			71	Life expectancy
Higher Education and Training				
	43	Local availability of specialized research and training services	85	Secondary enrollment
	47	Extent of staff training	82	Quality of the education system
			81	Tertiary enrollment
			80	Quality of math and science education
			80	Quality of management schools
			71	Internet access in schools

Source: World Economic Forum, 2007.

Table 5 (contd)
Turkey: Business Environment -- Major Strengths and Weaknesses

Category	Ranking/131	Areas of Strength	Ranking/131	Areas of Weakness
Goods and Market Efficiency				
	11	Time required to start a business	108	Agricultural policy costs
	31	Intensity of local competition	103	Extent and effect of taxation
	34	Effectiveness of anti-monopoly policy	66	Total tax rate
	35	Extent of market dominance	60	Buyer sophistication
	37	Number of procedures required to start a business	57	Burden of customs procedures
	37	Degree of customer orientation	55	Business impact of rules on FDI
	40	Trade-weighted tariff rate	52	Prevalence of foreign ownership
	42	Prevalence of trade barriers		
Labor Market Efficiency				
			125	Female participation in labor force
			112	Firing costs
			93	Cooperation in labor-employer relations
			89	Rigidity of employment
			88	Flexibility of wage determination
			88	Hiring and firing practices
			86	Non-wage labor costs
			83	Pay and productivity
			68	Reliance on professional management
			58	Brain drain
Financial Market Sophistication				
	14	Restriction on capital flows	94	Legal rights index
	29	Financing through local equity market	92	Soundness of banks
	36	Financial market sophistication	82	Venture capital availability
	39	Registration of securities exchanges	74	Ease of access to loans
	45	Strength of investor protection		
Technological Readiness				
	29	Firm level technology absorption	76	Personal computers
	47	Availability of latest technologies	73	FDI and technology transfer
	49	Broadband internet subscribers	62	Internet Users
	50	Laws relating to ICT	55	Mobile phone subscribers
Market Size				
	16	Domestic market size index		
	27	Foreign market size index		
Business Sophistication				
	22	Local labor supply quality	83	Nature of competitive advantage
	27	Control of international distribution	70	Willingness to delegate authority
	36	Value chain breadth	51	Extent of marketing
	39	Local supplier quality		
	46	State of cluster development		
	48	Production process sophistication		
Innovation				
	41	Availability of scientists and engineers	73	Government procurement of advanced technology
	47	Capacity for innovation	67	Utility patents
	49	University-industry research collaboration	62	Company spending on R&D
	50	Quality of scientific research institutions		

Source: World Economic Forum, 2007.

Regulations concerning permanent employment are not the most rigid in the OECD, but remain far from being flexible. They are characterized by relatively long notice periods for the termination of employment, and a particularly costly severance payment regime. Various amendments to the Labor Code in 2002 and 2003 did not alter these provisions, even if they raised the “enterprise size threshold” for the application of employment protection from 10 to 30 workers. All enterprises remain obliged to pay the high severance payments.

Other employment-related rules apply to enterprises employing more than 50 workers, such as the requirement to hire 6% of their workforce from socially-assisted groups (ex-convicts, handicapped people, and victims of terrorist acts); the requirement to hire a certain number of lawyers, physicians, and nurses; and the requirement to establish social and recreational facilities. In these circumstances, many enterprises ensure that their total number of (formal)

employees remains below the relevant threshold (30 or 50 employees) in order to avoid compliance with these additional rules.

Severance payments represent a very significant employment cost for formal sector firms. The law prescribes one month of compensation at the latest wage level for each year of service, which can be increased further under collective agreements. This rate of severance payment is the highest in the OECD. Moreover, severance payments are payable even in the case of certain voluntary departures (such as retirement). Many Turkish enterprises have a huge off-balance-sheet liability in the form of such obligations which, according to certain analysts, would make many of them insolvent in case of large employment adjustments. If compulsory severance payments were included in the labor tax wedge, the wedge would increase by 8 percentage points, making it the highest tax wedge in the OECD by a wide margin. Many firms circumvent this rule by firing workers and re-hiring them before they have been employed for 12 months, after which they become eligible for severance payments. However, those that play by the rules face growing liabilities.

The high cost of legal employment also stems from the high level of the legal minimum wage. The high minimum wage magnifies the negative impact of the labor tax wedge on employment in the formal sector, as the formal wage costs of low-skilled workers can easily exceed their productivity levels. Among OECD countries Turkey has the second-highest labor costs for minimum wage earners relative to formal sector median wage workers, and this ratio has sharply increased as a result of successive minimum wage increases over the past five years. These developments have undoubtedly contributed to employment losses in the formal sector.

EDUCATION

In the area of primary education, Turkey's main weaknesses lie in the amounts the country spends on that type of instruction, the quality of primary education, and primary enrollment. One in 10 children (about 1.85 million) work for small businesses, either as street peddlers or as seasonal agricultural workers. Statistics from 2007 indicate that approximately 8 million Turkish women are illiterate. More than 640,000 girls do not attend school in Turkey and only 3% receive a university education.

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Attempting to reverse this pattern the government has begun designating more funding to education in addition to several special initiatives:

1. In 1997, the government increased compulsory primary education attendance from five to eight years.
2. By 2005, the government for the first time in the history of the Turkish Republic spent more money on education than the military.
3. If poor families opt to send their children to school, they receive monthly government grants of \$15-20 per child, funded in part by a \$250 million World Bank program.
4. The government has increased grants for girls who stay in school in an effort to close the gender gap.

Higher education and training in Turkey also suffer from a number of weaknesses including low secondary enrollment, the quality of the education received, tertiary enrollment, quality of math and science education, quality of the country's management schools, and internet access in schools. The only areas of strength lay in the local availability of specialized research and training services, and the extent of staff training.

Most middle class parents are willing to spend considerable amounts to prepare their children for selective high school and university exams, viewing university admission as the key to economic gain. Thousands of 14- and 15-year old hopefuls spend a year of weekends in expensive private study centers called *dershanes* preparing for the exams of selective high schools. Spending another year training in these study centers, nearly all third-year high school students attend Preparation classes for the university exam. Yet entrance to a university or college is limited to 1/10 of the 1.5 million students who take the exam each year.

There are many exciting developments taking place in Turkish education.

Turkey's education experts are working hard to incorporate more critical thinking into the curriculum to reduce reliance on rote memorization in the curriculum and to incorporate more critical thinking. In 2006 the ministry introduced an innovation course in the primary school curriculum in which students present competitive business plans drawing on math, science, technology, critical thinking, and English skills. The goal is to foster employment relevance, technology, and critical thinking for the next generation, in an effort to more closely match international education standards.

The OECD has recommended that the university entrance exam should be fully aligned with the national curriculum to reduce the current barrier to higher education for students who do not have the means to pay for test preparation programs. The Organization emphasized that the state, rather than prioritizing sorting and selecting students for the elite schools, should provide the majority of young people with the basic literacy and mathematical skills necessary for the modern workforce.

Surveys⁵ suggest that for the most part, existing Turkish textbooks focus mostly on the transmission of knowledge, and they are considered ineffective in leading students to read the information with interest and develop an understanding of the content area. They also are found ineffective in developing students' thinking skills and positive attitudes toward the subject.

Unfortunately, Turkey has not made much progress in its attempts at reducing textbook piracy. Despite the introduction of intellectual property laws in 1995, the pirated market of copied books continues to expand. In a report made by the Union of Literature and Science Work Owners (EDISAM) and released in 2007, pirated copies of books control 60% of the entire book market. Bestsellers, culture and literature works, exported books, high school and secondary school books and especially university textbooks are among the books that are copied. Pirated copies of books comprise 90% of university textbooks while they account for 60% of exported books and 40% in cultural publications.

Police raids have disclosed that copied books contain numerous tax stamps acquired for other books. Due to the lack of experts in copyright directorates, pirate sellers can buy as many tax stamps as they need as long as they are in accordance with regulations.

The problem is clearly one of enforcement as the country's intellectual property laws are now in compliance with the TRIPS agreements signed with the Customs Union and the World Trade Organization. The government is well aware of the problem and is taking positive steps to ramp up the country's enforcement capabilities:

- Judges and prosecutors will be sent abroad for training in the fields of intellectual property and property rights.

5. Summarized in Ali Yildirim, "High School Textbooks in Turkey from the Teachers' and Students' Perspectives: The Case History of Textbooks," *Asia Pacific Education Review*, Vol. 7, No. 2 (2006), pp. 218-228.

Turkey's education experts are working hard to incorporate more critical thinking into the curriculum to reduce reliance on rote memorization.

- Authorities plan to add copyright-related material to a primary school course called “Knowledge of Life.”
- Essay competitions will be held for university students on the topic “how to prevent piracy.”
- Newspaper and television advertisements will be prepared to create and develop a social consciousness regarding the issue.

Under the new action plan, one of the goals will be to cultivate a copyright aware generation. Authorities plan to add copyright-related course material to piracy education curricula and university syllabi.

In short, it appears the country is starting to take piracy seriously. It has enacted tough laws, provided tools for more effective enforcement, and is laying the foundation for a new generation of citizens that are copyright aware.

CAPITAL MARKETS

Relative to its educational system, Turkey’s capital markets are much better balanced between strengths and weaknesses. Among its strengths (Table 5) are: (a) limited restrictions on capital flows, (b) the ability to finance through local equity markets, (c) the degree of financial market sophistication, (d) registration of security exchanges, and (e) strength of investor protection. The main weaknesses are: (a) legal rights, (b) soundness of banks, (c) venture capital availability, and (d) ease of access to loans.

A similar picture emerges from the more detailed Milken Capital Access Index. In terms of the overall index, Turkey has shown steady improvement since 2003, increasing its rank from 67th to 51st during this interval. The country’s institutional environment also has shown steady improvement, rising from 59th in 2005 to 46th in 2007. However, progress has stalled in several key areas: (a) equity market development (the extent to which financing of business operations is important for a given country and (b) bond market development (the importance of bond financing of business operations).

The past five years have seen generally significant improvements in Turkish capital markets.

In short, the past five years have seen generally significant improvements in Turkish capital markets. Still, most financial analysts rate the country as an emerging market along with countries such as Brazil, South Africa, Egypt, and those in Southeast Asia — all countries that are experiencing high real interest rates imposed as part of an effort to bring inflation under control after years of double or triple digit rates of price increases.

There are several implications for foreign financial companies in general. Even though the investment decisions of foreign brokers and institutions are showing increased maturity, domestic investors need education and more importantly need the support of a professional asset management industry. The fact is, Turkey’s financial markets are increasing in sophistication so rapidly that the typical investor is not always able to grasp the implications for a change in portfolio strategy. This, combined with the rapid growth in new financial instruments, should create a strong and lasting demand for professional investor assistance.

One area of great growth potential is the securitization of future cash flows. In the last decade, several major securitization transactions were undertaken generally involving trade finance cash flows and remittances of Turkish workers abroad. Securitization of future cash flows is not limited however to large-scale projects where banks are the main actors; due to its good credit rating and stellar performance, future flow securitization is attractive to a wide range of investors, and financial institutions and businesses of all kinds may use this means of structured finance to immediately realize the value of a cash producing asset.

In Turkey, as is the case with most European countries, there is not a specific law regulating securitization. Validity and enforceability of future flow securitization transactions are regulated by the Turkish Law of Obligations and Execution and Bankruptcy Law. This creates a situation where novel securitization structures are possible with only minor restrictions.

The market for Islamic financial services is lucrative in Turkey in part because it is the Muslim world's largest economy. Dow Jones has responded to the growing interest in Islamic financial services with indexes tracking Islamic stocks. Those are defined as shares of companies that are not involved in producing or offering alcohol, pork products, conventional financial services or entertainment such as pornography, music, film, or gambling.

There are 45 Islamic Indexes. Dow has six shaykhs on an advisory board helping to evaluate companies according to *Sharia* principles. One of the newest Islamic indexes is the Dow Jones Islamic Market Turkey Index, which tracks stocks trading on the Istanbul Stock Exchange. The index was introduced in September 2004 and has a float-adjusted market capitalization of around \$4 billion.

FINAL ASSESSMENT

Over the past five years, Turkey's government has pushed through changes that have increased growth to 7% a year and brought inflation down to single digits. The changes involved cuts in government spending, an overhaul of the financial sector, strengthening the independence of the central bank, and selling state-owned enterprises — all part of an economic recovery program introduced after a financial crisis in 2001.

While Turkey has the potential to quickly converge on Western European standards of living and economic and financial sophistication, great uncertainties remain. The divisions that triggered the current political crisis in Turkey could soon derail plans to boost economic growth and remake the landscape for foreign and domestic investors.

The next steps in the plans of Turkey's ruling Justice and Development Party (AKP) could reshape the government's fiscal health and attract foreign direct investment. But portions of the plan require changes to Turkey's Constitution, providing a forum for a clash between members of the country's secular-oriented establishment—which dominates the military—and the more religiously inclined members of the AKP.

Currently, secular groups, through use of the judiciary, are trying to get the AKP banned — only adding to the country's uncertainty. Unfortunately all this comes at a critical point in the country's liberalization efforts; without further liberalization the country will not be able to sustain recent growth rates and converge with the EU. More importantly, membership in the EU will become even more remote. Even in some of the worst-case scenarios there are still hopeful outcomes for the Turkish economic landscape. In the financial area, even slower overall growth will not stop the explosion in new financial instruments and the expanding need of investors to become better educated on the new markets and invest more wisely than in the past.

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