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Chapter Title: The Public Sector: Fiscal Adjustment and Resource Mobilization

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the export boom. The boom, of greater concern to Turkish policymakers, is also needed to maintain credit worthiness. In some ways, Turkish exporters have shown remarkable flexibility in the face of adverse market development. As declining oil revenues choked Middle Eastern import demand, exporters have successfully reoriented their efforts toward the OECD. But export performance remains extremely sensitive to the domestic policy environment. A public-investment-led boom in domestic demand in 1986 resulted in an absolute reduction in export earnings. A renewed program of export subsidization since late 1986 appears to have revived exports, as well as overinvoicing, but the underlying fragility is still clearly there.

A fundamental doubt regarding future export performance has to do with capacity constraints. The continuation of the export drive will henceforth require capital accumulation in export-oriented sectors, as output is reaching the limits of existing capacity. But, as discussed in previous chapters, private investment has remained soft since the late 1970s, and public investment continues to favor infrastructure projects with scant export potential. By late 1987, signs of a genuine structural transformation consistent with higher levels of trade orientation were still too few for comfort.

8 The Public Sector: Fiscal Adjustment and Resource Mobilization

In combination with price, incomes, and external borrowing policies, the government's fiscal policy has had a close bearing on the conditions of macroeconomic stability, trade balance, resource mobilization, and growth in the Turkish economy in the post-1973 period. Fiscal policy has affected macroeconomic performance through the workings of public sector deficits and their financing mechanisms, and the mix of public revenues and spending.

The 1973–77 period saw a surge in public spending and widening deficits, which were financed mainly through domestic credit expansion. Under reserve decumulation and heavy external borrowing, the expansion of credit to the public sector was largely sterilized by falling net foreign assets of the central bank, producing only a moderate monetary expansion and inflation. The unprecedented rise in imports also served to dampen the inflationary pressures. In turn, the reduced capital inflows in 1978–79 could no longer sterilize deficit financing through central bank credits, leading to a sharp

acceleration in monetary growth and inflation. Against the backdrop of rapidly worsening fiscal performance, the post-1980 adjustment program required policy actions to lower public deficits and to restore more sustainable fiscal conditions as part of an effort to pursue an outward-oriented approach in the growth process.

As pointed out in chapters 4 and 5, the fiscal correction in the post-1980 era included revenue mobilization in the SEE sector, real wage cuts for government workers, expenditure restraint, and a tax reform effort. To offset the contractionary effects of price shocks and falling private investment, public investment was maintained on a steadily rising path.

The post-1983 period under the Özal administration exhibits a new set of trends in fiscal strategy and adjustment, including fiscal decentralization, introduction of the value-added tax system, and increased reliance on domestic borrowing (at high interest rates) in financing fiscal deficits. We conclude that fiscal retrenchment has not been adequate in Turkey, portending serious policy difficulties for the late 1980s in coping with inflation, public debt, and deficits in an increasingly competitive political context.

The present chapter provides an overview of fiscal adjustment and resource mobilization in Turkey's public sector in the post-1980 period. We will attempt to document and interpret the major fiscal trends within the framework of public sector accounts arranged on the basis of national income accounting concepts. The chapter ends with an assessment of issues in and prospects for fiscal policy.

8.1 Public Finance: Scope, Size, and Structure

Turkey lacks a unified system of public sector accounts that is strictly adhered to in the presentation of subsector budgets. The classification and treatment of transactions have not been uniform across government units and have showed variation over time. Intrasectoral transfer payments and capital flows are not reported in sufficient detail on a regular basis. In the present Turkish setting, the highly aggregated data base of the SPO serves as the most consistent source of information on overall public finance. The SPO data on public finance include figures on public disposable income, savings, and investment, from which estimates may be derived (through the use of other relevant data) for public sector borrowing requirements (PSBRs).

8.1.1 Institutional Components

In the SPO data system, the Turkish public sector comprises six major components: (1) central government, (2) local government, (3) nonfinancial SEEs, (4) financial SEEs, (5) revolving fund agencies, and (6) extrabudgetary funds.

Central government covers all the usual public service departments. Its so-called consolidated budget (including budgets of several annexed agencies) serves as the central vehicle to mobilize public revenue and appropriate expenditures under the general scrutiny and approval of the Parliament. Local government comprises municipalities, special provincial administrations, and villages, which have had limited revenue-generating capacity until recently.

The *nonfinancial* (or operational) SEEs are directly engaged in the production of marketable goods and (nonfinancial) services, often requiring subsidies for their current operations and budgetary transfers for their investment programs. The *financial* SEEs include state-owned banks and, until recently, social security institutions. From 1984 on, the social security institutions have become revolving fund agencies, which exercise, as adjunct governmental entities, a considerable autonomy in their financial management.

In the post-1983 period, the Özal administration has introduced a large number of extrabudgetary funds, presumably to increase flexibility in revenue mobilization and expenditure allocation. The largest such funds in operation before 1983 were the Petroleum Price Stabilization Fund and the Support and Price Stabilization Fund (for fertilizer subsidies). As off-budget parastatals, these funds face less strict budgetary control and receive protection from general budget cuts.

The main financial sources of extrabudgetary funds are: (a) various earmarked taxes and surcharges on foreign trade, bank credits, and other transactions, (b) income-sharing certificates of public utilities and enterprises, (c) interest income on the funds' financial assets, (d) foreign credits, and (e) donations and transfers from other funds. Among the new funds, the particularly sizable ones are the Mass Housing Fund (for residential construction), the Public Participation Fund (for public infrastructure investment), the Resource Utilization Support Fund (for export and investment incentives), the Development and Support Fund (for animal feed stock), the Mutual Assistance and Support Fund (for income transfers to the poor), the Petroleum Consumption Fund (for highways and municipal investments), and the Defense Industry Support Fund.

The share of public services value added (comprising the gross salaries of government employees) in GNP was 9 percent in 1980, and declined to 6 percent in 1985. In turn, the ratio of the SEE value added to GNP was 11 percent in 1980, and increased to 17 percent in 1985. The share of SEEs in industrial value added was about 24 and 27 percent in 1980 and 1985, respectively.[1]

In terms of generating new employment, the public sector has played a restrained role in the post-1980 stabilization period. In the mid-1980s, the shares of public services and SEEs in nonagricultural employment were

nevertheless sizable, about 20 and 11.5 percent, respectively. As discussed in chapter 5, the real wage cuts from 1978 on have caused significant changes in the functional and size distribution of income.

8.1.2 Public Revenue, Disposable Income, and Expenditure

Table 8.1 shows public sector revenue, current transfers, disposable income, and final expenditure as a percentage of GNP (in current prices) over the 1978–86 period. The flows in this table exclude capital transfers to and from the private sector and abroad, and thus may be viewed as current account items. It should be emphasized that the receipts from off-budget funds are not included in the revenue figures of the pre-1984 period.[2] The SPO coverage of extrabudgetary funds in public revenue is partial in the post-1984 period, but progressively increases from 1984 onward.

Current transfers as an item includes subsidies, interest payments, tax rebates, and other income transfers to (and from) the private sector and rest of the world, making up the difference between public revenue and disposable income. Final expenditure is the sum of public consumption and investment, including inventory changes. In this table, the revenue-expenditure balance is equivalent to the savings-investment balance (or

Table 8.1 **Public Sector Current Account, 1978–86 (as a percentage of GNP, current prices)**

	1978–79 Average	1980	1981	1982	1983	1984	1985	1986[a]
Public Sector								
1. Revenue[b]	20.3	19.8	22.2	22.9	22.4	21.8	23.8	25.6
2. Current transfers[c]	2.9	2.3	2.9	3.2	5.0	5.2	6.1	8.1
3. Disposable income								
(1 minus 2)	17.4	17.5	19.3	19.7	17.4	16.6	17.7	17.5
a. Consumption	13.4	12.2	10.7	10.9	10.1	9.0	8.5	8.6
b. Savings	4.0	5.3	8.6	8.9	7.3	7.6	9.2	8.9
4. Final expenditure								
(consumption + investment)	22.9	23.7	23.9	22.7	21.6	19.0	19.5	20.8
5. Total expenditure (2 + 4)[d]	25.8	26.0	26.8	26.0	26.6	24.2	25.6	28.9
6. Savings-investment								
balance (3 minus 4)	−5.5	−6.2	−4.6	−3.1	−4.2	−2.4	−1.8	−3.3
Memo items:								
Wealth tax	0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.4
Public disposable income								
(1983 prices) of which	12.4	15.5	18.6	18.8	17.4	16.2	17.4	16.0
Consumption	9.8	10.9	10.5	10.2	10.1	9.8	9.6	9.4
Savings	2.6	4.6	8.1	8.6	7.3	6.4	7.8	6.6

Source: SPO (1985), Central Bank (1987), and various SPO Annual Programs.

[a]Provisional estimates.

[b]Excludes wealth and capital flows.

[c]Includes subsidies and interest payments; excludes capital transfers.

[d]Excludes capital transfers and debt (principal) repayment.

savings gap) of the public sector. Conceptually, wealth taxes (on property and motor vehicles) are not considered as an income flow, but as a capital transfer item. They are thus excluded from public revenue figures, but shown as a memo item in table 8.1.

Leaving the review of fiscal adjustment to section 8.2, we may now point to a number of basic trends emerging from the data shown in table 8.1. Public expenditure (excluding capital transfers) has been consistently around 26 percent of GNP during the 1978–85 period. Public revenue has remained several percentage points below public expenditures in this period. Notice that there has been a sharp rise in current transfers since 1983. This reflects mainly increased interest payments, which have required a downward adjustment in final expenditures in relation to domestic product.

The constant-price share of public disposable income in GNP (shown as another memo item in table 8.1) may be compared with the corresponding share in current prices to note the strong impact of relative price changes on the fiscal position in 1980 and 1981.

Table 8.2 gives the breakdown of public revenue (by sources) and disposable income (by institutional components) for selected benchmark years from 1979 to 1986. The data in the table show that the post-1980 economic program markedly altered the pattern of revenue mobilization in the public sector. The increased revenue contribution of factor income from

Table 8.2 **Structural Change in Public Revenue and Disposable Income, 1979–86**

	1979	1982	1985	1986[a]
A. Public revenue (%)				
1. Taxes				
a. Direct taxes	56.6	46.3	25.7	26.3
b. Indirect taxes	43.7	32.2	38.1	41.4
c. Subtotal	100.3	78.5	63.8	67.7
2. Nontax budget revenue	3.5	7.1	9.2	7.5
3. Factor income from property[b]	−3.8	14.4	27.0	24.8
4. Total	100.0	100.0	100.0	100.0
B. Public disposable income (PDY. %)[c]				
1. Central government budget	92.2	81.2	51.0	52.6
2. Local government	7.7	7.4	12.4	14.7
3. SEEs (nonfinancial)	−4.1	6.3	26.0	19.4
4. SEEs (financial)	3.3	4.2	0.6	0.7
5. Revolving fund agencies	1.0	0.9	3.6	3.2
6. Extrabudgetary funds	—	—	6.4	9.4
7. Total	100.0[d]	100.0	100.0	100.0

Source: SPO.

[a]Provisional estimates.

[b]Including net surplus of social security institutions.

[c]The PDY figures for subsectors are derived after taxes and intrasectoral transfers.

[d]Column does not add up exactly due to rounding errors.

property (including SEE profits and depreciation allowances) provided room for tax reform initiatives, which tended to lower the tax/GNP ratio in 1980–84. Only after the introduction of the VAT (in 1985) and extrabudgetary funds did the relative share of indirect taxes begin to shift upward. Correspondingly, the structure of public disposable income shifted away from the central government in favor of SEEs, local government, and extrabudgetary funds, with sharp implications for the savings structure as discussed in section 8.4.

8.1.3 PSBR

In the absence of official indicators of the overall PSBR, we have derived two sets of estimates under two variant procedures. In variant A, the PSBR(A) is estimated by adjusting the public savings-investment balance for the following three factors: (1) nondebt capital transfers (including wealth tax, grants, acquisition or sale of property, and capital flows connected with state participations); (2) valuation differences for the year-end SEE inventories; and (3) increase in accounts payable (or arrears) in the central government budget.[3]

In variant B, the PSBR(B) is estimated as the total cash deficit of the central government and nonfinancial SEEs, excluding the cash needs and/or surpluses of other public sector entities. It may be noted that the cash deficit of the central government (included in PSBR(B)) is the budget deficit adjusted for arrears.

Table 8.3 shows the estimates PSBR(A) and PSBR(B) for the 1980–86 period. Despite differences for particular years, the trends displayed by the two series are not too dissimilar. The estimation of PSBR(A) is conceptually more satisfactory, even though the quality of underlying data on nondebt capital transfers is somewhat questionable.[4] This qualification as regards data notwithstanding, the PSBR(A) estimates appear to be closer to the actual cash deficits of the overall public sector in the post-1980 adjustment period, and for this reason we have chosen to rely on this version here and in other chapters. Table 8.3 also gives the financing items for PSBR(A), which point to the tendency toward reduced central bank financing and increased domestic borrowing, especially after 1983. The particular fiscal characteristics of the intervening years in 1980–86 are reviewed in the next section.

8.2 Fiscal Adjustment, 1980–86

8.2.1 Overall Fiscal Policy

In main, four sets of factors have shaped the overall fiscal policy in the 1980–86 period. First, public sector deficits prior to 1980 required immediate corrective actions, both in the budget and SEEs, to regain control over monetary growth and inflation. Second, the policymakers attached

Table 8.3 PSBR Estimates, 1980–86 (as a percentage of GNP)

	1980	1981	1982	1983	1984	1985	1986[a]
1. Variant A: PSBR(A)	9.9	3.7	5.0	5.3	7.9	4.9	4.7
Financing (net)							
External borrowing	3.2	2.5	1.0	1.4	2.7	0.5	0.5
Domestic borrowing (Treasury)	1.1	1.4	1.5	0.9	2.3	2.7	2.8
Budget, long term	0.2	0.8	0.6	1.8	0.7	1.9	1.2
Budget, short term	0.9	0.6	0.8	−0.9	1.6	0.9	1.6
Central bank	3.5	2.0	0.3	0.6	0.7	1.3	0.6
Other	2.2	−2.2	2.2	2.3	2.1	0.4	0.8
2. Variant B: PSBR(B)							
Cash deficit							
a. Central government budget	5.0	1.3	2.1	2.1	5.2	2.8	3.2
b. SEEs[b]	6.6	4.7	3.9	2.9	2.8	2.8	2.4
c. Total (a + b) = PSBR(B)	11.6	6.0	6.0	5.0	8.0	5.6	5.6
Memo items:							
Interest rate on government bonds (%)				45	59	56	50
Increase in WPI (%)	107	37	25	31	52	40	27

Source: Variant A: Estimates based on SPO data, see tables A.7 and A.8 in statistical appendix. Variant B: OECD (1986) for 1980–84 and Central Bank (1987) for 1985–86 estimates.

[a]Provisional estimates.

[b]Cash deficit of nonfinancial SEEs after budgetary and parabudgetary transfers, and before arrears and State Investment Bank Credits.

importance to output recovery and growth objectives, and chose to reduce the public savings gap through increased savings rather than through a major reduction in public investment, especially in the context of falling private fixed investment. Third, the tax system needed qualitative changes and restructuring to halt bracket creep (or fiscal drag) in income taxation, reduce evasion, and revitalize indirect tax revenues, which had fallen rapidly in proportion to GNP in the latter part of the 1970s. Moreover, financial liberalization and various supply-side concerns required adjustments in tax burdens and incentives. Hence, a complex tax reform package had to be introduced with rather uncertain prospects for the tax/GNP ratio in the medium run. Fourth, a fiscal decentralization away from central government was perceived to be essential by the authorities to increase allocational flexibility in general and improve local government finances in particular.

Thus, the overall fiscal policy evolved under a number of cyclical and structural constraints in such a manner as to support the stabilization, recovery, and liberalization objectives in the post-1980 adjustment program. For adjustment mechanisms, the fiscal policy relied mainly on flexible pricing in the SEEs, real wage reductions, tax restructuring, and lately domestic borrowing in an effort to sustain an acceptable growth of developmental expenditures in the economy. The multiplicity of policy

objectives and instruments produced conflicts, however, in the implementation process. The fiscal adjustment in the intervening years is reviewed in the rest of this section.[5]

8.2.2 1980–82

This subperiod saw a determined price-stabilization effort, which resulted in a sizable fiscal retrenchment. The PSBR was nearly halved in this policy phase, mainly due to the rise in public revenue, disposable income, and savings. The external debt relief was helpful in avoiding a rapid increase in current transfers (including interest payments), and therefore indirectly contributed to the attainment of deficit reduction. Central bank financing of the PSBR declined sharply from 3.5 percent of GNP in 1980 to 0.3 percent in 1982.

Revenue mobilization was boosted in 1980–82 primarily by the rise in SEE factor incomes. With the maintenance of government employment at reduced real wages, public consumption continued to grow in real terms, providing social services to the economy at sharply lowered relative prices. The tax reform initiated in late 1980 showed positive results in 1981, yielding an increase in tax elasticity (i.e., the proportional response of tax revenues to increases in income) from 0.9 to 1.2 in that year. However, the tax elasticity dropped to 0.8 in 1982 because of altered income brackets and lowered tax rates.

8.2.3 1983

The public savings gap widened in 1983 because of the decline in the ratio of public disposable income to GNP, which was in turn due to the sizable increase in external interest payments of the central government budget. That year saw a legislative initiative to simplify the settlement of tax arrears and to assess taxable income in relation to observed expenditures. The further fall in tax/GNP ratio could not be adequately offset by SEE revenue increases. The PSBR/GNP ratio could be held around 5 percent in 1983, mainly through a large increase in the arrears of the central government.

8.2.4 1984

After the general elections of November 1983, the Özal administration could not reverse in 1984 the deteriorating revenue performance and the rising current transfers of the public sector. Foreign interest payments were grossly underestimated in the central government budget, but had to be fully serviced. The increase in the nominal value of SEE inventories (including agricultural support purchases) was unexpectedly large. In terms of public finance shares in GNP, the burden of adjustment was mainly on final expenditure categories. A restraint on nontransfer expenditures could not, however, halt the widening of the overall cash deficit, which increased above 7 percent of GNP, requiring an expansion in central bank financing and a significant rise in borrowing by the Treasury.

In the first half of 1984, the public sector financing pressures on money supply were augmented by pressures from the balance of payments as export earnings were stimulated by trade liberalization and new incentives. Despite the large rise in interest rates, the liquidity expansion could not be contained, and the inflation rate surged to 52 percent (as measured by the WPI) in 1984 from 31 percent in 1983. The reduction in real demand for money base after the introduction of foreign exchange deposits might also have contributed to excess money supply in 1984. In order to attract private financial savings, the interest rate on Treasury borrowing was raised to nearly 60 percent with vast consequences for the interest burden on the central government budget.

8.2.5 1985–86

The worsening fiscal trends were partially reversed in 1985. Despite the continuing rise in current transfers, the shares of public disposal income and savings in GNP could be raised that year mainly through a rapid recovery in public revenue. The sources of revenue expansion were SEE factor incomes, the VAT, nontax revenues, and various levy collections for the extrabudgetary funds.

The reversed fiscal trends more or less continued in 1986. The PSBR/GNP ratio was lowered from above 7 percent in 1984 to less than 5 percent in 1985–86, together with the reduction in the inflation rate to 27 percent in 1986 from 52 percent in 1984. In the context of falling dollar prices of oil and nonoil imports in 1986, a larger reduction in inflation could have been attained through a moderate rise in public expenditures and smaller cash deficits.

8.3 Public Debt

As argued in chapters 4 and 5, the post-1980 Turkish economic recovery benefited from the external debt relief extended in 1980–84. With the termination of debt relief in 1984, Turkey began to face an increase in external debt service, which may extend, if the debt is not partly rescheduled, over the 1985–90 period. This debt overhang gives rise to two familiar problems: the need for noninterest surpluses in the current account of the balance of payments, and additional domestic resource mobilization by the public sector for debt servicing.

As in other heavily indebted middle-income countries, the bulk of Turkey's external debt is held by the public sector. The rise in external debt service raises current transfers (through larger than usual interest payments), lowers public disposable income, and puts pressure on the budget balance. Furthermore, the repayment of principal reduces the volume of net foreign borrowing as a financing item for the PSBR, requiring the expansion of either central bank financing and/or domestic borrowing through the issue of government securities. Also, as part of the policy actions taken to increase

international competitiveness and generate noninterest current account surpluses, the exchange rate depreciation tends to increase the relative size of debt service in relation to budget revenue and expenditures.

In Turkey in 1984–86, policymakers faced all these problems and chose to use domestic borrowing as the main mechanism to cope with the remaining fiscal disequilibrium. However, a heavy reliance on domestic borrowing accelerated the rise in public debt from 1984 on, creating a larger debt claim on limited public sector resources.

Table 8.4 shows the principal indicators of the Turkish public debt from 1981 to 1986. In the presentation of figures for debt stock in part A of this table, following the official practice, the public sector includes the SEEs, while excluding the central bank. As a proportion of GNP, the public debt was about 35 percent in 1981–82, nearly 45 percent in 1983–84, and 49 percent in 1985–86.[6] From 1983 on, the ratio of public debt to public revenue has fluctuated around 200 percent.

Within the public sector, the central government budget carries the major burden of servicing public external debt. With an increasing recourse to

Table 8.4 Indicators of Public Debt, 1981–86

	1981	1982	1983	1984	1985	1986[a]
A. Public debt stock						
1. Public external debt						
a. billion $	10.3	11.6	1.6	13.0	14.9	18.7
b. trillion TL	1.1	1.9	2.6	4.7	7.7	12.5
2. Public domestic debt (trillion TL)						
a. Consolidated debt[b]	0.5	0.7	1.7	2.5	3.9	4.1
b. Nonconsolidated debt	0.5	0.7	0.8	1.0	1.8	2.9
c. Subtotal	1.0	1.4	2.5	3.5	5.7	7.0
3. Total public debt (1b + 2c)						
a. trillion TL	2.1	3.3	5.1	8.2	13.4	19.5
b. % GNP	32.0	37.7	44.4	44.8	48.5	49.1
c. % public revenue	144.1	164.6	198.2	205.5	203.8	191.8
B. Debt service in central government budget (% GNP)[c]						
1. External	0.9	1.5	2.4	2.7	3.1	3.7
2. Domestic	0.9	0.8	0.7	0.9	1.2	2.8
3. Total	1.8	2.3	3.1	3.6	4.3	6.5
Memo items:						
Central government budget revenue (% GNP)	20.3	19.6	18.7	15.4	17.0	17.4
External debt (billion $)						
Central bank	4.3	4.1	5.3	5.6	6.7	7.6
Private sector	2.2	2.0	1.5	2.6	3.7	4.9
Turkey	16.8	17.7	18.4	21.2	25.3	31.2

Source: Central bank of Turkey, SPO, and OECD (1986).

[a]Provisional estimates.

[b]The bulk of consolidated debt covers devaluation-induced valuation changes in external debt held by the central bank.

[c]Including principal and interest payments.

Treasury borrowing in financing the cash deficits, the domestic debt service burden also rose sharply in the post-1984 period as shown in part B of table 8.4. The ratio of total debt service to revenue in the central government budget increased from about 15 percent in 1981–83 to nearly 40 percent in 1985–86. The latter has required a tight stance on social outlays and personnel expenditures, lowering the general quality of social services (e.g., health and education) in Turkey.

In the review of public debt, it should also be noted that the so-called consolidated debt (of the central government) constitutes a significant portion of domestic public debt. Besides including obligations previously contracted, this debt stock primarily covers devaluation-induced differences in the Turkish lira value of external debt held by the central bank, which are treated as Treasury liabilities in the monetary authorities' accounting system. The nominal interest rates on consolidated debt are very low, and therefore average interest rates on total domestic debt have been much lower than interest rates on the newly issued government securities.

From 1984 on, the domestic borrowing for PSBR financing has relied basically on two financial instruments: short-term Treasury bills and longer term government bonds, with small nominal differences in their respective interest rates (see memo items in table 8.3). Since May 1985, the interest rates of these securities have been determined through weekly auctions. These default-free, tax-exempt, and high-yield money-market instruments have become quite popular for commercial banks, which are allowed to hold them against their liquidity requirements.[7]

Table 8.5 provides data on security issues in Turkey during 1982–86, with the volumes issued by the public and private sectors expressed as percentages of GNP. The indicators in the table crystallize the predominance of the public sector in the issue of securities in the Turkish financial system after 1983. While contributing to the promotion of financial intermediation, the disproportionately high share of the public sector in new security issues

Table 8.5 Securities Issued, 1982–86 (as a percentage of GNP)

	1982	1983	1984	1985	1986
1. Public sector					
a. Government bonds (long term)	0.9	2.2	2.0	4.3	3.2
b. Treasury bills (short term)	—	—	6.9	5.1	4.5
c. Income-sharing certificates	—	—	—	0.5	0.6
d. Total	0.9	2.2	8.9	9.9	8.3
2. Private sector					
a. Bonds	0.2	0.1	0.1	0.1	0.3
b. Equities	1.2	0.8	0.6	0.3	0.3
c. Total	1.4	0.9	0.7	0.4	0.6

Source: Central Bank (1987).

Note: Em-dashes indicate that percentages were negligible or zero.

has tended to crowd out suitable domestic financing for private investment, especially in the manufacturing sector, as further discussed at the end of the following section.

8.4 Role of the Public Sector in Savings and Investment

8.4.1 Basic Trends

A review of Turkey's public finances also requires a broad discussion of the share and role of the public sector in economywide savings and investment. The public sector influences capital formation directly through its own savings effort and investment programs. It affects private savings and investment behavior indirectly through demand management, external borrowing, and structural policies. Keeping in mind the longer term growth requirements of the Turkish economy, policymakers have placed a high premium on public investment in the 1980s (with some restructuring of its contents) at the cost of a continued fiscal imbalance.

Figure 8.1 illustrates the changes in investment rates (as percentages of GNP in current prices) from 1978 through 1986. The investments portrayed in this figure cover inventory changes (excluding valuation adjustments for year-end inventory stocks). Besides pointing to the relatively larger share of the public sector in total investment, figure 8.1 also brings out the active demand management role of the public sector in offsetting the large slack in private investment in the wake of the post-1980 adjustment program.

In turn, the changes in the composition of economywide savings over the same period are illustrated in figure 8.2. The time paths for various categories of savings (also measured as percentages of GNP in current prices) bring out four major points. First, the public sector saving effort rapidly improved under the post-1980 adjustment program, with some slippage in 1983–84. Second, notwithstanding the interest rate reform, the private savings/GNP ratio declined in 1980–83. Third, foreign savings were sizable in 1980–81, lending support to domestic measures aiming at macroeconomic stabilization. Fourth, from 1984 on, the share of private savings in GNP began to show some recovery from the lowest point reached in 1983.

To crystallize the savings-investment patterns further, table 8.6 gives (in part A) figures for the relevant ratios (to GNP), and provides (in part B) disaggregated data for the public sector. In effect, this table complements table 8.4, which presented an institutional breakdown of public disposable income for the same benchmark years between 1979 and 1986. While part A in table 8.6 quantifies the improvement in public savings from 1979 on, it also invites attention to the sharp rise in private savings and investment in 1986.

In part B of table 8.6, the breakdown of public savings and investment by institutional components over time clearly shows the decentralization trends

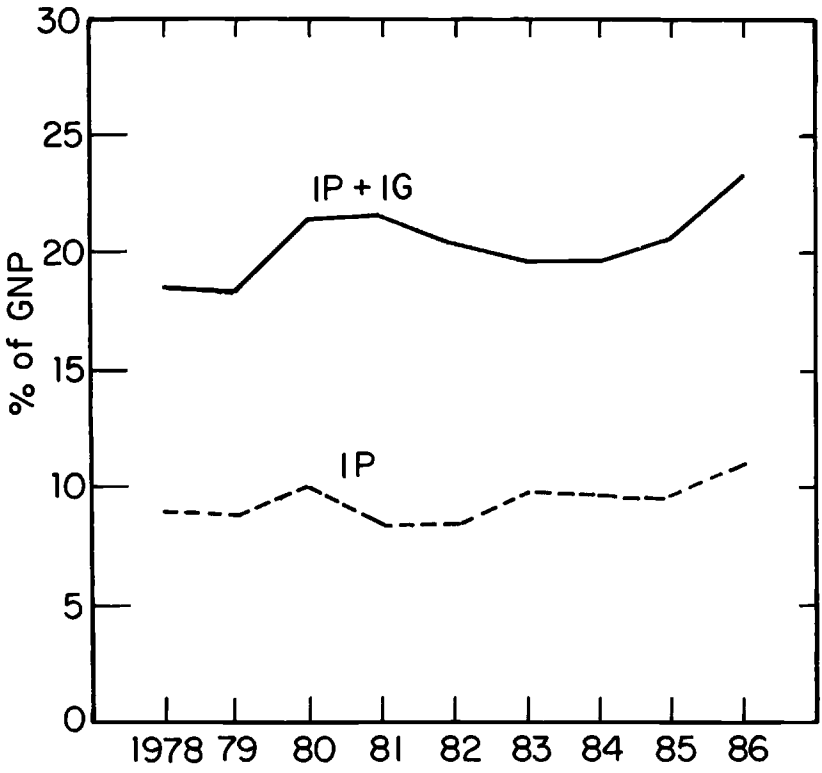

Fig. 8.1 Gross investment (% GNP, in current prices)
Note: IP is private investment; and IG is public investment.

in the public sector. The share of central government in public savings sharply fell to about 17 percent in 1985–86 from more than 100 percent in 1979. Under flexible pricing policies, the SEEs managed to increase their capacity for resource mobilization quite significantly, albeit at the cost of preventing deeper inroads into price stabilization. The investment programs of local government and extrabudgetary funds also became the beneficiaries of the reduced role of central government in the overall public finance.

8.4.2 Domestic Saving Behavior

Table 8.7 lists the major indicators of domestic savings from 1978 to 1986, which are based on current price data.[8] As these indicators show, the private saving performance was sluggish in 1980–85 despite the switch to positive real interest rates (on time deposits), which played a crucial role in monetary adjustment as discussed in chapters 4 and 5. In turn, the saving drive of the public sector contributed more effectively to the adjustments in

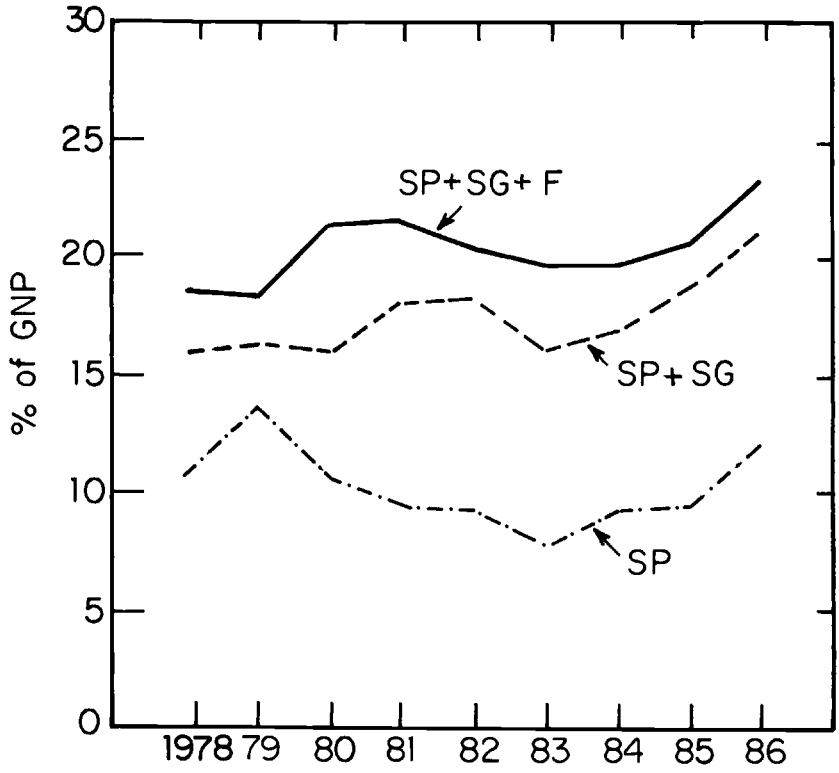

Fig. 8.2 Savings (% GNP, in current prices)
Note: SP is private savings; SG is public savings; and F is foreign savings.

the real side of the economy. The share of public sector in domestic savings increased to 50 percent in 1985 from 25 percent in 1978–79. How can we then explain the disappointing saving performance in the private sector in the earlier part of the 1980s, especially in the aftermath of a major reform of the interest rate policy?[9]

The relevant income base for private savings (and consumption) is not national income, but private disposable income, which dropped 5 percent in real terms in 1980 after stagnating in 1978–79. It also failed to increase in 1981. In per capita terms, the cumulative real fall in private disposable income was about 10 percent from 1978 to 1981. At the aggregate level, one possible hypothesis is that private agents strived to protect their consumption levels by lowering their short-run propensities to save.

The interpretation of private saving behavior in the early 1980s is confounded by another factor, namely the observed distributional change in favor of nonagricultural capital income, which is expected to have a priori a higher savings ratio. The distributional analysis summarized at the end of

Table 8.6 **Structural Change in Savings and Investment, 1979–86**

	1979		1982		1985		1986[a]	
	Savings	Investment	Savings	Investment	Savings	Investment	Savings	Investment
A. Sector totals (% GNP, current prices)								
1. Public	2.7	9.5	8.9	12.0	9.2	11.0	8.9	11.0
2. Private	13.5	8.8	9.2	8.3	9.2	9.5	12.1	12.2
3. Rest of the world	2.1	N.A.	2.2	N.A.	1.2	N.A.	2.2	N.A.
4. Total	18.3	18.3	20.3	20.3	20.5	20.5	23.2	23.2
B. Public sector (%)								
1. Central government budget	107.4	33.6	68.7	39.3	16.1	32.3	18.7	35.0
2. Local government	−8.1	3.8	6.2	4.7	14.2	9.6	17.1	15.4
3. SEEs (nonfinancial)	−24.7	60.0	13.9	54.1	49.6	50.8	38.1	37.9
4. SEEs (financial)	19.6	0.2	9.2	0.3	1.2	0.4	1.3	0.3
5. Revolving fund agencies	5.7	2.4	2.1	1.6	6.8	1.4	6.2	2.3
6. Extrabudgetary funds	N.A.	N.A.	N.A.	N.A.	12.2	5.5	18.6	9.1
7. Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: SPO

Note: N.A. means not applicable.

[a]Provisional estimates.

Table 8.7 Savings Ratios, 1979–86[a] (in percentages)

	1978–79 Average	1980	1981	1982	1983	1984	1985	1986[b]
1. Ratios								
a. Private savings to private disposable income	14.6	12.9	11.6	11.5	11.2	11.0	11.4	14.6
b. Public savings to public disposable income	21.0	29.8	43.4	45.2	42.1	46.3	52.3	50.9
c. Domestic savings to GNP	16.0	15.9	18.0	18.1	16.5	16.8	18.6	21.0
d. Foreign savings to GNP	2.4	5.5	3.5	2.2	4.1	2.8	1.9	2.2
e. Total savings to GNP	18.4	21.4	21.5	20.3	20.6	19.6	20.5	23.2
2. Composition of domestic savings								
a. Private	75.0	66.7	52.2	50.8	55.8	54.8	50.5	57.6
b. Public	25.0	33.3	47.8	49.2	44.2	45.2	49.5	42.4
c. Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo items:								
Growth of private disposable income	0.9	−5.1	0.3	4.3	5.1	7.6	3.4	9.8
Growth of private fixed investment	−8.9	−17.3	−8.7	5.5	4.8	1.8	13.3	13.5
Real interest rate (1-yr deposits, after tax)	−27.1	−37.6	0.2	8.2	4.9	4.0	7.9	15.9

Source: SPO (1985) for 1978–83, and Central Bank (1987) for 1984–86 data.

[a]Parts 1 and 2 are based on current price data.

[b]Provisional estimates.

chapter 5 points to the large income gains of the wholesale and retail trade sector from relative price changes observed in the post-1978 period. The saving propensity of income recipients in the trade sector might have been somewhat lower than the saving rates in other productive sectors, which contributed more substantially to savings in the earlier periods.

A further observation in this context relates to the composition of the private savings aggregate defined in the official national accounts, which we have used. Besides covering household savings, this aggregate also includes depreciation allowances and undistributed enterprise profits, which declined in some manufacturing firms confronted with illiquidity problems in the early 1980s. Moreover, the private savings aggregate in the national accounts is not voluntary savings in the pure sense, as it implicitly includes the forced transfers (to the public sector) effected via new money creation. The contraction of real money base from 1979 on (recall fig. 4.1) definitely played a role in lowering the seignorage portion of private savings in the early 1980s.

Finally, it may be noted that the nature of adjustment mechanisms (or closure rules) for the savings-investment balance also affects the determination of private savings in a general equilibrium context.[10] In the face of low capacity utilization rates, reduced aggregate demand, and high user cost of

capital, investors' enthusiasm was definitely at a low level prior to 1985, possibly dampening real demand for private savings. The actual outturn for 1985–86 suggests that private savings adjusted quite rapidly to the rising investment demand in the private sector in the wake of generous new incentives provided by the extrabudgetary funds, especially for mass housing projects.

In concluding our brief discussion on saving behavior, we would like to draw attention to the fact that domestic saving rates in Turkey have not been high by cross-country standards, as was shown in table 1.2. In relation to the size of its disposable income base, the public sector's direct contribution to resource mobilization for investment has been substantial in the 1980s, requiring a prolonged tight stance on public consumption. In turn, private saving rates have been rather low, despite the policymakers' preference for a market-directed growth process in the future. The present discussion suggests that private saving may respond favorably to new incentives under more viable and stable macroeconomic conditions for investment and growth.

8.4.3 Investment Allocation

To complement the analysis of saving and investment patterns at the macrolevel, table 8.8 provides sectoral data on the distribution of fixed investment for the periods 1973–78, 1979–83, and 1986. The sector-level data on investment allocation reveal four notable trends.

First, the share of manufacturing in total investment exhibits a continuing decline from 1978 on. Bearing in mind the heavy reliance on manufactured goods in the Turkish export drive, this trend gives rise to the question of the sustainability of export growth in the early 1980s. Second, the share of

Table 8.8 **Fixed Investment by Major Activity Sectors, 1973–86 (as a percentage of total)**

			1986[b]		
	1973–78 Total[a]	1979–83 Total[a]	Private	Public	Total
Agriculture	11.0	10.0	6.6	8.0	7.4
Energy & mining	11.1	20.6	1.6	28.5	16.9
Manufacturing	30.2	25.6	31.4	8.3	18.2
Transportation	19.0	18.0	17.0	33.2	26.2
Tourism	0.7	0.6	2.2	1.1	1.6
Housing	17.1	15.8	36.0	1.8	16.5
Education & health	3.8	3.4	1.0	5.6	3.6
Other services	7.1	6.0	4.2	13.5	9.6

Source: SPO.

[a]In constant 1983 prices.

[b]Provisional estimates reported in Central Bank (1987).

agriculture in total investment has been steadily low, despite the predominant position of this sector in total employment. From 1978 on, the depressed levels of investment in this sector may be attributed to the fall in farmers' real incomes and generally weakened external demand conditions for agricultural products in the mid-1980s. Third, the rising share of energy and mining (mainly hydroelectric power and coal) is a positive element in the pursuit of reduced dependence on energy imports in the growth process. Fourth, transportation and housing investments have definitely been boosted from 1983 on, following relatively low levels of investment activity in these sectors in 1978–83. The 1986 data also point to an encouraging revival in tourism investments.

To arrive at sound judgments on investment allocation, a wider analysis is needed of Turkey's comparative advantage, factor proportions, and sectoral interdependence in the longer term growth process. The investment trends emerging from data shown in table 8.8 broadly suggest that an allocational shift is needed from services to manufacturing to avoid capacity bottlenecks in outward-oriented growth in the medium-term future.

In the context of investment allocation, a critical problem is the efficient deployment of various categories of private savings to high-priority investment programs. In the past, Turkey's financial markets have played a highly limited role in coping with this problem. In the late 1980s, vigorous recovery of manufacturing investment requires, besides the sector's own resources, additional savings from the financial system at moderate costs. As the data presented earlier in table 8.5 show, the share of private bonds and equities in total security issues was less than 10 percent during 1984–86, a period which saw an unprecedented rise in the Treasury borrowing at high real rates of interest. Hence, the size and pattern of private investments will be closely affected by the fiscal adjustment in the public sector.

8.5 Fiscal Policy: Achievements, Issues, and Prospects

We have attempted in the present chapter to broadly document and review the patterns of fiscal adjustment and public resource mobilization in the 1980–86 period. The examination of fiscal trends suggests that SEEs, extrabudgetary funds, and local government should be integrated into public accounts for a wider assessment of fiscal policy links with macroeconomic performance.

For revenue mobilization, fiscal policy has relied heavily on SEE price adjustments. SEE prices were clearly out of line before 1980 and required immediate and large corrections at the outset. However, in the absence of deeper rationalization of the SEE system, a continuing and excessive reliance on SEE price hikes—in conjunction with markup pricing practices in the private industrial sector—has produced conflicts in the price stabilization process and contributed to the volatility of inflation rates.

Turkey's tax reform effort resulted in tax revenue losses toward the mid-1980s (after a short-lived tax rise in 1981) and contributed to the weakening of fiscal retrenchment. Again, the initial conditions were important in the choice of policy direction. The tax reform focused on tax restructuring to overcome bracket creep in income taxation, reduce the tax burden on financial intermediation, and broaden the base for indirect tax revenue. The illiquidity problems of part of the private sector also required a relief in corporate taxes.

The tax reform initiatives began to pay off after the introduction of the VAT system (in 1985) and the switch to tariff protection in the trade regime. Despite their unduly complicated nature, the taxes, surcharges, and nontax revenues collected by local government and new extrabudgetary funds also contributed to the rebound in public revenue in 1985–86. The Turkish tax reform experience shows that tax restructuring is a lengthy process and should not be exclusively relied upon as a vehicle for additional revenue mobilization in the early phases of adjustment programs. In this connection, the important lesson is that the tax system requires continual modernizing improvements in a rapidly changing economic structure. In the future, the Turkish tax system should have a broader base to encompass taxable incomes in the services sector.

A rapid output recovery after the 1978–80 episode required the maintenance of real growth of public investment with some alterations in its allocational pattern. Because of rising current transfers, the brunt of adjustment in the disposition of available net income fell on public consumption, mainly through real reductions in the salaries of government employees. The latter mechanism seems to have produced a general worsening in the quality of social services.

Turkey faces a substantial increase in its external debt service in the 1985–90 period. In 1985–86 the burden of external interest payments prevented a notable recovery in public disposable income (in relation to GNP) despite a marked rise in public revenue. With the reluctance to restrain public investment, the overall fiscal deficit (PSBR) could not be lowered adequately after reaching a peak in 1984. In the face of reduced net foreign borrowing, policymakers chose to rely on domestic borrowing at high real rates of interest, which crowded out investment financing in the private sector, especially in manufacturing, whose dependence on the financial system has increased in the post-1980 era.

From 1984 on, the heavy reliance on Treasury bond issues in coping with fiscal disequilibrium has given rise to a complex set of policy issues. The bond-financing of deficits adds a rising domestic debt burden to the public sector's external debt service. At the macro level, the internal adjustment shaped by fiscal policy becomes compatible with the balance-of-payments constraint at the cost of very high real rates of interest, to which private savings did not sharply respond in the 1980–85 period. On the other hand,

high interest rates aggravate the illiquidity problems and tend to discourage a vigorous investment recovery in the manufacturing sector, which provides the major productive base, besides tourism and some services, to sustain export expansion. Favorable supply conditions for export and GNP growth are essential to sustain the trade-liberalization process and to maintain an adequate capacity to service external debt.

As we argued in section 8.4, macroeconomic stability is particularly important for a harmonized savings-investment balance in the Turkish economy. The large fiscal deficits pose a threat to macroeconomic stability and growth because their monetization remains a tempting policy option, given the historical precedents in the Turkish context. With limited possibilities to reduce public consumption further, a noninflationary fiscal adjustment will have to be based on a socially acceptable mix of public revenue increase and restrained public investment for a brief transitional period. This process may require complementary actions for a partial refinancing and/or rescheduling of the public sector's external debt in such a way as to avoid a deterioration in Turkey's hard-earned creditworthiness in the international financial markets.

Finally, toward the end of the 1980s, Turkey's public finance system requires further qualitative changes and improvements aiming at noninflationary methods of revenue mobilization, deeper SEE rationalization (including gradual privatization), and streamlining of extrabudgetary funds and local government finances. While seeking a greater macrolevel flexibility in fiscal policy, efforts may also be usefully directed to the redesign of budgetary methods for a more efficient allocation of public resources.

9 External Financial Relations and Debt Management

Since the early 1970s, Turkey's relations with the international financial community have been consistently out of synch with those of most other highly indebted countries. Turkey entered its debt crisis in 1977, at a time when a general crisis was still far off in the horizon. Its recovery and export boom in 1981 coincided with increasing difficulties experienced by debtors in Latin America and elsewhere. In 1982, just as the rest of the developing world became engulfed in a debt crisis and new flows from commercial banks dried up, Turkey reentered private international capital markets. Since