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Regulatory Reforms to Unlock Long–Term Growth in Turkey

Rauf Gönenç, Lukasz Rawdanowicz

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REGULATORY REFORMS TO UNLOCK LONG–TERM GROWTH IN TURKEY

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By Rauf Gönenç and Łukasz Rawdanowicz

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ABSTRACT/ RÉSUMÉ

Regulatory reforms to unlock long–term growth in Turkey

In the 2000s, Turkey has enjoyed rapid catching–up. This was possible despite the adverse business environment, as the semi–formal and informal economy had a significant contribution to the expansion of the private sector. Productivity growth was strong, but labour utilisation remained very low. Looking forward, higher employment and productivity growth will not be possible without profound regulatory reforms of minimum wages, severance payments, social security contributions and flexible job contracts. These reforms have been discussed for a long time, but political obstacles prevented implementing them. Resolving this deadlock calls for advancing an integrated strategy of labour reforms and formalisation via experimenting with new regulation on the voluntary basis to identify the most successful solutions that can be later rolled out to the whole economy. Moreover, Turkey has to ease further anti–competitive product market regulations by reducing barriers to entrepreneurship and foreign direct investment, and by limiting government involvement in business. A successful implementation of these reforms would allow Turkey to enjoy golden decades. This paper relates to the *2010 OECD Economic Review of Turkey* (www.oecd.org/eco/surveys/turkey).

JEL Classification: D7; J2; J3; J4; L5; O4; P5
Key words: Turkey; labour market; political economy; product market; regulation; reform; growth

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Réformer les réglementations pour débloquer la croissance à long-terme de la Turquie

Dans les années 2000 la Turquie a réalisé un rattrapage rapide. Cela a été possible malgré un cadre réglementaire défavorable, grâce à des activités semi-formelles et informelles qui ont considérablement contribué à l'expansion du secteur privé. La croissance de la productivité a été forte, mais l'utilisation du travail reste très faible. A l'avenir l'emploi et la productivité ne pourront pas croitre plus vite sans de profondes réformes du salaire minimum, des indemnités de licenciement, des cotisations de sécurité sociale et des contrats de travail flexibles. Ces réformes ont été discutées depuis longtemps mais des obstacles politiques ont empêché leur mise en œuvre. Pour dépasser ce blocage, une stratégie intégrée de réformes du marché du travail et de formalisation est nécessaire, via l'expérimentation de nouvelles règlementations sur la base du volontariat, afin d'identifier de meilleures solutions qui peuvent être progressivement étendues à l'ensemble de l'économie. En outre, la Turquie devrait réduire les réglementations anti-concurrentielles dans les marchés de produits en diminuant les obstacles à l'entreprenariat et à l'investissement étranger direct, et en restreignant l'intervention du gouvernement dans les affaires. La mise en œuvre réussie de ces réformes permettrait à la Turquie de bénéficier de brillantes décennies de croissance. Ce document se rapporte à *l'Étude économique de Turquie de l'OCDE, 2010* (www.oecd.org/eco/etudes/turquie).

Classification JEL : D7; J2; J3; J4; L5; O4; P5
Mots clés : Turquie; marché du travail; économie politique; les marchés de produits, la réglementation, la réforme, la croissance

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REGULATORY REFORMS TO UNLOCK LONG–TERM GROWTH

By Rauf Gönenç and Łukasz Rawdanowicz[1]

Between the 2001 and 2008–09 recessions, Turkey grew rapidly and experienced a dynamic expansion of the private sector. This was made possible by decisive macroeconomic consolidation policy in the 2000s and important complementary institutional reforms (Rawdanowicz, 2010). However, the reform progress was less far reaching at the microeconomic level of labour and product market regulations. Consequently, the still poor business environment holds the development of dynamic enterprises. The formal business sector was faced in particular with strict labour market regulations, high labour costs and relatively costly market entry and competition conditions.

The costly and strict regulations have nourished informality and semi–formality as a way to circumvent them. This permitted large numbers of enterprises to lower operational costs, but also distorted competition, restrained productivity growth and burdened public finances. The structural reforms which are needed to permit the flexible operation of enterprises in compliance with the law are well identified, but political economy factors prevent their implementation. This has been especially the case for labour reforms. The recovery from the deep 2008–09 recession creates a good opportunity to advance the necessary reforms. Successful structural reforms would pave the path for higher GDP growth and employment. The challenges are serious, but the gains from overcoming them are large.

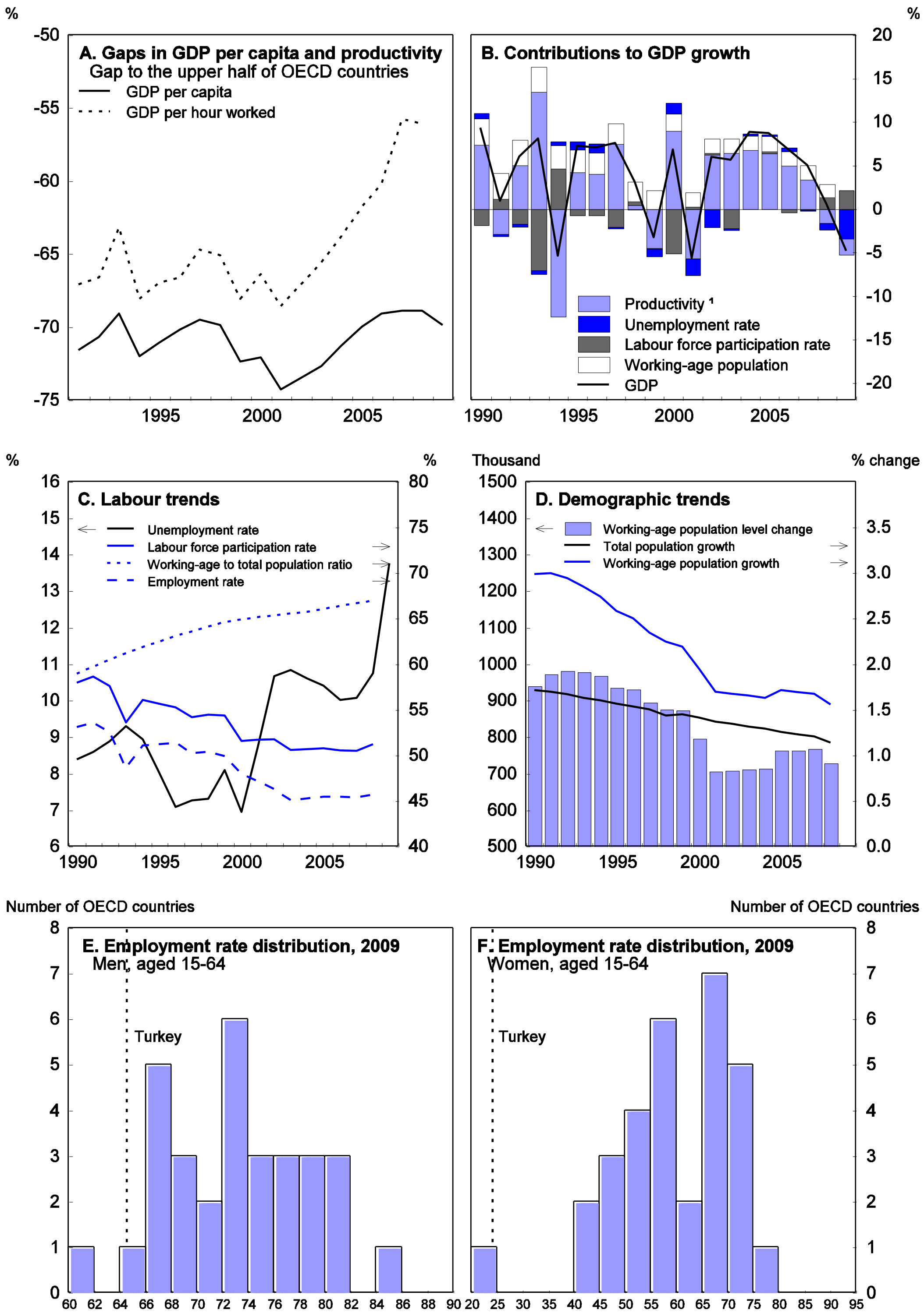
Against this background, this paper analyses recent growth performance and re–assess the underlying structural deficiencies, focusing first on labour and then on product markets. This is accompanied by a discussion of lessons from past attempts at structural reform, both achievements and limitations, and possible avenues to reactivate them. Finally, the paper sketches stylised long–term scenarios of economic growth to illustrate the benefits of structural reforms.

Performance has been strong in the 2000s but the income gap remains large

The income gap *vis–à–vis* the upper half of OECD countries has narrowed significantly since 2001 (Figure 1), mainly as a result of labour productivity growth, which was among the highest in the OECD. This was underpinned by the expansion of private sector strong investment, FDI inflows and competition. Many new enterprises entered the market, foreign know–how was more widely used, exports were diversified sectorally and geographically, and the industrial structure was upgraded (OECD, 2006a, 2008a). These impressive developments were achieved despite non–supportive labour and product market regulations, but were backed by macroeconomic consolidation and the great entrepreneurial spirit of the Turkish people. However, changes in labour utilisation were limited and provided a small contribution to growth. Following a decline in the 1980s and 1990s, the employment rate stabilised in the 2000s at a low level (slightly above 40%). Following the 2008–09 recession, the unemployment rate also increased. Despite the rapid catching–up in the 2000s, labour productivity and labour utilisation remain low and Turkey still has the lowest GDP *per capita* in the OECD (Figure 2).

1. OECD Economics Department. This paper was originally produced for the *OECD Economic Survey of Turkey* (http://www.oecd.org/eco/surveys/turkey) published in September 2010 under the authority of the Economic and Development Review Committee. The authors thank OECD staff members Andrew Dean, Robert Ford and Andreas Wörgötter for valuable comments and Danielle Venn for her input. Excellent statistical assistance from Béatrice Guerard and secretarial assistance from Josiane Gutierrez and Pascal Halim are gratefully acknowledged.

Figure 1. Evolution of GDP per capita growth and its components

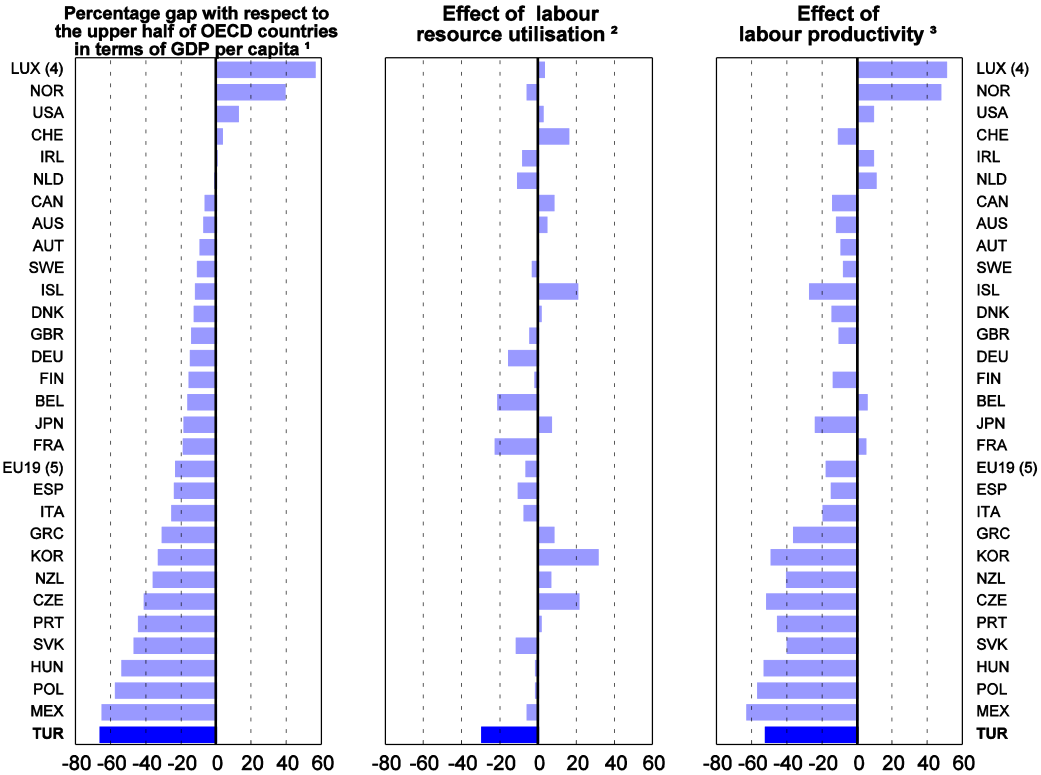


1. Labour productivity is measured as GDP per worker.

Source: OECD (2010), Economic Policy Reforms 2010: Going for Growth; OECD Economic Outlook Database and OECD Labour Force Statistics Database.

Figure 2. The income gap remains large

2008



1. Relative to the simple average of the highest 15 OECD countries in terms of GDP per capita, based on 2008 purchasing power parities (PPPs). The sum of the percentage gap in labour resource utilisation and labour productivity do not add up exactly to the GDP per capita gap since the decomposition is multiplicative.
2. Labour resource utilisation is measured as total number of hours worked per capita.
3. Labour productivity is measured as GDP per hour worked.
4. In the case of Luxembourg, the resident population is augmented by cross–border workers in order to take into account their contribution to GDP.
5. EU19 is an aggregate covering countries that are members of both the European Union and the OECD. These are the EU15 countries plus the Czech Republic, Hungary, Poland and the Slovak Republic.

Source: OECD, Economic Policy Reforms 2010: Going for Growth.

Obstacles to labour utilisation have been the key constraint on economic performance

Labour underutilisation reflects a combination of high labour costs, serious market rigidities, low human capital and deep structural and demographic changes.

Labour costs are high

High labour costs are the main constraint on job creation (Figure 3). They primarily reflect high legal minimum wages. Official minimum wages in Turkey are higher than in many countries in emerging Europe, which compete with Turkey and have higher GDP per capita (Figure 3). This undermines Turkish competitiveness for labour–intensive products (Saget, 2008). Minimum wages are also high given the average wage in the informal sector (OECD, 2008a). Finally, anecdotal evidence suggests that reservation wages, especially in poorer regions of Turkey, are significantly below the official minimum wage received by workers (OECD, 2008a).

On top of minimum wages, labour costs are boosted by labour tax wedges. Despite recent efforts to decrease them (see below), these remain high by OECD standards, reflecting high social security contributions (Figure 3).

Labour regulations are rigid

Job creation is also hindered by strict employment protection, in particular involving high firing costs for permanent workers. Severance payments are one of the highest in the OECD and in the world (Figure 3; OECD, 2006a). They entail high costs for companies and may create liquidity problems during cyclical adjustments. Moreover, firms employing more than 30 and 49 employees are subject to additional costly regulations, subjecting them to extra legal liabilities and requiring them to provide health, recreational and social facilities (OECD, 2006a, 2008a). Despite a number of improvements brought about by a new law in 2008 (No. 5763),[2] these conditions prevent many companies from expanding their employment beyond the 30 and 49 employee thresholds.

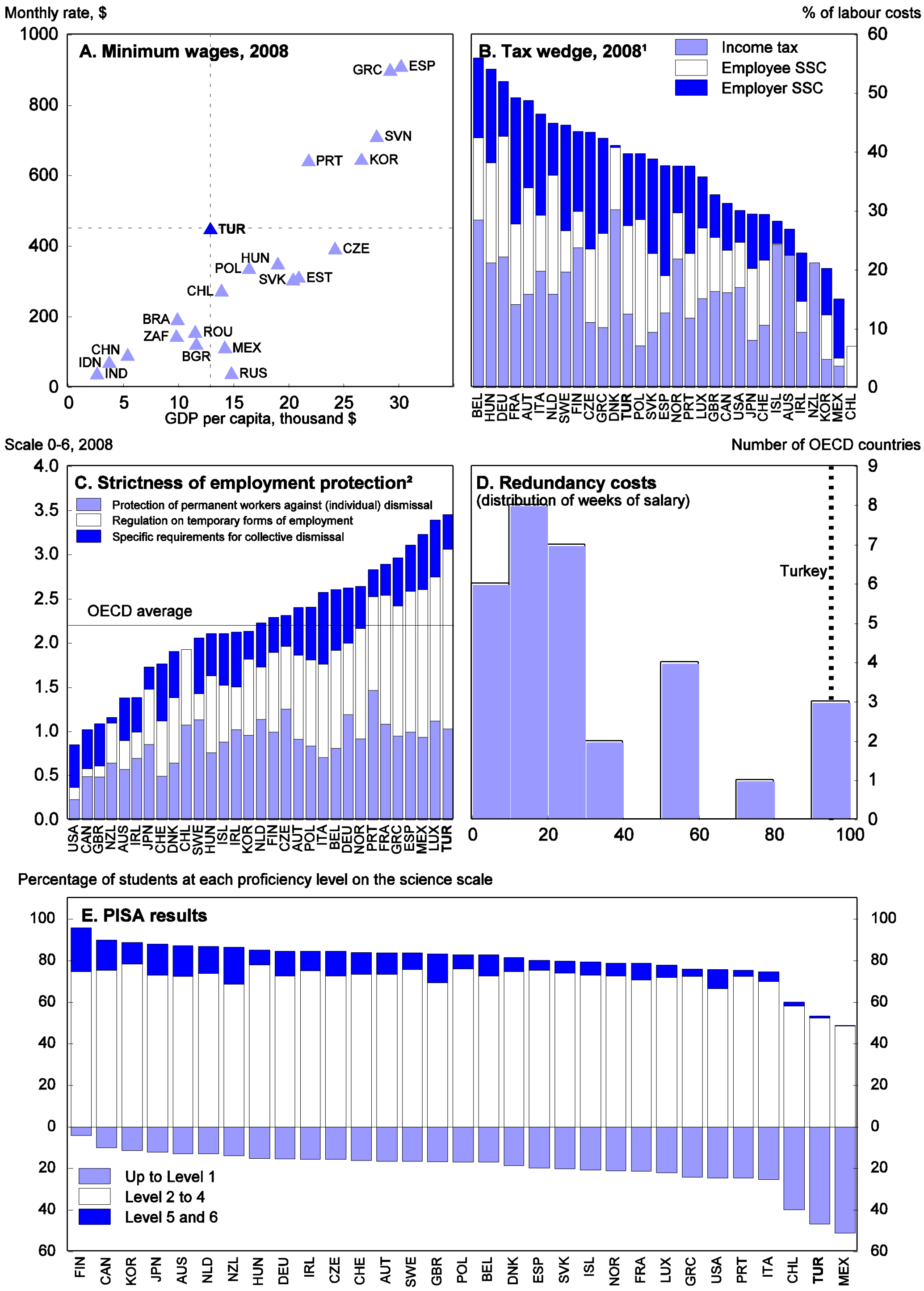
A telling example of how differences in legal and regulatory obligations distort incentives of enterprises to hire is found in the natural experiment provided by a legislative change implemented in 2003. At this date, dismissal costs increased for firms employing more than 30 employees. A careful statistical examination, recently undertaken by the OECD's Directorate for Employment, Labour and Social Affairs, shows that labour demand and job creation by different sizes of enterprises immediately reflected these changes, at the expense of large, higher productivity enterprises (Annex A1).

Turkey also has very strict regulations regarding temporary work. In contrast to many OECD countries, temporary agency work is not legally authorised and fixed–term contracts are permitted only in highly specific circumstances. As a result of this set of constraints, Turkey is classified as the country with the strictest protection among OECD countries (Venn, 2009; Figure 3).

However *de facto* employment protection is less restrictive than implied by *de jure* indicators, as the informal and semi–formal sector is large and the share of self–employed is high. Semi–formality concerns business enterprises employing only part of their labour legally and the other part informally, and declaring only part of the wages actually paid to the employees to the tax and social security authorities in order to minimise taxes and social security contributions. Pure informality is mainly encountered in agriculture, whereas semi–formality prevails in other sectors of the economy. There are no precise measures of the

2. Law No. 5763, adopted in May 2008, reduced certain obligations associated with employment size thresholds: *i)* Enterprises employing more than 50 workers had to employ disabled, ex–convicts and terror victims (at least 3%, 2% and 1% of the workforce, respectively). Obligations regarding the ex–convicts and the terror victims were abolished, whereas the employer's social security contributions for the disabled started to be fully compensated by the Treasury; *ii)* Enterprises employing more than 50 workers had to establish job safety and health units, and hire job safety personnel and doctors. These obligations were partly relieved by giving employers an opportunity to share job safety and health units with other employers or to provide job safety and health services via outsourcing; *iii)* Enterprises employing more than 100 female workers needed to build breast–feeding rooms and enterprises employing more than 150 female workers needed to build kindergarten. These obligations were partly relieved by giving employers an opportunity to provide these services via outsourcing; *iv)* Enterprises employing more than 500 workers had to build a sport facility. This obligation was fully abolished.

Figure 3. Structural deficiencies in the labour market



1. Single person at 100% of average earnings, no child.
2. Index scale of 0–6 from least to most restrictive.

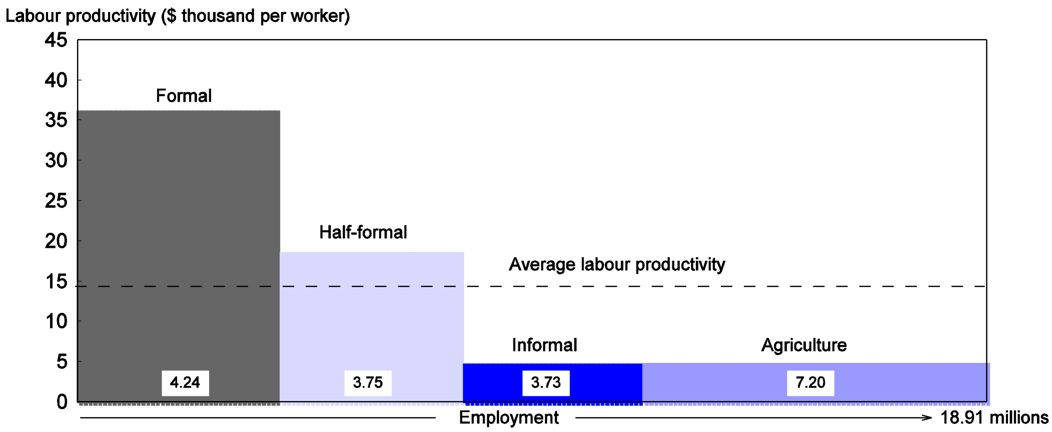
Source: ILO, Minimum Wages database; IMF, World Economic Outlook October 2009; OECD, Taxing Wages Database; OECD, Indicators of Employment Protection; World Bank Doing Business; and OECD (2007), PISA 2006: Science Competencies for Tomorrow's World.

actual extent of semi–formality. Informal employment constitutes 44% and self–employment 21% of total employment (around one third of informal workers are self–employed).[3]

The structure of the business sector mirrors such uneven compliance with laws. Strict labour and product regulations hindered the development of formal firms and nurtured a large population of informal and semi–formal firms. As a result, the business sector has a very thick–tail distribution of productivity levels, with modern firms modelled according to top OECD standards co–existing with informal and semi-formal entities with a much lower level of productivity. It was estimated that labour productivity in the informal sector was 80% below, and in the semi–formal sector 40% below, that in the modern, fully formal sector (OECD, 2006a; Figure 4). For informal and semi–formal firms, not only funding, investment capacity and capital intensity are reduced, but also access to professional labour markets and foreign direct investment is impaired (OECD, 2008a; World Bank, 2009). These firms' preference to keep their activities small in order to minimise interaction with enforcement agencies also hinders economies of scale.

Expanding the formal sector requires a fundamental easing of the regulations in order to permit the spontaneous growth of enterprises and jobs in compliance with the formal regulatory framework. Without such reforms, the *de facto* rigidity will become more intense if the ongoing fight against informality turns out more effective and the share of informal and/or self–employed workers declines. This will occur in particular as migration from rural areas continues and the share of the self–employed and informal employees, who are prevalent in agriculture, declines.

Figure 4. The skewed distribution of labour productivity[1]



1. OECD estimates as of 2006.

Source: TURKSTAT, SPO and OECD (2006a), OECD Economic Surveys: Turkey.

Structural, human capital and demographic challenges are serious

As in many emerging markets, Turkey in the past decades has been undergoing industrialisation and the downsizing of the agriculture sector. This has involved migration of the rural population to the cities. The share of agricultural employment in total employment declined from around 50% at the end of the 1980s to around 23.7% in 2008, but it is still among the highest among the OECD countries. In 2009, it actually increased (by around 1 percentage point), but this reflects the effects of the severe recession rather than a structural reversal. Unpaid family workers constitute a high share in total employment in agriculture

3. According to the classification adopted in the Turkish Labour Force Survey (LFS), informal workers are those who are not registered with any social security institutions.

(around 45%) and small, subsistence farms are still prevalent (OECD, 2006a). Unpaid family workers in agriculture are principally women (around 78%). The large employment outflows from agriculture raise the supply of low–skilled workers who have difficulties in finding jobs in other sectors of the economy. This process, combined with complex socio–economic factors (see below), makes many women withdraw from the labour force. The apparent trend decline in Turkey's effective employment rate (Figure 1) reflects partly this withdrawal of women from the labour force associated with urban migration.

Structural shifts in employment are complicated by the fact that working–age population has on average low education. Professional and sectoral adaptability is therefore limited. According to the Turkish Labour Force Survey data, over 60% of the working–age population has less than high school education, though this share has declined over recent years. Consequently, the average educational attainment of the working age population is less than seven school years. Moreover, gross schooling rates[4] remain below the OECD average and Turkish students, on average, do not perform well in international comparison[5] (Figure 3). At the same time, a small but well–trained group of workers perform well in the modern part of the business sector and are highly effective in absorbing international best practices.

The inflow of workers from rural areas creates challenges for absorbing them in the non–agricultural sectors, accentuating the challenge of the skill mismatch. The industrialisation of the economy requires higher skills and better education. In this regard, recent structural changes in the manufacturing sector have raised additional challenges. Labour–intensive manufacturing has been shrinking and new factories become more capital intensive, requiring less low–skilled labour. This change was evident, especially in the decline of the textile and clothing industries, where under the pressure of international competition Turkey has lost market share and closed down factories. In contrast, capital intensive and internationally competitive industries, such as steel, chemicals, and machinery and equipment (especially automotive), boomed in the 2000s (OECD, 2008a).

The employment of women is impaired by complex economic and social factors (SPO and World Bank, 2009). In 2009, the female labour force participation at around 26% was by far the lowest in the OECD and the gap in employment rates between men and women of more than 40 percentage points is the highest in the OECD (Figure 1).[6] In 2009, over 12 million women declared being a housewife as a reason for not participating in the labour market (45% of the total inactive population). On the economic side, female labour supply is discouraged by low salaries, especially when compared with the cost of child and elderly care. Poor working conditions are another deterrent. Women, in particular the less educated, are more often offered jobs in the informal sector which require long working hours. Social barriers involve a gender–based division of labour and patriarchal mindset. Women spend six times more time on daily household chores and child/elderly care than men. This is also affected by the insufficient availability of child and elderly care facilities (Toksöz, 2007). Family burdens are especially high for less educated women, strengthening the positive relation between education status and labour force participation. Female

4. Gross schooling rates are calculated as a ratio of all entrants, regardless of their age, to the size of the population at the typical age of entry, in contrast to net schooling rates which account for entrants only at the typical age of entry.

5. The OECD Programme of International Student Assessment (PISA) was thoroughly analysed in the 2006 *OECD Economic Survey of Turkey* (OECD, 2006a).

6. The assessment of trends in women employment rates is complicated by the migration of rural population (as explained in the text above). However, some measures suggest that women employment has been on the rise. According to the Turkish LFS, the women employment rate in urban areas has increased from 14.6% in 2004 to 17.7% in 2009. Higher women employment in 2008–09 is believed to partially result from the recession, as the loss of family income forced many women to take up jobs (the so-called second earner effect).

school enrolment continues to be lower than for men and the illiteracy rate for women, at 18%, is more than four times higher than for men.[7]

Growth in the Turkish working–age population makes sufficient job creation even more challenging. Though the increases have been moderating, they are still high by OECD standards (Figure 1). Between 2004 and 2009, the working–age population has increased each year by around 800 thousand people. New entrants to the labour market have longer education enrolment records, but they nonetheless face significant problems with finding a first job. The youth unemployment rate is almost twice as high as the overall unemployment rate and it is among the highest in the OECD.

Labour market reforms are indispensible

Lessons from past reform efforts

The need to implement reforms that would alleviate key structural constraints to Turkey's long-term growth became increasingly evident in the second half of 2000s and such reforms were added to the political agenda. Progress has, however, been uneven and slower than with macroeconomic and banking sector reforms (Rawdanowicz, 2010). To gauge the state of reforms in different areas, follow–ups on the past OECD recommendations in each individual area are analysed. Four observations are worth stressing:

- First, structural and institutional reforms helping with macroeconomic consolidation continue to make progress, even if they faced a number of technical difficulties and delays (as in the area of fiscal transparency at the general government level, see Gönenç *et al.* (2010)).

- Second, reinforcing key public services remain a priority for the government, even if the large changes required raise financial and human resource constraints and administrative challenges.

- Third, product market liberalisation has progressed, but at an uneven pace across sectors: global reforms improving general conditions for doing business have advanced, but promoting competition and privatisation in large government–dominated sectors has proved more difficult.

- Fourth, labour market reforms have made little progress. A very deep divide between the employment and wage conditions in the formal and informal business sector persists. Job creation in the formal sector remains very costly and as a result a significant proportion of employment creation is diverted to lower quality jobs in the semi–formal and informal sectors.

The desirable labour market reform strategy for Turkey is now well charted. It includes three standard elements which have been advocated in the previous OECD *Economic Surveys*: *i)* reforming labour market regulations for both permanent and temporary contracts to facilitate job creation by reducing employers' severance costs with possible transition to a severance payment fund, and by liberalising temporary work and temporary work agencies; *ii)* allowing for regional differentiation of minimum wages to reduce the real minimum wage in the regions where productivity and living costs are low;[8] and *iii)* continuing to lower employers' social security contributions (currently at 14.5% of gross wages, excluding employers' contribution to the unemployment insurance fund of 2% of gross wages) in compliance with the fiscal

7. According to the Turkish LFS, in 2009 the illiteracy rate was 4% for men at the working age and 18% for women at the working age.

8. Certain OECD countries implement regional minimum wages. These include the United States and Canada, where minimum wages are settled at the level of federal states and provinces; Mexico, where a tri-partite National Wage Commission decides on minimum wages for three broad geographical zones; and Japan, where separate minimum wages are set in each of the 47 prefectures (OECD, 1998).

framework to below 10% in the medium term (OECD, 2006a, 2007). Similar recommendations have been made by the World Bank (2007). This agenda is now increasingly acknowledged in government policy documents (SPO, 2009a, 2010). The latest Strategic Plan of the Ministry of Labour and Social Security stated that: "To make flexible employment more attractive, the degree of flexibility provided by the existing employment contracts will be evaluated, and the needed adjustments in the labour law will be effected in order to promote flexicurity in the labour market" (Ministry of Labour, 2008). The Medium Term Programme stated that: "To increase employment and reduce informality, flexible employment patterns will be promoted and diffused in compliance with the concept of flexicurity" (SPO, 2009b). The authorities have been preparing a comprehensive National Employment Strategy in this direction, which is expected to be released at the end of 2010.

The political economy obstacles to labour market reforms should be addressed

Political economy obstacles have prevented the implementation of this important agenda. Certain elements of reform have been initiated, but have stalled short of full implementation. Other elements could not even be put on the agenda. Action is arrested in three important areas:

- *Severance payment reform.* A draft law along OECD best practices was prepared, but could not be proposed to Parliament because of the strong opposition of social partners. The proposal was based on monthly contributions by all employers to a Severance Payments Fund, which was to be liable for severance compensation to workers. This would reduce employer costs, and guarantee employee rights in case of enterprise defaults. Labour organisations were vocal in opposing this reform because they anticipated a risk of lower worker entitlements to compensation if employer contributions to the Fund were set below 8% of gross wages (the actuarial equivalent of the present law of 30 days of severance compensation per year of employment). Employees covered by collective agreements also opposed the reform because agreements usually entailed more generous compensation than what was mandated by the then prevailing law (up to between 40 and 60 days of salary per year of service). Many employers not regularly provisioning their severance liabilities also tacitly opposed the reform because it would impose additional obligations on them.

- *Liberalisation of temporary work.* A law on temporary work was adopted by Parliament in early 2009 after several years of technical work and inconclusive consultations with social partners (the trade unions never endorsed the proposal). The law aimed at permitting enterprises to hire temporary labour via private employment agencies. However, the President vetoed the law in June 2009 on the ground that it incurs risks of abusing workers, is incompatible with human dignity and lacks proper social protection as required by the European Union legislation.

- *Lowering minimum wages*. Average productivity and living costs in less advanced regions are clearly lower than in urban areas. This creates a wide gap between real official minimum wages in western and eastern regions. The government objective of securing minimum living standards and stimulating labour demand should take productivity and wage differences into account. However, these suggestions have faced vehement opposition.

Progress may be underway in reducing social security contributions. In October 2008, employers' contributions to disability, old–age and death funds were permanently reduced by 5 percentage points, to 14.5% of gross wages. The cut was smaller than the OECD recommendation to reduce them below 10% (OECD, 2006a, 2008a), but a larger cut could not be afforded, given revenue losses.[9] The 5-percentage point reduction is not a loss for the Social Security Institution, as it is compensated by the Treasury. All

9. An estimation of these costs was provided in the 2008 *OECD Economic Survey of Turkey* (OECD, 2008a).

enterprises have been offered the reduction provided that they had no outstanding arrears with their social security contributions. In addition, employers' contributions for new young male workers (aged 18 to 29) and new female workers (without any age limit) were further reduced, but only temporarily.[10] In the context of regional policies, additional subsidies for employers' social security contributions for newly created jobs have also been granted. They amount to subsidising between 80% and 100% of contributions and are usually limited in time. Similar incentives were granted in 2009 for firms undertaking new big investment projects (see below).

While the additional reduction of social security contributions raises mainly a fiscal challenge, the other elements of the reform agenda face political economy obstacles, due to the conflict between insiders and outsiders to the formal labour market (Saint–Paul, 2002). Insiders, who are already employed and protected by existing law, oppose these reforms as they would reduce their acquired benefits (official minimum wages, indefinite duration contracts, employment protection and severance payments). In contrast, outsiders, who either work informally or are unemployed, enjoy none of these advantages and have an interest in the reforms as they would increase their chances of legal employment. This common political economy challenge of labour market reforms (OECD, 2009c) is found in Turkey in a particularly acute form because of the sizable gap between earning and employment conditions in the formal and informal sectors.

The task of Turkey's labour market reform is to marshal a politically acceptable reform avenue between insiders and outsiders. Little progress was achieved in the solution of this problem to date. The Turkish authorities could possibly draw on the experiences of other OECD countries which faced similar challenges in the recent past. These efforts deserve attention, even if none of them has achieved first-best objectives and most of them have encountered various challenges during their implementation (Box 1).

Box 1. Lessons from recent OECD labour market reforms

Three southern European OECD countries – Italy, Spain and Portugal – share with Turkey socially ambitious labour regulatory frameworks. Such frameworks aim at providing generous minimum income levels and employment protection for all workers, but are implemented in economic structures where only a part of the enterprises are productive and competitive enough to combine them with net employment creation. The aggregate employment rate in these countries falls short of the OECD average, while the informal sector provides an imperfect avenue for more flexible employment creation (although to a lesser extent than in Turkey). All these countries, participating in the general labour market reform efforts across OECD countries (OECD, 2006b), launched important reforms in the 2000s to make employment more flexible and less costly in their formal sectors (OECD, 2004b; Boeri and Garibaldi, 2007).

In Italy, reforms started with the so–called Treu package in 1997. The previously drastic sanctions applied in case of the violation of the fixed–term contract rules were eased, temporary work agencies were legalised, and new "atypical" labour contracts were encouraged by reducing social security contributions and pension provisions. The automatic conversion of temporary contracts into permanent contracts was removed. The package also eased regulations for apprenticeship and work training contracts. In 2000, additional flexibility was granted for part-time contracts and in 2002 private placement services were liberalised further. A "telematic labour exchange" was created. Finally the important "Biagi Law" was adopted in 2003, authorising additional labour contract types such as job on call, project work, supplementary work and job sharing.

In Spain a new type of permanent employment contract was created in 1997, reserved for young and disadvantaged workers, with reduced severance payment liabilities for employers. In 1999, compulsory social security contribution rates were lowered by 25–50% according to worker categories. An additional comprehensive set of market reforms was adopted in 2001, liberalising, among other things, part–time contracts and extending the new type of permanent contracts introduced in 1997 to new categories of workers. The package also introduced new severance

10. Initially, employers could benefit from this measure between July 2008 and June 2009, but in February 2009 the window was extended until May 26, 2010. The employer's share of social security contributions, which is calculated on the basis of the minimum wage, is reimbursed fully in the first year of the scheme and then the coverage gradually declines to 20% in the fifth year.

payments for temporary workers.

In Portugal, the government, the employers' association (AIP) and the trade unions signed a Strategic Social Pact in 1996, jointly accepting the wider utilisation of atypical job contracts. The Pact extended time limits for temporary work contracts and recommended a wider recourse to temporary work agencies. In 1999, new legislation was adopted on part–time work and trade unions were given additional legal and judicial rights. Conditions for recourse to temporary work were tightened in 1999 and a new joint statement was signed by social partners in 2001 regarding the rules for applying fixed–term contracts.

The three southern European OECD countries have thus made their labour legislation more flexible than in the past by introducing new, more flexible employment forms, but at the same time preserving the existing employment forms and their legal basis. This two–tier approach made new employment forms accessible to specific groups in the labour force. Targeted groups included young, female, elderly and other disadvantaged workers. New contract forms were optional, depending on mutual agreement between enterprises and their employees. Existing permanent contracts, however, were little affected by these legislative changes and a duality formed in the labour market.

New contracts were shown to account for a large share of job creation in the 2000s. They also resulted in the higher employment intensity of growth (Boeri and Garibaldi, 2007). Through both the legalisation of previously informal workers and new job creation in the legal sector, recourse to new labour contracts increased rapidly. The degree to which their effects are permanent remains debated, however, as empirical studies of this issue have led to conflicting results and certain researchers continue to argue that the introduction of new contract forms has no permanent effect, but merely increases employment volatility in the business cycle without long–term leverage on average labour demand (Boeri and Garibaldi, 2007). Nonetheless, positive impacts on the employment growth of specific and traditionally disadvantageous groups such as youth and prime–age women are clearly documented (OECD, 2004b).

A serious adverse effect of these reforms has been deepening labour market duality. Gaps between remuneration and job protection conditions for different types of contracts have widened in certain instances, raising obvious equity and efficiency concerns. These mounted given the observed serious asymmetries in the cyclical adjustment of employment. During the global crisis of 2008–09, almost the entire weight of employment adjustment in Italy, Spain and Portugal fell on workers with the new types of labour contracts. The rigid employment of incumbent cohorts and the excessive volatility of youth employment are now highlighted as a disincentive to human capital formation within enterprises. Therefore, governments have started to envisage new measures to diminish the protection and benefit gaps between different types of contracts. Expert organisations' advice also started to focus on the need to reduce excessive fragmentation in the labour market and to promote a more unified labour law, on a more flexible common basis (OECD, 2008, 2009c; Schindler, 2009).

Turkey could also draw from OECD experience regarding the political economy of labour market reforms as discussed in Box 2 and *2008 OECD Employment Outlook* (OECD, 2008b). In particular, as reforms seem to be complicated by a general lack of trust among stakeholders, the government would have to build more social trust to increase chances of implementing the needed labour market reforms. In this respect, it could commit credibly to improving the enforcement of labour rights and easing restrictions on trade union activity in line with International Labour Organisation conventions. This could help convince trade unions to broaden their concerns from the protection of the narrow interests of their members to the needs of a wealth and job creation for the entire society. Turkey should find a way of engaging in such a win–win process in the structural reform of the labour market.

Box 2. The political economy of labour market reforms

Recent OECD work on the political economy of labour market reforms, based on the experiences of Germany, Italy, Spain and Mexico, suggests five interesting lessons for Turkey (OECD, 2009c).

First, credible information on the costs of non–reform is a major ingredient to the reform process. A credible exposition of the economic and social costs of the lack of reform is helpful. Producing such analyses is however not easy and should be done by respected and non–controversial institutions.

Second, the cost of reform for incumbents should not be hidden in the hope that reform can proceed more smoothly. They should be explicitly recognised and addressed. It is important to realise that the regulatory entitlements of labour market incumbents, which represent a sort of capital for them. Reforms that "grandfather" these rights or explicitly compensate workers for foregoing them progress more easily – although at the cost of inequity and inefficiency during a potentially long transition period.

Third, newcomers into legal employment can constitute a potential pro–reform constituency. The outsiders to the formal labour market have little weight at the beginning of a reform process, but they gain more as they start to participate in the legal sector. Consequently, they may become more politically vocal and influential and they can form a constituency for additional reforms.

Fourth, economic crises help trigger reforms, but post–crisis growth also facilitates their implementation. Other structural reforms fuelling growth, notably in the product market, are for this reason complementary with and supportive of labour market reforms. Reforms and policies which facilitate new enterprise creation, market entry and investment growth are for this reason a good bedrock for labour market reforms. This interaction is particularly relevant for Turkey as discussed below.

Fifth, in certain circumstances, however, reforming the labour market may be a precondition for stronger growth. If labour costs and regulations are a truly binding constraint on new investment and business development, strong employment growth may not be obtained without shaking up the labour market. In such instances, pilot programmes reducing labour costs and making employment more flexible in narrow areas (such as in special economic zones or for specific employee groups) may be a way forward, although they raise the risks of inefficient market segmentation. Restricting such innovations in time, through for example sunset clauses and review rules which give all parties a say on their future extension may also help obtain political support to reforms. Offering new contract forms as optional innovations, *i.e.* as contracting instruments made available – but not imposed – on freely negotiating parties can also help with their introduction.

Advancing an integrated strategy of labour reforms and formalisation

In Turkey's circumstances, advancing the coordination of labour market reform and the strategy to overcome the divide between formal and informal sectors (*Strategy of Fight against Informality)* could ease the reform process politically. Labour market reform would help reduce the cost of job creation and enterprise development, giving formalisation a serious impulse, while enterprise development and job creation in the formal sector would help generate the productivity gains and income growth needed for broader support, by both entrepreneurs and workers, to labour market reform (OECD, 2006a, 2008a). The *Strategy of Fight against Informality* does not at present draw sufficiently on this synergy (Government, 2009). It seeks to accelerate formalisation through a variety of sensible means, but without reforming the labour market. More assertively enforcing the existing rules and regulations without, as a prior, reforming the labour market, may lead to competitiveness, output and employment losses.

Drawing on the experience of other OECD countries, labour market reforms in Turkey could be re-activated in the following directions:

i. Consider introducing more flexible and less costly legal employment forms on an experimental basis. New employment forms[11] can be made available to special categories of workers in the labour market, in special regions or economic zones, or on an optional and voluntary basis. The recent government measures to reduce labour taxes in selected provinces are a step in this direction.

ii. Support business enterprises experimenting with these new forms of employment, through for instance tax incentives. With the help of such incentives and other structural reforms facilitating market entry and business creation, try to foster a broad sphere of experimentation with such new forms of employment.

iii. As the benefits of at least some of these innovations for the creation of higher quality jobs in the legal sector become visible, make the most successful innovative forms more broadly available in the economy by incorporating them into the standard labour contract. This is crucial for avoiding the entrenchment of the innovation and experimentation into durable labour market duality.

iv. The alleviation of legal and regulatory burdens in the formal sector would permit a larger number of enterprises to grow in full abidance with law. They can therefore operate transparently and gain access to financial markets, as well as to other productivity–enhancing resources becoming available in the globalised world economy (international co–operation, FDI, etc.). They can therefore increase productivity and competitiveness, and offer their workers better terms of employment.

v. Higher–productivity and more competitive enterprises have the resources and incentives to provide workers with higher than average income levels, job or income security, and other social benefits than the statutory minima prescribed by the law. Progress with Turkey's convergence with the EU worker representation legislation may help in this respect. Less well performing enterprises and the national labour law can then progressively converge with these higher norms, as productivity and incomes increase.

Given the existing large pool of low–skilled workers, upskilling programmes should be activated in support of these efforts. It is thus welcome that the Turkish authorities recently reiterated their commitment to such measures. However, the international experience with upskilling policies is mixed and policies should be carefully designed to be effective and cost–efficient (OECD, 2009b). The challenge lies in adequately defining the target groups, the skill needs and effective measures. In this context, extending the scope of the Labour Market Research Programme conducted by the Turkish Employment Agency (İŞKUR) has been a welcome development. The idea of the research is to assess labour market needs and predict their future evolution to better design upskilling programmes. The scope of the activities carried out by İŞKUR within the framework of active labour market programmes has also been extended. Furthermore, the financing of these programmes was increased. In 2009, internship and entrepreneurship programmes were introduced along with public work programmes and vocational training courses. In 2009, 166 713 unemployed workers enrolled in training on the basis of this programme, 109 000 completed their courses, 34 000 are expected to complete in 2010 and 25 000 have found jobs. This is a very promising start. In order to better inform active labour market and upskilling policies, it is recommended that Turkey participates in OECD's new *Programme of International Assessment of Adult*

11. Entailing the combination of lower minimum wages, lower severance costs and easier temporary employment provisions.

Competencies (PIAAC). Through extensive surveys and tests, PIAAC will provide a new, systematic and internationally comparable evaluation of the human capital endowment of the working–age population in each participating country. Turkey's past experience with OECD's *Programme for International Student Assessment* (PISA) would help successfully undertake such an exercise.

Improving education attainment and quality will be crucial for alleviating the skill mismatches, which are likely to persist in the coming decades. Such reforms would also benefit productivity growth. In this respect, efforts to improve links between the education system, in particular vocational schools, and the labour market should be intensified. The government has already taken several measures in this area. The curricula in primary, vocational and technical secondary schools have been revised, but the curriculum in general secondary education still needs overhauling. Over the medium and long term, education reforms should focus on increasing cognitive skills, as these prove crucial for economic growth (Hanushek and Wössmann, 2009). In this respect education at early years should be strengthened. The enrolment rate for pre–school education is low, 38.5% for the 4–5 age group in 2009–10 education year (Ministry of National Education, 2010), and it is very diversified regionally, with the lowest enrolment rates prevailing in poorer rural areas. Increasing pre–school enrolment could have positive effects on women labour participation.

Mobilising inactive people, especially women, will be key for raising the employment rate. In this respect, in addition to the measures introduced by Law No. 5763 (see above), a further elimination of economic barriers to women's participation, by lowering tax wedges and providing more child and elderly care facilities, should be given priority. The social barriers are likely to gradually ease with better and more universal education and higher incomes. The recent government initiatives in these areas are useful. In 2008, the government launched "Promoting Women Employment" and "Promoting Youth Employment" initiatives which envisage providing entrepreneurship training, career consultancy and guidance services between 2009 and 2012. The social contribution rates have been temporarily lowered for women (see above).

Product market regulations hold back productivity

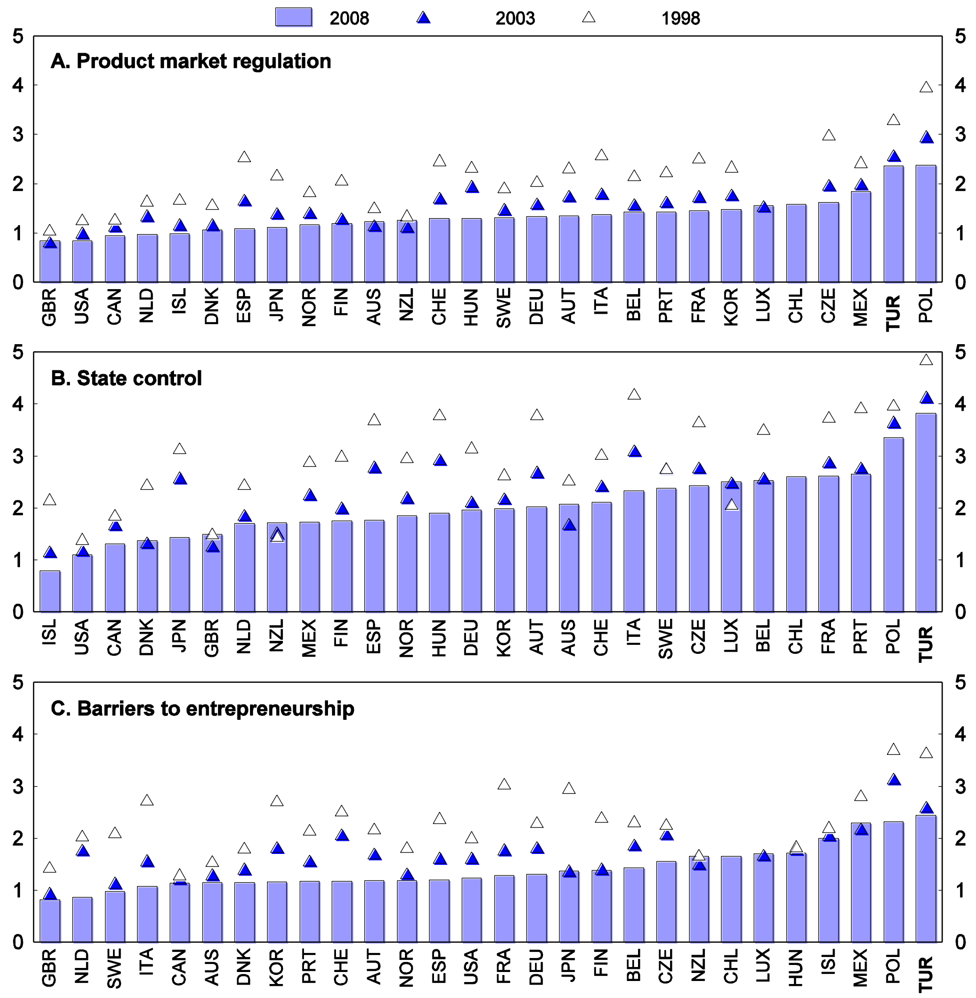
Impediments to productivity growth in Turkey are complex and numerous, but product market regulations are a key factor.[12] Even though they have been eased over the past decade (Figure 5), Turkey continues to have a restrictive competition environment in the formal sector. A similar picture is given by the World Bank's Doing Business indicators, which show that Turkey made progress but remains still in a weak position in the global sample. It was ranked 84th among 155 countries in 2005, progressed to the 60th rank in 2007 and then retreated to 73rd in 2009. These fluctuations reflect in part the fact that other emerging countries have reformed more rapidly than Turkey in recent years.

The tightest competition restrictions regard state control. Public ownership has been reduced in the past years due to privatisation in competitive sectors like petrochemicals, oil refining and distribution. However, public ownership still remains high by OECD standards. This applies especially to large network sectors such as electricity generation, natural gas distribution, postal services and rail transport. Moreover, government involvement in business operations is relatively intense. Command and control regulations continue to be used extensively, at the expense of incentive–based regulations (*i.e.* regulations which draw on price signals and competition dynamics). Price controls are used in several sectors such as air travel, road freight and mobile telecommunications and, according to the OECD product market indicator, the overall state price controls have intensified since 2003. Nevertheless, the international comparison of selected prices of electricity and telecommunication services suggests that Turkey has rather moderate prices in these sectors (Figure 6).

12. Beyond regulations and informality, productivity growth has been hindered by low human capital (see previous section) and inadequate infrastructure (EC, 2009). These factors are not analysed in depth in this paper.

Figure 5. Restrictive product market regulations

Index scale of 0–6 from least to most restrictive

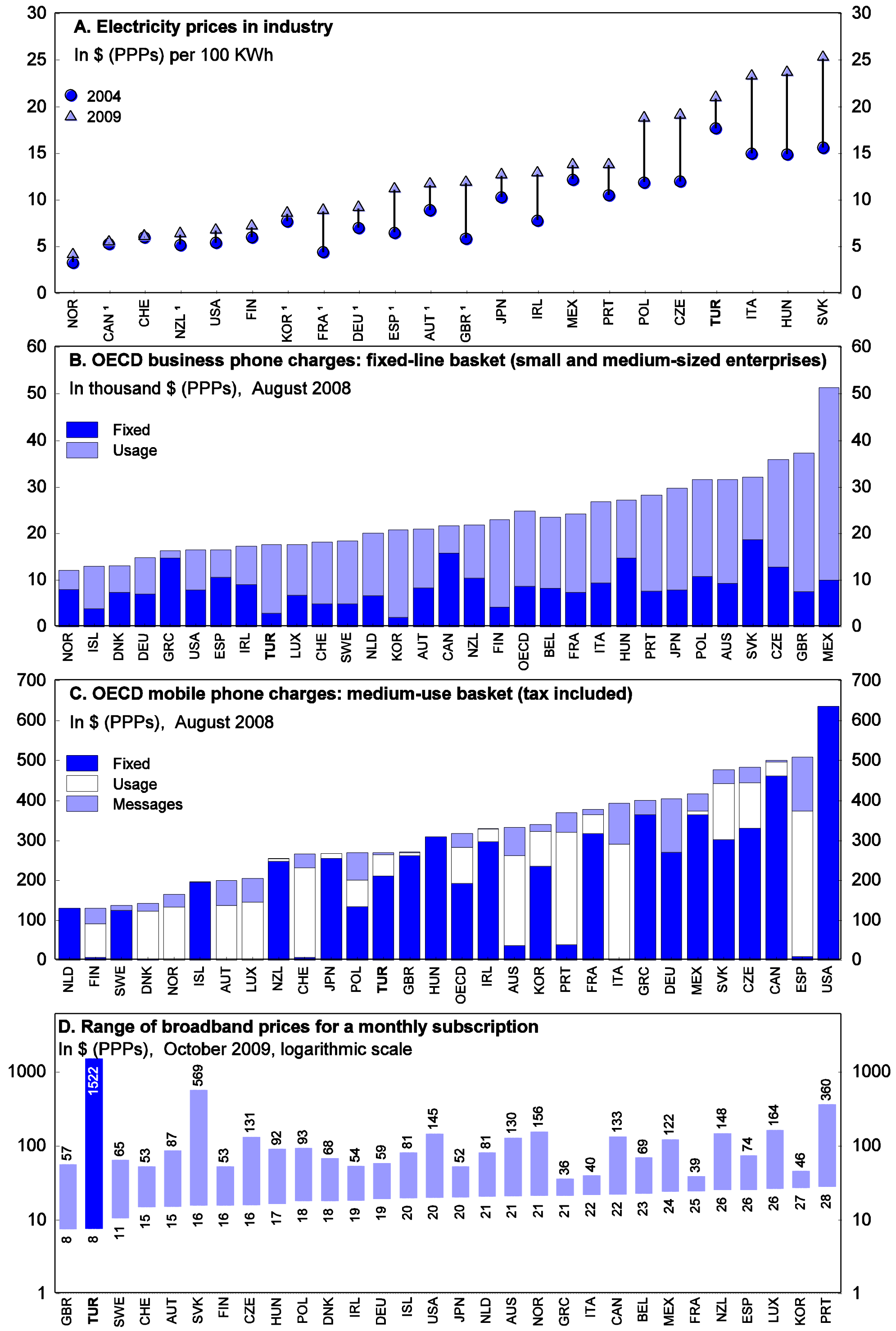


Source: OECD Indicators of economy–wide regulation (PMR) www.oecd.org/eco/pmr.

Barriers to entrepreneurship and to competition in the formal sector are higher than in most other OECD countries (Figure 5). Persisting regulatory and administrative opacities play a particularly important role in this. The licence and permits system is complex and there are neither “one–stop shops” nor “silence is consent” rules. However, the recent establishment of Development Agencies could offer an opportunity to ease licence and permits system since these agencies are intended to operate as one–stop shops across the country (see below). Administrative burdens on start–ups (concerning the creation of both sole proprietor firms and corporations) remain more cumbersome than in most other OECD countries. Notwithstanding improvements in certain areas, Turkish managers stress that they spend increasingly more time in dealing with government regulations (Enterprise Surveys, 2009).

Liberalisation reforms in product markets, in particular in network industries, would foster competition, help increase productivity and back labour market reforms by reducing monopolistic rents and helping overcome the entrenchment of insider interests (Nicoletti and Scarpetta, 2005). Such reforms would contribute to reducing the duality in the labour market and back labour market reforms – even if the

Figure 6. International comparison of selected electricity and telecommunication prices



1. Instead of 2009: 2007 for Canada and Germany, 2008 for Austria, France, Korea, New Zealand, Spain and the United Kingdom.

Source: AIE, Energy Prices and Taxes; OECD (2009), Communications Outlook; and OECD Broadband Statistics (www.oecd.org/sti/ict/broadband).

key divide between formal and informal employment occurs among competitive enterprises and is rooted in productivity and human capital differences within the competitive sector.

Regulatory enforcement at the local level in particular needs improvement. The local regulatory environments appear less transparent and less rule–based than at the central government level. Firms complain particularly about demands concerning "contributions to local community" (Dimireva, 2009). These distortions may be, paradoxically, more disturbing for domestic investors than for foreign investors because the latter are helped by the Turkish Foreign Investment Promotion Agency (Turkinvest).

A particular area where shortcomings in transparency and distortions to competition appear more frequently than in others is real estate planning and construction. Local enforcement in this area deserves thorough review and upgrading (Box 3). Its modernisation is also crucial for reinforcing the resilience of Turkey's physical infrastructure to natural risks. Turkey is exposed to important natural hazards, in particular to earthquake risks in the Istanbul/Marmara region. However, the majority of the outstanding building stock lacks formal authorisation and certification.[13] A response strategy is essential for human but also for economic and fiscal reasons. Minimum security norms should apply not only to new buildings but also to the existing ones.

Box 3. Real estate planning and construction permits

According to World Bank's Doing Business Indicators, Turkey ranks 133 among 183 countries in the area of construction permits. Average time spent dealing with such permits is lower than in comparator countries, but variations among regions and cities are very large. A recent review identified five key problematic areas in terms of bureaucratic procedures, without addressing in detail the risks that they entail in terms of distortions to competition. First, there are differences between sector–based strategies and urban development plans by different ministries. The coordination of spatial planning activities needs to be improved. Second, different government agencies happen to conflict on their respective areas of action. Two agencies may deal with the same issue without any authority to help solve their differences. Third, inspections related to construction permits are in the hands of the Ministry of Interior, which does not have special technical expertise. Ministry inspections focus on administrative procedures. Fourth, municipalities deliver certain permits and licenses, but few of them have adequate expertise to implement technical secondary legislation. Fifth, there are no standard procedures for the issuance of construction permits. No guidelines and handbooks exist to understand and implement the regulatory framework. The World Bank also mentioned that the recently established Development Agencies may provide opportunities for alleviating the related shortcomings in the investment and business environment.

Source: World Bank (2010).

Further product market reforms are needed to facilitate entrepreneurship in the formal sector

Although product market reforms are more advanced and the remaining barriers are less binding than in the labour markets, further relaxing anti–competitive product market regulations is needed. Such reforms would permit Turkey's exceptionally vibrant entrepreneurship culture to take hold in the formal sector rather than in the semi–formal and informal sector. Entrepreneurs could then operate more confidently and transparently, without feeling threatened by law enforcement and inspections. Such a new setting would provide a new impulse to productivity growth (Annex A2) and would reinforce reforms in the labour markets.

13. After the 1999 earthquakes physical protection against earthquake risks was partially improved (OECD, 2004a). This concerned mainly public buildings, notably schools and hospitals, which were severely damaged. In contrast, progress was limited with the reinforcement of private houses and commercial buildings.

A more competitive environment in the formal sector would benefit the productivity of both existing formal and informal firms. Formal firms would be exposed to more competition and semi-formal and informal firms would have access to new productivity–enhancing resources. In the light of OECD's analyses of the present status of Turkey's product market regulations in international comparison, three priorities of product market reforms should be to:

i. *Reduce barriers to entrepreneurship.* Turkey's licence and permits system remains complex in international comparison. "One–stop shops" for market entry authorisations and "silence is consent" rules, which facilitate market entry in the formal sector in other OECD countries, are not in force. The streamlining of the legal and regulatory framework would reduce the hurdles faced by formal sector entrepreneurs. This would also help reduce the excessive discretionary powers of regulatory authorities, which increase the risks of corruption.[14]

ii. *Reduce government's involvement in business operations*. Further advancing privatisation and reducing price controls are needed. After major privatisations in the 2000s (petrochemicals, oil refineries and telecommunications), more challenging privatisations await the government. They concern large network firms in electricity generation, natural gas, railways, postal services, etc. Following the slowdown in privatisations due to unfavourable global conditions in the crisis, the government announced that planned privatisation would resume. They may however be made more difficult due to labour market considerations (Box 4). This is an area where stronger social consensus on desirable labour market regulations would facilitate product market reforms.

iii. *Further ease conditions for foreign direct investment*. Turkey has considerably reduced barriers to foreign investment in 2003 by enacting a law which eliminated the special regime of foreign owned corporations and granted full national treatment to all foreign enterprises operating in Turkey. Nonetheless, Turkey remains among the OECD countries with comparatively restrictive rules. Sectoral investment restrictions such as on radio and TV broadcasting, energy and transport, and relatively cumbersome conditions for foreigners' work permits are two areas where additional liberalisation would be welcome.

Box 4. Handling the labour market impact of privatisation

In 2004, the government announced a new regulation permitting the re–hiring of redundant employees losing their jobs in privatised companies in other public sector entities. A first list was published with job vacancies to which privatised enterprises' workers could apply. Their applications were to be given preferential treatment, outside the standard procedures of public sector hiring. A new status, the so–called 4–C status, was created for this purpose. The employees concerned would continue to be covered by social security, but could not be employed for longer than 11 months per year and could not be hired with permanent employment contracts.

The procedure was meant to be made progressively available to all workers employed in public entities included in the privatisation programme. One of its implementations concerned the privatisation of Tekel, the large state-owned producer and distributor of tobacco, cigarettes and alcoholic drinks. Tekel was privatised to British American Tobacco in February 2008.

In December 2009, the government announced that 12 Tekel factories would be closed, with 10 000 workers redeployed to other jobs in the public sector under the 4–C status. As Tekel employees were previously covered by a rewarding collective agreement regarding pay and other entitlements, the announcement sparked a large-scale industrial action. About 12 000 workers from across the country demonstrated in Ankara. On February 2010, workers from unionised industries participated in a one day national strike in support. Following a court case, the State Administrative Court (*Danistay*) judged, in March 2010, that the 4–C status did not comply with the rights and social protection guaranteed by the Constitution to public sector workers. It passed the regulation to the Constitutional Court for the verification of compliance with Constitution.

14. According to international surveys the risks of corruption increase in proportion to the legal and regulatory complexities which vest public officials with unnecessary discretionary powers *vis-à-vis* business enterprises (Aidt and Dutta, 2004; Tøndel and Søreide, 2008).

In order to accelerate product market reforms, Turkey established a Coordination Council for the Improvement of the Investment Environment (YOIKK) at the end of 2001 (Box 5). This body steers and guides the reform initiatives and its actions have exerted a significant impact on the acceleration of product market reforms. This endeavour should be continued.

Box 5. The Coordination Council for the Improvement of the Investment Environment (YOIKK)

The Coordination Council for the Improvement of the Investment Environment (YOIKK) is a platform operating since 2001. It comprises high–level public and private sector representatives. It aims at streamlining business regulations and at facilitating the needed reforms. It has four key roles: *i)* identifying the main obstacles to market entry and doing business on the basis of the practical experience of private sector operators; *ii)* achieving a consensus within the public and between the public and private sectors on reform priorities; *iii)* taking leadership in setting specific reform targets and an associated timetable; and *iv)* providing a platform of accountability on reform policies.

The YOIKK is connected with an international high–level advisory board – the Investment Advisory Council. It includes top executives from multinational companies operating or interested in Turkey, the resident representatives of international institutions (such as the IMF, World Bank and European Investment Bank) and the chairpersons of the Turkish non–governmental organisations representing the private sector. IAC convenes yearly for a day, with the participation of the Prime Minister, and advises the government on reforms. IAC’s recommendations become a roadmap for YOIKK for the following year. Each year the government reports on progress on each of the previous recommendations.

During its initial years, the main YOIKK achievements included the preparation of the following concrete proposals, which were implemented by the government: *i)* the reduction of company association procedures from 19 to three transactions; *ii)* a new FDI law abolishing pre–entry screening and minimum capital requirements, based on international best practices; *iii)* the reduction of the corporate income tax rates; *iv)* the establishment of the Investment Support and Promotion Agency of Turkey (Turkinvest) as a one–stop shop for foreign investors.

For 2010, YOIKK has established programmes for 12 Technical Committees created in the following areas: Company Establishment, Employment, Licensing, Location of Investment, Taxation and Incentives, Foreign Trade and Customs, Intellectual Property Rights, Investment Promotion, R&D, Legislation of Foreign Direct Investment, Small and Medium–sized Enterprises and Corporate Governance.

According to the authorities, YOIKK–led reforms are expected to improve Turkey’s scoring in OECD’s product market regulation indicators, at the occasion of the next update of these indicators.

Productivity could be boosted by additional policy initiatives

Productivity growth can also be raised by supporting the development and dissemination of new technologies. The government goal of increasing R&D spending from 0.76% of GDP in 2006 to 2% of GDP in 2013 as targeted in the Ninth Development Plan is a welcome objective (SPO, 2006, 2010). It should be stressed, however, that the quality of R&D spending is more important than its level. In this respect, private R&D, which falls short of most OECD countries, should be encouraged. The government has introduced a number of incentives to boost R&D, including technology development zones (TDZs) and technology centres promoting a closer and more effective co–operation between universities and industry. In August 2009, it was decided to establish 36 TDZs and 20 technology centres. So far, 20 TDZs and 18 technology centres have become operational. TDZs enjoy tax incentives, including tax reductions on corporate profits and on income taxes for employees and VAT exemptions on products produced in these zones. Similar tax incentives apply to R&D companies that plan to employ more than 50 employees. As no comprehensive evaluation of the effectiveness of these recent programmes has been undertaken so far, it is difficult to assess their efficacy. The authorities have announced that all programmes will be evaluated and results will be published. The adoption and dissemination of technologies can also be facilitated by attracting higher FDI inflows.

The reforms to boost productivity and employment may be supported by regional policies. These can not only spur company and job creation, and technology and infrastructure improvement, but also address big regional differences in economic development (World Bank, 2008). Regional development is high on the political agenda and the government introduced a New Investment Incentive System in 2009 (SPO, 2009a, 2010). Incentives are differentiated across four designated regions and sectors as well as the size of the investment. The regions are selected based on a socio–economic development index and priority sectors are identified for each region. For instance, in the third and fourth regions, which cover mostly southern and eastern provinces, the focus is placed on agriculture, light manufacturing, tourism, health and education, whereas in the first and second regions the focus is mainly on high–technology industry. The incentives involve exemptions from custom duties, VAT, subsidies to interest on loans and employers' social security contributions, reduced corporate and income taxes and preferable land allocation. The system grants additional tax and social security incentives to investments started before the end of 2010. A review of the experience with this new investment incentive system could be included in the next *Economic Survey of Turkey*.

To ensure efficiency and effectiveness, these policies should be subject to thorough evaluation. This calls for a wide dissemination of information and disclosure of relevant economic information at the regional level, reporting on enterprise and job creation, output growth and productivity, and data helping explore links with the variety of support policies. The publication of up-to-date province-level economic data should be ensured. This especially applies to provincial GDP data, publication of which was discontinued in 2001. Experience with successful Organised Industrial Zones (OIZs) also deserves special attention. Successful OIZs demonstrate positive externalities in terms of industry clustering, cost-effective provision of infrastructure, dissemination of knowledge and technology, enforcement of environmental policies, co–operation between industry and universities.

Development Agencies (DAs) will be main instruments of the regional policy. DAs are being established in 26 regions across entire Turkey since 2006 to support business and investment activities in the regions. Their aim is to enhance co–operation and facilitate interactions between public and private sectors. DAs are expected to act as "one–stop" shops, intermediating between firms and official bodies in charge of granting licenses and other support measures. They could therefore help rationalise financial and non–financial support initiatives of local economic development. DAs will also carry out FDI promotion, through Investment Support Offices – which will be created in coordination with the national FDI promotion agency Turkinvest. DAs are also authorised to provide direct training services for enterprises in the areas of management, production, marketing, technology, finance and organisation. DAs are finally expected to develop regional innovation and cluster strategies and provide support for the joint activities of enterprises and universities.

Benefits of labour and product market reforms are large

According to the OECD analyses of the determinants of long–term growth, economic performance in the long run depends *inter alia* on convergence with international best practices of product and labour market regulations. The income gap in Turkey creates a vast scope for improvement and high costs of inaction. To demonstrate this, two simple, illustrative scenarios of long–term growth are presented in Annex A2. They indicate that even a modest improvement in labour force participation and average labour productivity may make a major difference for GDP per capita and jobs over the long run. With a relatively restricted set of structural reforms improving labour utilisation and productivity, GDP growth can accelerate to over 6%, GDP per capita can be higher by around 14% and employment by around 10% (*i.e.* around 2.5 million workers) by 2020 than would be the case if no such reforms were implemented and the past trends were preserved (Table A2.1 and Figure A2.1). If this ongoing reform agenda for Turkey is well orchestrated and fully implemented, actual GDP growth could be higher than 6% assumed in the growth acceleration scenario. The scenario is only indicative of possible gains in potential GDP and employment and should not be interpreted as the upper limit.

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ANNEX A1. THE IMPACT OF THE 2003 LABOUR LAW CHANGE ON JOB CREATION[15]

A reform of the Turkish Labour Code applicable from June 2003 increased dismissal costs for large firms, *i.e.* establishments with 30 or more employees. Large firms found to have made a dismissal without a valid reason are now required to either reinstate the worker within a month after the final decision or to pay compensation of 4–8 months' net wages in lieu of reinstatement. Additionally, the worker is paid maximum four months of the wages and other benefits that have accrued during the period he/she has not been reinstated until the final decision. This annex investigates the effect of this reform on the hiring behaviour of large firms.

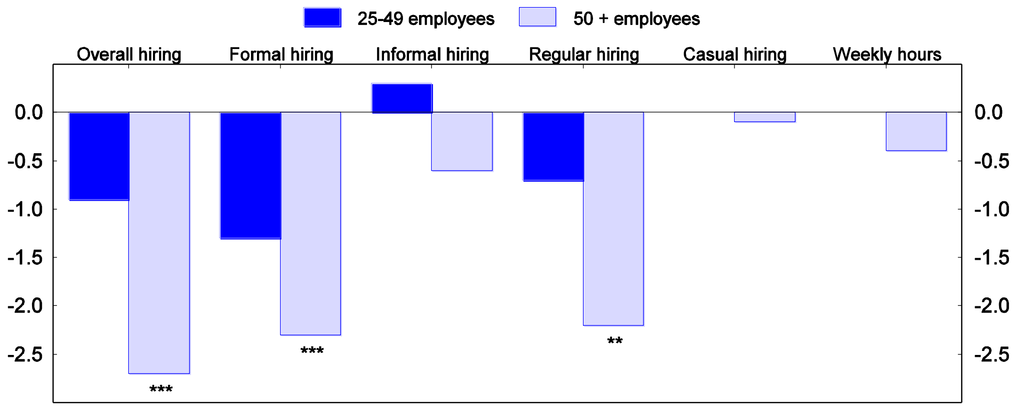
The impact of the reforms is tested by comparing the estimated probability of hiring and hours worked between large and small firms prior to and after the reform. The analysis assumes that the reform only affected the behaviour of large firms and that, in the absence of the reform, the difference between large and small firms would have remained unchanged. The analysis excludes workers in the agricultural industry (where establishments with fewer than 50 employees, which account for the bulk of agricultural employment, are exempted completely from the application of the Labour Code) and about 10% of non-farm employees who report working in a non–regular workplace such as a marketplace, field, garden, at home or in a mobile workplace. Estimations are based on the Turkish Household Labour Force Survey data and they include controls for employee demographic and human capital characteristics (age, gender, marital status, educational attainment and occupation). In the absence of detailed information about firm characteristics, controls for industry and urban/rural location are also added.

The results presented below show the impact of the reform on the probability of being hired and on weekly hours worked of employees in large firms (above 49 employees) compared with those in firms with 10–24 employees (which are used as a control group). There was no statistically significant impact of the reform on workers in firms with 25–49 employees compared with workers in smaller firms. This is not entirely surprising because some firms with 25–49 employees did not face increased dismissal costs as a result of the reform (which applied only to firms with 30 or more employees). Firms that are just above the threshold for higher dismissal costs may be able to hide their true size and so remain relatively unaffected by higher dismissal costs. However, there was a clear impact of higher dismissal costs on workers in firms with 50 or more workers. The impact – a reduction of just over 2% in hiring probability – was limited to those workers who could be expected to be bound by the legal change: formal employees (*i.e.* those registered for social security) and those with regular contracts (note that there is a large overlap between these groups). There was no significant impact of the reform on hiring probabilities for informal or casual workers. This suggests that large firms did not substitute informal/casual workers for formal/regular workers in order to get around the new requirements. Nor is there evidence that firms became more likely to adjust employment on the intensive margin by increasing hours rather than hiring new workers.

15 . This annex was prepared by Danielle Venn from the OECD Directorate for Employment, Labour and Social Affairs and it relates to Venn (2010).

Figure A1.1. Impact of reform on hiring probability (in percentage points) and weekly hours (in per cent)

By firm size, compared with employees in firms with 10–24 employees



Note: *** indicates that marginal effects are statistically significant at 1% level and ** at 5% level.

Source: Venn, D. (2010), "The Impact of Small–firm Exemptions from Employment Protection"; OECD Social, Employment and Migration Working Papers, OECD, Paris, forthcoming.

ANNEX A2. ILLUSTRATIVE LONG–TERM GROWTH SCENARIOS

Despite the proliferation of the literature on economic growth, particular determinants of growth and their relative importance are still debated and their estimates remain uncertain (Temple, 1999; Sala-i-Martin, 2002; Wacziarg, 2002). The consensus has been reached however that certain economic policies and reforms do indeed boost nation's prosperity, making growth an endogenous process, and that policy recipes may differ across countries (Aghion and Howitt, 1998; Rodrik, 2007). Given inherent challenges with quantifying, even *ex post*, all the structural determinants of growth and with making growth projections, only two simple, illustrative scenarios of long–term growth are presented.

These scenarios are based on a standard decomposition of GDP growth, similar to the framework used in *Going for Growth* (OECD, 2009a). The focus here is to abstract from cyclical volatility. Potential output (GDPVTR) is decomposed into trend labour productivity per person in employment (TRPDTY) and potential total employment (ETPT), with the latter decomposed further into the trend labour force participation rate (LFPRS), working age population (POPT) and equilibrium unemployment rate (approximated by the non–accelerating inflation rate of unemployment – NAIRU).[16] In growth terms, denoted by Δ, the decomposition is given by:

$$\Delta \text{GDPVTR} = \Delta \text{TRPDTY} + \Delta \text{ETPT}$$

$$= \Delta \text{TRPDTY} + \Delta(1 - \text{NAIRU}/100) + \Delta \text{LFPRS} + \Delta \text{POPT}$$

To illustrate possible potential output growth in Turkey over the long term two stylised scenarios are presented (Table A2.1 and Figure A2.1). The first assumes the *status quo*, where the labour force participation rate and NAIRU remain at the current level and labour productivity grows at its average rate calculated over the past decade. In the second scenario, a gradual improvement in the three components of potential output is envisaged (Table A2.1).[17] The resulting increase in GDP growth per capita can be almost treated as growth acceleration according to the definition of Hausmann *et al.* (2005), *i.e.* an acceleration of 2 or more percentage points for at least eight years. Working age population growth is taken to be exogenous and the same in two scenarios, and it is based on the UN demographic projections.

The assumed increase in productivity growth in the second scenario seems modest when compared with the full potential gains due to structural reforms. For instance, Conway *et al.* (2006) and Arnold *et al.* (2009) report that easing anti–competitive regulation in non–manufacturing sectors to the least restrictive in the OECD would increase annual productivity growth on average by 0.8 percentage points over ten years. However, the effect is likely to be twice as big for less advanced and highly regulated countries, which seems to be more relevant for Turkey. Productivity growth could in addition increase thanks to improved education, stronger physical infrastructure, higher and more efficient R&D spending and higher ICT investment. Effects of these factors are frequently discussed in the literature but are not always adequately quantified.

16 . Trend variables are calculated using a Hodrick–Prescott filter.

17 . No account is taken for a possible decline in potential output stemming from the 2008–09 recession.

The increase in labour force participation assumed in the second scenario is roughly equivalent to the situation where all people not seeking a job but available to work join the labour force by the end of the projection horizon.[18] Such an increase appears modest compared with the experience of some EU countries, which managed to increase the trend participation rate over the past decade by more than 5 percentage points. Higher labour participation would benefit from lowering the minimum wage for low-skilled workers, cutting the tax wedge, less restrictive employment protection legislation and from easing product market regulation. These reforms could also reduce the NAIRU. A decline of 1 percentage point, as assumed in the second scenario, is in line with the average fall in the NAIRU in the OECD countries over the past decade.

Table A2.1. Assumptions of GDP growth scenarios

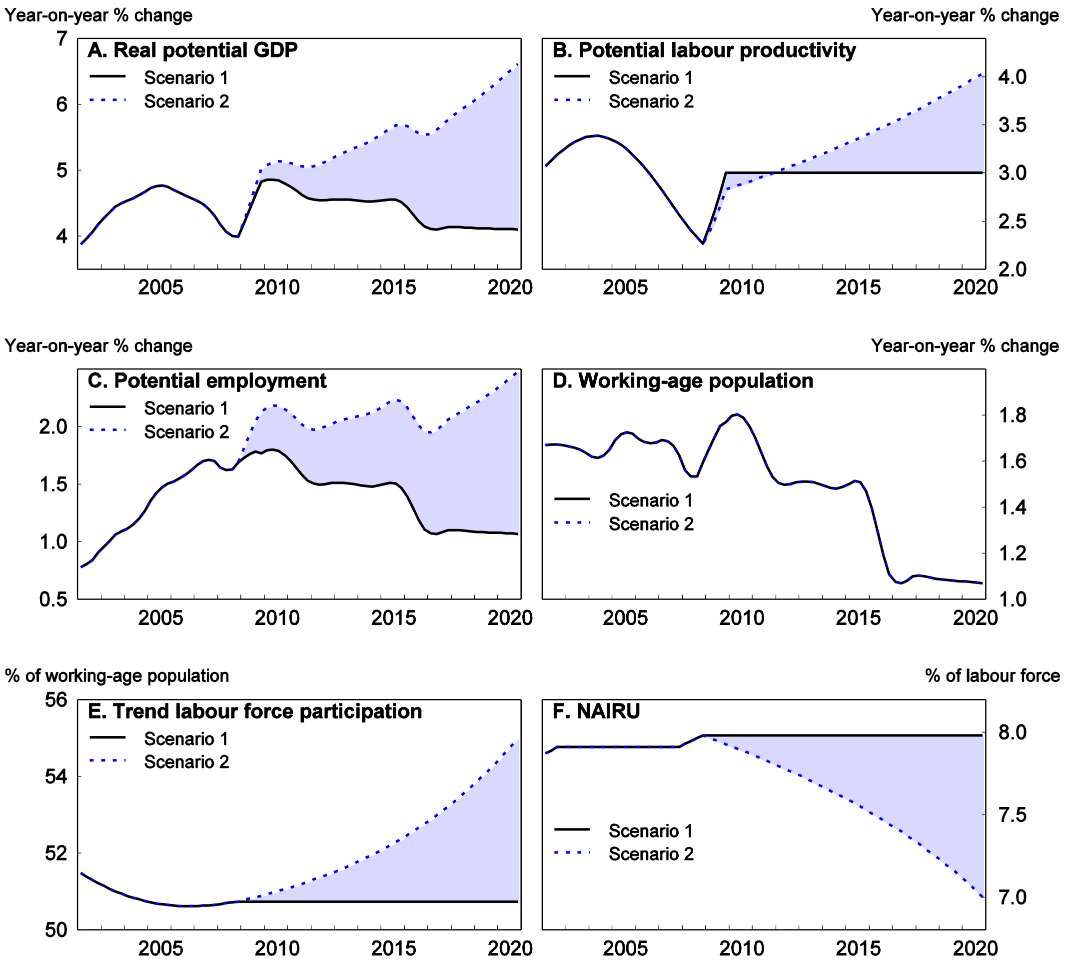
	Assumptions		Historic averages		Projected averages	
	Scenario 1 (*status quo*)	Scenario 2 (*acceleration*)	1998–2007	2003–2007	2009–2014[1]	2015–2020[1]
1. Trend labour productivity growth (TRPDTY)	3.0%	Gradually increases to 4.0%	2.9	3.1	3.0/3.0	3.0/3.7
2. Trend labour force participation rate (LFPRS)	Constant at 50.7%	Gradually increases to 56%	51.5	50.8	50.7/51.3	50.7/53.4
3. NAIRU	Constant at 8.0%	Gradually declines to 7.0%	7.8	7.9	8.0/7.8	8.0/7.3
4. Working–age population growth (POPT)	Gradually declines to 1%		1.8	1.7	1.6/1.6	1.2/1.2
5. Potential output growth (GDPVTR)	–	–	4.1	4.6	4.6/5.1	4.2/5.9
6. Growth in potential GDP per capita	–	–	2.7	3.2	3.4/3.9	3.2/4.9

1. The first number refers to the average for Scenario 1 and the second for Scenario 2.

Source: OECD and United Nations.

18 . Assuming that this group would grow in line with the working age population.

Figure A2.1. Long–term scenarios of potential output growth



Note: Scenario 1 refers to the status quo scenario and Scenario 2 to the growth acceleration scenario.

Source: OECD calculations based on the OECD Economic Outlook Database and UN population data.

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