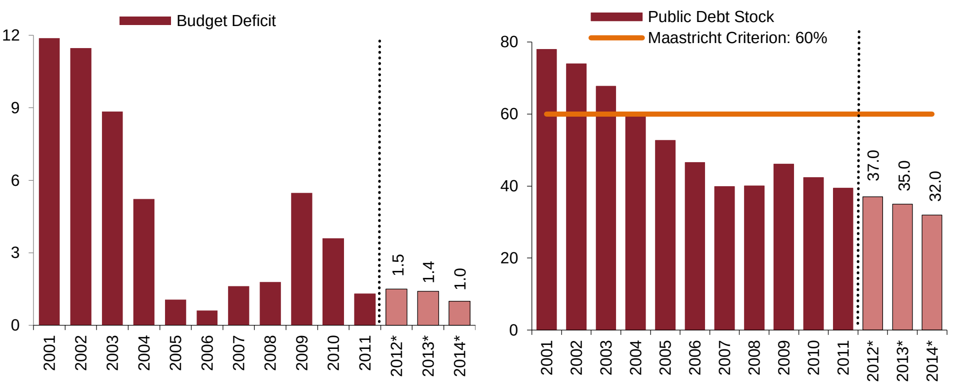
6. Public Finance

Soaring tax revenues and falling interest expenditures amid higher-than-anticipated economic growth favorably affected the fiscal balances in 2011, thus causing a year-on-year decline in central government budget deficit and public debt stock to GDP (Chart 6.1). The additional revenue collected within the Law No. 6111 on the "Restructuring of Public Claims", the applications of which had expired by May 31, 2011 besides the relative slowdown of the growth of primary expenditures also contributed to the improvement in budget performance.

Chart 6.1.
Central Government Budget Deficit and EU-Defined Public Debt Stock
(Percent of GDP)



* MTP targets.
Source: Ministry of Finance.

Increases in indirect taxes, VAT on imports in particular, which are mainly fuelled by the vigorous private consumption demand, in addition to revenues collected under the tax amnesty were particularly effective on the favorable outlook of the budget performance, pointing that the improvement in fiscal balances was mainly driven by cyclical factors and regulations. The additional revenues collected under the law on the restructuring of public claims will continue into 2012, providing further support to budget revenues. Furthermore, SCT rate hikes to certain products within fiscal measures effective as of October will also favorably affect the budget revenues in 2012. However, possible declines in tax revenues amid a potential slowdown in the economic activity as well as upside risks to public expenditures, personnel expenditures in particular, may interrupt the ongoing improvement in the budget performance in 2012. Moreover, stipulated tax cuts and other government incentives within the new incentive system, which was publicly announced on April 5, will favorably affect public revenues by enhancing investment and employment in the medium to long term, yet may lead to lower public savings in the short term (Box 6.1). Thus, it should be emphasized that in order to ensure sustainability of the favorable fiscal outlook as well as the fiscal discipline, reinforcement of the fiscal framework through institutional and structural improvements envisaged in the MTP remains critical.

6.1. Budget Developments

Central government budget posted a deficit of TL 6.4 billion, while primary balance registered a surplus of TL 10.9 billion in the first quarter of 2012 (Table 6.1.1). The increase in interest expenditures by 24 percent was mainly influential on the year-on-year deterioration in the budget performance. On the other hand, the quarterly increase in the interest expenditures is related to the maturity structure of the debt stock, and is anticipated to slow down in the following months. Moreover, the relatively slower growth of tax revenues signal a deceleration in the economic activity.

Table 6.1.1.
Central Government Budget Aggregates
(Billion TL)

	January-March 2011	January-March 2012	Rate of Increase (Percent)	Actual/Target (Percent)
Central Government Budget Expenditures	72.9	83.8	15.1	23.9
Interest Expenditures	14.0	17.3	24.0	34.5
Primary Expenditures	58.9	66.5	13.0	22.1
Central Government Budget Revenues	68.7	77.4	12.6	23.5
I. Tax Revenues	57.5	64.5	12.2	23.2
II. Non-Tax Revenues	8.7	9.6	9.9	21.7
Budget Balance	-4.1	-6.4	55.9	30.5
Primary Balance	9.8	10.9	10.6	37.4

Source: Ministry of Finance.

Having displayed a year-on-year improvement in 2011 on the back of the favorable budget outturn, the central government budget balance to GDP has deteriorated moderately in the first quarter of 2012, while continuing to remain low. The slightly worsening central government primary balance to GDP in the first quarter of 2011 amid rapidly soaring primary expenditures, remained unchanged in the first quarter of 2012 from the year-end (Chart 6.1.1). Central government budget revenues with a modest year-on-year decline in 2011, soared mildly in the first quarter of 2012, while central government primary expenditures to GDP remained unchanged since end-2011 (Chart 6.1.2).

Chart 6.1.1.
Central Government Budget Balance
(Annualized, Percent of GDP)

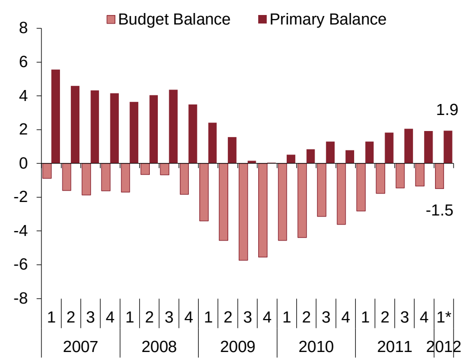
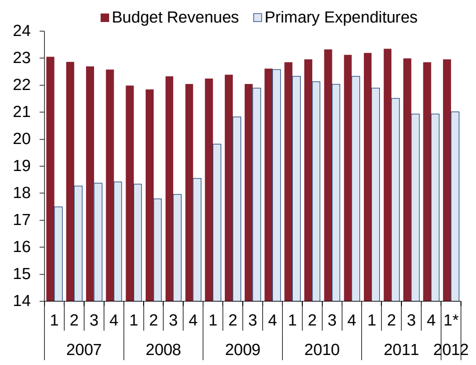


Chart 6.1.2.
Central Government Budget Revenues and Primary Expenditures
(Annualized, Percent of GDP)



* Estimate.
Source: Ministry of Finance.

Central government primary expenditures posted a year-on-year growth by 13 percent in the first quarter of 2012. Current transfers and personnel expenditures, major components of the primary expenditures, were up 9.3 percent and 15.3 percent, respectively. Meanwhile, expenditures on goods and services declined by 1.2 percent, mainly on the back of the dramatic fall in health expenditures due to coverage of green card holders under the general health insurance plan. Furthermore, expenditures within the general health insurance plan is a component of the current transfers, as opposed to being a component of the purchases of goods and services. The rapid surge in personnel expenditures in the January-March 2012 period was mainly owed to soaring salaries and severance pay. On the other hand, the low rate of increase in health, pension and social benefits, the major component of current transfers, restricted the rise in current transfers. Agricultural support declined temporarily by 7.2 percent (Table 6.1.2).

Table 6.1.2.
Central Government Primary Expenditures
(Billion TL)

	January-March 2011	January-March 2012	Rate of Increase (Percent)	Actual/Target (Percent)
Primary Expenditures	**58,.9**	**66.5**	**13.0**	**22.1**
1. Personnel Expenditures	18.8	21.6	15.3	26.5
2. Government Premiums to SSI	3.3	3.7	13.0	26.2
3. Purchase of Goods and Services	4.8	4.7	-1.2	16.3
a) Defense and Security	1.2	1.2	-3.3	11.3
b) Health Expenditures	1.1	0.3	-72.7	32.8
4. Current Transfers	29.6	32.3	9.3	24.8
a) Duty Losses	0.3	0.4	58.0	9.5
b) Health, Pension and Social Benefits	15.8	16.2	2.4	23.5
c) Agricultural Support	2.8	2.6	-7.2	36.3
d) Shares Reserved from Revenues	7.6	9.0	19.0	26.6
5. Capital Expenditures	1.5	1.7	13.8	6.1
6. Capital Transfers	0.3	0.2	-23.5	4.8

Source: Ministry of Finance.

Central government general budget revenues posted a year-on-year growth by 11.9 percent in the January-March 2012 period. Meanwhile, tax revenues and non-tax revenues increased by 12.2 percent and 9.9 percent, respectively (Table 6.1.3). The increase in income tax revenues by 24.7 percent slightly contained the slowdown in the growth of tax revenues. Income tax mainly comprises withholding tax on wages, salaries, interest and capital earnings. Therefore, the ongoing increase in registered employment is considered to be influential on soaring income tax revenues. Meanwhile, domestic VAT revenues increased mildly by 9.2 percent, while SCT revenues increased by a mere 4.5 percent. The slowdown in the growth of SCT revenues was mainly owed to the year-on-year decline in SCT collection on oil and natural gas products, as well motor vehicles by 0.4 percent and 11 percent, respectively. In the meantime, VAT revenues on imports registered a growth by 5.9 percent, remaining well below the growth rate by 34.5 percent in 2011.

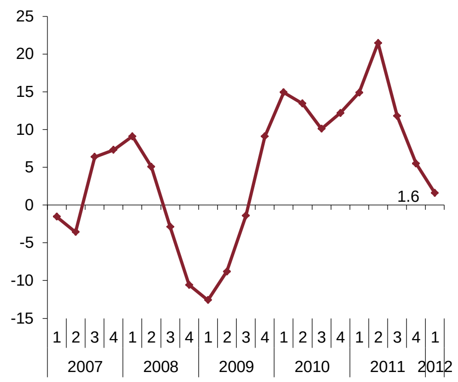
Table 6.1.3.
Central Government General Budget Revenues
(Billion TL)

	January-March 2011	January-March 2012	Rate of Increase (Percent)	Actual/Target (Percent)
General Budget Revenues	**66.2**	**74.0**	**11.9**	**23.0**
I-Tax Revenues	**57.5**	**64.5**	**12.2**	**23.2**
Income Tax	10.4	13.0	24.7	24.1
Corporate Tax	6.6	7.4	12.4	27.1
Domestic VAT	7.3	8.0	9.2	23.9
SCT	13.3	13.9	4.5	19.7
VAT on Imports	10.3	10.9	5.9	20.2
II-Non-Tax Revenues	**8.7**	**9.6**	**9.9**	**21.7**
Enterprises and Property Revenues	2.6	2.9	9.1	31.1
Interests, Shares and Fines	4.3	4.8	12.5	21.8
Capital Revenues	1.3	0.6	-51.6	5.5

Source: Ministry of Finance.

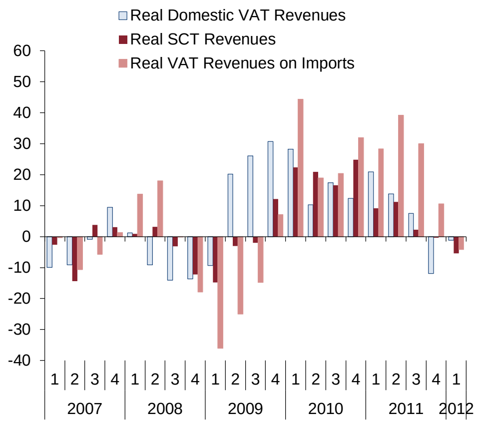
The annual rate of increase in real tax revenues, which has decelerated since the third quarter of 2011, continued to slow down further in the first quarter of 2012, hitting the recent-low since the last quarter of 2009. The slowdown in the economic activity since the third quarter of 2011 was especially influential on the declining growth of real tax revenues (Chart 6.1.3). Consumption-based tax revenues are the primary tax revenue items which were adversely affected by the slowdown in the economic activity. Hence, SCT revenues, a major component of the tax revenues, registered a year-on-year decline by 5.4 percent in real terms, in the first quarter of 2012. Meanwhile, during the same period, domestic VAT revenues and VAT revenues on imports posted a year-on-year decline by 1.2 percent and 4.1 percent, respectively, in real terms (Chart 6.1.4).

Chart 6.1.3.
Real Tax Revenues
(Annual Percent Change)



Source: Ministry of Finance.

Chart 6.1.4.
Real VAT and SCT Revenues
(Annual Percent Change)



6.2. Developments in the Debt Stock

Public debt stock indicators improved further in the first quarter of 2012. The real cost of borrowing decreased, the maturity of the debt stock was extended and the share of interest and exchange-rate-sensitive securities in the debt stock declined.

Chart 6.2.1.
Public Debt Stock Indicators

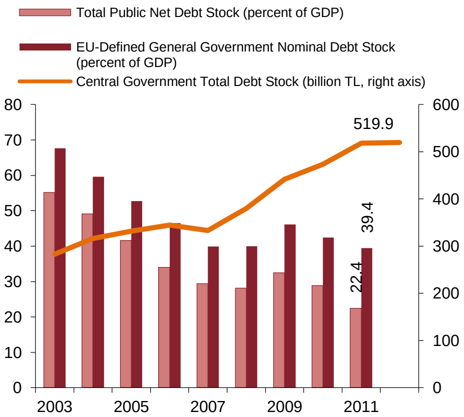
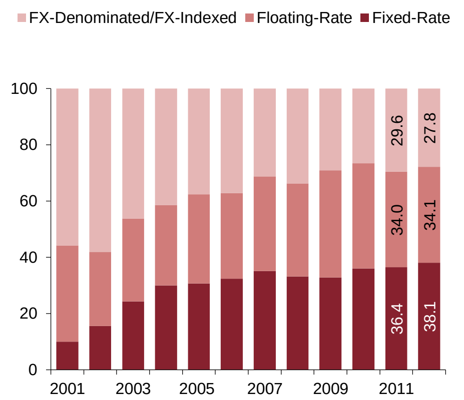


Chart 6.2.2.
Composition of the Central Government Debt Stock
(Percent)



* Floating-Rate debt stock includes discounted securities with a maturity less than 1 year and GDBS with floating rates.
** FX-Denominated/FX-Indexed debt stock includes external debt stock and FX-denominated and FX-indexed domestic debt stock.
Source: Treasury, CBRT.

The ratio of total public net debt stock and EU-defined general government nominal debt stock to GDP posted a year-on-year decline by 6.5 points and 3 points, to 22.4 percent and 39.4 percent, respectively, by end-2011

(Chart 6.2.1). Meanwhile, as of March 2012, central government debt stock remained unchanged from end-2011 (Chart 6.2.1).

Chart 6.2.3.
Average Maturity of Domestic Cash Borrowing and Term-to-Maturity of the Domestic Debt Stock
(Month)

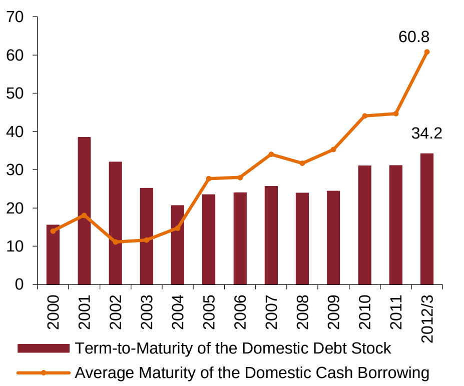
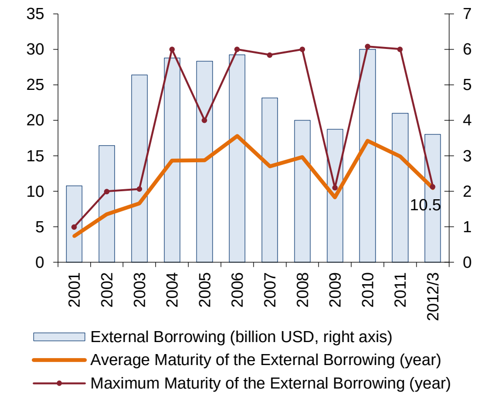


Chart 6.2.4.
Borrowing By Bond Issues



Source: Treasury, CBRT.

As of March 2012, the Treasury has continued on its borrowing strategy to alleviate the sensitivity of the debt stock to liquidity, interest rate and exchange rate. Accordingly, the share of fixed-rate securities increased in the total debt stock (Chart 6.2.2). The ratio of public deposits to average monthly debt service reached 154.6 percent. Term-to-maturity of the domestic debt stock hit 34.2 months amid the year-on-year increase in the average maturity of the domestic cash borrowing (Chart 6.2.3). External borrowing by bond issues amounted to USD 3.6 billion, with a year-on-year decline in the average maturity to 10.5 years (Chart 6.2.4).

Chart 6.2.5.
Total Domestic Debt Rollover Ratio
(Percent)

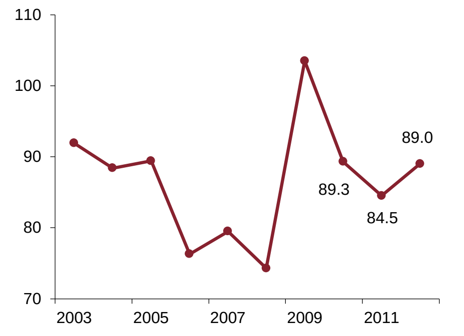
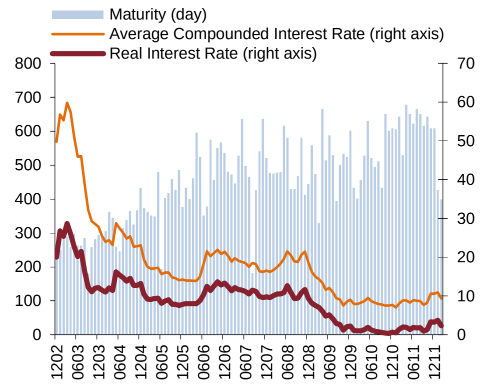


Chart 6.2.6.
Average Maturity of Borrowing and Interest Rates at Discount Auctions



Source: Treasury, CBRT.

According to the Treasury's announced strategy on domestic borrowing for April-June 2012, domestic debt rollover ratio, which is envisaged to fall to 78.8 percent by end-June, stood at 89 percent in February 2012 (Chart 6.2.5). Having fallen sharply from the onset of 2009 till the beginning of 2011, the average real interest rates at discount auctions have recently displayed a mild increase, albeit remaining currently low (Chart 6.2.6).

Box 6.1 Main Features of the New Incentive System

Fiscal policy is an instrument that can affect the economy both from the demand side as well as from the supply side. Fiscal policy is significant in the short term for improving macroeconomic stability from the demand side through taxes and expenditure policies, while in the long term, fiscal policy may affect supply side by enhancing economic growth and potential output. To give an example, a reduction in direct taxes such as income and corporate tax may affect factors of production like labor and capital, and thus, contribute to growth and employment in the long term without causing any inflationary pressures. Hence, the new incentive system, the general features of which were publicly announced on April 5, is estimated to have broad effects on the economy by supporting economic growth through supply-side economic policies. This Box summarizes the main features of the incentive package as well as its range of application.[1]

The new incentive system is the fourth incentive system in Turkey launched over the last decade. The new system preserves the main features of the previously enacted incentive system, the provision of government incentive for investments, which was published on Official Gazette on July 16, 2009. However, the new system brings about major changes and novelties in certain aspects. In fact, in the previous incentive system, Turkish provinces were categorized under 4 regions with respect to their socioeconomic development, while the new system divides Turkey into 6 regions, with higher incentives granted to socioeconomically inferior regions.

Narrowing the current account deficit by expanding the production of intermediate goods and products with high import dependency, providing higher investment incentives to least-developed regions, removing differences across regions with respect to their level of development, enhancing the effectiveness of incentives, contributing to clustering activities and supporting high and medium-high technology investments are determined as the main objectives of the new incentive system. The new incentive system comprises general and regional investment incentive schemes besides large scale and strategic investment incentives. Stipulated measures for the attainment of goals vary by schemes (Table 1). Measures of incentives include VAT exemption, customs duty exemption, tax reduction, social security premium support to employer's share,

[1] For further details, see Ministry of Economy (2012) and Prime Ministry of Turkey (2012).

interest support, land allocation and VAT refund. The use of each incentive depends on the region as well as the size of the investment. Furthermore, with the objective to ensure a net wage increase, to reduce cost of labor and to create new employment opportunities, investments in region 6 are eligible for additional incentives of income tax withholding allowance and social security premium support to employee's share.

Table 1. The New Incentive System

General Investment Incentive Scheme	Regional Investment Incentive Scheme	Large Scale Investment Incentive Scheme	Strategic Investment Incentive Scheme
VAT Exemption	VAT Exemption	VAT Exemption	VAT Exemption
Customs Duty Exemption	Customs Duty Exemption	Customs Duty Exemption	Customs Duty Exemption
	Tax Reduction	Tax Reduction	Tax Reduction
	Social Security Premium Support (Employer's Share)	Social Security Premium Support (Employer's Share)	Social Security Premium Support (Employer's Share)
	Land Allocation	Land Allocation	Land Allocation
	Interest Support		Interest Support
			VAT Refund

* Investments in region 6 are eligible for income tax withholding allowance and social security premium support to employee's share.
Source: Ministry of Economy (2012).

Unlike prior incentive packages, the new incentive system provided improved privileges to investments in industrial zones. Another new feature of the system is the facilitation of tax reduction both during the operation as well as the investment period. Furthermore, for investing firms in regions other than region 1, a certain portion of the tax reduction is applied to total earnings accrued through all activities during the investment period. The new system enables increased tax allowance in less-developed regions, thus providing significant funding to investing firms. Moreover, in order to enhance financing opportunities, interest support is maintained in the new incentive system as another measure of incentive.

Another important feature of the new incentive system is the special emphasis placed on the strategic investments for the production of intermediate goods and products, more than 50 percent of which are provided by imports. In addition, the announced package is expected to contribute significantly to the narrowing of the current account deficit and the improvement of the international competitiveness, by supporting high-technology investments as well as investments with high value added.

In sum, the new incentive system is expected to support economic growth through expansionary fiscal policies, including tax reduction and other government incentives, and therefore, enhance investment and employment, and consequently, lessen regional socioeconomic divergences. The adopted measures of incentives are stipulated to reduce public savings in the short term, while favorably affecting the fiscal outlook by creating higher public revenues in tandem with the expanding output, investment and employment in the medium to long term.

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