6. Public Finance

In the first nine months of 2016, the central government budget performance registered a rather limited year-on-year improvement, particularly upon the hikes in non-tax revenues. Although the growth of primary expenditures continued in this period, the mild uptick in tax revenues, besides the intermittent decline in interest expenditures, also contributed favorably to the budget performance.

The MTP covering the 2017-2019 period was announced to the public. The MTP states that the fiscal policy will be implemented to boost growth potential, maintain economic stability, keep a sustainable level of current account deficit and stimulate domestic savings and investments. The fiscal policy will be formulated to support these targets primarily by reviewing expenditures, and contain the public sector borrowing requirement by taking measures to reduce public savings and the investment deficit. Moreover, public infrastructure investments, regional development, education, R&D support and incentives will be given special priority in expenditures (Box 6.1). In addition, public revenue policies will safeguard the provision of required revenues from reliable and sustainable resources and also contribute to economic and social objectives like improving the income distribution, supporting development and increasing savings. In this respect, it is projected that fiscal discipline will be maintained amid the tight fiscal policy and the public debt stock to the GDP ratio will continue to decline gradually throughout the MTP period (Table 6.1). The fiscal harmonization envisaged in the MTP presents a framework that primary expenditures to the GDP ratio will be reduced gradually and tax revenues to the GDP ratio will not be subject to a noticeable change.

According to the new MTP, the central government budget deficit to the GDP ratio is estimated to stand at -1.6 percent in 2016 with a slight year-on-year increase (Table 6.1). Projected realizations in the MTP suggest that primary expenditures remained considerably above the target in 2016, while tax revenues remained largely consistent with the target. On the other hand, the deviation in the budget deficit is likely to remain low amid the high performance of non-tax revenues.

Table 6.1.
Central Government and General Budget Balance
(Percent of GDP)

	2015	2016*	2017**	2018**	2019**
Expenditures	25.9	27.0	26.8	25.9	25.1
Primary Expenditures	23.2	24.7	24.4	23.6	22.7
Interest Expenditures	2.7	2.4	2.4	2.3	2.4
Revenues	24.7	25.4	24.9	24.2	23.8
Tax Revenues	20.9	20.9	21.3	21.1	20.9
Other Revenues	3.8	4.5	3.6	3.1	2.9
Budget Balance	**-1.2**	**-1.6**	**-1.9**	**-1.6**	**-1.3**
Primary Balance	**1.5**	**0.8**	**0.4**	**0.7**	**1.1**
General Budget Balance	**-0.1**	**-1.9**	**-1.7**	**-1.6**	**-1.0**
Primary Budget Balance	**2.7**	**0.6**	**0.8**	**0.8**	**1.6**
EU-Defined Nominal Debt Stock	**32.9**	**32.8**	**31.9**	**31.0**	**29.9**

* Forecast.
** MTP (2017-2019).
Source: MTP (2017-2019).

6.1. Budget Developments

In the first nine months of 2016, the central government budget balance registered a deficit of 12.0 billion TL and the primary budget balance posted a surplus of 29.6 billion TL (Table 6.1.1). The robust tax revenue collection of 2015 continued into the first nine months of 2016 despite some deceleration. Due to the intermittent fall in interest expenditures and the sharp year-on-year growth in non-tax revenues, the central government budget balance exhibited a rather limited year-on-year improvement in the first nine months of 2016.

Table 6.1.1.
Central Government Budget Aggregates
(Billion TL)

	2015 January-September	2016 January-September	Rate of Increase (Percent)	Actual/Target (Percent)	Target Rate of Increase (Percent)
Central Government Budget Expenditures	367.7	416.5	13.3	73.0	12.8
Interest Expenditures	44.8	41.7	-6.9	74.4	5.6
Primary Expenditures	322.9	374.8	16.1	72.9	13.6
Central Government Budget Revenues	354.2	404.5	14.2	74.8	11.9
I. Tax Revenues	298.3	329.0	10.3	71.6	12.7
II. Non-Tax Revenues	42.2	60.4	43.3	87.3	20.7
Budget Balance	**-13.5**	**-12.0**	**-**	**-**	**-**
Primary Balance	**31.3**	**29.6**	**-5.3**	**112.7**	**-**

Source: Ministry of Finance.

After rising slightly to 1.3 percent in 2014 on an annual basis, the central government budget deficit to the GDP ratio dropped to 1.2 percent in 2015. This ratio is estimated to fall further to 1 percent in the first nine months of 2016 (Chart 6.1.1). Meanwhile, having declined to 1.1 percent in the third quarter of 2012, the primary budget surplus to the GDP ratio assumed an upward course, ending 2013 at 2 percent. The ratio receded to 1.6 percent in 2015, and is estimated to decrease slightly to 1.4 percent in the first nine months of 2016.

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

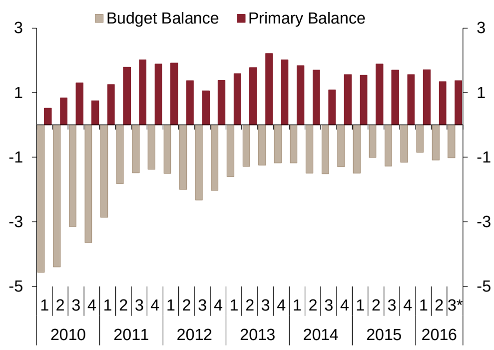
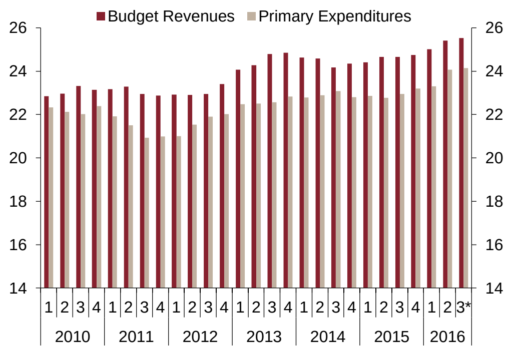


Chart 6.1.2.
Central Government Budget Revenues and Primary Expenditures
(Annualized, Percent of GDP)



* Forecast.
Source: Ministry of Finance.

Having followed a significant uptrend since 2012, the central government primary expenditures to the GDP ratio hit 23.2 percent in 2015. This ratio is expected to climb further to 24.2 percent in the first nine months of 2016, especially owing to sharp increases in personnel expenditures, capital transfers and consumption expenditures (Chart 6.1.2). On the other hand, upon the relatively robust economic activity as well as the tax adjustments in September 2012 and January 2013, the central government budget revenues to the GDP ratio climbed to 24.8 percent at end-2013. After dropping to 24.4 percent in 2014, mainly due to slowing tax revenues based on domestic demand, the ratio increased to 24.8 percent in 2015. Supported mainly by the hikes in non-tax revenues, the central government budget revenues to the GDP ratio is estimated to reach 25.5 percent in the nine months of 2016.

Having leaped since the second half of 2012, the central government primary budget expenditures remained on the rise in the first nine months of 2016. Accordingly, the central government primary budget expenditures posted a year-on-year increase of 16.1 percent in the January-September period of 2016 (Table 6.1.2).

Table 6.1.2.
Central Government Primary Expenditures
(Billion TL)

	2015 January-September	2016 January-September	Rate of Increase (Percent)	Actual/Target (Percent)
Primary Expenditures	**322.9**	**374.8**	**16.1**	**72.9**
1. Personnel Expenditures	95.0	113.6	19.6	76.9
2. Government Premiums to SSI	15.5	18.6	19.8	74.7
3. Purchases of Goods and Services	28.4	33.6	18.3	71.6
4. Current Transfers	138.8	167.5	20.7	76.9
a) Duty Losses	3.0	4.2	40.4	76.4
b) Health, Pension and Social Benefits	63.3	82.4	30.2	80.6
c) Agricultural Support	8.4	9.3	10.4	80.1
d) Reserved Share Revenues	41.6	46.1	10.8	73.2
e) Transfers to Households	6.6	7.4	11.7	72.2
5. Capital Expenditures	29.9	28.9	-3.5	55.8
6. Capital Transfers	5.6	4.2	-24.1	56.0
7. Lending	9.7	8.5	-12.3	65.6

Source: Ministry of Finance.

Across primary expenditures, current transfers, purchases of goods and services, and personnel expenditures surged by 20.7, 18.3 and 19.6 percent, respectively, in the first nine months of 2016. Health, pension and social benefit expenditures, a major component of current transfers, which also include social security deficit financing, soared by 30.2 percent in this period. Transfers for the financing of the social security deficit, which stood at 12.3 billion TL in the first nine months of 2015, amounted to 17.2 billion TL in the same period of 2016. Moreover, public expenditures were affected heavily by the 5-point reduction in employers' insurance premiums and posted a year-on-year surge by 65.7 percent in the first nine months of 2016, thus leading to a jump in health, pension and social benefit expenditures. As for public investment expenditures, capital expenditures remained limited while capital transfers posted a notable decline, which curbed the rise in primary budget expenditures.

In the first nine months of 2016, central government budget revenues displayed a year-on-year increase by 14.4 percent (Table 6.1.3). In the same period, tax revenues rose by 10.3 percent, while non-tax revenues exhibited an outstanding performance with an upsurge by 43.3 percent.

Across tax revenues, the collection of income tax, which makes up the largest share of direct taxes, recorded a year-on-year upsurge by 12.1 percent in the January-September period of 2016. Income tax collection is mostly composed of deductions from wages. In this regard, the large minimum wage hike in 2016 had a favorable impact on income tax revenues. Among consumption-based indirect taxes, the SCT and the domestic VAT rose by 10.7 and 11.9 percent, respectively. The details of SCT revenues show a jump of 18.6 and 6.7 percent, respectively, in tax revenues from tobacco products and motor vehicles, and an increase of 6.9 percent in petroleum and natural gas products, which account for a major share of total SCT revenues. The VAT on imports, on the other hand, remained unchanged in year-on-year terms. The sharp rise in non-tax revenues was largely caused by the inclusion of an additional 9.9 billion TL of privatization revenues into the budget in the first nine months of 2016 and the CBRT's profit transfer of 9.3 billion TL.

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

	2015 January-September	2016 January-September	Rate of Increase (Percent)	Actual/Target (Percent)
General Budget Revenues	**340.4**	**389.4**	**14.4**	**73.7**
I-Tax Revenues	**298.3**	**329.0**	**10.3**	**71.6**
Income Tax	61.9	69.4	12.1	70.2
Corporate Tax	24.5	31.0	26.6	84.2
Domestic VAT	34.5	38.6	11.9	75.3
SCT	77.4	85.7	10.7	73.7
VAT on Imports	53.4	53.5	0.1	61.5
II-Non-Tax Revenues	**42.2**	**60.4**	**43.3**	**87.3**
Enterprise and Property Revenues	13.2	19.4	47.5	102.6
Interests, Shares and Fines	19.7	26.2	32.8	77.2
Capital Revenues	7.2	12.1	67.9	99.0

Source: Ministry of Finance.

Having turned positive amid tax rate hikes in September 2012 as well as the base effect, the annual rate of increase in real tax revenues started to slacken in the third quarter of 2013. Real tax revenues remained unchanged on an annual basis in the last quarter of 2014, but increased by 7.7 percent in the last quarter of 2015. In the third quarter of 2016, however, real tax revenues rose merely by 0.4 percent year-on-year (Chart 6.1.3). The analysis of this increase by sub-items suggests that revenues from the VAT on imports and the domestic VAT, which are among consumption-based taxes, tumbled by 11.4 percent and surged by 9.1 percent in real terms, respectively, while the SCT collection edged down by 0.5 percent (Chart 6.1.4).

Chart 6.1.3.
Real Tax Revenues
(Annual Percent Change)

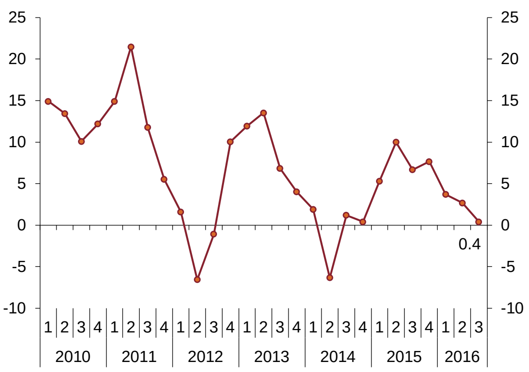
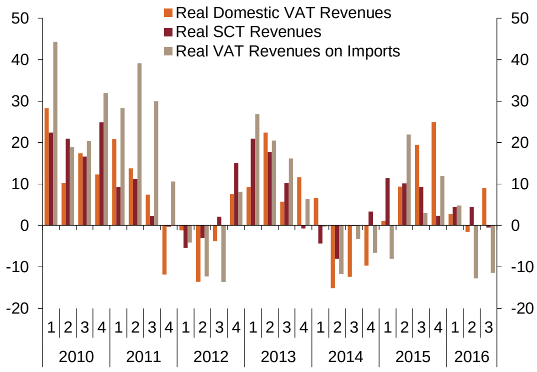


Chart 6.1.4.
Real VAT and SCT Revenues
(Annual Percent Change)



Source: Ministry of Finance.

6.2. Developments in the Public Debt Stock

The central government debt stock reached 712.9 billion TL in the first nine months of 2016 (Chart 6.2.1). Total public net debt stock to the GDP and the EU-defined general government nominal debt stock to the GDP posted a year-on-year drop of 1 and 0.5 points, respectively, in the first half of 2016 (Chart 6.2.1).

Chart 6.2.1.
Public Debt Stock Indicators

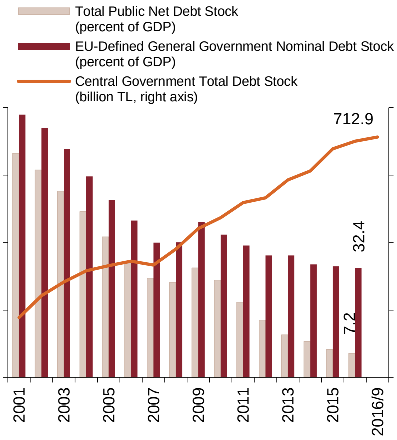
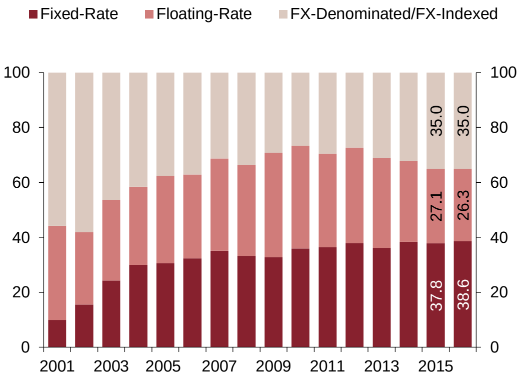


Chart 6.2.2.
Composition of the Central Government Debt Stock
(Percent)



Source: Treasury.

The share of fixed-rate securities in the total debt stock increased slightly from 2015 to September 2016 (Chart 6.2.2). As for the interest rate structure of domestic borrowing, the share of fixed-rate borrowing registered a year-on-year increase in the January-September period of 2016. Meanwhile, the ratio of public deposits to the average monthly debt service stood at 450.2 percent. The average term-to-maturity of the domestic debt stock reached 53.5 months (Chart 6.2.3). External borrowing by bond issues amounted to 3 billion USD in the first nine months of the year, with an average maturity of 19.7 years (Chart 6.2.4).

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

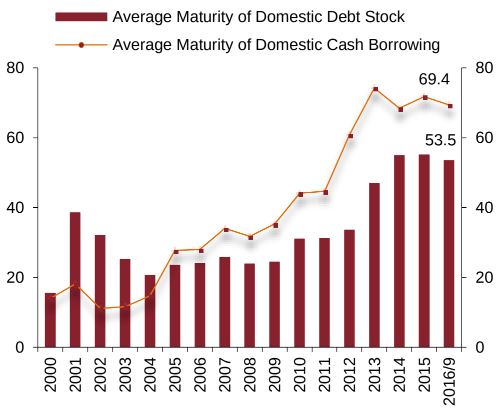
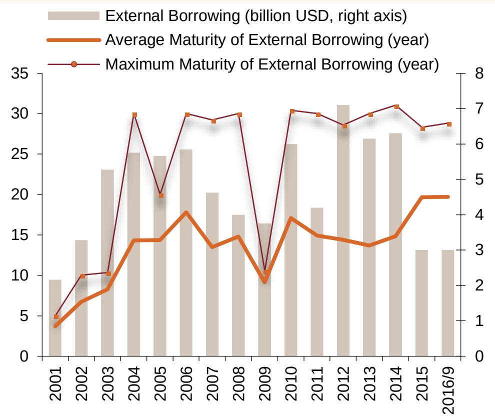


Chart 6.2.4.
Borrowing By Bond Issue



Source: Treasury.

The domestic debt rollover ratio stood at 86.7 percent by the end of August 2016 (Chart 6.2.5). The average real interest rate[1] has recently been on the decline(Chart 6.2.6).

Chart 6.2.5.
Total Domestic Debt Rollover Ratio
(Percent)

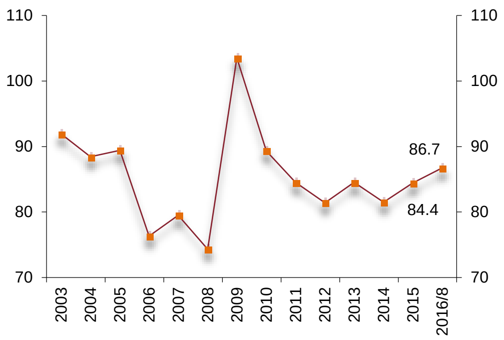
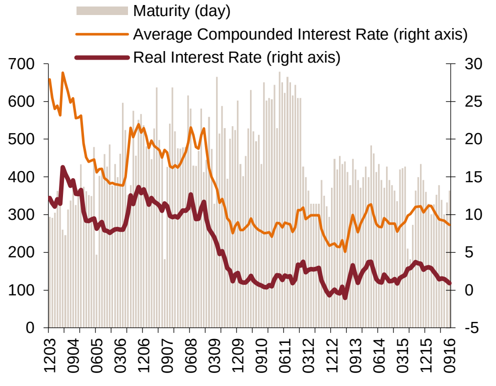


Chart 6.2.6.
Average Maturity and Interest Rates of Borrowing at Discount Auctions



Source: Treasury, CBRT.

[1] Real interest rates are calculated by subtracting the 12-month-ahead inflation expectations of the CBRT Survey of Expectations from nominal interest rates (average annual compounded interest rate at the Treasury's TL-denominated zero-coupon securities auction).

Box 6.1 Main Features of the Recent Incentive Schemes in Turkey

Fiscal policy can affect economic activity both from the demand and the supply side. Fiscal policy may stimulate economic activity from the demand side through tax and spending policies in the short run, while in the long run, it can affect the economy from the supply side by improving investment conditions and enhancing the potential output. In particular, a reduction in indirect taxes such as income tax or corporate tax or tax rates imposed on labor can stimulate economic growth and increase employment by influencing the supply of factors of production like labor and capital, without causing any inflationary pressures in the long run. Against this background, this box provides a summary of the general framework and the main features of the recent incentive schemes launched in Turkey.

The term incentive can be defined as material and non-material support, assistance and encouragements provided by the public sector through various methods to stimulate development of a certain economic activity. According to types of incentives, general incentives to induce development, enhance technological infrastructure and reduce labor costs are preferred in prioritized sectors. Incentive schemes may be in the form of financial incentives (tax reduction, tax exemption and investment deduction); special investment incentives for under-developed regions; financial incentives to provide credit access; and initiating incentives to facilitate both infrastructure and technical structure as well as to support business operations.

Amongst the objectives of investment incentives in Turkey are boosting investments, increasing employment by creating new business areas and alleviating interregional discrepancies in terms of development. The coverage of public subsidies granted to investments was changed and improved four times in a period of 12 years, the first one being in 2004, and the others in 2006, 2009 and 2012, respectively. Without prejudice to the main set up and the framework of the incentive scheme launched in 2012, energy and wage subsidies were added to incentive tools by the law called "Project-Based Support for Investments" that took effect on August 20, 2016.

The incentive scheme in 2009, which was newly designed with a broader coverage, expanded the range of investment fields subject to incentives by dividing the country into four regions for investment, and prioritized improvement of related macroeconomic indicators such as exports, imports, competitiveness and employment. As the effectiveness of the incentive scheme introduced in 2009 diminished over time and regional discrepancies also changed, a new incentive scheme was designed and put into effect in 2012.

The new incentive system launched in 2012 is the most comprehensive incentive scheme with the broadest coverage introduced so far. Under this incentive scheme, considering the needs and demands of investors, four main investment incentive items were identified as general incentives, regional incentives, incentives to large-scale investments and incentives to strategic investments. Similar to the former scheme, the new incentive scheme, which prioritizes some practices to solve current economic problems, offers incentives in eight cost factors to investors as VAT exemption, customs duty exemption, tax reduction, support for employer and employee insurance premium calculated over the minimum wage, land allocation for investment purposes, income tax withholding allowance, interest support and VAT refund (Table 1).

Table 1. Comparison of the Recent Incentive Programs in Turkey

Incentive Coverage		
2009	**2012**	**2016**
Turkey Overall (26 NUTS-2 Region divided into 4 sub-regions according to the level of socioeconomic development).	Turkey Overall (Turkey divided into 6 regions using a socioeconomic development index announced by the Ministry of Economy).	Investments are supported on a project basis.
Incentive Tools		
2009	**2012**	**2016**
1. Tax Reduction	1. Tax Reduction	1. Tax Reduction
2. Land Allocation for Investment	2. Land Allocation for Investment	2. Land Allocation for Investment
3. Customs Duty Exemption	3. Customs Duty Exemption	3. Customs Duty Exemption
4. VAT Exemption	4. VAT Exemption	4. VAT Exemption
5. Interest Support	5. Interest Support	5. Interest Support
6. Social Security Premium Support	6. Social Security Premium Support	6. Social Security Premium Support
	7. Income Tax Withholding Allowance	7. Income Tax Withholding Allowance
		8. Energy Support
		9. Wage Support

Source: Acar and Çağlar (2012), CBRT.

The incentive scheme launched in 2012 encourages investments that will enable strategic and technological transformation, contribute to the development of the least favored regions, enhance the effectiveness of support instruments and remove regional discrepancies. Similar to the former scheme, the incentives to be granted in the new incentive scheme also vary depending on the investment region and the scale of investment. However, the new incentive scheme is much more comprehensive than the previous one with regard to the field of practice and targeted sectors. Unlike past schemes, the new incentive scheme introduces privileges to investments to be made in organized industrial zones. The new scheme offers higher shares in tax reductions in investment periods for lesser developed regions, which provides considerable financing support to investor companies. In addition, interest support is also included in the new incentive scheme as another factor of incentive to spur financing opportunities.

Another notable feature of the new incentive scheme is the special attention given to strategic investments, i.e., the investments to produce intermediate goods or products, 50 percent of which is met by imports. Additionally, the new incentive scheme aims at reducing the structural current account deficit and boosting the international competitiveness by encouraging high-tech investments with considerable value added.

The new incentive scheme can be distinguished from previous schemes by its project-based nature. Another striking novelty in the new scheme is the introduction of energy and wage support besides existing tools from the previous schemes (Table 1).

It is noteworthy that both the wider variety of incentive tools and the greater regional coverage introduced in the 2009 and 2012 incentive systems led to increases in the amount of incentive-backed investments (Chart 1) and the number of jobs pledged to be created with incentives (Chart 2).

Chart 1. Incentive-Backed Investments
(Million TL)

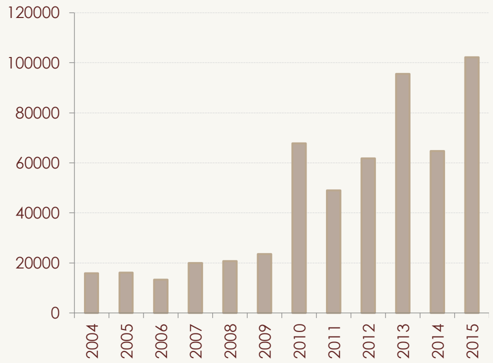
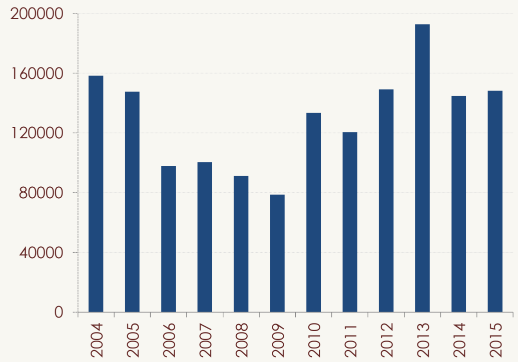


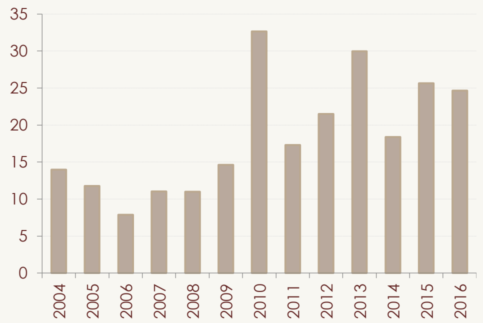
Chart 2. Incentive-Backed Employment
(Number of People)



Source: Ministry of Economy.

For a better understanding of the significance of incentive-backed investments in terms of the real economy, the share of investments that benefited from incentives within total investments is depicted in Chart 3. The ratio of incentive-backed investments to total investments increased during the years following the implementation of incentive schemes. As illustrated in these charts, a wider variety of tools and greater coverage of regions lead to enhanced effectiveness of the investment schemes on investment, growth and employment.

Chart 3. Ratio of Incentive-Backed Investments to Total Investments*
(Percent)



* As of July 2016.
Source: Ministry of Economy, Authors' calculations.

In sum, the incentive schemes implemented in Turkey spur economic growth mainly through tax reductions and other government subsidies, and contribute positively to the increase of investment and employment, thereby diminishing socioeconomic discrepancies among regions. The tools utilized in the implementation of incentive schemes have an expansionary effect on the fiscal policy and lead to a decline in public savings in the short run. However, public revenues improve in the medium and long terms due to the resulting increases in investment, employment and production.

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