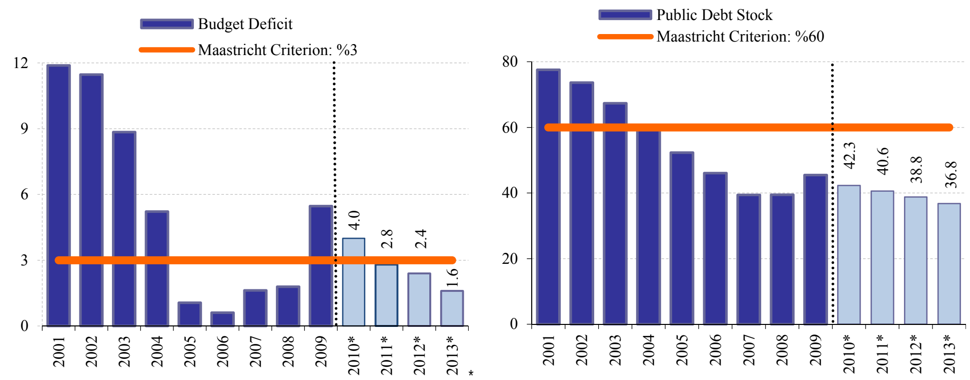
6. Public Finance

The economic contraction triggered by the global economic crisis has led to large fiscal deficits and high debt across the globe, especially in advanced economies. Many emerging economies, including Turkey, are on a more stable fiscal footing, as they recovered more swiftly and adopted relatively less comprehensive fiscal stimulus measures. Hence, the faster-than-expected economic recovery and falling interest expenditures help to improve Turkey's fiscal outlook (Graph 6.1).

The increase in tax revenues amid rapid economic growth was the major driver of the improved budget balances in 2010. In addition, the relative slowdown in the growth of non-interest expenditures as well as the decline in interest expenditures driven by falling domestic borrowing rates contributed to the improvement in budget balance.

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



Estimate.
** MTP(2011-2013) Targets.
Source: Ministry of Finance, MTP (2011-2013).

* Estimate.
** MTP (2011-2013) Targets.
Source: Treasury, MTP (2011-2013).

Fiscal targets available in the October 2010 MTP for the years 2011-2013 hint at a slight fiscal tightening for coming months. Therefore, the medium-term forecasts in the last chapter of this Report are based on an outlook where fiscal policy would be gradually tightened, and public expenditures would make an increasingly smaller contribution to domestic demand. In order to maintain fiscal discipline and ensure that Turkey continues to have more positive readings than other emerging economies, implementing the institutional and structural reforms set out in the MTP remains critical.

6.1. Budget Developments

The central government budget produced a deficit of 39.6 billion TL in 2010, while the primary balance delivered a surplus of 8.7 billion TL (Table 6.1.1). Higher tax revenues fueled by economic recovery and tax adjustments, and falling interest expenditures were the main drivers of the narrowing budget deficit. In addition, the relative slowdown in the growth of non-interest expenditures helped to bring the budget deficit down.

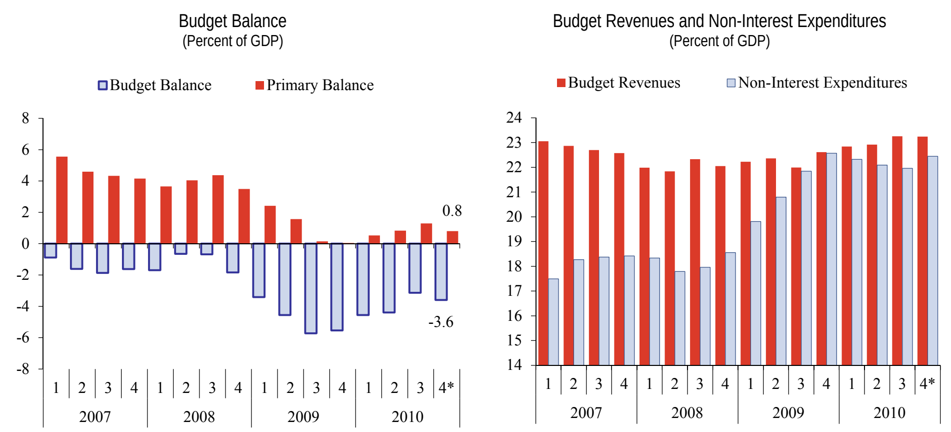
Table 6.1.1. Central Government Budget Aggregates
(Billion TL)

	2009	2010	Rate of Increase (Percent)	Actual/Target (Percent)
Central Government Expenditures	268.2	293.6	9.5	102.3
Interest Expenditures	53.2	48.3	-9.2	85.1
Non-Interest Expenditures	215.0	245.3	14.1	106.6
Central Government Revenues	215.5	254.0	17.9	107.3
I. Tax Revenues	172.4	210.5	22.1	108.9
II. Non-Tax Revenues	36.2	35.6	-1.5	97.2
Budget Balance	**-52.8**	**-39.6**	-	**78.9**
Primary Balance	**0.4**	**8.7**	-	**132.5**

Source: Ministry of Finance.

Having improved over the first three quarters of 2010, central government budget balance and primary budget balance to GDP ratios deteriorated slightly amid rising non-interest expenditures during the fourth quarter (Graph 6.1.1). The steady upward trend in the budget revenues to GDP ratio since the fourth quarter of 2009, driven by higher tax revenues, paused in the fourth quarter. Meanwhile, after having slowed slightly during the first three quarters of 2010, the non-interest expenditures to GDP ratio increased significantly in the last quarter (Graph 6.1.1).

Graph 6.1.1. Central Government Budget



* Estimate.
Source: Ministry of Finance.

Central government primary budget expenditures increased by 14.1 percent year-on-year in 2010. Among non-interest expenditures, current transfers and personnel expenditures were up by 10.8 and 11.4 percent, respectively, while purchase of goods and services decreased by 3.3 percent. This decline was mainly due to the fall in health expenditures of both public employees and green card holders, as these expenditures are now covered by the government's health insurance plan. Furthermore, government premiums to the SSA increased by a striking 53.4 percent, owing to the launch of premium payments for public employees covered by government's health insurance plan since January of 2010. Meanwhile, capital expenditures increased by about 29.1 percent, indicating that public investments made a positive contribution to GDP growth in 2010 (Table 6.1.2).

Table 6.1.2. Central Government Non-Interest Expenditures
(Billion TL)

	2009	2010	Rate of Increase (Percent)	Actual/Target (Percent)
Non-Interest Expenditures	**215.0**	**245.3**	**14.1**	**106.6**
1. Personnel Expenditures	55.9	62.3	11.4	103.2
2. Government Premiums to SSA	7.2	11.1	53.4	99.5
3. Purchase of Goods and Services	29.8	28.8	-3.3	114.4
a) Defense and Security	9.7	9.4	-2.3	103.5
b) Health Expenditures	8.8	5.8	-34.6	119.8
4. Current Transfers	92.0	101.9	10.8	99.7
a) Duty Losses	4.1	3.3	-20.3	76.5
b) Health, Pension and Social Benefits	52.7	55.0	4.5	95.4
c) Agricultural Support	4.5	5.8	29.4	103.8
d) Shares Reserved from Revenues	21.5	26.4	22.6	110.2
5. Capital Expenditures	20.1	25.9	29.1	136.9
6. Capital Transfers	4.3	6.7	56.0	196.4

Source: Ministry of Finance.

General budget revenues increased by 18 percent year-on-year in 2010. Tax revenues were up 22.1 percent, whereas non-tax revenues were down 1.5 percent due to falling enterprise and property revenues, interests, shares and fines (Table 6.1.3). In particular, the substantial increase in consumption-related tax revenues indicates that consumption demand remains strong.

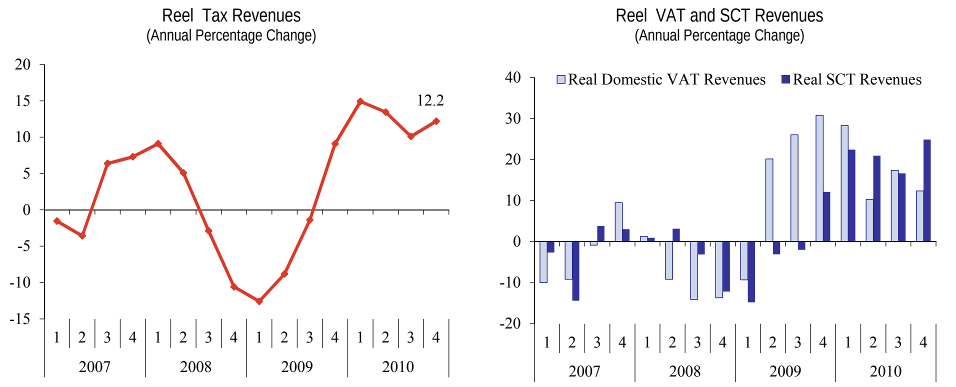
Table 6.1.3. Central Government General Budget Revenues
(Billion TL)

	2009	2010	Rate of Increase (Percent)	Actual/Target (Percent)
General Budget Revenues	**208.6**	**246.1**	**18.0**	**107.0**
I-Tax Revenues	**172.4**	**210.5**	**22.1**	**108.9**
Income Tax	38.4	40.4	5.1	97.3
Corporate Tax	18.0	20.9	16.1	116.5
Domestic VAT	20.9	26.3	26.2	116.3
SCT	43.6	57.3	31.3	104.9
VAT on Imports	26.1	36.2	38.5	120.3
II-Non-Tax Revenues	**36.2**	**35.6**	**-1.5**	**97.2**
Enterprise and Property Revenues	9.9	9.8	-1.6	144.9
Interests, Shares and Fines	23.1	21.0	-8.9	117.9
Capital Revenues	2.0	3.4	65.1	31.7

Source: Ministry of Finance.

The contraction in real tax revenues that started in the third quarter of 2008 has been replaced by a rapid growth as of the fourth quarter of 2009 with the rebound in private consumption demand. After a robust first quarter, the pace of annual growth in real tax revenues eased in the remaining quarters of 2010 on waning base effects (Graph 6.1.2). Real tax revenues were also boosted by the lump-sum tax hike on fuel and tobacco in early 2010. Accordingly, SCT revenues and domestic VAT revenues increased by 24.9 and 12.3 percent year-on-year, respectively, in real terms during the fourth quarter of 2010 (Graph 6.1.2).

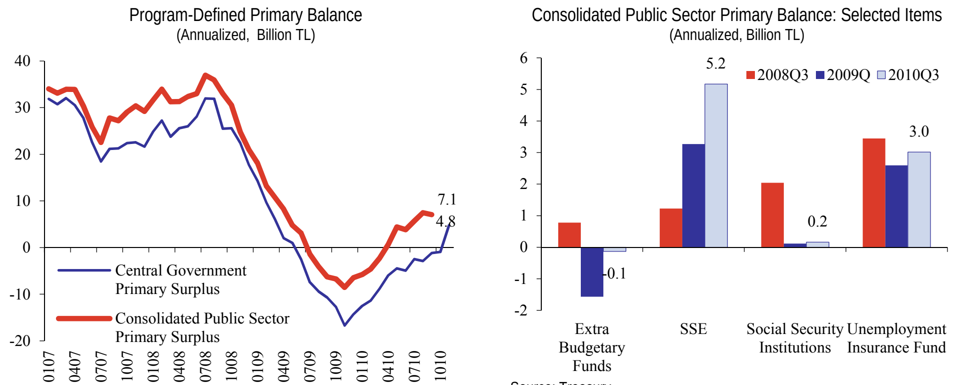
Graph 6.1.2. Real Tax Revenues



Source: Ministry of Finance.

The improvement in the program-defined consolidated public sector and central government primary balance that started in the last quarter of 2009 continued into the first three quarters of 2010 (Graph 6.1.3). Moreover, the primary balance of extrabudgetary funds, SEE, social security institutions and the Unemployment Insurance Fund improved year-on-year during the third quarter of 2010 (Graph 6.1.3).

Graph 6.1.3. Primary Balance



Source: Treasury.

Source: Treasury.

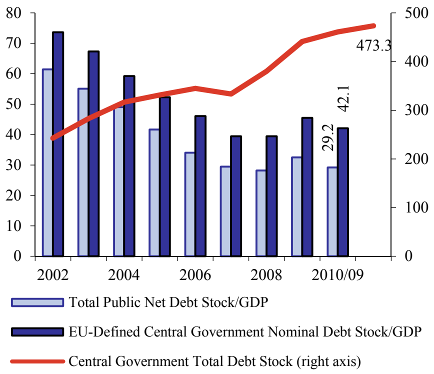
6.2. Developments in Debt Stock

The fiscal and debt management policies compliant with the prudent monetary policy stance in 2010 as well as the faster-than-expected economic recovery since the last quarter of 2009 helped improve fiscal balances, leading to a significant decline in the public sector borrowing requirement amid falling real interest rates, and thus, to a marked improvement in public debt indicators. Moreover, both the improvement of the legal and administrative framework for public debt management, and setting borrowing strategies with a long-term perspective provided a significant enhancement of the debt stock structure, insulating public debt considerably against macroeconomic shocks. Thus, 2010 was marked by an improvement in public debt ratios, a significant fall in the real cost of borrowing, an extended average maturity of debt and an increased share of TL-denominated debt in overall debt.

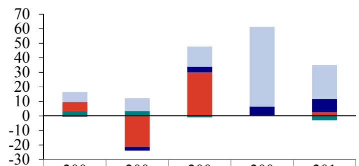
The central government debt stock increased by 7.2 percent from end-2009 to 473.3 billion TL at end-2010. Changes in net domestic debt and net external debt accounted for 23.3 billion and 9 billion TL, respectively, of the increase in central government debt. Meanwhile, with the appreciation of the USD against the euro in 2010, parity changes brought central government debt down by 3.1 billion TL (Graph 6.2.1). Therefore, debt ratios continued to decline in the third quarter of 2010. Total net public debt stock-to-GDP ratio and the EU-defined general government nominal debt stock-to-GDP ratio fell 3.3 and 3.4 percentage points from end-2009 to 29.2 and 42.1 percent, respectively (Graph 6.2.1).

Graph 6.2.1. Public Debt Stock Indicators

Public Debt Stock Indicators



Analysis of the Changes in Central Government Debt Stock

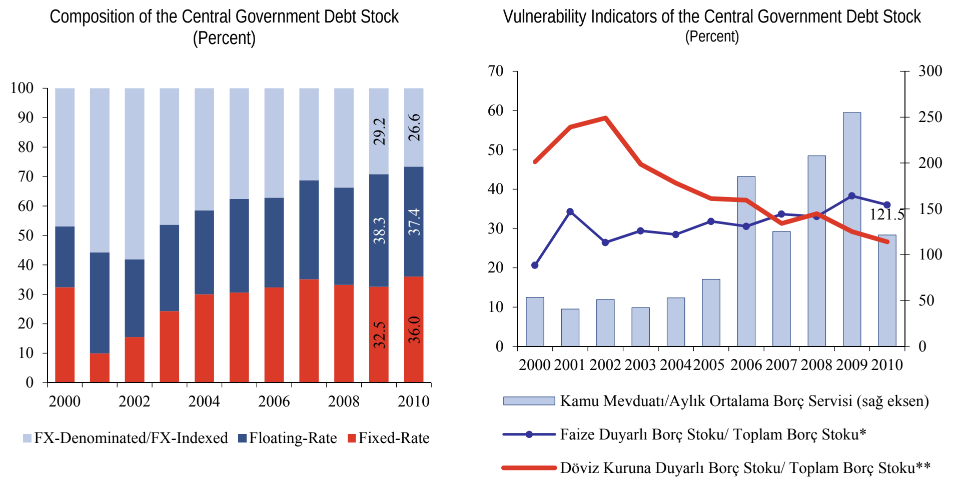


	2006	2007	2008	2009	2010*
Net Domestic Borrowing	6.7	8.9	13.9	54.8	23.3
Net External Borrowing**	-0.5	-2.6	4.0	5.9	9.0
Exchange Rate Effect***	6.4	-21.2	29.9	-0.1	2.6
Parity Effect****	3.2	3.4	-1.0	0.6	-3.1

* Changes compared to end-2009.
** Changes in net debt denote changes adjusted for exchange rate and parity effect.
*** Changes from fluctuations in TL/USD.
**** Changes from fluctuations in USD/EUR and USD/SDR.
Source: Treasury, CBRT.

Depending on market conditions, the Treasury's financing program for 2010 envisages to limit FX-denominated domestic borrowing to a maximum of 50 percent of FX-denominated domestic debt redemptions and to provide TL-denominated borrowing with fixed-rate instruments. In this regard, as of end-2010, the share of exchange rate-sensitive (FX-denominated and FX-indexed) instruments in central government debt has been lower compared to end-2009, while the share of fixed-rate instruments has increased (Graph 6.2.2).

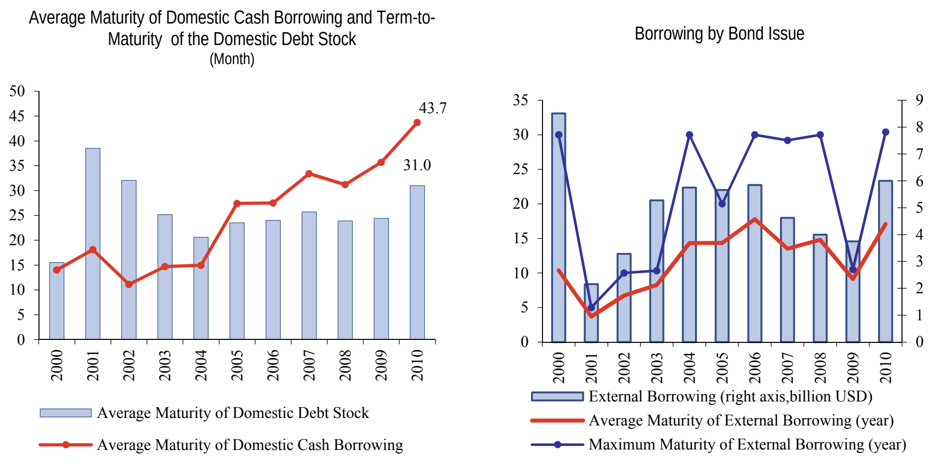
Graph 6.2.2. Structure of the Central Government Debt Stock



* Debt stock sensitive to interest rate includes discounted securities with a maturity less than 1-year and government securities with floating rates.
** Debt stock sensitive to exchange rate includes external debt stock, FX-denominated and FX-indexed domestic debt stock.
Source: Treasury, CBRT.

Following the financing strategy intended to reduce the liquidity risk, the ratio of public deposits to average monthly debt service ended 2010 at 121.5 percent (Graph 6.2.2). Amid the longer average maturity of domestic cash borrowing, term-to-maturity of total domestic debt stock has extended to 31 months at end-2010 (Graph 6.2.3). Moreover, bond issues yielded a 6 billion USD worth of long-term external debt in 2010 with an average maturity of 17.1 years, 8 years up from 2009 (Graph 6.2.3).

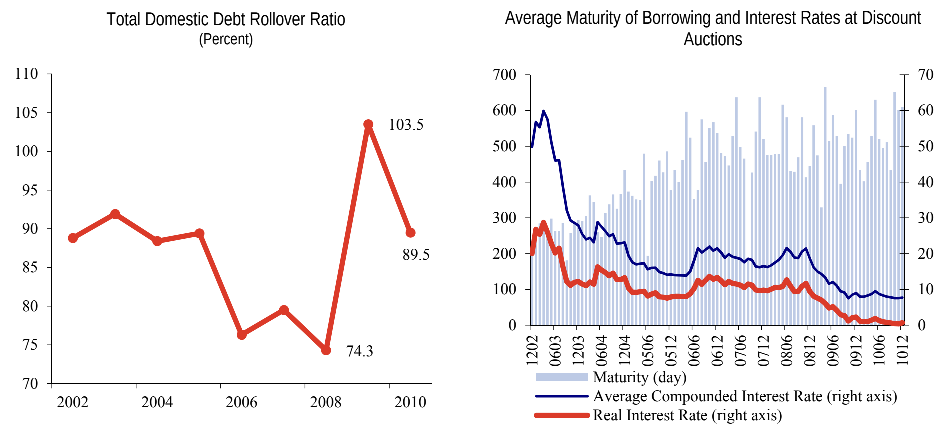
Graph 6.2.3. Maturity of Borrowing from Domestic and External Markets



Source: Treasury, CBRT.

Having fallen rapidly since early 2009, the monthly average real interest rates at discount Treasury bill auctions declined to 0.7 percent in December 2010 (Graph 6.2.4). Concerns about public debt sustainability have eased substantially due to the extended average maturity of domestic borrowing with costs at historic lows.

Graph 6.2.4. Domestic Borrowing



Source: Treasury, CBRT.

Total domestic debt rollover ratio declined to 89.5 percent in 2010, after rising above 100 percent amid financing of the large 2009 budget deficit mostly by domestic borrowing (Graph 6.2.4). Readings on domestic borrowing and domestic debt service show that the domestic debt rollover ratio was above 100 percent in December, and it is expected to fall again in the first quarter of 2011.

According to the Treasury's domestic borrowing strategy for January-March 2011, the domestic debt rollover ratio will decline to 88.2 percent in the first quarter of the year.