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Highlights in this issue:

- **In spite of its young population, Turkey's cumulative social security deficit amounted to 110% of GDP.**
- **Planned reform significantly improves long-term sustainability.**
- **Further pension reform is necessary, including for addressing Turkey's large scale informality.**

The pension reform challenge in Turkey

*By Dirk Verbeken**

Summary

Turkey is currently introducing a comprehensive pension reform, which aims at unifying the currently disperse system and reducing the significant - and rapidly growing – social security deficit from 4.8% of GDP in 2005 to less than 1% of GDP by 2035. The cumulative value of the deficits over the last ten years, plus their debt servicing cost, amounted to roughly 110% of GDP or 1.5 times total public debt. The age dependency ratio is just 9 while the average age of the Turkish population is currently 27 years. With an annual growth of about 1¼% in the working-age population, Turkey should not have had a pension deficit. Furthermore, today's demographic advantages are expected to disappear within the next thirty years. The ageing of population will lead to a ballooning deficit - to over 6.5% of GDP by 2050 - unless the authorities readjust benefits and/or contributions. Hence, fiscal space could be gradually created for more productive expenditures, which may lead to a faster convergence towards EU-income levels. Besides, in a country where the tax wedge is already much higher than in most EU Member States, any tax hike would risk further increasing informal employment without generating substantial revenue growth. This country focus concludes that the prepared reforms are steps in the right direction, even though not enough to build a sustainable, adequate system in this young and already highly indebted EU-candidate country.

Sustainability of public finances

Very strong fiscal consolidation following a decade of boom-bust cycles

Turkey has experienced high economic volatility in the previous decades, which resulted in a dramatic worsening of public finances. However, since the 2001 financial crisis, general government gross debt has fallen substantially, from over 100% of GDP to 65% of GDP in 2006 due to various factors, including high growth, tight fiscal policy and falling interest rates. At the same time, the Turkish authorities achieved primary surpluses of over 6% of GDP. Those surpluses not only reduced

Table 1: Main economic trends

		1990-1995	1996-2001	2002-2004	2005	2006
Real GDP growth	annual % change	4.6	2.0	4.2	7.4	6.0
Inflation	CPI, change in %	76.1	85.0	15.8	8.2	9.6
Unemployment	LFS, % of labour force	7.8	7.0	10.4	10.2	9.8
Current account	% of GDP	-0.9	-0.8	-2.3	-6.4	-8.5
Government debt*	% of GDP	44.9	54.8	85.0	69.6	65.5
Government balance*	% of GDP	-4.6	-11.6	-9.9	-1.2	-1.2

*: General government, ESA 95 when available
Source: Commission Services, Ecowin

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the debt ratio, but also helped to bring down interest rates by strengthening market confidence. An in-depth assessment of Turkey's debt dynamics[1] demonstrates a growing importance of the adherence to significant primary surpluses and of a further reduction of financing costs, in particular in the context of future ageing. Indeed, a large part of the accumulated debt is stemming from large and growing deficits in the social security system (see below).

Informality and the tax wedge

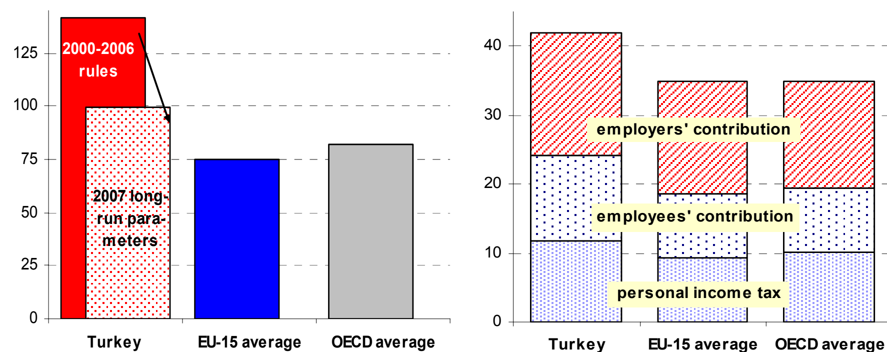
Generous and unsustainable pension system …

At first glance, Turkish pensions do seem particularly generous and distorting: replacement rates under the current PAYG scheme are high by EU standards, and the effective – and minimum – retirement age is only 44 for women and 47 for men. Moreover, parametric reforms introduced in 1999 have failed. No inverse life expectancy adjustment factor to benefits was considered. As long as the participation rate is so low (less than 50%, and only 23% for females) in Turkey, pension spending as a ratio to GDP must remain high at full system maturity. Foundations have been laid to develop second and third pillars, but – in part due to past economic volatility and crises – systems are undercapitalized. A key problem lies in the large informal sector, in combination with relatively easy access and generous pension benefits.

The high cost of employing someone formally is an important part of the explanation for Turkey's very large informal sector. Of that cost, social security contributions make up the bulk of the tax wedge on labour in Turkey suggesting that further pension reform must be an important part of the formalisation agenda.

Chart 1: Net replacement rates (% of avg. prod. wages)

Chart 2: Average tax wedges on labour



Source, Commission Services, OECD (2006c)

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Compared with other EU Member States, the very low rate of social security compliance, the sheer scale of the informal sector, and low levels of human capital and productivity, suggest that high contribution rates are more harmful in Turkey than in wealthier countries with high tax wedges. By pushing the cost of low-skilled labour above its marginal productivity, firms are de facto encouraged to hire such workers informally, thus feeding the economic duality that characterises almost all aspects of the Turkish economy. Indeed, it is difficult to imagine any significant contraction in the size of the informal sector as long as the cost of labour in the formal sector remains so high.

High tax wedge contributes to informality

Labour Force Surveys indicate that one third of private sector employees, along with half of the self-employed and almost 90% of the agricultural population are employed in the informal sector and therefore deprived of any chance of ever qualifying for a pension, and sometimes also of health insurance. Social security contributions are collected for only 50% of Turkey's 22 million working people. Employers, on the other hand, argue that while the reform ensures universal healthcare, it does nothing to encourage formal employment, since employers' and employees' pension and health contributions will still total about one third of gross salaries.

Obligatory, state-run schemes remain the norm. Private pension schemes and private health insurance are offered to the Turkish public and enjoy some tax benefits, but they remain optional extras.

Plans to introduce modern social assistance policies to tackle poverty on a more rational basis face the challenge of achieving their goals without excessively increasing expenditure.

The Turkish demographic challenge

Demographic structures provide Turkey with window of opportunity for social security reforms

With a population of 72 million, Turkey currently accounts for 15% of the EU-27 population. The demographic dynamic is significantly higher than in the Member States, with an annual average population growth of 1.3%, compared to 0.3% for the EU-15 and 0.2% of the EU-27. As a result, Turkey's population is expected to outnumber the population-wise largest Member State, Germany, in the middle of the next decade, at a level of about 82 million persons (UN, 2005). Due to a declining population growth rate, long-term projections expect Turkey to reach its maximum population with about 100 million citizens by around 2050. Afterwards, the population is set to decline. The EU-27 will reach its maximum population of about 487 million in the second decade of this century. Turkey's average age of population amounts to just 27. In the medium-term, he declining trend in birth rates will turn the currently favourable demographic structure into a situation of an aging society similar to what most EU Member States currently face.

Table 2: Age dependency ratio [1)]

	2000	2050
EU15	24	52
EU10	19	50
Turkey	9	28

[1)] Population aged 65 and over as % of population aged 15-64

Source: Commission Services

Table 3: Social spending (in % of GDP)

		Turkey	**OECD average***
Total age-related spending	Level 2000	**4.5**	21.2
	Change 2000-50	**17**	5.8
Old-age pensions	Level 2000	**3**	7.4
	Change 2000-50	**7**	3.4
"Early retirement" programmes	Level 2000	**..**	1.6
	Change 2000-50	**..**	0.2
Health care and long-term care	Level 2000	**2**	5.9
	Change 2000-50	**10**	3.1
Child/family bene-fits and education	Level 2000	**..**	6.2
	Change 2000-50	**..**	-0.9

* without Iceland, Luxembourg, Mexico and Portugal

Source: Commission Services, OECD (2006)

Current situation leaves no room for complacency

The proportion of those 65 or older as a percentage of the active population (aged 15-64) will increase from around 9% of the population today to 28% by 2050. On the basis of current rates of labour force participation, the ratio of non-workers to workers is projected to decline from almost factor 2 to in 2000 to factor 1.75 in 2050. However, even with this 1.75 ratio Turkey will remain above the EU average of roughly 1.6. The growth of the working age population in Turkey will slow from currently almost 1.5% per year to close to zero by 2050. Turkey therefore faces a risk over the next few decades of slowing economic growth, and rising tax rates to finance a greater volume of services for, and transfers to, the older generation. Because of these demographic factors, social spending is expected to grow from 4.8% of GDP in 2005 to 16.8% by 2050 (OECD, 2006a).

At the same time, few jobs have been created in so far that the inactive population is currently roughly two times as large as the employed. Therefore, reforms became both necessary and urgent. They must aim at reducing the future budgetary costs of ageing while also boosting the potential growth rate of the economy, notably by encouraging working more and longer. In particular female employment rates are very low and need to increase. Improving education and correcting the current mismatch between demand and supply of labour is of paramount importance to make Turkey's transformation from a largely agricultural low medium income economy into an EU type of high income economy with a strong and successful services sector.

The 2007 pension reform package

Fiscal targets are of prime concern .

Pension reforms can be a very powerful method of adjustment, because they not only reduce spending directly, but can also be designed to extend the age of retirement and boost labour supply, hence contributing to raise growth and fiscal revenues. Measures that reduce the "generosity" of pensions also create incentives to work longer, or more continuously before retirement, in order to earn an adequate pension income. Some studies[2] show that working longer is associated with better health due to continuing social interactions and a less rapid deterioration of mental capacity. In any event, despite rising productivity, retiring earlier while living longer is not acceptable from society's point of view, as it puts a large and growing burden on the economically active. At the same time, people who have already worked many years in possibly arduous jobs and can expect lower life expectancy can be given consideration by tying pension benefits more closely to contribution years than to age per se.

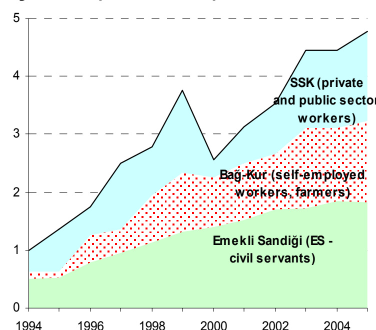
Turkey is in the process of designing a comprehensive reform of its social security system. The proposed reform has four basic components: (i) a pension reform aimed at unifying the currently disperse system and to increase the pension age to reduce the deficit of pension payments to revenues; (ii) the introduction of Universal Health Insurance complemented with health sector reform; (iii) a social assistance reform; and (iv) institutional reform with the establishment of a unified social security institution. Labour market reform may possibly follow as the authorities have indicated their interest in pursuing structural reforms aimed at making this market more flexible and efficient with respect to its current performance. This country focus mainly - albeit not exclusively – deals with pension reforms because about two thirds the accumulated deficits originated from financing gaps in the pension systems.

Comprehensive reform package under preparation

The public pension in Turkey is a pay-as-you-go (PAYG) defined benefit scheme which consists of (i*)* a minimum pension (a flat-rate basic pension plus a means tested special supplement) and (ii*)* a non-actuarial earnings-based supplementary pension, all integrated in the state budget. The old-age pension scheme has its historical roots in the tradition for redistributive minimum protection in old-age.

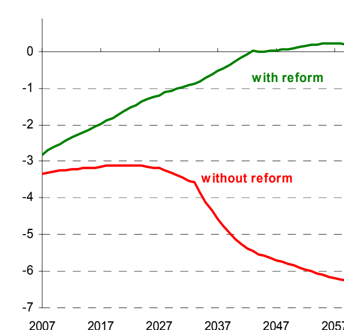
Until May 2006, Turkey's social security system comprised three separate institutions: Bağ-Kur, for self-employed workers and farmers, SSK, for private and public sector workers and Emekli Sandiği (ES) for the civil servants. For more than ten years, the system has been running deficits in spite of the very favourable demographics. These deficits have required increasingly large transfers from the general government budget, prompting several reform attempts. A first reform in 1999 led to a temporary fall in the size of the deficits in the SSK and, even though to a lesser extent, in the Bağ-Kur system, although they subsequently started to rise again due to a combination of discretionary increases in the pension level and fall in the premium base. In the Emekli Sandiği (ES) system, only one of the main parameters was changed and deficits have risen continuously.

Chart 3: Deficit of the pension system (% of GDP)



Source: Commission Services, OECD (2006c)

Chart 4: Projected social security deficits (%of GDP, 2002 base)



Source: Commission Services, OECD (2006c)

The cumulative value of these deficits between 1994 and 2004, plus their debt servicing cost (based on the Treasury bill rate), was 475 billion YTL (about €200

billion) in 2004 prices, or approximately 110% of the 2004 GDP and 1.5 times the total consolidated debt stock as at the end of 2004.[3] Indeed, the unsustainable social security system deserves a large part of the blame for Turkey's fiscal imbalances over the past decade. In this context, the 2006 social security reform was crucially important. Rather than continuing to increase, actuarial scenarios for these deficits now show them gradually declining over the next four decades and reaching balance by around 2050 (see graph 4).

In order to establish a more sustainable system, fiscal targets have been set, in line with IMF recommendations. These targets are (i) a combined deficit (fiscal transfers) of the pension and public health systems of below 4.5% of GDP over the period 2005-2007, (ii) a fiscal deficit by the pension system in the year 2015 under the reform case to be 1% of GDP lower than the deficit for the same year under the base case[4], and (iii) a total deficit of the pension system of less than 1% of GDP in the long run. It is thereby important that the budget constraint avoids relaxing efficiency in the public sector. Informality should not be encouraged via unreformed transfer schemes. This would amount to an erosion of forward looking policies, even if the fiscal rule is adhered to.

The reform provides in particular that (i) the minimum retirement age would gradually increase to 65 for both men and women by the year 2048 (the previous minimum limit was 44 for women and 47 for men); (ii) the minimum total period for which contributions must have been paid in order to qualify for a pension is increasing from approximately 19.5 years to 25 years; and (iii) the amounts of pensions relative to premiums paid are to be reduced in two phases. Eventually, pensions for those retiring after 25 years will come down to 50% of their average earnings over the 25-year period (adjusted for inflation). Those retiring after a career of 45 years or more will get pensions worth 90% of their average earnings.

However, implementation is delayed and uncertainty increases.

In late 2006, the Turkish constitutional court blocked some articles, in particular concerning the age of retirement. Therefore, the implementation date has been postponed and the format may change. Besides, it is difficult to foresee how the new health insurance scheme, coupled with changes in access routes and health provision, will work out in practice. The legislation seems concerned primarily with public finance. It could be complemented by measures to reduce informal employment, whereby employers avoid paying income tax and social security contributions for their workers.

Conclusion

This country focus examines, whether the new proposal of pensions reform which is in the process of being adopted by the Turkish authorities adequately addresses short and medium term challenges. While it is a step in the right direction, it appears to be still a long way from ensuring sustainability. More comprehensive reforms are both necessary and urgent. In the short term, new measures should focus on avoiding tax evasion and increasing forma labour. In parallel, the future budgetary costs of ageing should be reduced while also boosting the potential growth rate of the economy, notably by encouraging longer and fuller working lives.

With its very young population and an annual growth of about 1¼% of population in the working-age, Turkey should not have had a sizeable social security deficit. Furthermore, today's demographic advantages will phase out within the next thirty years. Unless the authorities further readjust benefits, the ageing of population will lead to a ballooning deficit.

Adoption of the reform package is key, but more comprehensive reforms are both necessary and urgent

Typically there are three ways of addressing Turkey's problem: (i) "pre-fund" the financing gap by building up assets or drawing down debts in the present; (ii) introduce pension and health care reforms to reduce future expenditure growth; and (iii) broad structural reforms to raise future output growth, raising the denominator of the gap. As in most EU-Member States, Turkey should adopt a mixed approach.

Turkey's 2007 reform chiefly aims at (ii) reducing the current and future expenditure growth. Turkey has to be commended for having begun to tackle this issue with a sensible set of proposals. However, even if ultimately passed and undistorted, the proposed reform would save only part of the estimated net financing gap due to pensions. Much uncertainty will remain as regards the future impact of the proposed pension reforms on labour supply. Given also other large fiscal risks, this

implies that more ambitious reforms, also in other areas, will certainly be necessary. In particular, it appears crucial that the informal economy is addressed in parallel, in part by a formalisation of the labour market and a widening of the tax base. The sheer size of the informal sector Turkey may be a serious impediment to improved economic growth and higher living standards. Addressing the problem will require a comprehensive approach, of which further pension reform is only one part, albeit an important one. As the pension reform reduces generosity, increasing employment (older workers, women) will be crucial - both for boosting economic growth and for widening the tax base.

Given the increasingly adverse effects of the social security deficits on public finances, this pension reform needs to be implemented in full and without delay. Looking back at EU Member States' experience, reforming the pension system has generally started earlier than in Turkey, in the 1990s, but at different speeds. With few exceptions, no reform seems to be definitive, and there is still a long way to go in most cases to ensure the long term sustainability of public finances (i.a. European Economy 2006a).

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[1] See European Economy, Enlargement Papers, 2006 Fiscal Notifications of Acceding and Candidate Countries: Overview and Assessment

[2] i.a."Living Longer, Working Longer", OECD 2006

3.Turkey, Ministry of Labour and Social Security (2005).

[4] Assuming for instance that under the base case the pension deficit were to be 3% of GDP, then the condition would be met by a projected deficit under the reform case of 2% of GDP or less

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.

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