

## **Turkey's Quest for Stable Growth**

**Didem Dinçer Başer, Diana Farrell, David E. Meen**

*One barrier to EU accession may be Turkey's failure to achieve stable economic growth. In Turkey, as elsewhere, GDP growth depends heavily on the rate of productivity increase, and our studies of 11 sectors of the economy shows that it is performing at only a little more than half of its potential productivity level. If Turkey took measures to realize its full productivity potential, it could create six million additional jobs by 2015 and achieve annual GDP growth as high as 8.5 percent. Compared with many other developing countries, which face dozens of barriers to productivity, Turkey is in a promising position. Thanks to economic reforms set in motion in the 1980s and to a customs union agreement with the EU in the mid-1990s, many barriers to productivity evident in other countries we have studied don't exist in Turkey. Turkey's level of foreign direct investment is lower than that in many other developing markets but not, we believe, because of regulatory. Turkey's productivity suffers from three specific problems: a large informal economy, macroeconomic and political instability, and government ownership. These are major issues, and tackling them will take sustained resolve, but at least Turkey has the comparative luxury of being able to focus on a limited number of areas for reform, and the fruits of doing so are potentially substantial.*

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***Turkey has come a long way, but the informal economy, macroeconomic and political instability, and state ownership continue to hold it back.***

*By Didem Dincer Baser, Diana Farrell, and David E. Meen*

Turkey began taking serious steps to liberalize and strengthen its economy a full 20 years ago. Before this reform program was instituted, tariff barriers were high, state ownership prevailed in key sectors, and competition was strangled by regulation. Today Turkey has plenty of modern, high-performing companies that hold their own against international competition. Many foreign companies, attracted by a relatively cheap but well-educated and skilled workforce, proximity to important markets, and the absence of major regulatory barriers, have also performed well there. So great has the country's economic progress been that it now has its sights set on becoming a member of the European Union. If Turkey succeeds in its ambition—and the EU is set to decide at the end of next year whether to begin entry negotiations—it is, based on current demographic projections, destined to be the bloc's largest member<sup>1</sup> and the only one with a predominantly Muslim population.

One barrier to EU accession may be Turkey's failure to achieve stable economic growth. During the 1980s, GDP grew strongly, at an average rate of 5.2 percent a year, thanks principally to the new wave of liberalization and increased competition. However, in the following decade growth fell to an average of 3.4 percent a year—lower than it was before liberalization began.

Turkey's economy was battered repeatedly during the 1990s, by the Persian Gulf War of 1991, currency crises in 1994 and 1997, a devastating earthquake in 1999, and a near economic meltdown in 2001 (when GDP contracted by almost 10 percent). Some of these developments were clearly beyond the control of any government. Yet a study by the McKinsey Global Institute (MGI)<sup>2</sup> suggests that the state *can* do a good deal to build the foundation of strong, sustainable economic expansion. In Turkey, as elsewhere, GDP growth depends heavily on the rate of productivity increase, and our study of 11 sectors of

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<sup>1</sup> Turkey currently has some 67 million people; the EU's most populous state, Germany, has 83 million. However, Germany's population is shrinking by about 82,000 a year, and Turkey's is growing rapidly. Turkey is expected to overtake Germany by 2014. If, as some expect, Turkey joins in 2007, along with Bulgaria and Romania, it will eventually be the EU's most populous state.

<sup>2</sup> A full version of the study can be found at [www.mckinsey.com](http://www.mckinsey.com).

the economy shows that it is performing at only a little more than half of its potential productivity level.<sup>3</sup> To put the facts another way, Turkish productivity currently stands at just 40 percent of the US level, but we believe that it could reach 70 percent (Exhibit 1).<sup>4</sup>

If Turkey took measures to realize its full productivity potential, it could create six million additional jobs by 2015 and achieve annual GDP growth as high as 8.5 percent. This would greatly improve the living standards of Turkey's 67 million people, with GDP per capita rising from around 30 percent of today's average EU per capita income (adjusted by purchasing power parity) to around 55 percent. Such convergence would substantially improve Turkey's chances for EU membership.

Compared with many other developing countries, which face dozens of barriers to productivity, Turkey is in a promising position. Thanks to economic reforms set in motion in the 1980s and to a customs union agreement with the EU in the mid-1990s,<sup>5</sup> many barriers to productivity evident in other countries we have studied don't exist in Turkey. It has relatively few specific product market regulations, such as pricing or product content laws, that stifle competition. We found little evidence that Turkey's labor market is handicapped by regulations, infrastructure, corporate-governance provisions, or the education of the labor force. Turkey's level of foreign direct investment is lower than that in many other developing markets but not, we believe, because of regulatory barriers (*see* sidebar, "Foreign investment: A poor record," on the next page).

Turkey's productivity suffers from three specific problems: a large informal economy, macroeconomic and political instability, and government ownership. Together, we

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<sup>3</sup> The 11 sectors studied were apparel, automotive parts, cement, confectionery, dairy processing, electricity, residential construction, retail banking, the retailing of fast-moving consumer goods, steel, and telecommunications. Combined, they account for more than one-quarter of nonagricultural GDP and more than 30 percent of nonagricultural employment. They were chosen both to represent the aggregate utilities, services, and manufacturing sectors and because international benchmarks were available from earlier MGI studies. Unless stated otherwise, productivity refers to labor productivity.

<sup>4</sup> Some productivity improvements aren't viable at Turkey's current consumer income and labor cost levels. Higher capital productivity can't be achieved in electricity, for example, because people don't consume enough of it at their current levels of income.

<sup>5</sup> The Turkey-EU Customs Union came into force on January 1, 1996. Apart from Andorra, Malta, and San Marino, Turkey is the only nonmember state to sign such an agreement. Under it, the country has abolished tariff and nontariff protection against all EU goods it covers, is progressively moving toward the EU's common external tariff, and has been adopting the EU's preferential trade system through free-trade agreements with third-party countries. As of 1999, Turkey was the EU's 7th-biggest export destination (up from 9th in 1990) and the 13th-biggest exporter to the EU (up from 17th in 1990).

estimate, the three problems account for 93 percent of the gap between Turkey's current and potential productivity (Exhibit 2, on the next spread). These are major issues, and tackling them will take sustained resolve, but at least Turkey has the comparative luxury of being able to focus on a limited number of areas for reform, and the fruits of doing so are potentially substantial.

### **A two-track economy**

Before analyzing the root causes of Turkey's low average productivity levels and what should be done to tackle them, it's important to recognize that this is a sharply divided economy.

In every sector, modern companies have adopted cutting-edge technologies, developed many best-practice operations, and managed to attain real economies of scale. Overall, the average productivity of such modern companies is 62 percent of the US level. However, alongside these effective performers, Turkey has many traditional entities that drag down its overall productivity.<sup>6</sup> They employ half of the labor force in the sectors we studied, and their average productivity is less than a quarter that of the average US enterprise. Traditional companies are typically small or midsize and tend to make relatively poor use of available technologies. Their products and services tend to be of low quality, they have few standardized production processes, and most are hampered by a lack of economies of scale.

The traditional operators' importance to the economy varies. In automotive parts, for example, they represent only 31 percent of all employment, so their drag on the productivity of the sector isn't massive; indeed, the sector's preponderance of efficient companies demonstrates how competitive intensity drives productivity. But in the retailing of fast-moving consumer goods, traditional firms account for 88 percent of all labor. Although this sector's modern players achieve 75 percent of the US productivity level, the average of the sector as a whole is therefore only 29 percent. In telecommunications, electricity generation, and retail banking—all with high capital requirements—traditional

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<sup>6</sup> The study revealed two distinct clusters of companies. "Traditional" is the label we gave to those with exceptionally low levels of productivity. A search for commonalities to explain this phenomenon revealed one broad characteristic: all traditional companies use business processes and technologies that are at least two, and often three or four, generations behind current state-of-the-art practices. "Modern" companies in our study have productivity levels two to three times higher than those of the traditional companies. Almost invariably, modern companies use business practices that are much closer to the state of the art.

operators aren't present at all. Exhibit 3, on the next page, shows the extent to which traditional companies drag down productivity in sectors they dominate.

Clearly, the traditional companies have ample room to improve. We estimate that their doing so would close half of the gap between the country's current and potential productivity.<sup>7</sup> But the problems are hardly confined to traditional operators. Modern companies also underperform, for three main reasons.

First, weak organization of business processes is common. Tackling this problem offers the biggest opportunity to improve productivity. Many retailers of fast-moving consumer goods, for example, don't have sophisticated logistics-management systems, so sales losses are high. In banking, lengthy credit checks are the norm even when they are clearly unnecessary. And government-owned monopolies—particularly the electricity and wireline telephone businesses—are overstaffed. Almost half of the employees in the electricity industry aren't needed. Second, low capacity utilization, due to overestimates of demand and to a lack of competition, leads to high prices and dampened demand. The third reason for the underperformance is a lack of investment in technology. The state-owned wireline company Türk Telekom, for example, has failed to invest sufficiently in high-speed value-added services and hasn't automated its management of faults.

If the modern companies tackled these problems and raised their productivity to 95 percent of the levels of their US counterparts, the other half of the gap between Turkey's current and potential productivity levels could be closed.

### **Root causes**

We have identified several causes of low productivity in both the traditional and the modern sectors, but companies aren't taking the necessary steps to correct the problem. Why don't modern companies invest more in technology, and why don't traditional ones

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<sup>7</sup> Productivity among traditional companies would reach its potential as a result of two things. First, certain companies would modernize. As the benchmark for their potential, we used the current productivity of US small and midsize enterprises. Second, some output would shift to more efficient operators as companies that failed to modernize went out of business. Consult the full MGI report for more details of the methodology.

upgrade their operations? The answer lies in the three underlying causes of Turkey's low productivity.

### 1. The informal economy

In Turkey as in other emerging economies, traditional companies that have failed to take measures to improve their performance are going out of business in the face of increased competition from more efficient players. Yet the scale of corporate failure is much more limited than would be expected given the extent of the operational inefficiency in sectors such as confectionery (*see* "Confectionery: Too many cooks," on page XX). The reason is that a lot of traditional companies derive a cost advantage by flouting tax, labor, and product market regulations. Many, for example, fail to remit value-added-tax (VAT) or social-security payments, to adhere to hygiene or product quality standards, or to pay minimum wages.

The size and impact of this cost advantage vary among industries. In the retailing of fast-moving consumer goods, not paying tax remittances could more than double a retailer's monthly income. That *isn't* enough in the long run to outweigh the overall cost advantage modern retailers enjoy thanks to their superior productivity. However, it is sufficient to enable some companies to survive a few more years even as turnover erodes. The low productivity of traditional retailers ought to imply a 10 or 20 percent annual decline in their numbers; the actual rate is 5 or 6 percent. In the dairy business, the bankruptcy rate is even lower, with some informal operators enjoying a cost advantage of as much as 20 percent, helping even the most inefficient to stay afloat.

Furthermore, the substantial cost advantages of the informal economy not only protect traditional firms from going out of business but also act as a disincentive to improving their productivity. For example, the Bakkalim project attempted by Migros Turk, the country's biggest grocery retailer, involved efforts to organize smaller stores under an umbrella brand that would give them extra purchasing, logistics, and merchandising muscle. Because membership required participants to comply with tax and social-security regulations, few grocers were willing to sign up.

Cracking down on informal operators does have a short-term cost: in developing countries, they provide work for large groups of unskilled laborers who migrate to urban centers, and many of these jobs could be lost. But in the long term, higher productivity would create far more jobs. We estimate that 33 percent of the gap between Turkey's current and potential productivity is due to the informal economy. No doubt, there would be a time lag between

job losses and job creation, and the transition wouldn't be easy. Much of the pain could be ameliorated with targeted programs, however, and we contend that tackling the problem of the informal economy will pay very worthwhile long-term dividends.

Since we found no evidence in Turkey of regulatory loopholes that allow companies to avoid tax and other social obligations and to violate product market rules, the first step is to ensure stricter enforcement of existing laws. Poor enforcement is largely the result of weak processes and systems: tax offices are understaffed and poorly organized, for instance, and penalties for evasion negligible. Political decisions exacerbate the problem. Since 1963, Turkey has issued ten tax amnesties, most of which permitted delinquent parties who came forward to pay back taxes in installments *and* to use old Turkish lira values—a fabulous offer in a country where inflation averaged more than 60 percent a year during the 1990s. Not surprisingly, many people prefer to bide their time until the next tax amnesty rather than make their payments on time.

Bolstering enforcement of a range of regulations across many industries simultaneously would be a massive undertaking. It would be more practical to focus initially on a single area. We believe that this area should be tax evasion, which accounts for the largest portion of the informal operators' cost advantage. Moreover, better tax enforcement should enable the government to lower tax rates, thereby encouraging more companies to join the formal economy. In the retailing of fast-moving consumer goods, for example, the state collects only some 64 percent of the VAT revenue owed. If that could be increased to 90 percent, the VAT rate could be lowered to 13 percent, from 18 percent, with no decrease in state revenues.

Turkey should consider following the lead of Poland, which under strong pressure from the European Union began tackling its informal economy in 1993 by focusing on VAT evasion in the retail sector. A combination of comprehensive audits, substantial monetary penalties, and, particularly, a change in cash register requirements to keep better track of sales had a significant impact, according to Polish experts.

If need be, Turkey could narrow its initial effort even further, to the retailing of fast-moving consumer goods. Enforcing VAT has the advantage that compliance by any single company makes enforcement possible both upstream and downstream.<sup>8</sup> The retailing of fast-moving consumer goods is an appropriate sector to choose not only because almost all

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<sup>8</sup> Businesses remit net VAT payments — that is, the difference between the VAT they receive from their customers and the VAT their suppliers receive from them. Thus, they identify sales from wholesalers, and wholesalers identify sales from manufacturers, which in turn identify raw-material providers

retail outlets in Turkey are registered and thus easy to identify<sup>9</sup> but also because the product range within this sector is quite broad. As much as 20 percent of total Turkish economic activity is connected with it at some level.

Tougher enforcement of tax and social obligations and of product market regulations is the stick that will encourage traditional companies to join the formal economy and to modernize their operations. A carrot too is needed. Many small and midsize enterprises lack the know-how to modernize, so government and private-enterprise associations ought to educate them. For a start, Turkey should aggressively exploit and even try to deepen the assistance the European Union already offers to implement programs (styled after EU models) that help such companies improve their technology, increase their operating efficiency, and access export markets.

## 2. Macroeconomic and political instability

The sine qua non for sustained economic progress in Turkey is macroeconomic and political stability. Analysts have shown how the debilitating economic contractions of the past decade—too often caused by weak and short-lived governments—have led to high interest rates, high inflation, and high government debt. But the effect of economic instability on productivity has received little attention. Our study indicates that almost half of the gap between Turkey's current and potential productivity is due to economic volatility, which hurts modern companies most and largely accounts for their failure to improve business processes, their low capacity utilization, and their insufficient investment in technology.

Instability hampers productivity in three ways. First, high real interest rates often mean that more money can be made, more easily, from treasury operations than from productivity improvements, particularly in cash-oriented businesses. In the 1990s, real interest rates averaged around 20 percent but were frequently much higher; immediately after the currency devaluation in early 2001, they shot up to 90 percent.

Exhibit 4 demonstrates the importance of nonoperating income for a single large retailer and for retail banks. In 2001, when the Turkish economy contracted by almost 10 percent, this retailer earned no net income from operations but had \$60 million in nonoperating income. Under these conditions, it is hard to blame a retailer's owner or manager for spending much more time negotiating payment terms with manufacturers and managing

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<sup>9</sup> In contrast to tax enforcement, conducted at the state level, the enforcement of the obligation to register businesses (for a relatively small charge) is strict, partly because the responsibility lies with municipalities that want to maximize receipts under their control.



cash than worrying about core operational improvements. We believe that this behavior, rather than a lack of management know-how, explains the limited use of advanced practices in the retail sector. In retail banking, most operators have made so much money from treasury operations that they haven't felt the need to become efficient in their core business.

The second effect of economic volatility is that high real interest rates make borrowing expensive, so investment in technology and automation is reduced; confectionery companies, for example, don't buy equipment to prepare dough or to automate packaging. And high real interest rates are a massive disincentive to borrowing for houses—Turkey has no mortgage market, because of prohibitively high (and volatile) real interest rates—and this problem weakens the construction industry.

Third, violent and sudden swings in demand make planning a nightmare; the automobile assembly and cement industries, for example, added substantial capacity in the late '80s and early '90s in anticipation of strong growth that never materialized. It is incredibly difficult to adjust labor and plant capacity effectively in the face of such macroeconomic uncertainty. After the financial crisis of 2001, loan activity was virtually nonexistent, but banks were reluctant to lay off employees, as they had no idea how long the crisis would last.

The MGI study doesn't aim to prescribe specific measures to stabilize Turkey's macroeconomic and political environment, though it should be noted that the financial prerequisites of macroeconomic stability are well understood and that loans from the International Monetary Fund are contingent upon them. However, this study should provide an incentive for sustained macroeconomic reforms, since it clearly demonstrates the enormous impact that a greater degree of stability would have on productivity and thus on economic growth.

### 3. Government ownership

Previous MGI work shows that, with few exceptions, state-owned enterprises are less productive than privately owned ones. In Turkey as elsewhere, managers in the state sector lack incentives to increase profits, while restructuring is politically difficult because of job losses. Our study found that government ownership accounted for one-sixth of the gap between Turkey's current and potential productivity.

The electricity and retail-banking sectors clearly suffer from excess labor, and retail banking and wireline telecommunications are held back because they don't experience enough pressure to offer new services that could increase output. The textbook response is

privatization and liberalization, and Turkey has plans for both in the electricity, wireline telecom, and retail-banking sectors. To ensure the desired benefits, it will be important to stage and manage the transfer of assets within a carefully constructed regulatory framework. Particularly in telecommunications and electricity, the country's regulatory framework falls well below the bar (*see* "Electricity: Unplugging the state," on page XX).

Turkey's telecom industry provides a cautionary tale. The wireline sector has yet to be liberalized and suffers from a lack of incentives. Its productivity<sup>10</sup> stands at 66 percent of the US level. Startlingly, however, productivity in the liberalized wireless sector is actually lower—59 percent. Part of the reason was the bad design of liberalization: the government insisted that the second wave of new mobile license holders build base-station networks covering the entire country instead of ensuring that newcomers and incumbents signed roaming agreements. The result has been that much of the new capacity is now redundant, which has dragged down capital productivity.

This experience shouldn't deter Turkey from undertaking further privatization and liberalization; it just serves to emphasize that reform needs to be carried out carefully. If the government hits on the right combination of privatization and liberalization, we estimate that labor productivity could double in telecommunications and triple in electricity generation.

It's make-or-break time for Turkey. If it has the resolve to undertake the reforms outlined here, it can double the living standards of its people within a decade and move that much closer to fulfilling its dream of joining the European Union. If it balks at the task, its economy will continue to underperform. The country has already come a long way, and many of its companies *have* become efficient and productive. It would be a terrible waste if Turkey now failed to grasp the opportunity to transform its entire economy.

### **Foreign investment: A poor record**

Turkey's level of foreign direct investment is lower in the sectors we studied than the level in many other emerging markets and much lower than one would expect for a country of its size and importance (exhibit). Foreign direct investment is crucial not only because of

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<sup>10</sup> In telecommunications, we use a measure of total factor productivity—that is, labor productivity and capital productivity.

its impact on the input side of the productivity equation but also because foreign companies usually force local ones to be more competitive.

It has been argued that the bureaucracy is to blame for Turkey's low foreign direct investment. Red tape can certainly be onerous; for example, 19 different administrative steps, several of them superfluous in the light of international standard practices, are required to establish a company. But our interviews suggest that this isn't a fundamental barrier to productivity: it affects all players, foreign and domestic alike, and therefore doesn't distort competitive intensity. Some foreign managers say that certain elements of red tape are just as bad elsewhere, both in developed and developing economies.

Instead, Turkey's poor record on foreign direct investment appears to be due to the same three factors that explain the country's low productivity. The informal economy, for one thing, hampers foreign investors' growth prospects. Nestlé and Danone, for example, both invested in Turkey's dairy market after the liberalization of raw-milk sourcing, in the early 1990s, but capacity utilization in the modern producers' plants is almost 30 percent lower than the US average because informal players, with their unearned cost advantages, have clung to a disproportionate share of the market.

Moreover, the high real interest rates resulting from macroeconomic and political instability have warped investment decisions. Until very recently, foreign banks participated in the Turkish market only to a limited extent because of the high valuations Turkish banks enjoyed on the strength of their treasury profits. Foreign banks weren't prepared to pay such high prices to enter the market. Last, state ownership of capital-intensive sectors such as telecommunications and electricity has deterred foreign investors from putting their money into Turkey, though they have poured funds into the same sectors in other developing economies.

### **Auto parts: Miles to go**

*Turkey's productivity in this sector is high. But to keep up with the global market, it will have to rise still higher.*

*By Didem Dincer Baser and David E. Meen*

Turkey's automotive parts manufacturing industry provides proof positive that high competitive intensity leads to high levels of productivity and, in turn, to growth. Turkey is a major player in global markets for car parts. Since 1996, when the customs union agreement with the European Union came into force, auto parts exports have risen by more than 12 percent a year as international manufacturers entered into joint ventures with Turkish partners. More than 150 foreign auto parts suppliers had partnerships in Turkey in 2000, and the sector now accounts for more than 5 percent of Turkish exports. Upward of 60 percent of these parts exports go to European markets. The industry's total factor productivity stands at 91 percent of the US level<sup>1</sup>, but it could rise still higher—to 127 percent, we estimate—and indeed *must* keep rising if Turkey is to retain its position in this market.

Many international car manufacturers use their Turkish plants as a base for exports, particularly to European markets, and thus demand high-quality parts from competitive suppliers. Global parts manufacturers also use Turkey as a base for supplying both original-equipment manufacturers (OEMs) and retailers in other markets. This demand has helped drive the sector's high level of productivity, which also reflects the relative absence of productivity restraints; Turkey, for instance, has a skilled workforce.

Yet as in other sectors of Turkey's economy, not all players are equal. The modern segment accounts for 69 percent of the sector's employment and outperforms its US counterpart, on average, by 10 percent. But this achievement is still undermined significantly by small-scale traditional manufacturers that reach only 41 percent of the US productivity level (Exhibit 1). These suppliers use labor to avoid capital investment, produce mostly low-value and low-quality products, and mainly supply the domestic retail market. Many have small operations with fewer than 20 employees.

The existence of these traditional players hampers further productivity gains by modern manufacturers. Evading taxes and producing substandard parts without penalty permit traditional companies to cut their costs by more than 30 percent, which allows them to undercut more modern companies on price. Without such a cost advantage, many would

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<sup>1</sup> The auto parts sector comprises more than 1,000 suppliers, which manufacture different components. Our study measured the productivity of manufacturers of brake systems relative to that of their US counterparts. Total factor productivity measures capital and labor productivity.

probably go out of business if they failed to raise their productivity. Modern companies would then increase their market share and, hence, the sector's overall productivity. And make no mistake, the sector must continue to raise its productivity; otherwise, as the economy grows and increased wealth leads to higher wages, Turkey will struggle to remain as competitive internationally as, say, the Eastern European manufacturers that supply OEMs.

Modernization should entail investing in automation, producing higher-value-added products, raising capacity utilization, introducing better management processes, and using better, more reliable suppliers. To force traditional businesses to change, the Turkish government should concentrate on preventing evasion of the value-added-tax payments downstream of the suppliers—that is, the evasion of VAT by wholesalers, retailers, and repair shops. Clamping down in this part of the value chain should force compliance in the majority of the sector as a whole. In addition, Turkey should take steps to ensure the standardization of product quality and safety codes, not least because substandard parts (such as brake components) endanger public safety. Creating consumer protection laws, as well as agencies and courts to enforce them, will help.

Improved performance in the sector depends as well upon macroeconomic and political stability, without which efficient manufacturers will find it difficult to raise their game further. Economic volatility, for instance, distorts capacity planning and utilization; in 2000, the capacity utilization of modern suppliers was 75 percent (as compared with the US average of 85 percent). Economic downturns also push cost-conscious consumers toward substandard parts. Exhibit 2 shows how market volatility has affected car sales.

If Turkey deals with these issues, the future looks positive, with output improving by some 8 percent a year, thereby creating about 170,000 jobs.

### **Confectionery: Too many cooks**

*Rationalization will be needed for a sweeter future.*

*By Didem Dincer Baser and David E. Meen*

If Turkey's automotive parts sector shows how competition strengthens an economy, its confectionery sector—producing biscuits, chocolate, candies, and chewing gum—demonstrates the opposite. One manufacturer dominates more than half of the national market, the foreign presence is minimal, and most of the remaining market share is fragmented among 350 companies (Exhibit 1, on the next page). Some 90 percent are traditional operators. No wonder productivity suffers.

Overall, the sector's productivity<sup>1</sup> stands at 35 percent of the US level. The traditional players, reaching a mere 18 percent of it, suffer from low capacity utilization<sup>2</sup> as well as from low economies of scale in production, a proliferation of products relative to their scale, and low levels of automation. The modern players index at 69 percent of the US productivity level—still only a mediocre performance. They suffer from many of the same problems that the traditional operators do, albeit to a lesser degree. Exhibit 2 shows both the extent to which Turkey's manufacturers are subscale and the way too many products eat into labor productivity, a result of frequent production line changeovers.

In an industry such as this, with low capital intensity and low skill requirements, the productivity of modern processors might be expected to resemble that of their US counterparts more closely. Consolidation would rapidly remove the smallest, least-productive manufacturers. The reason this doesn't happen? The informal economy. In the confectionery sector, the majority of traditional players evade their income taxes, value-added taxes, and social-security obligations, thus lowering the cost of their products by about 7 percent compared with modern operators—just enough, in many cases, to keep them in business. There is also another informality-related issue: retailers in Turkey tend to be very small, with relatively little shelf space. This restricts the number of brands they stock and serves as an entry barrier to suppliers, thereby dampening competition. Half of all retail outlets stock the products of only two confectionery companies, and often just one, in almost all product categories.

The easiest way to deal with this issue is to encourage the emergence of a modern retailing sector for fast-moving consumer goods. Over the past decade, modern retailers have grown

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<sup>1</sup> Labor productivity was used to measure productivity in confectionery, because it is a relatively low-capital sector. Labor productivity was defined as dollar of value added per labor hour worked. The value added was adjusted with purchasing power parity (PPP) applied to ingredient wholesale prices to measure input and to a market basket of items to measure output.

<sup>2</sup> This problem has plagued the entire sector since the Russian economy collapsed in 1997, taking with it Turkey's only substantial export market for confectionery.

to command a market share of about 30 percent, but they would grow much faster if the problem of informality among traditional grocery retailers were solved. Modern retailers with big stores can stock a much broader range of products, from many different suppliers. They would entice into the Turkish market global best-practice confectionery manufacturers, which would then force sectorwide productivity improvements.

Foreign confectionery producers that have won significant market share in much of the developing world play a minor role in Turkey: two of them account for just 6 percent of the market. A major reason for their absence is the lack of access to the small groceries that still control most retailing volume. Forced to use a number of third-party wholesalers that have limited penetration of the retail market, they are at a serious cost disadvantage. In addition, they have to bear indirect costs such as weight tariffs and other import-related expenses. These extra costs result in much higher prices.

If Turkey can remove the impediments to competition in the sector, we estimate that its productivity could reach 87 percent of the US level by 2015. Confectionery, however, is one of the few sectors of the Turkish economy in which output growth would not be sufficient to outstrip the impact of productivity gains on employment. While output would grow by around 6 percent a year from 2005 to 2015 (assuming that the economy were to grow by around 8 percent a year), total sector employment would remain static.

### **Electricity: Unplugging the state**

*Turkey should privatize and liberalize its government-held assets—but carefully.*

*By Mustafa Cem Acik, Onur Genc, and Yusuf Sukal*

Turkey's electricity sector provides a stark example of how state-run monopolies drag down productivity. While privatization and market liberalization would ultimately increase it, the government must recognize the need for careful management. Unless Turkey treads cautiously, it might raise much-needed money from the sale of state assets but fail to secure future supplies at fair prices.

Productivity in Turkey's electricity sector,<sup>1</sup> including generation, transmission, and distribution, is 75 percent of the US level. That gap can't be closed completely, as lower incomes in Turkey mean that electricity consumption per capita is lower though infrastructure costs are similar. The Turkish electricity sector could, however, reach 89 percent of the US level—just by removing excess labor, since low workforce productivity is responsible for almost all of the gap between the sector's current and potential productivity (Exhibit 1).

State institutions dominate the electricity sector: EUAS controls more than 70 percent of generation capacity, TEIAS, owns the entire transmission network, and TEDAS, accounts for some 90 percent of distribution. As might be expected of state-owned monopolies, their managers lack incentives to reduce the use of labor. Privatizing and liberalizing the sector would improve its labor productivity, and Turkey intends to do both rapidly.<sup>2</sup> But the government needs to think more carefully about the process. If its goals are to be reached, liberalization must take place gradually, in stages, guided by a detailed regulatory framework that is not yet in place. After all, the United Kingdom enjoys one of the world's most liberalized electricity markets, but to reach that position it took ten years from the date when state assets were sold. The liberalization process was intricately managed, steered by regulations ensuring that competition emerged and consumer interests were met. In contrast, Brazil found itself coping with a severe power supply crisis when it tried to liberalize its power markets, because it didn't have a detailed regulatory framework that outlined how competition would develop. The uncertainty kept private investors away.

Turkey's government wants to achieve three things from privatization and liberalization in electricity. First, it hopes to maximize the sale price of its assets; proceeds from privatization are an important element of Turkey's macroeconomic-reform program.

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<sup>1</sup> Productivity was measured as total factor productivity, including capital, labor and fuel productivity.

<sup>2</sup> The government has committed to initiating a tender for the privatization of electricity distribution assets by December 2003.



Second, it wants to encourage private investment in the sector to meet growing demand; during the next decade, more than \$40 billion worth will be needed to match it, and only \$10 billion is forecast to be available from public funds. Finally, the government wants to encourage competition so that electricity prices fall. For industrial customers, they are more than double those in the United States, while residential prices are 12 percent higher (Exhibit 2, on the next page). Factor in Turkey's lower purchasing power parity and the differences are even more significant, arguably hampering economic development.

All three goals aren't compatible in the short term, and trade-offs will have to be made. The state is likely to receive the highest bids for its assets if it chooses to sell them as a monopoly—as Greece did recently when it sold some of its shares in the incumbent electricity utility and as the Czech Republic did when it sold its gas assets. This approach, however, will not in itself guarantee new investments or promote lower prices.

To encourage new players and new investments, Turkey may well have to offer some form of guaranteed returns (perhaps price guarantees) for a certain period. As governments in many emerging markets have learned, without guarantees new players may find investments too risky, particularly given the massive cost of building new infrastructure. This strategy may well be counter to the notion of encouraging competition and could keep consumer prices higher, but it is a surer path to the ultimate goal of competition. Encouraging lower prices for consumers isn't necessarily compatible with encouraging new investments if, for example, they can be secured only by offering investors guaranteed prices.

Turkey's current high electricity charges are less a result of low productivity than of the contracts the state provider signed with private power generators in the 1990s, when it was desperate to secure new supplies. At the time, the government offered independent companies guaranteed prices that gave them returns of from 15 to 60 percent. The state supplier is now passing on the cost of those contracts to consumers.

The experience of other countries makes it clear that Turkey must prioritize its goals and then set about formulating a regulatory framework to ensure that they are reached in orderly progression. First, the country will need a consensus among the relevant institutions: Turkey's privatization agency, which secures privatization revenue for the state; the Ministry of Energy and Natural Resources, which is concerned about future supply; and the regulator, whose objective is opening up the market to competition to reduce end-user prices. Given the conflicting interests of these bodies, it is difficult to see how liberalization can proceed until they agree on some broad goals. The country will also

need a way to monitor demand and supply, so that the liberalization process can take them into consideration and avoid being derailed by imbalances, as happened in Brazil. Turkey can't afford a repeat of the mid-1990s, when looming shortages resulted in high-priced guaranteed contracts for private suppliers.

Finally, the country will need a clear understanding of which regulatory levers will guide the market toward the desired end goal. Price caps or supports, efficiency-improvement targets for incumbents, and tariffs are just three of a long list of tools available to the regulator to ensure that Turkey achieves the desired outcomes for consumers, incumbents, and new market entrants. Many other countries didn't fully understand the impact of these levers and have consequently disrupted the liberalization process. California's experience is a case in point; regulators capped the price that retailers could charge consumers but not wholesale prices—a mistake that led to bankruptcies among suppliers and to blackouts for consumers.