



Turkey's Path to Prosperity in 2023

How to Avoid the Middle-Income Trap Through Inclusive Economic Growth

Center for American Progress, Istanbul Policy Center,
and Istituto Affari Internazionali

July 2016

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Turkey 2023 Trilateral Task Force

The Turkey 2023 Trilateral Task Force is engaged in a wide-ranging effort to outline a long-term prosperity vision for Turkey; assess the evolution of Turkish civil society; and analyze Turkey's role in Europe, NATO, its various regions, and the world. The initial study in this series, presented here, focuses on the Turkish economy. In the pages that follow, the task force explores the challenge of meeting—or at least approaching—the lofty goals that the Turkish government has set for itself for the 100th anniversary of the Turkish Republic in 2023.

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Preface

This first discussion paper by the Turkey 2023 Trilateral Task Force is presented with the goal of contributing to an ongoing discussion of how to best ensure Turkey's prosperity in the years ahead. The members of the task force, including its expert working group on long-term economic growth, represent a wide range of opinion on these issues. This report is the result of close consultation with the members of the group, but there may be different interpretations regarding any given point.

Therefore, this discussion paper should not be understood as a consensus product, but rather as a reflection of mainstream opinion within the group on the several issues considered. Consequently, the findings of the task force and its expert working group on long-term economic growth are broad, and the recommendations made are necessarily a set of suggestions intended to spark a more detailed policy debate. Readers' comments and criticisms are more than welcome.

Introduction

The Republic of Turkey will celebrate its centennial in 2023. The ruling Justice and Development Party, or AKP, has set 2023 as the year in which a set of ambitious economic goals will come to fruition. According to this vision, by 2023, Turkey will be an economic powerhouse—the world’s 10th-largest economy—with a \$2 trillion economy, a per capita income of \$25,000, and exports amounting to \$500 billion.¹ By comparison, in 2014, Turkey was the 18th-largest economy in the world—down from 17th in 2013—with a gross domestic product, or GDP, of \$800 billion, a per capita income of just more than \$10,000, and \$160 billion in exports. Russia currently holds the 10th spot in world rankings, with a GDP that is roughly twice the size of Turkey’s GDP.² The AKP’s stated goals are ambitious, to say the least, and many economists believe they may be out of reach. Most economists and policy analysts agree, however, that aiming high can do no harm and could possibly carry benefits.

The Western world has a strategic stake in Turkey’s economic success. First, a prosperous Turkey is likely to remain stable and anchored to the West as a reliable and supportive ally. Prosperity often—though not invariably—supports the strengthening of democratic values, a development that would further reinforce Turkish-Western bonds. Second, the West itself stands to gain economically from a wealthier Turkey. In 2015, Turkey was the European Union’s fourth-largest export market and its sixth-largest source of imports.³ Greater wealth also means greater investment opportunities in both directions. Third, a prosperous Turkey could host, employ, and ultimately—if necessary—absorb its swelling Syrian refugee population, making Turkey a more resilient country in its own right and a stronger neighbor and partner for Europe.

So what is possible for the Turkish economy by the end of 2023? What challenges will Turkey face over the next eight years before the republic begins its second century?

If Turkey is to make the significant leap forward outlined by the AKP, the Turkish economy must escape the “middle-income trap”—a reference to the difficulty that many countries emerging from low-income status have faced in achieving continuous growth, rather than plateauing at middling levels of per capita income.⁴ In explaining the dilemma of the middle-income trap, the World Bank argues that:

The factors and advantages that propelled high growth in these [middle-income-trapped] countries during their rapid development phases—low-cost labor and easy technology adoption [from more developed states]—disappeared when they reached middle- and upper-middle-income levels, forcing them to find new sources of growth.⁵

The challenge for Turkey lies in finding those new sources of economic growth. In today’s highly globalized economy, that usually means developing a high-tech sector that can produce goods and services for export as well as for the domestic economy.⁶ These high-tech growth sectors, in turn, require the development of a highly skilled workforce. Today, Turkey’s economy lacks a meaningful high-tech sector and the skilled workforce needed to propel such growth.

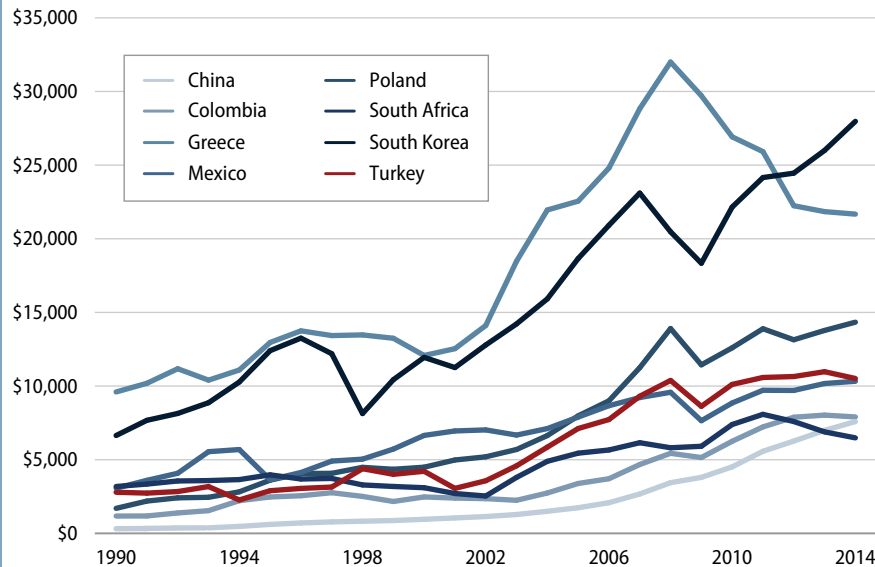
History illustrates the difficulty of moving from being a middle-income country to a high-income one—defined by the World Bank in 2016 as having a per capita income of at least \$12,736. Of the 101 countries that qualified as middle-income in 1960, only 13 of them have emerged as high-income countries more than a half-century later.⁷

Turkey graduated from low-income status to lower-middle-income status in 1955 and remained there for a half-century before being classified as an upper-middle-income country in 2005. According to the World Bank’s 2016 definitions, a lower-middle-income country is one with a per capita income between \$1,046 and \$4,125; an upper-middle-income country has a per capita income between \$4,126 and \$12,735.⁸

Turkey’s economy surged in the first decade of this century, following the financial crisis of 2001, with per capita income nearly tripling from \$3,500 in 2002 to \$10,400 in 2008.⁹ Aside from a dip and then a recovery reflecting the global economic situation in 2008 and 2009, Turkey has been largely stuck at the \$10,000 level ever since.¹⁰ Despite its failure to move into the high-income category, Turkey is clearly at the upper end of the middle-income level; in December 2014, the World Bank described Turkey as being on “the threshold of a high-income economy.”¹¹

FIGURE 1
GDP per capita

In current U.S. dollars



Source: World Bank World Development Indicators from World Bank national accounts data and national accounts data files from the Organisation for Economic Co-operation and Development. See The World Bank, "Data: GDP per capita (current US\$)," available at <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD/countries/TR-KR-ZA-MX-PL-CN-CO?display=default> (last accessed June 2016).

Moreover, Turkey's growth between 2002 and 2012 was largely inclusive, marked by a significant reduction in the poverty rate, major growth in the size of the middle class, and rough parity between the consumption rate of the lower 40 percent of society and that of the national average.¹²

Nor can Turkey be said to be suffering from enduring middle-income-trap status. Economists disagree as to how long a country must retain middle-income status before it is considered "trapped." Some of these definitions qualify Turkey as trapped, while others do not. By any reckoning, however, Turkey's 11 years of being ranked in the upper-middle-income bracket do not qualify its case as severe.

Yet Turkey does face many of the difficulties characteristic of nations caught in the middle-income trap, including persistent current account deficits, an economy based on low- and middle-tech production and services rather than innovation—"industry geared to the 1990s," as one economist said—problems with the rule of law and institutional autonomy, and an inadequate education system.¹³

Improvement in these areas would help Turkey tackle one of its fundamental economic problems—lack of investment, both foreign and domestic—and would thereby help it achieve sustained growth.

According to the World Bank, the elements necessary to escape the middle-income trap are:

*... an economy open to trade and [foreign direct investment], a sustainable macroeconomic framework that delivers low inflation and limits dependence on foreign capital inflows, low demographic dependency and rising labor force participation rates, a good skill base that facilitates the move towards more innovative production, a healthy business climate, and strong economic institutions that provide for the rule of law, [as well as] effective and accountable government.*¹⁴

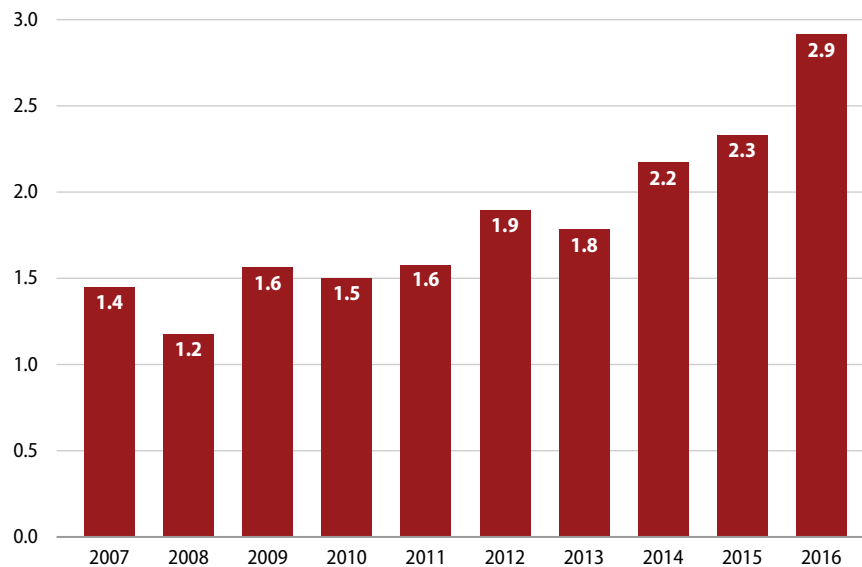
Elsewhere in the same 2014 report on Turkey, the World Bank asserted that “improvements in the rule of law, in public accountability and transparency, and in the climate for entrepreneurship and innovation will thus be needed for Turkey to complete the transition to a high-income economy.”¹⁵

This discussion paper briefly outlines the issues that Turkey must successfully confront if it is to make major strides toward the AKP’s 2023 goals and obtain high-income country classification. These issues fall into two broad categories: macroeconomic reform and other economic, institutional, educational, and political reforms with an economic impact, with the latter category including institutional, educational, and political reforms. The paper closes with a brief set of recommendations for how Turkey could sequence its needed reforms to achieve its goal of becoming an advanced economy by 2023.

FIGURE 2

Recent historical exchange rates of the Turkish lira and the U.S. dollar

Turkish lira to U.S. dollar exchange rate, 2007–2016



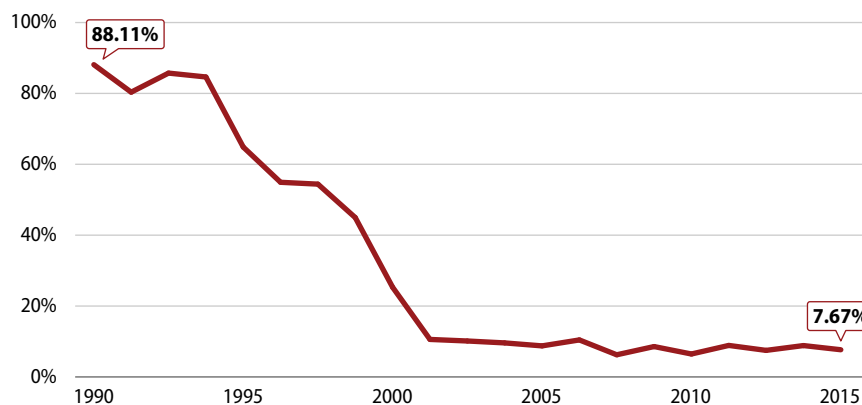
Note: Official rates are generally reported every week; this figure takes the first report of each calendar year, for reference.

Source: XE.com, "XE Currency Charts (USD/TRY)," available at <http://www.xe.com/currencycharts/?from=USD&to=TRY&view=10Y> (last accessed May 2016).

FIGURE 3

Turkish consumer inflation

Consumer price inflation (annual percentage increase)

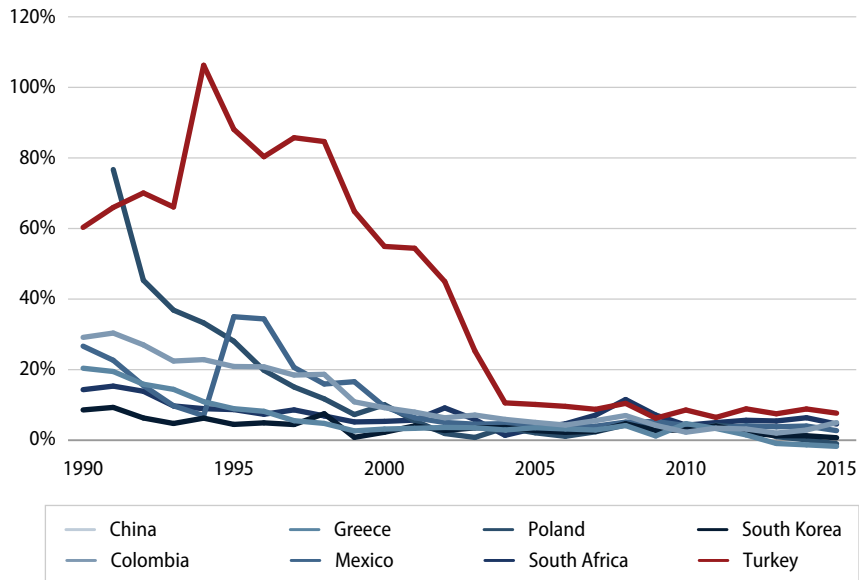


Source: World Bank World Development Indicators. See The World Bank, "Data: Inflation, consumer prices (annual %)," available at <http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG/countries/1W?display=default> (last accessed June 2016).

FIGURE 4

Turkish consumer price inflation in context

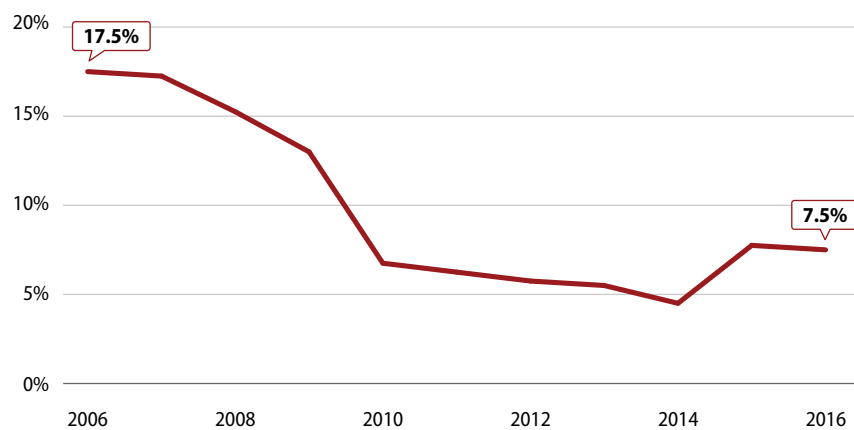
Consumer price inflation (annual percentage increase)



Source: World Bank World Development Indicators. See The World Bank, "Data: Inflation, consumer prices (annual %)," available at <http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG/countries/TR-CN-MX-ZA-CO-KR-PL?display=graph> (last accessed June 2016).

FIGURE 5

Turkish Central Bank benchmark interest rates, 2006–2016



Note: The Turkish benchmark interest rate is taken from the first report of that calendar year.

Source: World Bank World Development Indicators. See The World Bank, "Data: Inflation, consumer prices (annual %)," available at <http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG/countries/TR-CN-MX-ZA-CO-KR-PL?display=graph> (last accessed June 2016).

Economic reform

Sound macroeconomic policy in Turkey should have the broad goals of high economic growth with low inflation in tandem with steady and reliable fiscal policies that encourage greater investment in the future competitiveness and productivity of the economy. Accordingly, over the next eight years, Turkey should take steps to:

- Lower the trade deficit
- Increase the savings rate
- Improve fiscal policies
- Increase women's participation in the labor market
- Invest in transportation infrastructure
- Develop renewable energy sources

The report will now turn briefly to each of these policy goals in turn.

Lower the trade deficit

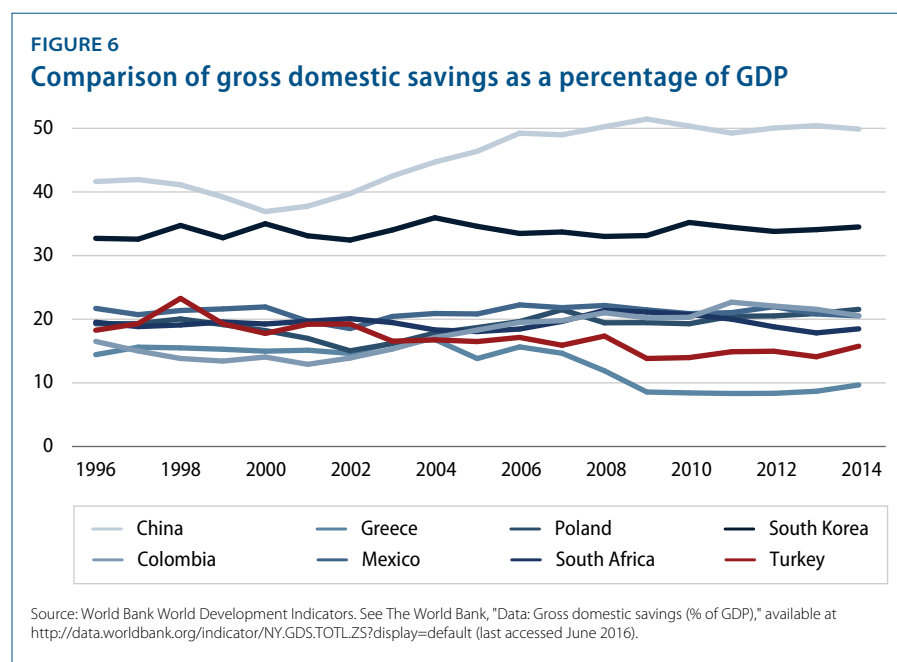
Turkey's trade deficit is structural. The country's low rate of savings—one of the lowest rates among emerging market economies at 15 percent of GDP—is largely responsible for the economy's low volume of exports and high volume of imports relative to other high-middle-income economies.¹⁶ Moreover, production of the goods that Turkey does export requires a significant degree of imported products and services. To escape this vicious cycle, Turkey must increase its savings rate and alter the mix of its exports to include a greater percentage of high-tech, innovation-driven products with more domestic value-added content.

In addition, Turkey meets roughly three-quarters of its energy demand through imports of oil, natural gas, and coal.¹⁷ Expanding the use of renewable energy sources would therefore help lower the trade deficit and move toward a more sustainable economy. In fact, the recent decline in global oil prices did help Turkey

reduce its current account deficit, which significantly reflects foreign trade deficits, from a worrisome 9.8 percent of GDP in 2011 to a still high but manageable 5.7 percent in 2014.¹⁸ Of course, given energy price volatility in recent decades, Turkey cannot count on permanently low energy prices.

Increase the savings rate

Even more than a favorable balance of trade, the savings rate is the most important factor in ensuring a healthy and sustainable current account deficit. Turkey's current savings rate of 15 percent is one of the lowest among emerging markets. A realistic goal might be to raise it to more than 20 percent by 2023. (see Figure 6)



The primary tool in achieving this goal is the influence of the Central Bank of the Republic of Turkey on interest rates. The Central Bank's benchmark rate now stands at 7.5 percent.¹⁹ The government could raise this rate to incentivize citizens to save more in the Turkish economy. Moreover, the government should develop a wider incentive structure to encourage savings, including tools such as matching-funds programs. Nevertheless, these steps will likely not be enough in isolation;

good governance also is a factor in the long-term success of a nation's monetary policy, as people tend not to bank their money in their home country if they doubt the stability of its government or its currency. The next section of the report goes into more detail about the factors that constitute good governance.

Improve fiscal policies

Turkey's tax revenue is currently just less than 30 percent of GDP, below the average of approximately 35 percent of GDP among member countries of the Organization for Economic Cooperation and Development, or OECD.²⁰ An array of economists, business people, and financial analysts have urged the Turkish government to increase the transparency and effectiveness of its tax policy in order to counter the ill effects of tax avoidance via the country's informal economy. Turkey's aim, they say, should be to increase its tax revenue to the OECD average.²¹

There is similar consensus among Turkey's economic and business elite that the domestic labor market must become more flexible to allow more workers to find jobs in the nonagricultural sector of the economy. Indeed, reforms to encourage more movement of workers out of the nation's agricultural sector, which employs a quarter of the nation's workforce yet accounts for only about 7 percent to 8 percent of the country's GDP, are an equally important 2023 goal.²² Government fiscal policy could encourage these reforms by cutting taxes for farmers and ranchers and encouraging agricultural modernization to allow for large-scale, more efficient farming.

Increase women's participation in the labor market

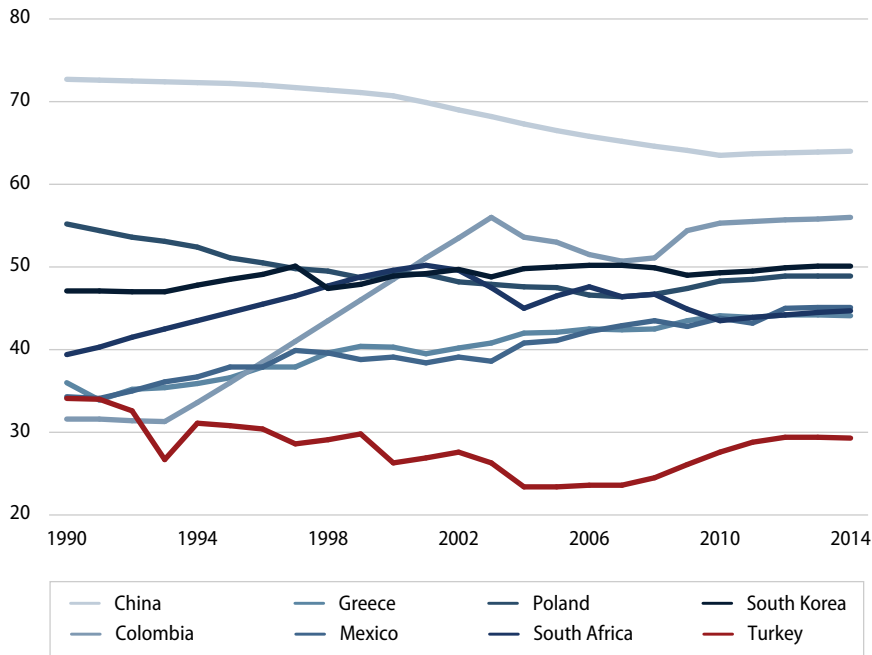
Just 32 percent of Turkish women were in the labor force as of 2014, less than half of the OECD average.²³ By contrast, the male participation rate in 2014 was 71 percent.²⁴ International Monetary Fund Chief Christine Lagarde has argued that Turkey could increase its per capita income by 22 percent if women were able to participate in the labor force at the same rate as men.²⁵

Among the measures that could encourage increased women's participation in the labor market are more robust government support for preschool, day care, and elder care programs; efforts to bridge the so-called digital divide in the use of the internet among women; and more supportive government rhetoric about the status of women in the workforce and the family.

FIGURE 7

Female workforce participation rates

Labor force participation rates for females above age 15 (percentage of female population, modeled International Labour Organization estimate)



Source: World Bank World Development Indicators. See The World Bank, "Data: Labor force participation rate, female (% of female population ages 15+) (modeled ILO estimate)," available at <http://data.worldbank.org/indicator/SL.TLF.CACT.FE.ZS?display=default> (last accessed June 2016).

Invest in transportation infrastructure

Turkey would benefit from continuing heavy investment in its national transportation infrastructure, such as expanding its railway network to cover the entire country, including the Black Sea region and the southeast. The development of a nationwide high-speed railroad system could be a valuable investment, particularly if it included linkages to major ports. Such a network would facilitate passenger travel as well as commerce and make Turkey a more attractive investment target.²⁶

The 2009 opening of the Ankara-Eskişehir high-speed rail line was a good start in this effort. Currently, the line links Ankara, Eskişehir, Istanbul, and Konya. The government hopes to build an additional 10,000 km of high-speed rail lines

and 5,000 km of conventional rail lines by 2023.²⁷ The Turkish government should protect this investment and focus especially on extending rail lines to the country's major ports to support efficient export activities.

Develop renewable energy sources

Turkey has no meaningful domestic sources of fossil fuels, yet it is dependent on those sources of energy. The country needs to move away from this fossil fuel dependence toward the use of renewable energy sources such as geothermal, solar, and wind, which Turkey has in abundance. According to Turkish government figures, roughly 10 percent of the country's primary energy demand is now met by renewables—7 percent by hydropower and 2.5 percent by other renewables—while the remainder of Turkey's primary energy demand is met by hydrocarbon-based fuels, most of which are imported.²⁸ The Turkish government has subsidized companies that produce renewable energy since 2010 but should expand and deepen support for renewable energy production and use.²⁹ Along with the environmental damage inflicted by nonrenewable energy sources, Turkey's dependence on fossil fuels depletes its hard currency reserves and leaves the country vulnerable to fluctuating global oil and gas prices, as well as to potential political pressure from producing countries.

In a 2013 report, the World Bank noted that a “shift toward locally produced, renewable energy and improved energy efficiency represents a potential triple win” for Turkey because such a shift would increase domestic energy generation, decrease carbon dioxide levels, and spur growth among the country's small, medium, and large energy companies.³⁰ Another recent report also urged the liberalization of Turkey's energy markets—particularly gas and electricity—building upon Turkey's great strides in electricity distribution stemming from market liberalization.³¹

In addition, after decades of delay, Turkey has plans in the works to build several nuclear power plants in the coming years with the support of Russian, French, Japanese, South Korean, and Chinese suppliers.³² All of these investments are designed to diversify the nation's sources of energy and prepare the economy for a continuing strong demand for power as Turkey seeks to enter the ranks of the world's most advanced economies by 2023.

Turkish officials say they hope that 10 percent of the country's electricity will be generated from nuclear power by 2023. They anticipate that the nuclear plants at Akkuyu on the Mediterranean Sea and Sinop on the Black Sea will be operational by then.³³ The latter is a Japanese project contracted in 2013. The former, a Russian project contracted in 2010, has undergone frequent delays and is running far behind schedule, putting its now-projected 2022 opening in doubt. Overall, while nuclear power may represent a necessary bridge investment in Turkey's long-term energy mix, given expectations of continuing rapid increases in energy demand, the country should focus on the renewable energy sources it enjoys in abundance. Turkey's long-term energy future is brighter with more flexible distributed renewable energy production—especially as the costs of these sources decline—than with expensive centralized investments in nuclear power plants and the attendant concerns about security and vulnerability to natural disasters.

Other economic and institutional reforms

Equally important as macroeconomic reforms are other economic, institutional, educational, and political reforms. Efficiently managed and well-supported economic and social institutions are the pillars of sustained economic prosperity. To build the workforce necessary to establish and sustain an innovation-driven economy, Turkey must strengthen its educational system. To build investor confidence, the country needs wide-ranging reform of government institutions, particularly related to effective, impartial rule of law and the resolution of longstanding political problems that divide Turkish society.

These types of reforms are more difficult to enact than most macroeconomic reforms because they tend to require shifts in long-held government prerogatives and ingrained national proclivities and sensibilities. For example, a key case in point is the low workforce participation rate of women—clearly a significant hurdle to greater economic growth and prosperity but one that will require slow and difficult changes to social and cultural mores. (see Figure 7)

In this section, the task force examines the following areas of reform:

- Institutional reform: rule of law
- Institutional reform: regulatory agency autonomy
- Educational reform
- Political reform

The first reform to consider—and the one with perhaps the most immediate impact on economic growth—is the rule of law.

Institutional reform: Rule of Law

Few reforms would benefit the Turkish economy and Turkish society more than an independent judiciary and more professionalized cadres of judges, prosecutors, and police. The perception that the court system is unreliable is a major deterrent to foreign investment.³⁴

To accomplish this goal, a number of steps are necessary, foremost among them enhancement of professional training of and personal autonomy for judges and prosecutors.³⁵ Equally important is the removal of politics from its dominant role in the Supreme Council of Judges and Prosecutors, which plays a critical role in the appointment, promotion, and placement of judges and prosecutors. In turn, the government's other branches must respect the independence of the judiciary and implement its decisions, even those unfavorable to the government.

This is particularly difficult in the current political atmosphere. Since the corruption allegations against government figures and their associates in December 2013, the Turkish government has exerted increasing control over the judiciary. But this lack of impartiality—real or perceived—in the judicial system discourages potential foreign and domestic investors, who lack faith in the prospect of legal recourse and suspect possible political motivation behind the awarding of contracts.

Likewise, the government has imposed greater control over the police force and the Jandarma—in effect, a rural police force. In the wake of the protests in Istanbul's Taksim Square and Gezi Park in May 2013, concern about large-scale demonstrations led the AKP to expand the police presence in urban areas and strengthen their legal authorities.³⁶ The government shifted authority over the Jandarma from the military to the Ministry of the Interior in 2014. The European Union had encouraged the change as a way of strengthening civilian control, but the shift also further tightened the government's political control over law enforcement.

Peaceful political protest is a sign of Turkey's diverse urban middle class; it is in many ways a testament to the country's success over the past 15 years. The mismanagement of the Gezi Park protests and the divisive rhetoric employed by leaders on all sides of Turkey's political and social fault lines have fed extreme polarization. Under these circumstances, steps to demonstrate the impartiality and professionalism of Turkish law enforcement would build social cohesion. In addition to judicial

reform to reassure foreign and domestic investors and greater transparency in the awarding of contracts, a wider effort to reassure Turkish citizens of diverse political and social backgrounds of their security and of the impartiality of law enforcement and judicial outcomes would have attendant economic benefits.

Institutional reform: Regulatory agency autonomy

Turkey must also ensure the legally prescribed autonomy of its Central Bank, Competition Authority, Capital Markets Board, Banking Regulation and Supervision Agency, Public Procurement Authority, Energy Market Regulatory Authority, and other economic regulatory agencies.³⁷ This means, in effect, that the government should respect the decisions of economic regulatory agencies and forgo efforts to pressure them or to find means of circumventing their decisions. Where necessary, legislation should be passed to ensure agency impartiality and to close loopholes that compromise autonomy.

Still, the relatively good news is that among upper-middle-income countries, Turkey is in the middle of the pack among its peers in terms of success in combatting corruption, according to the World Economic Forum's latest inclusive growth and development report.³⁸ The report ranks Turkey's so-called pillar institutions, such as the judiciary and the Central Bank, in the relatively high fourth quintile in terms of combatting corruption, alongside nations such as Costa Rica and Lithuania. The report ranks Turkey in that same quintile for one of its nonpillar institutions, business and political ethics, alongside such nations as Poland and Latvia but more poorly—in the third quintile—when judged on corruption due to rent-seeking, a clear indication of crony capitalism. In this category, the report ranks Turkey alongside countries such as Mexico and Panama.³⁹

Educational reform

Turkey's troubled education system impedes its economic advancement. According to a 2014 article by Turkish Deputy Prime Minister Mehmet Şimşek, the average Turk older than age 25 has between only seven years and eight years of schooling, four years less than the OECD average.⁴⁰ Until 1997, Turkish law required only five years of schooling; this requirement was raised to eight years in 1997 and to 12 years in 2012. Despite the higher requirements, Turkish students consistently score poorly among OECD countries on standardized tests for math, reading, and science.

Major educational improvements will likely require a top-down initiative since the voters currently most able to influence the government—those who support the ruling AKP—seem to be satisfied with the current state of education in state-run schools, at least according to one recent poll.⁴¹ In contrast, those voters pushing for educational reforms generally support opposition parties, particularly the Republican People's Party, or CHP, and the Peoples' Democratic Party, or HDP.⁴²

Turkey needs to develop policies to strengthen student performance in math, science, and reading, as well as to encourage critical thinking, in order to develop a skill base that facilitates more innovation. Turkey should carefully study and follow the examples of countries that have escaped the middle-income trap, such as South Korea, Singapore, and Taiwan. Based on the experiences of these countries, as well as European countries such as Poland, rapid improvement in education is possible, particularly through the application of rigorous standards for teachers.⁴³

Such educational improvement is essential to the kind of high-tech economy Turkey needs to build to make strides toward its 2023 goals. The share of high-tech exports in Turkey's total manufactured exports was less than 2 percent as of 2012. This was easily the lowest figure among upper-middle- and lower-middle-income countries, with South Africa's 5.5 percent being the next lowest.⁴⁴ While the fast growth rates in Turkey's information and communication technology sector are encouraging—the industry grew 18 percent in 2015 compared with the previous year—further investment and regulatory support from the government will be required to achieve the growth needed to make a meaningful impact on the overall economy.⁴⁵

Related to the educational hurdles facing Turkey, the country needs to develop a plan to stimulate innovation, starting with an increase in the share of GDP devoted to research and development, which was just 0.8 percent in 2014, again one of the lowest such figures among emerging economies.⁴⁶ Turkey should support projects that offer university students experience in innovative design methodologies. The country should also consider undertaking a major national project that would drive research and development as well as innovation, as the United States did with its space program in the 1960s, which galvanized primary and secondary students and teachers as well as students and professors in higher education.⁴⁷

One possible way to foster innovation is to invest heavily in closing the country's so-called digital divide in order to boost the nation's collective exposure to and comfort with new internet businesses. Such efforts could create a strong domestic business and retail customer base for homegrown digital innovation powered by

better-educated domestic software engineers. The Center for American Progress, one of the members of the Turkey 2023 Trilateral Task Force, recently published a paper on bridging Turkey's digital divide that includes a comprehensive set of institutional and educational recommendations.⁴⁸

Political reform

Political stability is an important determinant of investor confidence. It also helps to determine whether a nation's elites choose to remain in their home country or become part of a so-called brain drain. Among the many factors that affect long-term political stability in Turkey are chronic problems such as the Kurdish issue, secular-religious tensions, and overcentralization, as well as ongoing shortcomings in the realms of judicial independence, freedom of expression, property rights, and regulatory reliability. Societal consensus on the resolution of these issues, however difficult, would undoubtedly make Turkey more attractive to talented young people and potential investors, both foreign and domestic, in addition to enhancing the economy in other ways as well.

Related to these needed institutional political reforms but encompassing other dimensions as well is the need for internal security reforms. Since June 5, 2015, Turkey has suffered at least seven major terrorist attacks, including two Islamic State-claimed attacks that targeted tourists. If not stemmed, this violence—in addition to the ongoing fighting in the southeast—will alienate investors and tourists alike. Tourism constitutes 12 percent of Turkey's GDP and is particularly vulnerable to security threats from terrorism.⁴⁹

Turkey 2023 and European Union integration

As an anchor and as an incentive to implement all three broad sets of reforms outlined in the previous section, Turkey should seek to deepen its integration with the European Union.

Whatever the state of Turkey's EU accession talks, the nation's relationship with Europe will remain a primary engine of Turkish economic growth in the decades to come. Turkey should nevertheless continue to expand into new markets, as it has successfully with Russia, China, and the Middle East during the current AKP era. That diversification, however, cannot be a substitute for Turkey's primary economic relationship with the European Union. As demonstrated in recent years, economic relations with Russia and the Middle East are prone to disruption—for example, the sanctions Russia imposed on Turkey after the Turkish Air Force shot down a Russian fighter jet in November 2015. Likewise, the disintegration of Syria and the emergence of the Islamic State have blocked Turkey's overland transport routes to the Middle East and the Persian Gulf, increasing its dependence on trade with the European Union, its bedrock partner.⁵⁰

Accordingly, Turkey should seek to renegotiate the terms of its current customs union with the European Union in order to extend coverage beyond manufactured goods to include agricultural items, services, government contracts, and dispute resolution. To reach an upgraded customs union agreement with the European Union will require many of the far-reaching reforms outlined in the sections above, particularly in order to ensure Turkish involvement in EU trade arrangements with third parties.⁵¹

Turkey should also find other means of deepening its relations with the European Union, including a convergence of its laws and regulations with EU norms, even in the absence of meaningful chapter negotiations. In particular, convergence with EU trade union law, competition policy, and public procurement policy would level the playing field for EU competitors and thus help lay the basis for an expanded customs union agreement.

Turkey's economic relationship with the European Union is not without problems and risks. Financial problems have depressed European financial markets and many EU members' economies in recent years, and Turkey faces increasing competition there from other trade rivals, such as China. Nevertheless, it is likely that the European Union will remain Turkey's most stable trading and investment partner for the foreseeable future.

However, Turkey's relationship with Europe must go both ways; Turkey was the EU's fifth-largest export market and sixth-largest overall trading partner in 2014. It would thus behoove the European Union and the United States to incorporate Turkey into any Transatlantic Trade and Investment Partnership, or TTIP, agreement, should they succeed in negotiating one. There is general agreement that Turkey would benefit economically by inclusion in such an agreement and would suffer by exclusion.⁵² At the very least, European countries must negotiate in good faith with Turkey regarding its eventual EU accession.

The 2023 goals and longer-term trends

At least three major trends are likely to have a strong impact on Turkey's economic development in the years to come:

- Demographic change
- Ongoing urbanization
- Absorption of Syrian refugees

These trends will affect Turkey's trajectory irrespective of the government's policy, but their exact impact on Turkish economic and social life could be meaningfully shaped by forward-looking responses from Ankara.

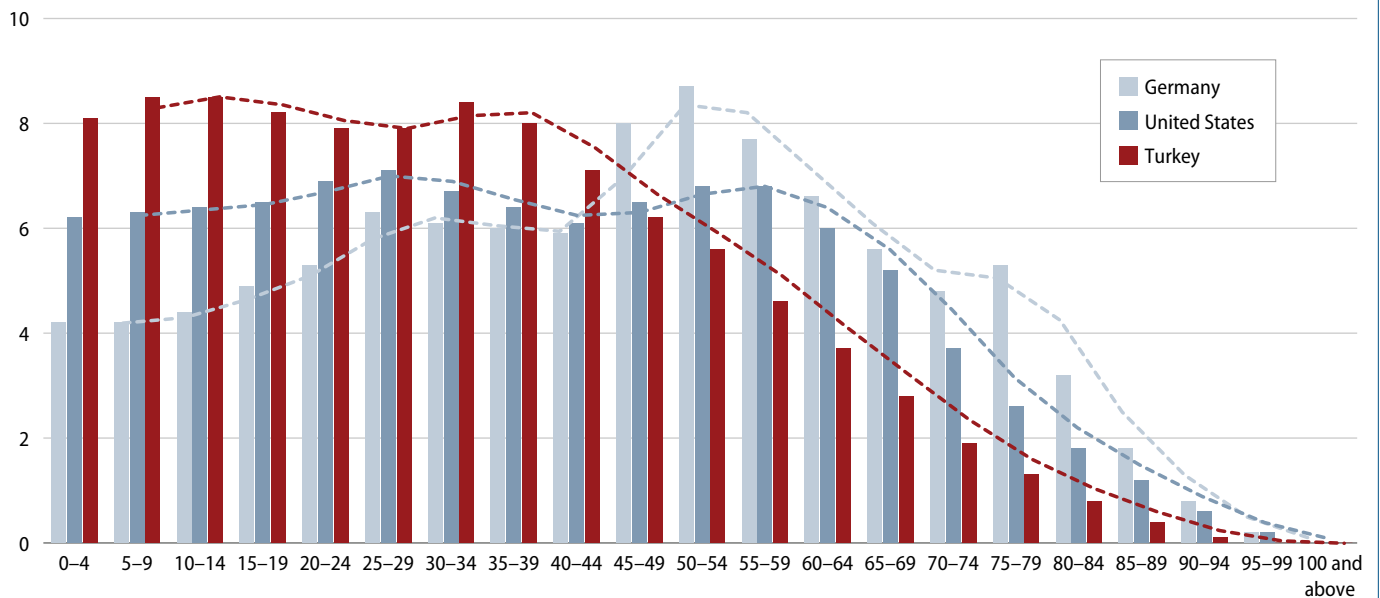
Demographic change

Turkey currently has a very young population, with more than a quarter of the country aged 14 or younger. This provides a demographic “window of opportunity” for Turkey, meaning that a well-educated younger generation could become a powerhouse of production, ensuring the sustainability of government pension systems and the well-being of the elderly for years to come.⁵³ The key to unlocking this potential is education, and Turkey should make a major effort in this regard as soon as possible in order to take advantage of the current demographic window.

In fact, Turkey's demographic advantage is already slowly changing. In 2012, only 7.5 percent of the population was aged 65 or older, and the median age was 30.1 years. In 2023, it is estimated that 10.2 percent will be 65 years old or older, and the median age will rise to 34 years.⁵⁴ The population in that year is estimated to be roughly 85 million people. By 2050, it is estimated that the median age will be close to 43 years, and that same year, the Turkish population will level off at 93.5 million and then begin a gradual decline.⁵⁵

FIGURE 8
German, American, and Turkish age cohorts

5-year distribution by percentage of population



Source: Bureau of the Census, "International Programs: International Data Base," available at <https://www.census.gov/population/international/data/idb/informationGateway.php> (last accessed May 2016).

As population growth rates diminish in wealthier western Turkey—presumably because of the expected economic and social reasons that wealthier societies face declining birth rates when there are enhanced educational and career opportunities for women—population growth rates remain high in the predominantly Kurdish-populated provinces in the east and southeast of the country. Economic growth is similarly lopsided in Turkey, with the western part of the country being quite developed and the eastern part being relatively undeveloped. This economic imbalance is likely to grow with demographic change if Turkey does not fully embrace the education reforms required to better equip all of the nation's youth. If not addressed, increasingly unequal educational outcomes could possibly disturb Turkey's prospects for sustainable and equitable growth as well as pose additional long-term challenges to Turkey's sociopolitical fabric.

Ongoing urbanization

Movement from rural areas to cities became a discernible trend in Turkey in the 1950s, as democracy brought to power a market-oriented government intent on developing Turkish industries. By 1983, Turkey was already a majority-urban country, and the process of urbanization accelerated throughout the 1980s, driven by further free market reform and globalization and diminishing Turkey's economic insularity and linking it to the world economy. By 2014, Turkey was 73 percent urban. Regarded as predominantly rural throughout most of its republican history, Turkey will celebrate its 100th anniversary in 2023 as a heavily urbanized and globally integrated country.⁵⁶

Before the 1980s, urbanization mainly took place in Istanbul, Ankara, and the western coastal cities. After the 1980s, this urbanization began to spread throughout Anatolia, led by cities such as Gaziantep, Kayseri, Konya, and Eskişehir. Galvanized by exports and stronger links to Europe, a “new middle class” that embraced entrepreneurship emerged in the Turkish heartland.⁵⁷ Holding fast to their traditional values and building on domestic family and business networks, this group has been the primary driver of Turkey's recently accelerated urbanization.

However, Turkey's cities will need to become more competitive and dynamic in the next decade. Decentralization, local democracy, and inclusive growth strategies to give cities more control over their economies will help sustain the success of central Anatolian cities and other Turkish cities.⁵⁸ Yet in recent years, a disconnect has emerged between the governance requirements for local growth and the more controlling tendency that animates the central government. Like its predecessors, the AKP government has preferred strong and centralized governance, asserting control over local authorities rather than pursuing collaborative interactions. This has created problems for Turkish cities, often hampering their engagement with foreign companies and investors and slowing economic growth. Overcoming this problem will require a significant change in attitude on the part of Turkey's ruling elites—specifically, a willingness to embrace the devolution of some decision-making on economic questions to local governments in the interests of society as a whole.

Influx of refugees

Many of the nearly 3 million Syrian refugees now residing in Turkey are likely to remain in Turkey due to the ongoing Syrian civil war, even if the fighting subsides.⁵⁹ Turkey needs to find a humane way to integrate these people into society. In doing so, the country should seek to maximize the benefit of Syrian human capital—such as professional talent and skilled labor—while minimizing societal dislocation.

The challenge presented by such a large refugee population is daunting. For the good of both the refugees and for Turkish society, this community must be integrated as soon as possible. Above all, this will require an emphasis on education, including Turkish-language instruction. But language instruction and basic education will not be enough; instruction should be planned with an eye toward workforce development and should be paired with assistance in securing long-term housing, effective health services, better municipal services, and social and cultural integration into Turkish life.⁶⁰

Turkey faces important decisions regarding the future of the refugees. What will be the legal basis for Syrians' long-term presence in Turkey? Will they remain under temporary protection or will they be given a more permanent status, such as full-fledged refugee status under the 1951 U.N. Convention Relating to the Status of Refugees or even citizenship?⁶¹

Thus far, the socioeconomic dimension of the refugee crisis has followed a familiar—and worrying—contour. Many jobless Turks blame their unemployment on the presence of cheaper Syrian refugee labor. Although the Syrian influx has not affected Turkish unemployment rates in a significant way—likely due to the new arrivals' disadvantage of not speaking Turkish—the employment of Syrians without work permits has indeed depressed wages in some local industries. Similarly, Syrians living outside the refugee camps have driven up the cost of renting apartments in various communities in southeast Turkey.⁶² In addition, refugees are also often blamed—again, usually falsely—for crime and other communal problems.

At the same time, some Turkish communities have clearly benefitted economically from the Syrian presence.⁶³ Whether or not the refugee influx benefits Turkey economically in the end will depend on factors such as the education and skill level of refugees who remain in Turkey and Turkey's ability to provide them with educational and professional opportunities.⁶⁴

Conclusion: Sequencing the reforms

The sooner Turkey implements relevant reforms the faster it will become a high-income country. In general, the less a given reform impinges on existing political prerogatives, the more readily it can be implemented. Therefore, most of the macroeconomic reforms discussed above could be initiated quickly since there is general Turkish agreement on free market solutions for economic problems. Obviously, political parties will have different views on specific reforms, but there is at least a reasonable prospect for consensus on major macroeconomic reforms.

Moreover, Turkey's macroeconomic balances are still strong, facilitating further macroeconomic reform. In 2015, the government debt-to-GDP ratio was 32.9 percent, and the budget deficit-to-GDP ratio was 1.2 percent; both of these figures represent record or near-record lows for Turkey.⁶⁵ This suggests that the Turkish government has the capacity to invest in infrastructure projects and compensate any immediate negative effects of labor market reforms and other reforms.

Educational reform—whether through teacher training, reduction in teacher-student ratios, curriculum reform, or other initiatives—should be undertaken immediately. Policies to encourage innovation and high-tech production, including university-business partnerships, should also begin as soon as possible. Legal protections of university autonomy would be helpful in this regard. Although all parties formally agree on the importance of good education, budgetary and interest group politics are likely to get in the way. Nevertheless, boosting Turkish educational outcomes is critical to developing a significant high-tech sector that, in turn, can vault Turkey into high-income status as a country.

Encouraging the development of an independent and nonpartisan judiciary—as well as nonpartisan prosecutors and police—is a long-term process, which requires increased professionalization as well as the erection of new firewalls to prevent government interference. Ensuring that the Central Bank and regulatory agencies are independent and nonpartisan may be easier goals to accomplish. In some cases, such as that of the Central Bank, it is simply a matter of respecting

the decisions of current officials. In other cases, such as that of the Competition Authority, it requires new legislation. The government's willingness to loosen its grip on society and share—rather than accumulate—power is critical to these types of reform. The atmosphere following the 2001 economic crisis induced a sense of urgency that produced significant regulatory reform; such urgency no longer exists, which means persistent top-level leadership is likely needed.

The economic impact of educational and institutional reform cannot be overstated. While that impact is inherently difficult to measure, many economists estimate that significant institutional improvement can add 0.8 percent to annual GDP growth, while significant investment in human capital—primarily education—can add an additional 0.5 percent per year, according to economic studies.⁶⁶

Structural political and social reform to resolve longstanding problems—the Kurdish issue, secular-religious tensions, and overcentralization—is the most difficult of all; these are emotionally charged issues about which Turkish citizens have very strong feelings. The solution to each will likely involve the devolution of some power from current elites. Turkey should also embrace reforms that promote greater freedom of expression and other human rights—including freedom of the press—both for their inherent benefits and for the positive impact they can have on transparency and the investment climate.

The reforms discussed herein are perhaps not all essential—witness China's success without any serious rule of law, freedom of the press, or credible democratic institutions—but most high-income countries are democracies, and countries that protect human rights tend to be the types of societies that attract investors and spur innovation. None of the prescribed reforms is easily accomplished, but a crude sequencing of easiest reforms to hardest reforms might look like this: macroeconomic, educational, institutional—including rule of law—and political. The AKP government's willingness to pursue these steps will be determinative in its effort to realize its 2023 economic vision.

Instituting the reforms in the areas listed in this paper may not propel Turkey to the AKP's very ambitious 2023 thresholds, but such reforms would likely lay the groundwork for a prosperous society driven by innovation and good governance—and one that would more than likely leave the middle-income trap behind. As demographic as well as global economic trends indicate, Turkey has little time to lose.

Acknowledgments

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- 57 See Fuat Keyman, *New Middle Classes and Urban Transformation in Turkey* (Istanbul, Turkey; forthcoming).
- 58 See, for example, Tunga Köroğlu and others, “Turkey Urbanization Review: City Competitiveness: Discussion Series #2” (2012), available at http://www.urbanknowledge.org/ur/docs/Turkey_UR_Presentation.pdf.
- 59 According to the UN High Commissioner for Refugees, or UNHCR, there were 2,749,140 Syrian refugees registered in Turkey as of April 11, 2016. This includes approximately 1 million refugees who arrived in 2015 alone. See Syria Regional Refugee Response, “Inter-Agency Information Sharing Portal,” available at <http://data.unhcr.org/syrianrefugees/country.php?id=224> (last accessed May 2016). It should be noted, however, that the UNHCR does not directly register the refugees. Rather, they are registered by the Turkish Ministry of the Interior Directorate-General for Migration Management, and the numbers are then passed by the Turkish government to UNHCR. Because it is not known how many of the refugees have departed Turkey for Europe—possibly hundreds of thousands—it is not clear precisely how many Syrian refugees are currently residing in Turkey. Approximately 300,000 refugees are residing in camps established and run by the Turkish government; the rest live among Turks in Turkish society. Beyond the claimed 2.7 million registered refugees, the Turkish government estimates that there are an additional approximately 300,000 unregistered Syrian refugees. There are also reportedly another 400,000 Syrian would-be refugees camped on the Syrian side of the Turkish border, barred entry by Turkish authorities, their fate uncertain. Another problem with determining the precise number of refugees is that there is no system in place for tracking them after they are registered. For a skeptical view of the figures offered by the Turkish government, see John Butler and S. Keleşoğlu, “Turkey’s Mysterious Disappearing Refugees,” *Balkanist Magazine*, March 9, 2016, available at <http://balkanist.net/turkeys-mysterious-disappearing-refugees>.
- 60 Center for Middle Eastern Strategic Studies and The Turkish Economic and Social Studies Foundation, “Effects of the Syrian Refugees on Turkey” (2015), available at http://www.orsam.org.tr/en/enUploads/Article/Files/201518_rapor195ing.pdf.
- 61 When ratifying the U.N. Convention Relating to the Status of Refugees, Turkey imposed a geographic limitation, asserting that it would accord refugee status only to those fleeing Europe. See Human Rights Watch, “Protecting Refugees,” available at <https://www.hrw.org/reports/2000/turkey2/Turk009-10.htm> (last accessed May 2016). According to a Metropoll survey taken between March 10 and March 14, 2016, Turks oppose citizenship for Syrian refugees, 83 percent to 10 percent. That represents a slight dip from the 81 percent to 14 percent result in November 2014, when the question was last asked. According to the same survey, 69 percent of Turks say they come across refugees every day, and three-quarters regard the refugees as a burden. Asked what most disturbs them about the refugees, 31 percent say the refugees have caused an increase in unemployment, 19 percent cite “begging,” 17 percent say they have increased terrorism and security problems, and 13 percent say they have depressed wages. It is not clear if this last question applied to all Turks or only to those who said they consider the refugees a burden. See Metropoll, “Turkey’s Pulse: Islam, Politics & Violence” (2016), private polling available upon request to the author and with approval from Metropoll.
- 62 Center for Middle Eastern Strategic Studies and The Turkish Economic and Social Studies Foundation, “Effects of the Syrian Refugees on Turkey.”
- 63 For a brief but useful review of the social and economic impact of the Syrian refugee presence on Turkey, see *Ibid*, p. 16–20. For an examination of this impact on various localities in southeastern Turkey, see *Ibid*, p. 21–33. For a more detailed focus on the strictly economic impact, including the differentiated impact on various localities, see Center for Middle Eastern Strategic Studies, “Suriyeli Mültecilerin Türkiye’ye Ekonomik Etkileri: Sentetik Bir Modelleme (Modeling the Economic Effect of Syrian Refugees on Turkey)” (2015), available at http://www.orsam.org.tr/tr/trUploads/Yazilar/Dosyalar/201519_rapor196tur.pdf.

64 In late 2014, Turkey granted Syrian refugees formal legal status for the first time, which gave them access to some basic services, such as health care and education. See Ceylan Yeginsu, "Turkey Strengthens Rights of Syrian Refugees," *The New York Times*, December 29, 2014, available at http://www.nytimes.com/2014/12/30/world/europe/turkey-strengthens-rights-of-syrian-refugees.html?_r=1. In January 2016, Turkey granted Syrian refugees the right to work legally, with certain restrictions: For example, they had to have been resident in Turkey at least six months, they could work only in the province in which they were registered, and they could constitute no more than 10 percent of personnel in most workplaces. Prior to this decision, Turkey had issued only 7,351 work permits to Syrian refugees, on a case-by-case basis, during the nearly five years of the refugee crisis. See Mehmet Cetingulec, "Turkey Grants Syrians Right to Work, But is it Too Little, Too Late?" *Al-Monitor*, January 25, 2016, available at <http://www.al-monitor.com/pulse/originals/2016/01/turkey-syrian-refugees-granted-right-to-work.html>. Cetingulec argues that Turkey erred with its restrictive work permit policy, as many talented professionals and skilled workers among the Syrians, lacking job opportunities, left Turkey for Europe; their potential contributions were thus lost to the Turkish economy.

65 Trading Economics, "Turkey Government Debt to GDP," available at <http://www.tradingeconomics.com/turkey/government-debt-to-gdp> (last accessed June 2016); Trading Economics, "Turkey Government Budget," available at <http://www.tradingeconomics.com/turkey/government-budget> (last accessed June 2016).

66 See, for example, Daron Acemoglu, Francisco A. Gallego, and James A. Robinson, "Institutions, Human Capital, and Development," *Annual Review of Economics* 6 (2014): 875–912, available at <http://economics.mit.edu/files/10415>.

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