

**Labor Market Performance after Structural Adjustment in Developing Countries:  
The Interesting But not so Unique Case of Turkey**

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**ABSTRACT**

After three decades of market-oriented reforms along the Washington consensus, full employment has not yet been materialized in developing countries despite significant gains in fiscal and monetary discipline, and price stability. The current study analyzes the sources of structural transformation in the labor markets of developing countries after liberalization and structural adjustment programs using Turkey as a case study. We argue that the experience of Turkey as a major developing country with almost three decades of liberalization experience is not unique and can help determine the causes of disappointing labor market performances observed in other countries. In exploring the sources of sluggish employment creation major attention is given to liberalization, fixed capital accumulation, growth and labor market interaction. The paper also explores the effects of liberalization programs on labor market flexibility, distribution, wage-productivity link, and gender divisions in labor markets.

## INTRODUCTION

Starting from early 1980s developing countries have accelerated their efforts to integrate their goods and financial markets with those of developed countries. Based on the assumption that free flow of goods and capital and the inherent efficiency and self-regulating capacity of free markets inevitably generate the most optimal allocation of resources, economic policies adopted around the world have become standardized, although with considerable costs in many cases. After almost three decades of this liberalization process, the performances of developing countries exhibit some common traits in terms of *success* achieved in the end that are yet unlike those predicted by their architects.

Given the inward oriented economic structure of most developing countries with a heavy public sector presence both in the production and organization of market activities, the ambitious program of liberalizing goods and capital markets and opening them to global competition was expected to bring about macro stability, enhance business confidence to invest in productive sectors and generate new employment opportunities, and stimulate growth. In retrospect, however, it has become extremely difficult to call the reforming countries as success stories especially with regard to capital accumulation, growth, labor market performance and macroeconomic stability. In this respect, as can also be seen from the Post-Washington consensus debate, there is a growing controversy among economists on the underlying reasons behind the dramatic gap between the expected gains from market led outward oriented growth path and the depressing results that have been achieved so far. The point of departure is whether the *disappointing performances* are because of: domestic policy failures, timing and sequencing mistakes, or the inherent difficulties and distortions created by the reforms themselves. A major source of contention is the fact that despite the exponential growth in capital flows (to the extent that the share of world annual foreign exchange transaction to world GDP increased from 2/1 in 1973 to 17/1 in 2007) fixed capital formation and income growth is slower in both developed and developing countries. Sluggish employment growth that has increasingly become disconnected from output growth is another striking feature of the post-liberalization era in many developing countries. After decades of market-oriented reforms along the Washington consensus, high growth and full employment have not yet been materialized despite achieving fiscal and monetary discipline and price stability. It is exactly at this point that labor market reforms through deregulation and increasing flexibility are put at the core of suggested policy solutions for recovering capital accumulation, low employment generation and growth. However, significant cuts in real wages and deregulation of labor markets have not yet lead to higher employment gains.

In this paper, we focus on the question of labor market reaction to neo-liberal liberalization and structural adjustment programs in developing countries using Turkey as a case study. We argue that the experience of Turkey as a major developing country with almost three decades of liberalization experience is not unique and can help determine the causes of disappointing labor market performances observed in other countries. Major attention will be given to capital accumulation, growth and labor market interaction as well as the sources of sluggish employment creation. Regarding the selection of Turkey, the choice was not random. Briefly, Turkey has not only been among the forerunners of

trade and financial liberalization among developing countries starting from early 1980s, but also faced potential negative effects of financial liberalization first hand through two major financial crises in 1994 and 2000-2001. During this period, the standard deviation of real GDP growth steadily increased from 3.5 in 1980-89 to 5.2 in 1990-1999, and to 6.1 between in 2000-2005. Moreover, the coefficient of variation of annual real Short-term Capital Inflows increased three-folds from 1982-1989 to 1990-2005.<sup>1</sup> Private firms, on the other hand, have continued to face credit rationing and been forced to finance their investments mostly from internal sources and short-term borrowing. As of 2007, the share of short-term debt in total debt of top 500 manufacturing firms was around 70% that made them more vulnerable to changes in expectations and macro fundamentals. Furthermore, while the share of manufactures exports exceeded 90% in 2008, we also observe a continuous decline in the share of manufacturing value added in GDP from around 22% during 1995-2001 to 17% during 2002-2007 with a low of 16.6 % in 2007, which is the lowest level since 1980. During this period, the manufactures sector share in total non-agricultural employment also declined from 28% in 1980 to less than 26% in 2008.

## **1. STRUCTURAL ADJUSTMENT, WASHINGTON CONSENSUS AND LABOR MARKET FLEXIBILITY**

The adoption of Washington consensus and the accompanying liberalization of goods and capital markets led to increasing pressure on both developed and developing countries to deregulate their labor markets. The persistently high unemployment rates in Western Europe compared to the US also provided further support to the free labor market supporters who blamed the '*rigid*' labor market institutions for low employment generation. Labor market flexibility, as a result, increasingly became a central point of policy debates regarding the causes of high unemployment rates. As commonly understood, labor market flexibility refers to both wage flexibility (that is constrained by institutional factors including collective bargaining, minimum wage settings, unemployment benefits and non-wage labor costs including social security and insurance costs) and easiness with which employers can fire/hire upon demand (that is constrained by legal employment protections) (Taymaz and Ozler, 2004).

To be more specific, labor market flexibility includes both internal and external flexibility (Keller and Seifert, 2005: 307-308). Accordingly, internal flexibility includes: i) *Internal numerical flexibility*, which is the employer's ability to change the number of working hours in the face of fluctuations in capacity utilization; ii) *Internal functional flexibility*, which allows the employer to handle "changing output requirements by reorganizing work processes"; iii) Internal wage flexibility that allows firms to "diverge from collective agreements"; iv) Internal temporal flexibility that allows firms to use part time or temporary work arrangements. External flexibility, on the other hand includes: i) *External numerical flexibility* defined as the employer's ability to adjust the number of employees to current needs through hiring and firing as well as through the use of

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<sup>1</sup> The real and nominal exchange rate volatility (defined as the annual standard deviation of the monthly percentage change in real and nominal exchange rates respectively) have also increased by 28% and 55% from 1982-89 to 1990-2005.

temporary or fixed term contracts; ii) *External functional flexibility*, which “involves improving the ability of the workforce to adapt to the external labor market”; iii) *External wage flexibility*, which involves the availability of wage cost subsidies to reduce labor costs.

The central claim is that inflexible labor markets: increase cost of hiring and firing for firms; make them less responsive to changes in output demand; cause higher than equilibrium level wages; and encourage informalization as firms try to bypass restrictions in the formal labor market.

Nevertheless, in addition to inconclusive empirical support for the claimed benefits of flexible labor markets, there are also theoretical counter arguments. First, even within the neo-classical framework, labor market flexibility may slow down investment in human capital by the firms as they use short-term and temporary contracts with no commitment to long term job security. As a result growth may slow down as human capital accumulation lags behind (Taymaz and Ozler, 2004). Furthermore, labor market flexibility may also affect the pattern of industrial specialization given that “countries with coordinated industrial relations systems and strict employment protection tend to specialize in industries with a cumulative knowledge base because coordinated industrial relations and employment protection encourage firm-sponsored training as well as the accumulation of firm-specific competencies” (Bassanini and Ernst, 2002 quoted in Taymaz and Ozler, 2004:4). Therefore, stable employment contracts, higher wage rates and more rigid flow of labor tend to make investment in human capital and training activities more profitable for firms as skill level of work force increases and leads to productivity gains.

In addition, economists outside the neoclassical tradition also point out several channels through which a flexible labor market can hurt long term growth and development. The list includes Keynesian efficiency wage theories where a higher than equilibrium wage may have positive effects on worker productivity through better worker motivation and health, lower shirking, better self selection into matching jobs, and also lower average costs through lower turnover rate. Furthermore, the Kaleckian and Structuralist tradition emphasizes the effects of income distribution on capital accumulation and growth especially with respect to the wage-led vs. profit-led growth dichotomy (Dutt, 1984; Taylor 1991, ch.3). As discussed by Taylor (1991: 82) “when output is the chief macroeconomic adjusting variable, real wage increases can either stimulate or hold down capacity utilization and the growth rate. Outcome depends on interactions between distribution and demand in a Kaleckian framework ... Beside output, the profit and growth rates may also increase in response to a higher real wage.” Income redistribution in favor of profits stimulates economy depending on whether or not the profit-earners have lower saving rates than workers and/or investment is highly sensitive to profit rate (profit-led growth). In contrast, if investment is more responsive to consumer demand and that workers have lower propensity to save, then a redistribution towards workers (wage-led growth) would increase profit rate and capital accumulation as capacity utilization rises. Existing evidence, as reviewed by Taylor (1988) based on 18 WIDER case studies, suggests that increasing real wages may in fact increase output, profit and growth rates.

Finally, the high degree of informalization of labor markets, repressed and disfranchised labor unions, falling real wages, low levels of minimum wages and lack of

unemployment benefits (that all reduce labor's bargaining power) in the aftermath of structural adjustment policies in most developing countries do not support the arguments that explain poor labor market performance with labor market rigidities. Also, the text-book example of using labor market rigidities to explain high European unemployment rates do not pass scrutiny tests given that countries with the most rigid labor market institutions (such as Scandinavian ones) are not necessarily the ones with higher unemployment rates (Nickell, 1997). Thus, the argument that "European unemployment is high because European labor markets are "rigid" is too vague and probably misleading. Many labor market institutions that conventionally come under the heading of rigidities have no observable impact on unemployment" (Nickell, 1997:73).

### **1.1. Structural Adjustment in Turkey: Changes in the Bargaining Power of Labor<sup>2</sup>**

The inward oriented Import Substituting Industrialization (ISI) model with its standard policy tools (such as high trade barriers, negative interest rates and overvalued exchange rate) combined with high degree of bargaining power of labor led to rising real wages in Turkey during most of the 1960-1980 period (Senses, 1994, 1996; and Figure 1 below). In fact, between 1963-1976 average real wages rose by around 50% (Köse ve Öncü, 2000). Rising real wages were also consistent with the domestic demand led ISI model.

In this background, January 24, 1980 when the Turkish currency was devalued by 49% and a new set of economic policies were announced by the government represents the departure point of the Turkish economy from its ancient regime. Following the 1980 balance of payments crisis, Turkey emerged as a test case for the World Bank (WB) and International Monetary Fund (IMF) joint programme involving cross conditionality along what was later to be termed Washington consensus. The program designed by these twin institutions and implemented by a World Bank trained economist, Turgut Ozal (who later became the prime minister and then the president), aimed at stabilizing and liberalizing the closed-inward oriented economic structure of Turkey and at shifting it to an outward-oriented path of development based on export-led growth model with a pro-capital distributional emphasis.

The new economic (and political) paradigm aimed at reducing the size of the public sector involvement in the real sector through its operations of State Economic Enterprises (SEE) as well as at reducing the degree of intervention in the organization of the market activities and at the same time shifting the balance in favor of capital (i.e. profit-led growth model) using wage repression, controls on labor power, and fiscal policies via reducing taxation on capital. Following these changes, the share of public investment expenditure in GDP fell from around 9% during early 1980s to 7% during 1989-1994, 5% during 1995-2001 and 4% during 2002-2007, with a low of 3% in 2007, which marked its lowest level since 1980.

**<Insert Figure 1 Here>**

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<sup>2</sup> Unless stated otherwise, from here on the data are from the following sources: World Bank's (WB) World Development Indicators, IMF's International Financial Statistics (IFS), Turkish Statistical Institute (TURKSTAT), and Central Bank of Republic of Turkey (CBRT).

Meanwhile, on the public finance side, the tax burden increasingly became unequal and regressive concentrating on low income groups. The share of indirect taxes in total tax revenues increased from 37% in 1980 to 58% in 1995 and to 73% in 2007 while the share of corporate income tax dropped from 9.5% in 1995 to less than 1% in 2007. As can also be seen from Figure 2 below, the tax rate on profits is one of the lowest among OECD countries.

**<Insert Figure 2 Here>**

In terms of sequencing of the reforms, it was a semi-heterodox program starting with trade liberalization, followed by first domestic and later external financial liberalization in 1989, bringing the degree of trade openness fully in line with EU standards in 1995 after customs' union agreement, and finally accelerated privatization program after 2000.

During the early stages of the reform program, the policy shift from domestic-demand-led to external-demand-led growth model required the suppression of labor costs for improving international competitiveness and contracting domestic absorption, especially given large increases in other production costs such as the cost of borrowing (thanks to rising interest rates after domestic financial liberalization), import costs of inputs and capital goods (thanks to devaluation of currency), rising input prices provided by SEEs, and increasing import competition (Boratav, 1991a). Yet, the wage suppression and restraints on labor's bargaining power would have proved difficult under a democratic regime, but as elsewhere (such as in Chile) a military coup made it easier for pro-free market (but not pro-democracy) policy makers. Thus, the structural shift from ISI regime to free market model took place under a military dictatorship (starting from September 12, 1980) that, seeing organized labor as an obstacle for free-market reforms, imposed strict restrictions over labor union rights and shredded labor's bargaining power during 1980-1983 (including severe restrictions on union activities and collective bargaining rights, banning strikes, closing the second largest labor union, DISK etc.) (Boratav, 1990). Furthermore, changes under military dictatorship became institutionalized through the 1982 constitution and the accompanying changes in labor law, tax codes etc. As a result, even after the re-transition to democracy in November 1983 considerable restrictions over labor's bargaining power continued to be held (up until 1987) together with a continuing ban on the political parties established before the 1980 coup. It was, therefore, no surprise that the organized labor appeared as one of the main losers under the new economic model.<sup>3</sup>

While real wages in manufacturing displayed a steady increase from 1950 up until 1978, it declined sharply after that (Figure 1). Comparatively speaking, the decline in wages was not as strong in public sector as in private. Taking 1977 as the base year, real wages were down by more than 40% by 1986 (Figure 1). During this period, strike activity (as a measure of strength of organized labor) also significantly declined (Figure 3). As discussed by Nelson (1991), one would expect a significant difference in governments' attitudes to labor militancy depending on the regime type. In general, union

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<sup>3</sup> For further analysis of labour market response to structural adjustment, see Onis (1988), Celasun (1989), Boratav (1990), Yeldan (1995), Boratav, Turel and Yeldan (1996), Senses (1994 and 1996), Metin Ozcan, Voyvoda and Yeldan (2001), Boratav and Yeldan (2002).

activity and bargaining power is more likely to be repressed under authoritarianism than democracies, which proves exactly to be the case in Turkey. Likewise, union membership rate, power of union confederations, and the scope and extent of collective bargaining are expected to be inversely correlated with strike activity and unemployment rates (Cameron, 1984). Walton and Ragin (1988) also found a strong correlation between the unionization rate and the degree of popular protests against austerity between 1976 and 1987 in 26 countries.<sup>4</sup>

**<Insert Figure 3 Here>**

Although the transition to democracy started in 1983, limitations on labor's bargaining power continued up until 1987. In this regard, the second phase of Structural Adjustment Program (SAP)-labor markets dynamics started in 1989 (that marks first after-coup free elections) and lasted till 1993 (right before the financial crisis of 1994). During this period the public and private labor regained part of their losses by forcing raises in real wages (Figure 1). In fact, by 1989, real wages recovered to their 1980 levels thanks to rising labor's bargaining power as well as the political considerations of the ruling government.

Increasing labor assertiveness during the late 1980s and early 1990s also led to increasing calls by employers for a more flexible labor market including more deregulated labor law, restraints on collective bargaining and smaller public sector employment (a topic we will discuss more in detail in the next section). Increasing labor assertiveness also showed its effects through increasing use of subcontracting, informalization, and job cuts by private sector firms.

By 1991 real wages recovered to and exceeded their preceding peak in 1978 while wage/value-added ratio remained "substantially behind the all-time peak due to productivity improvements, which took place during the period" (Figure 1 and Figure 4; and Boratav, Türel and Yeldan, 1994: 45). The manufacturing sector real wages increased by 51% from 1988 to 1990 that also underlined the correction speed of the forced downward adjustment in real wages. The Turkish experience also highlights the limits of relying on wage suppression alone for improving competitiveness. On the other hand, the public sector enjoyed even a steeper wage hike than the private sector. In fact the public/private real wage ratio increased from 1.42 in 1988 to 1.76 in 1990 (Boratav, Türel and Yeldan, 1996:379). Nevertheless, while during 1991-93, real wages on average rose by 25% compared to their 1977 levels, this was not sustained during the following period. The 1994-97 period led to the reversal of labor's gains during the previous period thanks to the effects of 1994 financial crisis that led to 45% depreciation of the currency in April, sky-rocketing interest rates, rising inflation and -6% GDP growth in 1995. Real wages fell significantly accompanied by sharp falls in formal employment. As a result, following the 1994 crisis real wages in manufacturing fell back to their 1977 levels. Similarly, the positive improvements during 1999 and 2000, on the other hand, were eroded after the 2000-2001 crisis. On the other hand, real wages (earnings) in manufacturing fell by 17% (14.4%), 5.6% (8.3%) and 2% (6.5%) in 2001, 2002, and 2003 respectively with an accumulated fall of 22% (26%) compared to their 2000 levels.

Yeldan (2005: 10-11) argued that "this contraction was especially pronounced in

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<sup>4</sup> For a detailed discussion see Nelson (1991).

US\$ terms. In the meantime productivity gains in private manufacturing accelerated especially after the first quarter 2002. It is known that this productivity surge was due mostly to labor shedding, rather than increased labor efficiency originating from advances in technology. As of the last quarter of 2003, index of labor productivity scored 1.77-folds higher than real wages in TL [Turkish lira], and 2.29-folds higher than the unit wage costs in US dollars.”

**<Insert Figure 4 Here>**

By 2006 labor productivity increased to 162.4 index points (1997=100), while the index of wage per hour and the real earnings per labour declined to 93.1 and 85.4 by 2006 (Figure 4). However, to further underline the changes in the relative bargaining power of labor, we also look at the relative share of wages in value added (Boratav, 1990, 1991a). Accordingly, the share of wage labor in manufacturing value added was reduced from 34% in 1976 to 17% by 1987. After a temporary recovery during early 1990s, it was again cut from 25% in 1991 to 16% by 1994 and 2001 (Figure 5).

**<Insert Figure 5 Here>**

Under mark-up pricing wage/value-added ratio ( $W/Y$ ) is determined by mark-up rate, and by the relative cost of nonlabor inputs and wages. Thus, given this framework, the factors which can reduce  $W/Y$  are: “increased mark-up rates, increased capital intensity of production under unchanging relative prices (constant real wages in terms of nonlabor input costs), and a decline in real wages (in terms of input costs), that is relative increases in intermediate costs (in terms of labor costs)” (Boratav, Türel ve Yeldan, 1996:379; also see Boratav, 1990).

In terms of distributional impacts, Boratav (1991b) shows that the rate of profit increased from 26.5% during 1963-79 under the ISI regime to 34.3% during 1980-88 under structural adjustment. During the peak of trade liberalization and export promotion era of 1984-88, the rate even increased as high as 35.6% (Boratav, 1991:39). Likewise, Memis (2008) found that the rate of profit (defined as the ratio of net profit before tax to net capital stock) rose from 15% during 1970-79 to 25% in 2000 (with a peak at 30% in 1996). Karahanoğulları (2008:296) also calculated that while the rate of profit in manufacturing industry increased after 2001, it declined in 1991, 1997, 2001 and 2004. On the other hand, the median (mean) profitability (net profits before taxes/net sales) of largest private 500 manufacturing firms steadily declined from 13% (13%) in 1979 to 6% (6.4%) in 1986 and further down to below 3% (4%) in 2005 with a minimum of 1.4% in 2001 (-2.2%) (despite a recovery to 9% (12%) during 1994-95). We also observe a steady increase in cross sectional volatility of profitability rates. Likewise, Eres (2007) finds a general decline in average profitability rates during 1968-2001 with an increase in its volatility.

## **1.2. Structural Adjustment: Labor Market Flexibility**

Onaran (2002) in an industry level panel study on Turkey found that the real wage flexibility with regard to unemployment increased in the post-liberalization period. We also see an increasing informalization of labor markets that now accounts for a quarter of

urban employment. Informal enterprises provide significant flexibility for themselves and for larger firms using them as subcontractors through cost cutting given that they are free of rules and regulations in the product and labor market (including health, safety, environmental regulations, tax obligations, social security payments, union pressures etc.). In fact, it is suggested that wages in such firms are even below the already low minimum wage (Kose and Oncu, 1998). It is estimated that “only 3% of full-time formal employees [in Turkey] earn less than the minimum wage. In contrast, 44% of informal employees earn less than the minimum wage” (OECD, 2008: 89). The presence of such large informal sector allows cost cutting in the formal sector through two channels, first direct gains from subcontracting at lower costs, and second, through undermining labor’s bargaining power and creating a buffer zone for labor militancy.

In terms of the employer social security contribution and payroll tax burden, which, as elsewhere<sup>5</sup>, is often cited as one of the top reasons for low formal employment growth, Turkey has the lowest upper limit (with 58% of average worker wage) among all OECD countries (OECD, 2007). The share of employer’s social security contributions in GDP (with 3%) also has been lower than the 18 of 26 OECD countries where data were available in 2004 (OECD, 2006)

The pattern of change is also visible in Figure 6, which shows that the employees’ and employers’ social security contributions and personal income tax as a share of gross labor costs first fell from around 54% in 1979 to 37% in 1985 then went up to 40% in 1993 before falling to 35% in 1995; after the crisis in 2001 it stabilized at around 43% (ending with 43% in 2007). Comparatively speaking, however, it was not higher than some other Eastern European countries despite being higher than OECD average. Another sign of low levels of government regulation in the labor market is the lack of supervision (Figure 7). Compared to other developing countries in OECD, not only the number of labor inspectors in Turkey (and Mexico) is significantly below the ILO recommended level but also is on the decline over the past decade.

**<Insert Figure 6 and 7 Here>**

Furthermore, it needs to be noted that during the entire period under SAP and up until recently in 2002, there was no unemployment insurance system. Even now the existing unemployment insurance system is not a binding force in labor market given that only 5% of the unemployed received benefits in 2007 (OECD, 2008: 109). Not only the qualification period is very long (600 days in 3 years and 120 days of continuous contributions) restricting access to it significantly (OECD, 2008), but also the high level of informality prevents workers from qualifying for it. Instead, it turned into a potential funding source for successive governments. Also, among all OECD countries, (excluding Japan) Turkey is the only country where workers lose unemployment benefits as soon as they take up work (OECD, 2005).

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<sup>5</sup> This is by far the most common explanation by the IMF, WB, and OECD for low employment growth and high share of informal markets in developing countries. Amadeo and Pero (2000) show that the same explanation (high level of legal taxes and wage bill), is often used to explain declining formal employment in Brazil.

Nevertheless, OECD (2008:89) continued to argue that “low productivity, rather than false reporting of income to avoid tax or social contributions, explains much of the distortion in the earnings distribution around the minimum wage [that is the probability of earning less than minimum wage].” Therefore, as a policy response to informality, OECD (2008) recommended: reducing the already low minimum wage and limiting its further increases, paying lower minimum wages to younger workers, and differentiating minimum wage on a regional basis where low GDP regions would be given lower minimum wage rates. Yet, after admitting that “a large proportion of informal workers earn far less than the minimum wage, and quite substantial reductions in the minimum wage would be required to make much impact on informal employment”, the report goes on to suggest the standard prescription of *reducing non-wage labor costs* (including income and social security taxes) (OECD, 2008:91) . As an alternative solution, only at the end it mentions investing in education and training to increase labor productivity. The sources of low employment generation, especially with regard to investment, are not mentioned at all. Likewise, possible link from trade liberalization to informalization is also ignored despite existing mixed evidence.<sup>6</sup>

As a last point, we also expect the degree of labor militancy to be inversely correlated with the business cycle, decreasing in good times and increasing in bad times. Therefore, it is reasonable to find a negative correlation between number of strikes and economic cycles. However, the degree of labor responsiveness will probably be a function of the degree of labor market flexibility and institutional setting. Epstein (1988), for example, finds very high negative correlation between increasing unemployment and the number and size of labor strikes in seven Latin American countries in response to austerity programs during 1976-1984. In the case of Turkey, looking at the simple correlation coefficient between number of strikes and GDP growth we find different results based on different periods. First, as expected, we find a strongly negative relationship during 1973-80, with a coefficient of -0.66. However, during and after the SAP, it became 0.16 during 1984-95, and -0.05 during 1996-2007. As can be seen Figure 8, the link between labor militancy and economic growth increasingly became weaker and weaker after the first half of the 1990s, which we interpret as decreasing bargaining power of labor and increasing labor market flexibility.

<Insert Figure 8 Here>

### **1.3. Structural Adjustment: Privatization and Downsizing of State**

Prior to 1980s, the share of public sector employment in Turkey, as in other developing countries, was very high with significant spillover effects on the employment policies of the private sector (for a discussion on this topic see Nelson, 1991). Following SAPs, however, the value added to GDP ratio of State Economic Enterprises (SEEs) fell from

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<sup>6</sup> According to Ghosh and Paul (2008), trade liberalization is accompanied by rising informality in labor markets of 18 Eastern European and post-Soviet countries. On the other hand, Goldberg and Pavcnik (2003) did not find any positive effect of trade liberalization (measured by tariff rates) on informal labor markets in Brazil and Colombia.

8.5% in 1985 to 2.6% in 2005. During the same period the total employment at SEEs dropped from 635,000 to 247,000. According to Heller and Tait (1984: 35), "central government decisions on wages and salaries in developing countries are likely to affect 15% to 40% of employed workers in the urban labor market and therefore have a pervasive 'leverage' effect on domestic unit wage costs." In fact, it is found that workers dismissed from privatized state enterprises in Turkey experienced significant earnings losses upon re-employment amounting to an average of 66% (Tansel, 2002).

Furthermore, recessions, and fiscal and financial shocks are expected to hurt public sector workers less due to political considerations of policy makers and patronage. As a result, given higher job security at the public sector, the effect of financial crisis in 1994 and 2000-2001 is felt more due to declining public sector ownership and employment. In this respect, the share of personnel costs in public expenditures is a good indicator of the weight of public workers importance for policy makers. Looking at the share of personnel expenditure in total (non-interest) government spending, we can see the same trend governing the private sector wages. Accordingly, the share of personnel expenditures fell from 36% in 1979 to 21% in 1986 then went up again to 42% by 1992. After 1992, however, it displayed a steady decline up until now, with a 15% in 2008 (Figure 9).

**<Insert Figure 9 Here>**

On the other hand, the privatization experience of Turkey did not follow a straight line resulting from the ongoing struggle between the pro and anti privatization groups and institutions (see Ercan and Onis, 2000). As a result, despite the fact that the move towards privatization had started much earlier than most developing countries, it has been much limited in scope and in its success. Accordingly, between its starting date in 1986 and 1999, total proceeds from privatization program has been only \$4.7 billion in current prices (Figure 10). Yet, the years 1995-2000 clearly marked an increased clash between pro and anti privatization groups. Ercan and Onis (2000) also pointed out that the intra-bureaucratic conflicts within as well as between different segments of the state (e.g. the Constitutional Court) or the bureaucracy (e.g. the Treasury or the Ministry of Finance) created additional obstacles.

**<Insert Figure 10 Here>**

The initial rationalization for such a radical change towards privatization in a heavily state-controlled economy included the standard productive and operating efficiency arguments and the moral hazard problems. However, over the course of time the main motivation for privatization has become financing public sector deficits rather than improving the efficiency and competitiveness of these firms and the market in which they operate. In other words, revenue generation has steadily replaced the efficiency gain arguments. Consequently, thanks to the rising public sector indebtedness and costly financial crises in 1994 and 2000/2001, privatization of large and often profitable and marketable SEEs became a top priority of successive governments. The program further accelerated its pace after 2000-2001 that marked the most serious economic crisis in its history (Figure 10). In fact, the policy makers capitalized on the crisis and managed to persuade the shocked public to accelerate the privatization of previously controversial and politically challenging SEEs. The appointment of the World Bank vice president, Kemal Dervis, as the minister of economy to calm the markets and to ease access to

foreign financing also helped speed up the privatization process without much political opposition. Overall, the public sector has withdrawn completely from cement, animal feed production, milk-diary products, forest products, handling and catering services, and petroleum distribution sectors. Moreover, more than 50% of the public sector shares have been privatized in tourism, iron and steel, textile, sea freight and meat processing sectors, the ports and petroleum refinery sector.

## **2. LABOR MARKET DYNAMICS IN TURKEY**

The Turkish labor market experienced a significant structural transformation since early 1980s including: declining share of agricultural employment, falling participation rates (especially for women), increasing informalization, decreasing labor's bargaining power, falling real wages and increasing unemployment, increasing labor market flexibility, and the weakening of the link between economic growth and employment (Boratav 1990, 1991a, 1991a' Sensen 1994, 1996; Mütevellioglu and Işik, 2009:160). In contrast to the general claim that explains the persistence of labor market problems listed above by institutional rigidities and incomplete adjustment to external markets, several studies explain them by exactly the opposite development, that is increasing integration of the Turkish economy to global markets (Ercan and Özar, 2004; Onaran, 2000; Boratav, Yeldan and Köse, 2000). In this respect, the increasing labor market flexibility during the 1980s and 1990s has been intensified during the 2000s through changes in labor and social security legislations. For example, the article 4857 (2003) of the labor law made it easier for firms to hire temporary and part time workers with no unemployment benefits or severance pay. In addition, the article 5510 of the Social Security and General Health Insurance law severely limited pension and social security rights.

Before proceeding further, we need to point out that reaching accurate and reliable data on the labor market characteristics in Turkey continues to be a fundamental problem. For this reason, it is important to keep in mind that official data on the labor market and income distribution do not fully reflect the adverse conditions that have emerged as a consequence of the transformations mentioned above. Despite these limitations, in this section we will try to analyze the structural transformations in the Turkish labor market by relying on the data of the Turkish Statistical Institute (TURKSTAT).

**<Insert Table 1 Here>**

### **2.1. Participation Rates**

The most recent projections regarding the demographic trends in Turkey suggest that the share of working age population (15-64) will continue to increase before reaching its peak. After 2025, however, Turkey is projected to enter its last phase of demographic transition with population growth reaching 0% before starting to become negative (SPO, 2007). As of 2006, 43% of total population in Turkey is between ages 15-39, that is the highest among all OECD countries and 8.5 percentage points higher than European average. The population growth has also been significantly higher than OECD average. High population growth and the high share of young population could

be turned into an advantage thanks to rising share of active population as opposed to the falling share in Europe. However, given low employment growth and low levels of educational attainment, this advantage has instead become a time bomb.

The participation rate of labor force declined from 69% in 1980 to 59% in 1990 and further down to below 50% after 2000 reaching as lows as 46% in 2007 (and is projected to be 44% in 2008), which is significantly below the EU or OECD averages (that were 72% in 2007). Likewise, the employment/working age population ratio continuously declined from 65% in 1980 to 56% in 1990, 51% in 2000 and further down to 46% in 2007 (as opposed to 68% OECD average). Part of the reason for this downward trend is the increasing migration from rural areas (where participation rate of women is much higher than in cities (Table 2) to the cities and higher school enrolment rates and raised number of compulsory elementary education (from 5 to 8 years). However, these cannot alone explain the sharp decline, and the increase in discouraged workers is probably a key reason in this fall (Senses, 1994). The low rate of female participation rate (as we discuss in the next section) is another major reason for low overall participation rate in Turkey.

**<Insert Table 2 Here>**

**<Insert Figure 11 Here>**

Open unemployment rate fluctuated between 6.5%-8.5% during 1988-2000/2001 before jumping to 10% and higher after 2002. The civilian labor force (ages 15+) is observed to reach 51.6 millions people as of 2006. Figure 11 and Table 1 also shows that when we add the *underemployed* people, the excess labor supply (unemployed + underemployed) is observed to reach 18.3% of the labor force as of 2006. We expect the already high unemployment rate to increase further as the effects of current global financial crisis are felt more through falling domestic and foreign demand.

**<Insert Figure 12 Here>**

The significantly higher share of 15-39 year olds, which was 43% in 2006 as opposed to 35% in OECD, in Turkey offers significant potential gains including avoiding the pension-fund problems and providing the labor markets with a dynamic force. However, existing evidence on how efficiently this potential resource is being utilized depicts a disappointing picture. Looking at the enrolment rates in childcare and early education for children under six in 2004 (Table 3), Turkey not only ranks at the bottom of the list among all OECD countries for 3 (1.7%), 4 (3.4), and 5 (26.2%) year olds but also is far away from nearest match that are 7.2% for 3-year olds, 34.4% for 4-year olds in Switzerland, and 46.2% in Poland with all Western European countries being above 80% and 90% (OECD, 2007).

Making things worse, more than 10% of the population is still illiterate and the share of university graduates in 25-64 year-olds is a mere 10% (which is the lowest among all OECD countries that have an average of 36%). Likewise, only 28% of the working-age population has high school education as of 2006 that is again the lowest among all OECD countries and rank behind other emerging countries such (OECD, 2008). The school drop-out rate for 15-19 is also the second highest in OECD (after Mexico) while the enrollment rate for 15-24 year olds is the lowest (Table 3).

**<Insert Table 3 Here>**

## 2.2. Female and Child Labor

The female labor force participation rate displayed a continuous decline in Turkey reaching as low as 25% in 2006 compared to 34% in 1988 (Figure 13). We observe a similar downward trend in male participation rate as well that dropped from 81% in 1988 to 71.5% in 2006. The gender difference in participation rates is even more visible in urban centers where female participation was around 20% and male participation was 71% in 2006 as opposed to 33% and 71% respectively in rural areas. One major reason for declining female participation rate is the increasing migration from country side to the cities. During this process, women who previously contributed to unpaid family labor in agriculture become either unemployed or joined informal labor market in urban areas.

**<Insert Figure 13 Here>**

Boratav (1995)'s findings based on his field work in various districts of Istanbul in 1991 show that the number of employed women in homes of white collar workers and professionals were higher than the number of employed women among other groups. It is argued that the dominant patriarchal mindset and the lack of education and training of women among blue collar and rural families are major factors contributing to this situation. (Dedeoglu, 2000). Nevertheless, even among the unemployed who are educated, the share of women has been increasing significantly especially after 2000. Accordingly, while the unemployment rate among those with university and higher education was 8% for men, it was over 19% for women during 2000-2006 (with peaks of 9% and 23% respectively in 2004) (Figure 14).

**<Insert Figure 14 Here>**

The high rates of unemployment among the young and educated workers in Turkey also clearly indicate that Turkey is unable to make use of its demographic advantages. In many countries applying SAPs, the female employment rates increased during the process of integration with world markets. In countries that have experienced the biggest increase in exports and the largest growth rate between 1970 and 1990, the female employment rate also increased. For example, in Southeastern Asia, this ratio has increased from 29.4% to 35.6% in industry, and from 26.9% to 31% in services. As for South America, the ratio of female labor force participation rate increased from 19% to 25.3% in industry and from 36.7% to 45.4% in services (UNCTAD, 2004:17). The United Nations, at the Fourth Annual Conference on the Status of Women in Beijing in 1995, concluded that political choices that increased the effectiveness of the market forces led to greater participation rate of women. However, the structural adjustment policies applied in Turkey have not yet produced an increase in the employment of women. On the contrary, the participation rate of women has dropped. Thus, the increase in non-agricultural female labor force has been limited and insufficient to cause any significant change in the structure of female labor market participation. Instead, women continue to cluster in limited occupations most of which are extensions of housework (such as cleaning maids, baby sitters, etc.) (Çağatay and Berik 1991; Özar, 1994 quoted in Ercan and Özar, 2004:202).

Çağatay and Berik (1991) state that the shift to export-led growth after 1980 has been “achieved” without an accompanying or subsequent feminization of employment.

The secondary status of women in society is reflected in the labor market, and on average, the wages of women are significantly lower than those of men. The percentage rate of those remaining outside social security protection is also higher among women than men (Kasnakoglu and Dayioglu, 1997 quoted in Ercan and Ozar, 2004:202). Moreover, “the traditional, “flexible” relationship that women have with the labor market has speeded up their employment in part-time, temporary and casual work (Ercan and Özar, 2004:202).

Cultural prejudices under the predominantly patriarchal social structure of Turkey favor keeping women inside the home rather than allowing them to work outside while encouraging the employment of children as cheap labor. (Ercan and Özar, 2004:203; Geniş, 2006: 145). The Child Labor survey of 1999, carried out by SIS (Turkish Statistical Institute), indicates that 1 million 635 thousand (4.2%) of children between the ages of 6 to 17 were working, and that 62% of those children were males and 38% were females. According to TURKSTAT data, despite the increased compulsory education to eight years, the labor force participation rate of children between the ages of 12 to 17 years was 14.1%, and the rate of employment was 12.2% in 2002. In urban centers, children are employed in industry while in rural areas they work in agricultural production. A field study done in low-income neighborhoods of Istanbul showed that the use of child labor was prevalent with children contributing a substantial portion of the family income (Özar, 2000).

### **2.3. Sectoral Distribution**

As in other developing countries, the most striking change in the sectoral distribution of employment in Turkey has been the sharp decline in the agricultural employment share from around 60% in 1970 to less than 30% in 2008 (Figure 15). Nevertheless, this decline was not matched by a proportional increase in industrial employment, which increased from 11% to only 19% during the same period. Instead, the employment in services (with low value added) expanded considerably from 24% in 1970 to 54% in 2008. For example, while total agricultural employment fell from 7.5 million in 2002 to less than 6 million in 2008, industrial employment increased from 3.9 million to 4.3 million during the same period. The real expansion, however, was realized in the services sector where employment rose from 9.9 million in 2002 to 11.6 million in 2008. To put these numbers in context, the number of working age (15+) population increased from 47 million to 51 million during 2001-2006 (Table 1).

**<Insert Figure 15 Here>**

Another structural change speeding up the declining agricultural employment has been the cuts in agricultural subsidies as a part of SAPs starting from 1980s and intensifying after the 1994 financial crisis. The option of continuing agricultural support mechanisms (similar to the EU’s Common Agricultural Policy framework) even under SAPs was completely ignored partly thanks to the conditionality requirements by the IMF, WB and EU and partly because of policy mistakes and short-sightedness of politicians.

The removal of agricultural subsidies, the privatization of SEEs that facilitated the production and distribution of crops, and the reduction in the quotas of some crops that were a source of livelihood for farmers (such as sugar beets and tobacco), and the

removal of subsidies for animal husbandry all resulted in the drying up of the sources of income for the rural population.<sup>7</sup> Agricultural subsidies that accounted for 3.2% of the national income in 1999 dropped to 0.7% in 2006 (compared to public sector interest payments that accounted for 9.4% of GDP during 2002-2007). During this period, Turkey, from being a net exporter, has become a net importer of agricultural products (ISSA, 2007). Consequently, this transformation in agriculture inevitably led to increasing rural to urban migration.

Nevertheless, the low level of investments in the industrial sectors and their inadequacy in creating new employment prevented the transfer of excess labor supply from agriculture to industry. Instead, workers who migrate to the cities end up working in informal jobs without any benefits or social security or worst remain unemployed (Bulutay, 1995:184).

#### **2.4. Informal Employment**

The informal labor market has expanded substantially since the second half of the 1990s. While the share of wage/salary workers in total employment remained constant at around 33-34%, it increased substantially after that reaching almost 50% by 2006 (Figure 16). Together with this increase, the rate of informal/marginal workers has also increased. Köse and Öncü (2000:80-3) report that the use of informal workforce, which made up 41% of the total employment in industry in early 1990s, rose to 46% in 1999. Furthermore, they also report that the use of informal/marginal workforce in the manufacturing industry was more common in labor and resource intensive sub sectors. In 1995, 46.9% of total employment was informal with 70.5% in agriculture and 29.9% in non-agricultural sectors. In 2006, however, the share of informal workers rose to 50.5% with the agriculture's share dropping to 52% and the non-agricultural sectors' share rising to 48% (Lordođlu, 2006: 51; Mütevelliođlu and Isik, 2009:180).

**<Insert Figure 16 Here>**

While the household surveys show that employment in the manufacturing industry increased by 21% during 1998-2006, manufacturing industry statistics indicate an opposite change that is a decline by 16%. In order for these figures, which belong to TURKSTAT, to be consistent a large switch towards informal employment and subcontracting within the manufacturing industry must have taken place. In fact, existing evidence based on field research suggests that such a switch did actually take place (ISSA, 2008:96-7). Moreover, as discussed before, while only 3% of full-time formal employees earn less than minimum wage, it is 44% for informal employees (OECD, 2008: 89; also see Köse and Öncü, 2000: 83; Lordođlu, 2006:49).

One major reason for increasing informal employment is the increasing share of small size enterprises in the manufacturing sector (employing 1-9 people) that account for 95% of all manufacturing sector enterprises but only 35% of formal employees (Köse and

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<sup>7</sup> For a discussion of the cuts in agricultural subsidies during the early stages of the reforms see Boratav (1990).

Öncü, 1998:84).<sup>8</sup> It is clear that the formal sector especially in large cities is unable to develop sufficiently to absorb immigrants from rural areas. Moreover, the removal of labor market regulations and the lack of enforcement of existing ones also led to the “informalization” of the formal sector. (Ercan and Özar, 2004:206).

### **3. ECONOMIC GROWTH WITHOUT EMPLOYMENT**

“Another key characteristic of the post-2001 Turkish growth path has been its “jobless” nature. The rate of open unemployment was 6.5% in 2000; increased to 10.3% in 2002, and remained at that plateau despite the rapid surges in GDP and exports. Open unemployment is a severe problem, in particular, among the young urban labor force reaching 26%” (Yeldan, 2007:14).

The relationship between economic growth and employment generation started falling apart in Turkey after 1999 and became more visible after the 2001 crisis such that despite an average 6.6% real GDP growth, employment growth was a disappointing -0.26% during 2002-2007. On the other hand, the decreasing employment response of growth is not a unique feature of Turkish development rather appears to be a global trend. According to ILO (2007:19) estimates, employment elasticity (i.e. percentage change in employment for a percentage change in GDP growth) declined from an average of 0.34 during 1991-1995 and 0.38 during 1995-1999 to 0.30 during 1999-2003. The decline after the 1995-99 period is even more striking and is observed in every region (for both developed and developing countries) except East and South East Asia. “This implies that around two-thirds of the economic growth realized between 1991 and 2003 can be attributed to gains in productivity, while one-third resulted from employment growth (ILO, 2007: 18). That is to say, economic growth is increasingly associated with rising productivity rather than employment growth.

#### **3.1. Capital Accumulation and Growth**

The level of capital accumulation is one of the few robust predictors of future economic growth. On the other hand its effect on labor demand is conditional on the aggregate demand, productivity growth and whether it is labor substituting or complementing. In this respect, similar to other major developing countries, such as Brazil and Mexico (Amadeo and Pero, 2000; Ros, 2000), we see a disappointing performance on the growth and investment fronts in Turkey. The average GDP growth rates were 4%, 3% and 3% during 1980-1988, 1989-1994, 1995-2001, respectively. Only during the most recent period, after dropping to -8% in 2001, it achieved an impressive average of 7% during 2002-2007. Yet, even during the last period, labor market performance was more than disappointing. The key reason seems to be the slowing capital accumulation and increasing importance of foreign portfolio capital inflows (reaching \$181 billion in 2000 prices during 1990-2007) for growth through demand push factors.

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<sup>8</sup> On flexible employment of those employed in small and medium-sized operations, see Güler-Müftüoğlu (2000), Türkün-Erendil (2000), and Genis (2006).

Gross fixed capital formation (GFCF) as a share of GDP declined from an average of 24% and 22% during 1989-1994 and 1995-2001, respectively to 20% during 2002-2007 that are below the 25% minimum (GFCF in GDP) that has been identified as the required threshold to generate high and sustained growth in middle-income developing countries (UNCTAD, 2003:61). In terms of its composition, we find that the share of private gross fixed capital formation in GDP declined to 14% during 2002-2007 from 18% during 1995-2001 and 17% during 1989-1994 periods. Likewise, we observe a significant fall in the share of public investment expenditures in GDP from around 9% during early 1980s to 7% during 1989-1994, 5% during 1995-2001 and 4% during 2002-2007, with a low of 3% in 2007, which marked its lowest level since 1980. Overall, weak investment performance explains the low level of employment generation in industrial sectors. The results may look surprising given the outstanding expansion of the manufacturing sectors output in total exports (exceeding 90%). Yet, the export boom and increasing competitiveness after 1980 was mostly realized through wage cuts, domestic demand contraction, successive exchange rate devaluations and utilization of excess capacity built before 1980 under the ISI regime instead of industrial restructuring through new capital accumulation.<sup>9</sup> The share of industrial value added in GDP also steadily declined from 27% in 1998 to 22% in 2001 and 20% in 2007. Meanwhile, the share of services in GDP increased from 60% in 1998 to 69% in 2001 and 73% in 2007.<sup>10</sup> Furthermore, we also observe a continuous decline in the share of manufacturing value added in GDP from around 22% during 1995-2001 to 17% during 2002-2007 with a low of 16.6% in 2007, which is the lowest share since 1980.

Structural fault lines including high real interest rates, capital market imperfections, lack of credit availability, high macro volatility, risk and uncertainty, and declining public investment rates appear to be the determining factors for low investment performance. Furthermore, given such bottlenecks, private real sector firms, in particular those with access to financial markets adopted a portfolio view of investment during the 1990s and started to take into account the availability of relatively quick and high returns in the booming financial markets and government debt instruments. In this picture, the existence of large public debts that are financed from domestic capital markets at high real interest rates further contributed to the rise of this new class of investors who chose short-term reversible financial investments over risky long-term fixed investments. For example, the ratio of financial revenues in total profits of top 500 manufacturing firms increased from around 22% during 1982-1988 to around 42% during 1989-1994 and further up to 160% during 1995-2001, with a peak of 546% in 2001 (Istanbul Chamber of Industry). Following 2001, however, it declined to an average of 54% during 2002-2007,

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<sup>9</sup> Helleiner (1992: 14) reports similar results in 17 WIDER case studies of developing countries: "Industrial growth [in the 1980s] associated with overall domestic demand expansion took place in industries that were developed in an earlier import substituting period" (quoted in Amsden and Hoeven, 1996:519). For a discussion on this common characteristics of developing countries after structural adjustment, see Amsden and Hoeven (1996).

<sup>10</sup> Amadeo and Pero (2000) also reports that following structural adjustment during the period of 1988-95 in Brazil industrial employment fell, with a reallocation of workers towards services, self-employment and informal labor market.

with a low of 26% in 2006 that has been the lowest since 1986. After 2006, however, it started increasing once again reaching 36% in 2007.

Looking at the effects of the gap between rates of return on fixed and financial assets (*Rgap*) using semi-annual panels of publicly traded industrial firms in Argentina, Mexico and Turkey, Demir (2009a) finds an economically and statistically significant positive relationship between *Rgap* and fixed investment spending in all three countries suggesting that increasing rates of return gap in favor of fixed (financial assets) increases (decreases) new fixed investment spending of private industrial firms. The results from Demir (2009a, 2009b) also highlight the negative effects of uncertainty and risk on new fixed investment decisions under multiple investment options. Accordingly, these studies find an economically and statistically significant negative effect of real exchange rate and inflation uncertainty, country risk, and short-term capital flow volatility on private fixed investment spending in Turkey, as well as in Argentina and Mexico. Furthermore, Demir (2009a) reports a significantly negative relationship between *Rgap* and the share of financial assets in total assets in all three countries.

We also see a weakening of the link between employment and output growth for the last two decades partly thanks to breaking down of vertical and horizontal linkages between domestic intermediate and capital goods suppliers and final good producers (ISSA, 2008; Yeldan, 2009). The simple correlation of lagged employment growth with output growth was 0.55 during 1971-79, 0.21 (with current periods) during 1980-89, and 0.098 during 1990-2001 and 0.05 during 2001-07 (Figure 17).<sup>11</sup>

Figure 18 shows the growth rates of both manufacturing production and manufacturing imports highlighting the increasingly import-dependent nature of industrial production in Turkey. In fact, the simple correlation between monthly manufacturing production growth and manufactures imports growth has been 0.72. Furthermore, the difference between the net sales and net sales from production of the largest 500 private manufacturing increased from around 4% in 1980 to 12% in 2005, reflecting increasing use of imported final goods for domestic sales.

**<Insert Figure 17 Here>**

**<Insert Figure 18 Here>**

There is also some evidence showing that the link between real wages and economic growth has increasingly become blurred. Amsden and Hovee (1996) for example show that for all country groups manufacturing wage growth was increasingly left behind GDP growth. In particular, while the GDP and wage growth was almost identical for all countries during 1960-70, wages started lagging GDP growth by 0.35 percentage points for all countries and by 1.25 percentage points for fast-growing countries during 1970-1980. During 1980-1990 the gap widened reaching 1.12 and 1.62 percentage points for all and fast growing countries respectively.

Comparing the median productivity growth (sales/workers) with employment growth in top 500 private manufacturing firms, we see no clear relationship between 1980 and 1989 (Figure 19). During 1989-1993, however, the relationship became a negative one, possible reflecting the effect of increasing productivity without capital

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<sup>11</sup> With current periods, the correlation coefficient becomes -0.63 and 0.16.

accumulation. During 1998-2002, on the other hand, the relationship became a positive one. The average productivity growth has also been 8% between 1980 and 1993 as opposed to 1.7% during 1994-2005.

<Insert Figure 19 Here>

In addition to disappointing investment performance, another reason for low employment and wage growth is the reliance on wage suppression and use of informal labor markets to retain competitiveness given the high level of volatility in exchange rate and the lack of technological upgrading of production systems (ISSA, 2008). Figure 20 highlights the lack of employment generation in the face of significant increases in labor productivity and the level of output since 2001.

<Insert Figure 20 Here>

### **3.2. Macroeconomic Volatility, Investment and Labor Markets**

After three decades of liberalization experience, Turkey emerged as one of several developing countries where the great moderation has not yet materialized. In contrast, increasing uncertainty and volatility in key macro and micro prices appeared as a serious problem for long term growth. The standard deviation of real GDP growth, for example, increased from 3.3% to 5.5% and 6.3% during 1980-88, 1989-1994, and 1995-2001, respectively, before falling to 1.7% during 2002-2007. In addition, the volatility of real private short-term capital inflows (measured by the average standard deviation of annual percentage change) increased from 1.2% to 7.3%, and 4.8% during 1980-88, 1989-1994, and 1995-2001 respectively with significantly negative effects on investment (Demir 2009b). Since then, however, it declined to 1.9% during 2002-2007. Increasing private short-term capital inflows (reaching \$181 billion in 2000 prices during 1990-2007) have also led to considerable appreciation of domestic currency and hurt tradable goods sectors due to changing relative prices (Frenkel and Ros, 2006). Between December 2001 and June 2008, for example, average monthly effective real exchange rate (RER) appreciated by 48% (CBRT). During this period, growth performance has also increasingly become pro-cyclical with respect to short-term capital flows (Erdem, 2007). Resulting from this increasingly external finance dependent nature of growth during the 1990s and 2000s, employment growth is also negatively effected.

We also observed an increase in real (and nominal) exchange rate volatility (measured by 12 month standard deviation of monthly real exchange rate percentage changes) from 2.4% during 1995-2001 to 3.4% during 2002-2007. Excess volatility in exchange rates (resulting from increasing capital flow volatility) is also shown to raise inflation uncertainty, encourage speculative financial investments, and hurt fixed investment performance of real sector firms (Felix, 1998; UNCTAD, 2006; Demir, 2009a, 2009b, 2009c).

Volatility can affect employment decisions of firms through multiple channels. Firstly, increasing volatility can reduce the total supply of credits available from the banking system (Bernanke and Getler, 1990). The existing evidence shows that in markets with capital market imperfections, financial constraints significantly affect firm level fluctuations in employment (Sharpe, 1994), inventories (Kashyap et al. 1994), investment (Fazzari et al., 1988), sales, and short-term borrowing (Gertler and Gilchrist, 1994; Bernanke et al., 1996). In addition, Braun and Larrain (2005) show that the

negative effect of recessions on industrial growth is increasing with the degree of external finance dependence and financial frictions. Increasing macroeconomic and exchange rate volatility also leads to higher interest rates through rising risk premium, and more restrictive monetary policy both to continue attracting capital inflows (in the case of current account deficits) and to fight against inflation (UNCTAD, 2006). Increasing interest payments is also found to have a negative effect on employment (Nickell and Nicolitsas, 1999).

Moreover, even in industries with low external finance dependence, volatility and aggregate demand shocks directly affect sales, profits, and investment risk and planning of firms (Federer, 1993; Aizenman and Marion, 1999). Excess volatility in exchange rates also raises inflation uncertainty (UNCTAD, 2006) that is shown to reduce employment (Seyfried and Ewing, 2001) and growth (Grier and Grier, 2006), and encourages speculative financial investments by financial and real sector firms alike (UNCTAD, 2006). In addition, increasing volatility can damage firms' balance sheets and reduce their net worth by increasing their liabilities and reducing asset values that limit the amount of credit they can get and aggravates the initial shock (Bernanke and Getler, 1990; Krugman, 1999; Braun and Larrain, 2005). Increasing volatility can also affect employment through its negative effect on economic growth (Ramey and Ramey, 1995). Furthermore, assuming risk-averse investors, an increase in exchange rate volatility is generally found to discourage international trade by raising the risk and uncertainty in international transactions (Thursby and Thursby, 1987; Qian and Varangis, 1994).

### **3.3 Financial Fragility, Capital Market Imperfections and Investment**

In addition to macroeconomic volatility, there are other bottlenecks constraining capital accumulation and labor market performance. The persistently high real interest rates probably rank as the number one culprit in that list given that Turkey continues to offer the highest real interest rate among emerging markets. The uncovered interest parity condition defines the net arbitrage gain as the difference between domestic interest rates deflated by the (next period) average depreciation of domestic currency, and the corresponding foreign (i.e. U.S.) interest rates. As a simple proxy, it shows the net rate of return on investing in domestic short-term financial assets as opposed to foreign ones. The annual average uncovered interest arbitrage gain in Turkey has been two and sometimes three digit numbers reaching on average 10%, 19% and 40% during 1989-1994, 1995-2001 and 2002-2007 respectively. The annual real interest rates reached 13% on average during 2002-2007 compared to 10% during 1995-2001 and 1.5% during 1989-1994.

Combined with high interest rates, a major fault line that continues to limit firms' growth performance in Turkey is the lack of external investment financing. While the real private credit (from the banking sector and other financial institutions) to the private sector (as a share of real GDP) increased to 18% during 2002-2007 (compared to 14% and 15% during 1989-1994 and 1995-2001), it is still well below the high income OECD average of over 160%. On the other hand, as a share of total deposit bank private credits, non-financial firms received only 60% on average during 2002-2007 compared to 71% during 1995-2001. In contrast, the share of households in deposit bank private credits has increased from an average of 14% during 1995-2001 to 34% during 2002-2007. As a

result, private firms continue to face strict credit rationing and are forced to finance investments mostly from internal sources or short-term borrowing. As of 2007, the share of short-term debt in total external debt of top 500 private manufacturing firms was 70% with an average of 75% during 1997-2001 and 68% during 2002-2007.

Furthermore, high interest rates have been disastrous for public finances. The share of interest expenditures in the consolidated budget increased from 5% in 1981 to 51% in 2001, and later dropped to 24% in 2007 with an average of 35% since 2002. To service the public debt, the central government channeled 32% of tax revenues to interest payments in 2007 as opposed to 103% in 2001.<sup>12</sup> Despite gains on the public finances in recent years, the interest burden continues to drain one third of tax revenues that should instead be spent on long-term development goals including health and education.

### **3.4 Financial Crisis and Labour Markets**

“The crucial element in gaining workers' cooperation is the belief that their sacrifice will contribute to general gains and that those gains will be distributed fairly. That belief requires (1) confidence in the government's economic management and at least contingent hope that the government has a plausible game plan; (2) confidence that labor's interests will be fairly represented and that labor representatives will have access to and influence in decision making circles; (3) as a prerequisite, reasonable confidence in political stability, that is, assurance that changes in administration are not likely to bring dramatic change in labor's position or in the rules of the game” Nelson (1991: 53).

The existing evidence both from the early years of liberalization experience under military dictatorship during early 1980s, and those after mid 1990s show that the costs of adjustment is disproportionately distributed with the labor bearing a larger burden. The two financial crises episodes in 1994 and 2000-2001 showed their impacts most radically in the labor markets. While the collapse of output in the aftermath of both crises was radical (6% and 8%), output growth recovered in the following years by 7% and 7.6% respectively. Yet, the same upward reversal was not realized in the case of real wages and employment. The open (open+disguised) unemployment rate increased from 6.5% (11.4%) in 2000 to 8.4% (12.9%) in 2001, 10.3% (14.6%) in 2002 and 10.5% (14.5%) in 2003. Supporting the argument that labour's bargaining power fell as unemployment rate increased, the number of strikes was only 35 in 2001 and 27 and 23 in 2002 and 2003 that are well below its peak number of 458 in 1990 when the unemployment rate was 8.2%. Similar to other developing countries, we also see an increase in informalization of labor market after the crisis.<sup>13</sup> Manufacturing industry real wages fell by 14% in 2001, and further by 5.5% and 2% in 2002 and 2003. Overall, real wages were down by 22% in 2003 compared to the 2000 level. The real wages in top 500 private and public firms fell by 12% and 13% respectively in 2001 and further by 4% and 3% in 2002. Likewise, the share of wages in net value added of top 500 private firms fell by 23 percentage points.

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<sup>12</sup> For a discussion of the sources of this high-interest hangover in Turkey, see Yeldan (2006).

<sup>13</sup> Amadeo and Pero (2000) report an increase in informal labor market and services employment in Brazil after recessions.

### 3.5. Trade

The existing research on the effects of trade liberalization on labor markets is a long and contentious one. While a majority of empirical research fails to find a significant (negative) effect of trade opening on employment, their findings have been heavily criticized based on a number of methodological and empirical shortcomings (Akyuz et al., 2008). Firstly, as discussed by Rodriguez and Rodrik (2000), the measurement of the degree and stages of trade liberalization is a difficult if not impossible job given that it generally is a part of a broader structural adjustment program including export promotion, import liberalization, financial liberalization, privatization etc. Therefore, it is difficult to disentangle the specific marginal effect of trade reforms among others. Also, the commonly used proxies for trade liberalization such as the level of tariffs or tariff revenues, or the degree of trade openness might be problematic. For example, in many developing countries, trade liberalization starts with a switch from quantitative restrictions to price based ones, which, lead to higher tariffs and tariff revenues. In the case of Turkey, for example, tariffs to imports ratio dropped from 34% in 1979 to 11% in 1982 but then went up to 22% in 1987 before dropping to 13% in 1996 (Taymaz, 1999). Secondly, the use of exports plus imports as a share of GDP to measure trade openness miss the different effects of export promotion and liberalization policies from the import liberalization policies. On the other hand, several recent studies found that trade liberalization is often accompanied by higher unemployment rates in many Latin American and sub-Saharan African countries.

Theoretically speaking, unemployment may arise as consumers switch from non-traded (and domestic goods) to imported goods as trade barriers are lowered. Yet, higher exports through increasing efficiency and productivity that increase competitiveness may create new employment opportunities that replace or exceed those lost from increasing import penetration and destruction of import-competing industries or firms. Overall, however, both IMF and WB argued that trade liberalization should increase employment generation as the price distortions against export-oriented sectors were removed. Accordingly, Turkey, as a labor-abundant developing country, was assumed to have comparative advantage in labor intensive sectors. Therefore, as trade barriers were lifted and real wages were reduced through increasing labor market flexibility, resources would be reallocated to more labor-intensive and export oriented sectors that would raise the labor demand in those sectors.<sup>14</sup>

We may also see increasing wage inequality after trade liberalization as the return on less-abundant factor (capital and skilled labor) increases at the expense of low-skill labor. Increasing labor demand in export-oriented sectors may also raise wages in those sectors and cause further wage inequality. In fact, wage inequality between skilled and unskilled labor, and between formal and informal workers has increased in most developing countries experiencing rapid trade liberalization (Akyuz et al., 2008). ILO (1996) reports a decline in real wages in two-thirds of 30 countries in Africa, Asia and Latin America from 1975-1979 to 1987-1991 accompanied by increasing wage dispersion.

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<sup>14</sup> For a detailed discussion of the labor market effects of trade liberalization in Turkey, see Taymaz (1999).

In the case of Turkey, we see increasing import dependence of domestic manufacturing sectors at the expense of the existing vertical and horizontal linkages among domestic industries (Figure 18). Senesen and Senesen (2001) report that 60 out of 64 sectors experienced significant increases in import dependency ratios with the economy-wide dependency jumping up by 60% during 1979-1985. Furthermore, Taymaz (1999:25) reported that “a one percentage point decline in the actual tariff rate [defined by tariffs to imports ratio] leads to the loss of about 8,000 jobs, whereas 1% appreciation of the real exchange rate destroys about 1,200 jobs in the large manufacturing industry”. Furthermore, despite increasing labor market flexibility and trade liberalization, Krishna, Mitra and Chinoy (2001) failed to find any significant effect of trade liberalization on labor-demand elasticities in Turkey.

In terms of differential effects of trade reforms on labor markets, cross-country studies suggest that export promotion and trade liberalization lead to increasing ‘feminization of labor force’ in developing countries, (Wood, 1991; Cagatay and Ozler, 1995; Cagatay and Berik, 1991).<sup>15</sup> Furthermore, in most cases the policy makers did not adequately consider the differential effects of trade reforms on small and medium sized versus large firms, the former of which is the main source of employment generation in most countries. Likewise, the type of jobs, skilled or unskilled, will differ across small and large firms. As discussed by Ozler (2000), looking at overall employment trends may also be misleading especially with regard to displacement and replacement effects leaving overall employment the same. For example, in the Turkish case trade liberalization was accompanied by higher job loss for males than female workers though women experienced higher reallocation effects (Ozler, 2000). Furthermore, Cagatay and Berik (1991), and Kasnakoglu and Dikbayir (1997) using industrial sectoral data and Ozler (2000) using plant level data find that increasing export share of output increases the share of female employment.

#### **4. CONCLUSION**

The labor market performance in Turkey has been disappointing for the last three decades with the persistence and deterioration of several fault lines including: low employment growth, high level of informalization, delinking from economic growth, increasing import content of production, falling participation rate (especially for urban women), increasing working age population and high population growth, decreasing agricultural employment, low safety nets, low regulation enforcement, and a growing disconnect between labor productivity gains and wage growth. International competitiveness is achieved by wage suppression and informalization of labor market instead of increasing capital formation and technological upgrading. The result has been highly erratic periodical movements in labor costs depending on the relative bargaining power of labor. Increasing labor market flexibility after the mid-1990s, however, has not yet generated the promised new jobs. Instead, we observe increasing informalization, falling real wages and slowing employment growth. Fixed capital formation rates also continued to fall with no sign of reversal since 1980s. Financial liberalization has not helped recover declining investment rates and support employment creation either. Rather, increasingly volatile capital flows

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<sup>15</sup> For a discussion of the sources of this change, see Ozler, 2000.

not only created an unstable macroeconomic environment that is not conducive to long term investment but also resulted in a highly pro-cyclical and capital flow dependent growth pattern. Two major crises in 1994 and 2000-2001 further aggravated the problem of limited labor market access to large segments of the society.

Given the three decade long experience with Structural Adjustment and liberalization, the poor performance of Turkey suggest that there is an urgent need to reconsider the goals of economic policies adopted with a renewed emphasis given to full employment. As clearly seen after 2002, achieving high rates of economic growth does not necessarily translate into high employment growth. Moreover, despite a remarkable export performance with manufacturing share reaching over 90% and despite high levels of FDI and portfolio inflows, fixed capital formation rates continued to decline in Turkey. Therefore, recognizing that neither financial or trade liberalization nor labor market flexibility have resolved labor market problems yet, a new approach is needed to address the low investment/low employment growth problem in Turkey.

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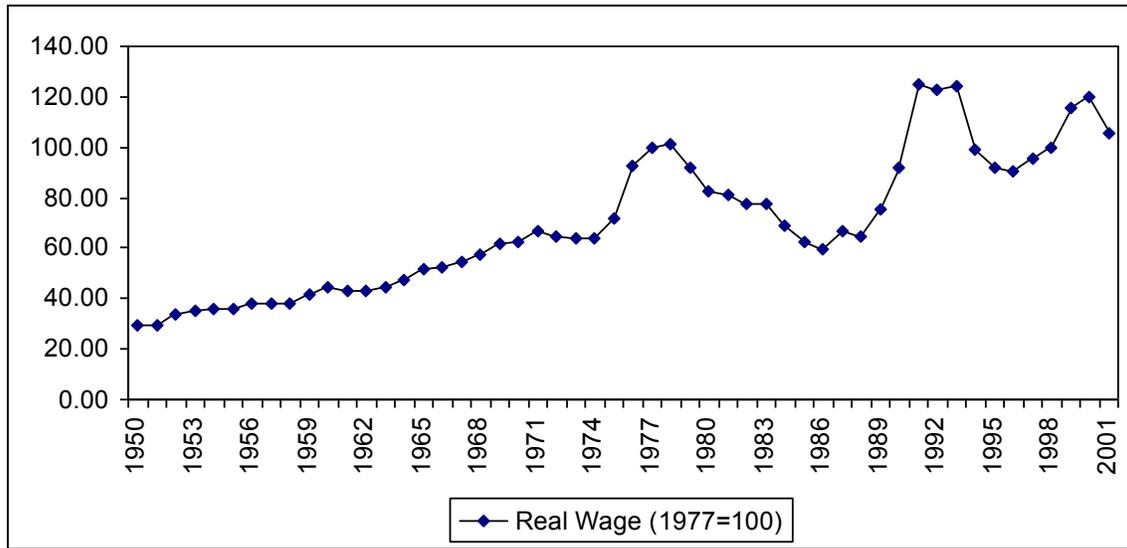
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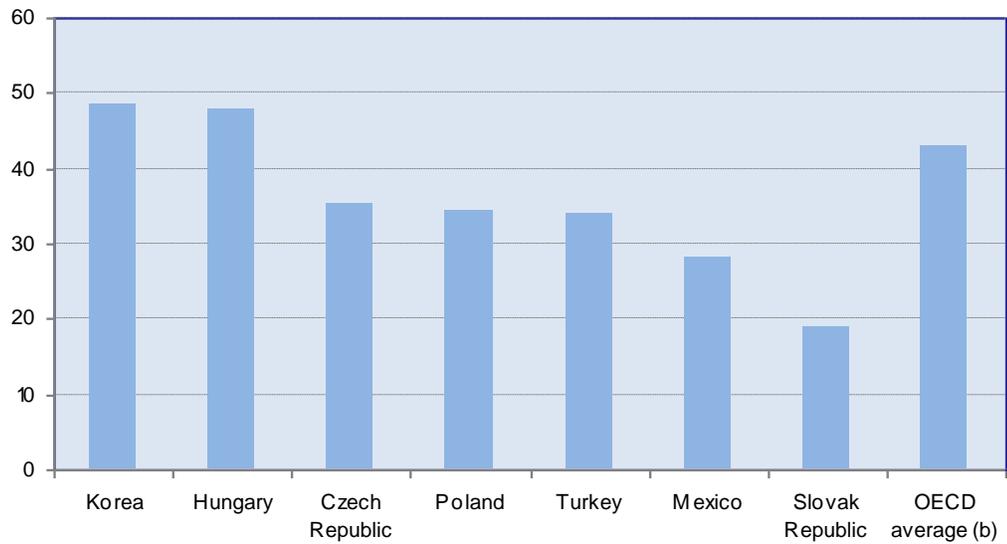
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Figure 1: Real Wages in Manufacturing Sectors, 1950-2001



Source: The Turkish Statistical Institute (TURKSTAT), 1923-2007 Statistical Yearbook.

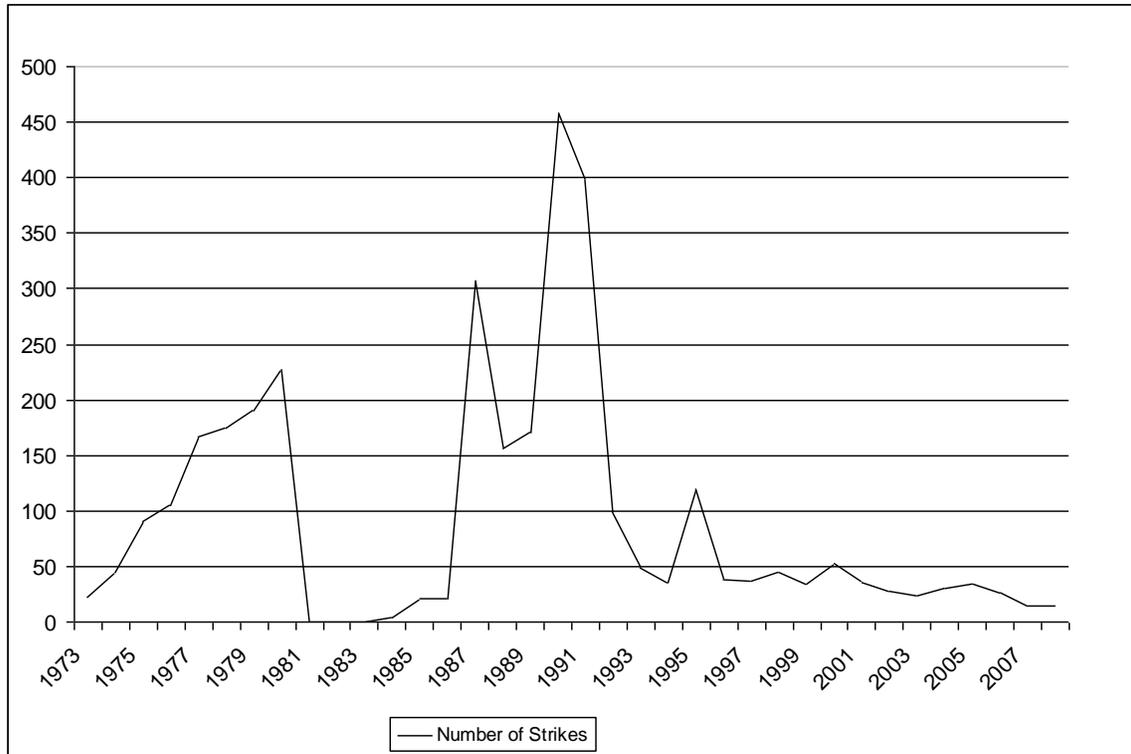
Figure 2: Tax Rates on Distributed Profits<sup>a</sup>, 2007



Notes: <sup>a</sup>Statutory corporate income tax rate and dividend income tax rate, <sup>b</sup>Unweighted average.

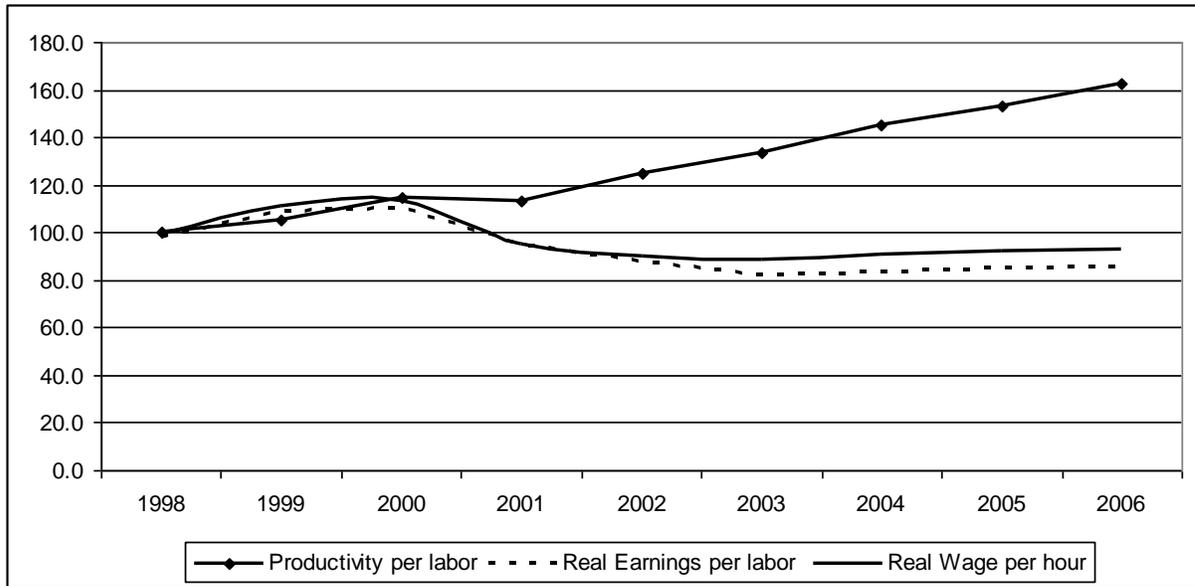
Source: OECD (2008).

Figure 3: Strike Activity, 1973-2008



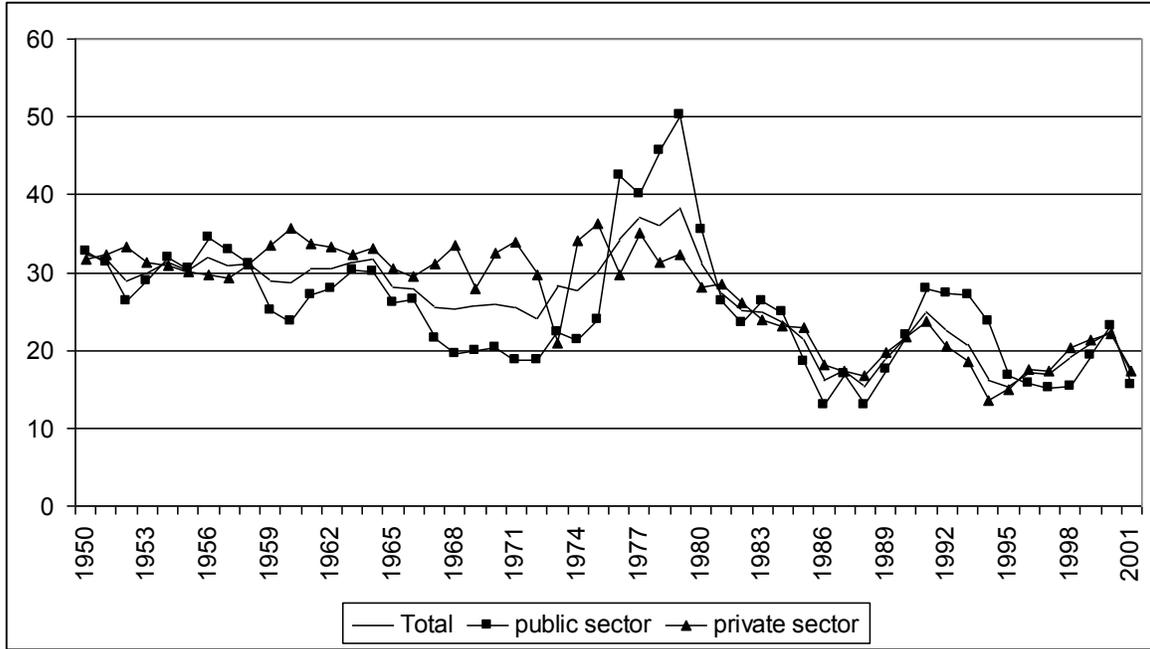
Source: TURKSTAT, CBRT and ILO online databases.

Figure 4: Real Wages and Labor Productivity in Manufacturing, 1998-2006



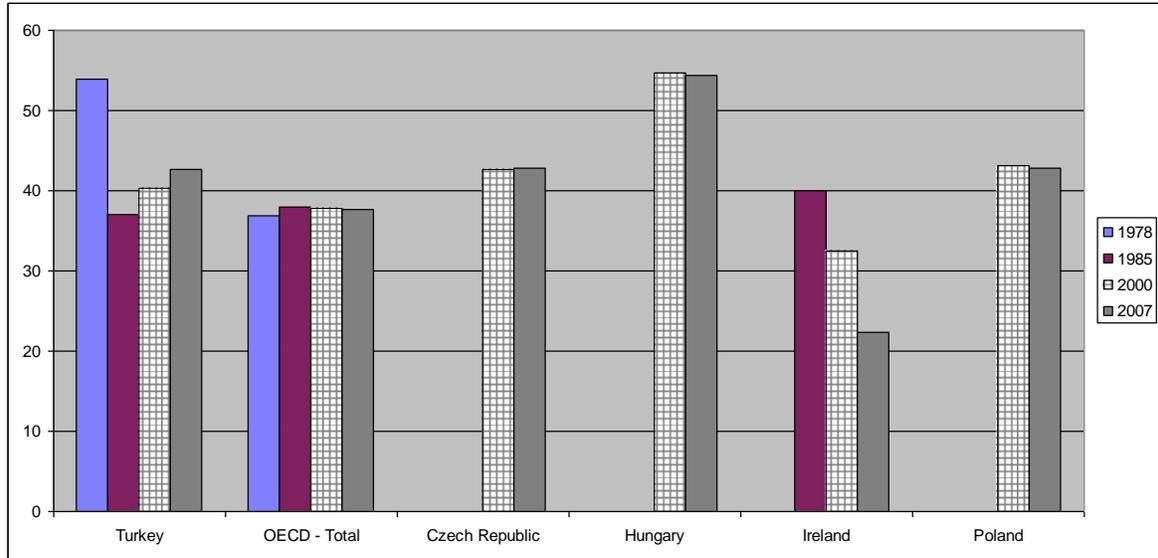
Source: ISSA (2008: 98, Table III.12).

Figure 5: Wage/Value Added Ratio in Manufacturing Industry 1950-2001



Source: Turkish Statistical Institute (TURKSTAT), 1923-2007 Statistical Yearbook, 1977=100.

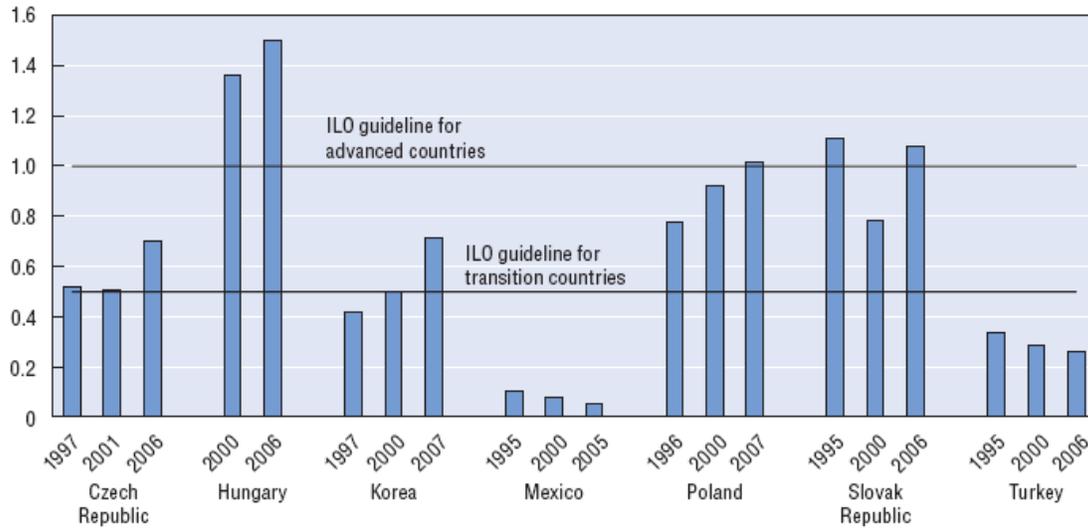
Figure 6: Employees' and Employers' Social Security Contributions and Personal Income Tax less Transfer Payments as Percentage of Gross Labour Costs



Notes: Gross labour costs: gross wage earnings plus employers' social security contributions (Item 144 of country tables).

Source: OECD online statistics.

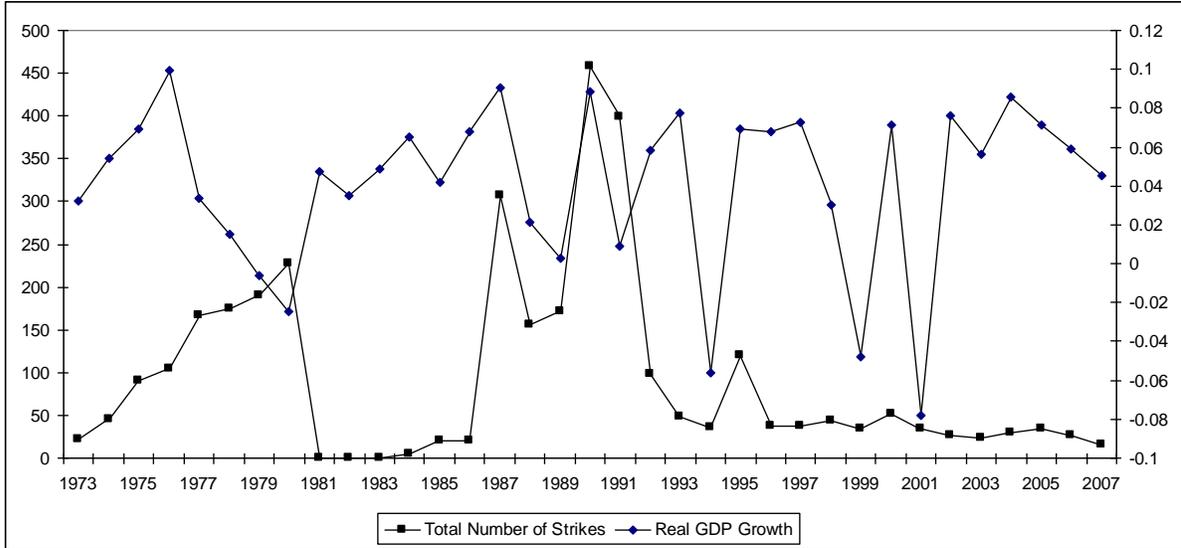
Figure 7: Labour Inspectors per 10 000 Employed Persons, 1995-2006



Notes: Figures for Mexico are for federal labour inspectors, who have responsibility for enforcing labour regulations in only a proportion of Mexican firms. No data are available on the number of state and local labour inspectors.

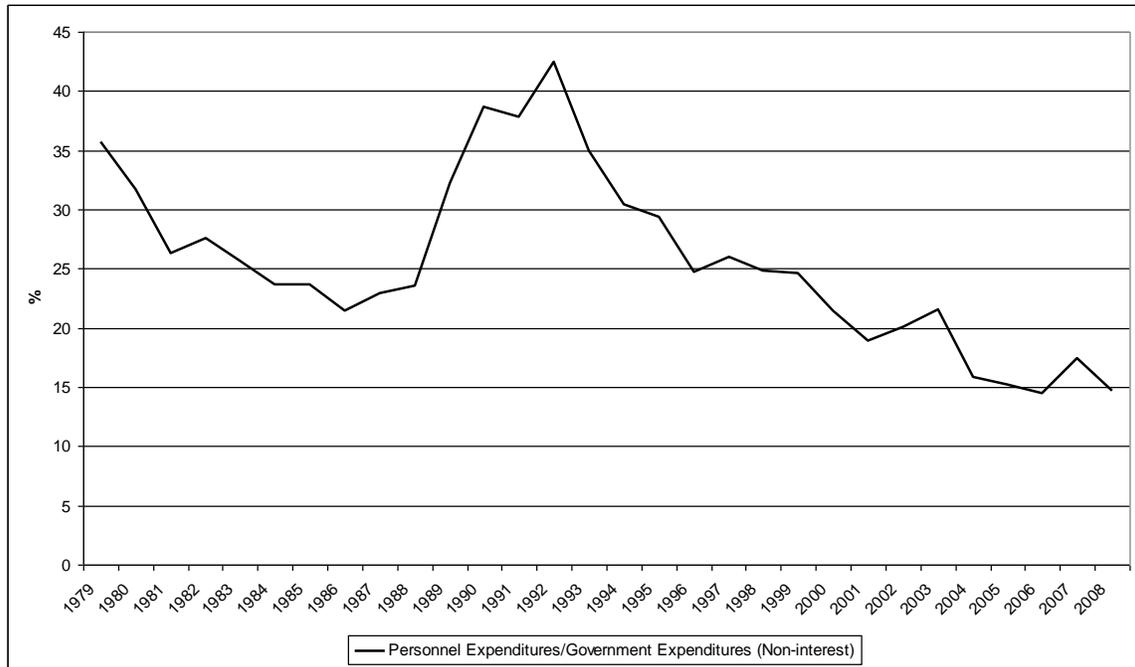
Source: OECD (2008: 117).

Figure 8: Labor Militancy and Economic Growth



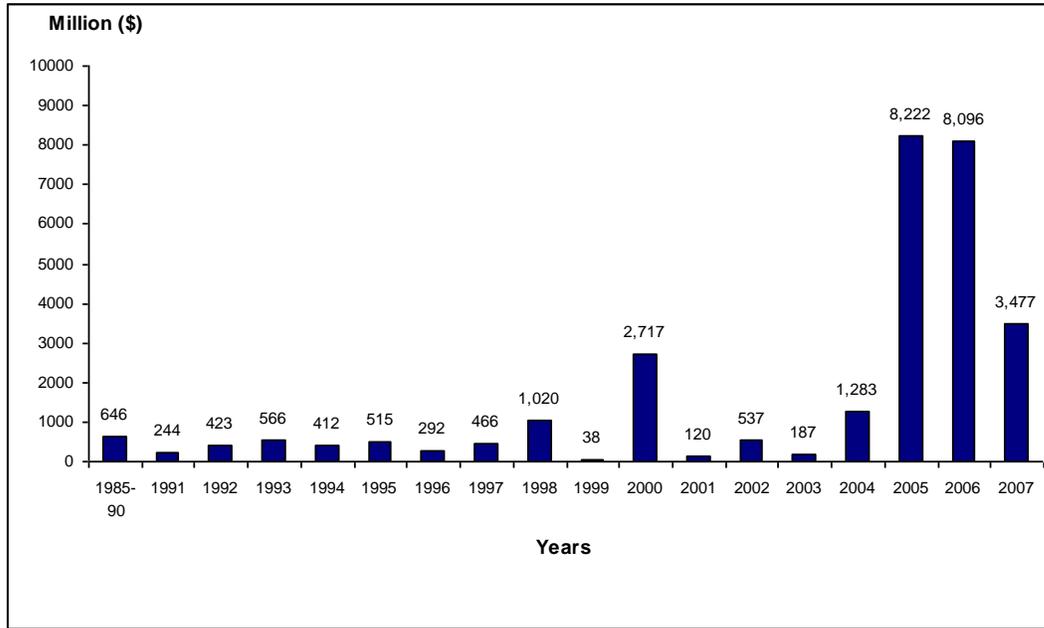
Source: TURKSTAT and CBRT online databases.

Figure 9: Public Sector Personnel Expenditures, 1979-2008.



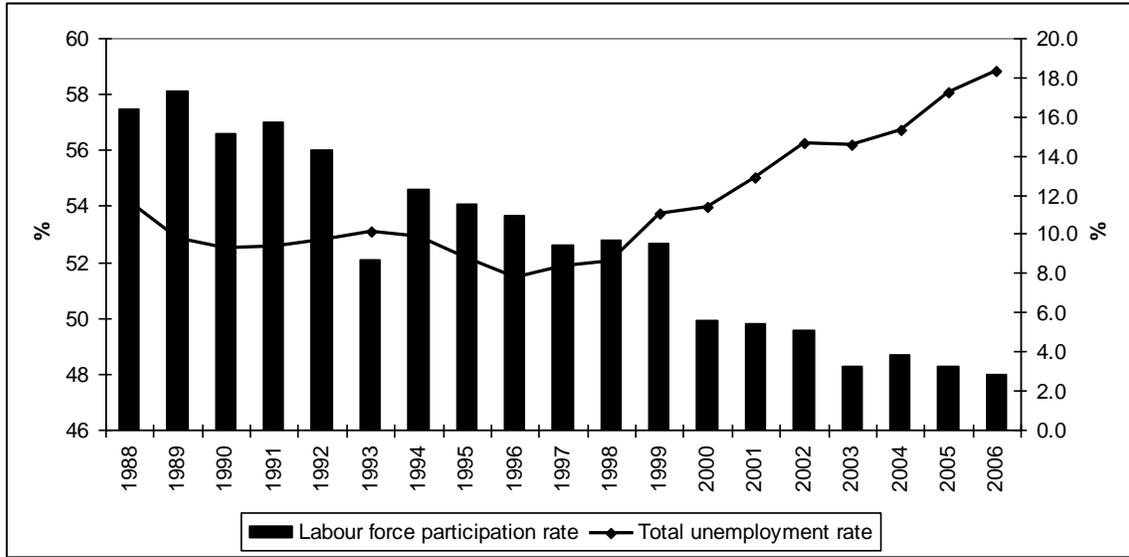
Source: CBRT and the Treasury.

Figure 10: Annual Privatization Implementations



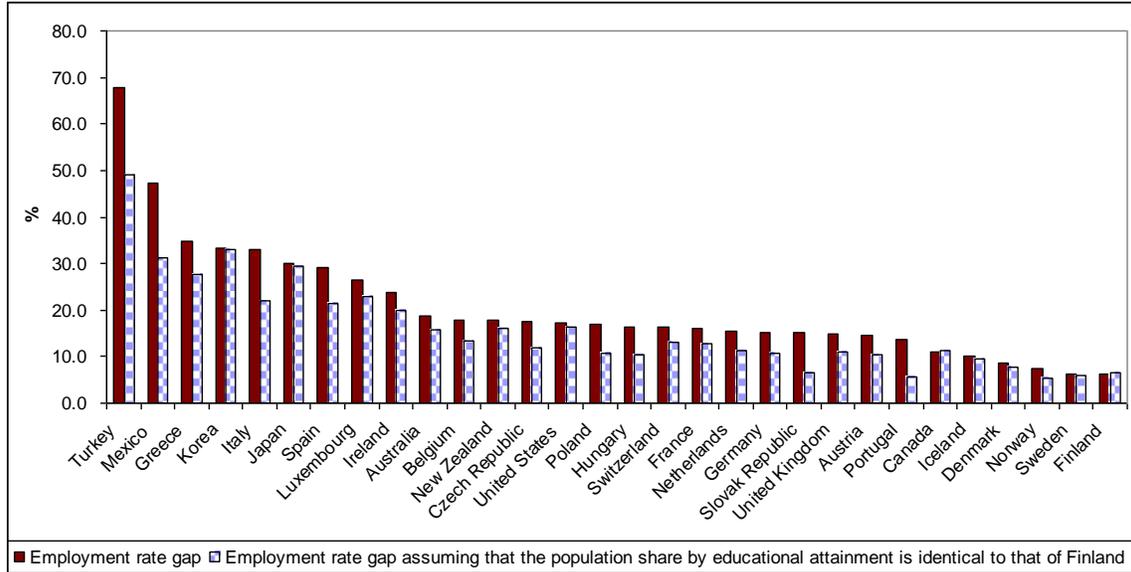
Source: Privatization Administration

Figure 11: Total Labor Force Participation and Unemployment Rate



Source: Turkish Statistical Institute (TURKSTAT), 1923-2007 Statistical Yearbook.

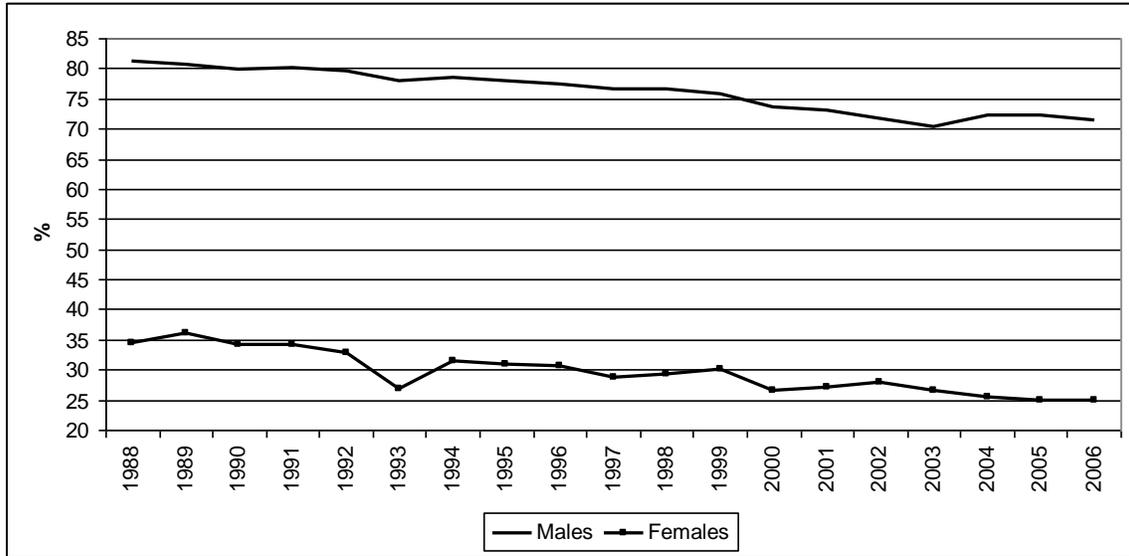
Figure 12: The Gender-Employment Gap across OECD Countries: Employment Gap between Prime-Age Men and Women, 2005



Notes: The gender employment gap is defined as the difference between male and female employment rates as a percentage of the male employment rate. Data refer to 2003 for Japan

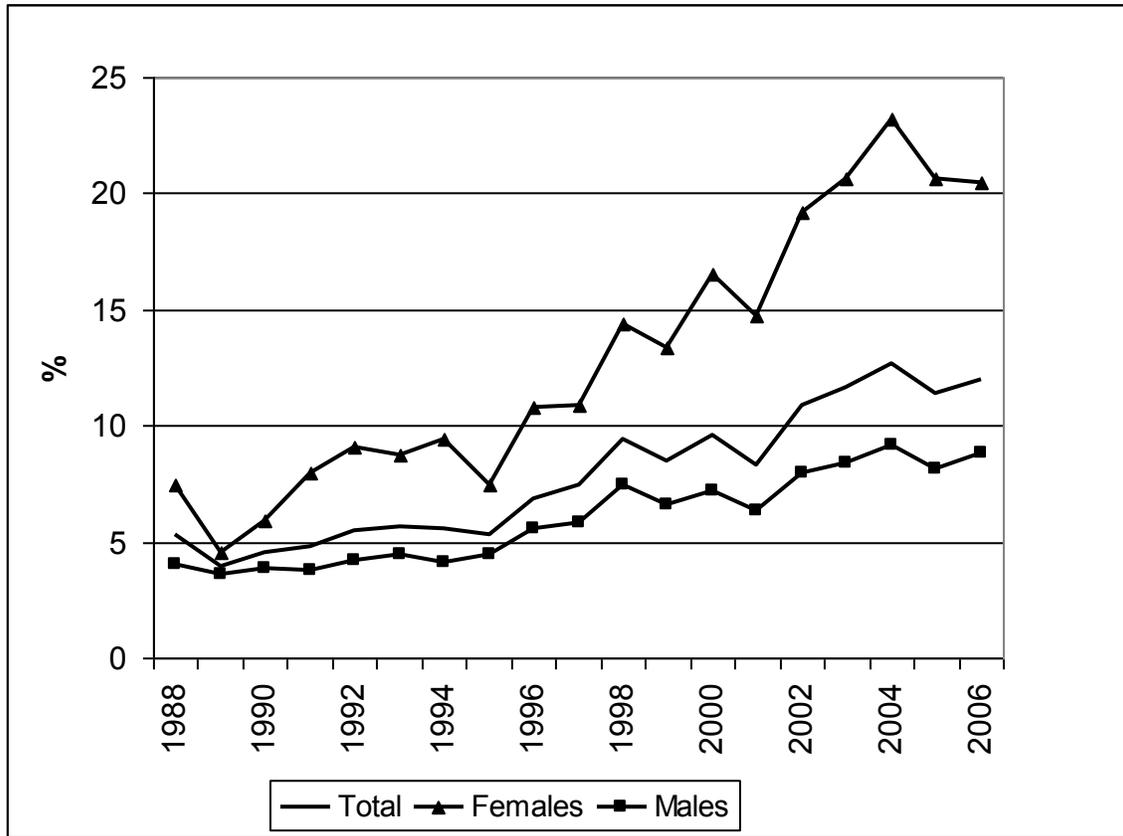
Source: OECD (2008:145).

Figure 13: Labor Force Participation Rates



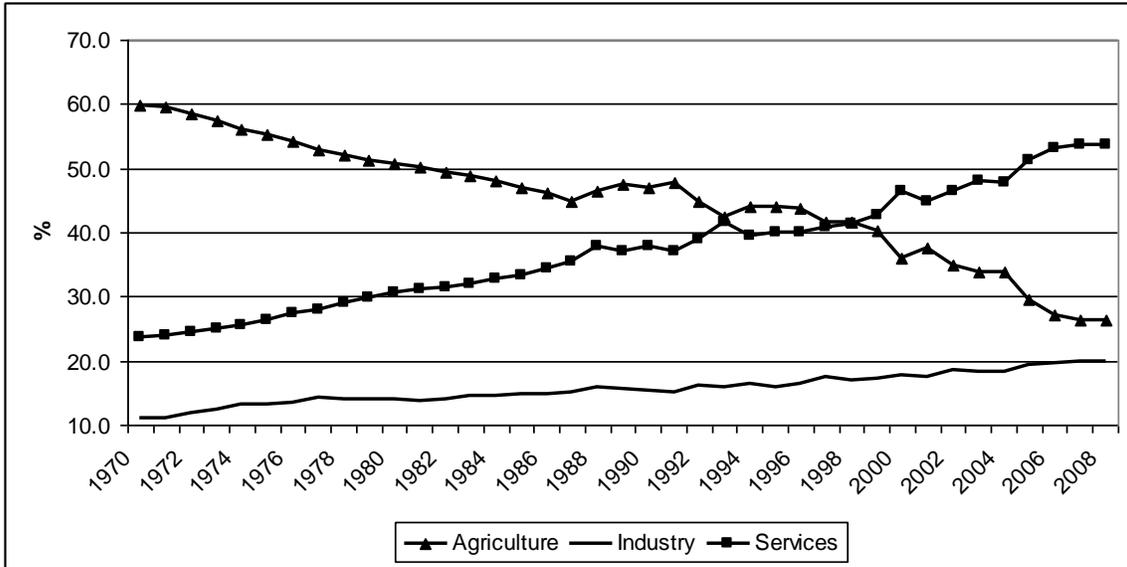
Source: TURKSTAT

Figure 14: Unemployed Persons by Education: University and Other Higher Education



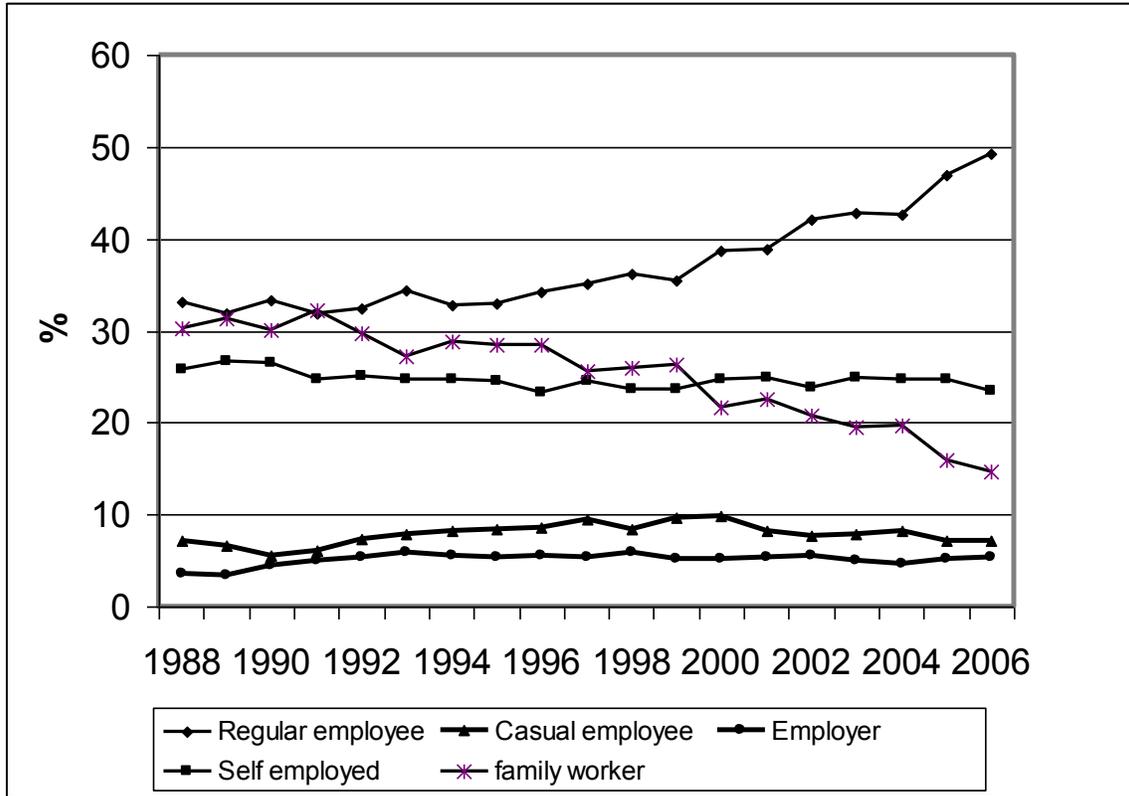
Source: TURKSTAT, Household Labor Surveys.

Figure 15: Sectoral Distribution of Employment: 1970-2008



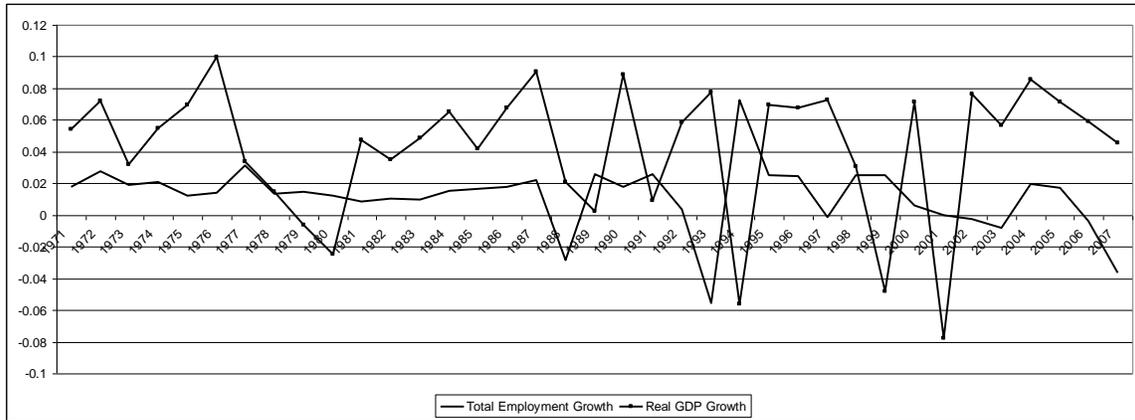
Source: TURKSTAT, 1923-2007 Statistical Yearbook and CBRT.

Figure 16: Employment Status, 1988-2006



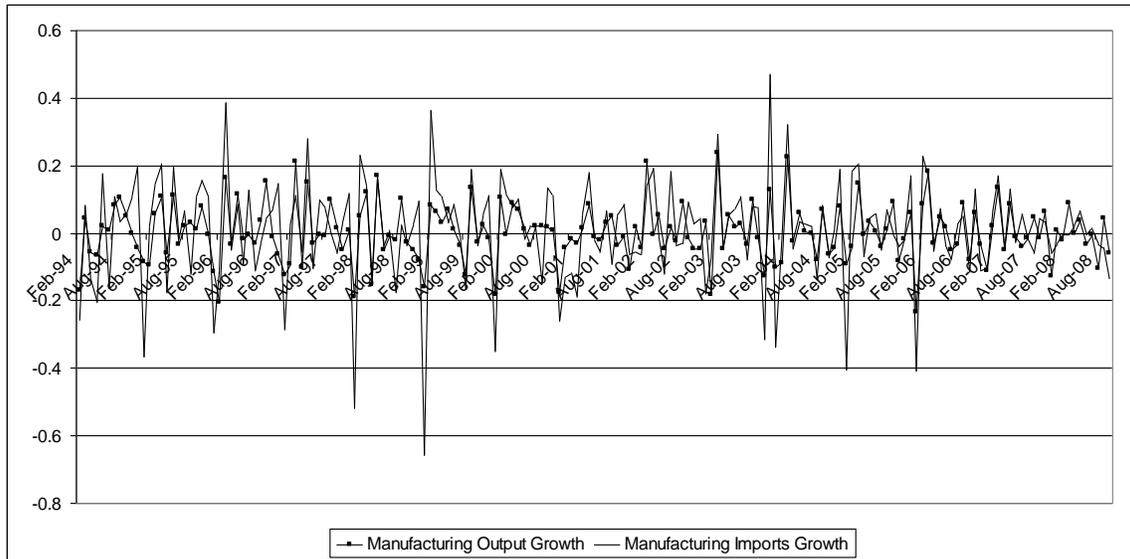
Source: TURKSTAT, 1923-2007 Statistical Yearbook.

Figure 17: Employment Growth and Output Growth, 1971-2007



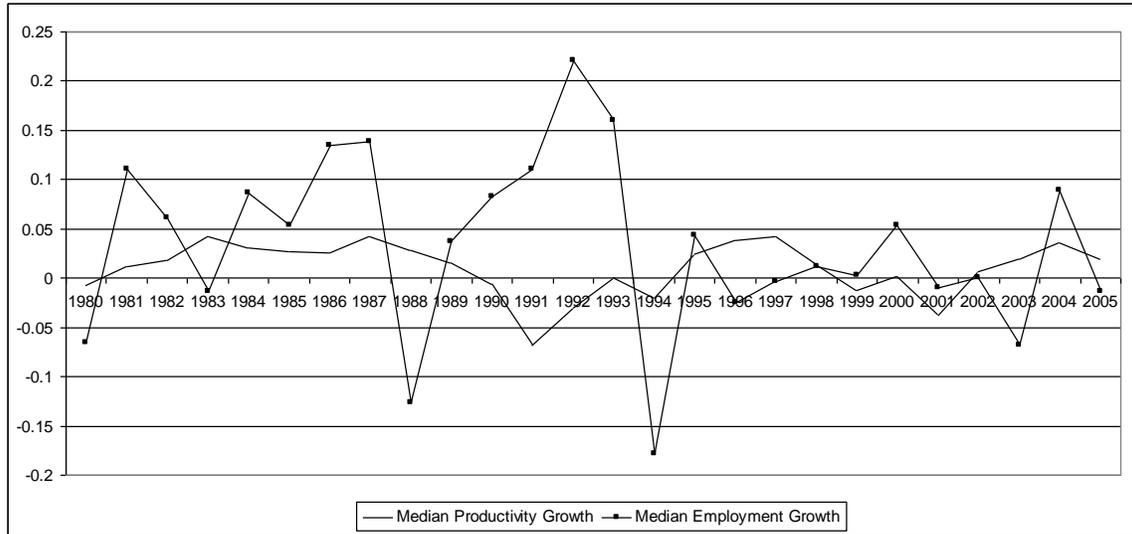
Source: CBRT.

Figure 18: Manufacturing Output Growth vs. Manufactures Import Growth, February  
1994-October 2008



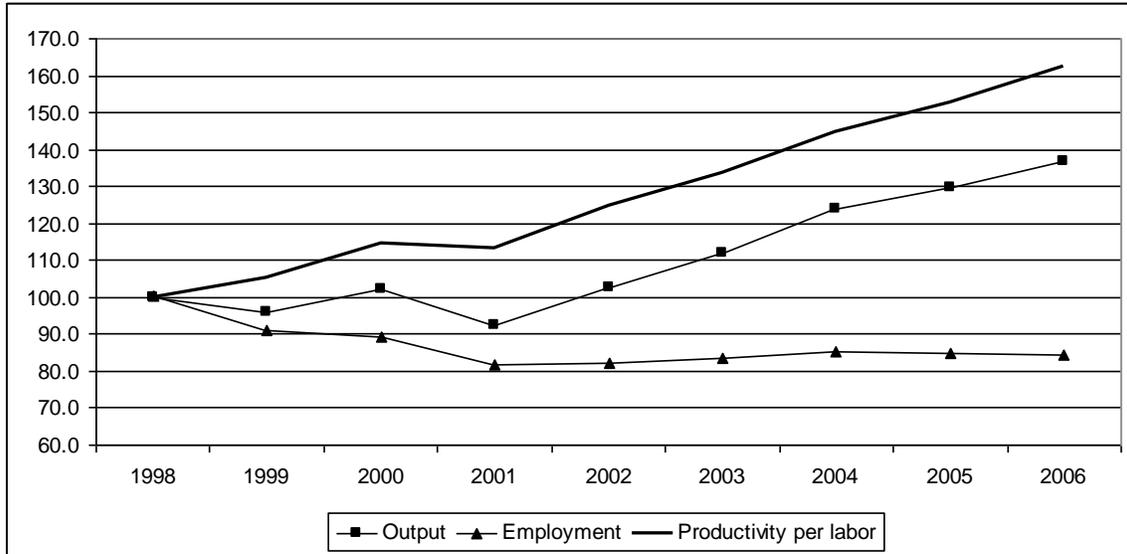
Source: CBRT.

Figure 19: Median Productivity vs. Employment Growth in top 500 Manufacturing Firms, 1980-2005



Source: Istanbul Chamber of Industry (ISO), Annual Top 500 Manufacturing Firm Survey, Various Years

. Figure 20: Output, Employment and Productivity, 1997=100



Source: ISSA (2008: 98, Table III.12).

Table 1: Developments in the Turkish Labor Market (1,000 persons)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Population (15+)	35,601	36,869	37,984	38,957	40,038	41,176	42,243	43,299	44,295	45,311	46,211	47,158	48,041	48,912	49,906	50,826	51,668
Civilian Labor Force	20,150	21,010	21,264	20,314	21,877	22,286	22,697	22,755	23,385	23,878	23,078	23,491	23,818	23,640	24,289	24,565	24,776
Females	6,160	6,345	6,262	5,269	6,324	6,428	6,514	6,292	6,537	6,853	6,188	6,451	6,760	6,555	6,388	6,352	6,480
Males	13,990	14,665	15,002	15,046	15,553	15,858	16,183	16,464	16,848	17,025	16,890	17,040	17,058	17,086	17,902	18,213	18,297
Civilian Employment	18,539	19,288	19,459	18,500	20,006	20,586	21,194	21,204	21,779	22,048	21,581	21,524	21,354	21,147	21,791	22,046	22,330
Unemployed (Open)	1,612	1,723	1,805	1,815	1,871	1,700	1,503	1,552	1,607	1,830	1,497	1,967	2,464	2,493	2,498	2,520	2,447
Open Unemployment Rate <sup>a</sup> (%)	8	8	9	9	9	8	7	7	7	8	7	8	10	11	10	10	10
Disguised Unemployment	253	252	263	235	285	263	272	355	412	803	1,139	1,060	1,020	945	1,223	1,714	2,088
Total Unemployment Rate <sup>b</sup> (%)	9.3	9.4	9.7	10.1	9.9	8.8	7.8	8.4	8.6	11.0	11.4	12.9	14.6	14.5	15.3	17.2	18.3
Females	10.8	9.3	10.0	11.6	10.7	9.3	8.1	10.8	10.1	13.3	13.2	13.1	14.8	15.0	19.0	24.6	27.4
Males	8.6	9.5	9.6	9.6	9.5	8.6	7.7	7.5	8.1	10.1	10.8	12.8	14.6	14.4	14.0	14.7	15.1
Civilian Employment by Sectors																	
Agriculture	8,691	9,212	8,718	7,862	8,813	9,080	9,259	8,837	9,039	8,856	7,769	8,089	7,458	7,165	7,400	6,493	6,088
Industry	2,845	2,934	3,156	2,942	3,295	3,295	3,487	3,715	3,723	3,784	3,810	3,774	3,954	3,846	3,988	4,280	4,407
Services	7,005	7,143	7,587	7,697	7,901	8,212	8,451	8,653	9,018	9,410	10,001	9,661	9,942	10,136	10,402	11,273	11,836

Source: TURKSTAT, Household Labor Force Surveys.

- a. Persons not looking for a job yet ready to work if offered a job: (i) Seeking employment and ready to work within 15 days, and yet did not use any of the job search channels in the last 3 months; plus (ii) discouraged workers.
- b. Total (open + disguised) unemployment accounting for the persons "not in labor force".

Table 2: Urban and Rural Population

	1970	1975	1980	1985	1990	2000	2001	2002	2003	2004	2005	2006
Total Population (millions)	35.6	40.3	44.7	50.7	56.5	67.4	68.4	69.4	70.4	71.3	72.1	73.0
Proportion of Urban Population (%)	28.7	32.9	35.9	45.9	51.3	57.3	58.1	58.8	59.6	60.3	62.1	62.7

Source: State Planning Organization and TURKSTAT

Table 3: Education and Labor Markets

	Enrolment rates in childcare and early education for children under six, 2004	Population share, 2006		School drop-out rates of teenagers (15-19)	School enrolment rates (15-24)
	5-year olds	Ages 15-24	Ages 15-39	2005	2005
Czech Rep.	96.7	18.4	36.8	2.2	61.5
Greece	84.1	17	35.3	5.7	59.3
Hungary	97.8	18.4	35.8	5.2	64.9
Ireland	100	22	39.5	3	45.1
Korea	88.7	17.6	39.5	...	...
Mexico	...	29.6	42.8	16.5	33
Poland	46.2	22.1	37.8	1.7	69.6
Slovak Rep.	84.7	22.2	39.3	3.4	58.4
<b>Turkey</b>	<b>26.2</b>	<b>25.5</b>	<b>43.1</b>	<b>16.2</b>	<b>26.5</b>
EU15	88	19.1	33.5	5.3	48.9
OECD	92	21.7	35.3	7	42.2

Source: OECD online statistics.