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COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

TURKEY
(2019-2021)

COMMISSION ASSESSMENT

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Contents

1. **EXECUTIVE SUMMARY**

The Turkish economy fell into recession in the third quarter of 2018 with a recovery expected to gain momentum in the second half of 2019. Turkey's domestic financial conditions deteriorated sharply due to capital outflow from the country following the sharp depreciation of the Turkish lira (TL). In March 2019, the central bank reaction to renewed TL volatility strongly affected financial conditions and risks having a lasting adverse impact on investors' perceptions of Turkey. The Government's baseline macroeconomic scenario is for the economy to bounce back in 2019. The strongly positive net trade contribution is expected to kick-start a recovery that will only fully gain traction in 2021. However, Turkey's heavy dependence on foreign finance and high past credit growth suggest more protracted economic headwinds in line with economic developments of credit crunches more broadly. Adding to these is the persistently high inflation, which shifts the debt burden from debtors to creditors and also risks creating expectations of a permanent rise, feeding corresponding wage inflation.

Fiscal discipline is the main pillar of the Turkish medium-term economic strategy. Turkey has a track record of fiscal prudence dating back to the reforms of the early 2000s. The credibility of its fiscal policy and low government debt levels were the main reasons for Turkey's ability to weather the currency crisis, as were a central bank rate hike, a financially sound banking system and easing international tensions. The stated ambition of fiscal austerity is reflected in the projected improvement of the primary balance by 2.8% of GDP between 2018 and 2021, driven mainly by expenditure restraint, in particular on capital spending. However, recent years have seen a slackening in public finances and the ambitious austerity agenda is heavily front-loaded. The relatively optimistic projections for economic growth and revenues at a time when spending pressures are emerging pose risks to the budget plans. Turkish budgetary policymaking would still benefit from greater transparency and better fiscal governance.

The main challenges for future economic policy are the following:

- **Promote domestic savings.** Renewed domestic demand growth is expected to renew pressure on the current account deficit. Policies to encourage domestic savings are now more needed than ones pushing reinvigorated credit growth while investment incentives should be carefully targeted.

- **Budgetary policy needs to become more transparent.** The institutional set-up of Turkish budgetary policymaking lacks credibility-enhancing elements such as numerical rules and an independent fiscal institution. Introducing these elements would improve transparency and credibility.

- **While the state of emergency has been lifted, important uncertainties remain in the investment climate and in the economy as a whole.** The volatile fluctuations in inflation combined with restrictions on capital flows have increased uncertainties in the business environment and have reduced the willingness to invest. A large number of companies remain under trusteeship after having been seized following the 2016 attempted coup, and have no clear prospects of timely due process for obtaining compensation. Additional work is also needed to shorten lengthy and costly insolvency procedures.

- **Despite efforts to increase formalisation, Turkey's informal sector remains substantial.** It continues to obstruct the establishment of a level playing field and fair competition, e.g. by permitting price competition based on factors such as health and safety standards or payment of social security contributions. Informal businesses find it more difficult to access finance and thus to invest, which increases the dual nature of the economy. More than one third of workers are in informal employment, yet there is a lack of integrated approach to address it.

- **Key challenges are low labour market participation, particularly for women and young people, and an underperforming education system.** Overall unemployment increased towards the end of 2018, as did the youth unemployment. Gender gaps and regional disparities remain significant. The Education system is facing challenges on all levels. Turkey's Programme for International Student Assessment (PISA) and Programme for the International Assessment of Adult Competencies (PIAAC) scores are far behind the average of other OECD countries, indicating the need to step up the quality and coverage of school education. In a knowledge-based economy educated and skilled labour is a prerequisite for further growth.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been implemented to a limited extent. In terms of the macro-fiscal framework, external imbalances have reduced, although this can hardly be attributed to deliberate policy action, and macroeconomic projections have become more realistic, but fiscal transparency has not improved. The Turkish authorities have been able to avoid the worst possible outcome from the rebalancing to date but a structural improvement of the drivers of previous current account imbalances, low household savings and high credit growth needs still to emerge. While the state of emergency has been lifted, no significant improvements in the rule of law have been observed. The number of companies under trusteeship actually increased without clear and timely prospects of due process for compensation. Concerning insolvency, Turkey introduced the possibility of obtaining post-commencement credit, improved voting arrangements in reorganisation and greater creditors' participation in the proceedings. No R&D strategy was adopted. Turkey has focused on improving the employment subsidies for the unemployed and has launched some programmes targeting women. However, more efforts are needed to address the labour market participation of women and youth, which has been deteriorating. Measures to address the fragmentation and effectiveness of social assistance have not yielded sufficient results, as shown by the increase in poverty rates. There is further need to step up the quality and coverage of education at all levels.

Overall, the programme sets a combination of commendable objectives reflecting high levels of ambition but it would be better served by a more realistic stance. The Turkish authorities have shown high levels of ambition in the past, but momentum for reform has waned recently. The medium-term macro-fiscal scenario is highly optimistic in assuming that high growth ambitions can be combined with improving government finances, a reduction in the external imbalances, and a reduction in the inflation rate. Although longer-term improvements cannot be excluded, these depend on the implementation of an ambitious reform agenda. The implications of structural reforms for public finances have not been identified. Measures in the area of education, employment and social policies are relevant in addressing structural bottlenecks and improving labour market participation. However, their implementation might be challenging as has been proven in the previous years. More efforts should be placed on linking social protection measures with employment and gender.

2. ECONOMIC OUTLOOK AND RISKS

Turkey's Economic Reform Programme (ERP) expects the recession that began in the wake of the 2018 currency crisis to be short, followed by a strong recovery. The economy entered into recession after the pronounced deterioration in foreign financing conditions in the third quarter of 2018. Domestic financial conditions sharply worsened following the substantial depreciation of the TL in the third quarter. The biggest immediate impact has been on private investment and, in particular, on construction. Private consumption growth also slowed considerably. The impact on GDP growth of the fall in domestic demand was softened by the decline in import demand and some positive impact of the TL depreciation on exports.

The ERP's baseline macroeconomic scenario is for the economy to bounce back in 2019 but only fully gain traction in 2021. A strongly positive net trade contribution is expected to lead the recovery in 2019. Gross fixed capital formation is expected to display negative growth, and consumption low growth, compared with earlier years. Public consumption will continue to follow a pro-cyclical path throughout the planning horizon. The Turkish authorities project an initial decline in the negative output gap in 2021, and expect that it will not close over the programme horizon. The growth forecast and potential output have been revised downward significantly compared to the 2018 ERP. In the 2018 ERP, the Turkish Government still expected growth of 5.5% in 2019. Potential output growth has been lowered from 5.3% in last year's ERP to 4.4% for the years 2019 and 2020. This reflects a lower contribution of gross fixed capital formation to potential growth. Total Factor Productivity growth projection has gone from very low to negative. Nominal growth is expected to be high as a consequence of continued high inflation. This will favour the debt-to-GDP ratio and implies a large expansion of the tax base despite low real economic growth.

The macroeconomic scenario reflects more realism but is still relatively optimistic when compared to the Autumn Forecast. Experiences of credit crunches and the large dependence on foreign finance, together with high inflation and the credit-intensity of the economic boom in preceding years, however, suggest more protracted economic headwinds. The ERP's growth scenario, based on the new medium-term scenario published in the autumn, does, however, display more realism than growth scenarios in earlier ERPs. In this ERP, the growth rate of 3.5% in 2020 is the most conservative and closest to other forecasts, including the Commission's Autumn Forecast and those of market participants.

Table 1:

Turkey - Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020		2021	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	7.4	7.4	3.8	3.8	-1.5	2.3	3.0	3.5	n.a.	5.0
Contributions:										
- **Final domestic demand**	6.7	6.7	3.1	3.3	-4.4	0.5	3.6	3.2	n.a.	4.7
- **Change in inventories**	0.6	0.6	-0.1	-0.9	0.2	0.2	-0.1	0.0	n.a.	0.0
- **External balance of goods and services**	0.1	0.1	0.7	1.4	2.7	1.5	-0.3	0.2	n.a.	0.2
Employment (% change)	3.9	3.6	3.0	1.7	0.2	1.5	2.6	2.6	n.a.	3.6
Unemployment rate (%)	10.9	10.9	10.1	11.3	12.8	12.1	12.7	11.9	n.a.	10.8
GDP deflator (% change)	10.8	10.8	14.9	16.0	15.3	16.3	13.1	11.8	n.a.	6.2
CPI inflation (%)	11.1	11.1	16.7	16.3	15.4	18.4	12.4	13.3	n.a.	7.9
Current account balance (% of GDP)	-5.6	-4.5	-6.8	-3.5	-2.9	-2.7	-3.4	-2.3	n.a.	-2.1
General government balance (% of GDP)	-2.3	-1.8	-2.5	-2.4	-1.9	-1.5	-2.2	-1.6	n.a.	-1.6
Government gross debt (% of GDP)	28.3	28.3	31.2	31.1	31.9	28.5	30.5	28.2	n.a.	27.2

Sources: Economic Reform Programme (ERP) 2019, Commission Autumn 2018 forecast (COM).
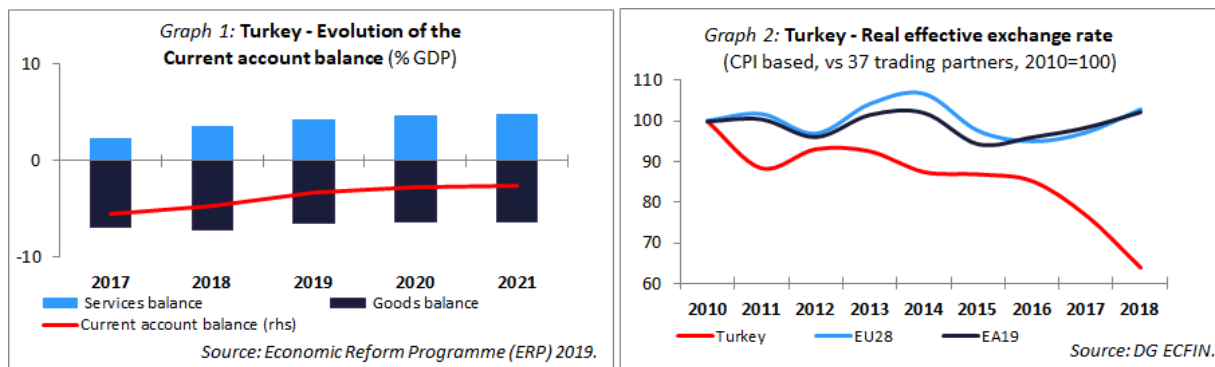
The ERP's inflation scenario would require firm action by the central bank to rein in unanchored inflation expectations. The ERP predicts a decline in the inflation rate from a

relatively high 18.4% in 2019 to an ambitious 7.9% in 2021. The inflation rate jumped to a high of 25.2% in October 2018 following the sharp TL depreciation but in recent months the stabilisation of the TL, a temporary lowering of tax rates on consumption goods and the fall-out in domestic demand have reduced upward pressures on price levels. The year-on-year inflation rate hovered around 20% in the first three months of 2019. The minimum wage was increased by 26% year-on-year at the beginning of 2019. Repeated large nominal wage rises risk triggering a wage-inflation spiral. Consumers' inflation expectations have been on the increase since 2016 but have remained below actual inflation so far. The inflation expectations of businesses jumped significantly in the second half of 2018. Increasing inflation expectations and the jump in minimum wages will make it harder for the central bank to permanently lower inflation. Recent actions like the lowering of reserve requirements in February and the early pay-out of dividends, interpreted by some as a way to smooth public finances, could also undermine attempts to regain public confidence. Moreover, the temporary lower VAT rates will provide upward pressure on inflation once expiring in June and December of this year. On the other hand, the large interest rate hike in September and the fall-out in domestic demand will deliver significant downward pressure on the inflation rate in 2019. The main difference between the Commission Autumn Forecast's and the ERP is attributable to the larger impact of the cyclical position.

The current account sharply corrected following the TL crisis, making a lower current account deficit for 2019 likely whereas the projected further decrease in the current account deficit in subsequent years is at odds with the expected recovery. The current account balance turned positive in the final four months of 2018. As analysis by the Turkish central bank shows, the reduction in the current account deficit is mainly due to the drop in imports that resulted from recent declines in the real exchange rate and domestic demand. The correction of the current account was supported by declining energy prices from October, a fall in demand for petrochemicals and a near-complete fall-off of gold imports. These factors are likely to be temporary and the recovery can be expected to be accompanied by a renewed increase in the current account deficit. In addition, although tourist numbers have recovered, the amount they spent in 2018 was 16% below 2015 levels and the services balances was at about the same level in percent of GDP as in 2015 (2.9%). The projected rise in the services balances to 4.7% of GDP in 2021 assumes that Turkey will be able to move away from price competition to higher-value tourists in a historically unprecedented way. The improving trade deficit in the ERP thus seems rather optimistic.

Except for foreign direct investment (FDI) capital flows have been volatile. FDI has historically been a relatively small share of capital inflows into Turkey and the country has a history of relying on more volatile forms of capital inflows. In late 2018 and early 2019, government debt instruments constituted the major capital inflows. Banks have seen their roll-over ratios fall to well below 100 percent as domestic credit expansion reversed. Future growth will likely come with renewed credit growth. Past economic growth has been associated with high credit growth with the credit-to-GDP ratio increasing from 25% in 2005 to a high of 89% in Q2 2018. A sizable part of this increase in credit was financed from abroad with foreign debt increasing from 36% of GDP in 2005 to 52% in Q2 2018. On a remaining maturity basis short-term debt consisted of 26% of GDP in Q3 2018 (23% in Q2 2018).

The ERP's projected increase in savings would suggest continued rebalancing of balance sheets, which is at odds with domestic demand driving the recovery from 2019 onwards. Despite attempts to increase private savings, the success of the most important policy instrument to achieve this - the obligatory enrolment into a private pension scheme - has been mixed. The government premium (25% after 10 years for minimum wage earners) has lost its attractiveness due to high inflation. Indebtedness has remained high with a large share of corporate debt denominated in foreign currency.

Graph 1: Turkey - Evolution of the Current account balance (% GDP)

Graph 2: Turkey - Real effective exchange rate (CPI based, vs 37 trading partners, 2010=100)

Source: Economic Reform Programme (ERP) 2019.

Source: DG ECFIN.

The sharp depreciation of the TL has tested the solidity of the banking sector and will continue to weigh on asset quality and the size of the balance sheet. Headline figures in the banking sector continue to be solid even after the strong volatility in the capital markets. Following the TL crisis, the Turkish Banking Regulation and Supervision Agency did introduce several changes in accounting practices which reduced the transparency of the financial system and, seemingly, lowered the impact of deteriorating asset quality and the TL depreciation on banks' balance sheets. Banking stocks have recovered well following the trough in November but renewed pressure emerged towards the end of March 2019 when the central bank reduced liquidity in reaction to renewed TL volatility. Turkish banks have taken a pro-active role in addressing the crisis, among other things by restructuring loans; restructuring means that banks do not have to rely on the less efficient business courts. Asset quality, nonetheless, has deteriorated as shown by the increase in non-performing loans (NPLs), which in multiple sectors has risen above 5%, and the increase in loans 'under close watch', which is partly related to the introduction of IFRS 9. The impact on banking soundness is heterogeneous with state owned banks continuing to take on risks, easing credit conditions for households(changing credit card debts into personal loans, offering mortgages at below market rates) and the corporate sector (extending loans to SME's). The central bank has preferred measures that soften market differentiation (such as a lowering of the reserve coefficient of the Reserve Options Mechanism, lowering reserve requirements, and using overnight lending rather than steering banks to the upper rate of the interest rate channel). High inflation will reduce the real burden of TL debt, transferring the real burden of deleveraging from households and the corporate sector to the banking sector. In a stress test published on 27 December 2018, the Turkish Banking Regulation and Supervision Agency estimated that in a worst case scenario NPL's could rise to 6% of total cash loans and the capital adequacy ratio would decline to 15.5%. These figures are still relatively sound. The stress test was not particularly rich in background information, though, and attracted some criticism for the lack of transparency.

Table 2:

Turkey - Financial sector indicators

	2014	2015	2016	2017	2018
Total assets of the banking system (EUR million)	705	744	735	715	636
Foreign ownership of banking system (%)	21.0	30.8	30.0	28.2	26.8
Credit growth	17.7	20.7	16.7	20.9	16.0
Deposit growth	11.6	18.6	17.7	17.7	22.1
Loan-to-deposit ratio	1.12	1.13	1.12	1.15	1.08
Financial soundness indicators					
- non-performing loans	2.8	3.1	3.2	3.0	3.9
- net capital to risk-weighted assets	16.3	15.6	15.6	16.9	17.3
- liquid assets to total assets	14.0	13.0	13.6	8.0	10.7
- return on equity	10.6	9.9	12.5	15.9	14.7
- forex loans to total loans (%)	29.0	31.8	34.8	32.6	39.9

* including the impact of write-offs.
Sources: National Central Bank, Macrobond.

3. PUBLIC FINANCE

The central government almost met the October 2018 revised deficit target for 2018, despite underlying trends in public finances turning negative at the end of the year. The central government had set an initial target for the budget deficit of TL 65.9billion. In October 2018, Parliament agreed on a budget amendment that saw a new target of TL 72.1 billion or 1.9% of GDP. The actual budget deficit of the central government was TL 72.6billion. The revised budget target was almost met, due to exceptionally high end-of -year non-tax revenues and postponement of capital outlays. The budget deficit as a percentage of GDP did not change between the original and the revised budget as a consequence of higher nominal GDP growth. An exceptional increase in other revenues, originating in particular in an ad hoc measure for conscripts to pay a fee for exemption from military service, mitigated the impact of the tax revenue short-fall on overall revenues. A sizable part of the capital outlays (capital expenditures and capital transfers) was carried over into the New Year. Normally, capital outlays in January are about one tenth of those in December but, in January 2019, they were almost as high (96%) as in December 2018. The development of the budget balance throughout the year was, however, worse on average than since (at least) 2009. The general government's budget deficit was an estimated 2.4% of GDP in 2018 according to the ERP. Throughout the ERP different concepts are used for the general government and the numbers for budget outcomes, including for central government, do not always match (Tables 3.2, 3.4, and 3.6 as well as table 2 from the Annex).

The 2019 budget continues the pro-cyclicality of earlier years, now aiming for lower budget deficits in a time of recession. The 2019 central government budget was approved on 21 December and, in line with the medium-term planning, anticipates a budget deficit of 1.8% of GDP in 2019. The general government deficit is expected to be smaller (1.5%) and has been reduced from last year's ERP by 0.4 percentage points. Compared to the 2018 outcome, the budgeted expenditures of the central government are projected to increase by 23.9% and revenues by 25.2%. Capital outlays (capital expenditures and capital transfers together) are reduced in nominal terms by 27.8% year-on-year. The decrease in capital outlays is consistent with the stated intention to freeze infrastructure investments. At the same time, almost half of the allocated budget of capital transfers was spent in the first month of the budget year. There are significant increases budgeted for personnel expenditures (+35.1% year-on-year), state

premiums paid to the social security institutions (+40.1% year-on-year), current transfers (+25.8% year-on-year) and interest payments (+63.6% year-on-year). It is, however, hard to match these expenditure figures with those for the respective categories in the ERP (Table 3.4) where the increases are more moderate. The Government uses a relatively optimistic growth assumption of 2.3% in 2019. General government tax revenues are expected to increase which is rather optimistic given the downward pressure on nominal GDP growth. No specific measures to increase the tax base are mentioned in the ERP, either, to substantiate an increase in tax revenues relative to nominal GDP. Budget discussions in the Turkish Parliament do not rule out a redistribution of expenditures between categories in the current budget year. Those expenditure categories that see an increase in the budget allocation can be used to cover cost overruns in other categories. Figures presented under the ESA methodology (Table 2 in the Annex) suggest a central government deficit of 0.9%. No explanation is given regarding the source of the difference from the headline budget deficit.

Box: The budget for 2019

The draft budget for 2019 was presented to Parliament on 17 October and was accepted on 21 December, within the 45 days deadline. Parliamentary discussions did not lead to any changes in the proposed central government budget. The central government is aiming for a budget deficit of 1.8% of GDP in 2019. It aims to reduce expenditures by TL 60 billion and increase revenues by TL 16 billion. The Turkish Government does not work with expenditure ceilings and revenues are estimated from the bottom up. This adds to the difficulty in identifying a benchmark for budgetary savings. Total budgetary savings would amount to 1.7% of 2019 GDP but, in absence of a benchmark for the savings, it is hard to measure the real impact on the budget. In broad terms, overall projected budget developments and budget components do follow the structure of proposed budgetary measures.

Main measures in the budget for 2019

Revenue measures*	Expenditure measures**
	• Lower capital spending (+0,7% of GDP)
	• Rationalised government incentives (+0.3% of GDP)
• Higher tax revenues (+0.4% of GDP)	• Social security cuts (+0.2% of GDP)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: ERP

The Turkish authorities identify fiscal discipline as the main pillar of their medium-term economic strategy. Turkey's fiscal policy credibility and low government debt levels have been the main reasons for Turkey's ability to weather the TL crisis along with the central bank interest rate hike, a financially sound banking system and easing international tensions. The ambition of fiscal austerity is reflected in the projected decrease in primary expenditures by 2.9% of GDP over the programme period and an increase in tax revenues by 0.7% of GDP. Interest expenditure is projected to increase by 1.0% of GDP from 2018 to 2021. This is also

reflected in the primary balance, which is projected to improve more than the general government balance – from -1.6% of GDP in 2018 to +1.2% of GDP in 2021. The structural primary balance as defined by the Turkish authorities, which compensates for temporary factors like privatisation revenues on top of a cyclical adjustment, shows even more improvement (3.4% of GDP between 2018 and 2021). This also reflects the planned pro-cyclical nature of a budgetary policy that was expansionary through both fiscal and quasi-fiscal channels at a time of high growth and now aims for austerity at a time of economic contraction. Fiscal austerity is heavily front-loaded in the ERP with 72% of the total adjustment in the structural primary balance and 69% of the total actual primary balance adjustment taking place in 2019.

The lower budget deficit anticipated in the ERP lacks specificity and there is a risk that *ad hoc* measures are needed to meet the budget target. The programme anticipates cuts in government spending of TL 59.9 billion and revenue increasing measures of TL 16 billion in 2019. This is in line with the budget and the medium-term "New Economy Programme" (NEP) presented in September 2018. While the ERP does not give further numerical details on the expenditure cuts, the NEP itemises them but does not provide a benchmark. As a consequence, it is difficult to match the more detailed figures from the NEP with the ERP figures. However, like the NEP, the ERP projects falling current and investment expenditure as a percentage of GDP with a higher emphasis on cuts in investment expenditures. Relative to GDP, consumption and investment expenditure are projected to fall to levels below those recorded in recent years. Recent government action is pointing in the opposite direction, however, and likely to lead to an increase in the budget deficit. Moreover, the recent pick-up in quasi-fiscal operations also complicates the assessment of the fiscal stance and fiscal discipline in a broader sense. Additional measures will likely be needed to achieve the envisioned budget target and would need to be more structural in character than the ad hoc measures undertaken at the end of 2018 and beginning of 2019.

Table 3:

Turkey - Composition of the budgetary adjustment (% of GDP)

	2017	2018	2019	2020	2021	Change: 2018-21
Revenues	33.1	32.7	32.1	31.9	31.6	-1.1
- Taxes and social security contributions	26.7	26.1	26.0	26.1	26.3	0.2
- Other (residual)	6.4	6.5	6.1	5.7	5.4	-1.1
Expenditure	34.9	35.1	33.6	33.6	33.2	-1.9
- Primary expenditure	33.0	32.9	30.8	30.5	30.0	-2.9
of which:						
Gross fixed capital formation	3.7	3.6	2.4	2.2	2.2	-1.4
Consumption	15.5	15.8	15.1	14.9	14.6	-1.2
Transfers & subsidies	13.9	13.5	13.4	13.4	13.3	-0.2
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.9	2.2	2.8	3.0	3.1	0.9
Budget balance	-1.8	-2.4	-1.5	-1.6	-1.6	0.8
- Cyclically adjusted	-2.4	-2.6	-1.2	-1.1	-1.2	1.4
Primary balance	0.1	-0.2	1.3	1.4	1.5	1.7
- Cyclically adjusted	-0.4	-0.4	1.5	1.9	1.9	2.3
Gross debt level	28.3	31.1	28.5	28.2	27.2	-3.9

Sources: Economic Reform Programme (ERP) 2019.

The government debt ratio increased due to the TL depreciation but remains low. The longer-term trend has been for a larger proportion of Turkish debt to be foreign. Foreign debt

has grown from 28% of total debt at the end of 2011 to 45% at the end of 2018. The greater reliance on foreign debt has allowed for a lengthening of maturity and, thereby, allowed Turkey to benefit from relatively low yields at the long end of the yield curve. However, the higher share of foreign debt has led to a higher exposure to exchange rate developments. The domestic value of foreign debt increased by 35% between July and August 2018 as the TL depreciated. Still, the debt remained modest compared to GDP. Government debt reached 32.6% of GDP in the third quarter of 2018. The jump in the third quarter following the depreciation of the TL fits in with the sustainability scenarios given in last year's ERP. However, while the shock was larger than anticipated in the extreme scenario, the sharp rise in nominal GDP throughout 2018 helped limit the increase in the debt ratio. In the first two months of 2019, the Treasury has resorted to foreign debt markets and has issued over half of the scheduled foreign currency denominated debt despite the objective, stated in the ERP, to finance mostly through domestic debt. The high savings in foreign countries and easy monetary conditions continue to offer the Turkish government favourable long-term conditions despite Turkey's downgrading to below investment grade. However, both domestic and foreign debt have risen substantially in recent years which will necessitate higher roll-overs in the future. Turkey also has an unpublished amount of contingent liabilities not just from infrastructural projects but also through state banks and other sources.

Box: Debt dynamics

High inflation is expected to be the main driver of a decrease in the Turkish government debt-to-GDP ratio. Real GDP growth and a positive primary balance are expected to contribute to the lower debt ratio as well whereas interest expenditure and further depreciation of the lira are expected to provide upward pressure.

Table 4:
Turkey - Composition of changes in the debt ratio (% of GDP)

	2017	2018	2019	2020	2021
Gross debt ratio [1]	28.3	31.1	28.5	28.2	27.2
Change in the ratio	-0.2	2.9	-2.6	-0.4	-1.0
Contributions [2]:					
1. Primary balance	-0.1	0.2	-1.3	-1.4	-1.6
2. "Snowball" effect	-2.9	-2.7	-2.3	-1.0	0.1
Of which:					
Interest expenditure	1.9	2.2	2.8	3.0	3.1
Growth effect	-2.0	-1.0	-0.7	-1.0	-1.3
Inflation effect	-2.8	-3.9	-4.4	-3.0	-1.6
3. Stock-flow adjustment	2.7	5.4	0.9	2.0	0.5

[1] End of period.
[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.

The ambitious budgetary policy agenda has substantial risks attached and the budgetary plans would benefit from greater transparency. First, lower-than-expected nominal GDP growth constitutes a risk to the realisation of revenue forecasts. Second, previous experience of lowering inflation from high levels and reining in inflation expectations suggests that nominal declines in revenues are likely to lead to nominal declines in expenditures. Third, tax revenues from international trade constituted 18.9% of all government revenues in 2018, up from 17.0% in 2008-2017. When Turkish economic growth decelerated in 2009 and 2016 tax revenues from international trade underperformed significantly compared to other budget revenues. Fourth, transparency of public finances continues to be limited. Turkey does not have any numerical fiscal rules or independent fiscal institutions that could enhance the credibility of fiscal policy. There is still no published inventory of all contingent liabilities, which means that Turkey has not implemented the 2018

policy guidance. The contingent liabilities listed in the ERP are only those covered by the Ministry of Treasury and Finance.

The ERP provides very limited information on the quality of public finances. It does not divide government spending into components that would allow an understanding of how the quality of public finances is evolving. No clear strategy is presented to increase the quality of public finance. In the budget for 2019, however, investments on infrastructural works and on technology and science have been reduced compared to 2018 which would generally be considered to lower the quality of public finance. The ERP does suggest that tax reform is imminent, which could improve the quality of public finances. However, an overhaul of the tax system has been envisioned for some years and it remains to be seen whether it can be designed and implemented in the coming years.

The Turkish budgetary framework lacks important elements from the 2011 EU Budget Directive, such as numerical rules and an independent fiscal institution. The Government has to present a revised draft to Parliament if the budget deficit exceeds the nominal target agreed with Parliament by more than 5%. Parliament has agreed to a revised budget in the past 2 years. Positive budget outcome have relied mostly on commitment by the authorities. The conservative bias has historically been due to a relatively low estimate of tax revenues compared to forecasted economic growth. The growth forecast has become more realistic in the 2019 ERP but tax revenue estimates appear relatively optimistic. More generally, and taking into account the absence of a published inventory of contingent liabilities and the transition to the presidential system, Turkish budgetary planning would benefit from independent fiscal institutions to improve transparency and, thereby, credibility.

4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Turkey is endowed with a strategic geographic position, a strong and entrepreneurial business sector, a large domestic market and a growing young population. It also has a privileged access to the EU market through the Customs Union with the EU. To provide jobs for the many new entrants to the labour market, the Turkish economy has been allowed to grow fast in recent years, mostly thanks to cheap foreign financing. As a consequence, a number of known structural imbalances were exacerbated, amplifying the vulnerability of the economy. Triggered by political tensions with the USA, this led to a currency crisis in August 2018. In addition, measures taken after the 2016 attempted coup and the 2018 TL crisis had a profound impact on the business environment.

The Commission has conducted an independent analysis of the Turkish economy to identify the key structural challenges to boost competitiveness and inclusive growth, drawing from the Turkish ERP itself, as well as other sources. This analysis of the economy shows that Turkey is experiencing a number of structural weaknesses across many sectors. However, the the main challenges in terms of boosting competitiveness and long-term and inclusive growth are (i) raising the performance level of the education system, (ii) improving transparency and predictability in the regulatory and institutional environment affecting businesses, and (iii) formalisation of the economy.

4.1 Key challenges

Key challenge #1: Raising the performance level of the education system

The labour market is characterised by low activity rates and the underused labour potential of women and youth. Education is key to address these structural deficiencies. Turkey has focused on advancing the employment subsidies for the unemployed and has launched some programmes targeting women. However, more efforts are needed to address labour market deficiencies, notably the participation of women and youth. It is important to further step up the quality and coverage of education at all levels as it is key for improved

labour market participation. Studies on pupil (PISA) and adult education (PIAAC) reveal a considerable gap to the OECD average, which is an impediment for the further development of a knowledge based economy, in which hundreds of thousands young people enter every year into the labour market. VET training needs to be further extended and further streamlined.

Key challenge #2: Improving transparency and predictability in the regulatory and institutional environment affecting businesses

The effective application of the rule of law is key to improving the business environment. Effective, efficient and independent judicial systems are crucial for creating an environment that is investment- and business-friendly, since they instil confidence throughout the entire business cycle. Effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes will be key to improve the business environment in Turkey. Moreover, corruption will make Turkey a less attractive place for doing business unless it is forcefully addressed.

Commercial judicial processes are slow and the large backlog of commercial court cases remains. Resources for judicial procedures, notably for commercial cases, have been increased and regional appeal courts and courts specialised in commercial litigation have been established. Alternative dispute resolution mechanisms have been promoted.

In addition, the number of companies transferred to management under the trusteeship of the Savings Deposit Insurance Fund (TMSF) has increased further. As of 13 November 2018, 1,008 companies across Turkey with a total asset value of TL 55.9 billion (EUR 8.8 billion) and a total of 45,364 employees had been seized or had a trustee appointed, since the attempted coup (the February 2018 figure was 985 companies). The fact that the number has increased since last year indicates that politically-motivated actions against private companies continue. Furthermore there is no adequate, effective and timely means of legal redress in these cases.

The regulatory environment is not stable. In the course of 2018, the Turkish authorities took a range of actions that significantly affected the business environment and the proper functioning of the markets. These included: banning the use of foreign currencies in high value transactions (car lease and property), blocking price hikes for specific consumer goods, and forcing transfers of foreign currency proceeds into domestic currency. The Government also influenced price setting by coordinating a voluntary price reduction while intensifying the monitoring of prices and offering groceries at below market prices in government outlets. Turkey still does not have an overarching public financial management reform programme. Transparency of public investment programmes and state assets is weak.

Turkey's long-term growth is constrained by provisions, which are not friendly to competition. While the ease of doing business has improved (see the 2019 World Bank rankings), regulations in Turkey are still significantly less competition-friendly than in many other OECD-countries. There is insufficient implementation of competition and State aid provisions. Weaknesses have been identified in the level of state control (with concerns about the government involvement in network sectors, price controls and command and control regulations), in barriers to entrepreneurship (with protection of incumbents in e.g. energy and telecom and administrative burdens for obtaining licenses and permits, especially for start-ups) and in barriers to trade and investment (with differential treatment of foreign suppliers and barriers to trade facilitation, OECD 2013). Procurement rules still favour local bidders in crucial sectors, and many public sector bodies have been granted exceptions from compliance with public procurement legislation. In the Support for Improvement of Governance and Management (SIGMA) monitoring report '*The Principles of Public Administration*', Turkey scores low on efficiency, non-discrimination, transparency and equal treatment in public procurement. Localisation requirements (e.g. in pharmaceuticals and renewable energy) and

the increase in both other non-tariff trade barriers and additional tariff duties encountered in the Customs Union also hamper competition. Finally, there is little transparency regarding the granted State aid.

The lack of competition comes at a cost. It is estimated that if Turkey were to align its product market regulations with the three best performing countries in this regard, GDP per capita could be 9.7% higher in the long run (OECD, 2016a). Consequently, Turkey has a lot to gain from aligning with international best practice. Competition is further distorted by the weak rule of law, corruption and the large informal sector. Turkey scores low on governance indicators, and gaps with international good practices have widened lately in the areas of rule of law, public administration reform, control of corruption, and government effectiveness, (OECD, 2018).

Key challenge #3: Formalisation of the economy

Informality is very high in the Turkish economy exacerbated by the high influx of refugees. Recent estimates put the share of informal activities in the total added value at approximately 27%, which is substantial in itself and higher than that of its peers, such as Poland and Hungary (OECD, 2018). Undeclared work is similarly high at 33% of all employment (Turkstat, 2019). The potential productivity gains of addressing this issue are significant: an earlier study estimated that shifting all informal firms in the Turkish manufacturing and service sectors into the formal sector could raise total output by 5% and 25% respectively (Taymaz, 2009). The large influx of refugees and the associated high rate of informality are significant challenges for the reduction of informality in the Turkish labour market, while also complicating the social inclusion of these refugees.

Informality has a number of negative consequences for the competitiveness of the economy. Informality is an obstacle to a level playing field and distorts fair competition. A larger informal sector is associated with lower productivity, reduced tax revenues, and higher levels of poverty and inequality (because of the lower wages paid to informal workers compared with formal workers (World Bank, 2019a)). Some studies suggest that informal employment can damage long-term career prospects and entrench income differentials (Taymaz, 2009). The many small informal businesses, which employ the largest share of Turkey's labour force, have very limited access to bank credit, and so find it difficult to fund long-term investments.

The high level of informality has several underlying causes. The agricultural sector still employs a significant amount of people with typically very high rates of unregistered work. In addition, the large influx of (mostly unskilled) Syrian migrants provides for a steady supply of workers who have few other options than informal work in construction or agriculture. Lastly, the high costs of dismissal (through severance payments) may also be pushing firms into informality.

The importance of formalisation is recognised by the Turkish Government. To reduce informality, the NEP proposes increased audits and improved taxation practices by integrating various data sources. Turkey's 2019-2021 ERP sets out the launch of an action plan covering 2019-2021, which has the ambition of bringing the informal sector down to the EU average in the medium term. Turkey has already made a number of reforms, which are steps in the right direction. Since 2018, employer contributions for each newly-hired worker in eligible firms have been reduced by 50% (the Government pays all taxes and insurance premiums of additional employment for one year). The minimum wage, which increased by 0.2% in 2017 and 3.0% in 2018 in real terms was kept below the previous year's labour productivity growth. The same is true for the 26% increase in the monthly net minimum wage in January 2019, designed to compensate for the depreciation of the TL. Since March 2016, retired individuals working on their own account are exempt from social security contributions, encouraging continuing work in the formal sector after the official retirement age. Social

security and tax incentives have been increased to incentivize recruitment, with a focus on female, young or disabled employees, in an effort to include and formalize vulnerable groups (EBRD, 2018).

Given the large size of the informal sector, reforms should continue in a more focused way. In particular, informal employment could be further reduced through an increase in inspection capacities, with particular focus on non-agricultural employment. Such capacities are currently decreasing in Turkey because the increased number of inspectors, even if already below ILO standards, does not match the increase in the work force. Increasing inspection capacity is deemed critical for enforcing labour law and reducing informal labour. In addition, it is important to evaluate the uptake of the various recent social security contribution cuts in order to make permanent those, which have proven most supportive of formalisation (OECD, 2018).

4.2 Labour market, education and social policies

Labour market developments

Employment remains at a low level, and the challenge of creating jobs for the young remains. In 2018, the overall employment rate increased to 52% (15-64). The employment rate of older workers (60-64) is particularly low at 30.1%. The labour force participation rate in the 15-64 age group is also low at 58.5% with a large gender gap of 40.3 percentage points (78.6% for men and 38.3% for women). The unemployment rate has increased to 11% in the yearly average of 2018. However, the unemployment rate has been even further increasing by the end of the year (M12-2018 13.5%). In addition, there are strong regional disparities in regional employment and unemployment figures. Particularly affected are young people in Turkey: Although youth unemployment decreased in the yearly average for 2018 slightly to 20.3%, the share of young persons (15-24) not in employment, education or training (NEETs) has further increased to 24.5%. The rate for men is 15.6% and the one for women a striking 33.6%. The growth-induced job creation lags behind the demographic development.

Women's labour market participation and informality remain among the essential shortcomings of the labour market. The male employment rate in the 15-64 age group is 70.9% and the female employment rate is only 32.9%. This leads to a gender employment gap of 38 pps. Poor working conditions, deficits in decent jobs, low wages, skills mismatching and gender segregation among occupations are among the barriers women face in the labour market. The lack of institutions and services to provide care for children, the sick and the elderly and the cultural divide on female education and labour between urban and rural communities of Turkey adds further obstacles to the employment of women. A big proportion of the female population in rural areas never enters the formal labour market. More than one third of the workforce is still in informal employment. Although the figure has been declining in the last 10 years, which were characterised by high growth rates, the absolute level of informality is still too high. Although there are sporadic efforts to tackle informality there is no integrated framework addressing the issue.

The main active labour market policies are employment subsidies. In 2017, more than TL 5.5 billion was allocated for employment incentives covering social security contributions of employers. There is no integrated policy framework in place to address the low rates of labour market participation of women and young people, the informal sector or the skills mismatch of the labour force. Turkey has launched a women's employment programme which offers vocational or on-the-job training and individual action plans prepared by special units in public employment centres. Unemployment benefits amount to 40% of the average gross salary of the last four months, but are limited to 80% of the minimum wage (currently TL 2020 per month). Unemployment benefits are paid for a maximum of 300 days. In total 577, 054 persons were receiving unemployment benefits in December 2018.

Social dialogue has deteriorated. The Economic and Social Council has not convened since 2009 and the Labour Assembly has not convened since 2015. The Tripartite Consultative Committee, which is the main social dialogue forum, held one meeting in 2018 and produced no tangible results. Trade union density in the private sector is low at 13.86%. This is mainly due to the high rate of informal employment, which discourages workers joining trade unions. In addition, 85% of the Turkish economy consists of SMEs with fewer than 30 staff that makes unionisation difficult. The trade union density is higher in the public sector (67.65%), but has been falling since 2016. Generally, Turkey has a very low collective bargaining coverage. Collective agreement coverage is below 10% in the private sector. In addition, trade union activities are in some cases obstructed with union members facing dismissals, harassment and in some cases even detention. The limitation of the right to collective bargaining and freedom of association has attracted the attention of the International Labour Organisation (ILO). In order to reinvigorate social dialogue ILO has together with the Turkish Ministry of Family, Labour and Social Services implemented an EU-funded project "Improving Social Dialogue in Working Life" in 2016-2019 with a focus on capacity development of all related institutions and parties. Numerous tripartite and bipartite consultation processes were carried out during the span of the project. However, the regular social dialogue mechanisms (Economic and Social Council, Labour Assembly, Tripartite Consultative Committee) are not functioning.

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning employment markets and welfare systems, they are equally relevant for candidate countries and potential candidates.

Turkey faces considerable challenges concerning the indicators of the Social Scoreboard[1] supporting the European Pillar of Social Rights. This is notably the case for equal opportunities and fair working conditions, especially for those in informal employment. Turkey has a high rate of early school leavers (31%) and young people not in employment, education or training (NEETs). In 2018, the gender employment gap is at 38 pps the highest among the enlargement countries. Both the at-risk-of-poverty-rate (2016: 22.8%) and the income quintile ratio are higher than EU-28 averages. Social dialogue has been deteriorating in the recent years.

Low participation in the labour market applies in particular to women. The labour force participation rate of women is 38.3%. A significant part of the female population never enters the formal labour market. The unemployment rates and overall unemployment are increasing. Enrolment figures for pre-primary and primary education have improved starting from a low level over the years but the quality of education remains an issue, as indicated in the result of PISA testing.

Skills mismatch and limited reskilling opportunities limit labour market integration and mobility. Overall, education outcomes remain low at various levels. While primary education is nearly universal, there are low enrolment and high dropout rates in secondary education. Teacher training and quality of education are other areas which require investment.

The impact of social transfers on poverty reduction is small. It accounts for only 7.69% (EU average 33.2%). The risk of poverty and social exclusion in the country has been increasing, and so have the income inequalities.

Turkey has a well-developed system for labour market and social statistics.

TURKEY		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Worse than EU average, improving
	Gender employment gap	Worse than EU average, improving
	Income quintile ratio (S80/S20)	Worse than EU average, deteriorating
	At risk of poverty or social exclusion (in %)	Worse than EU average, deteriorating
	Youth NEET (% of total population aged 15-24)	Worse than EU average, deteriorating
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, deteriorating
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average, improving
	Children aged less than 3 years in formal childcare	N/A
	Self-reported unmet need for medical care	Worse than EU average, improving
	Individuals' level of digital skills	Worse than EU average, improving

The Turkish Statistical Institute (Turkstat) is the main producer and coordinator of the statistical system of Turkey. Turkstat publishes the Labour Force Survey (LFS) quarterly and annually and the Survey on Income and Living Conditions (SILC) annually.

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[1] The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

Social protection system

Income inequalities remain at high rates and above the level of EU countries. Standing at 0.426 the Gini coefficient is considerably higher than in the EU (0.308) and so is the income quintile ratio (S80/S20) at 8.6 (EU: 5.2). The at-risk-of-poverty rate remains at around 22%. The reduction in the poverty rates is linked to the availability of new and better-paid jobs as social security transfers and the minimum wage do not significantly mitigate poverty risk. The high level of informal employment aggravates the situation. The impact of social security transfers on poverty reduction is small at 7.69%, but has been improving in recent years. However, it is nonetheless still much lower than the EU average of 33.2%.

Turkey has a number of fragmented social assistance schemes. There are pensions for the elderly, for widows and for the disabled. There is no minimum income scheme in Turkey. There is neither a strategy for homeless nor a long-term care strategy in place. Some social benefits provide relatively discretionary and irregular in-kind and cash assistance to poor households. There are also targeted assistance schemes where households receive conditional cash transfers based on their children's school attendance or visits to healthcare providers. All of the schemes are subject to means-testing. In the absence of reliable income indicators, estimations are made, which renders the final decision on social assistance largely discretionary. Formally employed persons covered by social security are not eligible for social assistance.

Early childhood education and care services are limited in Turkey. The enrolment rate for children up to the age of 2 years is less than 1% and not much higher at the age of 3. It is 50.42% for the 4-5 age group and for the age group 5 it increased from 58.8% in 2017 to 66.8% in 2018. Funded by the EU, the Social Security Institution (SSI) provided a childcare subsidy to women who were working or returning to work and who had children younger than 24 months. The programme lasted from March 2015 to November 2017 and reached a total of 11,400 women at a cost of TL 38.9 million (EUR 6.88 million). Through another programme initiated in March 2017 by the Ministry of Family, Labour and Social Services, a subsidy was offered to grandmothers who cared for their grandchildren. The project covered 6,000 women and lasted for 1 year. However, it has been discontinued, as it did not have any structural impact on the employment of working mothers. Available grandmothers provided the service with and without subsidies and hence the number of working mothers did not increase.

Education and skills

Progress in increasing provision and quality of education is mixed. The net enrolment rates in primary school increased from 91.2% in 2017 to 91.5% in 2018. Turkey's PISA (Programme for International Student Assessment) and PIAAC (Programme for International Assessment of Adult Competencies) scores are far behind the average of other OECD countries, indicating the need to step up the quality and coverage of school education. In secondary education, the net enrolment rate increased from 82.5% in 2017 to 83.6% in 2018. Since 2014, Turkey participates in Erasmus+ on the same footing as EU Member States. The country has access to actions in the field of higher education, youth, sport, vocational education and training (VET) as well as school and adult education projects for cooperation and mobility. Turkey can also cooperate with partners outside Europe under international projects.

The implementation of a national vocational qualifications system by the Vocational Qualifications Authority (VQA) is ongoing. The Turkish qualifications framework (TQF) is now referenced to the European Qualifications Framework. Incentives are offered to provide vocational training. Between February 2017 and June 2018, 3,109,971 incentives were paid to businesses. Apprenticeships were introduced into 12-year compulsory education. An important step has been taken to further develop skills using enhanced on-the-job training. Students can now become graduates from high school by passing the complementary courses

leading to a mastership in a trade and if they wish they can sit for the university entrance exam, and attend higher education. Turkey will need to develop skills development strategies to ensure the continual renewal of skills in a changing world. This will require a focus on the transitions individuals face (for example, moving from the informal to the formal economy or from the manufacturing to the service sector), so that each person successfully adapt to the labour market and can interrupt, reskill and re-engage in employment throughout their careers.

The Education Vision 2023 was approved in November 2018 with a very inclusive approach involving all the public and private stakeholders including civil society. As a result of Turkey signing the European Alliances for Apprenticeship (EAfA), there has been increased involvement of the private sector in skills matching for all levels of education.

Tertiary education tends to concentrate on fields which are less relevant for the labour market. Based on the Adult Education Survey, these are humanities and social sciences, business and law. Industrial and technological sectors require increasingly mathematics, IT, natural sciences and technology (MINT) qualifications.

Adult education in lifelong learning is 5.8% lower than the EU average of 10.8%. Adult education takes place in a broad range of institutions but its performance regarding literacy, numeracy and problem solving skills in technical contexts is weak.

4.3 Competitiveness and sectoral issues

Business environment

The ease of doing business and access to finance have improved, but as outlined above, concerns about commercial justice processes and competition continue to hamper the business environment. The 2019 World Bank Doing Business report ranked Turkey 43 out of 190 economies, recognising it for its reforms by lifting it from 60th place in 2017. Specific measures were implemented to make it easier to: start a business, apply for construction permits, access credit, pay taxes, trade across borders, enforce contracts and resolve insolvency. The protection of intellectual property rights was also improved. However, other aspects of the business environment are deteriorating. Concerns over commercial justice processes and unfair competition, not least from the informal sector, are outlined above. Insolvency also remains an important issue. The process still takes a long time (five years on average) and is expensive (requiring 14.8% of debtors' assets) with a recovery rate of only 14.7 percent (World Bank, 2019b). The impact of the insolvency reforms remain to be seen. The OECD also points to Turkey as having one of the largest gaps between entrepreneurial dynamics and institutional capacity (OECD, 2018).

The fight against corruption is seen as important to attracting FDI and upgrading the business environment. Turkey scored 41 points out of 100 and ranked 78 out of 180 countries (down from a high of 50 points and 53rd ranking in 2013) on the 2018 Corruption Perceptions Index reported by Transparency International. The OECD estimates that a one percentage point increase in the World Bank corruption index reduces FDI from selected countries by 4-9%. Turkey's policy response remains weak. While Turkey has indicated the ambition to enter the top 20 in the WB Doing Business ranking within two years, no specific measures are set out in either in the NEP 2019-2021 or the ERP to further combat corruption.

Research, development and innovation

R&D expenditure is increasing, but more and continued support is needed. The share of R&D expenditure in GDP has risen fourfold since 2005, outstripping countries such as Mexico and Greece and comparable to that of Poland. R&D tax incentives have become the main tool for the government to boost R&D (e.g. by exempting key R&D salaries from income tax: 90% for staff holding a PhD). Nevertheless, tax credits and tax allowances are

among the lowest in the OECD. While the number of full-time equivalent R&D personnel increased by 12%, Turkey's overall research capacity is still limited in terms of the number of researchers per million inhabitants (a third of the European average).

Turkey's R&D expenditure as share of GDP (0.96% in 2017) is below the EU average (2%) and significantly below the target, which Turkey has set for itself (1.8% in 2018). Only 0.07% of GDP is spent on private sector R&D activities, which is very low compared to OECD countries. Current institutional capacity and resources spent on R&D, and the level of commercialisation of innovation, are insufficient to support Turkey's ambition for higher value added production. In this regard, it is important to increase domestic savings, as it is generally considered difficult to attract external financing for R&D (OECD, 2018).

Digital economy

Turkey has the ambition to move towards a digital economy, but insufficient competition and limited digital skills are challenges. Fixed broadband subscriptions rose to 14.8 per 100 people in 2017. Mobile broadband penetration significantly increased to 73%, though it is still below the OECD average of 102.4%. The share of households with access to the internet at home increased from 81% to 84% between April 2017 and April 2018. Over the same period, internet usage by individuals aged 16-74 increased from 67% to 73%. The number of 4/5G subscribers reached 68 million within two years. However, Turkey's digital sector suffers from insufficient competition in the telecom markets and excessive taxation and costs for operators and for consumers of information and communications technologies. In addition, digital upskilling is urgently needed, as earlier studies highlighted limited proficiency in information processing skills (OECD, 2016b). Turkish firms increasingly invest in digitalisation, although the adoption of digital applications related to core business management functions should be expanded.

Turkey has made progress in integrating digital government into its public administration reform. It provides an e-government portal as a single access point for electronic services for its citizens. The Government has also promoted digitalisation by facilitating the connection of business to public authorities by, for instance, online filing of tax and social security returns and online applications for construction permits. The number of registered users reached 40 million in 2018, a significant increase from 25.2 million in 2015. However, other public administration areas in Turkey remain a concern.

Investment activity

Turkey's objective to scale up the value added of its production requires more productive investment. Investment in construction outpaced the investment in machinery: during the period 2013-2018, the average quarterly growth rate in investments in construction was 8.6%, compared to only 4.2% for machinery. The credit crunch that Turkey experienced at the end of the year as a matter of fact hit machinery investments harder than construction. More specific measures would be needed and this also fits into the broader need for raising domestic savings in order to finance these productive investments. With investments outpacing domestic savings, foreign investment is essential. FDI flows have been the most stable, but continue to play a relatively limited role, registering a net inflow of 1.0% of GDP in the first three quarters of 2018 (compared to a peak of 3.65% in 2006). The EU remains the largest source of FDI in Turkey with a 71% share of stocks in 2017, although the rate has been declining (77% in 2013).

Trade performance

Turkish remained an open economy, with trade openness, measured as exports and imports as a proportion of GDP, at 54% in 2018. This is a relatively high figure compared to the past two decades. Price competitiveness benefited from the continuous depreciation of the TL in 2018. Calendar adjusted exports grew by 7.0% while imports fell by 4.6%, resulting

in a 28% reduction of the trade deficit, and increased export coverage (to 75.3% from 67.15%). The ratio of exports of high-technology products in manufacturing industries was 4.3%, indicating the relatively low innovative component of locally produced goods. Turkey's trade integration with the EU is high, and rising, although a particularly pronounced decrease in imports from the EU, and hence adjustment of the trade balance, took place in 2018. Turkey is the EU's fifth largest trade partner and the EU remains by far Turkey's largest trade partner, accounting for 50.0% of exports and 36.2% of imports. In 2018, the main export destinations were Germany, the United Kingdom and Italy, and the main sources of imports were Russia, China and Germany.

In addition to Turkey's continuing introduction of additional tariff duties diverging from the Common Customs Tariff, several non-tariff barriers remain between Turkey and the EU, which restrict imports and exports in several sectors. This is despite Turkey's high level of legislative alignment with EU law under the Customs Union. Such non-tariff barriers include the requirement for foreign firms exporting pharmaceutical products to relocate part of their production to Turkey, export restrictions in certain sectors, excessive testing and certification requirements at customs, heavy import surveillance etc. In addition, public procurement does not provide a level playing field, since it favours local companies and some public bodies are exempt from the provisions of public procurement law.

Energy

Turkey's energy sector is heavily reliant on imports of fossil fuels and suffers from a lack of price competition. Turkey's dependence on imported energy is one of the main drivers of its external imbalance. Oil and gas are mostly imported from Russia, Azerbaijan and Iran. Turkey has made efforts to improve its security of supply, with the completion of the first phase of the Trans-Anatolian Pipeline (TANAP) and the offshore section of the Turkstream pipeline as well as by expanding its LNG Floating Storage Regasification Unit capacity and gas storage capacities. Turkey has a large programme of construction of coal burning power plants. Further steps to diversification were made by the launching of three big tenders for solar and wind energy last year (although the tenders failed to attract tenderers). Renewables account for 35% of total energy production (mostly hydropower and wind), and 44% of the total installed capacity. Electrical power transmission and distribution losses are estimated at 12.1% (TEIAŞ 2017).

There is still a need to fully liberalise the energy market to make it fully aligned with the Third Energy Package. The large increase in energy costs (31% over 2018, Producers Price Index increase of 75% for the electricity industry) has reduced the competitiveness of Turkish manufacturers and the local-content requirements do not provide a level-playing field in procurement. As a country dependent upon energy imports, energy efficiency is a priority. The national energy efficiency action plan has been approved and is under implementation. The key focus of the SME strategy in the context of SME greening is the promotion of eco-efficient products, services and processes, as well as eco-innovation. Business support schemes assist SMEs in greening their projects (with a focus on energy efficiency) and also aim to improve the quality and quantity of the energy efficiency consulting companies.

Transport

Turkey's transport sector is heavily reliant on road transport, with little diversification into other transport modes such as rail. Road transport is still the primary mode of domestic freight transport in Turkey, accounting for more than 85% of total freight, measured in tonne-kilometers (Turkey, 2018)**.** This reliance on road transport continues to generate environmental and traffic safety problems. Moreover, there are a number of urban mobility issues especially in large cities such as Istanbul that reduce economic efficiency. The logistics master plan and the strategy for intelligent transport systems have both been finalised and aim at a more balanced, multimodal approach to transport; however, implementation has not

started yet. A large program of track renewal and modernisation is being completed to restore the rail infrastructure to a normal condition after a long period of neglect (Turkey, 2018). The rail sector still needs to be liberalised. Current investments in rail infrastructure will only gradually shift the modal split for passenger and freight transport. Projects to increase transport by water do not seem like immediate prospects. Border crossings remain as a key bottleneck, with significant cost implications for the time lost.

Agriculture

The agricultural sector is characterised by informality, a lack of reliable data, land fragmentation and a lack of modern technologies. Agriculture is important in Turkey's economy, providing 5.8% of gross value added and 18.4% of total employment in 2018. Typically associated with a prevalence of low-productivity informal activity, the share of agriculture in total GDP has been decreasing (from 6.9% in 2013, for example) as has the share of total employment. The lack of reliable agricultural data complicates the development of a proper policy response. Land fragmentation, which limits economies of scale, illustrated by the small average farm size (7 ha, compared to the EU average of 16 ha), is exacerbated by distorted territorial integrity caused by inheritance by family members (EBRD 2016). While agricultural value added and agricultural production have grown moderately over the last decade, major crops such as wheat have difficulty to compete in the market, and depend on subsidies for their economic viability. The level of agricultural subsidisation in Turkey is considered moderate, close to the EU average (support amounting to 28% of gross farm receipts, compared to the EU average of 21%, OECD, 2019). Poor access to finance and lack of a predictable support system discourage any attempts at modernisation or innovation by individual farmers. The system as a whole suffers from weak irrigation systems. The protectionist aspects of Turkey's agricultural policy also need to be addressed. This is especially important to allow further liberalisation of agriculture.

Industry

Turkey's industrial sector is dynamic, but performs below potential and suffers from a high dependency on foreign energy sources and raw materials, and regional disparities in industrial development. Helped by its geographic location, it is generally well integrated into European and global value chains. Recent regional development strategies promote local efforts to cultivate technology, industry and service clusters (in the absence of industrial strategies). Industry also accounted for 19.7% of employment and 22.2% of GDP in 2018. Exports have diversified over the past decade, with vehicles, machinery, mechanical appliances and jewellery now being the commodities which contribute most to exports. Labour productivity has increased to 79% of the EU average and now is higher than in e.g. Portugal and the Czech Republic.

Turkey's ambition is to increase the proportion of high technology in its industries. Currently, however, high-technology products from manufacturing industries represent only 4.3% of the value of exports. In addition, R&D investment is still relatively low: even listed firms (large corporates, generally considered the most competitive segment) show R&D investment rates lower than those of their peers (Cilasun, 2019). Lastly, the generally poor performance of the education system creates obstacles to Turkey's ambition. To decrease dependency on foreign input, efforts are being made to boost the domestic energy supply and support domestic inputs. Regional disparities among Turkey's 81 provinces are substantial: three provinces together account for more than 46% of GDP. Turkey's less-advanced regions have relied increasingly on low-technology and low-skilled manufacturing. For the future, it will be key to help these businesses upgrade the quality of their products and increase their productivity. The formalisation of informal and semiformal activities in these regions will be essential for inclusive growth in this regard (OECD, 2018).

Services

The service sector is expected to remain the fastest growing sector in terms of value added and employment, but could benefit from liberalisation. The service sector dominates in terms of gross value added (54%) and represents 54.9% of employment in 2018. The services sector grew 5.6% y-o-y, and represented 21% of the value of exports in 2017. Turkey is not fully aligned with EU legislation on the right of establishment and freedom to provide services. It is important that this is addressed in possible further liberalisation of the services market. As a major export sector, tourism is expected to grow and contribute significantly to the rebalancing of the economy. To tap into this potential, a policy of inclusive and ecologically sustainable growth should be pursued (OECD, 2018).

Overall: Limited implementation (28.9%)[2]	

2018 policy guidance	Summary assessment
PG 1:	There was **limited implementation** of PG 1:
Lower external imbalances in light of high external funding needs constituting a substantial risk for the Turkish economy.	**1) Limited implementation:** The current account deficit decreased significantly by 42% over the last year, from USD 47.1 billion in 2017 to USD 27.1 billion in 2018. Turkey recorded a current account surplus over 4 consecutive months between August and November 2018. However, the government did not pursue this correction of external imbalances but was, instead confronted with an abrupt unravelling.
Promote domestic savings by incentivising higher private sector savings	**2) Limited implementation:** The Government continues to offer incentives to encourage households to bring their gold to banks to be deposited. The Treasury has been issuing gold denominated bonds and lease certificates. The premium on pension savings continued but high inflation eroded its impact.
and by following a sufficiently tight fiscal stance over the medium term in light of external vulnerabilities built up over the years.	**3) Limited implementation:** The budget deficit widened significantly from TL 47.8 billion in 2017 to TL 72.6 billion in 2018 and the structural government balance went further into deficit in 2018. The Government has made significant tax cuts and introduced incentives during election periods.
PG 2:	There was **limited implementation** of PG2:
Increase the prudence and transparency of fiscal policy by (i) making a sufficiently prudent inventory of risks to public finances stemming from Public Private Partnerships and other contingent liabilities	**1) No implementation:** There is no publicly available inventory retracing the risks to finances stemming from public private partnerships and other contingent liabilities.
(ii) limiting the accumulation of new contingent liabilities reflected in the budget	**2) No implementation:** The Government announced that public investment projects for which tender processes have not been launched or for those which have started but not yet been finalized, will be suspended. However, the 2019 investment programme suggests investments are continuing according to plan. It is envisaged that large infrastructure projects will be implemented using foreign investment and international financing (and expectedly through PPPs) only, and, therefore, will most likely add to the existing contingent liabilities.
(iii) avoiding ad hoc increases in tax exemptions and subsidies,	**3) No implementation:** Turkey introduced temporary tax cuts and opportunities for capital repatriation and restructuring for a wide range of taxes and penalties during the first half of 2018. Afterwards, almost all of them were extended until the end of March 2019. Turkey maintains its policy of introducing temporary tax-cutting schemes particularly before elections and after economic fluctuations.
and (iv) making the medium-term economic	**4) Partial implementation:** In the NEP (2019-2021),

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[2]   For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

scenario more conservative.	the macroeconomic indicators were revised compared with last year's medium term economic programme (2018-2020). The new macroeconomic forecast seems to be somewhat more realistic, at least for some of the indicators, such as economic growth (considering the rebalancing process in the Turkish economy) and the inflation rate (in light of recent developments including the weakening of the TL and the increase in food prices).
PG 3: Focus monetary policy on the pursuit of price stability and ensure that the monetary policy stance is sufficiently tight to bring back to the target band, anchor inflation expectations and increase trust in the local currency. Simplify the monetary policy framework by returning to the main policy rate as the key signalling device for the monetary policy stance in order to increase transparency of monetary policy. Closely monitor asset quality amid buoyant credit growth, especially for loans backed by the credit guarantee fund. Continue addressing possible risks associated with corporate forex borrowing.	There was **partial implementation** of PG3: 1) **No implementation:** The monetary policy stance remained loose (with a real average interest rate of 1.5% in 2018). Inflation, core inflation and inflation expectations have further increased with inflation reaching a 15-year high. 2) **Partial implementation:** In June, the Turkish central bank (CBRT) reverted to a simplified monetary policy framework by using the one-week repo rate as the key policy rate and putting a surrounding interest corridor of 150 basis points in place. However, during the financial turmoil in August and September 2018, and as of late March 2019 the CBRT deviated from the simplified monetary policy framework.. 3) **Partial implementation:** The authorities undertook an asset quality review, but did not communicate the methodology used or any more specific outcomes except for the headline ratios, which lacks transparency and did not help restore confidence in the banking sector. 4) **Partial implementation:** Effective from May 2018, the government banned foreign exchange borrowing by SMEs that are not naturally hedged against forex risks, and it imposed certain limits on forex borrowing for exporting SMEs. However, the authorities did not explore further measures except for taking some ad-hoc measures after the financial turmoil in August.
PG 4: With a view to improving the business environment, strengthen the rule of law and the judiciary. Further reduce the administrative burden for companies, including by shortening the timing and lowering the cost of insolvency procedures through the effective implementation of the amended law on bankruptcy.	There was **partial implementation** of PG 4: 1) **Limited implementation:** Turkey lifted the state of emergency in July 2018 and new civil courts judges were recruited and trained. However, a large number of companies remain under trusteeship after having been seized in the wake of the attempted coup with no clear prospects of timely due process. 2) **Partially implemented:** Legislative amendments helped to reduce the administrative burden mainly by removing the paid-in minimum capital requirement, eliminating notarization requirements and reducing registration costs. Concerning insolvency, Turkey introduced the possibility of obtaining post-commencement credit, improved voting arrangements in reorganisation and granted creditors greater participation in the proceedings.
PG 5: Adopt the strategy in support of research and development. Encourage private companies' uptake of innovative	There was **partial implementation** of PG 5: 1) **Limited implementation:** According to the second 100 day action plan of the Presidency, the Science, Technology and Innovation (STI) Policy Board is expected to adopt the new national strategy for research, development and innovation (RDI) in the course of 2019. 2) **Partial implementation:** The 100 Day Action Plan

production processes.	of the Presidency included priorities on business-academia cooperation. Several initiatives (to improve innovation networks, strengthen research capacity and increase access to finance) have been launched by the Scientific and Technological Research Council of Turkey (TUBITAK). A comprehensive roadmap for digital transformation has been developed to increase the use, development and production of digital technologies.
PG 6:	There was **limited implementation** of PG 6.
Ensure a balanced regulation of the labour market combining flexibility with security including the reform of the severance pay system	1) **Limited implementation:** In December 2017, a state of emergency decree came into force in which subcontracted workers in public service were given the right to become permanent staff under certain conditions. The decree was implemented in the first half of 2018, but does not address similar challenges in the private sector. Plans for reforming the severance pay system were announced in the 2019 annual presidency programme.
and reduce informal employment through, inter alia, increase of inspection capacities, with particular focus on non-agricultural employment.	2) **Limited implementation**: Informal employment has been around 33% since 2015. Inspection capacities have not sufficiently increased. The Social Security Institution has continued the "KİDEP" project to promote registered employment. The project has a guidance and inspection component where programmed inspections based on a risk analysis are expanded. The project had also a nationwide awareness raising component. However, the results remain to be seen.
Target support for job creation to young people and women.	3) **Partial implementation**: Employment subsidies to help businesses hire new employees were further expanded. Certain social security-related costs of employees, with a focus on youth and women, have been covered from the unemployment insurance fund. New employment subsidy programmes were launched and existing ones continued to be implemented in 2018. A new subsidy programme, the "New Generation Incentive", launched in 2018, aims to provide additional employment subsidies for youth in manufacturing and IT. A 2018-2023 Strategy and Action Plan on Women's Empowerment was adopted and includes support for female entrepreneurship and cooperatives. In 2018, 60 776 women participated in entrepreneurship trainings. Some of the Regional Development Agencies implemented programmes to support female entrepreneurship via trainings and grants.
Focus support to the expanded provision of vocational training on sectors with growth potential and skills needs.	4) **Limited implementation**: In December 2017, a protocol on "Improvement of Vocational Trainings and Skill Development" was signed between the Ministry of Family, Labour and Social Services and the Union of Chambers and Commodity Exchanges of Turkey and some training was delivered under this protocol during 2018. However, there is no available assessment of this training on employment in the sectors.

Measure 1: Increasing share of renewable energy in electricity generation

Increasing the share of renewable energy is expected to help reduce Turkey's dependence on energy imports and ultimately the current account deficit, and this measure is intended to support the trend of growing share of renewables in Turkey's total energy generation. It complements important investments that have been initiated in wind and PV energy. However, concerns have been voiced about special incentives and local-content requirements, which affect access by EU and other international companies to tenders in the renewable energy sector in Turkey. As regards the planned activities, energy sector stakeholders should be consulted on the legislation setting out the new renewable energy incentive mechanism and it should be adopted well in advance of the expiry of the current mechanism (i.e. end of 2020). This will provide predictability for investors.

Measure 2: Development of financial mechanisms regarding energy efficiency

The national energy efficiency action plan (NEEAP) was finally adopted in 2018, but its actual implementation is yet to be rolled out. Priority needs to be given to the development of national energy efficiency financing mechanism, envisaged under the NEEAP. Involving and regularly consulting relevant stakeholders in the design, monitoring and evaluation of energy efficiency policies and measures will help ensure their feasibility and increase the rate of compliance.

Measure 3: Turkish railway transport liberalization

Proper liberalisation of railways will bring down the unit costs of transportation and significantly reduce the externalities from the transport sector. Railway liberalisation features prominently in the transport master plan adopted in 2018. Still, it is unclear how this measure will address the several significant obstacles to true liberalisation, such as ensuring that there is no public financial support in the freight sector, that all passenger lines should be supported through public service obligation contracts, that the government-owned TCDD Transport operates as an independent commercial company in an open market, that all freight and passenger rolling stock will be registered, irrespective of origin, and that there is fair competition.

Measure 4: Increasing the capacity of improvement and evaluation in agricultural statistics data collection processes

An overall strategy is needed to address the shortcomings identified within the agricultural sector (still an important sector for the Turkish economy). The availability of complete and accurate agricultural statistical data is a precondition of evidence-based policy development. As such, the proposed measure is important and relevant. However, the description of the identified scope and activities (and their linkages) is not sufficient. Furthermore, it is not clear if the aim is to develop a methodology in accordance with that of Eurostat or a more country-specific one.

Measure 5: Project proposal call and implementation within the scope of KOBIGEL-SME development support programme

It is unclear how this measure helps to boost the competitiveness of SMEs. More detailed information on the KOBIGEL (small and medium-sized enterprise development support programme)-programme is needed to be able to assess its relevance and importance. The impact on employment and gender is not really explained.

Measure 6: Supporting domestic manufacturing of products with high import and strategic importance to reduce the current account deficit

The strategic product support programme, which is also a KOSGEB programme, is not sufficiently explained. When implementing this measure, it is essential to avoid violating international obligations or the terms of the EU-Turkey Customs Union, i.e. the measure should not be implemented, in principle, by using trade protection measures that run counter to Turkey's obligations (for instance, as in the case of localisation of pharmaceuticals).

Measure 7: Increasing tourism market share and brand value

Tourism is an important economic sector and has performed strongly over the last two years with the number of tourists and total tourism income increasing significantly. However, the tourism sector remains below its potential, especially when considering the decline in average expenditure per visitor. In this context, the preparation of an action plan (the tourism master plan) to diversify tourism products/services and markets will help further boost the tourism sector and help increase the country's competitiveness and reduce the current account deficit. However, the proposed measure is too general (no details) and does not seem to be mature enough (no KPI) for inclusion in this year's ERP.

Measure 8: Supporting the cooperation between SMEs or SMEs and large enterprises

Better incorporating of SMEs into the value chain of large enterprises is relevant. The lack of exchange of knowledge and experience between SMEs, and between SMEs and large enterprises, has been presented for the first time as a constraint on growth. More detailed explanation on the cooperation support program is required to allow the credibility and the effectiveness of this measure to be assessed. The number of targeted enterprises is small compared to the total SME population.

Measure 9: Establishment of SME guidance and counselling System

Improving the operations and management of SMEs (especially middle-sized ones) has been identified as an important factor for their ability to remain competitive and to grow. As such, the proposed measure is relevant and credible. More detailed explanation is needed to allow the effectiveness of this measure to be assessed. The number of targeted enterprises is small compared to the total SME population.

Measure 10: Increasing private sector investment by carrying out more effective support and promotion activities

Investment promotion is not regarded as structural reform within the scope of the ERP. Government efforts to increase investment needs to be evaluated, including from a State aid perspective (because substantially fewer companies are being selected, which means that each is being awarded a proportionally higher amount of incentive, compared with previous years).

Measure 11: Increasing the number and efficiency of business development, incubation and accelerator centers in order to support innovative entrepreneurship

Several years ago, EU funds were used to establish enterprise development (ISGEM) centres in less-developed regions of Turkey to support local economic development. These centres are considered to be successful tools for boosting local economic potential, although their sustainability is yet to be assessed. The planned measure will further expand the number of centres and complements a planned measure under the competitiveness and innovation sector operational programme (CISOP), which is co-financed by the EU.

The suggested support to innovative enterprises will help reduce regional disparities and long-term growth and is considered feasible and credible provided that it ensures complementarity with other measures in the area of innovative entrepreneurship.

Measure 12: Enhancing the R&D and innovation activities of SMEs

The measure refers only to one activity, the "SME technological investment support programme" that was designed and launched by KOSGEB. However, the measure overlooks,

and does not make explicit the link to relevant ongoing programmes, such as the tech-invest programme and industrial innovation networks mechanism from TUBITAK.

Although it is relevant and in line with the existing strategies, the measure is not based on a coherent approach (it takes into account one action only) and overlooks the parallel public support mechanisms. This may limit the overall impact of these mechanisms and result in duplication of some activities.

Measure 13: Supporting competent research infrastructures on a performance basis within the new legal framework

The measure refers to Law No. 6550 on Supporting Research Infrastructures. However, activities are outlined in terms of the expected results (e.g. plans to introduce four new research infrastructures), instead of setting out well-defined activities to be put in place to implement the law. A good example of well-defined activities is the "high technology support program 1004" that was initiated by TÜBİTAK for the production of high technology products through national capabilities. The program aims to provide up to TL 50 million to each of ten High Technology Platforms to be selected.

The measure is in line with the strategies and has already provided some results such as the selection of four research infrastructures. However, related activities should be better explained to enable an assessment of long term feasibility and credibility.

Measure 14: Update of Turkey-EU Customs Union

The ERP document presents again the prospective modernisation of the Customs Union as a trade related 'reform' measure. It has been repeatedly underlined by the Commission that it could, at best, be a trade policy objective.

Like last year's ERP, this year's ERP does not provide an account of the structural problems that inhibit Turkey's closer integration into global value chains or that reduce its external competitiveness, nor does it present any autonomous measures that Turkey could take to address them. Instead, it refers to a few problems that can arguably be accounted for by Turkey's underutilisation of the benefits of the Customs Union.

Measure 15: Dissemination of pre-school education

The measure is an important priority for the education system and for improving pre-school education coverage. Pre-school education for five-year-olds has been increasing steadily in recent years. It is expected that pre-school education will be compulsory in all provinces starting from the 2020-2021 school year. The proposed measure and its four sub-measures aim to put in place the necessary investments in infrastructure, equipment and support staff to ensure that hard-to-reach children are able to attend pre-school education.

Measure 16: Increasing the 'reading culture'

Boosting the habit of reading among pupils at an early age is important for their social and cultural development. There are plans to increase the number of schools with a 'Z –library'. Steps will be taken to achieve the average reading skills reflected in PISA testing, and school communities will given information about the reading measure. There are plans to develop collaboration with teachers and joint teaching activities. The proposed activities are relevant, but they need to be closely monitored and supplemented with guidance for teachers.

Measure 17: Updating curricula and strengthening education

This measure plans to update the curricula by identifying student skills and needs by school and programme type, to improve the quality of education. The proposed activities are suitable for primary and lower secondary schools. For secondary schools, however (including general secondary, vocational secondary and private secondary schools), there are other important priorities. A modular credit system based on learning outcomes is needed in order to create

coherence between non-formal and formal training institutions (secondary schools) from a lifelong learning perspective. The proposed activities, especially for VET secondary schools, need to include the development of such modules. Pilot implementation of the credited modular passing system needs to be implemented, replacing the existing class passing system.

Measure 18: Redirection of people on social assistance into active employment programmes in order to increase their productivity and find sustainable employment

This measure, designed to enhance the link between social assistance and active labour market programmes, is relevant for inclusive growth, as it increases the qualified labour supply and helps reduce dependence on the social assistance system. The planned activities are very specific. However, the indicator for the number of referred and employed people formerly on social assistance (130 000 and 20 000, respectively, for 2019) seems extremely ambitious when compared with last year's outcome. There is no focus on a tailor-made approach to the design and effective delivery of active labour measures for this group. The design of a measure which creates employment incentives only by reducing the burden on employers seems questionable in terms of effectiveness and sustainability. This measure would have benefited from gender mainstreaming elements.

Measure 19: Job clubs

The measure concerns the establishment of 49 new job clubs, and is a way of increasing the employability of disadvantaged persons. The planned activities, focusing on establishment of new job clubs and training job and career counsellors, appear credible. However, there may be a need to focus on boosting awareness of the job clubs, to avoid lack of uptake. It is important to establish a system to monitor and assess the impact of the clubs. In terms of gender equality, there is a focus on bringing women into the clubs. An impact assessment should also consider how effective this measure is in terms of gender equality. The cost of the measure is provided indicatively, yet the budgetary source is not mentioned.

Measure 20: Social assistance plus (+)

The measure is designed to increase the social protection of poor people while establishing a link between social assistance and social protection services. As an ongoing measure, however, it showed limited progress in 2018. The planned activities for 3 years do not include concrete steps to support ASDEP (the family social support programme) in the Social Assistance Plus (+) approach, such as increasing the number of ASDEP staff and improving ASDEP staff capacity in order to ensure links between ASDEP, social assistance programmes, the labour market and social protection services in specific ways. Moreover, the resources allocated and the set indicators do not give the impression that this measure will contribute significantly to ensuring that there is inclusive social protection which will decrease social exclusion and poverty within 3 years. This measure would have benefited from better employment and gender links.

ANNEX B2: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020

The ERP 2019-2021 submitted by Turkey did not include any reporting on the implementation of the structural reform measures of the ERP 2018-2020.

The 2019-2021 Economic Reform Programme was sent informally to the Commission on 11 February 2019 and was formally submitted on 26 February 2019, with almost one month's delay. Overall, adherence to the Commission Guidance Note has improved.

Inter-ministerial coordination

Following the transition to the new presidential system, the central coordination of the ERP was given this year to the newly established Presidency's Strategy and Budget Directorate. However, the work was carried out by the same team as last year, just inside a new structure. This year, each line ministry designated a coordinator for the ERP. The line ministries and institutions involved in the ERP process had approximately one month to provide inputs to the ERP coordinator. Afterwards, the ERP coordinator, when deemed necessary, got in touch with the different line ministries and relevant institutions to request additional inputs.

Stakeholder consultation

According to the Government, the social partners were involved in the preparation of the ERP document, although it is not clear how. Business associations and civil society were not consulted. No comprehensive consultation of external stakeholders was done and no draft was made available to the public before the adoption of the programme.

Macroeconomic framework

The set-up of the chapter on the macroeconomic framework broadly follows the outline given in the guidance note. It covers nearly all the main elements. Some rebalancing between the section on recent economic developments and the sections on the medium-term scenario and, in particular, on alternative scenarios and risks would be welcome. The guidance note suggests that the first section should be very brief (it is 11 pages in the 2018 ERP) whereas the section "main risks in projections" is less than one page. The medium-term scenario does not explain differences with the Commission's services forecast. Nor is it fully clear how the IMF World Economic Outlook of October 2017 and its update of January 2018 are integrated into the forecast (second and third footnote of table 6 of the Annex).

Fiscal framework

The set-up of the chapter on the fiscal framework closely follows the outline given by the guidance note. It covers all of the main elements and gives significant detail on some elements which helps assessing the state of the Turkish public finances and its medium-term scenario. This year, a more elaborate analysis of debt sustainability is added which is welcome. Still, how the 2018 budget fits into the medium-term fiscal scenario is unclear. The section on contingent liabilities covers only Treasury-related contingent liabilities and excluded contingent liabilities of line ministries and state-owned financial institutions (including the KGF credit guarantee fund and the Turkish Wealth Fund).

Structural reforms

The structural reform priorities section improved this year. Reform measures are better specified than last year, although the quality of these measures in terms of description, timeline, estimated impact and risks could be improved. Further improvement of the key performance indicators is also needed. The number of reforms is limited to 20, but the page limit of 40 is not respected. Section 5 on budgetary implications of structural reforms is again completely missing, as is Table 9 on selected employment and social indicators. Table 11 on the reporting on the implementation of the structural reform measures of the 2018-2020 ERP is not complete and contains only very few activities.

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