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COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

TURKEY
(2018-2020)

COMMISSION ASSESSMENT

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1. EXECUTIVE SUMMARY

The Turkish economy regained momentum in 2017 supported by a broad range of policy measures to stimulate the economy and a strengthening of foreign demand. In the second half of 2017, private domestic demand became an increasingly important driving force for economic growth. Private domestic demand will continue to drive the economy in the short term with strong employment growth supporting private consumption and high capacity utilisation and robust foreign demand growth requiring investments in manufacturing. As the elections approach (scheduled for 2019), government incentives are expected to increasingly influence economic developments as seen in the run-up to the 2017 referendum on the presidential system. While the Economic Reform Programme's (ERP) projections for domestic demand appear plausible, albeit with a rather high emphasis on private investments, the medium-term economic scenario sets out an unlikely combination of strong domestic demand, a more than halving of the annual inflation rate and a narrowing of the current account deficit. In such a scenario it is likely that, contrary to the ERP projections, net trade will become a drag on the economy as a consequence of high import growth. In addition, as the output gap turns positive, inflation will plausibly continue to be significantly above the central bank's target.

The positive output gap and risks of an overheating economy make it necessary to turn to a countercyclical fiscal policy stance. The ERP's estimate of potential output growth is estimated to be 5.3%, which is significantly higher than the forecasts of international institutions and market participants. The high inflation rate, the widening of the current account deficit and the high capacity utilisation rate suggest there is significant risk of an overheating economy. After a year of strong government stimulus, which turned out to be pro-cyclical, the budgetary stance now needs to become countercyclical. The current budget envisions only a limited reduction in the general government deficit and in the first two months of 2018 new policy proposals have already been launched that will have a sizeable impact on public finances.

The main challenges for future economic policy are the following:

- **The current account deficit has started to widen again as domestic demand has increased.** Continued strong domestic demand growth is expected to lead to a further widening of the current account deficit. Policies to encourage domestic savings should be preferred over those spurring loan growth, and investment incentives should be carefully targeted. Budgetary policy needs to become countercyclical and its predictability needs to be improved through more transparent budget planning.
- **Both headline and core inflation have recorded double digit figures continuously since August 2017, leading to unanchored inflation expectations.** This makes sustainably lowering inflation expectations harder as wage demands have followed suit. A credible monetary policy focused on a disinflationary trajectory is the policy option with the lowest risk of shocks to the economy.
- **The ongoing state of emergency and its impact on the rule of law had a detrimental effect on the investment climate and as such on the economy as a whole.** Turkey's substantial informal sector continues to hinder the establishment of a level playing field and fair competition between firms. Companies in addition face a considerable administrative burden in doing business. The ERP plans to address this by harmonising and simplifying procedures for starting a company. Additional work is however needed to shorten the lengthy and costly insolvency procedures. In addition, companies that were seized after the attempted coup need to have access to due process in which the separation of powers and the independence of the judiciary is respected.
- **Turkey's current institutional capacity and resources spent on R&D and the level of commercialisation of innovation are insufficient to enable its planned**

transformation process to higher added value production. The national R&D strategy was updated (although not yet adopted) to target an increase in overall spending innovation and to promote and support the absorption of innovative knowledge by Turkey's private sector, including SMEs. Turkey's digital economy sector suffers from insufficient competition in telecom markets and excessive taxation and costs for operators and consumers of information and communication technologies.

- **Structural reforms in the labour market should be given higher priority.** The substantial financial support given to job creation represents a considerable reduction of labour costs of new hires, including in higher wage segments. Such active labour market measures should be more targeted to categories having difficulties in accessing employment, while adjustments in the labour market framework could ease the hiring of new workers.

The implementation of the policy guidance jointly adopted at the Economic and Financial Dialogue of 23 May 2017 has been limited. The ERP itself does not provide a dedicated section assessing the degree of implementation. However, according to the ERP, the structural balance of the general government has increased from -2.2% of potential GDP in 2015 to -3.1% in 2016 and -3.3% in 2017. A fiscal rule has not been introduced and budgetary policy making is increasingly characterised by ad hoc measures. The revised national accounting methodology has been taken into account in the new medium-term economic scenario but this appears not to be the case for the new medium-term budgetary scenario. The budgetary impact of major policy initiatives has not been made clear despite these being to lead to a significant increase in contingent liabilities. Regardless of the GDP rebound, there has not been clear communication to the public regarding a change in monetary policy or its framework that would sustainably lower the inflation rate and anchor inflation expectations.

Regarding the implementation of policy guidance on structural reforms, implementation has been weak since the state of emergency continues and the government took active control of close to 1000 companies accusations following alleged links with forces behind the attempted coup. Trustees assigned to the transferred companies are immune from administrative, financial and criminal liabilities. However, there was some progress as new judges and prosecutors were recruited following the dismissals after the attempted coup. The R&D strategy was updated by TUBITAK, the Scientific and Technological Research Council of Turkey, but this has not yet been adopted. The draft strategy focuses on an increase in total R&D spending. In addition, laws on industry and R&D activities were amended, enabling innovation support programmes. The policy guidance in the area of labour market policies has not been implemented. Skills development has been stepped up notably through the inclusion of workplace learning in vocational education and training. Education reforms are supported by a comprehensive Teacher Strategy 2017-2023.

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.

2. ECONOMIC OUTLOOK AND RISKS

The ERP sketches an optimistic baseline economic scenario. The Turkish authorities refer themselves to the figures in the economic scenario as growth objectives rather than a prudent economic scenario. These growth projections will be met if the global economy develops positively and the strong underlying momentum of the Turkish economy continues. The medium-term scenario combines relatively high economic growth (of 5.5% in every single year over the programme's period) with declining budget deficits, a declining current account deficit, a decreasing unemployment rate and a more than halving of the inflation rate. The likelihood of such a scenario is rather limited. For one thing, the output gap has closed and growth above potential would usually be associated with upward pressure on inflation. Secondly, the high economic growth forecast in the ERP is grounded in buoyant private consumption and investment. That would usually be associated with a widening current account deficit as both the trade balance and income balance turn more negative. Thirdly, the dynamics behind such a scenario are more likely to play out over a longer term and only after implementing an ambitious reform agenda that encourages investment in human capital and innovation. This year's medium-term economic scenario is based on the revised national accounting methodology as was agreed in the 2017 joint policy guidance.

Table 1:

Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019		2020	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	3.2	**3.2**	5.3	**5.5**	4.0	**5.5**	3.2	**5.5**	n.a.	**5.5**
Contributions:										
- Final domestic demand	4.2	**4.2**	4.5	**4.7**	4.5	**4.5**	4.9	**4.8**	n.a.	**4.7**
- Change in inventories	0.3	**0.3**	0.3	**-0.4**	0.0	**0.1**	0.0	**0.0**	n.a.	**0.1**
- External balance of goods and services	-1.3	**-1.3**	0.4	**1.3**	-0.4	**0.8**	-0.8	**0.7**	n.a.	**0.7**
Employment (% change)	2.2	**2.7**	2.8	**3.5**	3.1	**3.7**	3.1	**3.7**	n.a.	**3.6**
Unemployment rate (%)	11.0	**10.9**	11.3	**10.8**	11.0	**10.5**	10.7	**9.9**	n.a.	**9.6**
GDP deflator (% change)	8.1	**8.1**	10.3	**10.3**	8.8	**7.6**	7.6	**6.5**	n.a.	**5.8**
CPI inflation (%)	7.0	**8.5**	11.0	**11.9**	8.5	**7.0**	7.4	**6.0**	n.a.	**5.0**
Current account balance (% of GDP)	-3.8	**-3.8**	-3.9	**-4.6**	-4.2	**-4.3**	-4.4	**-4.1**	n.a.	**-3.9**
General government balance* (% of GDP)	-1.3	**-1.3**	-2.4	**-2.4**	-1.8	**-1.9**	-2.6	**-1.9**	n.a.	**-1.3**
Government gross debt (% of GDP)	28.1	**28.1**	28.2	**28.5**	27.9	**28.5**	28.0	**28.0**	n.a.	**27.5**

** excluding privatisation revenues*

Sources: Economic Reform Program 2018 (ERP), Commission Autumn 2017 forecast (COM)

The economy is likely to continue growing at a brisk pace in 2018 after strong growth in 2017. Growth in the first half of 2017 was spurred by sizeable stimulus measures which have abated but are expected to surge again as elections approach. Annual growth was a spectacular 11.2% in the third quarter of 2017 and a solid 7.3% in the fourth quarter, resulting in very strong 7.2% growth over full 2017. Whereas nearly half of the strong annual growth in the third quarter could be explained by one-off effects, i.e. a different number of calendar days, and a base effect due to low economic activity in the aftermath of the failed coup attempt, the fourth quarter showed renewed momentum. The shift observed in growth drivers from government stimulus to private demand during 2017 is positive for Turkey's economic outlook and in line with the European Commission's 2017 Autumn Forecast. Industrial production and household consumption registered strong growth numbers in the fourth quarter bolstering domestic demand but investment continued to lag expectations. Imports registered very high increases whereas exports grew more modest, leading to an increase in the trade imbalance. In the Commission's view, private consumption will be supported in 2018 by higher employment growth, improved confidence and lower inflation in combination with a boost for purchasing power from high nominal wage growth. The contribution of net trade will turn negative as a consequence of higher private domestic demand. As the elections approach (scheduled for 2019), government incentives are expected to increasingly influence economic developments as seen in the run-up to the 2017 referendum on the presidential system.

Potential growth is easily overestimated in the current context. Gross fixed capital formation is expected to contribute 3.7 percentage points to potential output growth of 5.3 %. Estimating the potential output growth rate and the contribution of gross fixed capital formation is, however, complicated by the large contribution from construction to recent growth performance under the revised national accounting methodology. Since the beginning of the revised national accounts series (2009 – 2016) construction investment grew a total of 52 % more than investment in machinery and equipment. Construction investment represented 56 % of gross fixed capital formation in 2016 (52 % in 2009) whereas that in machinery and equipment 37 % (39 % in 2009). Predicting the contribution from increases in the capital stock to future potential growth is, therefore, prone to a high margin of error. Using trend estimates to determine future capital stock is likely to lead to overestimating this. High inflation, high loan growth and a depreciating currency further complicate disentangling real economic developments from nominal economic developments and temporary from structural factors. The precision of the national accounts may also be compromised by dropping the survey method and switching exclusively to administrative accounts[1]. Other anomalies, like the decreasing labour input into construction and the co-movement of construction and the nominal effective exchange rate, further complicate the estimation of trends in the constituent components of a potential output growth rate with a production function approach. The other factors that would contribute to potential growth seem to be more realistic. Going forward, total factor productivity growth will likely continue to contribute in a limited way as the structural reform agenda still needs to be implemented and human capital increased. In addition, higher labour force participation is associated with generally lower productivity as those with lower productivity enter the labour market. The ERP, therefore, rightly expects total factor productivity (TFP) growth to contribute little to GDP growth in the medium term. All in all, a conservative estimate of potential output growth would be well below the 5.3% estimated in the ERP and closer to 4 %.

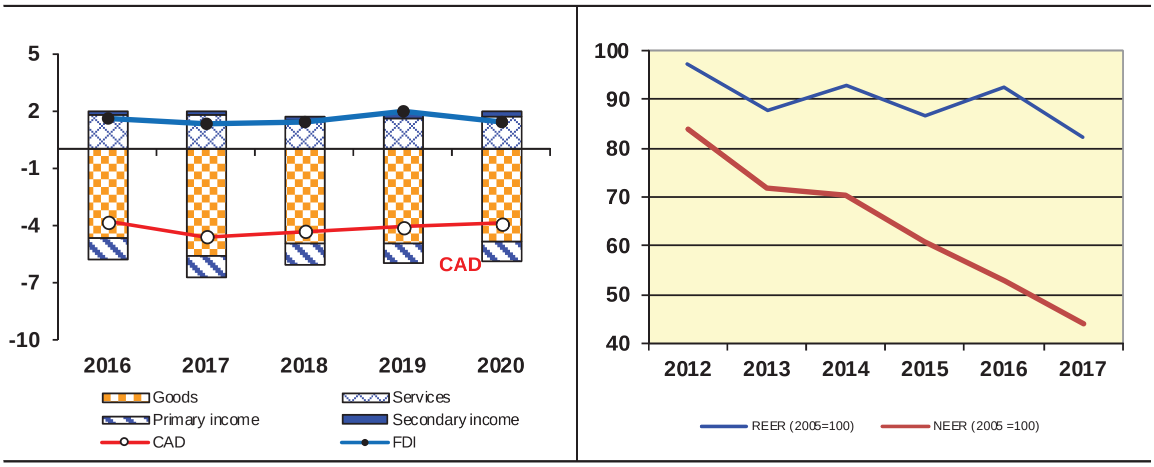
Inflation expectations have become increasingly unanchored, as core inflation reached double digits. In the ERP, a drop in the inflation rate is foreseen from 11.9% in 2017 to the central bank target of 5 % in 2020. The pattern of inflation expectations is similar to last year's, although shifted by 1 year, e.g. instead of 7.0 % in 2017 the expectation is now for 7.0 % inflation in 2018. Given Turkey's recent inflation history, reaching this downward inflation path is highly ambitious. Capacity utilisation is near a historic high, employment growth is strengthening, wage growth is already high, money growth has outpaced nominal GDP growth by a wide margin and the ERP's economic scenario projects economic growth above potential. It would therefore require a strong anchoring of inflation expectations and low money growth combined with declining energy prices and an appreciating currency to decisively reach lower inflation. The use of the emergency window as the sole policy channel is unlikely to accomplish the shift needed in the credibility of central bank policy. The use of

[1] For one, there is no cross check of results. Second, the administrative accounts are based on government tax collection. This is prone to lead to a bias resulting from tax optimisation by companies which might be difficult to correct. An indication of a possible issue is the almost perfect correlation between the difference in the growth rate of VAT on imports and domestic and GDP growth. One would expect this difference to be less related to GDP growth as both should be correlated with GDP growth.

the Late Liquidity Window may actually stimulate moral hazard as there is no emergency window at a punitive rate left in the monetary policy tool box, the determination of liquidity provision becomes more judgemental compared to an ordinary monetary policy framework of a central rate with a band and it could raise expectations that normalisation will come with lower rates. It should, therefore, not be seen as a sustainable simplification of monetary policy and is unlikely to raise credibility. It is also not the simplification envisioned in the policy guidance from the 2017 exercise.

Graph 1 : **External competitiveness and Current account**

Evolution of the current account balance | Effective Exchange Rate (Total economy, REER: ULC based)



Source: Economic Reform Program 2018, European Commission and Macrobond

Higher private consumption will weigh on external imbalances which require a sustainable improvement in competitiveness. The net trade balance can be expected to turn more negative as private domestic demand continues to be the main driver of economic growth in 2018. However, the ERP predicts both a strengthening of domestic demand from increased investment and an improvement in the current account balance. Government incentives to save have not yet had the positive savings impact that is needed. The most important incentive provided in 2017 was the obligatory enrolment in pension systems for large companies, in which the government gives a 25 % bonus on premiums paid. The strong incentives provided in 2017 to increase loans, high inflation and low real interest rates have not helped to increase net domestic savings. The current account balance is also at risk from the pressure on Turkish competitiveness and from higher risk aversion of international investors. The strong depreciation of the Turkish lira in recent years (see graph 1) has supported the trade balance in goods. High inflation and nominal wage growth have, however, erased much of the competitiveness gains from nominal exchange rate developments. Second-round effects now risk further undoing the gains in competitiveness. Low expected productivity growth further adds to Turkey's competitiveness. To address competitiveness, the authorities have the ambition to increase the technology content of Turkish exports. Exports to the euro area have a relatively high technology content, and there have been increased exports to the euro area. Medium to high technology industries represented 38.5 % of exported value in 2017 (36.6 % in 2016). However, part of the challenge will be to broaden the range of export goods with a high technology content. In addition, educational attainment scores and the stubbornly high unemployment rate for the proportion of the labour force that have completed higher education suggest that Turkey faces challenges in increasing its use of human capital in production. An increase in the technology content of exports will need sustained policy efforts that will only pay off after several years. On the positive side, the recovery of services exports through an increase in tourism visits to Turkey will support the trade balance, but total revenues remain subdued as spending per tourist has been trending lower since 2013.

Financial risk metrics attest to the overall soundness of the Turkish financial sector but high loan growth implies a larger dependence on foreign financing for the Turkish private sector. The capital adequacy ratio is well above the regulatory requirement although it benefited from a change in risk weights in 2016 and from a large increase in the value of the equity share in 2017. Profitability is generally high in the banking sector and has registered strong growth in 2016 (44 % y-o-y) and 2017 (31 % y-o-y). Non-performing loans are also a relatively small portion of total loans and largely covered by provisions. Nonetheless, loans have grown fast helped by prudential relaxation, increased government guarantees and by expectations of rising inflation. Domestic deposit growth could not keep up with domestic loan growth, leading to a need for foreign financing. As a consequence, Turkish banks have become increasingly reliant on foreign financing. In the global context of ample liquidity, Turkish banks could attract this finance in domestic currency and with longer maturity. In addition, the squeezing of the money market by the central bank towards the Late Liquidity Window might have had repercussions for interbank funding up to three months. While liquidity through overnight funding is easily available, banks' liquidity in the period up to three months is less so and relies heavily on derivatives, in particular swaps. The new law on foreign financing will reduce the risks for the non-financial corporate sector by prohibiting smaller firms with no large foreign cash inflows from borrowing in foreign currency. However, careful monitoring is needed to see whether banks take a larger currency risk as a consequence.

Table 2:

Financial sector indicators

	2012	**2013**	**2014**	**2015**	**2016**
Total assets of the banking system, mEUR	582	623	742	751	740
Foreign ownership of banking system	16.9	18.5	19.2	30.3	29.4
Credit growth	36.4	31.7	18.5	18.5	16.8
Bank loans to the private sector ratio	98.7	98.8	98.9	99.0	98.9
Deposit growth	11.1	22.5	11.3	18.2	16.7
Loan to deposit ratio	101.2	108.5	114.8	117.2	117.4
Financial soundness indicators					
- non-performing loans	2.8	2.7	2.8	3.1	3.2
- net capital to risk weighted assets	17.9	15.3	16.3	15.6	15.6
- liquid to total assets	17.5	14.2	14.0	13.0	13.6
- return on equity	12.9	12.7	10.6	9.9	12.5
- forex loans to total loans %	25.9	28.2	29.0	31.8	34.8

Sources: BDDK Banking Regulation and Supervisory Authority, Macrobond

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3. PUBLIC FINANCE

Public finances have deteriorated in the last two years, due to ad hoc budgetary measures on both the expenditure and revenue side. Until 2016, public finances had been improving. The government benefited from lower interest payments and the primary balance was in surplus. The budgetary figures also improved because of the revised national accounting methodology that led to the large increase in GDP and due to accounting rules under ESA2010. No budget figures under the ESA2010 methodology have been published since December 2016 when the revised budget figures were presented for the years 2009-2015. The document does not make explicit which methodology was used to present the new public finance figures. The 2018 budget has not been presented under ESA2010 and the fiscal medium term scenario uses still ESA95 methodology (in contrast with the macro-economic medium term scenario). Clearly, the government has embarked on a trajectory of fiscal stimulus in the aftermath of the failed coup attempt and the run-up to the presidential referendum. The presented figures confirm that government initiatives (like lowering VAT on white goods, waving social security contributions and the employment scheme) negatively impacted government finances. For 2016 and 2017, the general government's primary balance deteriorated by 1.5% and 1.1% of GDP respectively compared to the previous year[2]. At the same time, contingent liabilities from public-private partnership (PPP) commitments, from government guarantees to the KGF credit fund and in state-owned banks have built up.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2016	2017	2018	2019	2020	Change: 2017-20
Revenues	40.9	41.9	41.4	40.3	39.7	-2.2
- Taxes and social security contributions	27.5	26.9	26.7	26.2	25.8	-1.1
- Other (residual)	7.1	6.4	6.2	5.8	5.7	-0.7
Expenditure	41.0	43.7	43.0	42.0	40.6	-3.1
- Primary expenditure	39.0	41.7	40.8	39.7	38.3	-3.4
of which:						
Gross fixed capital formation	3.5	3.6	3.3	3.2	3.0	-0.6
Consumption	18.3	20.0	19.2	18.6	18.0	-2.0
Social transfers & subsidies	8.1	8.0	7.9	7.6	7.5	-0.5
Other (residual)	9.1	10.1	10.4	10.3	9.8	-0.3
- Interest payments	2.0	2.0	2.2	2.3	2.3	0.3
Budget balance	-0.1	-1.8	-1.6	-1.7	-0.9	0.9
Structural balance	-3.1	-3.3	-2.6	-2.3	-1.7	1.6
Primary balance	-0.7	0.4	-0.2	-0.5	-1.1	-1.5
Gross debt level	28.1	28.5	28.5	28.0	27.5	-1.0

Sources: Economic Reform Program (ERP) 2017, ECFIN calculations, differences due to rounding

In 2017, government spending was more than 5% above the budget, necessitating a budget revision that was approved by Parliament in October 2017. The stimulus given to the economy is most notable in the structural balance which fell from -2.2% of potential GDP in 2015 to -3.3% in 2017. With the benefit of hindsight, pushing the structural budget balance

[2] Note that "primary surplus" in tables 3.2 and 3.3 should read "primary deficit".

further into deficit, the government acted pro-cyclically. The stimulus was even larger than was visible in the structural budget balance as it also included macro-prudential relaxation, increased government loan guarantees and very low real interest rates. Despite this, because of high nominal GDP growth and better than expected revenue development the central budget deficit was only 0.1 percentage point higher than the originally budgeted 1.9% of GDP according to the ERP[3]. More recent indications are that the central government budget deficit benefited from surprisingly strong tax revenues towards the end of 2017 and reached 1½ % of GDP. Over the whole year in 2017, revenues increased by 14.8% year-on-year while expenditures increased by 15.3 %. High inflation, however, implies that the real growth of government expenditures and revenues was below real GDP growth and the nominal revenues above nominal budget expectations to which the ERP refers can in part be attributed to higher increases in the price level. The exceptionally positive developments are in company profit taxation and in VAT on imports, lifting overall revenues as together these account for a quarter of central government revenues.

The stated aim of preserving strong public finances is within reach but the risks are sizeable. On 22 December, Parliament adopted the central government budget for 2018, targeting a budget deficit of 1.9% of GDP or TRY 66bn. Box 1 discusses the 2018 budget and gives an overview of the main policy measures. The programme provides for a tightening of budgetary policy over the medium term mostly on account of reducing spending while keeping taxes at roughly the same level. General government expenditures are projected to decline from 35.8 % of GDP in 2017 to 32.7 % in 2020. The Commission's Autumn Forecast predicts that the political cycle will have an impact on the budgetary cycle. Elections are scheduled for March and November 2019. As a consequence, budgetary policy is expected to become more expansionary in 2019. Regardless of the adoption of 2018 budget by Parliament at the very end of 2017, new ideas were floated already at the beginning of 2018 that are likely to have a noticeable impact on the budget realisations. The speed at which new policy ideas (Istanbul canal, investment incentives, targeted VAT rate reductions for the EurAsia tunnel, labour market incentives) have been floated after the finalisation of the 2018 budget suggests that some expansionary policy measures will be frontloaded compared to the Autumn Forecast focus on 2019. The absence of a strong budgetary framework increases the need for a political commitment to maintain strong public finances. The main risk on the revenue side is the increasing dependence on taxes on imported goods, i.e. the VAT on imports and the special consumption tax (nearly half of which is levied on petroleum and natural gas but very little on coke). The reform of the VAT law, sent to Parliament on 27 February 2018, aims to strongly reduce the time required for companies to receive the VAT rebates they are entitled to on investments. The total amount of rebates still on companies' balance sheets is estimated to have reached TRY 140 billion in the first half of 2017.

The trend of increasing transfers is likely to complicate the envisaged expenditure consolidation in the coming years. The proportion of total primary expenditures provided by transfers has increased from about 50 % in 2010 to 59 % in 2017. Central government transfers have been driven up by a trend of increasing health expenditure and the legacy of public-private partnerships, i.e. the need to supplement shortfalls in earnings below the guaranteed revenues. Spending on defence goods is likely to see upward pressure. However, the impact on the budget balance of spending on defence goods will differ between ESA95 and ESA2010 accounting because, in the latter, these expenditures are (partly) accounted for as investments, and therefore on an accrual basis, rather than as current expenditure, and therefore on a cash basis. This difference could be as large as 0.5 % of GDP for the recorded

[3] The general government recorded a deficit of 2.4 % of GDP according to the ERP.

budget deficit, which was the size of spending on this budget item in 2016. From the ERP, it is not clear which specific policy measures are expected to reduce spending and what budgetary impact they will have. Relief could come, firstly, from the public sector payrolls. The modest increase in pay for public sector employees agreed for 2018 will help create some budgetary space. Secondly, the assumptions on interest payments for the next two years appear to offer some buffer. The Treasury has used advantageous global financing conditions to lengthen debt maturity against favourable rates. The yield curve for domestic debt has been negative in 2017. The proportion of total government debt provided by foreign currency denominated debt has, however, come under upward pressure due to the depreciation of the lira. Overall, the envisaged reduction in government expenditures is on the optimistic side. The fiscal consolidation effort is back-loaded to the last year of the programme and less ambitious than in last year's ERP.

Box: The 2018 budget

The Grand National Assembly of Turkey adopted the 2018 budget on 22 December 2017. According to the ERP, the 2018 budget ('the annual programme') is included in its figures. Although the deficit figure as a proportion of GDP is the same, the ERP does not list the main policy measures with their budgetary impact. More generally, in the absence of comparable figures (nominal terms in budget, shares of GDP in ERP), comparison between the budgetary measures and the ERP's budgetary scenario is difficult. This box lists the highlights of the budget for 2018, while the main text is based on the ERP.

In the 2018 budget, increased spending on security is funded through increases in the corporate taxes and in taxes on motor vehicles. The central government budget is predicted to record a TRY 66 billion deficit (a 6.8 % increase over 2017). Expenditures are forecast to amount to TRY 763 billion, while revenues are expected to reach TRY 697 billion with rises in company taxation and motor vehicle taxation.

Employee expenditures are forecast to be TRY 183.1 billion, while the social security institutions' state premium is expected to be TRY 30.8 billion, procurement of goods and services to be TRY 66.1 billion, current transfers (social aid, subsidies etc.) to be TRY 299.4 billion, capital expenditures to be TRY 68.8 billion, capital transfers to be TRY 15.3 billion, and interest payments are expected to be TRY 71.7 billion. In the 2018 budget, TRY 134 billion will be allocated to education, representing 17.6 % of the budget. Healthcare expenditure has been allocated a budget of TRY 127 billion and investment a budget of TRY 85.1 billion, of which 30 % will be allocated to transportation. Defence modernisation has been allocated TRY 18 bn.

The reduction in government revenues as a proportion of GDP is expected to come predominantly from lower social security contributions and from lower returns on state assets ('factor incomes'). Five sixths of the reduction in the government revenues from 33.3 % of GDP in 2017 to 31.5 % in 2020 is expected to come from a reduction in returns on state assets, called 'factor incomes', (1.0 percentage point reduction) and social security contributions (0.8 percentage point). The ERP does not substantiate this. In the 2017 ERP, factor incomes were also the largest contributor to the reduction in the fiscal burden but, in fact, the size of factor incomes relative to GDP has been broadly stable in the past five years at 5 % of GDP. The reduction in social security contributions is hard to square with an increase in the participation rate, unless the contribution per employee is reduced. It is also unclear what the impact is of the government's waiver for companies on social security benefits. Over the past few years, the increase in labour force participation has gone in tandem with an increase in social security contributions, except for 2017 when there was a waiver for social contributions. The total from taxes (indirect and direct) is expected to increase slightly from 17.6 % of GDP in 2017 to 17.8 % of GDP in 2018, before declining to 17.3 % in 2020. In 2018, the government will increase the corporate tax rate, which is expected to increase tax revenues by 0.2 % of GDP. Corporate taxes have provided a relatively minor proportion of tax revenues (2.5 % of total revenues), however. Tax revenues are more likely to benefit from increased imports (VAT on imports amounted to 17.8 % of total tax revenues in 2017) and the return of tourists leading to increased income from the special consumption tax (21.9 % of total tax revenues in 2017). However, the increasing dependence on tax revenues from imported goods also implies increased exposure to external developments and can easily lead to a pro-cyclical bias, as the value of taxed imports is more susceptible to cyclical developments than domestic demand.

Turkish public finances would benefit from improved budgetary planning and discipline. The transparency of the budget and predictability of its outcome continue to be a challenge in tracking Turkish public finances. First, in Autumn the Turkish parliament approved a supplementary budget that turned out to be unnecessary as the 2017 deficit (1.5% of GDP) came out better than the originally planned (1.7% of GDP). Second, although the Parliament approved the 2018 budget on 22 December 2017, the government floated new policy initiatives with sizable budgetary impacts in early 2018. Although the government bases its budget for the year on a medium-term program, public finances are thus effectively characterised by ad hoc measures that can even be introduced within a short time of completing the budget. To improve budget making, the budget should be based on a conservative medium-term macro-fiscal scenario and budgetary transparency should be improved by presenting an inventory of contingent liabilities, which would go beyond those covered in the ERP to include all contingent liabilities such as those from all Public Private Partnerships, the Turkish Wealth Fund, state banks and other sources.

Government debt is sustainable in almost every scenario. The ERP sets out a debt sensitivity analysis that now, reportedly, takes into account the interaction between macroeconomic variables and debt dynamics. Although the scenario does not include the contingent liabilities built up by policy incentives in 2017 (government loan guarantees, relaxation of macro-prudential regulation, Turkey's Sovereign Wealth Fund), publicly owned banks and PPP liabilities built up over the years (EurAsia tunnel, third bridge over the Bosphorus, the new airport near Istanbul) it does confirm that government debt seems to be firmly on a sustainable footing.

Box: Debt dynamics

Table 4:

Composition of changes in the debt ratio (% of GDP)

	2016	2017	2018	2019	2020
Gross debt ratio [1]	**28.1**	**28.5**	**28.5**	**28.0**	**27.5**
Change in the ratio	-	0.4	0.0	-0.5	-0.5
Contributions [2]:					
1. Primary balance	**-0.7**	**0.4**	**-0.2**	**-0.5**	**-1.1**
2. "Snow-ball" effect	**-1.2**	**-2.7**	**-1.7**	**-1.2**	**-0.9**
Of which:					
Interest expenditure	2.0	2.0	2.2	2.3	2.3
Growth effect	-3.2	-4.7	-3.9	-3.5	-3.2
3. Other	**2.5**	**2.7**	**1.9**	**1.2**	**1.5**

Notes:

[1] End of period.

[2] The snow-ball 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.

Source: Economic Reform Program (ERP) 2018, ECFIN calculations

Government debt is forecast to decline over the programme's horizon in the ERP. The biggest contribution to the reduction in government debt comes from the increase in nominal GDP ("growth effect"). Since the forecast for the GDP deflator assumes a strong decline in prices, which is on the optimistic side, the decline in the government debt ratio appears to be on the conservative side. However, the realised debt ratio underperformed in comparison with projections in 2017. When taking into account the large increase in GDP (20% for volume alone) under the revised accounting methodology, the debt ratio should have been much lower (1.5 % of GDP if accounting for changes in GDP volume only). The difference appears to come from the category of "other" adjustments in the table above. This most likely reflects the effect of the depreciation of the lira because privatisation revenues were only 0.1 percentage point lower than budgeted. Foreign currency denominated debt formed 38 % of total debt in 2016 with two thirds of debt denominated in USD and one third in EUR. The ERP does not explain the "other" adjustment category. As discussed elsewhere, the expected primary balance looks optimistic given the political cycle.

4. Structural reforms

Several bottlenecks to sustainably raise Turkish growth and competitiveness remain. One of them is the uncertain business environment for companies caused by the state of emergency. Under the ongoing state of emergency businesses continue to face the possibility of expropriation. Since the attempted coup, the management of close to 1000 companies has been brought under the trusteeship of the Savings Deposit Insurance Fund (TMSF). These companies represent a total value of assets of TL 47.6 billion (EUR 9.8 billion). The business environment is also hampered by challenges in the judicial system. Some progress was made in recruiting new judges and public prosecutors following the large scale dismissals in the aftermath of the attempted coup, but the judiciary still faces capacity problems and a considerable backlog of commercial cases. Another major impediment to the business environment is the burden of bureaucratic procedures, especially in the areas of resolving insolvency, dealing with construction permits and paying taxes. Turkey’s current institutional capacity and resources spent on R&D and the level of commercialisation of innovation are insufficient to enable its planned transformation process to higher added value production. Moreover, the rigid labour market framework impedes job creation. While these bottlenecks are broadly recognised by the ERP, it does not clearly identify obstacles to inclusive growth and competitiveness through a proper diagnostic exercise. In general, obstacles to growth can only indirectly be derived from the stated policy goals. The ERP is silent on the rule of law and the judiciary and on Turkey's considerable informal sector.

Compared to last year, Turkey made progress in identifying 10 specific measures for its structural reforms. However, this small number of measures and their nature calls into question the comprehensiveness and prioritisation of the suggested reform agenda. Three measures relate to health tourism. While this sector in itself might have potential, the focus is disproportionate. Another measure encourages public institutions to make savings and as such has no direct link to competitiveness. Activities under the measures often lack a clear timeframe and budget. This, in combination with the weak diagnostic exercise, makes it difficult to assess the effectiveness of the measures in improving competitiveness. The Commission assessment from 2017, in which this was also mentioned, has not been taken into account. Given the above, the reform assessments below are to a large extent based on information provided by Turkey during the visit by Commission staff in February 2018 and other available data. As such, the area assessments are limited in scope. In general, the role played by the ERP in Turkey’s strategic planning is rather limited, while the Medium Term Plan and the Development Plan are more prominent in this process.

Public finance management

Turkey's budget planning and execution process suffers from a lack of transparency and predictability. Monitoring and evaluation of the effectiveness of public spending in achieving policy objectives are insufficient. Concerns remain over the accountability of the off-budget sovereign wealth fund, which is exempt from public auditing.

The performance based budgeting measure – if implemented correctly – can be expected to increase efficiency in public spending and to lead to a better resource allocation. The aim is to use public funds more effectively in supporting public policies. The ERP mentions "partial" implementation of the activities planned under this measure in 2017, but does not provide details. The success of the reform will depend on all central government institutions implementing appropriate monitoring and evaluation procedures. The ERP states that the new approach will be adopted in 2018, but this seems too ambitious given the required preparations. No activities are specified for 2019 and 2020. The second measure under public finance management relates to financial incentives for public institutions to make savings and as such belongs under the public finance part of the ERP rather than under structural reforms.

Energy and transport market reform

Turkey's energy sector relies to a large extent on imports and suffers from a lack of price competition, while its transport sector is characterised by low diversification in transport modes, road transport being dominant. The ERP does not contain a description of obstacles to competitiveness in the energy sector, nor any measures beyond draft legislation pending adoption. It mentions the need to create a competitive and liberalised energy sector compatible with EU energy legislation, but without giving a timeline for this. It also notes supply side developments in power generation and the need for more renewable energy for security of supply, but fails to mention the ongoing nuclear power projects, the potential of energy efficiency measures and the forthcoming diversification of supply through the Trans-Anatolian Pipeline (TANAP). The ERP includes a limited analysis of obstacles to the transport sector and highlights the dominance in Turkey of road transport as opposed to other modes of transport, generating environmental and traffic safety problems. The logistics master plan, referred to in last year's ERP and providing for a more balanced, multimodal approach for transport, is not finalised yet. Urban mobility issues that constitute an increasing threat to economic efficiency are not mentioned.

For the transport sector, the programme envisages Turkey's railway transport liberalisation. This measure in itself is relevant, as private sector participation and competition in the railway sector remain low. However, activities planned under this measure are limited to the adoption of four by-laws and no other activities are expected after 2018. It is unclear what the costs of this measure are. To achieve real liberalisation, additional measures are required relating to the status and functioning of the economic regulator, the safety authority, the infrastructure manager and the state owned company managing rolling stock. Implementing these reforms would help boost private investments in the sector.

Sectoral development

Agricultural sector development

Key obstacles to growth in the agricultural sector are related to access to finance, lack of a predictable support system, low innovation leading to low productivity, lack of reliable agricultural data, land fragmentation and weak irrigation systems. The ERP identifies some of these shortcomings, but there is no overall strategy on agriculture to address them. Despite the importance of agriculture for Turkey's economy (7% of gross value added and 19.5% of employment in 2016), the ERP does not contain measures in this sector. It does however mention the EU project to set up a common market organisation, including support for advisory services. The ERP does not address the protectionist aspects of Turkey's agricultural policy, an important issue not only for CAP alignment, but also for further possible liberalisation of agriculture in the framework of potential negotiations on the modernisation of the EU-Turkey Customs Union.

Industry sector development

Turkey's industrial sector suffers from low productivity, a low proportion of high technology sectors in its value added, regional disparities in industrial development and a high dependency on foreign energy sources and raw materials. The ERP acknowledges most of these obstacles but does not contain any measures in relation to this area. As a main objective, it mentions increasing the proportion of high technology in industries. This in itself is logical, given Turkey's desire to move its production up in global value chains. No link is however made with the issue of the skills mismatch (covered under the education heading). In addition, given Turkey's large labour supply and the fact that industry still takes up 20% of overall employment, attention also seems warranted on developing more basic manufacturing sectors.

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Service sector development

The service sector accounted for almost 61% of gross value addes and almost 54% of employment in 2016. Within the services sector, the ERP focuses heavily on tourism, in particular on health tourism. It briefly mentions construction, but fails to mention any other areas, such as financial or transport services, and does not contain an analysis of the obstacles to competitiveness for services in general. No information is given on further alignment with EU legislation on the right of establishment and freedom to provide services, despite possible upcoming negotiations on modernising the Customs Union, including further liberalisation of the services market.

The three measures covering health tourism could improve Turkey's competitiveness, especially given Turkey's comparative cost advantage in this area; however, their overall effectiveness is difficult to assess. Activities are not spelled out in detail over the three year time period; neither are budgets, nor the involvement required from the private sector. There is a disproportionate focus on the health tourism sector in the ERP with three measures (out of a total of ten).

Business environment and reduction of the informal economy

The ongoing state of emergency, its impact on the rule of law, the large informal economy and widespread corruption remain concerns for the business environment. The ERP rightly identifies the informal sector and bureaucratic processes as obstacles to the business environment, but it does not acknowledge the uncertainty the state of emergency creates for both domestic and foreign investors. It does not mention the targeted actions against business people, the seizure of private companies and the dismissal of large numbers of judges and prosecutors in the aftermath of the attempted coup, nor whether adequate means of legal redress are available in these cases. No information is provided on follow up to last year's joint policy guidance to strengthen the rule of law and the judiciary to improve investors' confidence. Upon request, the authorities provided information that the recruitment process for some 3600 judges and prosecutors has been completed. It will, however, take time before they acquire the necessary professional experience. Although improvements have been made in recent years, the informal economy in Turkey remains substantial, with a proportion of 26.8% of GDP. The ERP states that the informal economy will be reduced further during 2018-2020. However, no details are given on how to achieve this.

The measure to harmonise and simplify procedures for opening a business has the potential to improve the business environment. The government plans to eliminate differences between the central administration and local government for the process of opening a business and obtaining a working licence, and to reduce the number of approvals and documents required. However, no activities are planned in relation to this after 2018 and the costs are not specified. Reforms which are not noted in the ERP but which are likely to improve the business environment include resolving insolvency (procedures for which are still costly and lengthy) and introducing a regulatory impact assessment on new legislation that is expected to have an impact on companies.

Research, development and innovation and the digital economy

Turkey’s current institutional capacity and efforts spent on innovation are insufficient to enable its planned transformation process to provide higher added value production and to move up in global value chains. Commercialisation of innovation also remains a challenge, especially for SMEs. Like last year, the ERP recognises this in its area diagnostic section. Research needs to be sustained as a long term national priority with the aim to increase the number of researchers. Turkey’s digital economy sector suffers from insufficient competition in telecom markets and excessive taxation and costs for operators and consumers of information and communications technologies. The ERP does not acknowledge this and does not contain an analysis of the main bottlenecks in this area.

The measure through which research centres are supported on a performance basis was partially implemented in 2017 with the collection of data, site visits and the selection of four institutes as candidates for support. The measure can be expected to contribute to competitiveness by improving Turkey's public and private research infrastructure. However, the ERP does not give sufficient information (especially with regard to the number of institutes to be supported) to assess whether the cost estimate (EUR 90 million for 2018-2020) is appropriate.

Trade related reforms

Further integration into global value chains is hampered by a weak logistics infrastructure and a relatively low innovative component of locally produced goods. The ERP rightly identifies these elements as main challenges in improving competitiveness. Whereas some of the measures under this programme may be effective, others (stimulating preferences for domestic products) may be at odds with competition legislation and Turkey's existing international obligations, such as the Customs Union with the EU. Despite the high level of Turkey's legislative alignment with EU law under the Customs Union, several non-tariff barriers remain in Turkey which restrict imports and exports in several sectors (e.g. 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.).

The modernisation of the Customs Union is presented as a measure, while it should instead be considered a policy objective, as its realisation does not solely depend on Turkey. If it happens, this modernisation can indeed be expected to have a positive impact on Turkey's competitiveness, resulting from further liberalisation of trade in the agricultural and services sectors and a harmonisation of policy on public procurement. The timeframe set out in the ERP for the negotiation process currently does not seem realistic. In the meantime, Turkey is advised to improve its implementation of the existing EU-Turkey Customs Union, inter alia by removing current non-tariff barriers to trade. This would further improve Turkey's trade relations with the EU and third countries. The removal of additional duties that Turkey applies to third country imports would also contribute to increased trade flows.

Education and skills

Improving the quality of education is an essential factor for addressing Turkey's socioeconomic challenges. After a period of improvements in education outcomes, the results of the PISA 2015 round revealed a drop in Turkey's relative performance below the level of 2003. Turkey ranked 52nd in science, 49th in mathematics, and 50th in reading skills among 70 countries. Nearly one in four youth aged 15-24 is not in employment, education or training (NEET).

Despite the importance attached to skills development and the stated objective to move towards production with high technological content, the ERP does not include a specific reform measure in this area. Still, a number of important domestic policy initiatives are currently being implemented. Pre-school education of 5 year-olds will be expanded from currently 60% to full coverage and become obligatory in the next two to three years. In view of the introduction of a one-shift school system for all pupils by 2019, large infrastructure investments of around EUR 1 billion are planned in 2018. To address longstanding issues of education quality, the first comprehensive Teacher Strategy 2017-2023 has recently been adopted. Another priority is to increase the share of private education institutions from 8% to 25%.

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Substantial investments into the development of a vocational training system in tune with labour market needs continued. The aim is to raise the share of students attending VET schools to 60%. To this end, in addition to the public VET schools, VET provided in company schools in the so-called organised industrial zones was financially supported for 40.000 students in 2017. Furthermore, around 200.000 apprentices are now supported per year at the level of 30% of minimum wage per month. In sum, around EUR 1.63 billion were spent in 2017 from the unemployment insurance fund to support apprentices and trainees. The Employment Agency funds another 390.000 beneficiaries per year in continuous VET and on-the-job training. It will be important to assess the effectiveness of these measures over time.

Employment and labour markets

The steady increase in labour force participation and a substantial rise in employment marked labour market dynamics in 2017. The labour force grew to 31.6 million people in 2017, up by 1.1 million. The labour force participation rate (15+) reached 52.8 %, up 0.8 percentage points, in the age group 15-64 it increased by 1 percentage points to 58 % Employment rose by 0.98 million to 28.2 million, primarily in non-agricultural sectors (22.7 million). Female labour market participation (15-64) continued to increase at a modest pace (up 1.4percentage points to 37.6 %), but the gender gap remains huge (40.6 percentage points). Unemployment (15-64) stood at 11.1 %, unchanged to 2016. Despite employment growth, youth unemployment increased by 1.2 percentage points up to 20.8%, and significantly more for young women (+2.4 percentage points up to 26.1 %) than men (+0.4 percentage points up to 17.8 %).

It remains unclear to what extent job creation in Turkey in 2017 was natural or owed to large scale employment incentives. Despite solid employment growth of 3.6% year-on-year in 2017, following slow employment growth in the second half of 2016 twelve employment support programmes were implemented by different institutions providing financial support to job creation. Subsidies per new hire are in the order of TL 350-775 per month, which is up to one third of the employer's total net cost of TL 2000 for a worker at minimum wage. Policies are not clearly targeted to specific groups that would need particular support. Information about the budget and the number of beneficiaries is not available. In 2018 further new specific employment incentives will be given to the ICT and manufacturing sector. The level of support (as percentage of the monthly wage) can be applied to monthly wages up to TL 5200. A main objective of this support is probably to lower the labour cost for the employer, but this could be achieved through more adequate measures than untargeted direct financial support. Furthermore, the impacts of all support measures should be monitored.

Structural reforms in the labour market are not advancing. The ERP does not spell out any specific labour market measure beyond listing some priorities. Reform plans for the severance pay system have not been developed due to lack of consensus on the direction to take. The legal framework for temporary agency work adopted in 2015 is not yet fully effective. There is no progress in the reduction of informal work despite an increase in monitoring and soft measures. The proportion of unregistered workers increased by 0.5 pps to 34.0% (29.2% for men and 44.6% for women) and 22.1% in the non-agricultural sector (2017). In addition, there are an estimated 700,000 to 800,000 unregistered Syrian workers.

Social inclusion, poverty reduction and equal opportunities

Turkish income inequality is higher than in all European countries. The Gini coefficient is 0.404, and the P80/P20 ratio stands at 7.7. The poverty line defined as 50% of median equalised household income classified 14.3% of households as poor. Poverty is strongly correlated to education levels. Half of all individuals identified as poor do not have any diploma, whereas only 1.7% of college graduates were poor. The rate of chronic poverty based on SILC data stands at 14.6%.

Initiatives and investments for poverty reduction remain limited. The measure aiming at the establishment of a Family Support Programme is rolled over from last year. The key feature of this measure is the establishment of a country-wide network of social workers who are assisting families in need. In a first pilot wave of the programme, 1500 social workers have been trained. The target is to reach 3000 and to aim at a ratio of 1 worker per 5000 families in need. The time frame of the reform is three to five years; in 2018 work focuses primarily on establishing the IT system funded by donors.

A small scale measure for reintegrating social assistance beneficiaries into the labour market has been implemented. The Job Orientation and Job Starting Assistance covers the costs for attending a job interview, a one-off support of 1/3 monthly minimum wage in case the job is obtained, and the continuation of social assistance paid to the family of the worker for one year. In 2018 this measure will be stepped up by a one year rebate on the social security contribution for the worker. The budget provision for this measure is however marginal in comparison to the employment incentives; in 2018 a budget for 1880 families is available.

ANNEX 1: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017

2017 policy guidance	Summary assessment (jointly with EEAS delegation)
PG 1: • Lower external imbalances in light of high external funding needs constituting a substantial risk for the Turkish economy. • Promote domestic savings by incentivising higher private sector savings and by following a sufficiently tight fiscal stance over the medium term in light of external vulnerabilities built up over the years. • The adoption of a fiscal rule would enhance budget transparency, provide an important fiscal anchor and enhance credibility.	There has been **limited implementation** of PG 1. **No implementation:** Current account deficit increased in 2017. **Partially implemented**: The Treasury started to issue gold-denominated bonds and lease certificates in view of attracting the gold kept under-the-mattress and bringing it into the economy. **No implementation**: No fiscal rule was introduced.
PG 2: • Update the macro-fiscal scenario taking into account the revised national accounting methodology • Update the budgetary impact of new policy initiatives, such as the Turkish sovereign wealth fund and the new credit guarantee scheme	There has been **limited implementation** of PG 2. **Partially implemented:** while the medium term economic outlook is based on the revised national accounting methodology, this is not the case for the fiscal scenario. **Not implemented:** Despite the massive set of assets transferred under its control, the SWF failed to carry out any concrete steps towards the financing of major infrastructure projects so far, which was announced to be its main raison d'être. The adoption of the SWF's strategic plan by the Cabinet is still pending. It should be also noted that according to State of Emergency Decree 690 the Turkish Wealth Fund (TWF) can take over the foreign debts of companies and sub-funds established under the Fund or the companies whose 50% of shares are owned by TWF or by the public sphere. With this decree, it is also possible to provide a Treasury guarantee. As a result, the TWF will be indirectly borrowing from external sources through the companies under its trustee. The impact of the new guarantees under the credit guarantee fund has not been made explicit in the ERP.
PG 3: • Intensify efforts to sustainably achieve price stability. • Better anchor inflation expectations by pursuing a more credible and tighter monetary policy stance as soon as GDP growth rebounds and by clearly communicating this to the public.	There has been **limited implementation** of PG3: • **Limited implementation:** The monetary tightening that was undertaken was not sufficient to prevent a further rise in both headline and core inflation. • **Not implemented:** Inflation expectations were constantly above the target and continued on a rising path. Moreover, the limited tightening of the monetary policy stance was counteracted by the strong expansion of the credit guarantee fund, which

	contributed to a surge in credit growth.
• The central bank should not step backwards in terms of its self-imposed objective to simplify the monetary policy framework	• **Limited implementation:** All funding was shifted to the late liquidity window. However, the framework is still distant from a transparent and predictable operational setting under an inflation targeting regime, with the main policy rate being the key signaling instrument for the monetary policy stance.
PG 4: Strengthen the rule of law and the judiciary with a view to improving the business environment and investors' confidence.	There has been **limited implementation** of PG 4: • The state of emergency continues and the government took active control of close to 1000 companies over accusations of alleged links with forces behind the attempted coup. Investigations into these companies continue. • New judges and prosecutors were recruited following the dismissals after the attempted coup.
PG 5: Update the strategy in support of research and development; this should target an increase in total spending on research and development and include financial and legislative initiatives to support the capacity of companies, notably SMEs, to adopt and implement innovative production processes.	Turkey has **partially implemented** PG 5: • The R&D strategy has been updated by TUBITAK but not adopted yet. • The draft focuses on increasing total R&D spending. • Laws on support for industry and support for R&D activities have already been amended, enabling support programmes and incentives for SMEs, the establishment of technology development zones, the employment of R&D staff and support for R&D activities.
PG 6: Focus skill developments on sectors with growth potential and skills needs, and expand provision of relevant vocational training. Reform the severance pay system in order to reduce labour market rigidity. Reduce informal employment through, *inter alia*, increase of inspection capacities, with particular focus on non-agricultural employment. Improve teacher training and improve the performance of the education system towards international best practices. Promote the professional education and labour participation of women.	There has been **limited implemented** of PG6: • **Partial implementation**: Vocational training is being expanded across the board in a rather non-focussed manner. • **No implementation:** Reform continues to be discussed, but no concrete legislative initiatives so far. • **No implementation**: Informal employment level unchanged. Inspection capacities in Turkey are overall decreasing, since the number of inspectors is not following the increase in workforce. • **Substantial implementation**: Adoption of the Teacher Strategy Document 2017-2023, which includes continuous professional development of teachers among its objectives. Pre-school education became mandatory in 22 provinces, in a pilot initiative. In the school year 2017-18, foreign language teaching in grade 5 rolled out to 110.000 students. • **Partial implementation**: The draft « Empowerment of Women Strategy Document and Action Plan 2018-2023 » includes measures for promoting gender balance in the private sector, job coaching for women with disabilities, and measures for promoting access to employment for women who are currently unpaid family workers (mainly in agriculture).

ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2018-2020 was sent to the Commission on 31 January 2018. Overall, adherence to the Commission Guidance Note is weak. The ERP does not contain information on the implementation of the policy guidance from 23 May 2017. The area diagnostics are largely missing from section 4.3., as is a description of potential risks and possible mitigating actions. Section 5 on budgetary implications of structural reforms is completely missing, as is table 9 on selected employment and social indicators. Table 10 on the matrix of policy commitments does not include all structural reforms measures.

Inter-ministerial coordination

The ERP was centrally coordinated by the Ministry of Development. Proposed reform priorities of line ministries were only partially taken over by the Ministry of Development, mostly in cases where these were already included in Turkey's Medium-Term Programme (on which the ERP is largely based). The input from line-ministries in several cases was incomplete, leading to weak area diagnostics, describing past achievements and future plans rather than key obstacles to growth and competitiveness. Line ministries were not consistently informed by the Ministry of Development on reasons why their proposed priorities were not taken over. Communication should therefore be improved and the ERP process itself should start earlier (line ministries' input was only requested mid-October, after the finalisation of the Medium Term Programme).

Stakeholder consultation

No consultation with external stakeholders took place. External stakeholders should be given the possibility to comment on a draft ERP before it is finalised and adopted.

Macroeconomic framework

The set-up of the chapter on the macroeconomic framework broadly follows the outline given by 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 notes suggests the first section to 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 services forecast. It is also not fully clear how the IMF World Economic Outlook of October 2017 and its update of January 2018 are integrated in the forecast (second and third footnote of the annex' table 6).

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 reforms priorities section does not follow the guidance note and for most areas does not identify key obstacles to competitiveness and long-term growth. The reporting on the implementation of the policy guidance is completely missing, whereas the reporting on the implementation of the structural reform measures for 2017-2019 is inconsistent with last year's programme and also contains measures from the ERP 2018-2020. The 2018-2020 ERP includes 10 reform measures. This low number of measures (the guidance note prescribing

15-20) calls into question the comprehensiveness of the suggested reform agenda and the role played by the ERP in Turkey's strategic planning. The reform measures are better specified than last year, but in many cases still not accompanied by well-defined activities planned over the programme's three-year lifetime. Clear timelines and budget information are often lacking and the level of concrete detail is low. Table 10 on policy commitments does not include all 10 measures and contains a measure in transport (national transport master plan) which is not included in the programme.

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