

## EXECUTIVE SUMMARY

1. ***The EU accession process will continue to be a driving force for Turkey's reform efforts.*** Commitment to sound economic policies since 2001 has placed the Turkish economy in a good position to embark on a sustained path of faster growth. The process of European Union (EU) accession that was launched on October 3 2005 will provide an anchor for the continuation and deepening of reforms in the years ahead, thus fostering Turkey's growth potential and accelerating convergence to EU living standards.

2. ***This study aims to contribute to the ongoing process of elaborating a strategic vision on Turkey's policy priorities during EU accession.*** The thrust of the analysis in the CEM is on two simultaneous challenges:

- How could Turkey take advantage of policy and institutional convergence with the EU, while managing the broader development agenda that lies outside the scope of the EU *Acquis*, so as to prioritize reforms with the greatest benefits for growth with social inclusion?
- How could Turkey smoothly manage the EU accession process, by appropriately sequencing reforms and alignment with the EU *Acquis*, so as to best prepare for EU accession and minimize the costs of transition?

3. ***Because of the broad-ranging reform agenda to be addressed, the complexity of implementation, and the span of the accession time frame, this study is part of a programmatic series.*** This first study reviews the macroeconomic factors affecting Turkey's capacity to sustain faster medium-term growth and job creation; addresses overarching challenges in public finance management and policy coordination; reviews policy priorities for improving the functioning of key markets and the efficiency of production factors—such as product market regulations; labor market reform; financial sector development; innovation and skills; infrastructure services, and agriculture. It also provides an overview of challenges for inclusive growth, addressing issues in rural development, social inclusion, and cost-effectiveness of health care services. The expanded report (Volume II) provides the full analytical background of the findings highlighted in the main report (Volume I).

4. ***Future work is intended to cover additional subjects.*** Because of the expected length of the negotiation period for Turkey's EU accession, but also the uncertainty surrounding, until the December 2005 EU Council summit, the EU's Financial Perspective for 2007-2013, calculations of the budgetary costs and benefits of EU accession for Turkey will be conducted in a future exercise. Moreover, environmental

protection will be addressed in a next study because, while alignment with the Acquis will be costly and will necessitate a major shift in investment priorities, the planning horizon is likely to be long to the extent Turkey is granted additional compliance time post-accession, as in the case of new EU members. Additional subjects to be covered in a follow-up study include public sector governance, education, and regional development.<sup>1</sup>

5. ***Turkey's economic performance since the 2000/2001 crisis has been very strong***— Following the 2001 crisis, the Turkish economy rebounded very strongly, with annual growth averaging 8 percent during 2002-2004 and a 5 percent growth rate for 2005 well within reach. Inflation has come down to single digits in 2004 (9.3 percent) for the first time in the last 35 years, greatly facilitating the reduction in interest rates. Two weak spots have emerged in the picture: (i) Despite strong growth for three consecutive years, high unemployment continues to persist, at an estimated 10.4 percent on average in the first half of 2005; (ii) The current account deficit reached 5.2 percent of the GNP in 2004 and continues to remain a cause of concern as it may exceed 6 percent of GDP in 2005, especially as the imported energy bill gets inflated with the spike in the price of oil.

6. ***—and has been powered by far-reaching policy reforms.*** Resolute fiscal consolidation has been the cornerstone of the economic program. The public sector primary balance moved to a surplus of 6.8 percent of GNP by 2004, from a deficit of 2.5 percent in 1999, enabling a reduction of gross public debt from 108 percent of GDP in 2001 to 77 percent in 2004. Monetary policy focused on implicit inflation targeting, facilitated by fiscal consolidation and the introduction of a floating exchange rate regime. Progress has been achieved in restructuring the financial sector, improving the business environment, and reforming the public sector. Key markets have been liberalized and regulatory capacity in the economy has been strengthened. Turkey has thus strengthened its position as a functioning market economy, although further reforms are needed to secure resilience and strengthen the capacity of the economy to cope with competition in the EU single market.

7. ***Contrary to comparator countries, Turkey missed the opportunity to achieve convergence over the past decades.*** Slow labor productivity growth and declining labor utilization prevented Turkey from realizing its full long-run growth potential, particularly in the 1990s. The decrease in labor productivity growth during the 1990s fully reflects slower Total Factor Productivity (TFP) growth. There is evidence that high output volatility adversely affected both TFP growth and the investment ratio. Moreover, labor productivity growth in services has turned almost stagnant, owing to low efficiency and extensive informality, reflected into negative TFP growth. Stronger TFP growth will be the key to achieving accelerated convergence in the years ahead. But fast productivity growth will also have to be combined with stronger job creation than in the past, with support by healthy private investment, to achieve the required acceleration of growth. Evidence points to increased trade openness and greater financial depth as pillars for strong TFP performance—underscoring the importance of continuing integration in the

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<sup>1</sup> Other studies conducted in parallel by the World Bank (education, labor markets, investment climate assessment, public expenditure review) provide a more comprehensive analysis of challenges in specific areas and complement the analysis in the CEM series.

EU single market and of pressing ahead with the financial sector reform agenda. With services now by far the largest sector in the economy, reforms that enhance efficiency and job creation in services would be a precondition for faster growth of the economy as a whole.

8. ***EU accession holds the promise of significant economic and social benefits for Turkey.*** EU accession will promote growth and social development in different ways: (i) by strengthening the overall policy framework, facilitated by the adoption of the EU *Acquis*—especially in the many areas related to deeper integration into the EU single market; (ii) by making Turkey a better place to invest, especially by attracting higher FDI; (iii) by fostering absorption of superior know-how and promoting productivity growth; (iv) by extending the Customs Union with the EU to agriculture—with expected significant net benefits down the road for Turkey’s farmers, but also for consumers, as a result of better access to EU markets; (v) through inflows of EU CAP and structural funds, which, with the right policy framework in place, will provide an impetus to regional and rural development. Above all, by strengthening the investment climate, EU accession will create more employment opportunities for Turkey’s rapidly growing labor force. The prospect of eventual free labor mobility will deliver further welfare gains, both for Turkey and the EU.

9. ***Turkey should take advantage of the EU accession process as an anchor for continuing reform, economic stability, and accelerated growth.*** EU accession will provide impetus for deepening the reform process in the years ahead, and contribute to improving convergence of Turkey’s living standards to the EU average. This process will be self-reinforcing, as accelerated income convergence would enhance prospects for Turkey’s eventual membership. But income convergence is not spontaneous. The experience of EU cohesion countries suggests that benefits of EU integration are not guaranteed—they are contingent on the quality of the policy framework, efficient and effective public management, and maintaining the reform momentum. The task will be even more demanding for Turkey, requiring more intense and focused efforts, because, contrary to new EU members, accession will be conditional on *effective compliance* with the EU *Acquis*, not only legal alignment and commitment to implement the *Acquis*.

10. ***The speed of convergence to EU average living standards will depend on the pace of structural reform.*** In a *base-case scenario*, where sound economic policies are maintained and structural reforms are kept on track, per capita income in Turkey would increase from 29.1 percent of EU25 in 2004 to 34.2 percent by 2015, giving rise to some but not substantial convergence. However, in a *high-case scenario*, where the scope of structural reforms is broadened in a number of priority areas reviewed below, per capita income could reach 40.4 percent of the EU25 by 2015—assuming constant real exchange rates. In the high-case scenario, income convergence could be further accelerated by productivity-driven real exchange rate appreciation—up to an estimated 50 percent of the EU25 by 2015. The estimated convergence speeds for Turkey under these scenarios are in line with the experience of EU countries. Downside risks should not be disregarded, however, as reform fatigue and vulnerability to external risks could lead to a *low-case scenario* with virtually no convergence to the EU.

11. ***As strong growth of domestic demand is likely to persist in a fast-growth scenario, preserving current account sustainability raises a simultaneous challenge for both macroeconomic and structural policies.*** On the macroeconomic front, it is important that fiscal discipline be continuously maintained through a high primary budget surplus, to ensure needed mobilization of domestic savings for the financing of investment. Moreover, a sufficiently tight fiscal stance would be needed to support monetary policy and avoid high short-term real interest rates in order to achieve inflation targets—which would risk further appreciating the currency and damaging the external balance, as well as increasing the cost of borrowing in domestic markets for the Treasury. Continuing liberalization of product and service markets and further strengthening of competition policy would enable competitive cost reductions, especially in non traded services—thus facilitating an easier stance of monetary policy. Structural reforms to strengthen the investment climate would not only be a condition for higher private investment and faster growth, but also for attracting foreign savings in the form of foreign direct investment and thus for ensuring sustainable financing of the external current account. Financial sector reforms that ensure a better mobilization of domestic private savings will also help contain the current account deficit in the years ahead.

12. ***The challenge of regional convergence should be addressed on the way to the EU.*** With per capita income in the richest provinces 6.9 times higher than in the poorest, Turkey stands out as a country with large regional disparities by international comparison. Internal migration has been extensive and would have been expected to somewhat contribute to bridging the gap in per capita income across regions. However, per capita incomes have not converged, with GDP growing much *faster* in rich than in poor regions. Faster growth of backward regions would thus contribute to reducing disparities, but also to accelerating growth of the economy as a whole. The challenge for Turkey will be to make best possible use of “pre accession funds” to promote regional development during accession.

13. ***Reforms should be conducted with the aim of sustaining faster and inclusive growth while preparing for EU accession—by maintaining a stable macroeconomic and fiscal framework, improving the functioning of key markets and the efficiency of production factors, and ensuring cost-effectiveness of safety nets.***

- Structural fiscal reforms deserve particular attention because they underpin the broader reform agenda. Maintaining a sound fiscal framework is a precondition for economic stability and sustained faster growth, while more fiscal space should be created for growth-enhancing public expenditures and lower taxes that would support productivity and a sound investment climate.
- Prominent structural reform areas, reviewed in this study, are those conducive to stepped up productivity growth and a strong investment climate. These reform areas encompass both: (i) *the functioning of key markets* (ensuring competitive and investment-friendly product market regulations; improving

responsiveness of labor markets to changing conditions; furthering the capacity of the financial sector to mobilize finance for productive investment; enhancing the capacity of agriculture to respond to structural change on the way to the EU Common Agricultural Policy); and, (ii) *initiatives to improve the efficiency of production factors* (fostering increased technology absorption and innovation; aligning worker skills with private sector needs; improving the quality and lowering the cost of infrastructure services).

- In particular, while a pro-growth investment climate and sound macroeconomic environment are important prerequisites for growth, the labor market reform agenda deserves special attention as it holds the key for accelerating the pace of job creation and reducing informality.
- Reforms to improve the cost/effectiveness of social protection and health care raise a particular challenge for Turkey, in view of the existing important social and regional gaps, the need to shift protection “from jobs to workers”, and the potential for the EU accession process to create “winners”, but also some “losers”.

Policy options in the above key reform areas are summarized below and presented in synthesis policy tables.

14. ***Steering the process of EU accession and ensuring effective compliance with the Acquis will critically hinge on the quality of policy coordination across various parts of the public administration.*** Because implementation of the Acquis will be a prerequisite for EU accession, strengthening vertical and horizontal coordination, in particular within large ministries and agencies, would deserve special attention. In parallel, the operating efficiency of the government should be strengthened by clarifying policy and other competences, and reducing their fragmentation and overlapping; ensuring strong quality control of new regulations; improving the procedural efficiency of policy-making; and reducing procedural delays within line ministries and agencies.

#### ***Structural Fiscal Reforms and Public Finance Management***

15. ***Turkey’s focus for achieving fiscal consolidation has been more on revenue-increasing measures rather than expenditure rationalization.*** While primary revenues of the consolidated general government increased by 4.8 percent of GDP over 1999-2004, primary expenditures declined by only 0.6 percent of GDP—and, at 33 percent of GDP, remain higher than in other fast-growing emerging economies. The increase in tax revenue was mainly generated by higher indirect taxes. As a result, fiscal revenues in Turkey stand at 40 percent of GDP, a level that is now similar to EU countries, despite a smaller welfare state. Cuts in investment expenditures and capital transfers have merely offset a growing social security deficit, which reached 3.8 percent in 2004. Expenditures for personnel, goods and services and current transfers were largely unaffected by fiscal consolidation. However, although more steps are clearly needed, initiatives have been taken to prevent wasting in expenditures and set expenditure priorities, which have supported a better control of expenditure growth than in the past.

16. ***Improving the quality of fiscal consolidation will greatly help meet Turkey's development challenges on the way to the EU.*** Structural fiscal reform, aimed at improving the quality of fiscal consolidation, is the only viable means of sustaining the adjustment in the future while making appropriate fiscal space for growth-enhancing expenditures and lower taxes. Room for increased expenditure will be needed in education, in infrastructure for less-developed regions, in areas where alignment with the EU Acquis entails a cost (e.g., environment), and when significant co-financing is needed for absorbing pre-accession funds (e.g., rural development). But expenditure is already high compared to other fast-growing countries and it should also be contained in order to make room for lower taxes in the future. Moreover, a high primary budget surplus will need to be maintained in order to accelerate the reduction of public debt in proportion to GDP and forestall pressures on the external current account.

17. ***Trade offs in expenditure allocations would need to be combined with expenditure reforms aimed at efficiency gains.*** Increased fiscal space should be sought possibly by reducing spending in functional areas where it appears to be oversized in international comparison (such as general public services, defense, public order and safety), and by implementing reforms that improve efficiency and help contain costs in areas where expenditure pressures are being felt—such as health care and pensions. Horizontal reforms, focused on the modernization of civil service pay and employment and the careful formulation of the investment program, would also help contain pressures on the wage bill and investment spending across functional areas. Ensuring appropriate allocations for operation and maintenance of public capital is important because accelerated decay of capital goods may unduly burden the investment program in the future.

18. ***Moving to a simpler and more transparent compensation system would contribute to containing pressures on the wage bill.*** Since 1999, and despite downsizing of public employment, total compensation for General Government employees has been relatively stable, at around 10 percent of GDP. The share of personnel expenditures on economic affairs is particularly high in international comparison. Linking wage increases to inflation has not proven enough to contain growth in the wage bill, probably because other forms of compensation have provided room for increases in personnel costs. About 32 percent of personnel compensation is composed of various allowances, compensations, and rewards—many of these exempt from the income tax. The system of allowances and overtime pay is complex and offers substantial opportunities for discretion.

19. ***Reforms to improve tax efficiency and broaden the tax base have been initiated and should be continued.*** Because there is little fiscal space for lowering the tax rates in the short term, reform efforts should focus on tax rationalization and base broadening. This will improve tax efficiency while laying the groundwork for lowering tax rates in the future. Important reforms of the Corporate and Personal Income Taxes have been initiated, with a reduction in the CIT rate and tax base broadening, and a simplification of the rate structure of the PIT, together with the harmonization of the taxation of wage and

non-wage income. Further reform options for the *Personal Income Tax (PIT)* could include: replacing the costly and potentially inequitable VAT-based consumption credit with a simpler tax credit; introducing reduction for dependents so as to reduce the high tax wedge on married workers;. Further reform options for the *Corporate Income Tax (CIT)* could include: avoiding regional and sectoral tax incentives; and incorporating dividends into a new regime for capital income taxation, with a view to progressively phasing out the double taxation of dividends.

20. ***Despite significant progress, debt reduction remains a challenge.*** The level of gross debt still remains high, especially when compared with new EU members and acceding countries. In a base-case scenario, sound macroeconomic fundamentals will lead to a further reduction in the gross debt ratio to about 60 percent in 2008. However, the level, short average maturity, and interest rate and currency composition of public debt underscore the need of credible policies that maintain a robust fiscal framework in order to further build confidence. Preserving a tight fiscal stance, as needed for accelerating the reduction of the debt ratio, and using projected large privatization proceeds to further reduce public debt, would be the best course to mitigate surrounding risks.

***Structural policies—improving the functioning of key markets and the efficiency of production factors***

***Product Market Regulations to improve the Investment Climate***

21. ***Progress has been made in reducing administrative barriers to business entry, operation and exit but further steps should be considered.*** Further measures are needed to reduce start up costs and streamline business registration across the country. Focus should be on measures that reduce the time and costs of licensing, both for general and for sector-specific licenses. Factors that complicate licensing include: an excessive number of licenses overlapping responsibilities of several agencies and municipalities in the licensing process and requests for excessive documentation. Further steps to streamline bankruptcy procedures should be assessed after an evaluation of the 2005 reforms of the bankruptcy law.

22. ***Contract enforcement has improved, but backlogs in the commercial courts and enforcement proceedings remain of concern.*** Since 2000, Turkish authorities and the judiciary have taken important steps to speed the resolution of commercial disputes. Further suggested reforms—with a specific focus on reducing backlogs in the commercial courts and enforcement proceedings—include: (a) adopting a case management system and an associated alternative dispute resolution mechanisms; (b) reforming the system for choosing experts; (c) applying to domestic arbitrations the same rules that govern international arbitrations; (d) providing competitive restraints on fees for legal professionals; and (e) evaluating the courts' caseload to ensure the principle of proportionality is observed.

23. ***Progress in the area of state aid is urgently needed.*** Turkey has yet to comply with commitments to reform the state aid regime taken in 1996, as part of the Customs Union agreement with the EU. Several programs and instruments channel state aid, in amounts that still lack sufficient monitorable disclosure, although progress towards horizontal design of the system is noted. Some of these instruments have a potentially distorting effect on competition—such as electricity consumption subsidies granted to firms established in less developed areas, as they constitute operating rather than investment aid. Suggested reforms include: (a) adopting state aid control legislation; (b) setting up a state aid monitoring agency with adequate capacity; (c) increasing transparency by preparing and disclosing an inventory of “Existing State Aid Programs”; (d) based on the results of the assessment, devising and ensuring implementation of a strategy to eliminate aid with a potentially distorting effect on competition.

24. ***Progress towards stronger market contestability should be sustained.*** While the competition law and the Competition Authority are overall very effective, the following additional measures could be implemented: (a) clearly delineating the responsibilities of the competition authority and sector-specific regulatory bodies; (b) speeding up the adjudication of cases under appeal; and (c) establishing *de minimis* principles for exempting agreements involving only small companies. Antidumping laws could be replaced with competition laws to deal with potentially predatory dumping, while accelerating transposition of the EU competition *Acquis*, and enhancing the capacity to enforce the EU rules in competition policy and state aid.

25. ***On top of credible preparation for EU accession and a strong commitment to reform, increasing attractiveness to FDI will be facilitated by more targeted initiatives.*** In addition to improving product market regulations and the investment climate, attracting FDI will require full implementation of the existing FDI legislation. Elimination of FDI restrictions in some sectors (including civil aviation, maritime transport, mining, and energy), would also send strong signals to the business community. Attracting FDI through promotion and foreign investment policy advocacy is an important complementary measure, and the performance in this respect of General Directorate of Foreign Investment of the Undersecretariat of Treasury should be evaluated against international best practice and necessary follow up measures be taken.

### ***Expanding Employment—the Labor Market Reform Agenda***

26. ***Labor market performance is a concern as Turkey prepares for EU Accession.*** Employment grew by less than 1 percent per year over the past decade, far less than what is needed to provide jobs to Turkey’s rapidly growing labor force. Output growth has not been fast enough to create needed jobs, but also Turkey has not translated output growth into job creation as well as most other countries. The employment elasticity of growth, especially in services, has been at the low end of comparators. The employment rate in 2004 was 46 percent, far from the “Lisbon agenda” target for 2010 of 70 percent. Creating enough job opportunities at home and reducing the large pool of unemployed workers would alleviate concerns about potentially large labor flows out of Turkey, seeking work in Europe, and would greatly support Turkey’s bid for EU membership.

27. ***The reform agenda to accelerate job creation is multifaceted.*** Some essential elements rest outside the labor market—for example, a sound macroeconomic environment and a pro-growth investment climate. However, a number of critical factors fall within the ambit of the labor market, including regulation, labor institutions, active and passive programs, labor costs, and workforce development. Recent initiatives, including the 2003 Labor Code, have brought Turkey’s labor market framework into closer alignment with EU requirements. While the labor market reform agenda goes well beyond the Acquis, more changes will still be needed for full Acquis alignment. These generally represent useful reforms for achieving a more efficient and equitable labor market but some of the reforms will require careful design and implementation in order not to work against the job creation objective.

28. ***The underlying policy principle for labor market reform should be to shift protection from jobs to workers.*** More flexible rules for severance pay requirements and flexible contracting would encourage employment creation, especially in the formal sector—with women and young people the main beneficiaries. As more flexible job security rules are put in place, better protection for workers would need to be provided through less restrictive eligibility requirements and higher benefit levels of the unemployment insurance (UI) system. Improved capacity to implement cost-effective active labor market programs would also be needed. Changes to the UI system would be facilitated by the strong financial position of the UI Fund, but should be designed with a view to preserving the Consolidated General Government’s strong fiscal position.

29. ***The “tax wedge” on labor income is high, hampering job creation in the formal sector.*** Turkey’s personal-and-payroll tax burden on workers with dependents is the highest compared to all EU countries. Low-wage workers face a relatively high tax wedge regardless of their family situation. Solid evidence does not exist to confidently assess how much these taxes are constraining employment in Turkey. The strategy should be to successfully implement social security reforms, to generate a surplus that could fund significant payroll tax cuts in the future. Regardless of the employment impact, reducing payroll taxes and strengthening tax collection and inspection would bring more workers into the formal labor market and social protection system.

### ***Financial Sector Development***

30. ***Resolute reform steps have been taken since the 2000/2001 financial crisis but the contribution of the financial sector to efficiency and growth remains uneven.*** Between 1997 and 2002, 20 banks were taken over, the bank supervisory system strengthened, and public banks were restructured and recapitalized. Turkey’s financial sector provides a good payment system and has efficiently mobilized savings, but the mobilized funds have historically not been supporting private sector investments and have instead been largely invested in few large firms and in Government securities.

31. ***A multi-pronged financial sector reform agenda lies ahead.*** The three large state banks, which required fiscal outlay of US\$ 22 billion (15 percent of 2001 GDP) in

the aftermath of the financial crisis, are yet to be sold to private investors. The supervisory frameworks are still in the process of building capacity while adapting to the EU directives and Basel II requirements. The credit markets, which to a great extent remained dormant during the time of economic volatility, need institutional support in the areas of auditing and accounting, credit information system, collateral regime, enforcement of contracts, as well as more sector specific reforms, for instance in the mortgage market. Financial intermediation is also distorted by transaction-based taxes, which should be abandoned. A sound regulatory system, good accounting and auditing, credit information infrastructure, collateral registry and regime, contract enforcement and an effective judiciary will be the foundations for a sound and efficient financial sector. Some reforms are directly required by the EU, others are indirectly necessary, and yet others should be pursued by the objective of facilitating sound financial sector development. By pursuing such reforms, Turkey has the prospects for a vibrant financial sector that will provide a key pillar for more broadly developing the private sector by allocating credit in a more sound and efficient manner.

### ***Fostering Technology Adoption, Innovation, and Skills***

32. ***Harnessing the knowledge factors—technology absorption, innovation, quality standards and labor skills—is critical to promote TFP growth and improve the country’s capacity to cope with competition in the EU single market.*** Despite some recent improvements, such as the surge in FDI in 2005, Turkey lags behind comparator countries on many indicators in the knowledge areas, including Greenfield FDI and importing of capital goods, R&D, patents, access to finance for start up, university/firm collaboration, and use of quality standards by labs and firms. Skilled workers that can match the need of the private sector are also in short supply.

33. ***The reform agenda to improve technology adoption and innovation encompasses both cross-cutting regulatory reforms and strengthening of institutional capacity.*** Main initiatives include: (i) improving effectiveness of the National Innovation System (NIS), which in turn requires strengthening TUBITAK’s institutional capacity and further improving overall coordination; (ii) reviewing the industrial and intellectual property rights (IPR) legislation to ensure full alignment with EU and international requirements, while improving IPR enforcement by increasing the autonomy of the Turkish Patent Institute (TPE), improving its staff’s capacity, increasing the number of IPR courts and reducing piracy and counterfeiting; (iii) ensuring productive uses of public R&D as institutional capacity to deploy increased resources efficiently is low; (iv) promoting private R&D and access to finance for start ups by assessing effectiveness and fiscal impact of existing R&D tax incentives, matching grants and loan programs and by reducing constraints to development of the venture capital industry; and (v) creating a technology infrastructure that facilitates university/firm collaboration while revising the legal framework to support this collaboration beyond technoparks.

34. ***Turkey has gone a long way towards establishing a modern quality standards regime, but some further steps should be taken.*** Suggested reforms include aligning

some sector-specific legislation with Acquis requirements, further progress in adopting food safety and foodstuff legislation, reforming the Turkish Standard Institute (TSE), including assigning responsibilities for testing and certification to a private institution, and increasing Turkish labs' requests for accreditation and firms' requests for certification.

35. ***The skills of the labor force need to be better aligned with the needs of the private sector and the modernizing economy.*** This will require further reforms of the curriculum for all educational levels to ensure that students can develop the full range of academic, knowledge, and behavioral competencies required for success in the labor market, in further levels of schooling and training, and to serve as a foundation for lifelong learning; providing more flexibility for students to move horizontally between programs and courses at both the secondary and tertiary levels of schooling; promoting greater diversification of higher education institutions across the domains of teaching, research, and service; modernizing the admission system to postsecondary education; and reforming post-secondary vocational schools (MYOs) to ensure that their quality increases and that they provide training that is relevant to local labor market needs.

#### ***Infrastructure Services for Improved Competitiveness***

36. ***In key infrastructure service areas, Turkey has already made substantial progress in designing the changes to legal and regulatory structures needed to meet EU Acquis requirements.*** The combination of internal market liberalization and effective integration with international markets offers efficiency gains that will increase competitiveness and employment growth. Although Turkey is relatively well-endowed with infrastructure compared to other emerging economies, it falls short of OECD and EU standards. Businesses are burdened by costly, low-quality backbone infrastructure services. In particular, the cost of telecommunication services and energy remains among the highest in the OECD area. The dominant transport mode, road, suffers from deteriorating road quality. This combination suggests that much can be gained through more efficient, user financed, operations.

37. ***Promoting growth across all segments of Information and Communications Technologies (ICT) holds the promise of important productivity gains.*** To promote ICT, continued efforts to liberalize the ICT market should head the reform agenda. This will be particularly important further to the privatization of Turk Telekom, to ensure that market power over bottleneck facilities do not impede the development of competition. Reducing high and potentially distortionary excise taxes on mobile phone services would also help. The transposition and effective implementation of the *Acquis* for electronic communications, well before EU accession, would speed ICT diffusion. The government can also play a vital role through its procurement of ICT, both by fostering more intense competition in and encouraging the aggregation of demand for certain goods and services to bring about lower prices.

38. ***Challenges facing the transport sector go well beyond alignment with the Acquis.*** Turkey needs to develop a sustainable model for road sector financing,

especially to meet maintenance needs, while a shift is needed between the various modes of transport, especially for gradually transferring the transport of freight from the roads to the railways. On the regulatory front, steps have been initiated, and need to be carried forward, for alignment with road transport legislation; railways and air transport (particularly air safety and air traffic management); and maritime safety. The rail system has been a major drain on government fiscal resources and ongoing restructuring efforts of the Turkish State Railways should be pursued. Plans for port privatization should be designed carefully, by implementing an adequate regulatory framework for concessions and ensuring effective regulatory capacity.

39. ***Ongoing restructuring efforts of the energy sector will need to go in tandem with liberalization and adequate regulation to lead to more competitive, higher quality supply.*** Power prices are higher than those faced by average EU users and the tariff structure creates a cross-subsidy to households from businesses that cannot be sustained under the EU acquis. In the gas sector reform initiatives are in the right direction but should be fine-tuned. Moving to competitive gas wholesaling, which is established policy in the EU, and now explicitly called for in Turkish legislation, is important for promoting the efficiency of the sector.

### ***Promoting inclusive growth***

#### ***Agriculture and Rural Development***

40. ***The reform of agricultural subsidies through the non-distortionary Direct Income Support is a valuable start towards promoting efficiency, but indirect subsidies to producers, through trade protection, is still high.*** With reform of most budgetary subsidies for agricultural outputs and inputs and substitution by a Direct Income Support program, the *overall* level of support (comprising both direct subsidies and indirect support through trade protection) remains about 10-15 percent below that of the EU. However, continually high import tariffs on agricultural commodities and non-trade barriers have kept agricultural prices high, with 22 percent of consumers' food expenditures an indirect subsidy to agricultural producers—roughly on par with the EU-25.

41. ***Eventually, full alignment with CAP would entail a decrease in tariff protection, but also free market access for exports, while direct subsidies will have to be aligned with a moving CAP landscape.*** As producer prices for many commodities are comparable to (often higher than) those in the EU, while EU external tariffs are on the decline, alignment of indirect subsidies through trade protection with CAP is expected to reduce prices and value of production for several products. However, because the structure of CAP keeps evolving, it is uncertain that upon accession CAP budgetary transfers could increase by enough to offset the expected decline in EU agricultural trade protection. Free EU market access for Turkish agricultural and food exports will act as a countervailing factor, with the potential of boosting agricultural output but also entailing structural change in production.

42. ***On current CAP structure and EU trade policies, Turkish agriculture is poised for growth as a result of EU accession.*** Simulations of the long-term impact of EU accession, based on a general equilibrium model, suggest that free market access into the EU could generate an increase in demand that would support significant long-term growth of the agricultural and food sectors in Turkey. Moreover, net exports of agricultural and food products are also projected to increase, despite the decrease in tariff protection. Net fiscal savings are also expected as a result of domestic support to agriculture being funded by the CAP—and despite the expected drop in tariff revenues from agricultural imports—of an estimated 0.9 percent of GDP. The extent to which farmers can switch across crops will underpin the potential gains from accession.

43. ***Because the CAP landscape is moving, alignment of tariff protection with the EU external tariffs should proceed throughout the accession period.*** It is uncertain that, upon Turkey's EU accession, large enough budgetary transfers from CAP would become available to offset lower indirect subsidies from reduced tariffs on imports of agricultural commodities. Turkish agricultural policy during pre-accession should thus aim at gradually reducing tariffs so as to converge to EU levels prior to accession and avoid any sharp falls in prices and contractions in agricultural income. Consumers would benefit as food expenditures would decline. At the same time, government budget support for agriculture should remain more focused on non-market distorting instruments to ensure efficiency.

44. ***The dual challenge is to support adjustment to structural changes in agriculture and promote rural development off-farm more widely.*** Analysis of rural spending at the provincial level suggests that targeting may need to be strengthened to better reflect the regional priorities of the government—with the exception of GAP investments. In the years ahead, particular emphasis will have to be placed on coherence of instruments and policy objectives between the agricultural and rural development policies, and of their respective institutional and implementation arrangements, as determined by on-going changes in the CAP. Support to non-farming activities in the services and industry sectors should be given particular attention, with priority on financing of essential infrastructure rather than subsidies. To take maximum advantage of pre-accession funds for rural development, several complementary actions would be needed—elaborating a rural development strategy and an IPARD plan; establishing a Rural Development Agency; strengthening participatory management processes.

### ***Policies for Social Cohesion***

45. ***Promoting social inclusion is a major element of meeting the Copenhagen criteria and thus keeping the entire accession negotiation process on track.*** Turkey has made notable progress in strengthening the social safety-net towards the disadvantaged and vulnerable. Main priorities in the years ahead include: (i) maintaining and strengthening the Conditional Cash Transfer program targeted towards the poorest children; (ii) developing an integrated social policy under one lead ministry, with the aim of improving the monitoring and evaluation of social services and then expanding cost-effective services to underserved population groups; (iii) taking initiatives aiming at

youth empowerment and inclusion; (iv) providing continuous support to female employment, reducing the pay gap and in general integrating women as full equal partners in society.

46. ***Health care expenditures and outcomes are unevenly distributed.*** In 2003 Turkey spent around 6.7 percent of its Gross National Income on health, of which public expenditures account for about 70 percent. Per capita expenditure is relatively higher than in countries with similar income levels, while the health system fails to reach the poor and vulnerable sections of society and the health status of the population is well below that of countries of comparable income. There is thus ample room for efficiency gains in public expenditure for health care. Public provision of health is characterized by poor incentives for managers and providers alike, leaving them open and vulnerable to alternative sources of income to augment their salaries. Like financing, the delivery of health care is fragmented, and there is little continuity in the different levels of care. Clinical effectiveness of existing medical interventions and treatment protocols is not always tested and attention to quality and effectiveness of care is uneven.

47. ***Reforms to contain expenditure should be a necessary complement of the move towards improved access to health care services.*** Key elements of ongoing reforms that aim at improving equity and access to health services are the introduction of Universal Health Insurance (UHI) and the creation of a health insurance fund that would integrate all flows of funds in the health sector. Unless it is accompanied by cost-reduction and efficiency enhancing measures, the introduction of UHI could lead to higher levels of public expenditure on health in the short run and jeopardize the fiscal sustainability of the system. Emphasis needs to be increasingly on ensuring that the desired access and efficiency outcomes are achieved without any increase in public expenditures on health. Consolidating hospitals, strengthening delivery of health services, separating provision and purchasing of services, reforming provider payment mechanisms, containing outpatient care provided by hospitals, and managing pharmaceutical costs are some of the measures that need to be urgently put in place with due attention paid to sequencing.

48. ***Policies for enhanced growth and social inclusion encompass large parts of the EU Acquis, but also a broader development agenda.*** The many areas where the alignment with the *Acquis* can strongly contribute to reinforcing the economic management framework would deserve particular attention early on in the accession process (e.g., market contestability; services liberalization; financial system supervision). Areas where the scope of the reform agenda goes beyond the *EU Acquis*, yet are important underpinnings of medium-term growth with better social inclusion, should also receive due attention in the reform agenda. In areas where the *EU Acquis* is less complementary with economic management, or compliance costs are significant (e.g., environmental protection), reforms could be paced so as to intensify when an advanced stage of the accession process is reached and faster, sustained growth has taken hold. The cost of reforms (fiscal and social) should be appropriately factored in the prioritization of the agenda, as efforts and social consensus to reform would need to be maintained over a long time. Structural reforms with low fiscal cost and public finance reforms that create

needed fiscal space for more costly initiatives in the future would thus merit to be prioritized.