

EXECUTIVE SUMMARY

1. ***Turkey's ambitious fiscal adjustment has facilitated a substantial decline in the public debt ratio and underpinned the strong economic performance since 2001 but existing vulnerabilities underscore the need for continuous fiscal discipline.*** Resolute fiscal consolidation—primarily based on the revenue side so far—has been the cornerstone of the economic program that led to Turkey's strong economic performance, with annual real GDP growth averaging 7.4 percent during 2002-2005; inflation reduced to single digits in 2004 and 2005; and a significant reduction in the public debt ratio. However, despite improved resilience to shocks, vulnerabilities remain, as confirmed by the strong impact of recent global market volatility on Turkey. In the current environment, maintaining continuous fiscal discipline, with a high primary fiscal surplus, will be necessary in order to stem pressures on the current account, help keep disinflation on track, and achieve a reduction of the public debt ratio so as to further improve resilience to external shocks.

2. ***Turkey faces two simultaneous fiscal challenges—maintaining fiscal discipline, while creating the fiscal space needed to meet pressing development challenges and sustain a fast pace of medium-term growth.*** As strong fiscal discipline needs to be maintained in the years ahead, there is little room for Turkey to further increase total expenditure in order to meet pressing development challenges. Structural fiscal reforms, aimed at improving the quality of fiscal consolidation, are the only viable means of sustaining the adjustment, while making appropriate fiscal space for growth-enhancing expenditures and lower taxes in the future.

3. ***Fiscal space to meet expenditure pressures should be created by a combination of structural public expenditure reforms, expenditure reallocations, and continuing tax reform efforts.***

- Sector-specific reforms to improve the efficiency of expenditure programs would be required in areas where expenditure pressures are being felt;
- Trade-offs in expenditure allocations would need to be considered, with the aim of shifting resources to priority programs for growth and social development;
- Sector-specific expenditure reforms should be underpinned by horizontal reforms that improve the efficiency of expenditure programs across sectors;
- Initiatives to further rationalize the tax system—including the tax expenditures—would help create fiscal space by broadening the tax bases.

4. ***Significant fiscal space to meet expenditure pressures will be required during 2007-2009 under a baseline and alternative scenarios.*** In a baseline scenario taking into

account the expenditure pressures in key sectors such as health and education, the fiscal space needed to meet these expenditures is estimated at 1.1 percent of GDP in 2007, reaching 1.7 percent in 2008 and 2 percent in 2009. With a stronger effort in education, and assuming a larger primary fiscal surplus—as needed in order to reduce the public debt ratio to the levels projected before the recent market turmoil—the needed fiscal space would increase to 2.4 percent of GDP in 2007, up to 3.3 percent by 2009. However, the fiscal space required to reduce the debt ratio would be lower if expected privatization revenues were used to repay debt.

5. ***Improving education outcomes will require additional financial resources, together with increased institutional efficiency.*** Existing educational gaps suggest the need for additional fiscal space for educational expenditures with the aim of: increasing the share of non personnel expenditures to levels similar to private schools and universities; improving the regional balance of educational services across the country; increasing per student expenditure on pre primary education. The tight fiscal framework in the years ahead makes it necessary to improve the efficiency of public spending on education—by encouraging schools to fill their classrooms up to acceptable capacity levels; providing financial resource autonomy to schools while introducing accountability for results; granting higher education institutions greater autonomy over financial resources, with incentives for efficient management.

6. ***The combination of poor health outcomes and relatively high expenditures suggests that important room exists for improving the efficiency of the health care system.*** The introduction of Universal Health Insurance (UHI) will improve access and equity but, to remain fiscally viable, it should go in tandem with cost savings and marked improvements in efficiency of public spending. The principal measure to control costs and dissuade indiscriminate use of health care services is *the introduction of copayments for outpatient visits and for drugs*. But cost containment measures should go in tandem with more comprehensive structural reform—such as, full expansion of family medicine; reforming the patient referral system; introduction of payment mechanisms for providers which will discourage unnecessary use of physician and diagnostic services; consolidation of hospitals and greater management autonomy.

7. ***The 2006 reform will bring fiscal balance to the pension system in the long term, as well as the unification of a previously fragmented system, but future challenges should be kept in sight.*** With adequate implementation of the reform, the pension system deficit is expected to be absorbed by 2040, with a fiscal gain of 7 percent of GDP compared to a “no reform scenario”. However, long-run financial sustainability will be secured under a high level of payroll taxes by international standards—a key impediment to job creation in the formal sector. The results of the 2006 reform should be closely monitored, and if lowering contribution rates is a desired objective, more changes may be required in the future to generate sufficient surpluses in the pension system.

8. ***Sector-specific expenditure reforms will provide a better pay-off when combined with “horizontal” reforms that improve the efficiency of expenditure programs across sectors.*** Horizontal reforms should include initiatives aimed at strengthening incentives

in the civil service towards the achievement of results, while containing pressures on the wage bill. Adoption of efficient project evaluation methods, effective multi-year programming, and adequate provisioning for long-term operation and maintenance of public capital will be key to improving the quality of the investment program across functional expenditure areas. A framework conducive to a greater role of the private sector in the financing, development, and operation of infrastructure should be created—requiring a predictable policy and regulatory environment, together with careful design of Government commitments to private operators to minimize the risk of contingent liabilities.

9. ***On the revenue side, 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. Establishing an adequate tax expenditure framework would promote fiscal accountability and transparency and help rationalize the tax system. Preliminary estimations suggest that, at around 5 percent of GDP in 2003, tax expenditures in Turkey were close to the high end of the OECD country range. A sustained effort is required over the medium term to rationalize tax expenditures, and make their selection and associated trade offs with direct spending programs an integral part of the budgeting process.

10. ***Despite progress, addressing the unfinished agenda in public financial management reform represents a major challenge and requires strong coordination and monitoring.*** Far-reaching public financial management reforms—further to the enactment of the Public Financial Management and Control (PFMC) Law in 2003 and several other laws—have improved budget coverage, formulation, execution, accounting, audit, and procurement, providing a new legal framework for modern public expenditure management and accountability. The main challenge ahead is the implementation of the reform agenda throughout the entire general government, including extra-budgetary funds and revolving funds. The key areas that require immediate attention are: (i) establishment of the internal audit structures; (ii) enactment of the Turkish Court of Account legislation consistent with the PFMC law; and, (iii) bringing the remaining Extra Budgetary Funds and Revolving Funds under the budgetary and financial control structures. Effective leadership and coordination among agencies would be required for the effective implementation of the overall Public Financial Management reform agenda.