

OVERVIEW*

1. ***Turkey's ambitious fiscal adjustment has paved the way for the strong economic performance since the 2000/2001 crisis.*** Following the 2001 crisis, the Turkish economy rebounded very strongly, with annual real GDP growth averaging 7.4 percent during 2002-2005. Inflation came down to single digits in 2004 and 2005 for the first time in the last 35 years. Resolute fiscal consolidation—primarily based on the revenue side so far—has been the cornerstone of the economic program, with the public sector primary balance moving to a surplus of 6.9 percent of GDP in 2005, from a deficit of 1.6 percent in 1999. Gross public debt was thus reduced from 106 percent of GDP in 2001 to 71 percent in 2005. Resolute fiscal consolidation relieved the conduct of monetary policy from fiscal dominance, thus enhancing the credibility of the commitment to low inflation and facilitating the implementation of inflation targeting.

2. ***Despite progress, the need for continuous fiscal discipline has been recently underscored by existing vulnerabilities.*** Vulnerabilities have also emerged because, despite fiscal consolidation, strong domestic demand growth, exchange rate appreciation during 2002-2005, and an imported energy bill inflated by record-high oil prices, have all resulted in a widening deficit of the external current account that reached 6.4 percent of GDP in 2005. As a result of recent global financial market volatility, the lira has depreciated by 20 percent and domestic government bond yields have significantly increased. The disinflation, whose pace had already slowed in the late months of 2005, will likely be further prejudiced in the short term by the pass-through of depreciation of the currency. Owing to higher interest rates and currency depreciation, the debt ratio will also be reduced at a slower pace. In the current environment, maintaining fiscal discipline and a high primary fiscal surplus will be necessary in order to stem pressures on the current account, while an increase in private savings will also work in the same direction. Continuous fiscal discipline will help keep disinflation on track, sustain market confidence, and achieve a reduction of the public debt ratio so as to improve resilience to external shocks.

3. ***Structural public expenditure reforms—reviewed in this study—would be the main option to create the fiscal space needed to meet Turkey's pressing development challenges and sustain a fast pace of medium-term growth.*** As strong fiscal discipline will have 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 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. The focus of efforts should now shift to the expenditure side in critical sectors, with the aim of achieving efficiency gains and sustained cost savings in areas where expenditure pressures are being felt. At the same time, horizontal trade-offs in expenditure allocations would need to be considered, with the aim of shifting resources to priority programs for growth and social development.

* The Analysis in this study draws on information and policy initiatives until mid-November 2006

Expenditure reforms should be combined with initiatives to further rationalize the tax system and broaden the tax bases so as to create room for a sustained reduction in Turkey's high tax burden in the future.

The quality of fiscal adjustment

4. ***At the General Government level, Turkey's ambitious fiscal consolidation has relied mainly on revenue-increasing measures rather than expenditure rationalization.***

Over 1999-2005 the primary fiscal surplus of the Consolidated General Government increased by 5.7 percentage points of GDP. This improvement was largely driven by primary fiscal revenues, which increased by 6.1 percentage points of GDP, while primary expenditures slightly increased by 0.4 percentage points. However, although more steps are clearly needed, initiatives have been taken to prevent growth of low-productivity expenditures and improve priority setting, which have supported a better control of overall expenditure growth than in the past.

5. ***Outside the General Government, expenditure downsizing came mainly through adjustment in State-Owned Enterprises (SOEs).***

The SOEs covered under the IMF program were generating a deficit of 2.1 percent of GDP in 1999, which was turned into a surplus of 0.15 percent of GDP in 2005. These SOEs thus added the equivalent of almost 3 percentage points of GDP to fiscal consolidation of the public sector as a whole. This improvement was generated by a close to 2 percentage points of GDP reduction in their investment expenditures, mainly for infrastructure, and a cut in personnel compensation equivalent to 1 percent of GDP—as a result of a 45 percent downsizing of employment since 1999 (including the privatized SOEs).

6. ***Fiscal adjustment has been impeded by a growing social security deficit.***

Cuts in investment expenditures have merely offset a growing deficit of the social security institutions, which—despite Turkey's favorable demographics—reached 4.8 percent of GDP in 2005, from 1.9 percent of GDP in 2000. In the absence of the social security reform enacted in June 2006, the projected deficit of the system would have further increased to reach 7 percent of GDP in the long term.

7. ***Most of the fiscal adjustment since 2002 came from cyclical revenue improvements, reflecting robust growth after the 2001 crisis.***

From 2002 to 2005 the primary fiscal surplus of the consolidated general government (excluding SOEs) increased by 2 percentage points of GDP. Over this period, buoyant fiscal revenues, due to robust growth, contributed an estimated 3.4 percentage points of GDP to fiscal consolidation—more than the improvement in the primary fiscal balance. Thus, since 2002 the *structural* primary fiscal surplus—a better measure of policy-induced changes in the fiscal stance—has actually declined (by an estimated 1.2 percent of potential GDP).

8. ***The decline in the structural primary surplus is of concern both for the sustainability of fiscal adjustment and the management of the fiscal stance.*** From a sustainability perspective, the positive cyclical contribution to the budget may wane if growth were to slow down in the future, triggering a decline in the primary fiscal surplus and hindering the reduction of public debt. From a fiscal policy perspective, the declining structural primary surplus, especially in 2004-05, has added fiscal stimulus to domestic demand and indicates that the fiscal stance has turned *pro-cyclical*—a potentially unwelcome development at a time of broadening external current account imbalances and slowing disinflation. To avoid a pro-cyclical fiscal stance, the *structural* primary surplus should be maintained unchanged during years of robust growth. This would call for saving fiscal revenue over performance due to robust growth—a policy that would be reflected in an increasing *actual* primary surplus in proportion to GDP. An alternative option would be to introduce an expenditure cap together with a target for the actual (as opposed to the structural) primary fiscal surplus.

9. ***Turkey's primary expenditures are still at the low end of EU countries but much higher than in other fast-growing emerging economies.*** At 33 percent of GDP in 2005, primary expenditures of the general government were lower than in European Union (EU) member countries, but about 10 percentage points higher than in a comparison group of emerging economies. The difference mainly reflects a larger general government wage bill, which, at 9 percent of GDP in 2005, has remained largely unaffected by fiscal consolidation. It also reflects large expenditures for current transfers, mainly comprising social benefits, despite Turkey's favorable demographics. Despite significant downsizing since 2001, public investment remains comparable to levels seen in other EU members, and higher than in some other emerging economies. However, infrastructure gaps in Turkey are larger than in some new EU members.

10. ***Functional allocations of public expenditures reveal potential for trade offs and room for improved efficiency and cost containment.*** Expenditures in general public services and in defense and public order and safety are above the average of comparator countries by the equivalent of 0.8 and 1.2 percentage points of GDP respectively. By contrast, expenditure on environmental protection is comparatively low and would need to increase on the way to the EU. Expenditure on health care is relatively high in international comparison, while outcomes are below the average of comparator countries. Similarly, expenditure on social protection is high by international comparison in view of Turkey's favorable demographics. Expenditure on education is in line with comparator countries but educational attainment remains weak.

Horizontal public expenditure reforms

11. ***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. A larger share of expenditures could thus be spent on materials and equipment necessary for the provision of high-quality public services. Adoption of efficient project

evaluation methods, effective multi-year programming, and adequate provisioning for long-term operation and maintenance of public capital will also help improve the quality of the investment program across functional expenditure areas.

12. ***Managing personnel costs would merit attention as the Government wage bill has been bypassed by fiscal consolidation.*** From 1999 to 2004 total compensation for General Government employees hovered at around 10 percent of GDP, before declining to 9 percent of GDP in 2005. However, the wage bill could increase again as a result of the additional pay rise for civil servants granted for 2006, the estimated cost of which is 0.35 percent of GDP. While the wage bill has remained rigid, employment in consolidated budget agencies and municipalities has declined by 3 percent since 1999, resulting in fast growth of average compensation.

13. ***The share of personnel expenditures on economic affairs and security is particularly high in international comparison.*** Personnel expenditures are concentrated on education, security, and health care, which absorb more than two-thirds of the wage bill. The share of personnel compensation in economic affairs—for the provision of infrastructure services, rural development, and services to agriculture—is twice as high as the average of comparator countries, revealing a possible room for savings.

14. ***Slower growth in average compensation would create room for fiscal savings.*** Average compensation in consolidated budget agencies, when measured in proportion to per capita GDP, is higher than in comparator countries for which similar information is available. Over 2000-2004, had the ratio of average compensation to per capita GDP remained constant at its average level in 1999-2000, the wage bill of consolidated budget agencies would have been reduced by about 1 percentage point of GDP. Linking wage increases to inflation has not proven enough to contain growth in average compensation, probably because other forms of compensation have provided room for increases in personnel costs.

15. ***Moving to a simpler and more transparent compensation system would contribute to containing pressures on the wage bill.*** About 32 percent of personnel compensation is composed of various allowances, compensations, and rewards. Many of these side benefits are exempt from the income tax, with estimated foregone tax revenue of around 0.5 percent of GDP. The system of allowances and overtime pay is complex and offers substantial opportunities for discretion.

16. ***The Government is considering plans for civil service reform to address a number of major objectives:***

- improving efficiency—by making it easier to adjust staffing composition when required; enhancing sources of performance motivation; facilitating opportunities for human capital improvement of public servants;
- eliminating discrepancies in remuneration across similar positions within the public sector—by consolidating the legal framework governing salary setting; concentrating salary in basic duty wage and duty difference allocation;

- making it easier to ensure a fiscally sound wage bill—with the consolidation of legal frameworks expected to facilitate monitoring of employment and pay policy changes;
- providing competitive opportunities for entry into the public administration—by further strengthening requirements for standardized examination-based competitive recruitment and promotions

17. ***All of the proposed changes in the legal framework represent important steps towards achieving those objectives but some changes are likely to pose implementation challenges.*** These include in particular: (i) establishing a clear legal distinction between civil servants and contracted personnel; (ii) mandating dismissal of civil servants for repeated unsatisfactory performance rating; (iii) introducing performance bonuses; (iv) concentrating salary in basic duty and “duty difference” components; (v) managing the fiscal cost of compensation harmonization by setting a new structure of basic salary and wage scale index; and (vi) monitoring the reliability of recruitment and promotion procedures.

18. ***Public investment was cut significantly as part of the fiscal adjustment efforts during 2001-2004 at a time when rationalization of the public investment portfolio was overdue.*** Total public sector investment fell to 4.2 percent of GNP in 2004, from 6.8 percent in 2000, before recovering to 5.1 percent in 2005, and the brunt of adjustment was borne by investment in infrastructure. In the past, unclear criteria and processing rules had resulted in “over programming” of the public investment portfolio (PIP), with the average project completion time as high as 12 years in 2001. Rationalization of the PIP has been quite effective in reducing the number of projects and the average completion time to 6.7 years by 2005. However, as a result of the downsizing of the PIP, the number of projects put on hold has significantly increased, with “trace allocation” projects accounting for about 10 percent of the total value of the PIP in 2003-04, a significant rise from the 1999-2000 average of only 3 percent.

19. ***Meeting financing requirements of infrastructure is a key challenge for sustained growth.*** In order to emulate EU standards of infrastructure service provision, Turkey must systematically improve the quality of infrastructure investments in the medium term. The quantity of infrastructure investments will also need to increase in some key areas for EU accession. Key issues in infrastructure financing in Turkey include (i) protecting high-priority investment projects from fiscal adjustments, and ensuring that key multi-year projects are carried on and completed on time, (ii) long-term provisioning for operation and maintenance of existing assets, (iii) ensuring adequate security and reliability of supply of infrastructure services, and (iv) ensuring that infrastructure investment addresses economic development objectives. More effective utilization of the recently introduced medium-term expenditure framework and enhancing the participation of operating agencies in actual budget allocation decisions will be important in addressing these challenges.

20. ***An important challenge is to create a framework conducive to a greater role of the private sector in the financing, development, and operation of infrastructure.*** In

view of the large financing requirements in infrastructure, achieving the Government's objectives of secure and reliable infrastructure services in a sustainable way will require sufficient support from private investment. A predictable policy and regulatory environment will be required to encourage Private-Public Partnerships (PPPs), together with careful design of Government commitments to private operators to minimize the risk of contingent liabilities. In the energy sector private investment now makes up about 50 percent of electricity generation, but this has been made possible only by significant contingent liabilities on the Government in the form of guarantees and off-take agreements. Letting the regulatory framework operate independently, and allowing prices to fully reflect costs would make it possible to attract private investment without significant guarantees.

21. ***The quality of the infrastructure portfolio needs to be assessed in order to determine which projects are worth pursuing further, dropped, or redefined in their scopes.*** This involves carrying on a project-level evaluation and revising the rationalization policies and criteria, while establishing a proper prioritization of investments aligned with the Government's development objectives. Projects that are considered economically unviable due to cost escalation, changing government priorities, or even an initial deficient project appraisal, should be individually assessed and either redefined or dropped as the case may be. Proper economic and financial appraisals of projects and improved incentives and pricing/subsidy policies are necessary for enhancing efficiency.

22. ***Appropriate allocations for operation and maintenance of public capital need to be ensured.*** This is a requirement not only for improving the quality of services, but also for restricting the cost of the projects as accelerated decay of capital goods may unduly burden the investment program in the future. Appropriations for maintenance declined from 0.4 percent of GNP in 1999-2000 to 0.2 percent in 2003-04, in particular in the transportation sector, health sector, and other public services. Such reductions in O&M expenses should be avoided since they are not sustainable while they reduce the contribution of public capital to efficiency and growth.

23. ***The medium-term challenge is to create fiscal space for public investment while preserving fiscal discipline.*** In order to complete all on-going projects, Turkey would require about YTL 82 billion over the next 5 years: an annual average investment of roughly 2.5 percent of GNP for 2006-10. Funding for infrastructure would thus need to substantially increase compared to current levels. Due to the overarching requirement to preserve fiscal sustainability, the level of investments that can be made is constrained not so much by the availability of financing but by the need to meet the primary balance targets in the face of strong expenditure pressures in some other functional areas. Creating the needed fiscal space through structural expenditure reforms and cost containment in these areas would be the key requirement for stepped up investment in infrastructure in the future. Well designed Private-Public Partnerships for the provision of infrastructure services will also help alleviate existing constraints.

Structural expenditure reforms in key sectors

24. ***Public education expenditures have been on a downward trend since the 1999 crisis.*** At approximately 4 percent of GNP on average over the past decade, public education expenditures have reached an estimated 4.17 percent of GNP in the 2006 budget—less than the 4.33 percent of GNP spent in 2002. Including private financing, Turkey spends on education the equivalent of 7 percent of GDP. There is significant private financing of courses for high school and college entrance exams, and private financing also significantly contributes to the operation of public schools as a consequence of the continuing financial constraints faced by the public schools.

25. ***Total education expenditures in proportion to GDP are higher in Turkey than in most OECD countries, but expenditures per student vary widely by level of education.*** Turkey's per student spending on pre-primary schools is very low, while spending in primary schools is consistent with expectations accounting for differences in per capita income. For secondary and tertiary education, Turkey spends somewhat more per student than what would be predicted on the basis of its per capita income.

26. ***Even though per student expenditures in secondary education are comparatively high, student achievement is lagging behind comparator countries.*** Turkey's educational achievements, as measured by the learning scores in the PISA study, remain relatively poor. Importantly, Turkey's score remains below the level that could have been expected in view of the relatively high per student expenditures in secondary education. Although student achievement, as measured by PISA indicators, is expected to increase with per capita spending, it would be counterproductive to further increase expenditure without, at the same time, taking steps to ensure that the impact of spending has improved.

27. ***The differences in educational expenditures at public and private schools are significant.*** Per-student spending in public primary schools is almost two-thirds lower than in private primary schools, while per-student expenditure in public general secondary schools is almost half the spending at private schools offering the same education. Public schools, regardless of the level of education provided, spend more on personnel relative to private schools, while use of books, supporting educational materials, and school support services is more intensive in private schools. Thus, educational outcomes vary by school type, with primary school students studying in private primary schools performing about twice as well as those in public primary schools.

28. ***Improving education outcomes will require additional financial resources together with increased institutional efficiency.*** New education policies to be introduced by the Government will have a significant medium-term impact on the budget, while existing educational gaps suggest the need for additional fiscal space for educational expenditures:

- improving the quality of educational achievement in public schools would require 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 would require enhanced public education service provision in most backward provinces to compensate for possible lack of private sector initiative—while taking advantage of opportunities for public school retrenchment where private sector initiative is strong;
- increasing per student expenditure on pre primary education—an area where progress is critical to encourage greater participation of women in the labor force.

29. ***The tight fiscal framework in the years ahead makes it necessary to improve the efficiency of public spending on education.*** A first priority is to implement policies that encourage or force schools to fill their classrooms up to acceptable capacity levels. This would increase the efficiency of spending by reducing the number of teachers employed for the same level of enrollment. Second, schools need to be given autonomy over their resources and held accountable for their results. A system of per-student financing could be considered, with funding allocated in proportion to the number of students a school enrolls, up to its capacity. Schools would be responsible for using these funds to cover their personnel, material, and professional development costs, and would be held accountable for results.

30. ***Higher education institutions need to be given greater autonomy over financial resources, with incentives to manage these resources efficiently.*** To become more efficient and provide better results, universities need to move funds between items and activities during the course of the year. Within a financially autonomous system, the amount of funding allocated to each university should not be based on inputs, but on performance, in terms of outputs for teaching, research and service development. Increases in financial autonomy should be matched by a commensurate increase in accountability for internal accounting, reporting to independent boards, and producing annual reports. A comprehensive approach need to be designed to achieve administrative and financial autonomy of higher education institutions. In a complementary way, the university entrance examination system should be modernized in such a way as to eliminate the advantage of the widespread private examination preparation courses.

31. ***The Turkish pension system has been a perennial drain on public finances as it continues to run large deficits.*** Turkey is a young country and should not be experiencing pension system deficits of the current magnitude. However, because of very low retirement ages, high benefit accrual rates, and other disincentives to remain in the formal labor force, pension deficits have persisted, with the exception of a temporary improvement in 1999, when parameters improved with the passage of a pension reform law.

32. ***The 2006 reform will bring fiscal balance of the pension system in the long term as well as the unification of a previously fragmented system.*** With adequate implementation of the reform, the pension system deficit is expected to decline by 1

percent of GDP below a “no reform” projection by 2020. The deficit will be absorbed by 2040, with a fiscal gain of 7 percent of GDP compared to a “no reform scenario”. However, the beneficial impact of these measures is expected to be rather limited over the medium run, thus creating little fiscal space for expenditure reallocations towards more productive uses. Moreover, long-run financial sustainability will be secured only thanks to a high level of payroll taxes by international standards. High contribution rates hamper job creation in the formal sector, and eventually deprive the budget from significant revenues. If lowering contribution rates is a desired objective, more changes will be required to achieve that goal by generating sufficient surpluses in the pension system.

33. ***Despite the strong ambition of the 2006 reform, the pension system still offers options for further fiscal savings that would help reduce payroll taxes in the future.*** Retirement ages remain substantially below those in other OECD countries. As the 2006 law will increase retirement ages only for new entrants to the labor force, low retirement ages will prevail for a very long time, becoming comparable to the OECD average only by 2048. Accrual rates of benefits per year of contribution are coming closer to OECD levels, but will not reach OECD averages even with the new pension law. High accrual rates undermine incentives for longer careers into the formal labor force. This works against the formalization of the labor force—a key requirement for a better fiscal performance of the pension system. The new law stipulates that the full working career will be 25 years, but this is being phased in extremely slowly so that only those who begin work in 2026 will face the 25 year constraint. Furthermore, the new system continues to offer the possibility of a partial pension with only 15 years of contributions.

34. ***The combination of poor health outcomes and relatively high expenditures suggests that important room exists for improving the efficiency of the health care system.*** Turkey spent approximately 6.6 percent of its GDP on health in 2004—a higher level than comparator countries. Public health care expenditures accounted for 68 percent of total, up from 61 percent in 1999. Although the health status of the population has considerably improved, health outcomes still compare unfavorably with countries that have similar or lower level of GDP per capita and approximately the same share of public spending on health. Improvements in health indicators are not spread evenly across urban and rural areas and across regions, with infant and under-five mortality rates in rural areas and in the Northern and Eastern regions much higher than in the rest of the country. High levels of infant and under-five mortality, as well as high maternal mortality, are related to the poor usage of preventive care.

35. ***Public expenditures on health care are on a strong upward drift.*** Public expenditures have exceeded 5 percent of GNP in 2004 and 2005, up from 3.3 percent in 1999. The increase in health expenditures in recent years is almost entirely explained by fast growing spending on hospitals and pharmaceuticals, while the share of expenditures on preventive services has actually decreased (from 11 percent in 1999 to 7 percent in 2005). The increase in the quantity of medical services partly reflects expanded coverage and access—even before the official enactment of Universal Health Insurance (UHI). The change of incentives facing medical providers in Ministry of Health hospitals and

outsourcing of services may have led to supplier-induced demand and an increase in production, provision and utilization of health services.

36. ***Efficiency and equity should be simultaneous objectives of health care reform.*** The introduction of UHI will improve access and equity but will undoubtedly generate greater demand for public expenditures on health. To remain fiscally viable, the introduction of UHI should go in tandem with marked improvements in efficiency of public spending. Turkey should also consider devoting a higher share of public expenditures to preventive activities, while targeting resources where they are most needed, to address the persistent variation of health indicators between urban and rural areas and among regions.

37. ***Consolidation of hospitals and greater management autonomy hold the promise of efficiency gains.*** Many MOH hospitals are too small in size to allow for efficient operation and provision of care, and have significantly lower utilization rates compared to University hospitals. The introduction of UHI provides a good opportunity to further strengthen the gains from the merger of MOH and SSK hospitals under MOH ownership and management. Further gains will come about by improving efficiency in the use of hospital resources and overall management and accountability, which would be facilitated by granting financial and administrative autonomy to public hospitals.

38. ***The challenge for cost--containing measures is to manage quantity—especially to contain pharmaceutical expenditures—without adversely affecting access, utilization and effectiveness of services.*** The principal measure suggested to control quantity and dissuade indiscriminate use is *the introduction of copayments for outpatient visits and for drugs*. Even nominal levels of copayments would help rationalize the consumption of health services and result in savings, not only in the production of health services but also in the consumption of drugs.

39. ***Changes in provider payment systems should introduce incentives for physicians to provide quality care at lowest costs.*** Key options involve paying family physicians on the basis of capitation fee per enrollee, so as to encourage conservative use of health care services. Such changes could be complemented with prospective payment mechanisms, introduced at the hospital level—according to which hospitals get reimbursed according to a pre-fixed rate per bundle of services associated with a particular treatment. To make such changes work, hospital care providers and managers would need the flexibility and tools to actively manage their resources and redirect their use.

40. ***Redeploying of rural public expenditures would be needed to improve their efficiency.*** At 1.2 per cent of GDP, the level of public rural investments is low compared to the size of the agricultural sector and its modernization needs—although rural investments have recently been on an upward trend. Greater emphasis would be needed in areas such as land consolidation, storage and pre-marketing facilities, and alignment with the EU *acquis* on safety and phytosanitary standards—with particular focus on small farmers with weak links to markets—and away from irrigation projects. Agricultural

transfers have been significantly reduced and restructured by switching the main focus of agricultural transfers to the Direct Income Support (DIS) program, with reduced artificial incentives for inputs and particular crops. As recognized by the Government, the DIS Program needs to be accompanied by transfer payments with the aim of promoting productivity and market development more directly. But with more than a third of rural expenditures on salaries of government employees, there is little room in the budget for investments as well as other operation and maintenance expenses. With greater emphasis on participatory approaches and private sector involvement in service provision, more effective and efficient use of funds could be achieved.

41. ***Horizontal and sectoral expenditure reforms to contain costs should be combined with expenditure reallocations to maximize the expected efficiency gains.*** Tables A and B, at the end of the overview section, summarize some key reform options in expenditure programs discussed in this study with a view to promoting expenditure efficiency and realizing fiscal costs over the medium term. Some of the proposed measures aim to directly contain short-term expenditure pressures, especially in health care, and it would be advisable to consider implementation in 2007. Other reforms should be planned over the medium term, during 2008-09, but preparatory steps would need to be taken earlier. The tables provide an illustrative implementation time frame of the proposed reform options. In some sectors, some proposed measures would entail expenditure reallocations or an increase in expenditure levels over the medium term—such as, for example, measures to strengthen pre-primary education or preventive health care. In these cases, increased expenditures could improve the functioning of a sector and thus facilitate the realization of cost savings—such as, for example, an increase in preventive health care expenditures that would help contain pharmaceutical and hospital costs over the long run.

Tax revenues and progress in tax reform

42. ***The composition of revenues has shifted markedly toward indirect taxation over the last few years.*** Hikes in excise rates along with buoyant VAT collections in the post-crisis years combined to increase indirect tax revenues from 11.6 percent of GDP in 1999 to 16.7 percent of GDP in 2005. During the same period, personal income tax revenue fell from 6.5 percent of GDP in 2001 to only 4.9 percent GDP in 2005, while corporate income tax revenue remained broadly stable. As a result of the reliance on revenue-increasing measures, tax revenues in Turkey (including social security contributions) reached nearly 32 percent of GDP in 2005, with an estimated tax effort of about 30 percent higher than expected in international comparison. Primary fiscal revenues stand at 40 percent of GDP, a level similar to EU countries despite Turkey's smaller welfare state.

43. ***Reliance on indirect taxation may have a regressive incidence on income distribution but offers some advantages that should be taken into account in the design of the tax system.*** Given pervasive informality, in the short term, reliance on indirect taxes appears to be a reasonable way of ensuring some degree of compliance of those who would have otherwise escaped taxes altogether. In addition, indirect taxes uniformly

levied on consumption offer advantages on efficiency grounds as they are relatively neutral towards saving and investment decisions while they do not distort incentives to work. However, greater reliance on indirect taxes should not be accompanied by proliferation of special regimes and exemptions. In particular, reduced VAT rates introduced recently for textile and clothing products are of questionable effectiveness as a means of assisting domestic producers to withstand competition and tackle the problem of fraudulent refunds. Multiple VAT rates and exemptions increase the complexity of the tax system, create more opportunities for misreporting and misclassification for tax purposes, and thus work against efforts of strengthening tax compliance.

44. ***Because there is little fiscal space for further 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 a reduction for dependents so as to reduce the high tax wedge on married workers; maintaining neutrality in the taxation of interest income across asset classes and avoiding discrimination among domestic and foreign investors.
- 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.

45. ***Establishing an adequate tax expenditure framework would promote fiscal accountability and transparency.*** Aware of the challenges, the Government has initiated work to analyze and estimate tax expenditures. Based on draft tax benchmarks, initially some 186 tax provisions were identified as generating potential tax expenditures. Some of the major tax expenditures are granted with the aim of promoting investment, employment, regional development, R&D, and trade incentives (primarily through the CIT). A range of tax expenditures aims at assisting low-income tax payers, in support of social policy. These are delivered primarily through the PIT and CIT and, to a lesser extent, the VAT. Some major tax expenditures in this latter group include the deductibility (for PIT purposes) of contributions to the social security system for pensions, disability, unemployment and health benefits as well as contributions to private pension and insurance company-based pension and health policies.

46. ***The estimation of tax expenditures is still in its early stages but preliminary estimations point to a significant fiscal cost.*** As part of the PFMC Law, the authorities have estimated that tax expenditures for 15 tax provisions will cost 1.6 percent of GDP per year over 2006-08—including, however, the investment tax allowance, since phased out. According to very approximate estimations, including part of omitted tax

expenditures would raise total tax expenditures to at least 5 percent of GDP per year, or about 18 percent of government revenues in 2003. This level of tax expenditures would place Turkey towards 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.

Required fiscal space to meet medium-term expenditure pressures

47. ***Expenditure pressures are growing in key sectors while the development challenges on the way to the EU are amplifying expenditure needs.***

- *Several new policies have been initiated or proposed in education that will have a significant impact on the medium-term expenditure program. Simulated new or proposed policies would increasingly boost annual expenditures, by up to 0.5 percent of GDP in 2009.*
- *Health expenditures are projected to increase from 5.2 percent of GDP in 2006 to 6.1 percent in 2009—assuming no effective cost containment through co-payments for outpatient visits and drugs.*
- *To sustain income convergence and alignment with the EU, investment in infrastructure, operation and maintenance, and environmental expenditures will all need to increase. Combined annual general government investment in infrastructure and environmental expenditures would need to increase by at least 0.6-07 percent of GNP during 2007-2009.*

48. ***The social security system deficit is set to decline, generating some modest fiscal space.*** With the enactment of the new social security laws, revenues of the system are projected to increase by 0.3 percent of GDP until 2009, while expenditures would decline by 0.2 percent of GDP. As a result, the social security system deficit is estimated to decrease by half a percentage point of GDP until 2009—with further savings expected in the long term.

49. ***A sustainable budget envelope for the financing of primary expenditures at the general government level is estimated at around 33 percent of GDP until 2009.*** A sustainable expenditure envelope is calculated based on a revenue projection and the assumption that the primary surplus *for the whole public sector* would be kept at 6.5 percent of GDP. Maintaining a high primary surplus will be needed to further reduce the public debt ratio. Despite the substantial improvements in the level and composition of public debt, Turkey's debt ratio is relatively high and its maturity short. The recent turmoil in international markets and its transmission to domestic markets justify the need for a lower debt ratio to ensure macroeconomic stability.

50. ***Significant fiscal space to meet expenditure pressures will be required during 2007-2009 under the baseline and alternative scenarios.*** The fiscal space needed to meet expenditure pressures is calculated as the difference between the projected primary expenditures and the sustainable expenditure envelope. In the baseline projection, the needed fiscal space is estimated at 1.1 percent of GDP in 2007, reaching 1.7 percent in

2008 and 2 percent in 2009. In a scenario with a stronger reform initiative in education, the expenditure pressures would be larger, by 0.3 percent of GDP each year. In an alternative scenario, 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 sustainable expenditure envelope would be reduced by an estimated 1 percent of GDP. The required fiscal space would thus increase by an equivalent amount. With a stronger effort in education and more ambitious reduction of the debt ratio the fiscal space needed would increase from 2.4 percent of GDP in 2007 to 3.3 percent by 2009. Using expected privatization revenues to repay debt would significantly reduce the fiscal space needed to reduce the debt ratio.

51. ***Fiscal space to meet expenditure pressures should be created by a combination of structural public expenditure reforms and expenditure reallocations.*** Structural fiscal reforms, aimed at improving the quality of fiscal consolidation, are the only viable means of sustaining the adjustment in the future while making appropriate fiscal space for growth-enhancing expenditures and lower taxes in the future. Reforms that improve the efficiency of expenditure programs would be required in sectors where expenditure pressures are being felt. Trade-offs in expenditure allocations would also 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 also create fiscal space by broadening the tax bases.

Strengthening budgetary institutions

52. ***Far-reaching public financial management reforms have improved budget coverage, formulation, execution, accounting, audit, and procurement.*** Enactment of the Public Financial Management and Control (PFMC) Law in 2003 marked a defining moment, providing a new legal framework for modern public expenditure management and accountability. Several other laws have been or are being enacted, including the Special Provincial Administration Law, the Municipalities Law, the Metropolitan Municipalities Law, The Turkish Court of Accounts (TCA) Law. The law for redefining the revenue sharing between the central and local administrations is also in Parliament. In 2004, a GFS-compliant budget classification system was adopted. An online networked accounting system for the central government and an automated tax management system have also been implemented. The new laws are inspired in part by the prospect of EU accession and by the government's desire to introduce greater performance orientation in budget management.

53. ***The coverage of the 2006 budget and medium-term fiscal framework has been expanded to all central government institutions but some steps are still pending to broaden the comprehensiveness of the budget.*** As defined by the PFMC, the budget approved by the Parliament covers the general budget, special budget, and regulatory and supervisory institutions. Moreover, several extrabudgetary funds have been closed down, creating a framework more conducive to fiscal discipline. However, even though the

PFMC Law required incorporation of extrabudgetary funds into the budget of the related administration, they continue to operate outside of budget discipline, with insufficient scrutiny of their operations. Similarly, revolving funds continue to operate outside the budget coverage at the risk of distorting budget discipline, further to a decision to restructure the revolving funds by the end of 2007 with an amendment made to the PFMC in December 2005. The Government's preferred approach is to restructure remaining revolving funds, rather than including them in the budget.

54. ***Properly phasing-in and completing the implementation of the accrual accounting system requires addressing complex issues.*** Key issues include valuation of assets and inventories, depreciation rates, and gains and losses from foreign exchange. As shown by the experience of countries that have switched to accrual accounting, implementation generally works best when done in phases. Extensive training is necessary in how to use and interpret accrual accounting statements. Implementing full commitment accounting is also needed as, until recently, only commitments for large multiyear capital expenditure projects were fully captured. Recording of all commitments will ensure budget discipline and avoid the possible accumulation of arrears.

55. ***The PFMC Law has introduced a modern internal audit framework—*** The PFMC Law requires each public administration to establish an internal audit unit. The law clearly articulates the accountability of ministers and other high-level civil servants. It also requires every line ministry to prepare an annual accountability report—also including performance data and details in the implementation of the strategic plan and budget.

56. ***—but implementation of the law itself poses a major challenge as it envisions a substantial change in the public internal financial control framework.*** The law envisages a uniform implementation schedule across the general government, irrespective of the size or capacity of the agencies concerned. This raises an implementation challenge, as smaller municipalities may either ignore the provisions that they may consider too expensive, or they may implement the provisions by focusing on form rather than substance. A transition strategy needs to be devised, outlining interim measures while the new institutional structures become fully operational.

57. ***The Turkish Court of Account's (TCA) draft law creates a sound basis for the development of government audit and should be complemented by additional initiatives.*** In particular, the audit side of TCA is not yet fully developed as the draft law is still insufficient in terms of structures and responsibilities. Even after enactment of the law, TCA will still be dominated by its judicial side. Developing capacity for financial statement audits would be necessary since the government will be producing accrual-based financial statements in addition to cash-based budget execution reports. Moreover, the envisioned increase in the role for local administration prompts the need for reconsideration of audit policies for local government. TCA's role might be redefined in several ways—for example, with different strategies for local administrations of differing sizes; creating a new local government audit service; using private sector auditors to audit local administrations.

58. ***Since 2001 the public procurement system has made good progress, yet some significant issues require attention.*** A new Public Procurement Law (PPL) and secondary legislation was prepared. However, other laws have made several amendments to the PPL, mainly to provide exemptions to various agencies and to exclude procurement of certain services from the scope of the law. Internal consistency and integrity of the original law should be sought before making amendments. All draft laws amending the PPL should be prepared and finalized in close consultation with the Public Procurement Authority. Improvements are also required as part of the alignment with the EU *acquis*—in particular because: (i) the 15 percent national preference for public contracts above the threshold is incompatible with the *acquis*; (ii) there is lack of sector (utilities) legislation; (iii) a horizontal legal framework for concessions is lacking; and (iv) a platform for Electronic Procurement is still to be developed.

59. ***Despite progress, addressing the unfinished agenda in public financial management laws represents a major challenge and requires strong coordination and monitoring.*** In some instances implementation of the reform agenda has been hesitant, and some regressive tendencies in the implementation of the PFMC law tend to perpetuate budgetary fragmentation. Although some aspects of the new legal framework are being piloted intermittently, some of the secondary regulations related to practical implementation are yet to be issued. The government's decision to undertake fundamental changes in the responsibilities of provincial and municipal governments also injects new complexity and considerable uncertainty into the PFMC implementation schedule. Enactment of the Omnibus Law has created concern that its provisions run counter to the intention of the PFMD and PFMC Law as approved by the Parliament. Without addressing the unfinished elements of the agenda and arrangements to ensure effective leadership and coordination among agencies, implementation of the overall PFM reform agenda will remain at risk.

Table A: Horizontal Public Expenditure Reforms—key policy options		
	Short-term options (one year)	Medium-term options (2-3 years)
Public sector employment and the wage bill	<ul style="list-style-type: none"> • Refrain from ad hoc pay rises for civil servants and ensure that the extra (40+40) pay rise granted in 2006 is not built in the salary base for calculating the 2007 pay increase • Formulate a MTEF over 2007-2010 with the aim of restraining Consolidated General Government personnel compensation in percent of GDP • Establish a consistent set of criteria to distinguish between public servants and contracted personnel 	<ul style="list-style-type: none"> • Harmonize salary scales for civil servants across various career streams • Design harmonization of salary scales with a view to minimizing its fiscal cost • Concentrate salary in elements most closely linked to human capital requirements of positions • Consolidate the legal framework governing salary setting throughout the public sector • Reform the allowance and side benefit system for civil servants to incorporate all elements of compensation in the personal income tax base • Consider replacing uniform step salary increases with unit-specific salary increases based on annual performance ratings and a fixed unit-specific budget envelope • Design an annual personnel performance appraisal process that ensures reliable and fair performance ratings • Continuously monitor that the integrity of competitive selection procedures and procedures governing changes in grade is ensured
Managing the public investment program	<ul style="list-style-type: none"> • Formulate a plan for a detailed assessment of operation and maintenance (O&M) expenses of public capital • Integrate responsibilities across agencies for planning of investment and O&M during the budget formulation process 	<ul style="list-style-type: none"> • Conduct the assessment of O&M requirements and formulate a MTEF with the aim of ensuring sufficient appropriations to meet these requirements • Design and implement policies to enhance the environment for private investment • Assess the public investment portfolio to

		<p>determine which projects are worth pursuing further, dropped, or redefined in their scopes, with a view to eliminating projects in “trace allocation”</p> <ul style="list-style-type: none"> • Ensure that the newly introduced MTEF is effectively and realistically utilized as a tool for formulating a sustainable investment program, including effective participation by the line agencies • Formulate a MTEF with the aim of gradually increasing appropriations for public investment in infrastructure conditional on reforms to contain pressures in recurrent expenditures
<p>Managing tax expenditures</p>	<ul style="list-style-type: none"> • Finalize benchmark tax structures for each tax type • Complete the list of tax expenditures for all tax types • Provide a functional classification of tax expenditures • Identify gaps in existing and/or currently planned data bases and tax models to estimate and forecast tax expenditures and undertake initial steps to construct improved databases and models • Plan required changes in tax laws, tax reporting requirements or modalities and/or database construction procedures including linking tax returns between years in databases. • Draft discussion documents and hold working meetings with all stakeholders to discuss concepts, benefits and issues of tax expenditure accounting and budgeting and modalities for implementation 	<ul style="list-style-type: none"> • Complete the construction of databases • Complete models (depends upon completion of databases) • Refine the cost estimate of tax expenditures by tax and by government function • Conduct a systematic review of tax expenditures with the aim of eliminating or modifying those with most distorting impact on efficiency and tax payer equity, overlap with direct expenditures, and/or where objectives can be more efficiently achieved through direct expenditures • All tax expenditures should have sunset dates; be subject to period review; and be repelled if the original economic and social situations on which they were enacted have changed • Estimate and publish tax expenditure accounts for completed financial years. • Forecast tax expenditures for use in budgeting • Review budgeting process to provide for selection of and trade-offs between tax expenditures and direct expenditures

Table B: Public expenditures in key sectors—summary of reform options		
	Short-term options (one year)	Medium-term options (2-3 years)
Education	<ul style="list-style-type: none"> • Design an incentive system and action plan to ensure that secondary schools fill their classrooms up to capacity levels • Introduce a legally viable mechanism for primary and secondary schools to manage certain, limited financial resources • Design mechanisms that would give higher education institutions autonomy over financial resources in an accountability framework whereby they would receive their funding in blocks rather than as line items; would be allowed to carry over unspent funds between years, and receive their funding on the basis of output performance for the three main responsibilities of tertiary education: teaching (using student numbers), research and service provision 	<ul style="list-style-type: none"> • Pilot test mechanisms for higher education institutions autonomy • Develop a policy to measure and report on student learning performance at every school, coherent with the new national curriculum • Introduce detailed strategic planning for educational institutions, linking outcome objectives to education expenditures at all levels • Evaluate primary and secondary schools' financial controls and other outcomes with respect to their limited autonomy over certain financial resources • Introduce a system of per student financing for schools to cover a significantly larger share of the acquisition of educational materials, equipment, professional development services and other services normally acquired by MONE or provincial offices • Modernize the university entrance examination system to promote improved learning outcomes and in such a way as to eliminate the advantage of private examination preparation courses • Roll out the financial autonomy mechanisms to all higher education institutions based on the lessons learned in the pilot implementation • Change the composition of spending in public schools to increase the share of non personnel expenditures on educational materials to levels similar to private schools and universities • Enhance public education service provision in most backward provinces to compensate for lack of private sector initiative • Consider increasing per student expenditure on pre

		primary education and introduce financing instruments that leverage private initiative
Pensions	<ul style="list-style-type: none"> Implementing the Social Security and Universal Health Insurance Law as enacted in 2006 to ensure the sustainability of the pension system 	<ul style="list-style-type: none"> Initiate a nation-wide consultation on a medium-term action plan to realize savings in the pension system, with the aim of financing a future reduction in payroll taxes that would promote employment creation and formalization Consider phasing in earlier than currently planned the requirement of 15 minimum years of contribution to gain entitlement to partial pension Consider further reducing accrual rates of pension benefits to bring them to the average level in OECD countries To strengthen incentives to contribute to the pension system consider amending the Law so that the pensionable base be calculated on the basis of 100 percent of average wage growth
Health care	<ul style="list-style-type: none"> Reduce range of reimbursable drugs (i.e., difference between original and closest generic) to 10% of price of generic drug Reassess and possibly reduce the number of drugs on the positive list Adjust and possibly increase the co-payment rates in drugs by category Introduce a flat fee (co-payment) per prescription 	<ul style="list-style-type: none"> Devote a larger share of well-targeted resources on preventive health care activities Rationalize price of generics and original drugs Introduce medical audit for pharmaceuticals Expand bioequivalence to avoid switch to more expensive drugs Training of physicians on appropriate use of drugs (mostly antibiotics) and development of standard treatment protocols Switch to dispensing drugs by the actual # of pills rather than bottles/vials Grant financial and administrative autonomy to public hospitals with a view to creating appropriate incentives for innovative management and stronger accountability Consider consolidating small MOH hospitals to improve capacity utilization and allow more efficient operation Consider introducing prospective payment mechanisms at

		the hospital level to strengthen incentives to contain costs
Rural expenditures	<ul style="list-style-type: none"> • Step up financing in the rural investment budget to accelerate project completion 	<ul style="list-style-type: none"> • Redeploy expenditures from the transfer budget into investment-oriented programs with the aim of improving agricultural productivity and off-farm rural employment growth • Shift emphasis in rural investment from irrigation to high-return activities such as land consolidation, and storage and pre-marketing facilities • Address over programming in the rural investment budget and maintain adequate level of financing to accelerate project completion • Maintain focus on rural investments to improve drinking water facilities • Emphasize participatory approaches, cooperatives, and private sector involvement in service provision to reduce over reliance on government staff for agricultural and rural development activities

Note: Measures highlighted in grey denote options that may require additional expenditures