EUROPEAN
COMMISSION

Brussels, 22.4.2021
SWD(2021) 88 final

COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

TURKEY
(2021-2023)

COMMISSION ASSESSMENT

EN EN

TABLE OF CONTENTS

1. EXECUTIVE SUMMARY

Turkey was one of the few countries in the world that experienced positive economic growth in 2020, at the cost of exacerbating long-standing vulnerabilities and inequalities. The growth performance was driven by a low base effect, strong growth momentum before the pandemic, and a sizeable policy stimulus that boosted domestic demand. Crisis-response measures were dominated by a large credit impulse, led by state-owned banks, and underpinned by a rapid relaxation of monetary conditions. As a result, the lira depreciated, external imbalances and dollarisation increased, foreign exchange reserves declined precipitously, and the country risk premium went up markedly. Rising inflation and consumer lending at subsidised rates increased inequalities. In response to worsening vulnerabilities, monetary policy has shifted to a tighter stance since last November, bringing some relief to the lira, but decisively lowering inflation requires consistent policies sustained over a much longer period. Even though it is affected by high uncertainty due to the COVID-19 pandemic, the economic outlook of the Economic Reform Programme (ERP) is positive, with a strong rebound expected in 2021. Correcting external vulnerabilities, however, is likely to take longer than acknowledged in the programme and requires sustained stability-oriented policies. Reducing the high level of dollarisation poses a particular challenge. In view of the severely reduced buffers and renewed policy uncertainty following the dismissal of the central bank governor in March, Turkey also remains very exposed to changes in global financial markets and investors' sentiment in a challenging geopolitical environment. While bank liquidity and capitalisation appear strong, the risk premium remains high and the sector will have to deal with legacy issues and worsening asset quality once crisis related measures are lifted.

The programme targets a frontloaded fiscal consolidation, but misses an opportunity to alleviate a tense labour market situation. The policy response to the crisis involved a rather limited increase in crisis-related expenditure. Together with a strong revenue performance, this led to a significant fiscal tightening in 2020. In line with the previous programme's intentions, the authorities envisage a continued frontloaded fiscal consolidation. The magnitude of the planned consolidation in 2021, however, looks overly ambitious in view of the still fragile recovery and the extremely challenging labour market situation. The programme's medium-term deficit path is entirely based on a continuous decline in primary expenditure, to a level not seen in a decade. In view of the high level of uncertainty, a strong asset of the programme is that it presents rather prudent revenue estimates. Government debt is projected to stabilise in the low 40s as a percentage of GDP, but its maturity and currency structure implies some vulnerabilities. Transparency and public finance reforms advanced. However, fiscal risks, in particular from quasi-fiscal activities, remain elevated.

The main challenges for future economic policy are the following:

- **Renewed policy uncertainty, high inflation and low foreign exchange reserves contribute to elevated external vulnerabilities.** Addressing these challenges would require reinforcing central bank independence and maintaining a tight monetary policy stance over a prolonged period under a transparent framework and consistent communication.

- **The recovery remains fragile, uncertainty is high, and the labour market is still weak.** A more accommodative fiscal policy may be needed to balance the required tight monetary stance, support the recovery, and relieve some of the pressure on the labour market in 2021. Advancing a credible medium-term consolidation plan and further improving public finance quality could lower fiscal risks.

- **The regulatory and institutional environment lacks transparency and predictability which hampers much-needed foreign and domestic investments.** Major shortcomings in terms of independence of regulatory authorities and increased state interference in the economy hinder a market-based consolidation of a level playing field for economic actors.

Limited access to finance is an obstacle to investments and growth perspectives for companies, which are particularly needed for the economic recovery from the COVID-19 pandemic and the realisation of Turkey's industrial policy ambitions.

The weakness of the labour market remains an issue. The unemployment rate fell slightly in 2020 but this is not a sign of a structurally better performing labour market. It is rather the result of massive job-retention policies and an indication that workers were discouraged to look actively for a new job during the pandemic. The employment rate fell further with the COVID-19 crisis and may even come under more pressure when the short-term work schemes and the ban on layoffs expire. The potential of women in the labour market remains largely untapped. Active labour market policies as well as reskilling and upskilling offers do exist but are limited in scope. Undeclared work has decreased but remains at a high level. The already high NEET (not in education, employment or training) and youth unemployment rates have increased further.

- **The education system has improved but remains a key challenge.** Unfortunately, some of Education Vision targets such as mandatory schooling for 5 year olds, had already fallen behind. During the pandemic Turkey embarked on a commendable distance learning system, in which the state TV TRT-EBA broadcasts school lessons for the pre-school, primary, secondary and high school students on separate channels. In addition there is an education platform on the internet and tablets were distributed to families in need. Generally, the quality of education has improved as evidenced by the latest Programme for International Student Assessment (PISA).

The policy guidance set out in the conclusions from the Economic and Financial dialogue of May 2020 has been partially implemented, with the rate of implementation improving in comparison to previous years. Budget transfers to households and companies increased and measures were taken to cushion the impact of the crisis on the labour market, although the scope and size of these transfers were rather limited, leaving informal workers particularly exposed. Government investment was greater than initially planned and medium-term plans have been revised slightly upwards. Selective expenditure reviews were conducted in some spending areas and the 2021 budget law was prepared in line with programme budgeting. Monetary policy tightening and simplification since November have addressed a major policy shortcoming, helped stabilise the lira and lowered the country risk premium. However, the dismissal of the central bank governor in March has reversed most of these gains and significantly increased risks. Some reform measures have been announced with regard to the rule of law and the business regulatory environment, but these fall short of addressing core problems in these areas. The number of companies under trusteeship decreased but still remains significant. Turkey rolled out a bold job retention scheme and a ban on layoffs which avoided an employment meltdown. Undeclared work has decreased but there were no specific measures for refugees under temporary protection. Active labour market policies encouraging female labour market participation and youth employment have been continuing but remain limited. Education reforms have continued but the impact remains to be seen.

Overall, the programme correctly identifies the main structural challenges facing the economy, but policy credibility is weak and reform implementation remains uncertain. The Turkish authorities are aware of the numerous structural challenges and vulnerabilities facing the economy. Reform plans have been prepared to address many of them across a wide range of sectors. However, their timely implementation would test the authorities' resolve. Some of the proposed measures in the ERP are also rather small-scale projects that will not result in systemic changes. Despite a strong rebound from the crisis, the recovery remains fragile and major imbalances persist. Turkey has started to address the challenges in the area of education but the impact of the measures will show only in the following years.

Unfortunately, mandatory schooling for all 5 year olds was pushed beyond 2023. Evidence-based active labour market policies need to be stepped up and the fight against informal employment needs to be continued. Structural bottlenecks, like the low labour market participation of notably women and young people in general, remain as relevant as before.

2. ECONOMIC OUTLOOK AND RISKS

Turkey was one of the few countries in the world that experienced positive economic growth in 2020. The economy expanded by 1.8%, clearly above the 0.3% expected by the ERP. Several factors made this growth performance possible – the low base effect (2019 growth was just 0.9%), a strong growth momentum before the pandemic (end-2019, early 2020), and a large policy stimulus. Thus, after a slump in the second quarter, the economy rebounded quickly to its pre-crisis level as early as the third quarter of 2020. Growth was driven by domestic demand and remained strong in the last quarter, despite subsiding as a result of a shift towards tighter monetary policy and new restrictions introduced in the wake of a second COVID-19 wave.

The policy reaction to the crisis delivered a quick rebound but exacerbated long-standing vulnerabilities and inequalities. The authorities' crisis-response measures were dominated by a large credit impulse, led by state-owned banks and underpinned by regulatory decisions and rapid relaxation of monetary conditions. Of the estimated 12% of GDP stimulus in 2020, some four fifths came through the credit channel. However, the large-scale monetary stimulus weakened the lira, increased external imbalances and dollarisation, and depleted foreign exchange reserves. Importantly, the policy response also aggravated inequalities by increasing inflation and providing consumer lending at subsidised rates to the relatively well-off segments of society. At the same time, fiscal measures focused on deferring tax and social security obligations, with rather limited transfers to the most vulnerable, like those who lost income and jobs in the crisis.

The ERP expects economic growth to increase further and the negative output gap to close in 2023. The macroeconomic and fiscal outlook continues to be affected by high uncertainty due to the COVID-19 pandemic. Nonetheless, after rebounding to 5.8% in 2021, economic growth is forecast to move to 5% in the medium term. Final domestic demand is projected to remain persistently robust throughout the whole 2021-23 period. Following a strong recovery in 2021, the contribution of net exports to growth is seen as broadly neutral afterwards. A larger-than-expected carry-over effect could potentially boost short-term economic growth even beyond the programme's expectations. At the same time, assuming unchanged growth fundamentals, medium-term growth prospects might prove lower as the output gap might close earlier than forecast. Capital stock and employment are expected to be the main factors of growth, while total factor productivity is projected to remain subdued. The programme acknowledges the high pandemic-related uncertainty and sketches out an alternative low-growth scenario, but fails to present sufficient detail to allow it to be assessed. In addition, the policy uncertainty following the dismissal of the central bank governor in March is likely to affect confidence, thereby constraining growth and undermining growth fundamentals.

Lowering persistently high inflation is a medium-term project, which is undermined by the lack of central bank independence and high policy uncertainty. Inflation increased to 15% y-o-y at the end of 2020, far above the central bank's 5% target. The disinflation path envisaged in the ERP is too ambitious and has since been revised. In an attempt to strengthen confidence, monetary policy reversed course in August last year. It tightened further under a new central bank governor, who took over the reins at the bank in November and in several steps raised the key policy rate by 875 basis points to 19% in March 2021. The monetary framework was simplified and made more transparent. The authorities' intention, outlined in the ERP, to maintain a tight monetary policy stance until 2023 is motivated by the need to anchor inflation expectations, stabilise the exchange rate, reduce dollarisation and rebuild foreign exchange reserves. However, this policy direction was severely undermined by the dismissal of the central bank governor in March, barely four months after he took office. His removal triggered financial market instability, increased uncertainty and called into question the authorities' commitment to reducing inflation and external vulnerabilities. It also showed that maintaining a sufficiently tight monetary policy stance over a prolonged period remains a challenging task, as demonstrated by a long history of missed targets and rapid policy reversals.

Table 1:

Turkey - Comparison of macroeconomic developments and forecasts

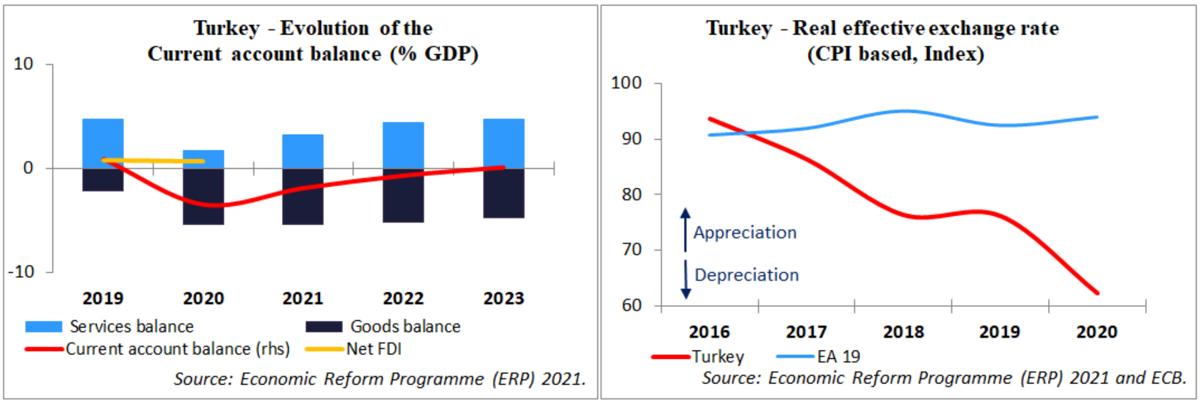
	2019		2020		2021		2022		2023	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	0.9	**0.9**	-2.5	**0.3**	3.9	**5.8**	4.5	**5.0**	n.a.	**5.0**
Contributions:										
- Final domestic demand	-2.2	**-2.0**	-1.8	**0.2**	2.4	**4.8**	4.0	**4.9**	n.a.	**4.7**
- Change in inventories	-0.1	**0.6**	4.0	**5.0**	-1.0	**-1.0**	0.0	**-0.1**	n.a.	**0.1**
- External balance of goods and services	3.2	**2.4**	-4.7	**-5.0**	2.5	**2.0**	0.5	**0.2**	n.a.	**0.2**
Employment (% change)	-2.3	**-2.3**	-4.3	**-4.8**	3.6	**6.0**	4.3	**4.1**	n.a.	**4.2**
Unemployment rate (%)	13.7	**13.7**	13.7	**13.8**	14.1	**12.9**	14.1	**11.8**	n.a.	**10.9**
GDP deflator (% change)	13.9	**13.9**	12.1	**11.9**	11.9	**9.9**	9.4	**6.4**	n.a.	**5.9**
CPI inflation (%)	15.2	**15.2**	11.8	**11.6**	11.7	**9.9**	9.2	**6.2**	n.a.	**5.4**
Current account balance (% of GDP)	1.2	**0.9**	-4.0	**-3.5**	-2.0	**-1.9**	-2.1	**-0.7**	n.a.	**0.1**
General government balance (% of GDP)	-3.0	**-3.0**	-6.2	**-6.1**	-6.0	**-4.5**	-5.3	**-4.0**	n.a.	**-3.6**
Government gross debt (% of GDP)	32.8	**32.5**	41.4	**41.1**	44.5	**40.8**	47.5	**41.6**	n.a.	**41.8**

Sources: Economic Reform Programme (ERP) 2021, Commission Autumn 2020 forecast (COM).

External vulnerabilities increased significantly and correcting them is likely to take longer than acknowledged in the programme. Foreign indebtedness surpassed 60% of GDP. The level and quality of central bank's foreign exchange reserves deteriorated notably as the share of the main global currencies in gross reserves declined. The central bank's net foreign assets (excluding swaps with local banks and foreign central banks) turned negative, falling to around USD 60 billion at the end of 2020. The country risk premium is likely to remain very high, given the increased policy uncertainty following the dismissal of the central bank governor in March. The current account deficit increased to above 5% of GDP last year, markedly above expectations, as a result of a widening trade deficit and losses in tourism revenues. Imports of goods remained relatively strong, in particular in the second half of the year. They were boosted by an outsized credit expansion and higher non-monetary gold imports, reflecting increased domestic financial stress. The ERP's external projections so not fully take into account the latest developments and are rather optimistic. In view of what is likely to be an only partial tourism recovery, higher than forecast import prices, and continued non-monetary gold imports, the current account deficit is set to remain sizeable in 2021 and clearly above programme estimates.

The potential to further expand the tradable sector and to attract more stable and longer-term external financing is still largely untapped. Although goods exports declined during the peak of the lockdown, they have recovered quickly, expanding mainly to non-EU markets. Despite the lira's appreciation since November, the effective exchange rate still gives a competitive edge to local exporters. This, combined with relatively low domestic labour costs and the expected recovery of the global economy, could support robust export growth over the programme horizon. The return to a more orthodox monetary policy was instrumental in bringing back some portfolio investment at the end of 2020. However, the dismissal of the central bank governor has not only renewed depreciation pressures on the lira but also triggered portfolio and other investment outflows. Attracting foreign direct investment (FDI) is recognised by the authorities as important to fostering the technological transformation of the economy. FDI has declined in recent years, hampered by geopolitical uncertainty, macroeconomic instability and concerns over the rule of law. If these are addressed, Turkey's competitive advantages could potentially allow it to attract much bigger FDI inflows.

Graphs: external competitiveness and current accout



Boosting bank lending was the preferred policy reaction to recent crises but, although effective in the short-run, it has also built-up financial vulnerabilities. At the outset of the pandemic, the authorities doubled down on policies to support credit, using a wide range of macro-prudential measures. State-owned banks led the way, providing loans at below market rates and expanding their portfolio significantly. The size and scope of the Credit Guarantee Fund increased as well. Many of these measures have been lifted since the policy normalisation started at the end of 2020. As a result, credit growth has declined steeply, while in January 2021 total loans fell by 3% from their peak in October. Bank liquidity and capitalisation remain strong but, as loan deferrals and regulatory forbearance are removed, prudential measures are strengthened and the risk premium remains high, the sector will have to deal with legacy issues and worsening asset quality. This is likely to put additional pressure on commercial banks' equity and on the already low profitability of the sector.

Increased dollarisation poses a particular challenge. Deposit dollarisation (including gold) reached new highs in 2020 as excess liquidity seeped through to the currency market and confidence in the lira was shaken. From the beginning of the year until early November, the lira lost some 40% of its value against the US dollar. It has since recovered part of these losses, but was again under significant depreciation pressure after the dismissal of the central bank governor in March. In view of the renewed policy uncertainty, dollarisation is likely to increase further from an already high level. Reversing this trend would require a prolonged stabilisation of the lira and reduced inflation expectations, which calls for sustained implementation of an independent and tight monetary policy. In managing their excess foreign exchange liabilities, banks have increased their exposure to the central bank by engaging in significant swaps. Gradually winding down the stock of these swaps, which amounted to around USD 40 billion in March 2021, poses a particular challenge. In view of the severely reduced buffers, Turkey remains particularly exposed to changes in global financial markets and investors' sentiment in a challenging geopolitical environment.

Table 2:
Turkey - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	742	719	641	676	673
Foreign ownership of banking system (%)	30.0	28.2	26.8	26.0	25.0
Credit growth	16.7	20.9	16.0	10.9	34.7
Deposit growth	17.7	17.7	22.1	24.0	35.4
Loan-to-deposit ratio	1.19	1.23	1.18	1.03	1.04
Financial soundness indicators (end of period)					
- non-performing loans*	3.2	3.0	3.9	5.4	4.1
- net capital to risk-weighted assets	15.6	16.9	17.3	18.4	18.8
- liquid assets to total assets	8.1	8.0	10.7	10.0	9.4
- return on equity	12.5	15.9	14.7	11.5	11.6
- forex loans to total loans (%)	34.8	32.6	39.9	38.0	34.0

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

3. PUBLIC FINANCE

Budget performance significantly surpassed expectations in 2020. The central government budget deficit was 3.5% of GDP, against a revised target of 4.9%. Nonetheless, the deficit grew compared to the previous year and to the initial, pre-pandemic target of 2.9% of GDP, as interest payments, transfers and capital expenditure increased, while dividends from the central bank declined. Overall, revenue, in particular from indirect taxes, held up strongly. Buoyant domestic demand and targeted tax increases on certain goods, such as motor vehicles, supported revenue growth. Tax collection improved as well, as increased use of digital transactions curtailed the shadow economy. The targeted tax reductions and deferrals, introduced to combat the economic fallout of the crisis, were limited and had only a marginal impact on revenue. The policy response to the crisis involved a rather small increase in social spending and transfers to households, which kept the general government deficit significantly below the ERP target of 6.1% of GDP, implying a fiscal tightening in 2020. Although improving, the underlying budgetary balance, net of one-offs and temporary transactions (including another large super-dividend payment from the central bank), exceeded the headline deficit by some 1.8% of GDP.

Box: The Impact of the Measures Taken Against the COVID-19 Outbreak on Public Finance *

Estimated fiscal impact of the COVID-19 crisis in 2020	**Due to one-off discretionary measures (in % of GDP)**	**Due to the slowdown of economic activity (in % of GDP)**
Central budget expenditure impact	One-off discretionary expenditure in different measures, 0.8% (TRY 38.5 billion)	Cost of credit subsidy provided for crafts and agricultural producers, 0.02% (TRY 1.1 billion)
Central budget revenue impact	Cost of tax reductions, 0.3% (TRY 15 billion)	Cost of tax and social security insurance premium deferrals 0.07% (TRY 3.6 billion)
Central budget total impact	**1.1% (TRY 53.5 billion)**	**0.1% (TRY 4.7 billion)**
Unemployment Insurance Fund impact	Short-term work allowance, unpaid leave cash support and normalisation support, 0.8% (TRY 36.9 billion)	
Total fiscal impact	**2.0% (TRY 90.4 billion)**	**0.1% (TRY 4.7 billion)**

Source: Economic Reform Programme (ERP) 2021 – Presidency of Strategy and Budget, Ministry of Treasury and Finance

*Only the direct budget effects of measures taken to mitigate the adverse effects of COVID-19 are given. The total economic impact of measures including loan service deferrals and subsided credits amount to TRY 552.7 billion (12.1% of GDP).

The ERP targets further frontloaded fiscal consolidation but misses an opportunity to alleviate a tense labour market situation. In line with the previous programme's policy intentions, the authorities envisage a significant reduction of the budget deficit over the programme period, by 2.5 percentage points (pps.), from 6.1% of GDP in 2020 to 3.6% of GDP in 2023. However, most of the reduction (1.6 pps.) is planned for 2021, with an estimated structural adjustment of 1.2 pps. The magnitude of the planned fiscal tightening in 2021 looks overly ambitious in view of the still fragile recovery and the difficult labour market situation. The programme's medium-term deficit path is entirely based on a continuous decline in primary expenditure, which is set to fall to 31.4% of GDP in 2023 – a level not seen in a decade. This comes at the cost of further supressing current expenditure and leaving capital expenditure at its current level, which is far below historical averages and the economy's needs. Nonetheless, in view of the high level of uncertainty, a strong asset of the programme is that it presents rather prudent revenue estimates. Although gradually declining to 31.0% of GDP, the starting point of total revenue in 2020 is stronger than assumed in the programme, thus leaving a margin for upside surprises.

Table 3:

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

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	33.1	32.5	31.7	31.2	31.0	-1.5
- Taxes and social security contributions	25.1	25.3	25.6	25.5	25.4	0.1
- Other (residual)	8.0	7.2	6.2	5.8	5.7	-1.5
Expenditure	36.1	38.6	36.3	35.2	34.6	-4.0
- Primary expenditure	33.6	35.5	32.9	31.8	31.4	-4.1
of which:						
Gross fixed capital formation	2.7	2.6	2.6	2.4	2.6	0.0
Consumption	16.5	17.7	16.0	15.3	14.9	-2.8
Transfers & subsidies	7.8	8.8	7.8	7.7	7.6	-1.2
Other (residual)	6.6	6.4	6.5	6.4	6.3	-0.1
- Interest payments	2.5	3.0	3.4	3.4	3.3	0.3
Budget balance	-3.0	-6.1	-4.5	-4.0	-3.6	2.5
- Cyclically adjusted	-2.8	-4.4	-3.7	-3.6	-3.6	0.8
Primary balance	-0.5	-3.0	-1.2	-0.5	-0.3	2.7
- Cyclically adjusted	-0.3	-1.5	-0.4	-0.2	-0.3	1.2
Gross debt level	32.5	41.1	40.8	41.6	41.8	0.7

Sources: Economic Reform Programme (ERP) 2021.

The 2021 budget is conservative and has some space to accommodate additional measures to support economic recovery. The parliament approved the 2021 government budget on 19 December, envisaging a budget deficit of TRY 245 billion (4.3% of GDP), which corresponds to an estimated general government deficit of 4.5% of GDP. The programme expects real GDP to grow by 5.8%, while inflation is projected to be 8.0% at the end of the year. Since the budget's adoption, and taking into account the better than expected outcome in 2020, the authorities have identified additional fiscal space of at least 0.8 pps. in 2021. After the submission of the ERP, they signalled their intention to allocate it entirely to deficit reduction, which would further tighten an already tight fiscal stance. General government revenue is estimated to decrease by 0.8 pps., to 31.7% of GDP, almost entirely because of a drop in non-tax revenue due to lower interest income and receipts from the central bank. Total expenditure is planned to fall significantly more, by 2.3 pps., to 36.3% of GDP. The envisaged savings are planned to come from spending on goods and services (including on defence and security) and social security transfers, as pandemic-related measures are gradually lifted.

The authorities have extended some of the crisis-mitigation measures into 2021 but intend to withdraw them swiftly, despite the still high uncertainty and a weak labour market. With the 2021 budget, the government preserved its approach of providing limited, temporary and targeted support to sectors most affected by the pandemic. It extended the reduced value added tax rate on certain goods and services in the hospitality sector, maintenance and repair, until May 2021. It also extended the reduced withholding tax rate on interest from lira deposits and on rent payments. However, these revenue measures would have a marginal impact on the economy and the budget. Direct payments from the budget to the most vulnerable remained limited and are envisaged to expire as early as the first half of the year. The government has several times prolonged a short-term working allowance and a lay-off ban, currently into the second quarter of 2021 – two measures with significant cushioning impact on the labour market benefiting several million employees. Overall, fiscal support measures remain parsimonious, especially if set against the very challenging labour market situation.

The structural fiscal reforms strategy is evolving. In March, the authorities announced additional measures, including steps to increase budget transparency, promote expenditure efficiency, reduce the informal sector and improve public finance and debt management. If implemented, they would potentially allow for a further reduction in the share of one-off and temporary revenue, improvement of the tax structure, and a reduction in distortions. Permanently strengthening the revenue base could limit the conditions that have favoured ad-hoc decisions and tax amnesties in recent years. Expenditure reviews, on the other hand, could lead to budgetary savings over the medium term. The reform package includes targeted tax exemptions for around 850 thousand small entrepreneurs. There is also a set of largely administrative measures designed to monitor price increases and lower inflation, but they are likely to fall short of expectations, unless monetary policy is used decisively as the main tool for achieving price stability. Some of the steps identified to address another major vulnerability – the high current account deficit – are rather vaguely defined or a continuation of already applied policies, while others openly promote import substitution.

Government debt is projected to stabilise in the low 40s as a share of GDP. In 2020, the government debt ratio increased by 7 pps., to close to 40% of GDP. In addition to the higher primary deficit and interest payments, the depreciation of the lira pushed the government debt-to-GDP ratio up as well. With the forecast stabilisation of the exchange rate, and under the baseline budgetary scenario, the programme expects government debt to remain broadly stable over the medium term. Nevertheless, interest payments are projected to remain relatively elevated, above 3% of GDP, throughout the whole programme period. Part of the increased indebtedness was a result of the government's higher liquidity preference during the crisis and its enlarged holdings of financial assets. Consequently, last year net government debt expanded at a more measured pace, to around 20% of GDP.

Government debt maturity and currency structure imply some vulnerabilities. The significant increase in borrowing last year came at the cost of worsening debt vulnerability indicators. The average time to maturity of central government debt fell from 6.4 years in 2018 to 5.1 years in 2020. The decline was more pronounced for external debt, as the average time to maturity of domestic debt was already quite low at 2.8 years. Long-term borrowing in domestic currency remained relatively costly. Borrowing decisions and the depreciation of the lira drove the share of foreign exchange-denominated debt up to 56.2% of the total at the end of 2020 – a level last seen in the early 2000s. The share of domestic debt in total debt inched up to 58.5%. The flight of foreign investors from the domestic bond market was nearly complete last year – their share tanked to under 4%, before rebounding somewhat at the end of the year. Corporate investors also significantly reduced their exposure. State-owned banks filled the gap, holding close to 35% of all domestic debt by the end of 2020. The country's sovereign rating remains several steps below investment grade. The five-year sovereign risk premium increased considerably in the spring last year, peaking above 640 basis points in early May 2020. The changed monetary policy stance in November brought another rapid turnaround, bringing down the risk premium to 300 bps. It increased again to around 450 bps after the dismissal of the central bank governor at the end of March 2021, remaining significantly above that of peers and historic averages.

Box: Debt dynamics

Inflation effects are expected to remain the main factor driving down the government debt-to-GDP ratio. Real economic growth is forecast to increasingly contribute to lowering the debt as well, while the debt-increasing contribution from the primary balance is expected to wind down gradually. Higher interest payments are projected to continue to be the main debt-increasing factor. Stock-flow adjustments, mainly driven by shifts in the exchange rate, are also pushing up government debt.

Turkey

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**32.5**	**41.1**	**40.8**	**41.6**	**41.8**
Change in the ratio	2.7	8.6	-0.3	0.8	0.2
Contributions [2]:					
1. Primary balance	**0.5**	**3.0**	**1.2**	**0.5**	**0.3**
2. "Snowball" effect	**-1.3**	**-0.5**	**-2.6**	**-1.0**	**-1.1**
Of which:					
Interest expenditure	2.6	3.0	3.4	3.4	3.3
Growth effect	-0.3	-0.1	-2.3	-1.9	-2.0
Inflation effect	-3.6	-3.5	-3.7	-2.5	-2.3
3. Stock-flow adjustment	**3.5**	**6.1**	**1.1**	**1.3**	**1.0**

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

Continued efforts are needed to counter the elevated fiscal risks. The authorities are cognizant of the still very high macroeconomic uncertainty and domestic vulnerabilities. To counter them, they have opted for a relatively conservative fiscal scenario, leaving some space to accommodate potential pressures on the budget. Motivated by the high level of risk, they have also increased significantly the level of public sector deposits and other financial assets, which stood at 5.4% of GDP for 2020. Efforts are being made to strengthen the monitoring and control of other risks, stemming from state guarantees and deficiencies in the framework for public-private partnerships (PPPs). Within the scope of the risk management framework, the debt assumption limit under PPPs has been kept unchanged at USD 4.5 billion in 2021. Other quasi-fiscal activities, however, like the operation of state-owned banks and enterprises, and of the Turkey Wealth Fund also carry budgetary risks that are not fully acknowledged. Potentially important risks, not sufficiently recognised in the ERP, could arise in particular from the sizeable amount of new credit provided by state-owned banks and public guarantees issued in response to the COVID-19 crisis with a view to supporting the economy. Recapitalisation and restructuring needs of the public sector as a whole, and in particular in sectors such as transportation that have been heavily affected by the crisis, may also put significant pressure on public finance.

Reforms to improve the quality of public finance have advanced. The 2021 central government budget and administration performance programmes were prepared and submitted to the parliament under the programme budget structure. Work on expenditure reviews has progressed as well, which the ERP expects will improve resource allocation and result in budgetary savings over the medium term. Systematic public information on expenditure arrears remained scarce. Important reforms have been announced with a view to strengthening the tax system and reviewing tax expenditure and exemptions. New legislation, which is at an advanced stage of preparation, aims to consolidate the preparation and management of PPPs into a single framework, fully integrating them into the budget process. While reform preparation has advanced, however, there is a need to avoid further delays and move decisively to the implementation phase. The structure of public expenditure is not sufficiently supportive of growth, as the level and share of investment in human and physical capital remains low.

Transparency improved but some weaknesses in the fiscal framework persist. The publication of the 2018 and 2019 audited reports of the Turkey Wealth Fund, in line with the ERP joint policy guidance from last year, is welcome. However, transparency related to quasi-fiscal activities and risks could be further improved. The fiscal framework remains narrowly defined and more efforts are needed to improve the credibility and effectiveness of the medium-term budgetary framework. There are no strong national fiscal rules and independent fiscal institutions to monitor fiscal performance and advise the government on fiscal policy matters. Budgetary preparation and fiscal analysis focuses almost exclusively on the central government level, with little attention being paid to developments at other levels of government.

4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Turkey is endowed with a strategic geographic position, a strong and entrepreneurial business sector, a large domestic market and a young population. It also has privileged access to the EU market through the Customs Union with the EU. To provide jobs for the many new entrants to the labour market, since the early 2000s, the Turkish economy has relied on credit growth and foreign financing. As a consequence, structural imbalances worsened, amplifying the economy's vulnerability. As Turkey entered the COVID-19 crisis in the spring of 2020, it doubled down on expanding even further domestic credit and relaxing monetary policy. While this policy was effective in providing some short-term relief, it also further exacerbated the imbalances and increased inequalities.

The Commission has conducted an independent analysis of the Turkish economy to identify the key structural challenges to boosting competitiveness and inclusive growth. This analysis drew on the Turkish ERP itself, discussions with the authorities, as well as other sources. It shows that Turkey is experiencing a number of structural weaknesses across many sectors. Besides the need to secure long-lasting macroeconomic stability, which ultimately underpins prospects for inclusive and durable growth, the main challenges in terms of boosting competitiveness and long-term and inclusive growth are (i) increasing employment, in particular of women and young people, and formalising employment, (ii) raising the performance level of education, and (iii) improving transparency and predictability in the regulatory and institutional environment affecting businesses.

Turkey needs to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for successfully transforming the economy. In its annual report on Turkey, the Commission is closely following the issues of strengthening the rule of law and fighting corruption.

Key challenge #1: Increasing employment, in particular of women and young people, and formalising employment

The strong economic growth rates since the turn of the millennium helped moving people out of informal employment in agriculture into formal urban employment in services. However, this development has come to a halt and the new reality is falling employment rates. The natural population growth with 800 000 new jobseekers every year, the influx of 3.6 million refugees under temporary protection and the labour market impact of the COVID-19 pandemic have left their traces on the labour market.

The country faced severe social and economic problems in 2020 but the rollout of short-term work schemes and a ban on layoffs prevented an employment meltdown. The pandemic has worsened the economic situation and Turkey's labour market has come under further pressure. The employment rate (20-64) was at 53.8% in 2019 (EU 73.1%). In the fourth quarter of 2020 it was further decreasing by 2.4 pps. to 51.3.% in comparison with the fourth quarter of 2019. The activity rate (20-64) dropped from 61.9.% in the fourth quarter of 2019 to 58.7% in the fourth quarter of 2020. According to Turkstat, the number of employed persons decreased by 1 million 268 thousand persons in 2020 compared to the year before. The massive roll out of short- term work schemes, which involved a total of 6.2 million beneficiaries, the ban on layoffs and the obligation to grant unpaid leave for those not entitled to short-term work benefits avoided a worse employment downturn. The short-term work scheme pays benefits up to 60% of gross wages, with a ceiling of 1.5 times the gross minimum wage. The maximum of the short-term work benefit is TRY 4 380. For workers who are not entitled to the short-term work benefits due to insufficient prior contribution to the unemployment insurance scheme, the ban on layoffs applies. 1.4 million workers were granted unpaid leave until January 2021 and the government pays them monthly benefits of around TRY 1 200 (around EUR 135). This is approximately half of the minimum wage and hardly enough to survive. People who are informally employed and lost their jobs do not receive any benefits from the unemployment insurance. They are left to their own means as there is no minimum income scheme in Turkey.

The unemployment rate (15-74) amounted to 12.8% in the fourth quarter of 2020 (EU 7.5%), which is actually a 0.5% decrease from the same period of last year. However, this is mostly a statistical effect resulting from the ban on layoffs and the fact that many workers were discouraged from actively looking for formal employment, which is the prerequisite for being registered as unemployed. After the phasing out of the short-term work schemes and the ban on layoffs the unemployment is expected to increase again unless the economy rebounds very quickly.

One particular challenge is the underused potential of Turkey's young population. The rate of young people (15-24) not in employment, education or training (NEET) has increased to 26.9% in the third quarter of 2020, a rate almost triple the EU-27 average (10.1%) and 0.6 pps. above the same period of last year. Turkstat indicates an annual NEET rate of 28.3% (15-24) for 2020, which is an increase of 2.3 pps. compared to the year before. The biggest share out of this group are women, who do not enter the labour market. Until recently, the growth rates mitigated the situation to some extent, but now youth unemployment (15-24) stands at 25.5% in the third quarter of 2020, almost twice the level of overall unemployment. The fact that the labour force participation rate in the age group 15-24 has decreased in the third quarter of 2020 by 5.3 pps. y-o-y to 42.1%, suggests that an increased number of young people might have given up looking for a job in the current situation. The natural population growth that results in hundreds of thousands people joining the labour market every year aggravates the pressure on the labour market since the economy does not generate an equivalent number of jobs. Labour market participation thus deteriorates. To offer young people and especially those in the low-skilled segment valid prospects is one of the most immediate tasks for Turkish employment policy. The seriousness of the problem is demonstrated by the rate of young people in informal employment, which is 47.7% (i.e. almost half of all employment). In order to reverse the trend, Turkey has rolled out employment incentives for young people (18-29) for whom social security contributions are paid at minimum wage level.

Another big structural deficiency of the Turkish labour market is the underused potential of women in the labour force. The employment rate of women continues to be structurally lower than that for men. In the third quarter of 2020, the employment rate for women (20-64) was 32.7%, less than half of that for men (71.5%), which makes a gender employment gap of 38.8 pps. for the third quarter. The picture is the same for the activity rate. The activity rate of women (20-64) in the third quarter of 2020 was 38.8%, while that for men was 81.0%. Policies aimed at getting women into the labour market have so far had limited results. The most important policy initiative to increase employment and labour force participation among women has been to provide incentives to employers to hire female employees. This measure was introduced in response to the 2008 global economic crisis. More recently, Turkey introduced a number of Social Security Institution (SSI) pilot projects.

EU funds financed one, where women are subsidised for third party childcare if they return to work and another involved grandmothers to provide childcare for children aged 0-3 years. Both programmes were discontinued. In 2019, two further programmes started, which support childcare provision but they do not involve more than 14 000 working mothers. The ERP contains now also includes Measure 20: "*Mother at work and child care support*", under which mothers with children can attend vocational training courses. 16 000 women are expected to participate in this qualification measure in 2021 and they can receive a childcare support of TRY 400 per month. These measures are indeed commendable but remain limited in scope and impact. The lack of childcare facilities beyond the big urban centres like Istanbul, Ankara and Izmir and the lack of appropriate work-life balance policies which would stimulate working-time flexibilisation continue to hinder female labour force participation. In addition, part-time work is less developed in Turkey at 10% in comparison with the EU average of 19%. Last but not least, traditional gender stereotypes do not see women as part of the labour force. They rather reduce women to unpaid care and household work in the family. Data compiled by the Turkish Statistical Institute indicate a very clear relationship between women's education and their labour force participation. 15.9% of illiterate women, 27.7% of female lower secondary school graduates, 34.3% of female high school graduates and 72.7% of female university graduates are in the labour force. Besides excluding them from societal life, the partial exclusion of women from participation in economic life is substantially limiting the growth perspectives in Turkey. According to a McKinsey study in co-operation with the Turkish Industry and Business Association (TÜSİAD)[1], Turkey's GDP would increase by 20% if it were to reach the OECD activity rate average of women (53.1% in 2019) within 10 years.

The bipartite and tripartite social dialogue is underdeveloped. Few employer organisations in Turkey such as the Turkish Confederation of Employer Associations (TISK) realise this or contribute towards its strengthening. Turkey continues to have a very low private sector trade union affiliation (13.8% of registered workers) and collective bargaining coverage (11% of registered workers). Only the public sector has a high organisation rate with 66.7%. The Economic and Social Council has not convened since 2009 and other social dialogue mechanisms are either not used or lack active involvement. As a result bipartite and tripartite social dialogue is weak and does not play a role as an enabling factor for inclusive growth. This and the limited involvement of social partners in defining an appropriate response to the COVID-19 pandemic are clearly missed opportunities.

Employers sometimes face difficulties in finding employees with the right profile. According to a survey by the HR solutions provider Manpower[2] 51 in 100 companies in Turkey state that they cannot find the right talent. Indeed, there is often a mismatch in horizontal skills such as ICT and oral and written expression. The low level of average problem-solving skills in technology-rich environments coincides with lower proficiency in literacy and numeracy among adults and low upper secondary attainment: In addition, jobs in Turkey face a high risk of automation. More than half of all occupations are at risk of redundancy in the near future. Further tailor-made reskilling and upskilling would be of great benefit for the workers affected by the changing world of work. With a view to this, Turkey has included Measure 22: "*Future Professions*" in the ERP programme, under which 18-29 year old workers are trained for the skills of Industry 4.0, namely digital processes and

[1] https://tusiad.org/en/reports/item/9642-women-matter-turkey-2016-report-turkey-s-potential-for-the-future-women-in-business

[2] https://go.manpowergroup.com/hubfs/Talent%20Shortage%202019/2019_TSS_Infographic-Turkey.pdf

robotics. Unfortunately, the scope of the programme is limited to 1 750 participants. With some exceptions, the offers for lifelong learning are not fit for purpose and limited in coverage. Only 6.2% of the adult population participated in lifelong learning, which is considerably fewer than the EU (11.1%). For the time being there is no alignment with the objectives set by the European Agenda for Adult Learning and the European Skills Agenda. Nonetheless, the public employment service (ISKUR) has made efforts and, with the help of the EU programmes, has invested in capacity building. It has reinforced the career guidance system and increased the number of career counsellors. The ERP includes Measure 19: "*Job Clubs"*, under which job-seekers receive job and vocational counselling. This is in itself a good initiative but women, young people and refugees often still get no, or no appropriate, advice and support and are left to their own devices. The coverage of active labour market policies is limited in general.

The rate of unregistered employment remains at a high level. It was at 28.0% in January 2021. The fall of 3.6 pps. in comparison to the same period last year is largely a statistical effect as the informal jobs in tourism, construction and domestic services were not available during the pandemic, whereas the formal registered employment was preserved by job retention schemes. Apart from economic costs such as lower productivity and tax revenues, there are considerable social costs generated by informality. Workers employed in the informal economy are subject to social exclusion and the absence of social security contributions and taxes weakens social security and tax revenues of the state budget. In Turkey tax revenues account for 25% of GDP, while on the average in the EU it is around 40% of GDP. Low levels of taxation can reduce the resources available for public education. This can lead to low levels of schooling, poverty and next generation informality. It is a difficult to break this vicious circle, which is limiting the growth potential of Turkey. In order to bring informality rates down further, the country has submitted a draft law to parliament, which provides for the waiving of fees and penalties if employers formalise workers. In addition, social security contributions for workers will be subsidised. This measure incentivises the creation of formal employment and is a step in the right direction. Additional steps should follow, notably targeting refugees under temporary protection, who largely work in the informal economy.

Key challenge #2: Raising the performance level of the education system

Overall, Turkey has made progress in education, especially in improving access to various levels of education. However, it faces many and various human capital development challenges.

At present, the educational attainment levels are still lagging behind the economic development in Turkey. Only 39% in the 25-64 age group has completed upper secondary education (OECD average 78%). The proportion of low skilled workers, i.e. those who have not completed upper secondary education, is even more striking: 53% of the workers in Turkey belong to this category as opposed to 17% in the EU. Compulsory schooling from 8 to 12 years was only introduced in 2012. In addition, the refugee and migrant influx continues to put substantial pressure on the education system, not only for the displaced people but also for the communities into which they settle.

Historically, Turkey has had the problem of an unskilled labour force, which is still an impediment for further growth. The country is addressing the low human capital development by upscaling its education system and the latest PISA 2018 assessment in Turkey shows that the gap between Turkey and the OECD average has indeed narrowed. The scores in mathematical and science skills went upwards between 2015 (mathematics score 420, science score 425) and 2018 (mathematics score 454, science score 468). Turkey has advanced from the 50th place in 2015 to 40th in 2018, out of 79 participating countries. The remaining challenge is notably reading skills (score 466 in 2018). Only 3% of students were top-performers in reading (OECD average 9%), whereas 26.1% were low performers (OECD average 23%). The ERP also includes Measure 15: "*Increasing the reading culture*", which is intended to boost the reading skills of the Turkey's young people through the rollout of Z-libraries and by providing e-book facilities. The measure is a step in the right direction and will improve reading skills.

Early childhood education and care services continue to be very limited in Turkey. The COVID-19 crisis did not help to improve the situation. Early childhood care is still only available in big urban centres and the enrolment rate for children up to the age of 3 years is very low. This has had consequences that go beyond education. It has hampered women's labour market integration and jobs recovery in the pandemic because women have often been taking care of the kids while schools were closed.

The kindergarten is attended by 54% of children and 71% of children aged 5 years were enrolled in preschool education. Full enrolment of 5 year olds in preschool education was initially scheduled for 2023, but has now been pushed back. The ERP includes Measure 14: "*Dissemination of pre-school education".* It provides for an enrolment rate of 75% by 2023. Turkey should pursue the original Education Vision goal of full enrolment of 5 year olds.

The enrolment rates in primary and secondary education leave room for improvement. The enrolment rate in primary education was 95.9% and the enrolment rate of 14-17 year olds in upper secondary education was 85% in 2020. At 95% lower secondary education is not universal either. In addition, there is a serious problem with early leavers from education and training (18-24 year olds), which at 31% is three times higher than the EU-27 average (10.2% in 2019).

Turkey responded to the COVID-19 crisis in education by launching distance learning through four channels provided by the state-run Turkish Radio and Television Corporation (TRT). The TRT-EBA TV broadcasts school lessons for pre-school, primary, secondary and high school students on separate channels. In addition there is an education platform on the internet. This is a commendable endeavour. However, according to the teachers' union Egitim-Sen some 6 million children are experiencing problems accessing the Education Informatics Network either because they have no computers or because of poor connectivity. This is an additional challenge for the inclusiveness of education as high-income households are more likely to provide the necessary equipment and infrastructure. Efforts targeted at disadvantaged students and refugees, who are less likely to have access to distance education, will be crucial. In this context, it has certainly helped to some extent that Turkey has distributed 500 000 tablets with a data package to children in need.

Turkey's ERP also includes Measure 16: "*Preparing digital skill based programmes"* which aims to enhance digital skills in the ninth grade: Digital literacy is indeed a key competence of the 21 century. In this sense the measure is more than appropriate.

Vocational education and training (VET) in Turkey has a potential for further development as it can mitigate to a certain degree the high NEET and youth unemployment rates. However, VET institutions often fail to provide the right skills set. The regular VET schools, where pupils in the tenth and eleventh grade are in class and in twelfth grade learn through practical work, are often not geared to the labour market. Turkey is aware of this and is broadly updating the curricula of VET education. It has also rolled out dual VET education, where theoretical training in VET school alternates with practical training in companies. The uptake of students in dual VET is better. 82% of the dual VET students get a job after completing dual VET training. Students of regular VET schools have greater difficulties in finding employment when they leave school.

Turkey's 2021-2023 ERP outlines the reform measures needed in technical and vocational education and training (TVET), some of which are related and complementary to the Riga

Mid Term Deliverables. These include Measure 17: "*Updating curricula in vocational and technical education",* which aims to fostering labour market skills of presence and future and Measure 2*1: "Establishing a private sector cooperation protocol for vocational training and skills development"* (the MEGEP project – Strengthening the VET system in Turkey). These two measures were rolled over from the last ERP and go in the right direction. They are helping to increase the relevance of VET in Turkey for the labour markets of today and tomorrow. Efforts in this direction should be stepped up.

Turkey participates in the European Alliances for Apprenticeship (EAfA), which promotes the increased involvement of the private sector in skills matching for all levels of VET education. Turkey is also a partner in the EU programme Erasmus+. The country has access to actions in the field of higher education, youth, sport and VET as well as school and adult education projects for cooperation and mobility. It can also cooperate with partners outside Europe under international projects.

Turkey has also always shown a strong commitment to EU policies on education and training. Examples of this include the ET2020 Working Groups and the implementation and monitoring of the EU priorities for VET 2015–2020 (Riga Council Conclusions), in its commitment and pledges to EAfA. As regards skills mismatch in higher education, the business community observes a certain horizontal skills mismatch, as humanities are often preferred to ICT, natural science, business and economic studies, for which is greater demand. More and more university graduates have difficulty in finding a stable formal employment which causes academic informality and labour emigration. Generally, academic proficiency differs widely depending on the school and the students' socioeconomic background. In international co-operation on education Turkey participates in the Bologna process on higher education.

Nationally, Turkey has embarked on the Education Vision 2023 strategy, which is the strategic reform framework for the upscaling of the education system. The commitments are bold. There is a series of evaluation and assessment reports on different targets of the strategy, which is necessary to ensure the outcome. The ministries in charge of the implementation of strategy meet twice a year to take stock.

Key challenge #3: Improving transparency and predictability in the regulatory and institutional environment affecting businesses

Turkey's overall institutional and regulatory environment has been weakening further, despite the government's intention to improve the business climate. In the absence of an effective checks and balances system, the accountability of the executive remains limited. The backsliding in the rule of law continued, and major shortcomings remained in terms of the independence of the regulatory authorities. The increased state interference in the economy hinders the market-based consolidation of a level playing field for economic actors. Limitations in the access to finance are an obstacle to investment and to growth perspectives for companies, which are particularly needed for the economic recovery from the COVID-19 pandemic and the realisation of Turkey's industrial policy ambitions.

The New Economy Programme 2021-2023 recognises the need for reform and puts forward a set of initiatives reflecting the course of the Judicial Reform Strategy. These include the establishment of specialised jurisdictions in various sectors, the specialisation of judges, a reform of the notary system and its expansion to cover non-contentious cases, the promotion of arbitration systems and the increased use of digital technologies for judicial procedures. Such steps may improve procedures technically; however, they do not address overarching concerns, in particular with regard to the independence and professionalism of the judicial system. The Human Rights Action Plan announced in early March also envisages a number of new reforms, including new specialised courts and a revision of the anti-corruption and public procurement legislations. A new economic reform package was presented on 12 March 2021. Its four pillars (investment, production, export and employment) includes a series of measures addressing both macroeconomic imbalances and structural weaknesses. Operational details on the roll-out of these measures have not yet been published.

Effective measures to strengthen the rule of law, to ensure appropriate and timely contract enforcement and improve the availability and functioning of dispute settlement mechanisms remain key factors for improving Turkey's business environment. While Turkey has generally improved its position in the World Bank's Doing Business Index 2020, there has been further backsliding in the areas of contract enforcement and insolvency resolution. Even though alternative dispute resolution mechanisms have been promoted, commercial judicial processes are slow and a large backlog of commercial court cases remains. The implementation of the legislation to improve the insolvency system is behind schedule and the process remains inefficient. In order to mitigate the impact of the COVID-19 pandemic on businesses, all pending and new enforcement and bankruptcy procedures were put on hold until 15 June 2020, and concordat proceedings were suspended as well. However, no further initiatives on bankruptcy procedures were taken after that date, despite an alleged rise in cases.

The unpredictable regulatory environment represents a major obstacle to competitiveness. The regulatory environment ranks among the weakest dimensions in the latest available editions of notably the IMD Competitiveness Index, the INSEAD Global Innovation Index and the IMF country report. The number of regulatory changes in numerous sectors, in particular due to the transition from a parliamentary to a presidential system, has significantly increased in the last 5 years. There are no systematic mechanisms in place for consultations with businesses and social partners on legislative initiatives. Consultations are held through consultative boards, councils, working groups and technical committees established by a few ministries; yet neither a clear calendar for these meetings nor their conclusions are publicly available. Despite a legal framework already being in place for regulatory impact assessments, such studies are rarely carried out.

Market interventions by the state hinder competition and the capacity of economic operators to implement long-term business plans. Strengthening the legal framework for state intervention by making it more transparent, accountable and predictable is a key requirement for a more favourable business environment. Legislation to implement the law on State aid law has been pending for almost a decade. Recent changes in the administrative set-up for state aid have led to an oversight structure that is neither complete, nor independent or operational. Turkey continued the implementation of the general incentive package (2012 Incentive Scheme), the Project Basis Investment Programme and the support programmes provided by TÜBITAK (Scientific and Technological Research Council of Turkey) and KOSGEB (Small and Medium Enterprises Development Organization of Turkey). These programmes were, however, not adapted to mitigate the impact of the COVID-19 pandemic.

State interventions in price-setting mechanisms in key product areas hamper the free functioning of product markets. The price level of more than a quarter of the goods in the consumer price inflation basket is directly set or strongly influenced by public authorities. In the energy sector, commercial and industrial clients who do not reach a consumption threshold are required to buy electricity from an assigned supplier at a price set by the regulatory authority. The gradual phasing-out of this obligation is still ongoing, but no end-date has been set.

The Turkey Wealth Fund and the Savings Deposits Insurance Fund (TMSF) are largely exempt from transparency requirements and competition. The Turkey Wealth Fund was created under a special law in 2016 and is fully owned by the government. According to its consolidated financial statements at the end of 2019, its total assets at that time were

TRY 1 457 billion. The Fund was granted immunity, notably from the Law on the Protection of Competition, the Turkish Commercial Code and the Law on Capital Markets, and it is vested with unlimited borrowing capacity. The Fund is also exempt from certain taxes and charges such as the stamp duty, income and corporate taxes, tax deductions and the Istanbul stock exchange fees. These exemptions are problematic from a competition perspective with regard to the Fund's operations, despite the welcomed publication of its activity reports and financial statements for the years 2018 and 2019. The acquisition and management of companies under the trusteeship of the Savings Deposits Insurance Fund (TMSF) remains non-transparent. As of 30 September 2020, 804 companies with a total asset value of EUR 7.5 billion had been placed under TMSF trusteeship, down from 815 companies in February 2020. Neither a schedule for resolving the release of all companies from trusteeship nor appropriate, effective and timely means of legal redress are in place.

Another factor disrupting the smooth functioning of the market is widespread distortion in the allocation of government contracts and assets. Turkey lacks preventive and anti-corruption bodies while severe flaws in the anti-corruption legal framework allow undue political influence in the allocation of public resources. Public procurement is especially prone to corrupt activities on account of a number of exceptions allowed under public procurement law. Tender procedures covered by exceptions have significantly increased in recent years, while the number of contracts awarded via open auctions has fallen relative to the total number of contracts awarded. The lack of transparency in the selling of public assets by agencies such as the Housing Development Administration and the Saving Deposits Insurance Fund poses serious concerns about the political influence exerted over these bodies.

The informal economy also continues to distort the level-playing field for businesses and thus undermines competitiveness. The informal sector remains large, at close to 30% of GDP, well above the OECD average. The authorities continued to implement the Action Plan and Strategy for the fight against the informal economy (2019-2021). The results of the actions taken so far are, however, difficult to assess, since no concrete performance indicators were set and no data published. There are plans to extend the focus on reducing unregistered employment (ERP 2021, Measure 9, "*Reducing unregistered employment by focusing on increasing audit capacity in non-agricultural sectors"*); however, no targets have been set. There is no comprehensive longer-term approach for addressing the informal economy, including aspects of employment and the business environment that disincentivise formalisation, which would allow for sustained progress in addressing these issues.

The government has started to address the very low level of foreign direct investment in Turkey. Potential investors are discouraged by a number of obstacles, such as difficulties in getting approvals, weak enforcement of industrial and property rights and hidden market restrictions. Various measures for improving the investment climate have been initiated under the guidance of the Vice-President's Office. The finalisation of a new Investment Framework Law planned for mid-2020 and foreseen in the ERP 2020 was delayed; the draft is currently under consultation with stakeholders. As part of the ERP measure on investment procedures (ERP 2020, Measure 9, "*Creating guidelines for investment procedures in various sectors*") the additional action of a virtual one-stop-shop portal for information about investment support per sector and province provided by the Ministry of Industry and Technology has been set up and is operational (www.yatirimadestek.gov.tr). The procedural guidelines are still to be initiated (ERP 2021, Measure 8, Preparing new legislation for easing private sector investments).

Recent changes in capital market and banking legislations are welcome steps for the further development and deepening of capital markets. They include the easing of loan securitisation, the establishment of a single public insurance company, the establishment of a board of debt instrument holders, the concept of security trusts, project bonds, and project finance funds, and the expansion of the areas of activity of development and investment banks.

Limited financial resources hamper business development and the growth of companies. While emergency support has been provided to businesses to cushion the impact of the COVID-19 pandemic on economic activity, access to finance remains limited, especially for SMEs. Analysis from the United Nations and the World Bank highlights the fact that the business continuity of micro and small enterprises has been disproportionately put under strain by the COVID-19 pandemic. Such businesses are facing difficulties in maintaining employment and payments with limited operational liquidity, and are thus more likely to close permanently. Despite significant increases in the capacity of Credit Guarantee Fund (since early 2017), the 2019 Enterprise Survey shows that two thirds of Turkish firms are credit-constrained, compared to an average of 52% in higher middle-income countries. Most constrained firms are the discouraged firms, who didn't apply for a loan. The main reason deterring firms from applying loan is by far the high borrowing costs. The government has introduced stimulus packages to support business continuity, protect jobs and keep cash flowing to workers and businesses. The government support measures included a deferral of tax and social security payments, the provision of additional loan guarantees, extended cash transfers to low-income households and extended employment benefits. KOSGEB supported SMEs by extending the maturity date and covering interest costs of loans disbursed under the SME Loan Interest Support Regulation.

Box: Monitoring performance in light of the European Pillar of Social Rights

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

Turkey faces considerable challenges concerning the indicators of the Social Scoreboard[3] supporting the European Pillar of Social Rights. This is notably the case for equal opportunities and fair working conditions, especially for those in informal employment. Turkey has a high rate of early school leavers (31%) and young people not in employment, education or training (NEETs, 27.6% for age group 15-24 in the third quarter of 2020). In the third quarter of 2020, the gender employment gap stood at 38.8 pps., the highest among the enlargement countries. Both the at-risk-of-poverty-rate-or-social-inclusion rate (39.8% in 2019) and the income quintile ratio (8.35 in 2019) are higher than EU-27 averages. Social dialogue has been deteriorating in recent years.

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

Low participation in the labour market applies in particular to women. The labour force participation rate of women is 32.7% in the third quarter of 2020. A significant part of the female population never enters the formal labour market. Between 2018 and 2019 unemployment rate was already high but largely stable, in the third quarter of 2020 it fell slightly to 13.2%. This was the positive effect of the short-term work schemes which were rolled out to 6.2 million beneficiaries and no sign of a structural improvement. .Enrolment figures for pre-primary and primary education were low but have improved over the years. However, the quality of education remains an issue, as indicated in the results of PISA testing.

Skills mismatch and limited reskilling opportunities limit labour market integration and mobility. Overall, education outcomes remain low. While primary education is nearly universal, there are low enrolment and high dropout rates in secondary education. Teacher training and quality is another area which requires investment.

The impact of social transfers on poverty reduction is small. It accounts for only 8.94% (EU-27 average 32.38%).

Turkey has a well-developed system for labour market and social statistics. The Turkish Statistical Institute (TurkStat) is the main producer and coordinator of Turkey's statistical system. TurkStat publishes the Labour Force Survey (LFS) quarterly and annually and the Survey on Income and Living Conditions (SILC) annually.

[3] The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey, with one small adjustment in the age bracket for the unemployment rate (reducing the upper age limit to 64 instead of 74) for Albania and Kosovo* due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

5. Overview of the implementation of the policy guidance adopted at the Economic and Financial Dialogue in 2020

Overall: Partial implementation (48.5%)[4]	
2020 policy guidance	**Summary assessment**
PG 1: Increase in a transparent manner fiscal transfers to households and companies with the view to limiting the fall-out in employment. Increase growth-enhancing capital expenditure above budget plans in 2020 and in the medium term. To reinforce the medium-term sustainability of public finances, prepare an exit strategy to lower the use of one-off and temporary measures over the medium term.	There was **partial implementation** of PG 1. 1) **Partial implementation:** Budget transfers to households and companies increased and measures were taken to cushion the impact of the crisis on the labour market. However, the scope and size of these transfers was rather limited. 2) **Substantial implementation:** Central government investment increased and capital expenditure execution in 2020 was above initial plans. Medium-term government capital expenditure plans have been revised only marginally upwards in comparison to the previous programme. 3) **Limited implementation:** Although budgetary performance improved, a medium-term consolidation strategy, focused on the phasing out of one-off and temporary measures is still under preparation.
PG 2: Conduct spending reviews and implement performance budgeting as planned, in order to create space for more productive expenditure and to increase budgetary transparency and accountability. Publish the regular audited reports of the Sovereign Wealth Fund. Take preparatory steps towards publishing higher-than-annual frequency data by sub-sector on general government budget execution.	There was **substantial implementation** of PG 2. 1) **Substantial implementation:** Selective expenditure reviews were prepared in some spending areas. The 2021 budget law was prepared in line with programme budgeting and submitted to the Parliament. 2) **Full implementation:** The 2018 and 2019 audited reports of the Turkey Wealth Fund were published on the Fund's web site. 3) **Substantial implementation:** Quarterly expenditure data are available by general government sub-sectors. Detailed revenue data are also available but in different formats.
PG 3: Implement an appropriate monetary policy stance at the central bank's own discretion to contain inflation broadly in line with the target and anchor inflation expectations, increase trust in the local currency and boost investor confidence, in particular amid the global risk-off environment evoked by the COVID-19 pandemic.	There was **partial implementation** of PG 3. 1) **Partial implementation:** The monetary policy stance was not sufficiently tight throughout most of the year with highly negative real interest rates and double-digit inflation drifting further away from the target. In November 2020 policy priorities shifted towards price stability and simplifying the monetary policy framework, increasing credibility and temporarily boosting market confidence. These gains were, however, quickly erased after the unexpected dismissal of the central bank governor following the bigger-than-expected rate hike in March 2021. This has renewed concerns over the central bank's ability to determine

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

	the monetary policy stance at its own discretion and brought significant uncertainty about the future direction of monetary policy.
Closely monitor financial stability challenges arising as a result of the COVID-19 pandemic and take appropriate action if needed. Ensure the transparency of measures taken to provide liquidity for the banking sector and support the flow of credit to the private sector.	2) **Substantial implementation:** The authorities have taken decisive measures to provide borrower relief and help smoothing the adjustment of the banking system to the major economic shock experienced. The measures used to support lending throughout the year are gradually withdrawn and the normalisation process towards more stringent regulation is underway. In addition, banks were also required to maintain a prudent approach in loan restructurings. Regulation is nevertheless still complex, lacks transparency and deviated from international standards, e.g. concerning the NPL definition.
Enhance confidence in the banking sector by conducting transparent asset quality reviews, and explore further measures to mitigate the likely build-up of new NPLs.	3) **Limited implementation:** There has been no tangible improvement with regard to transparency in asset quality. The authorities are not considering an independent third-party asset quality review, but are conducting regular stress tests. The full impact of the crisis in particular on asset quality is yet to become visible, likely requiring further adjustments.
PG 4: With the aim to improving the business environment, further strengthen the rule of law and the regulatory environment and improve consultation mechanisms with business organisations and social partners on relevant new legislation.	There was **limited implementation** of PG 4**.** 1) **Limited implementation**: The absence of an effective checks and balances system, the backsliding in fundamental freedoms, and shortcomings in the independence of regulatory authorities continued.A systematic consultation mechanism does not seem to be in place with the private sector, with the exception of the consultative board meetings of the Ministry of Trade, the Ministry of Culture and Tourism and the Coordination Council for the Improvement of Investment Environment. As regards social partners, tri-partite social dialogue mechanisms that are legally established are not fully functioning in Turkey.
In order to mitigate the impact of the COVID-19 pandemic, target state aid and small and medium-sized enterprises support programmes in a transparent manner to sectors with strong potential for economic recovery.	**2) No implementation:** During the pandemic, Turkey continued with the implementation of the general incentive package (known as the 2012 Incentive Scheme), the Project Basis Investment Programme and KOSGEB and TÜBITAK support programmes. There has been no particular targeting of State aid to mitigate the impact of the COVID-19 pandemic.
Implement additional measures helping viable businesses to avoid insolvency.	**3) Partial implementation:** All pending and new enforcement and bankruptcy procedures (with the exception of execution proceedings related to maintenance payments) were put on hold until 15 June 2020. Concordat proceedings were also suspended. At the beginning of the COVID-19 pandemic, the Government decided that trade registers would note 'default due to force majeure' for firms that defaulted in the period covering April to June. These steps were followed on 17 November 2020 by a Law on the Restructuring of Public receivables in order to ease the financial burden on companies. However, there has been no further legislative or administrative development since 15 June 2020 on bankruptcy procedures.

PG 5: Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.	There was **limited implementation** of PG 5: 1) **Limited implementation:** as part of the measures taken during COVID-19 pandemic, Law No 7256 (Provisional Article 27) enacted in November 2020 introduced an incentive for employers to register their unregistered employees. The incentive which is to be covered from the unemployment insurance fund provides a contribution support of TRY 44.15 for employers for each day they employ unregistered employees. The employer can use this incentive for up to 3 months provided he or she applied to the Social Security Institution by the end of 2020. Furthermore, the employer will not have to pay any penalties for employing unregistered employees. Since this is a recent incentive, no data are available yet.
Revise the Action Plan for reducing the informal economy taking into account the specific situation of migrant workers and those under temporary protection as well as the impact of COVID-19 pandemic.	2) **No implementation:** The action plan for reducing informal economy (2019-2021) has not been revised to include any action directly targeting migrant workers and those under temporary protection.
PG 6: Take measures to preserve jobs including through short-time work schemes and other employment flexibility schemes,	There was **partial implementation** of PG 6: 1) **Substantial implementation:** In 2020, during the COVID-19 pandemic, Turkey took bold measures to preserve jobs. Within this framework, the country eased the application criteria for the short-term work allowance (SWA). Accordingly, workers who have paid social security contributions for the last 60 days, and have paid unemployment insurance contributions for at least 450 days in the last three years can benefit from the SWA. According to statistics released on 31 December 2020, approximately 3.6 million workers received a short-term work allowance. Furthermore, an unpaid leave option for workers was introduced with an income support TRY 39.27 per day an there was a ban on dismissing workers during COVID-19 pandemic except for reasons of malicious intention on the part of the workers. Turkey also introduced flexible and remote working arrangements for civil servants during the COVID-19 pandemic..
step up VET training, re-skilling and up-skilling, and redesign and upscale targeted employment incentives, in particular for recently unemployed workers and young people.	**2) Partial implementation:** The Ministry of National Education has made the necessary legislative changes to open Private Vocational Education Centres for the re-skilling and up-skilling of individuals. These Centres are affiliated to the Ministry of National Education and follow the programmes defined by it. Graduates receive high school diplomas in the same way as those of other Vocational Education Centres. Due to the COVID-19 pandemic, till now only one centre has been opened in Gebze, in the newly established Electric Automobile Factory, but the planning process is ongoing for other centres. Existing employment incentives for women and young workers have been extended until end 2022. A “normalisation support” payment scheme was launched to encourage employers to rehire employees. This involves government clearing of a part of social security contribution debts. Debts of TRY 2.5 billion

	relating to 3.3 million employees have been cleared. No other measures have been developed for the unemployed, except measures to keep people in employment (see also first point of PG6).
Ensure adequate income support and social assistance for the unemployed and those at risk of poverty and social exclusion.	**3) Partial Implementation**: Due to the ban on dismissing workers, and the strict eligibility criteria of the unemployment insurance fund, the number of unemployment insurance beneficiaries has been decreasing since March 2020. In October 2020, only 255 000 people received unemployment benefits (compared to 594 000 in March 2020), though 4 million people were unemployed. Turkey has run a social support programme to increase the resilience of low income households in the face of the COVID-19 crisis. 6.4 million households each received a one-off payment of TRY 1 000 (around 40% of the net minimum wage). 2 million more households received TRY 1 000 each from a nationwide solidarity fund campaign launched by the Government. In a contradictory move, the Government has also banned solidarity campaigns led by some metropolitan municipalities and blocked the amounts already collected. Due to extensive bans on concerts and entertainment centres, around 24 000 musicians who lost their jobs will receive TRY 1 000 monthly support for three months.

6. ASSESSMENT OF THE AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2021-2023 ERP

Energy

The ratio of renewable energy installations in the total installed power generation capacity increased from 45% in 2019 to 51% in 2020. The share of the country's renewable energy in electricity generation in 2020 reached 47%, 33.3% of which came from hydropower. The increase in Turkey's installed renewable energy capacity is driven mainly by private investments benefitting from a preferential feed-in-tariff mechanism, which expired at the end of 2020. The continuation of this financial support mechanism was announced on 30 January 2021. As before, the State will provide financial support for the first 10 years of operation to all renewable energy power plants installed by 2025. The major difference is that the new mechanism is based on the local currency (i.e. the Turkish lira). In general, the new feed-in-tariff mechanism offers lower support than the previous support mechanism (e.g. 25% lower for hydropower, 40% lower for wind and 67% lower for solar power). The practice of granting state financial support for the use of domestic equipment in renewable energy installations continues to be of concern to the EU since such a local content requirement is not considered compatible with the EU-Turkey Customs Union.

Measure 1: "Increasing share of renewable energy regarding electricity generation"

This measure has been rolled over from the previous ERP. Its performance is considered to be very good. More details could have been provided as regards the scope of the planned monitoring activities. Turkey has been successful in the implementation of this reform measure, which therefore no longer needs to be rolled over in the upcoming period.

Measure 2: "Development of financial mechanisms regarding energy efficiency"

This measure has been rolled over from the previous ERP. Its performance is considered to be insufficient. Although some progress has been made as regards the implementation of the National Energy Efficiency Action Plan, the national energy efficiency financing mechanism planned is still not in place.

Measure 4: "Support mechanism will be established for the replacement of inefficient electric motors used in industry with more efficient ones"

This measure has been rolled over from the previous ERP. It is in line with Commission Regulation (EC) No 640/2009 with regard to eco-design requirements for electric motors, which Turkey transposed in 2012 (Turkish title: "*Elektrik Motorları ile ilgili Çevreye Duyarli Tasarim Gereklerine dair Tebliğ"*). Indicating the legal basis of the measure may add value to the text as the existing Turkish legislation has required the transition to energy-efficient motors since 2015. The measure can help the implementation of this legislation in an area where EU alignment is also targeted. However, rather than being a structural reform measure, this measure could have been considered as a part of overarching reform to increase the environmental, social and governance standards of industrial enterprises. It is difficult to assess the real impact since the overall number of electric motors to be replaced and the potential for savings is not known. Meanwhile, the risk defined as "Inability of measuring savings resulting from replacement" should have already been mitigated by defining the baseline data, measurement methods and target indicators.

Agriculture

The ERP identifies the need to change the legislation on agricultural statistics in order for agricultural holdings to be required to provide data on a mandatory basis rather than a voluntary basis. In the EU's common agriculture policy, only participation and provision of data for the Farm Accountancy Data Network System (FADN) is voluntary, but not statistical data collection. The FADN system has been established in Turkey since 2009 and is currently used in 81 provinces. However, the data collected through FADN are used for different purposes, particularly for determining and monitoring the annual agricultural incomes of enterprises and measuring their performances, and they are confidential. The ERP refers to the need for a legislative change from a voluntary system to a mandatory one, but the FADN cannot be mandatory if harmonisation with EU practice is to be secured.

Measure 3: "Improvement of data collection processes and increasing the capacity of evaluation in agriculture statistics"

This measure has been rolled over from the previous two ERPs. Insufficient information has been provided on what has been achieved so far within the context of this project. The report states that planned trainings could not be organised in 2020 due to the COVID-19 pandemic and several activities remained limited. The table on result indicators clearly shows that no improvement can have been achieved so

Industry

Turkey's industry, having struggled to maintain its competitiveness in the years prior to COVID-19, faces a severe double challenge of recovery and preparation for the green and digital transformation in a worsening business and investment environment. Industry, without construction, has raised its share of gross value-added in the second half of the last decade by around 10%, keeping its contribution to employment about constant. The domestic producer price index for industry has shot up by 80% during this period. The high dependency on foreign energy sources and raw materials has hardly diminished. Labour productivity has increased to almost 80% of the EU average. Salient structural weaknesses in comparison to the EU are indicated by the low number of top R&D spending enterprises and the employment share of medium to high-technology manufacturing and knowledge-intensive services that can be part of manufacturing value networks. Manufacturing exports are predominantly of low and medium technology intensity, with each accounting for around 40% of manufacturing exports, followed by resource-based goods at almost 17% and the high-technology share having surpassed 3% in 2018. Foreign direct investment (FDI) in manufacturing went dominantly into the chemical and the ICT industries in 2019. The EU is Turkey's largest export destination and FDI source. The automobile and the machinery industries contribute most to manufacturing exports to the EU. Among the manufacturing industries, the machinery industry is particularly characterised by small family-run enterprises. The productivity gap between large and small- to medium-sized enterprises has accelerated to increase, except for start-ups. The commercialisation of R&D remains hindered by the low capacity of Turkish SMEs to adopt process innovations.

Turkey implements policies to increase the proportion of high technology in its industry. The EU's acceleration of the green and digital transformation of its industry has not yet found an appropriate response in the ERP. The predominantly low-technology manufacturing in Turkey's less-advanced regions need access to services specific to upgrading their products and processes. The ERP measures 7 and 10 target the adoption and growth capacity of SMEs and hence add to the existing measures. They address manifest needs, if they target specifically SMEs likely to be threatened by the twin transformation or the low-technology trap. However, more systemic responses are to be conceived, if Turkey wants to fulfil its economic ambition.

Measure 5: "Establishing Model Factories (SME Competency and Digital Transformation Centers) and Innovation Centers to increase the efficiency of SMEs and their digital transformation"

This measure has been rolled over from the previous ERP. Under the measure, 14 Model Factories (SME Competence and Digital Transformation Centres) and Innovation Centres will be established and a Training-Consultancy Support Programme will be initiated in order to increase the productivity of SMEs and contribute to their digital transformation. However, the indicator used for this measure remains unclear and may not be performance-related. More specifically, as regards impact on gender, the measure is said to be gender-neutral. However, digitalisation may have a negative impact on gender balance if women do not have access to education in digital skills on an equal footing with men. It is also a fact that women participate less in digital professions. On the other hand, it may create opportunities for women through a transformation of the work space. Clearly, the issue is not gender-neutral and needs to be considered in connection with gender-based data. In 2018, the Ministry of Industry and Technology published the 'Digital Transformation Road Map for Turkish Industry'. However, there is no reference to this macro level policy document in this measure. Furthermore, there is no information about the Road Map targets and achievements.

Measure 7: "Establishment of SME Guidance and Counseling System"

This measure has been rolled over from the previous ERP. Like last year, it is included under the "Business environment and reduction of the informal economy" heading. It is not clear how business consultancy can improve the business environment. The measure puts the baseline at zero as of October 2020 and seeks to achieve ambitious targets by the end of 2021 in a pandemic-affected economy. The document does not indicate how this will be made possible. Under the measure, the number of authorised technical consultants for SME counselling is to increase to 1 250 from 0 and the number of SMEs serviced to 750 from 0.

Measure 10: "Increasing the number and efficiency of business development, incubation and accelerator centers in order to support innovative entrepreneurship"

This measure has been rolled over from the previous ERP and aims to increase the number and efficiency of business development, incubation and accelerator centres. However, the analysis fails to mention the lack of adequate infrastructure. There are 85 Technology Development Zones, 1 237 R&D centres and 368 design centres in Turkey. The measure could be better focused on increasing the efficiency of the existing centres. The support is provided for furniture, equipment, hardware, human resources and training and marketing costs. Therefore, the link between the main problems (entrepreneurs access to finance for technology transfer and support to networking) and the measure (support for the establishment of new centres) is not clear.

Services

The further expansion and diversification of tourism in Turkey is one of the priorities of Turkey's New Economic Programme 2020-2022 for restoring sustainable growth and increasing employment. In spite of the already strong performance of the tourism sector, the average expenditure per person remains very low, and there is still a largely untapped potential in the tourism sector.

Tourism is one of the sectors most affected by the COVID-19 pandemic, which has brought about new challenges for the approach to developing this sector in the future.

Measure 6: "Increasing tourism market share and brand value"

This measure has been rolled over from the previous ERP. As the tourism sector is one of the sectors which were hit hard by the COVID-19 pandemic, the roll-over of this measure from the previous ERPs is justifiable. The measure therefore remains relevant, as it aims to address Turkey's needs to diversify its tourism products. In the light of the global pandemic developments, the scope of the measure has been also broadened, this time with a special emphasis on the development of tourism-related digital services and platforms as well as on activities focusing on hygiene and health-oriented service understanding. However, the measure only focuses on marketing and branding actions and refers to the Tourism Master Plan as a very limited basis. There are no actions to increase service quality and tourism infrastructure, in particular for rural areas and the regions that are lagging behind. Indeed, there are significant disparities between the different regions of Turkey in terms of quality of services and tourism infrastructure. Therefore, if Turkey intends to diversify its tourism products and destinations; the quality of services, skills and the tourism infrastructure (accommodation, transport, urban and municipal infrastructure) should be upgraded in particular in rural areas and those regions that are lagging behind but have remarkably important natural, historical and cultural assets (such as the Black Sea and eastern and south-eastern Anatolia). Furthermore, if the aim is to diversify the types of tourism, it is essential to develop a strategy which keeps in mind the prospect of promoting sustainable tourism; this means that a better assessment of the expected impacts on the environment is required than the one presented in the ERP.

Business environment

The business environment and the relevant Measure 8 is analysed above in section 4 under key challenge #3.

Informal economy

The informal economy and the relevant Measure 9 is analysed above in section 4 under key challenge #3.

Research, development and innovation

Turkey's new Industry and Technology Strategy has set ambitious targets for increasing expenditure on R&D to 1.8% of GDP and for increasing full-time-equivalent staff in R&D to 300 000 by 2023. Although there has been some progress since 2018, the gap between actual figures and the 2023 targets remains significant, as does the gap with the EU-27 averages.

Turkey remains a 'moderate innovator' according to the European Innovation Scoreboard for 2019. In 2018, there was a significant increase in innovation performance, mainly due to the number of innovators, the amounts invested by firms and an innovation-friendly environment. Structural challenges persist in the low proportion of employment in high-tech manufacturing and knowledge-intense services as well in the limited inflow of foreign direct investment. To raise the export capacity of Turkish SMEs, Turkish priorities would need to be aligned to concepts such as the digital single market and smart specialisation.

Measure 11: "Enhancing the R&D and innovation activities of SMEs"

This measure has been rolled over from the previous ERP. Its targets are rather ambitious. The complementarity between Measure 11a and Measure 11b and the link with Green Growth and environmental impact could be better explained. The measure includes a focus on product development. However, there is no mention of clean or energy-efficient technologies. Furthermore, the impact of Measure 11a on employment is not clear.

Measure 12: "Supporting competent research infrastructures on a performance basis within the new legal framework"

This measure has been rolled over from the previous ERP. The implementation of Law No 6550 to support research infrastructures is in line with the 11th National Development Plan. Positive impacts on the environment have not been elaborated, but the selected institutions and the potential results are expected to contribute to green growth.

Economic integration

EU-Turkey bilateral trade has increased rapidly in recent years. Since the entry into force on 31 December 1995 of the EU-Turkey Customs Union, the value of bilateral trade has increased more than fourfold. From the EU perspective, Turkey is the sixth largest partner for EU exports of goods (3%) and also the sixth largest partner for EU imports of goods (4%).

Measure 13: "Update of the Turkey-EU Customs Union"

This measure has once more been rolled over from the previous ERP. The purpose of the ERP, however to present measures which Turkey can implement on its own.

Education and skills

Education and skills and the relevant reform measures 14, 15, 16, 17 and 21 are analysed above in section 4 under key challenge #2.

Employment and the labour market

Employment and the labour market and the relevant reform measures 19, 20 and 22 are analysed above in section 4 under key challenge #1.

Social protection and inclusion

The situation regarding the risk of poverty and income inequalities was improving in the year before the pandemic (2019). According to the official Statistics on Income and Living Conditions (EU-SILC) for 2019, Gini coefficient was 0.437 with a fall of 1.3 points compared with the previous year. The P80/P20 rate decreased from 8.66 to 8.35. These two figures indicate that income inequality decreased slightly in 2019 but remained structurally higher than the EU average. The at-risk-of-poverty-rate[5] was 39.8% in 2019 which is almost double the EU average of 20.9%.

Poverty is expected to have risen with the pandemic in 2020/2021 as more than 6 million people live on frugal short term work benefits -or in the case of unpaid leave- on benefits amounting to half of the minimum wage.

Measure 23: "Increasing the scope of ASDEP and enhancing the accessibility of social assistance beneficiaries to other public services by the transition to the Integrated Social Protection Period"

This measure has been rolled over from the previous ERP and is designed to increase social protection coverage while establishing a link between social assistance and social protection services. It is relevant and important to provide supply-driven and quality social services, but the design of the measure is ambiguous. The measure continues to reflect several deficiencies mentioned in last year's assessment. The steps and activities involved are not clear. The activities are indicators rather than activities. The measure does not include any activity to improve the quality of services delivered by the staff of the Family Social Support Programme (ASDEP). It does not include any gender equality approach. Such a measure should definitely have an impact on poverty, equality and gender but is described as having no impact. No risk is defined, but certain risks, such as coordination among relevant actors, sufficient number of ASDEP staff, etc. should be assessed.

Measure 24: "Dissemination of Family-Oriented Social Services Models"

This measure has been rolled over from the previous ERP and concerns social services for children. The measure seems to have an impact on the well-being of children and poverty. However, the activities are not defined clearly for the measure; they seem to be indicators rather than activities. There is a need to provide social services for the beneficiaries of Social and Economic Support (SED); however, there is no activities are provided for to serve that aim. Providing only financial support is not enough to ensure the social protection of children. There is an urgent need to increase complementarily and cooperation between social assistance and social services for children. There is also a need for an updated impact assessment of the SED programme in terms of aim, selection criteria and results. Even though there is an indicator on foster care, no activity is defined for foster care. The fact that the government is implementing this measure does not necessarily mean that there is no risk. Potential risks should be assessed and mitigating actions should be determined.

Health

As the outbreak of the COVID-19 pandemic has posed a global threat with significant human casualties and severe economic losses, there is a pressing demand to further understand the current situation and develop rational strategies to contain the spread of the virus. To prevent further morbidity and mortality, efforts are being made to develop effective antiviral therapies and an efficacious vaccine at global level.

Measure 18: "Expanding occupational health and safety activities in schools and institutions"

This is a newly introduced measure in the ERP process. In order to support the development of a health and safety culture among students and employees, it is necessary to improve and maintain health and safety conditions in the educational environment and processes. The purpose of this measure is to expand occupational health and safety activities and to improve hygiene conditions in schools. Certification of 25 schools for the Occupational Health and Safety Management system, 20 for the Quality Management system, and five for the Environmental Management system will be completed in 2021. The first auxiliary training of the 80 000 personnel, and document renewal audits, will be carried out for schools that receive a 'clean school' certificate. Especially during the COVID-19 pandemic, hygiene in schools has become very important and therefore it is crucial for this measure to be supported.

Measure 25: "Supporting clinical trials on vaccines and drugs R&D Studies"

The measure will support vaccine and drug development efforts during the COVID-19 pandemic by increasing the number and quality of clinical trials in line with the objectives set out in the 11th Development Plan. Expected impacts on other outcomes are not considered

Measure 26: "Strengthening of the Ministry of Health's COVID-19 Response Capacity"

-The measure aims to develop Turkey's domestic capacities for responding to health emergencies by adding a molecular surveillance component to its existing national surveillance system. It will include the use of rapid antigen tests (Ag-RDT) for rapid COVID-19 detection and whole-genome sequencing for the timely detection of mutations in pathogens.

The measure is relevant and in line with the body of EU law on communicable diseases and on serious cross-border threats to health as well the WHO's International Health Regulation (2005), and seeks to coordinate preparedness and response planning and to strengthen capacities for monitoring, early warning and assessment of, and response to, health emergencies. However, no activities are planned for 2021 and the indicators are at output level rather than result-oriented. Expected impacts on other outcomes are not considered.

ANNEX A: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	75.5%	77.2%	73.8%	N/A	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	175.03	175.30	167.72	N/A	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	13.7% [w]	12.8% [w]	13.7% [w]	N/A	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	12.920 [w]	13.081 [w]	13.219 [w]	13.305 [w]	49.0 (2018)
Motorization rate (Passenger cars per 1000 inhabitants)	142	149	151	154.7 [w]	519 (2018)
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	7.0%	6.8%	6.4%	7.1%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	19.5%	19.4%	18.4%	18.1%	4.3%
Utilised agricultural area (% of total land area)	49.1%	48.9%	49.0%	48.4%	40.0% (2017)
Industry					
Share of gross value added (except construction)	22.2%	23.3%	24.9%	24.2%	19.7%
Contribution to employment (% of total employment)	19.5%	19.1%	19.7%	19.8%	18.1%
Services					
Share of gross value added	61.2%	60.3%	60.8%	62.7%	73.0%
Contribution to employment (% of total employment)	53.7%	54.1%	54.9%	56.6%	70.8%

Business Environment					
Rank in WB Doing Business (Source: World Bank)	63	69	60	43	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	51	53	61	61	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 29.6%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	0.94%	0.95%	1.03%	1.06%	2.2%
R&D expenditure – EUR per inhabitant	93.6€	90.8€	83.5€	88.1€	688.6€
Digital Economy					
Percentage of households who have internet access at home	76%	81%	84%	88%	86%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	58.3% [w]	64.7% [w]	71% [w]	73.98% [w]	85%
Trade					
Export of goods and services (as % of GDP)	23.1%	26.0%	31.2%	32.7%	49.4%
Import of goods and services (as % of GDP)	25.2%	29.7%	31.3%	29.9%	45.7%
Trade balance (as % of GDP)	-6.5%	-8.9%	-7.0%	-4.1%	N/A
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	34.3%	32.5%	31.0%	28.7%	10.2%
Youth NEET (% of population aged 15-24)	23.9%	24.2%	24.4%	26.0%	10.1%
Formal child care - children aged less than 3 years (% of total)	NA	N/A	N/A	N/A	35.3%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	28%	34%	N/A	36%	56%

Employment					
Employment Rate (% of population aged 20-64)	54.4%	55.3%	55.6%	53.8%	73.1%
Unemployment rate (% of labour force aged 15-74)	10.9%	10.9%	10.9%	13.7%	6.7%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	42.3 pps.	41.6 pps.	40.8 pps.	38.8 pps.	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	45.1%	41.3%	39.8%	39.8%	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	7.69%	8.64%	7.88%	8.94%	32.38%
Self-reported unmet need for medical care (of people over 16)	3.8%	2.6%	2.9%	3.0%	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	8.65	8.68	8.66	8.35	4.99

w: *data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'*

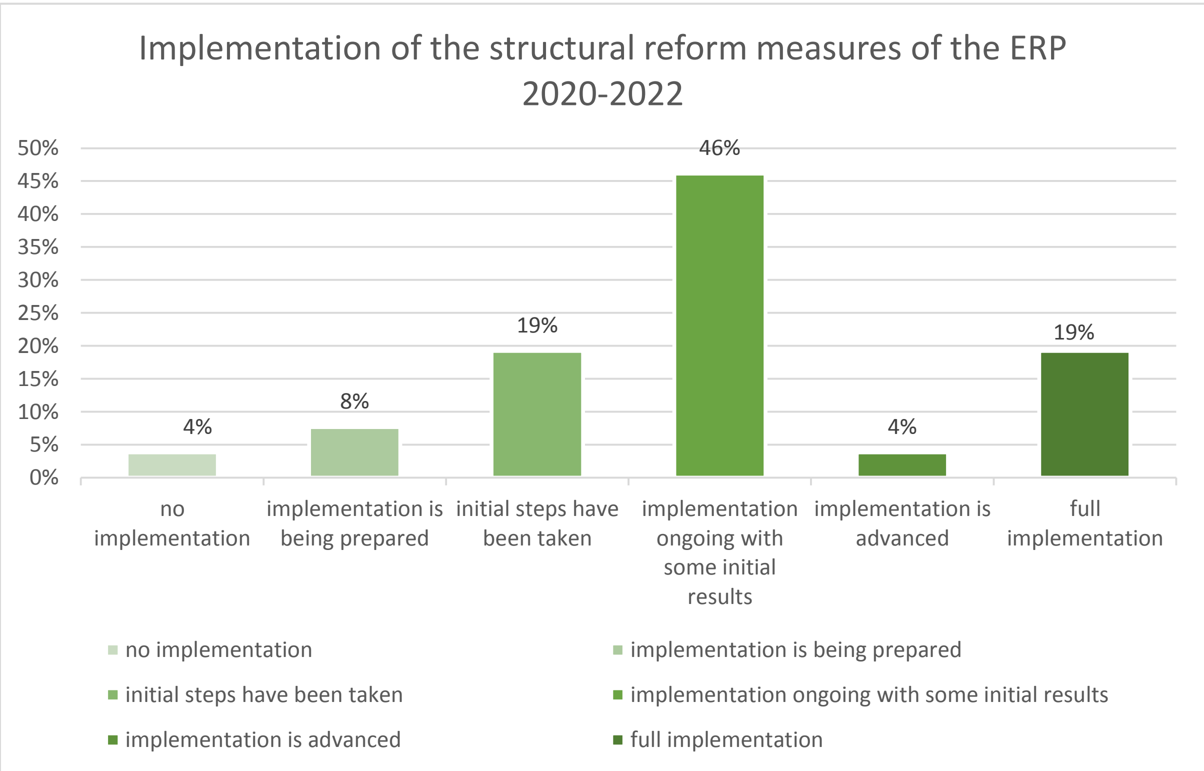
Source of data in Annex A: EUROSTAT, unless otherwise indicated.

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE 2020-2022 ERP

The average score for implementing the measures in 2020 is 2.4 out of 5, which constitutes progress compared to the previous year (2.0), but it needs to be taken into account that last year's score was low due to the abandoning of some measures. The score of 2.4 is impacted by the fact that some measures could not be implemented to the extent planned due to the onset of the COVID-19 pandemic, which induced limitations on measures involving close interpersonal settings (such as on-site training and counselling).

Turkey's reporting on the activities carried out has further improved, but the level of details varies still between measures. A detailed scoring for the planned activities in 2020 has been provided for only two measures. To provide a picture of the level of implementation consistent with the approach for all ERPs, some adjustments to the scoring of activities were made, based on the description of the implementation and explanations presented in the ERP and the Commission's own research.

For six measures, full implementation of the steps foreseen in the measure for 2020 can be noted; these fall in the areas of renewable energy, investment procedures, informal employment, research infrastructure, patents and vocational training. Implementation was particularly weak for the measures on agricultural statistics and skills-based curricula in secondary education. The measure related to the EU-Turkey Customs Union is not considered as a structural reform in the context of the ERP, since its implementation does not depend on Turkey alone.



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2021-2023 Economic Reform Programme was formally submitted to the Commission on 1 February 2021. Overall, adherence to the Commission Guidance Note has further improved.

Inter-ministerial coordination

The central coordination of the ERP has been under the Presidency of Strategy and Budget since 2019. Each line ministry provided the respective ministry's inputs to the ERP coordinator. The proposed measures for the new ERP were discussed in a workshop held by the Presidency of Strategy and Budget with the ERP coordinators. Afterwards, the ERP coordinator, when deemed necessary, got in touch with the different line ministries and relevant institutions to request additional input. The preparation of the macroeconomic part of the ERP was led by the Presidency of Strategy and Budget on the basis of contributions from relevant institutions.

Stakeholder consultation

The ERP is based on the 11th Development Plan (2019-2023) approved by the Turkish Parliament on 18 July 2019. Furthermore, it was prepared in line with the 2021-2023 New Economy Programme and the 2021 Presidential Annual Programme, which are both implemented upon Presidential Decision. The Development Plan was developed in a broad consultation process with stakeholders and experts, involving working groups and ad hoc committees. However, the reports established by the working groups have not been made public. No specific consultation of external stakeholders on the draft ERP took place and no draft was made available to the public before its adoption.

Macroeconomic framework

The chapter on the macroeconomic framework broadly follows the outline of the guidance note. It succinctly covers nearly all of the required elements with one important exception – it does not present an alternative scenario. This omission is repetitive and is a major drawback, especially in view of the high domestic and global uncertainty. The analysis would have benefited from further improving the links between the macroeconomic and fiscal framework sections and to the macro-relevant structural reforms. The presentation and analysis of risks could also be expanded and deepened.

Fiscal framework

The structure of the chapter on the fiscal framework closely follows the guidance note. It covers all major elements and provides extensive information on the 2021 budget. It is less detailed on the medium-term plans and the underlying measures. The section on contingent liabilities could be expanded to cover all sources of liabilities in a systematic way. The section on public finance risks could be further developed and elaborated as well. The fiscal framework chapter may be usefully expanded to cover elements related to fiscal rules and the medium-term budgetary framework. Providing more data and focusing the analysis at general government level could be welcome as well.

Structural reforms

The structural reform priorities section improved. Reform measures are better specified than last year, although the quality of these measures in terms of description, timeline, estimated impact and risks and key performance indicators could be improved. The maximum number of reforms (20) and the page limit (40) are not respected. Section 6 on budgetary implications of structural reforms is again completely missing. Table 1c in incomplete, tables 1f (external sector developments), 1g (sustainability indicators), 3 (general government expenditure by function), 7 (contingent liabilities) and 9 (selected employment and social indicators), as well as Annex 2 on the external contributions to the ERP were not submitted.

REFERENCES

Institute for Management Development (IMD), *Country Profile Turkey, World Competitiveness Yearbook 2020.*

Institut Européen d'Administration des Affaires (INSEAD), *Global Innovation Index 2020*.

International Monetary Fund (IMF), *Turkey: Selected Issues, Country Report No 19/396. December 2019.*

Republic of Turkey, *Action Plan of the Program for reducing the informal economy. Republic of Turkey, Ministry of Treasury and Finance, Revenue Administration, 2019.*

Republic of Turkey, *New Economy Program 2020-2022. Republic of Turkey, Ministry of Treasury and Finance.*

Republic of Turkey, *Pre-accession Economic Reform Programme 2021-2023, Republic of Turkey, Ministry of Treasury and Finance. Ankara January 2020.*

The World Bank, *Turkey - Enterprise Survey (ES) 2019.*Turkstat, *Labour Force Statistics, monthly series.*