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Report No. 115772-TR

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED LOAN

IN THE AMOUNT OF EUR 350.9 MILLION

(US\$400 MILLION EQUIVALENT)

TO

THE REPUBLIC OF TURKEY

FOR THE

RESILIENCE, INCLUSION AND GROWTH DEVELOPMENT POLICY FINANCING

July 25, 2017

Macroeconomics and Fiscal Management Global Practice  
Turkey Country Unit  
Europe and Central Asia Region

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## **TURKEY -GOVERNMENT FISCAL YEAR**

January 1 – December 31

### **CURRENCY EQUIVALENTS**

(Exchange Rate Effective as of *June 30, 2017*)

Currency Unit	TL
USD 1.00	3.5168

### **ABBREVIATIONS AND ACRONYMS**

CBRT	Central Bank of the Republic of Turkey
CHU-FMC	Central Harmonization Unit for Financial Management and Control
CPF	Country Partnership Framework
DPF	Development Policy Financing
DPL	Development Policy Loan
EC	European Commission
EKAP	E-Procurement Platform
ERP	Pre-Accession Economic Reform Program
EU	European Union
FDI	Foreign Direct Investment
FIRST	Financial Sector Reform and Strengthening Initiative
FiT	Feed-in Tariff
FSAP	Financial Sector Assessment Program
FX	Foreign Exchange
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GNFS	Goods and Non-Factor Services
GRS	Grievance Redress Service
GW	Gigawatt
IACB	Internal Audit Coordination Board
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IMF	International Monetary Fund
IP	Industrial Property
ISKUR	Public Employment Services Agency
LDP	Letter of Development Policy
M&E	Monitoring and Evaluation
MENR	Ministry of Energy and Natural Resources
MIGA	Multilateral Investment Guarantee Agency
MOD	Ministry of Development
MOF	Ministry of Finance
MTFP	Medium-Term Fiscal Plan
MTP	Medium Term Program
MW	Megawatt
NDC	Nationally Determined Contribution
DP	Development Plan
NPL	Non-Performing Loan
NREAP	National Renewable Energy Action Plan
OECD	Organization for Economic Co-Operation and Development
PCT	Patent Cooperation Treaty
PDO	Program Development Objective
PFM	Public Financial Management
PFMC	Public Financial Management and Control

PMR	Product Market Regulation
PPL	Public Procurement Law
PPP	Public Private Partnership
R&D	Research and Development
RIG	Resilience Inclusion and Growth
RERA	Renewable Energy Resource Areas
ROA	Return on Assets
ROE	Return on Equity
PSIA	Poverty and Social Impact Assessment
SCD	Systematic Country Diagnostic
SME	Small and Medium Enterprise
SOE	State Owned Enterprises
SORT	Standardized Operations Risk-rating Tool
SSG	Sustaining Shared Growth
SuTP	Syrians Under Temporary Protection
TA	Technical Assistance
TCA	Turkish Court of Accounts
TCDD	Turkish Railways Company
TFP	Total Factor Productivity
TGNA	Turkish Grand National Assembly
TURKSTAT	Turkish Statistical Institute
UNDP	United Nations Development Program
UNICEF	United Nations Children's Fund
UNFCCC	United Nations Framework Convention on Climate Change
UNCITRAL	United Nations Commission on International Trade Law
WBG	World Bank Group

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## **TURKEY**

### **RESILIENCE, INCLUSION AND GROWTH DEVELOPMENT POLICY FINANCING**

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**SUMMARY OF PROPOSED LOAN AND PROGRAM**  
**TURKEY**  
**RESILIENCE, INCLUSION AND GROWTH**  
**DEVELOPMENT POLICY FINANCING (RIG-DPF)**

Borrower	Republic of Turkey
Implementation Agency	Undersecretariat of Treasury
Financing Data	Terms: IBRD Flexible Loan with an interest rate equal to 6 months EURIBOR for Euro, plus the fixed spread, with total maturity of 10 years including 3.5 years of grace period, with disbursement linked repayment and level repayment pattern. Amount: Euro 350.9 million (USD 400 million equivalent)
Operation Type	Stand-alone, single tranche
Pillars of the Operation and Program Development Objective(s)	<p>The Program Development Objectives (PDO) of the proposed operation are to: (i) increase domestic savings and enhance fiscal transparency (Pillar A); (ii) support the economic inclusion of vulnerable groups (Pillar B); and (iii) address structural bottlenecks to sustainable growth (Pillar C).</p> <p>Pillar A aims to increase domestic savings to help address external imbalances and reduce fiscal risks. Amendments to the Private Pension Savings and Investments Law introducing auto-enrollment will increase private savings and eventually reduce dependence on external financing. The pillar also aims to enhance fiscal discipline by including financial statements in the audit reports of all general budget institutions thus promoting transparency of fiscal accounts and reducing fiscal risks. Pillar B aims to support participation of women, youth, long-term unemployed, and Syrians under temporary protection in the labor market by supporting flexible employment, increasing access to childcare and granting work permits to “foreigners under temporary protection”. Pillar C aims to remove structural bottlenecks to sustainable growth. This will be achieved by enacting an appropriate legal framework for the protection of industrial property, improving allocation of capital by facilitating access to credit for small and medium enterprises, deregulating network industries through the liberalization of the railways sector, and supporting renewable energy zones to increase its share in total energy supply.</p>
Result Indicators	<ul style="list-style-type: none"> <li>• Increase in the coverage of employees in the auto-enrollment private pension system</li> <li>• Turkish Court of Accounts financial audit reports of General Budget Institutions that include financial statements</li> <li>• Increase in the female labor force participation rate</li> <li>• Increase in the net enrollment rate in childcare facilities</li> <li>• Reduction in unregistered female employment</li> <li>• Increase in the youth labor force participation rate</li> <li>• Increase in work permits issued to foreigners under temporary protection</li> <li>• Increase in number of patent applications</li> <li>• Increase in credit volume generated through movable collateral</li> <li>• A railways operator and Railway Infrastructure Company stipulate a contract regulating access rights and access charges for using the infrastructure</li> <li>• Renewable energy auctions for the renewable energy resource areas</li> </ul>
Overall risk rating	Substantial
Operation ID	P162071

**IBRD PROGRAM DOCUMENT FOR A  
PROPOSED RESILIENCE, INCLUSION AND GROWTH DEVELOPMENT POLICY  
FINANCING  
TO THE REPUBLIC OF TURKEY**

**1. INTRODUCTION AND COUNTRY CONTEXT**

1. The proposed Resilience, Inclusion and Growth Development Policy Financing (RIG-DPF) in the amount of Euro 350.9 million (USD 400 million equivalent) seeks to strengthen the foundations for inclusive and sustainable growth in Turkey. The Program Development Objectives of the RIG-DPF are to: (i) increase domestic savings and enhance fiscal transparency (Pillar A); (ii) support the economic inclusion of vulnerable groups (Pillar B); and (iii) address structural bottlenecks to sustainable growth (Pillar C). The DPF is consistent with Turkey's Tenth Development Plan (DP) and with the proposed Country Partnership Framework (CPF, 2017-2021). Although a stand-alone operation, the RIG-DPF builds on the reforms supported in previous programmatic development policy loans, with six out of nine prior actions a continuation of the 2014 Sustaining Shared Growth Development Policy Loan (SSG-DPL) agenda.

2. **The reforms supported by the proposed RIG-DPF are being implemented against the backdrop of slowing growth.** Turkey made steady progress since the early 2000s, with GDP per capita more than tripling from USD 3,073 in 2001 to USD 10,816 in 2016, accompanied by an unprecedented reduction in poverty. This impressive economic performance was made possible by good macroeconomic management and structural reforms that paved the way for a shift of employment out of agriculture into industry and services. Despite this progress, economic uncertainty has increased due to a weak global economy, a failed coup attempt and political challenges. Thus, economic growth decelerated to 2.9 percent in 2016, from 6.1 percent in 2015. Turkey's resilient growth engine is being challenged by changes in domestic and external conditions in the presence of long-standing structural rigidities. In particular, inadequate domestic savings, relative to Turkey's investment needs, pose a risk in an environment of tightening global liquidity and rising borrowing costs. At the same time, low labor force participation by women and youth risks dampening growth in labor income, the main avenue for poverty reduction. Finally, the sustainability of Turkey's growth model is being challenged by structural constraints on productivity and a rising environmental footprint.

3. **The proposed RIG-DPF supports the authorities in addressing these challenges with prior actions under three pillars.** Pillar A aims at increasing domestic savings and enhancing fiscal transparency to address external imbalances and reduce fiscal risks. Amendments to the Private Pension Savings and Investment Law that introduced auto-enrollment will increase private savings and reduce dependence on external financing, while the inclusion of financial statements in the audit reports of general budget institutions is expected to support fiscal discipline by encouraging transparency of fiscal accounts and expanding fiscal risk disclosure in accordance with international practice. Pillar B supports the economic inclusion of vulnerable groups by expanding modalities of flexible employment, increasing access to childcare, enabling "Foreigners under Temporary Protection" to be integrated into the labor market, and prompting active labor market policies. Pillar C aims at removing structural bottlenecks to sustainable growth. This will be achieved through improved legislation for protecting industrial property, allocating capital better by facilitating access to credit for SMEs, deregulating network industries

through the liberalization of the railways sector, and supporting renewable energy zones to increase the share of renewable energy in total energy supply.

4. **These reforms are expected to underpin continued progress towards reducing poverty and boosting shared prosperity.** Turkey has made significant progress in reducing poverty and sharing prosperity in the 2000s. The poverty headcount ratio declined sharply during 2002-2014, from 44 to 18 percent, with extreme poverty falling from 13 to 3.1 percent. Annualized growth of consumption of the bottom 40 percent of the population – measuring efforts to boost shared prosperity – reached 4.3 percent between 2007-2012, less than that for the entire population (4.8 percent). After declining significantly, inequality rose following the global financial crisis, with the Gini coefficient increasing from 0.38 in 2008 to 0.41 in 2014.<sup>1</sup> Increased labor income, due to higher growth, was the main driver of improved poverty outcomes. The decline in poverty mostly stemmed from growing levels of consumption, rather than changes in its distribution. Around 60 percent of the decline in the poverty headcount ratio resulted from labor income growth (both growth of earnings and employment) among poor households, while a reduced tax wedge on labor and expansion of active labor market programs contributed to job creation, particularly after 2008.

5. **There are substantial risks to this operation.** Turkey is facing a unique set of political and governance risks. Government efforts to amend the constitution and manage geopolitical tensions are absorbing much of the time and attention of government officials, with the risk that needed reforms may lag. Yet, government ownership of the reform agenda appears strong and long-standing, since it is grounded in the priorities of the Tenth Development Plan, as well as in medium term and annual programs. The macroeconomic and fiscal outlook is facing both global and domestic challenges. In 2016, foreign direct investment (FDI) inflows remained weak, the current account deficit remained noticeable, and the country's international credit ratings were downgraded below investment grade. In 2017, rising oil prices, increasing U.S. interest rates and depressed tourism revenues are likely to maintain pressure on the trade and current accounts. Domestically, inflation remains above target, while fiscal policy, until recently a cornerstone of Turkey's economic success, is on an expansionary path, with rising contingent liabilities. Turkey's financial sector is also under pressure due to exchange rate volatility and the dynamic political context. Higher growth in the European Union (EU) (Turkey's main trading partner), a depreciated currency that will likely boost growth, and a possible revival of relations with the EU could help mitigate some of these political and economic challenges.

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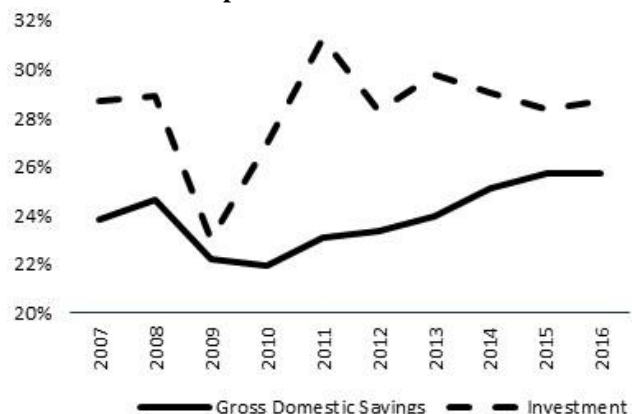
<sup>1</sup> This Gini coefficient is based in a consumption based welfare aggregate. Similar trends are observed when using income.

## 2. MACROECONOMIC POLICY FRAMEWORK

### RECENT ECONOMIC DEVELOPMENTS

6. **Turkey enjoyed high growth rates during 2010-2015, but domestic and external imbalances persisted because growth continued to be driven by domestic demand and was dependent on debt-creating capital inflows.** After the crisis of 2001, sound macroeconomic management (a flexible exchange rate regime, an independent central bank focused on inflation targeting, and fiscal consolidation) and much-needed structural reforms paved the way for economic dynamism. During 2010-2015, real GDP growth averaged 7.4 percent per year, making Turkey one of the fastest growing emerging economies during this period. However, domestic imbalances persisted, with growth disproportionately centered on domestic demand – consumption and residential construction investment – boosted by unbalanced credit growth and debt-creating capital inflows. Gross domestic savings, despite exceeding 25 percent of GDP in 2016, were insufficient to cover Turkey's investment needs (Figure 1). Dependence on energy imports, insufficient domestic savings and domestic demand imbalances contributed to chronic external imbalances and reliance on external sources of financing. Meanwhile, on the positive side, fiscal management remained prudent resulting in a sustainable public debt-to-GDP ratio and robust macro prudential regulations ensured that the banking sector remained well capitalized. Turkey could comfortably meet its external financing needs.

**Figure 1: Savings and Investment Rates, percent of GDP**

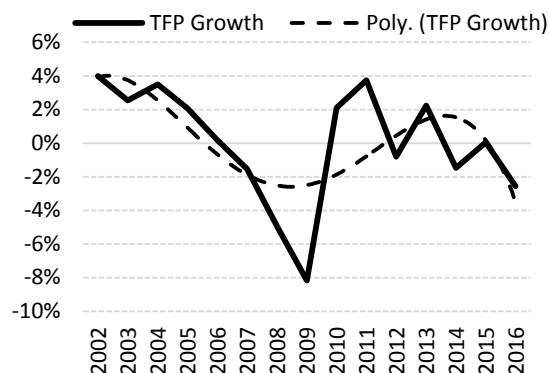


Source: TurkStat.

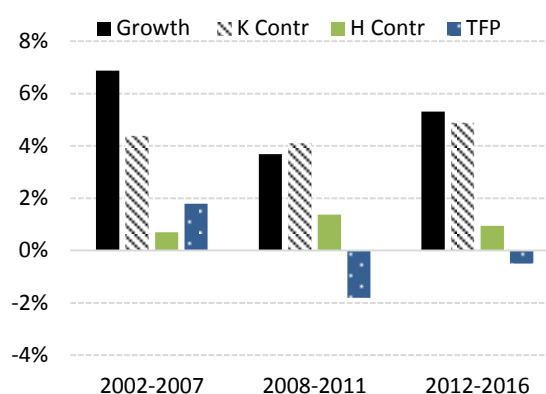
7. **Although Turkey's average growth rate has remained relatively high since 2010, vulnerabilities have increased due to a slowdown in productivity, structural rigidities in the labor market, and a weak investment climate.** Between 2002 and 2007, GDP grew at 7.1 percent per annum, amidst a structural transformation that shifted resources from agriculture to industry and services, leading to remarkable productivity gains. Total Factor Productivity (TFP) increased by 1.8 percent on average in the 2002-2007 period (Figure 2). Following a sharp drop during the global financial crisis, GDP rebounded quickly, registering annual growth of 6.7 percent on average in 2010-2016. In the latter period, however, GDP growth accounting shows that growth was driven by capital accumulation (Figure 3) and, to a lesser extent, increasing labor force participation and employment, although significant segments of the population – women and youth – did not fully take part in the labor force. Productivity gains from labor reallocation from agriculture to industry and services slowed, while within-sector productivity improvements remained gradual, undermined by weaknesses in investment and business environment. Meanwhile, the contribution of TFP to GDP growth declined from 2.1 percentage points in 2010 to a negative contribution of 2.6 percentage points in 2016, in line with the slowdown in reforms that address key structural bottlenecks undermining Turkey's growth potential.



**Figure 2: Dynamics of TFP growth, percent YoY**



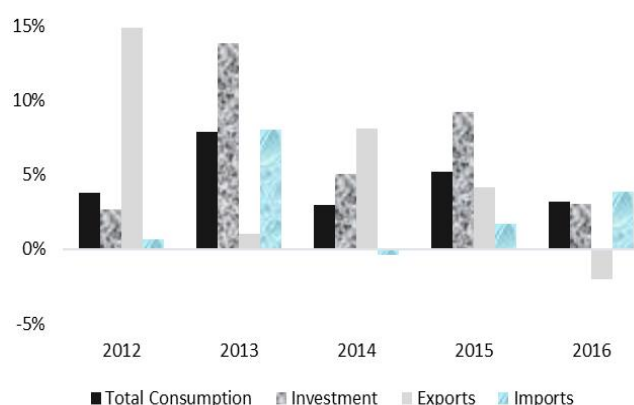
**Figure 3: GDP Growth accounting, 2002-2016**



Source: Turkish Statistical Institute (TurkStat) and World Bank Staff Calculations.

8. **Despite being hit by adverse shocks in 2016, the economy has shown remarkable resilience.** The failed coup attempt in July 2016 undermined investors' confidence, leading to a slowdown in tourism and putting the currency under pressure. Meanwhile, agriculture contracted by 4.1 percent due to adverse weather conditions. Despite these adverse developments, real GDP grew by 2.9 percent in 2016 (Table 1). Even though this was the lowest growth rate since the global financial crisis, public finances and the banking sector showed remarkable resilience, thereby containing the impact of these shocks. On the production side, growth was supported by construction and manufacturing, posting 7.2 percent and 3.9 percent y-o-y growth respectively, on the back of a 30 percent increase in the minimum wage and higher subsidies to enterprises. On the demand side, public consumption growth increased to 7.3 percent in 2016 (up from 4.1 percent in 2015), while fixed investment growth slowed to 3.0 percent in 2016 (from 9.2 percent in 2015). Net exports negatively contributed to growth because of weak demand from key trading partners (Figure 4).

**Figure 4: Dynamics of key GDP components, percent YoY**



Source: TurkStat.

9. **While strong public balances served to mitigate the negative impacts of the shocks in 2016, the fiscal space has been used extensively to revive the economy in 2017.** After maintaining fiscal discipline for three years in a row,<sup>2</sup> the government's move to an accommodative fiscal policy stance in 2016 coincided with a slowdown in growth. Fiscal policy was used to stimulate growth, while remaining within the fiscal targets - the central government

<sup>2</sup> General government budget deficit averaged 0.7 percent and the central government budget deficit averaged 1.0 percent of GDP.

and general government budgets posted modest deficits of 1.1 percent and 1.6 percent of GDP in 2016, respectively (Table 2). The tax restructuring and amnesties<sup>3</sup> adopted in 2016 were among the key reasons for fiscal targets being met, as they helped to generate additional revenues that covered the boost in the expenditures. While central government revenues grew by 14.8 percent in 2016, central government expenditures grew by 15.4 percent in 2016, due to increases in wages (including a significant increase in the minimum wage), transfers, and purchases of goods and services. The government announced a package of measures at the end of 2016,<sup>4</sup> which together with credit growth fueled by the government's Credit Guarantee Scheme, has further boosted domestic demand in early 2017. Private and public consumption grew by 5.1 percent and 9.4 percent y-o-y in the first quarter of 2017. While these current expenditures helped to stimulate short-term growth, they have also been eroding the fiscal space. Expansionary fiscal policy will likely lead budget balances to exceed fiscal targets in 2017, while the growing public private partnership (PPP) portfolio will warrant closer monitoring.

**10. The current account deficit, which remained sizable despite improvement in the terms of trade in 2016, started to widen in 2017 along with the rebound in global oil prices.**

The current account deficit remained noticeable at 3.8 percent of GDP in 2016, a modest increase relative to 2015. The positive impact of the reduced value of oil imports was offset by a decline in exports of goods – due to weaker demand from key trading partners – and high dependency of imports of non-energy consumer and intermediate goods driven by growth in domestic demand. The energy and gold adjusted current account deficit widened to 1.2 percent of GDP in 2016 (Figure 5). Moreover, the services balance deteriorated by over 30 percent y-o-y because of a decline in tourism revenues on the back of security concerns connected with the failed coup attempt and several terrorist attacks. In 2017, the external environment has started to improve. With stronger growth in the EU, enhanced relations with trading partners, and a weaker lira, exports of goods and services in real terms increased by 10.6 percent in the first quarter. The energy and gold excluded trade deficit also started to narrow over the first three months of the year, but the current account deficit has widened due to the rebound in global oil prices.

**11. Although Turkey could cover all of its external financing needs in recent years, the quality of the external financing inflows has weakened.** Cyclical factors - the increase in global interest rates and domestic policy challenges - have contributed to an increase in the cost of financing, sovereign rating downgrades and increased reliance on short-term debt-flows. More importantly, structural factors – particularly a weak investment and business climate – have undermined Turkey's ability to attract sizable FDI inflows. Net FDI dropped to a low 1.1 percent of GDP in 2016, from an average of 1.4 percent over 2002-2015. The inability to attract FDI has made the corporate sector increasingly dependent on external borrowing, creating significant refinancing pressures. Net other investment inflows almost halved to 0.8 percent of GDP in 2016, because of the increase in repayment of the banking sector. Thus, the current account deficit was partially financed with the placement of Eurobonds (in the total amount of USD 5.5

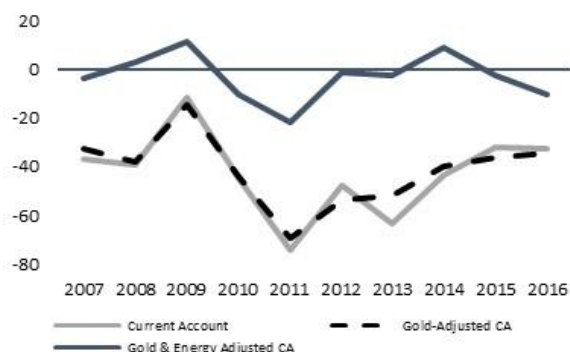
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<sup>3</sup> The Law regarding the Restructuring of Certain Receivables (the Tax Amnesty Law No. 6736) became effective on August 19, 2016. With the Law, taxpayers were provided opportunities to reduce or cancel a certain amount of taxes, related penalties and interest and to pay the remaining amounts in a lump-sum or in instalments subject to an adjustment. In 2016, 13.7 billion TL revenue was generated as a part of restructuring.

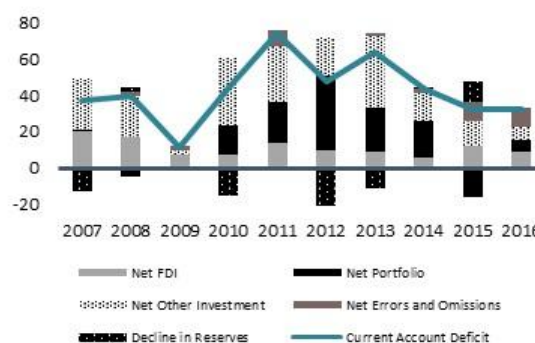
<sup>4</sup> Tax cuts (on white goods, furniture, purchase of real estate), a national employment campaign (with government incurring 30 percent of the cost of newly hired employee for one year), deferral of social security premium payments, extension of government credit guarantees, additional investment incentives.

billion) and net nonfinancial corporate borrowing. Net errors and omissions showed USD 10.9 billion in unrecorded inflows (about 1.3 percent of GDP), which financed the gap and prevented a fall in foreign exchange reserves in 2016 (Figure 6).<sup>5</sup> In 2017, improvements in global risk appetite have triggered capital inflows to developing economies, with portfolio inflows to Turkey amounting to USD 6.1 billion in February-April.

**Figure 5: Dynamics of the current account balance, USD billion**



**Figure 6: Foreign financial flows USD billion**



Source: TurkStat

**12. Rapid depreciation of the lira and inflation pressures prompted the Central Bank to increase interest rates in 2016-17.** The Central Bank started simplifying its complex unorthodox monetary policy framework in March 2016 and it narrowed the interest rate corridor by cutting the overnight lending rate by 250 basis points through September.<sup>6</sup> Following rapid depreciation of the lira in late 2016 due to global developments and domestic uncertainties, it reversed course and increased the 1-week repo and overnight lending rates by 50 basis points and 100 basis points respectively, over November to January while returning to its previous policy framework. Starting from mid-January 2017, the Central Bank ceased 1-week repo auctions and lowered the single borrower limit for its overnight lending facility to force banks to borrow at the late liquidity window rate, tightening liquidity and increasing the average cost of funding by 366 basis points to 11.94 percent between December 30 and mid-May 2017. In 2016, inflation reached 8.5 percent, with lower food inflation offset by tax increases on cars and tobacco products, higher transport and energy prices and lira depreciation. The foreign-exchange pass-through associated with rapid lira depreciation, higher global energy prices and unfavorable weather conditions fed into prices and pushed headline inflation to 11.9 percent and core

<sup>5</sup> The gross foreign reserves of the Central Bank remained unchanged at USD 106 billion at the end of 2016 – a level equivalent to 6.9 months of imports and net reserves were around USD 35.4 billion. Given the uncertainties regarding global liquidity conditions, further reserve accumulation is warranted.

<sup>6</sup> In late 2010, the CBRT designed a new unorthodox monetary policy mix to prevent the negative effects of capital inflows on the economy, keeping its primary objective of reducing inflation but also focusing on financial stability at the same time. Under this unorthodox monetary policy, by using more than one policy variable in monetary policy decision-making, CBRT has the flexibility to adjust the policy depending on the current state of the economy by narrowing or widening the interest rate corridor. Currently, the CBRT uses four interest rates: (i) The overnight borrowing rate (ii) The weekly repo rate, or the policy rate, (iii) The overnight lending rate and (iv) The late liquidity window lending rate.

inflation to 9.4 percent by April 2017. Inflation is likely to hover in low double-digit levels throughout the year 2017 (Table 1).

**Table 1: Key Macroeconomic Indicators**

Indicators	2013	2014	2015	2016	2017f	2018f	2019f	2020f
<b>Real Economy</b>	Annual percentage change, unless otherwise indicated							
GDP (nominal-billion TL)	1,810	2,045	2,338	2,591	2,973	3,339	3,751	4,181
Per Capita GDP (USD)	12,483	12,104	10,987	10,816	9,950	10,069	10,682	11,263
Real Gross Domestic Product (GDP)	8.5	5.2	6.1	2.9	4.0	3.5	4.0	4.0
Private Consumption Contributions (in percentage points)	5.0	1.9	3.4	1.4	3.0	1.9	2.2	2.1
Government Consumption Contributions (in percentage points)	1.1	0.4	0.5	1.0	1.2	0.3	0.5	0.5
Gross Fixed Investment Contributions (in percentage points)	3.8	1.5	2.7	0.9	0.9	1.1	1.2	1.4
Exports, GNFS, Contributions (in percentage points)	0.3	1.8	0.9	-0.5	1.3	1.2	1.2	1.1
Imports, GNFS, Contributions (in percentage points)	-2.1	0.1	-0.4	-0.9	-1.0	-1.0	-1.1	-1.2
Unemployment rate	9.0	9.9	10.3	10.9	---	---	---	---
GDP Deflator	6.3	7.4	7.8	7.7	10.3	8.6	8.0	7.1
Consumer Price Index (average)	7.5	8.9	7.7	7.8	10.1	8.6	7.9	7.1
<b>Fiscal Accounts</b>	Percent of GDP, unless otherwise indicated							
Total Revenues	34.6	33.8	34.2	34.7	34.3	34.1	34.3	34.2
Expenditures	35.2	34.3	34.3	36.3	36.4	35.8	35.7	35.4
General government balance	-0.6	-0.5	-0.1	-1.6	-2.1	-1.6	-1.3	-1.2
Government Debt Stock <sup>7</sup>	33.5	31.0	30.0	30.5	30.0	29.4	27.9	26.7
<b>Balance of Payments</b>	Percent of GDP, unless otherwise indicated							
Exports Total	22.0	23.6	23.1	21.9	25.1	25.7	26.3	27.3
Imports Total	28.0	27.6	25.9	24.8	28.9	29.3	30.1	31.4
Current account balance (percent of GDP)	-6.7	-4.7	-3.7	-3.8	-4.7	-4.5	-4.6	-4.8
Net Foreign Direct Investment	1.0	0.6	1.4	1.1	1.1	1.2	1.3	1.4
Gross Reserves (CBRT), billion USD, eop	131.0	127.3	110.5	106.3	---	---	---	---
In months of next year's merchandise imports	6.9	6.8	6.7	6.9	---	---	---	---
Percent of short-term external debt	100.5	96.8	108.5	108.5	---	---	---	---
Memorandum Item								
<b>Nominal GDP (USD billion)</b>	950,6	934,2	859,4	857,4				

**Source:** The World Bank staff projections, TurkStat, Central Bank of the Republic of Turkey (CBRT), Ministry of Development (MOD).

<sup>7</sup> EU defined general government debt amounted to 28.3 percent of GDP in 2016. It includes total general government debt stock and adjustment items. It shows the total consolidated liabilities of general government related to currency and deposits, securities other than shares and loans at a given time.

13. **The banking system remains well capitalized with low Non-Performing Loans (NPL), but risks persist.** The banking sector exhibits good financial metrics; the capital adequacy ratio is at 15.6, non-performing loans at 3.2, return on assets (ROA) at 1.5 and return on equity (ROE) at 14.3 percent at the end of 2016. Although still comfortably above the regulatory thresholds, capital buffers and liquidity have been in a downward trend since the global crisis. Profitability had also been in a downward trend until 2015, but recovered in 2016 (ROE 14.3 and ROA 1.5 in 2016). On the other hand, there has been an upward trend in non-performing loans in recent years, although currently they remain low at 3.2 percent and well-provisioned, providing comfort in case of an additional deterioration in credit quality. Meanwhile, lending to SMEs due to the increased amount of guarantee provided by the Credit Guarantee Fund in 2017 led the loan-to-deposit ratio to rise in May 2017. Going forward, credit growth may come under pressure because of limited resources of banks to support further loan growth because of slow growth in the deposit base, uncertainty concerning global liquidity, as well as a possible rise in the cost of external borrowing.

**Table 2: Key Fiscal Indicators**

	2013	2014	2015	2016	2017f	2018f	2019f	2020f
<b>General Government Balance</b>	<b>-0.6</b>	<b>-0.5</b>	<b>-0.1</b>	<b>-1.6</b>	<b>-2.1</b>	<b>-1.6</b>	<b>-1.3</b>	<b>-1.2</b>
<b>General Government Primary Balance</b>	<b>2.2</b>	<b>2.0</b>	<b>2.2</b>	<b>0.5</b>	<b>-0.1</b>	<b>0.5</b>	<b>0.9</b>	<b>1.1</b>
<b>Revenues</b>	<b>34.6</b>	<b>33.8</b>	<b>34.2</b>	<b>34.7</b>	<b>34.3</b>	<b>34.1</b>	<b>34.3</b>	<b>34.2</b>
Direct tax revenues	5.7	5.8	5.7	5.9	5.8	5.9	5.9	5.8
Tax on Income and Profit	5.1	5.2	5.1	5.3	5.3	5.3	5.3	5.3
Tax on Property	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Indirect tax revenues	12.8	11.9	12.2	11.9	11.7	11.8	12.1	12.1
Other revenues	16.1	16.1	16.3	16.9	16.6	16.4	16.3	16.2
<b>Expenditures</b>	<b>35.2</b>	<b>34.3</b>	<b>34.3</b>	<b>36.3</b>	<b>36.4</b>	<b>35.8</b>	<b>35.7</b>	<b>35.4</b>
Current Expenditures	15.6	15.4	15.3	16.5	16.7	16.0	16.0	15.9
Capital Expenditures	3.6	3.3	3.5	3.4	3.3	3.4	3.4	3.4
Total Transfers	13.2	13.1	13.2	14.2	14.3	14.2	14.0	13.8
Interest Payments	2.9	2.5	2.3	2.1	2.0	2.1	2.2	2.3

**Source:** The World Bank staff projections and MOD.

## **MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY**

14. **GDP growth is projected to increase to 4 percent in 2017,<sup>8</sup> accompanied by increases in the current account and fiscal deficits.** Fiscal stimulus and credit facilitation are expected to boost private and public consumption growth by 5 percent and 8.9 percent respectively in 2017, although these measures are expected to be temporary and applied only in the current year. Investment growth is expected to reach a relatively low 3 percent in 2017, unless additional structural reforms are implemented. The fiscal deficit is expected to widen to 2.1 percent of GDP and the primary budget balance to be slightly negative. The current account deficit is projected to widen to 4.7 percent of GDP and will be partially covered by higher public and corporate

<sup>8</sup> Real GDP growth could reach 5 percent in 2017 if seasonally adjusted GDP grew by around 1 percent in the last three quarters of 2017, as it did in the first quarter.

borrowing. At the same time, depreciation and inflationary pressures are expected to persist in the short-term.

15. **Although expansionary fiscal policy is helping growth to recover in 2017, deeper structural reforms are needed to ensure a more sustainable economic growth trajectory in the medium term.** It is expected that the recent fiscal stimulus to be temporary to prevent further increases in the structural imbalances. Under this scenario, after declining to 3.5 percent in 2018, economic growth is expected to increase to 4 percent by 2020 reaching its current potential level. Although the economy is projected to grow modestly, the growth rate is likely to remain below the impressive performance of the last decade unless additional reforms are implemented to improve the investment climate and encourage a more efficient allocation of resources to stimulate productivity growth. Provided structural reforms continue to be implemented and investor confidence resumes, private investment is expected to gradually pick up in the medium term and increase its contribution to growth. Private consumption will continue to support growth, albeit at a slower pace.

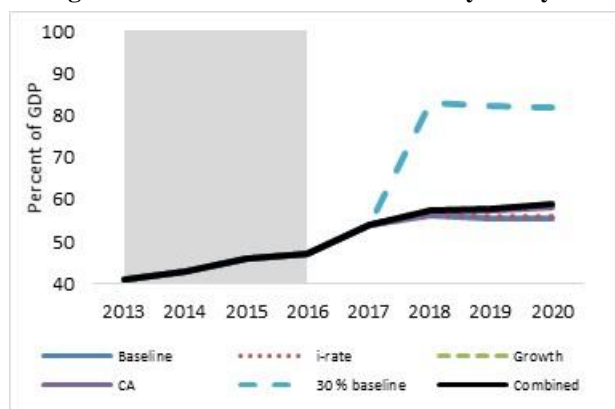
16. **External imbalances are likely to rise again in the medium-term if commodity prices increase.** External adjustment driven by lower commodity prices is expected to be reversed starting from 2017. Exports are projected to recover, fueled by rising external demand, particularly from the EU, as well as recovery in tourism revenues. On the import side, growth driven by domestic demand, combined with recovery in commodity prices, will also lead to an increase in imports. The current account deficit is expected to increase gradually, reaching 4.8 percent of GDP by 2020. Turkey's current account deficit remains large compared to its peers, and will continue to be one of the weak spots of the economy. An inadequate saving rate relative to Turkey's investment needs, and high energy import dependency will remain the main factors behind large external imbalances.

17. **The external debt trajectory is sustainable, but with increased vulnerability to adverse shocks.** Turkey's external debt increased by 8.3 percentage points to 47.1 percent of GDP between 2012 and 2016, because of dependence on debt-creating flows and depreciation of the lira (Table 3). In our baseline scenario, external debt is forecast to increase to 55.3 percent of GDP by 2020, which does not pose significant sustainability risks (Figure 7). Yet, external shocks can accelerate the rising trend, pushing external debt to risky levels. A steeper recovery in global energy prices could widen the current account deficit by more than envisaged in the baseline scenario, pushing the debt ratio to 58.3 percent of GDP. With a permanent 30 percent real depreciation shock, external debt would increase dramatically to 81.9 percent of GDP in 2020, a level where external sustainability constraints become binding. The gross external financing requirement is forecast to decline to 23.8 percent of GDP in 2020. In an adverse scenario, a permanent 30 percent real depreciation would push the external financing need to 35.3 percent in 2020, putting external sustainability at risk.

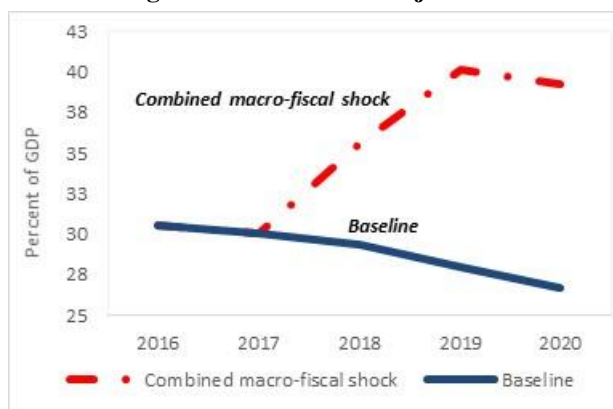
18. **The public debt level is sustainable, with a downward trajectory in the medium-term.** The reduction in public debt stock is expected to slow in the medium-term in comparison with historical trends, because of lower growth prospects and smaller primary surpluses. The public debt-to-GDP ratio is still expected to remain significantly below the standard risk thresholds in the medium-term with a projected downward trajectory, from 30.5 percent to 26.7 percent of GDP between 2016 and 2020 in the baseline scenario. But this scenario is subject to several risks. A weaker than expected growth performance - 1 standard deviation (4.5 percentage points) below the baseline in two consecutive years - would increase the projected public debt

level in 2020 to 36.1 percent of GDP, 9.4 percentage points above the baseline. On the fiscal front, lower levels of primary surplus would worsen public debt dynamics beyond the baseline. In an extreme downside scenario where domestic interest rates go up, the exchange rate would depreciate, GDP would contract, fiscal performance would worsen and public debt would increase to 39.3 percent of GDP (Figure 8).

**Figure 7: External Debt Sustainability Analysis**



**Figure 8: Public Debt Projections**



Source: World Bank staff calculations

**Table 3: External Debt Composition, December 2016**

	USD (billion)	Share of total debt	Percent of GDP
Monetary authorities	0.8	0.2	0.1
General government	85.5	21.1	10.0
Banks	161.2	39.9	18.8
Other sectors	156.7	38.8	18.3
Total external debt	404.2	100.0	47.1
Long term	306.2	75.8	35.7
Short term	98.0	24.2	11.4

Source: Undersecretariat of Treasury

19. **Despite Turkey's remarkable resilience to the recent crises, there are several risks to the macroeconomic framework:**

- **Risks of reversal of external capital flows in light of non-financial corporations' dependence on short-term capital inflows and sizeable open foreign exchange positions.** The corporate sector's dependence on short-term capital inflows poses downside risks to growth. The current account deficit is forecast at 4.7 percent of GDP in 2017, and external debt equivalent to 20.3 percent of GDP is coming due by early 2018. The sizeable open foreign exchange position in the corporate sector (23.5 percent of GDP) with its substantial rollover needs leaves Turkey vulnerable to changes in investor sentiment and external conditions. In an adverse scenario of rapidly tightening global liquidity and inadequate monetary policy response, a new round of lira depreciation would put severe strain on corporate balance sheets, depressing private investment and lowering GDP growth.

- **Credit risk in the banking sector.** A higher than expected depreciation of the lira may impact the banking sector negatively through defaults of corporates with large foreign exchange exposure. The recent increase in guarantees provided by the Credit Guarantee Fund has put additional pressures on the banking sector, driving the loan to deposit ratio to 125 percent in May 2017. Going forward, banks have limited resources to support further loan growth because insufficient domestic savings significantly limit banks' ability to attract new deposits, the uncertainty on global liquidity constrains foreign borrowing, and moderate profitability growth does not encourage capital increases.
- **Risks of growing contingent liabilities and quasi-fiscal activities.** The recent expansion of the credit guarantee mechanism and other contractual government commitments<sup>9</sup> may lead to increases in contingent liabilities potentially putting pressure on fiscal and debt sustainability in the medium term. Additional fiscal and quasi-fiscal risks are created by the establishment of the Sovereign Wealth Fund, which was mainly set up to secure funding for large infrastructure projects.
- **External risks related to adverse geopolitical events and security concerns.** The deterioration in geopolitical relations in the region could undermine investor confidence, reduce capital inflows and demand from the main trading partners.
- **Risks related to economic governance.** A state of emergency has been in place since the failed coup attempt, during which counter-terrorism measures were taken by the Government such as the dismissal of civil servants and the transfer of assets of some entities whose links to a terrorist organization have been investigated. Taking measures to improve the quality of Turkey's institutions (regulatory institutions to ensure market functioning and the rule of law) and ensuring strong and credible public institutions and a clear policy framework would help enhancing macro balances, securing financial stability and achieving inflation targets.

20. **Macro-fiscal prudence and acceleration of structural reform will help mitigate these risks.** A gradual move to prudent fiscal policy, accompanied with acceleration of the momentum for structural reforms to stimulate productivity and investment growth, should help to reduce Turkey's dependency on the short term external borrowings and attract more FDI. Continued fiscal discipline and close monitoring of quasi-fiscal liabilities will be important for maintaining fiscal buffers. Reduced political uncertainties, accompanied with acceleration in

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<sup>9</sup> The Undersecretariat of Treasury publishes the figures related to explicit contingent liabilities, which are Treasury guaranteed credits and guarantees provided for financing for the PPP projects (debt assumption guarantee). Treasury guaranteed debt stock, as a result of credit guarantees, reached USD 12.4 billion in 2016. The Undersecretariat of Treasury has provided USD 8.7 billion in debt assumption guarantees (initiated in 2013) for three large PPP projects. Additionally, demand guarantees provided for the PPP projects are another source of contingent liabilities in Turkey. The data related to this type of liabilities are not available as the contracts are not published. The Government is committed to improve its institutional capacity on the process of planning, implementation, monitoring and evaluation of the PPP projects as stated in the Medium Term Program 2017-2019. In this regard, the recently signed PPP RAS aims to support the Government efforts to enhance institutional capacity building.



reform momentum will also help in mitigating these risks. As discussed in the relevant sections below, the proposed RIG-DPF will support reforms to help reduce external imbalances, remove rigidities in the labor market and strengthen the foundations of sustainable growth.

**21. Turkey’s macroeconomic framework is adequate for the proposed operation.**

Turkey’s economy proved to be resilient to crises owing to the strong fiscal discipline it maintained for the last decade and to a well-capitalized banking system. Internal and external imbalances, however, have remained, making the country dependent on external financing. Risks to growth arise from a widening current account deficit, rising external debt (50 percent of GDP), large gross financing requirements (about USD 200 billion per annum), a large open foreign exchange position in the corporate sector, and a growing funding gap in the banking sector that is likely to curtail loan growth (Table 4). At the same time, these challenges can be mitigated with the proper policy mix. Despite the recent fiscal easing (that is expected to be temporary), monetary policy remains tight, gross international reserves are sufficient to cover medium term needs, access to external funding is stable, and the debt levels remain low.

**Table 4: Balance of Payment Financing Requirements and Sources**

	2013	2014	2015	2016	2017f	2018f	2019f	2020f
<b>Financing requirements (USD billion)</b>	<b>207.8</b>	<b>212.0</b>	<b>200.3</b>	<b>192.5</b>	<b>198.5</b>	<b>202.1</b>	<b>210.5</b>	<b>221.1</b>
Current account deficit	63.6	43.6	32.1	32.6	37.5	37.0	40.4	44.4
Short-term debt amortization	100.2	130.3	131.6	101.9	98.0	100.7	103.7	107.1
Long-term debt amortizations	44.0	38.1	36.6	58.0	63.0	64.3	66.3	69.6
<b>Financing Sources (USD billion)</b>	<b>207.8</b>	<b>212.0</b>	<b>200.3</b>	<b>192.5</b>	<b>198.5</b>	<b>202.1</b>	<b>210.5</b>	<b>221.1</b>
FDI Flows (net)	9.3	5.8	12.5	9.1	8.7	9.9	11.2	13.0
Portfolio Flows (net)	24.0	20.1	-15.7	6.3	14.1	14.7	15.7	17.4
of which equity	0.8	2.6	-2.4	0.8	1.5	1.5	2.0	1.9
Short-term debt disbursement	131.2	139.9	128.3	107.0	100.7	107.0	109.1	111.8
Long-term debt disbursement	49.2	45.4	68.2	65.9	72.9	75.7	79.4	84.8
Other <sup>/1</sup>	2.3	-1.7	-15.0	-6.1	-5.5	-5.5	-5.0	-5.0
Change in Reserves (-, increase)	-9.9	0.5	11.8	-0.8	7.6*	0.2	0.1	-1.0
Net Errors and Omissions	1.6	2.0	10.2	10.9	0.0	0.0	0.0	0.0

<sup>/1</sup> Sales of assets under Other Investments

\* In the first four months of 2017, decline in reserves totaled USD 7.8 billion.

**Source:** The World Bank staff projections

## **INTERNATIONAL MONETARY FUND (IMF) RELATIONS**

**22. The World Bank is coordinating this budget support operation with the IMF, with periodic exchanges on macroeconomic, fiscal, and structural reforms.** The IMF’s Stand-By Arrangement for Turkey was completed successfully in May 2008. The latest Article IV report, published in February 2017, underlined the importance of strengthening the resilience of the Turkish economy in the face of severe and increasing challenges, as well as the authorities’ efforts to avoid an excessive slowdown in the near term. At the same time, the assessment stressed vulnerabilities of the economy, including high inflation, external imbalances, and substantial reliance on external financing, while dealing with complex geopolitical and security challenges. The IMF welcomed the authorities’ steps before November 2016 to simplify the monetary policy framework. The IMF assessment strongly emphasized the need to advance on

the policy reform agenda, with a view to increasing domestic savings, while welcoming the progress made to reform the voluntary pension system and raising potential growth, while ensuring strong and credible public institutions. The Executive Board of the IMF commended the authorities for hosting a large number of refugees and for their efforts to integrate them into the labor market, while stressing the importance of continued international assistance. Annex 3 provides additional details of the Fund's Article IV consultations.

### **3. THE GOVERNMENT'S PROGRAM**

**23. The Tenth DP for 2014-18 was adopted by the Government and approved by Parliament in July 2013.** The DP diagnoses the key challenges that Turkey needs to address to overcome the "middle income trap" with the aim of "strengthening macroeconomic stability, improving human capital, increasing effectiveness of the labor market, increasing technology development and innovative capacity, strengthening physical infrastructure, and improving institutional quality". The DP builds on four pillars: Pillar 1: Qualified Individuals, Strong Society, Pillar 2: Innovative Production, Sustainable High Growth, Pillar 3: Livable Spaces, Sustainable Environment, and Pillar 4: International Cooperation and Development. Implementation of the four pillars is articulated around 25, largely cross-sectoral, priority transformation programs, reflecting the complexity of the challenges that Turkey faces as it moves towards high-income status. Relative to previous development plans, an increased focus has been placed on monitoring and evaluation (M&E), with specific targets and one program focusing on further strengthening Turkey's statistical and information infrastructure. The DP also includes policy measures to improve governance and transparency.

**24. Prior actions supported by the DPF are closely aligned with the strategic objectives of the government.** The policies supported by the DPF - aiming at increasing domestic savings and enhancing fiscal transparency, supporting the economic inclusion of vulnerable groups, and addressing structural bottlenecks to sustainable growth - overlap with Pillars 1, 2 and 3 of the DP. The transformation programs that are most closely aligned with the DPF are: (i) Enhancing Productivity in Manufacturing, (ii) Increasing Domestic Savings and Avoiding Waste, (iii) Improving Labor Market Effectiveness, (iv) Commercialization in Priority Technology Areas, (v) Transformation from Transportation to Logistics, and (vi) Energy Efficiency Improvement and Domestic Resource Based Energy Supply.

**25. The Turkish government implements its development plans through annual programs, with the 2017 Annual Program issued in October 2016.** The government moved to medium-term budgeting in 2006. The Medium-Term Fiscal Plan (MTFP) and Medium-Term Program (MTP) covering 2017-2019 were issued in October 2016. Turkey also produces annual EU Pre-Accession Economic Reform Programs (ERP) that detail short and medium-term policy actions and structural reform priorities related to EU accession. The last ERP, covering 2017-2019, was issued in January 2017 and builds on the DP's framework.

### **4. THE PROPOSED OPERATION**

**26. The RIG-DPF is a stand-alone operation aimed at supporting high-priority reforms.** The operation supports nine prior actions, structured around three pillars, and aims to increase domestic savings and enhance fiscal transparency, support the economic inclusion of vulnerable groups, and reduce structural bottlenecks to sustainable growth.

27. **The selection of prior actions was guided by alignment with the Government's development strategy, prior World Bank Group (WBG) engagement, and contribution to the World Bank's twin goals of poverty reduction and shared prosperity.** First, the program is focused on policy actions that are government priorities, as detailed in the Government's Program section above. Second, the program includes policy actions in areas where the WBG has produced analytical work and has engaged in a substantive policy dialogue, as presented in Table 5, showing the link between prior actions and supporting analytical underpinnings. Third, the program seeks to address key constraints towards the twin goals, as identified in the Systematic Country Diagnostic.

28. **The RIG-DPF builds on the agenda of the 2014 SSG-DPL.** Six out of nine prior actions included in the RIG-DPF are a continuation of the reform agenda of the 2014 SSG-DPL, which aimed to improve the business climate and enhance transparency; boost labor force participation and widen access to finance; and deepen Turkey's infrastructure reforms. A dense political calendar and a number of unforeseen events over 2015-16 delayed implementation of some reforms in the SSG-DPL series. At the same time, Turkey has been faced with new challenges, including the refugee crisis and changing global economic conditions. The RIG-DPF is designed with these new conditions in mind, and, while it completes SSG-DPL reforms in several areas, it introduces new policy actions that have become a priority for the Government of Turkey.

29. **The design of the operation incorporates lessons learnt from earlier budget support operations in Turkey, as well as globally.** Implementation Completion and Results Reports of previous budget support operations in Turkey and in other upper middle-income countries emphasize the importance of institutional capacity for the successful implementation of DPF programs, especially when PDOs are achieved through many prior actions spanning several sectors. Design should also be informed by strong knowledge products and synergies with other operations, especially in stand-alone DPFs. As in previous DPLs, analytical work and policy financing have been fully integrated, including a mix of local knowledge and international experience from the Bank. The strong basis of this operation in knowledge work and synergies with other forms of Bank engagement in Turkey should facilitate monitoring and evaluation, as well as communication among the different stakeholders.

## **PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS**

### ***Pillar A: Increasing Domestic Savings and Enhancing Fiscal Transparency***

30. **Macro-fiscal risks, in particular the dependence on foreign savings, remain the economy's Achilles' heel.** Possible adverse developments in capital flows can undermine growth and progress towards the twin goals. Deep economic and financial crises lead to loss of incomes and reduction in the availability of public services. Closely related to inadequate savings, fiscal risks have increased due to expenditure rigidities and mounting contingent liabilities, mainly due to an increasing PPP portfolio, the recent expansion of the Credit Guarantee Fund, other explicit or implicit guarantees to state-owned and private enterprises, and the establishment of the Turkish Wealth Fund in 2016. Against this backdrop, this pillar aims to increase domestic saving to address external imbalances and reduce fiscal risks. Amendments in the Private Pension Saving and Investment System Law that introduced auto-enrollment will help increase private savings and eventually reduce dependence on external financing. At the same time, the inclusion of financial statements in the Turkish Court of Accounts (TCA)

financial audit reports of all general budget institutions is expected to support fiscal discipline by promoting transparency of fiscal accounts and expanding fiscal risk disclosure.

31. **Results.** Prior actions under this pillar would support an increase in private savings and strengthen fiscal discipline by promoting transparency of fiscal accounts and fiscal risk disclosure.

***DPF Prior Action #1:** The Borrower enacted the Law on Amending the Private Pension Savings and Investment System Law, specifically with respect to the introduction of auto-enrollment in the private pension system.<sup>10</sup>*

32. **With a generous pay-as-you-go public pillar, limited private provision, and a rapidly aging population, the Turkish pension system is unsustainable.** Based on the 2008 pension reform, the retirement age in Turkey is planned to gradually rise to 65 for both genders by 2048. According to the OECD's Pensions at A Glance 2015, Turkey has one of the most generous public pillars in the world, paying 75 percent of wages to workers who retire at 60. World Bank projections from 2011 showed that earlier reforms had helped but that much more was needed. The provision of private pensions is limited, with approximately 6.8 million individual accounts by the end of June 2017 (12 percent of the working age population), since the individual account private pension system was established in 2003. Yet, Turkey's population is aging, with median age projected to reach 42.9 by 2050 from 31 in 2015, jeopardizing the sustainability of the system in the long run.

33. **The introduction of auto-enrollment into private pensions is a major advance for the pension system.** A much higher proportion of the population needs to have complementary pension saving – to create a more balanced system and to protect them for the time when the public system will inevitably have to be made less generous. The auto-enrollment legislation came into effect on January 1, 2017. It introduces a mass market private pension pillar and is an essential step in creating a sustainable and diversified pension system. Auto-enrollment compels employers to automatically enroll employees into a pension saving scheme, leaving employees the choice to opt out. Because of inertia and because employees receive matches and incentives only if they stay, international experience confirms that higher coverage and increased contributions can be achieved (e.g. over 7 million extra savers in the United Kingdom). Against this backdrop, the reform will (i) help increase the coverage of private pensions, by enhancing retirement security and reducing fiscal pressure in the future from a public pension pillar which is already cash negative;<sup>11</sup> (ii) help increase the stock of assets through extra contributions and reduced costs (which have been cut significantly in the new pillar), thus aiding total and long term and illiquid investments and reducing macroeconomic vulnerabilities; and (iii) support development of the capital market by generating an increased supply of assets to fund investment, adding diversity to the institutional investor base, and helping diversify a traditionally bank-dominated lending market. By the end of June 2017, assets under management have reached TL 600 million.

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<sup>10</sup> The action is a continuation of the SSG-DPL agenda, where the trigger for a second operation would have been to pilot the auto-enrollment scheme with 5 companies. The action exceeds the trigger originally conceived for the operation following the SSG-DPL by going beyond a pilot to initiate nationwide implementation.

<sup>11</sup> The growth of a broad-based private pensions pillar will make it easier to reform the public pension pillar in the future.

34. **The new pillar is being rolled out in stages, starting with the largest employers and continuing to cover all employers with more than five employees by January 2019.** Regulations and guidelines on fees, investments, duties of employers and other issues have been introduced. The WBG supported Turkey's Treasury in creating the new system, together with an improved model for regulation and supervision of the private pension system.<sup>12</sup> As a result, fees in the new system are less than half those in the old system. They are currently 0.75 percent a year, with a cap of 0.85 percent a year, compared to 1.7 percent in the individual system (a figure that was itself reduced from 2.5 percent in 2013). Current assets in the individual private pensions are around USD 17 billion. The lower fees will generate significant savings in the coming decades, which will be available for investment in better pensions.

35. **Going forward, the system could be further improved by establishing an independent regulator and increasing the period for which contributions are locked in.** The Treasury is the regulator of private pensions in Turkey. The next phase of reform would involve the transition to a more standard international model with an independent pension regulator. Another major area for future reform is to increase the period for which contributions are locked in before they can be withdrawn, to encourage investment in long-term assets.<sup>13</sup> Based on international experience, the relative contribution of pension fund assets to long-term investment is greater if pension assets are locked-in for a longer period. However, trying to do this on top of the radical auto-enrollment reforms would have been politically risky. Hence, these sensible changes for the future neither detract from the major advance created by auto-enrollment, nor were necessary for the greater coverage and contributions to be realized. Moreover, given the developing governance challenges, suggestions to move to a more state-controlled procurement model were not considered prudent at this time.

*DPF Prior action #2 The Borrower, through the Turkish Court of Accounts, submitted to Parliament in 2016 audit reports (for the year ending in December 2015) comprising individual financial statements for all general budget institutions in accordance with the Law on Turkish Court of Accounts.*<sup>14</sup>

36. **Despite significant improvements in the external audit framework introduced by the 2010 TCA law, implementation challenges continue limiting public sector accountability.** An enhanced accountability framework contributes to fiscal transparency. The TCA Law, which became effective in 2010, has been a key legislation in promoting transparency of public spending and increasing the accountability of public institutions. The law, by expanding the scope of public audit and introducing international auditing standards, has contributed to building stronger accountability mechanisms between the government and citizens. Implementation of the Law was challenging. The number of reports to be submitted to the Turkish Grand National Assembly (TGNA) increased significantly and the individual financial statements of line agencies (general budget institutions) were not available when the law became effective. Accordingly, in 2013 when it became a requirement, TCA submitted audit reports for all general government institutions to the TGNA with two major issues left to be addressed.

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<sup>12</sup> The technical assistance was financed through the Financial Sector Reform and Strengthening initiative (FIRST).

<sup>13</sup> Even currently the auto-enrollment pillar and the existing individual private pension pillar supply more 'patient' capital than mutual funds, where the average duration of assets held in mutual funds is only one year,

<sup>14</sup> This prior action also continues the SSG-DPL agenda. The trigger in SSG-DPL for a second operation was less ambitious and would have excluded General Budget Institutions (mainly central ministries).

First, the audit reports of the special budget, regulatory and supervisory authorities and local administrations had audit opinions on the financial statements but did not include the financial statements themselves. Second, the TCA issued disclaimers of audit opinions on the general budget institutions because of unavailability of financial statements.

**37. In October 2016, the reform became fully effective, with the TCA submitting to Parliament audit reports, inclusive of financial statements, for all general budget institutions.** The TCA addressed the first issue and included the financial statements of general government institutions (excluding general budget institutions) in the TCA audit reports prepared for the year ended December 31, 2013. To address the second issue, the TCA and the Ministry of Finance agreed on a three-year transition period (2013-2015) for the preparation of entity level financial statements for general budget institutions. Consequently, the Ministry of Finance renewed the Communiqué on Central Government Accounting (published in the supplementary Official Gazette 29218 on December 27, 2014) and the Communiqué on General Government Accounting (published in the Official Gazette 29214 on December 23, 2014). These changes have enabled the preparation of financial statements for the year ended December 31, 2015, one year ahead of the agreed transition period. Subsequently, the TCA conducted the financial audit of general budget institutions and published the audit reports in its website. These reports were submitted to Parliament in October 2016, before the budgetary discussions for the fiscal year 2017. Going forward, in observance of the TCA Law, this will be a requirement for every fiscal year.

**38. Despite significant progress, there is still scope to improve the external audit framework.** First, the role of Parliament in the accountability framework could be strengthened by establishing a dedicated public accounts sub-committee within the Plan and Budget Committee at the TGNA. Second, the quality of TCA reports could be further enhanced through continued convergence with international standards. Third, based on TCA's assessment that the legal mandate to publish audit reports for State-Owned Enterprises (SOE) lies with the SOE Committee in the TGNA, TCA's recent decision not to publish the reports in the TCA website needs to be compensated by immediate action by the TGNA SOE Committee.

### ***Pillar B: Supporting the Economic Inclusion of Vulnerable Groups***

**39. Employment is the largest contributor to poverty reduction and shared prosperity, yet low labor force participation of women and other disadvantaged groups constrains economic growth, as well as broader social and economic empowerment.** Female labor force participation, at 35 percent (aged 15-64), is far below the Organization for Economic Co-Operation and Development (OECD) average of 63 percent in 2015. Lower levels of education, relatively inflexible work arrangements, lack of quality affordable child and elderly care, and overall cultural norms are barriers for the inclusion of women. The youth unemployment rate (18.5 percent in 2015, aged 15-24) is higher than the OECD average (14 percent) and, despite rising levels of education, youth unemployment rates are still increasing. Informality remains high (33.5 percent in the total economy, 82 percent in agriculture, 22 percent in non-agriculture sectors in 2016), especially among women (44.3 percent in 2016) and youth (45.3 percent in 2015), causing an earnings gap between workers with similar characteristics. The influx of refugees in recent years generated another disadvantaged social group that, when working, is employed mostly in the informal sector. Against this backdrop, Pillar B helps to strengthen the foundations for inclusive growth by improving labor market conditions. Amendments in the labor market legislation are expected to facilitate labor force participation of women, youth,

long-term unemployed and Syrians under temporary protection by supporting flexible employment, increasing access to childcare, and integrating refugees in the labor market.

40. **Results.** Prior actions under this pillar would increase social and economic empowerment through reducing constraints to integrating into the labor market.

***DPF Prior Action #3:** The Borrower enacted the Law on Supporting Investments on Project Basis and Amending Various Laws and Decrees, specifically with respect to the introduction of tax incentives for private nursery schools (crèches) through amendments to the Income Tax Law.<sup>15</sup>*

41. **Increasing women's economic participation remains an important challenge for Turkey.** The recent Turkey Systematic Country Diagnostic (SCD) identifies low female labor force participation as a priority constraint to achieve the Bank's twin goals of poverty eradication and shared prosperity. Better childcare options constitute a fundamental policy to help parents combine work and the care of young children. Incentivizing the availability of affordable childcare can build on the introduction of more maternal and paternal-friendly labor market institutions to relax important barriers to increased female labor force participation. Currently, around 35 percent of children aged 3-5 are enrolled in preschool or childcare services, compared to 80 percent on average in OECD countries, with 15.5 percent of children enrolled in private childcare centers, compared to 37 percent in OECD countries. New childcare capacity is needed, with a complementary role played by private providers.

42. **Efforts to promote the affordability and accessibility of childcare services build on previous reforms to strengthen maternity and paternity leave rights of employees.** The Law no: 6745, that was issued in the Official Gazette on September 7, 2016, amends the Income Tax Law by allowing for the provision of tax incentives for childcare facilities, thus promoting the supply and affordability of childcare services. The Law builds on the reforms introduced with Law no: 6663, issued on February 10, 2016, which contributed to reducing key constraints on female labor force participation by enhancing flexibility and working rights, namely by promoting the involvement of both spouses in childcare, increasing paternity leave, introducing flexible working hours, and preventing employment termination or redundancy during paternity/maternity leave. Accessible and affordable childcare services and stronger maternity and paternity leave rights of employees are important steps in the right direction, particularly to bridge the gap between women's median monthly earnings and the cost of care. The unattended demand is large – 2.5 million children aged 3-5 do not attend any preschool or childcare services – and the care market size starts from a low basis.<sup>16</sup> Simulations suggest that the policy changes that have been introduced will increase the supply of care by an average of 3.5 percent per annum.

43. **Further efforts are needed to improve affordability and quality of childcare services.** Apart from increasing access, two aspects of childcare are fundamental to successful programs: quality and affordability/convenience. Building up the quality and availability of affordable kindergartens to meet the demand for preschool enrollments is therefore an important policy priority and one that can not only expand women's opportunities but also simultaneously address equality and efficiency challenges. In this respect, it is important to complement present

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<sup>15</sup> This prior action continues the SSG-DPL related to the implementation of the National Employment Strategy.

<sup>16</sup> Ministry of National Education, 2016-2017.

efforts with other measures to compel municipalities to open nurseries that can be accessed by local women and incentivize individual firms to offer childcare options on-site.

***DPF Prior Action #4: The Borrower enacted the Law on Amending the Labor Law and Public Employment Services Agency (ISKUR) Law, specifically with respect to making labor market programs more flexible through the introduction of various work contract modalities.<sup>17</sup>***

44. **High dismissal costs and stringent contract types constrain employers from creating more formal jobs.** Employment protection legislation in Turkey is stringent by OECD standards. Stringency is largely a result of severance payment regulations, which impose high costs of dismissal and discourage employers from offering formal contracts. But stringency is also partly due to inflexible types of formal contract modalities, which limit contracting arrangements that employers can offer workers to full-time permanent jobs. Severance pay reform remains under discussion and has not yet been made.

45. **The government recently introduced legislative amendments to make work contract arrangements more flexible by legalizing formal temporary work contracts.** Enactment of Law no: 6715 introduced an amendment in the labor law legalizing various telecommuting work arrangements, such as distance or remote, home, mobile, or virtual working. The reform affords temporary and part-time workers protections equal to other workers under Turkish labor law. The legislative changes provide employers with flexibility in contracting workers by allowing them to adapt their contracting modalities to the reality of the modern economy. Although dismissal costs remain a limiting factor to labor market flexibility, the flexibility gained will likely open opportunities for more workers to become economically active.

46. **Even though Law no: 6715 does not target a specific demographic group, both women and youth are likely to disproportionately benefit.** Women and youth, have lower employment and labor participation rates than men, especially women and youth with relatively low levels of education (completed secondary or below) and limited work experience. In the case of women, a combination of economic and cultural barriers affects their labor participation rates. Economic barriers relate to the quality of working conditions that low educated women face in the labor market (informal jobs with low salaries, long working hours, and lack of affordable childcare), while cultural barriers mainly relate to women's role as caregivers and family/social demands to stay at home. In the case of youth, one critical factor limiting their entry into formal work is the lack of work experience and employment history. Employers are reluctant to hire new entrants to the labor market permanently without evidence of their work abilities. Thus, the introduction of more flexible work arrangements will likely benefit youth and women by making it possible for employers to offer them work contracts which are more suitable to the needs of the firm. Flexible work contracts will also ease entry into work for women and youth by addressing some of the limitations mentioned. For instance, part-time work, remote and distance work, and telecommuting arrangements can address some of the economic and cultural barriers women face. For youth, temporary work contracts can help them get access to formal jobs, allowing them to obtain relevant work experience.

47. **Going forward, the Government should consider reforms that address dismissal costs to encourage job creation and promote inclusion.** The next step to continue to increase

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<sup>17</sup> This prior action also continues the SSG-DPL related to the implementation of the National Employment Strategy.



flexibility and efficiency of the labor market and to offer better formal sector jobs to more workers is to reform the severance pay system. Many studies by the World Bank, OECD and others find that the current severance pay system in Turkey is too costly as judged by international standards. Workers qualify after one year of service, and the system mandates a payment of one month wages per year of service for qualifying separations, with no ceiling on the number of years. International comparisons show that the level of severance pay mandated in Turkey is well above the average for all regions and country groupings by level of income. As shown in various studies, the current system negatively affects the incentives for employers to hire workers formally, with open contracts. Anecdotal evidence suggests that employers use various practices to avoid payments; and non-compliance is high, which limits the policy's ability to provide income protection to workers after dismissal. The weaknesses of the policy have prompted the government to explore reform options to not only reduce the costs of dismissal but to also increase the compliance rates and subsequent protection that workers are entitled to upon dismissal.

***DPF Prior Action #5:** The Borrower, through its Council of Ministers, issued a communique on the introduction of work permits for foreigners under temporary protection, pursuant to the Council of Ministers' Decision No. 2016/8375, to support the inclusion of said persons in the Turkish labor market.*

**48. Turkey is hosting the largest refugee population in the world, with more than 3 million refugees, the vast majority of whom are Syrian.** Since the early years of the refugee crisis (in 2011), Turkey has continuously stepped up to support the refugees with basic services and rights, setting a global precedent for a refugee response that is both government-financed and non-camp-based. The Government has adapted to the changing nature of the crisis and the needs of the Syrians in Turkey, through increasing focus on longer-term and more development-oriented support. In 2013, the Government officially defined its response through a Law on Foreigners and International Protection which granted temporary protection to foreigners who are affected by forced displacement. The Regulation of Temporary Protection issued in 2014 defined implementation details for temporary protection and provided temporary protection for Syrians. In particular, Syrians under Temporary Protection (SuTPs) are provided the right to have free access to public services such as health care, education, social services, and psycho-socio emotional support (especially for children and elderly).

**49. In 2016, recognizing the increasing informality of Syrian workers in the Turkish labor market, the Government also enabled SuTPs to obtain work permits, thus enabling them to move out of the informal economy and into the formal labor market.**<sup>18</sup> This secondary regulation is widely acknowledged as a very positive step forward, not only for the people it affects directly but also for the Turkish labor market more broadly. The issuance of the

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<sup>18</sup> Official Gazette No. 29594 on January 15, 2016. The basis of the Regulation is Article 91 of the Law on Foreigners and International Protection No. 6458 and Article 29 of the Regulation of Temporary Protection issued on October 22, 2014. Since Syrians are the only ones granted temporary protection status, they are the only group eligible for the work permit at this time. On April 26, 2016 a regulation, namely "The Regulation on Working Procedures of International Protection Applicants and Holders of International Protection Status", was issued in Official Gazette No 29695, which determines the procedures and principles governing the employment of the applicants or the beneficiaries of international protection status (refugees, subsidiary protection and conditional refugees).

regulation is fully aligned with Turkey's development objectives to formalize the economy and protect workers from unsafe working conditions. It provides an opportunity for Syrians to integrate into the Turkish economy formally and reduces unfair competition and informality. Moreover, the issuance of this regulation has served as an example to other refugee-hosting nations, such as Jordan.

**50. Implementation of this regulation is underway with many thousands of work permits already granted.** However, there are critical challenges still to be overcome to see the full impact of the law, notably the slow administrative process of obtaining a work permit through the Ministry of Labor and Social Security. The reasons for the slow progress are multiple. Among other things, the system is new and requires continuous improvements.<sup>19</sup> The Turkish labor market has slowed down and the creation of formal jobs has decreased. In addition, some employers are reluctant formally to hire new employees – whether Turkish or Syrian –because of the requirement that they must pay at least the minimum wage;<sup>20</sup> moreover, this reluctance is likely to be greater with respect to Syrian workers due to language barriers, low skills and limited local work experience, which negatively impact the productivity of Syrian workers and their ability to access the minimum wage. Finally, there are legitimate concerns that SuTPs could crowd out work opportunities for less educated or experienced Turkish workers in the SuTP host communities;<sup>21</sup> to address this concern, the regulations enabling SuTPs to obtain a work permit also requires that no Turkish national be available to perform the work, and also that the share of refugees in the firm not exceed 10 percent of the firm's total workforce. In short, the continuing challenges faced in implementing this regulation must be seen within an overall context of the laudable commitment of the Government to formalize SuTPs in an economy with increasing unemployment rates among the local population.

### ***Pillar C: Addressing Structural Bottlenecks to Sustainable Growth***

**51. Long-run growth requires supply-side reforms to increase private sector productivity and investment, while ensuring environmental sustainability.** Turkey's growth potential is constrained by dwindling productivity growth and private investment dominated by residential construction. Structural reforms are needed to improve the allocation of resources, increase productivity, and create a business environment more conducive to private sector investment and innovation. Innovation and research and development (R&D) are at the center of the government's efforts to boost productivity growth. The Tenth Development Plan embraces ambitious targets, including an increase in R&D expenditures as a percentage of GDP to 1.8 percent in 2018, up from 1.06 percent in 2015. Business expenditures are targeted to account for 60 percent of this amount (i.e. 1.1 percent of GDP) by 2018, compared to 50 percent in 2015.<sup>22</sup> Yet, business investment and innovation – and ultimately productivity – are constrained by difficult access to finance in vast segments of the enterprise sector, with SMEs receiving only 27 percent of total bank loans despite their much larger share in economic activity. The pervasiveness of regulatory restrictions to competition further dampens productivity growth and

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<sup>19</sup> One critical improvement was to move from in-person applications to online applications. This required an adequate IT system to be in place and massive training of employers and Ministry of Labor staff to be done.

<sup>20</sup> There are exceptions to the need for a work permit for seasonal workers in agriculture and stockbreeding.

<sup>21</sup> Del Carpio and Wagner (2016), *The Impact of Syrian Refugees on the Turkish Labor Market*. Tumen, (2016). "The Economic Impact of Syrian Refugees on Host Countries: Quasi-Experimental Evidence from Turkey."

<sup>22</sup> 2018 estimates are from the Tenth Development Plan; 2015 data is from TURKSTAT.

the incentives to invest and innovate. In fact, Turkey's score on the OECD Product Market Regulation (PMR) index was 2.2, on a scale of 0 to 6, compared with 0.9 for the top 5 performers, and 1.3 on average in the EU. The main reason for Turkey's relatively poor standing in the PMR index is a high level of state control of economic activity, particularly in network sectors. Further undermining the sustainability of growth, Turkey's economy is characterized by an increasing environmental footprint. Emissions have been increasing much faster than in other OECD countries, posing the challenge of reducing the link between economic growth and impacts on the environment. Against this backdrop, the prior actions under this pillar aim to ease structural bottlenecks to sustainable growth by strengthening protection of industrial property rights; improving allocation of capital by supporting Small and Medium Enterprises (SME) access to credit; deregulating network industries through the liberalization of the railways sector; and increasing the share of renewable energy in total energy supply.

52. **Results.** Prior actions under this pillar would strengthen the foundations of Turkey's growth potential by increasing private sector productivity.

***DPF Prior Action #6:** The Borrower enacted the Law on Industrial Property, specifically with respect to the establishment of a more sophisticated system for the protection and enforcement of industrial property rights through incentives for inventors to obtain patents for inventions, the provision of improved support for research and development activities, and the regulation of patents, utility models, trademarks, industrial designs and geographical indications.<sup>23</sup>*

53. **Turkey ranks poorly in innovation.** According to the Global Competitiveness Index (2016-2017), Turkey ranks 71<sup>st</sup> in the innovation pillar, 63<sup>rd</sup> in university-industry collaboration in R&D and 103<sup>rd</sup> in quality of scientific research institutions. Turkey also falls close to the bottom of the European Innovation Scoreboard rankings on most indicators, including international scientific co-publications, public-private co-publications, Patent Cooperation Treaty (PCT) patent applications,<sup>24</sup> medium and high tech product exports, knowledge intensive service exports, and others. Similarly, the World Bank's 2015-2016 Enterprise Survey found relatively low levels of product innovation in Turkey. Despite a wide range of support programs, Turkey does not seem to be living up to its potential in terms of innovation outcomes. In 2015, there were 58 support programs implemented by different public organizations through which 15,079 R&D and innovation projects were financed with a total budget of USD 480 million.

54. **The new Industrial Property (IP) Law no: 6769 modernizes the protection of intellectual property in Turkey providing an important foundation for increasing R&D and innovation.** Without protection of ideas, businesses and individuals would not reap the full benefits of their inventions and would focus less on R&D. Previously, intellectual property rights were covered by a series of old decrees on patents, trademarks, industrial designs, and geographical signs, as well as laws on the functions of the Turkish Patent Institute (now renamed to the Turkish Patent and Trademark Office) and on the protection of integrated circuits. The

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<sup>23</sup> This prior action continues the SSG-DPL agenda. The trigger for a second operation would have been enactment of the Patent Law and finalization of the Intellectual Property Strategy. The Government approved the Strategy and Action Plan (2015-2018) in November 2014 and the Strategy is under implementation.

<sup>24</sup> By filing one international patent application under the PCT, applicants can simultaneously seek protection for an invention in many countries. While the number of patent applications to Turkey's Patent and Trademark Office has been increasing—there were 6,445 domestic and 10,333 foreign applications in 2016 compared to 3,250 domestic and 8,343 foreign applications in 2010—there is room for further growth to reach EU levels.

new Law combines and rationalizes the legal framework for these issues, bringing them largely in line with EU standards. It incorporates appropriate incentive systems to motivate the rapid commercialization of innovations derived at universities and with the assistance of government research funds. It eliminates registration protection of unexamined patents, a practice that had created two classes of patents in Turkey, while providing for a substantive examination to ensure that all patented innovations incorporate novelty, an inventive step, and an industrial application. The new Law also incorporates provisions allowing the new patent authority to cancel patents, either through a post-grant review or due to extended periods of non-use. In addition to harmonizing Turkey's IP legislation with the EU, it makes the legal framework more systemic, understandable, and user-friendly.

**55. Turkey's innovation policy mix could be fine-tuned to better encourage high quality public research, technology transfer, and private R&D.** While the new IP Law is a necessary step in the right direction, a fully functioning system is built over time and requires that administrators examining and granting patents and the judges or tribunals resolving patent disputes develop a reputation for integrity and predictability. More generally, a thorough mapping of the current innovation policy mix, followed by an assessment of the overlaps, efficiency, and effectiveness of existing programs is a necessary condition for effective innovation policy. The policy mix could then be adjusted to ensure a strong focus on incentivizing excellence in publicly funded research, facilitating technology transfer and commercialization of that research to the private sector, and boosting R&D undertaken by firms. This process could result in a more strategic, targeted approach to R&D policy that supports more frontier innovation.

***DPF Prior Action #7:** The Borrower enacted the Law on Moveable Collateral in Commercial Operations, specifically with respect to the enablement of small- and medium-sized enterprises to obtain access to credit through the use of moveable assets as collateral.*

**56. Lack of a functioning secured transactions system, enabling the use of movable property as collateral for a loan, makes banking more inflexible for the debtor and riskier for the creditor.** The Turkish legal framework for secured transactions is fragmented. Provisions relating to secured transactions are scattered in several legal texts, including the Civil Code, the Code of Obligations, the Banking Law and the Commercial Enterprise Pledge Law. Likewise, there is no single place for filing a security interest on movable property. This constrains access to finance, encourages unproductive investment in real property, and limits alternative schemes such as inventory financing, value chain financing, and agricultural financing. On average, only 22 percent of an enterprise's assets are real property, compared to 78 percent of the assets accepted as collateral.

**57. A legal framework allowing the use of tangible and intangible movable assets as collateral (equipment, inventory, accounts receivable, vehicles, shares and stocks, intellectual property rights, livestock, etc.) will improve access to finance, especially for SMEs and startups.**<sup>25</sup> The Law no: 6750 on Moveable Collateral in Commercial Operations

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<sup>25</sup> Recent research by the World Bank Group shows that movable asset registries have a positive effect on firm financing, with an 8 percent increase in access to finance, a 7 percent increase in access to a loan, a 10 percent increase in working capital financed by banks, an increase in loan terms by 6 months, and a 3 percent reduction in interest rates.

establishes a comprehensive regulatory framework that enables businesses to continue using their productive assets and keep them in possession while creating a pledge on them in order to access finance. The law contains innovative elements, in particular for the creation of floating liens and the covering of proceeds, but also in extending the system for security to a much broader group of movable property than in the existing legal framework. The system, which became operational on January 1, 2017, has its scope refined with the introduction of three additional regulations.<sup>26</sup> The new moveable collateral registry will enable interested third parties registered in the system through the Notaries Union of Turkey to perform registrations, amendments, cancellations and searches online. The registry for items such as inventory, account receivables and intangible assets, which were previously not required to be registered, eliminates the creation of secret liens and enables creditors to accept movables as collateral. As of late April 2017, 2,408 pledge agreements on moveable assets had been recorded in the system, securing a loan volume of TL 18 billion.

**58. The new secured transactions system could be further improved to conform more closely with international practice.** A secured transactions system can be benchmarked against several international standards. Among these are the United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide and Model Law and the Getting Credit indicator of the World Bank's Doing Business Report. Deviations from international practice, which could be addressed in designing secondary regulations, include (i) reducing and simplifying registration cost, (ii) enabling priority of payment for secured creditors in case of default and availability of out of court enforcement, and (iii) granting non-possessory security, without requiring a specific description of collateral, which can be extended to future or after-acquired assets, including the products, proceeds or replacements of the original assets.

***DPF Prior Action #8:** The Borrower, through the Board of Directors of the Turkish Railways Company, issued the first network statement to complement the Law on Liberalization of Turkish Railway Transportation, as part of the legal framework for unbundling the railway company and enabling private train operators to operate in Turkey.*<sup>27</sup>

**59. Turkey's transport sector is heavily regulated, imposing costs on the rest of the economy and generating negative externalities related to congestion, road accidents and a high carbon footprint.** In most OECD countries, regulated service sectors account for over two-thirds of the inputs used by other sectors of the economy. Transport, like other network industries in Turkey, is heavily regulated, imposing inefficiencies and costs on the rest the economy.<sup>28</sup> The 2013 OECD PMR indicators show that Turkey compares poorly with OECD

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<sup>26</sup> The Regulation on "Establishment of Commercial Pledge and Execution of Pledge Rights in the Event of a Default" provides clarity on establishment of the pledge rights, pledge systems, and right and obligations of pledgee and pledger in the event of a default. The regulation on "Registry for Pledged Movable Assets" sets the principles for the operations

<sup>27</sup> This prior action continues the SSG-DPL agenda. Triggers for a second operation would have been: (i) adoption of critical secondary legislation of the new railway law; (ii) registration of TCDD Infrastructure and TCDD Transport, (iii) allocation of staff, fixed assets, rolling stock and financial resources/liabilities between TCDD infrastructure and TCDD Trains, and (iv) TCDD issuance of a Network Statement.

<sup>28</sup> The OECD notes that limited competition in network industries slows productivity growth and innovation and recommends reducing barriers to entry in network industries (OECD, 2015, 'Economic Policy Reforms Going for Growth, Paris: OECD; and OECD, 2017, Economic Policy Reforms 2017 Going for Growth, Chapter 3 Reform Agenda for 2017: Overview and Country Notes, Paris: OECD).

countries across the board but particularly in railways regulation, where, on a scale of 0 to 6 in regulatory restrictiveness, it scores 6, indicating that no progress has been made in regulation of entry, public ownership, vertical integration and market structure. Through the Turkey Transport Strategy 2023, the Government is taking steps in deregulating the sector. The strategy aims to develop sustainable intermodal transportation options enabling a modal shift from road to lower-carbon transport modes, such as railways. As such, the Strategy is also in line with and contributes to Turkey's climate-related targets in the sector, as stated in the Climate Change Action Plan and Nationally Determined Contribution (NDC), which emphasize increasing the share of rail transport systems and ensuring balanced utilization of transport modes in freight and passenger transport. The participation of private operators in railway operations is a key vehicle for the modernization of the sector, bringing know-how and investments to better manage commercial services, rolling stock and dedicated freight logistic terminals. This can enhance the efficiency of rail freight services, allowing rail customers to benefit from higher connectivity to the railway network, additional capacity and more reliable services.

**60. The 2013 Law on Liberalization of Railway Transport and its implementing regulations are beginning to liberalize the sector in line with EU guidelines.** A first decisive step in implementing the reform was taken by the government through the Law on Liberalization of Railway Transport, which became effective in May 2013. This piece of primary legislation establishes the overarching principles for railway sector restructuring. The endpoint of the reform, in compliance with EU Directive 91-440, is to separate the infrastructure, which will remain in the public domain, from operations, which will be opened to private operators. During 2015-2016, the government issued secondary legislation aiming to define technical conditions and regulatory provisions for the reform to become operational. In June 2016, the public monopoly Turkish Railways Company (TCDD) was unbundled into two separate legal entities (infrastructure and operation) with separate financial accounts. The secondary legislation covers, *inter alia*, network statement, licensing of train operators, non-discriminatory access to infrastructure, and registration of railway vehicles, safety, and public service obligations. The issuance of a Network Statement in January 2017 constitutes a major step towards the finalization of the sector reform. The Network Statement is a document that describes the physical infrastructure, the current operational conditions, the process for reserving train paths and the adopted charging methodology for using infrastructure and ancillary services.

**61. Finalizing the reform will require strong political will and oversight from the government.** For the Government to ensure the railway reform is effective, a number of key steps remain to be achieved, including the establishment of a capable independent regulatory entity that monitors implementation and ensures a level playing field for private sector operators.

*DPF Prior Action #9: The Borrower, through the Ministry of Energy and Natural Resources issued the Regulation on the Renewable Energy Resources Areas to establish large scale renewable energy resources areas.*

**62. Establishing incentive mechanisms towards clean production, including in the areas of energy efficiency and transport, is one of the priorities of the Government, as stated in the Climate Change Action Plan 2011-2023 and in Turkey's intended NDC.**<sup>29</sup> Turkey

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<sup>29</sup> Submitted to the UN Framework Convention on Climate Change ahead of the Conference of the Parties in Paris in December 2015.

submitted its intended NDC to the United Nations Framework Convention on Climate Change (UNFCCC) committing to reduce up to 21 percent of its Greenhouse Gas (GHG) emissions by 2030 compared to a business-as-usual scenario. Considering economic development and related industrialization and urbanization trends, Turkey's total GHG emissions rose from 207.8 MtCO<sub>2</sub>e (in 1990) to 467.6 m MtCO<sub>2</sub>e (in 2014), implying that, for Turkey to achieve its climate change mitigation targets, it needs to urgently cap its emissions and return to 2010 (298.0 MtCO<sub>2</sub>e) levels by 2030. The climate change agenda provides an opportunity for “decoupling” economic growth and carbon emissions and, in this regard, Turkey intends to pursue climate actions by adopting new policies in urban infrastructure, sustainable energy, transport, and renewable energy, as well as supporting innovative technologies in these sectors. Since a majority of the GHG emissions come from the energy sector, by doing so, Turkey will sustain a decrease in GHG emission, while achieving economic targets.

**63. Turkey's energy strategy emphasizes the importance of increasing the share of renewable energy.** With almost 80 gigawatt (GW) of installed electricity generation in 2016, over 56 percent of Turkey's power plants rely on fossil fuels, which has resulted in a grid emission factor of 0.552 kg of CO<sub>2</sub>/kWh. According to projections under the 2015 National Renewable Energy Action Plan (NREAP), boosting the share of renewable energy to 30 percent would result in 47.1 million tonnes of CO<sub>2</sub> emission reductions by 2023. In early 2015, the Ministry of Energy and Natural Resources (MENR) adopted the NREAP, which calls for an increase in renewable energy generation to 30 percent, or 127 TWh, by 2023. The government has also emphasized the importance of fostering a domestic renewable energy industry to support green jobs. Current electricity policies encourage renewable energy for power generation, with preferential feed-in-tariffs (FiTs) for private developers. The FiT regime also includes incentives for use of components produced locally. As a result of these supportive policies, the share of renewable energy has increased substantially and already met the 2023 goal, rising from about 10 percent in 2012 to 30 percent in 2016. This rapid rise in renewable energy capacity (about 34 GW) has created an estimated 94,400 jobs in the renewable energy sector, which is steadily increasing as the market continues to develop. A majority of these jobs are in the wind and solar sectors (53,000 and 29,300, respectively). In the solar heating market alone, Turkey has 90 manufacturers, 700-800 retailers, and more than 3,000 system installers, who all together provide 20,000 direct and indirect jobs.

**64. Adoption of a regulation to support renewable energy zones will introduce renewable energy auctions.** The Ministry of Energy and Natural Resources issued the Regulation on the Renewable Energy Resource Areas (RERA) in the Official Gazette (dated October 9, 2016 and no. 29852). The regulation embodies a key policy instrument for helping Turkey to meet its ambitious renewable goals by streamlining procedures for renewable energy permits and licenses, financing and operations. In addition, the regulation establishes large scale renewable energy resource areas (RERAs) aimed to foster efficient use of renewable energy resources, promote renewable energy investments by the private sector and increase the use of domestically produced equipment through technology transfer. There is growing consensus that renewable energy auctions offer a better way to drive down prices for renewable energy technologies and systems than traditional schemes like portfolio standards and FiTs because

large-scale auctions create substantial competition among suppliers and developers.<sup>30</sup> The auction will thus be contributing to the renewable energy targets and employment generation goals at a much lower cost to electricity customers than the FiT regime offered. The first solar auction under one of the renewable energy zones established under the regulation is expected to result in CO<sub>2</sub> emission reductions of almost 950,000 tons.

65. **In the near future, renewable energy development in Turkey will be scaled up.** The second auction under the RERA regulation will be for about 1,000 megawatt (MW) of wind power. The tender was announced in April 2017 and bids are due in late July 2017. Beyond that, Turkey aims to increase the number of renewable energy zones substantially in the next few years. For solar, Karaman and Nigde are likely the next candidates for RERAs, with an estimated resource potential of about 800 MW.

**Table 5: DPO Prior Actions and Analytical Underpinnings**

Prior actions	Analytical Underpinnings
<b>Pillar A: Increasing Domestic Savings and Enhancing Fiscal Transparency</b>	
<b>Prior action #1</b> The Borrower enacted the Law on Amending the Private Pension Savings and Investment System Law, specifically with respect to the introduction of auto-enrollment in the private pension system.	<i>The World Bank Technical Assistance (TA) for enhancing the regulation, supervision and coverage of private pensions to contribute to a secure, sustainable and efficient pension system in Turkey via Pension Supervision, Regulation and Development (FIRST project) (P151028).</i>  <i>Recommendations to introduce a new auto-enrollment system for building a more diversified pension system for Turkey and increasing long-term savings.</i>
<b>Prior action #2</b> The Borrower, through the Turkish Court of Accounts, submitted to Parliament in 2016 audit reports (for the year ending in December 2015) comprising individual financial statements for all general budget institutions in accordance with the Law on Turkish Court of Accounts.	<i>The World Bank, 2012. Strengthening TCA's Audit: Audit Strategy for the Period 2013-2017 under TA via Strengthening Turkish Court of Accounts Project (P128598). The World Bank, 2014. Turkey's Transitions: Integration, Inclusion, Institutions, Report No: 90509-TR.</i> <i>Recommendations to introduce TCA-produced performance and financial audits that provide a basis for holding all public entities to account.</i>
<b>Pillar B: Supporting the Economic Inclusion of Vulnerable Groups</b>	

<sup>30</sup> This is evidenced by the first solar photovoltaic auction in the RERA in Karapinar. While the existing FiT for solar is 13 US¢/kWh, with up to 20 US¢/kWh for projects with locally produced equipment, the first solar auction for 1,000 MW (concluded in March 2017) resulted in a winning bid of only 6.99 US¢/kWh. The solar photovoltaic modules are required to meet a minimum threshold of 60 percent local equipment and, as a result, the winning bidder agreed to manufacture the modules in Turkey by end 2018.



<p><b>Prior action #3</b> The Borrower enacted the Law on Supporting Investments on Project Basis and Amending Various Laws and Decrees, specifically with respect to the introduction of tax incentives for private nursery schools (crèches) through amendments to the Income Tax Law.</p>	<p><i>The World Bank, 2013. A Review and Analysis of International Childcare Programs: Inputs for MoFSP Turkey. The World Bank, 2014. Laws and Regulations Governing Private and Community-Based Childcare in Mexico and Turkey. The World Bank, 2015. Supply and demand for childcare services in Turkey: a mixed methods study. The World Bank, 2015. Ex-Ante Policy Evaluation of Supply and Demand Side Childcare Subsidies in Turkey: Estimating Impact on Capacity, Utilization, Female Employment and Fiscal Space. Farre, Lidia, 2013. Critical literature review on part-time labor policies and other policy packages impact on female labor force participation. Greulich, Angela; Dasre, Aurélien; Inan, Ceren, 2015. Fertility transition in Turkey—who is most at risk of deciding against child arrival?, Policy Research Working Paper No: WPS 7310.</i></p> <p><i>Recommendations to expand child-care services for all working mothers and fathers by promoting an expansion of supply and subsidizing demand; increase protections and flexibility (hours and others) for working mothers to prevent them from leaving the labor market; and work with employers to reduce discrimination and biases against women.</i></p>
<p><b>Prior action #4</b> The Borrower enacted the Law on Amending the Labor Law and ISKUR Law, specifically with respect to making labor market programs more flexible through the introduction of various work contract modalities.</p>	<p><i>Good Jobs in Turkey Report (2014), Creating Good Jobs Report (2016), Measuring the quality of Jobs in Turkey (2016), Activation of Vulnerable Populations (2014), Various assessments of the ISKUR, Assessment of ISKUR service delivery undertaken for the planning of a pilot project “Socio-Emotional Skills”.</i></p> <p><i>Recommendation to review the labor code to reduce barriers to formal employment, including the introduction of more flexible work arrangements, improve the effectiveness and efficiency of public employment services, especially skills training, active labor market programs, and strengthen school-to-work transition, introduce incentives and mechanisms for employers to reduce informal labor.</i></p>
<p><b>Prior action #5</b> The Borrower, through its Council of Ministers, issued a communique on the introduction of work permits for foreigners under temporary protection, pursuant to the Council of Ministers’ Decision No. 2016/8375, to support the inclusion of said persons in the Turkish labor market.</p>	<p><i>Multi-sector policy brief “Turkey’s Response to the Syrian Refugee Crisis and the Road Ahead” (2015). Impact of Syrians Under Temporary Protection on the Turkish Labor Market (2015). Workshop: Work permit workshop Germany model (November 2015). Workshop: Mechanisms for designing a foreign labor supply and demand system United Kingdom Model (November 2015)</i></p> <p><i>Recommendation to introduce formal work permits for foreigners under temporary protection, identify and introduce mechanisms for assisting the most vulnerable Turkish population (who may compete with foreigners under temporary protection in the labor market) are in</i></p>

	<i>place and introduce a mechanism for identifying labor supply needs and labor demand needs for better migration management.</i>
<b>Pillar C: Addressing Structural Bottlenecks to Sustainable Growth</b>	
<b>Prior action #6</b> The Borrower enacted the Law on Industrial Property, specifically with respect to the establishment of a more sophisticated system for the protection and enforcement of industrial property rights through incentives for inventors to obtain patents for inventions, the provision of improved support for research and development activities, and the regulation of patents, utility models, trademarks, industrial designs and geographical indications.	<p><i>The World Bank, 2014. Trading up to High Income, Report No: 82307-TR. The World Bank, 2014. Trade Competitiveness of Turkey, Unpublished Background Paper for Turkey Country Economic Memorandum. The World Bank, 2015. The Relationship Between Firm Innovation and Exporting in the Turkish Manufacturing Industry under Programmatic TA for Business Environment and Innovation (P152536). The World Bank, 2016. Policy Note on Innovation under Programmatic TA for Business Environment and Innovation (P152536). Atiyas, I., Bakis, O., 2015. Identifying the Links between Innovation and FDI Flows in Turkey.</i></p> <p><i>Recommendations to improve the enabling legislation and the coordination of various R&amp;D and innovation support programs provided by different government bodies to increase their efficiency.</i></p>
<b>Prior action #7</b> The Borrower enacted the Law on Moveable Collateral in Commercial Operations, specifically with respect to the enablement of small- and medium-sized enterprises to obtain access to credit through the use of moveable assets as collateral.	<p><i>“Diagnostic: Secured Transactions System in Turkey” (January 2015). This report was one of the outputs under the Financial Deepening and Financial Inclusion Technical Assistance Project.</i></p> <p><i>Recommendations included: (i) introduction of a legal and regulatory reform to ensure establishment of a comprehensive and integrated framework that treats all types of non-possessory interests in movables on equal terms, (ii) creation of a modern collateral registry, and (iii) introduction of an awareness and communication strategy targeting the financial sector to ensure that the financial sector utilizes the new system most effectively.</i></p>
<b>Prior Action #8</b> The Borrower, through the Board of Directors of the Turkish Railways Company, issued the first network statement to complement the Law on Liberalization of Turkish Railway Transportation, as part of the legal framework for unbundling the railway company and enabling private train operators to operate in Turkey.	<p><i>The World Bank, 2014. Turkey’s Transitions: Integration, Inclusion, Institutions, Report No: 90509-TR. The Ministry of Development, 2013. Tenth Development Plan 2014-2018. TA for Sustainable, Efficient and Safe Transport for Turkey, EU instrument for Pre-Accession Assistance (IPA-2), Turkey, 2015.</i></p> <p><i>Recommendations to improve efficiency by promoting competition and private sector participation in the railways sector.</i></p>
<b>Prior Action #9</b> The Borrower, through the Ministry of Energy and Natural Resources issued the Regulation on the Renewable Energy Resources Areas to establish large scale renewable energy resources areas.	<p><i>Turkey National Climate Change Action Plan (2011-2023). Adoption of this Action Plan was one of the prior actions in Turkey Third Programmatic Environmental Sustainability and Energy Sector Development Policy Loan. The World Bank, 2015. Turkey’s Energy Transition: Milestones and Challenges</i></p>

	<i>Recommendations to improve the security of energy supply e.g. through increasing share of indigenous and renewable resources in the electricity generation.</i>
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## **LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY**

66. **The proposed DPF contributes to the realization of the objectives of the Turkey Country Partnership Framework (CPF) for the period FY17-21.** The CPF is planned to be presented to the World Bank’s Executive Board at the same time as the DPF. The proposed DPF supports several objectives of the CPF, including: (i) increased fiscal space; (ii) enhanced access to finance to underserved segments; (iii) enhanced competitiveness and employment in selected industries; and (iv) increased labor force participation of women and vulnerable groups.

67. **A number of prior actions in the proposed DPF support progress towards the twin goals of ending extreme poverty and promoting shared prosperity in a sustainable manner.** Policy actions supported by the operation will encourage greater inclusion of women and refugees in the workforce, reduction in informality of labor and increasing the domestic saving rate.

68. **The SCD ‘Turkey’s Future Transitions’ was completed and disclosed in March 2017.** The SCD investigates poverty reduction and shared prosperity, engines of growth and challenges to sustainable growth. The proposed DPF tackles a number of constraints identified in the SCD’s analytical framework, including: (i) low quality of regulatory and accountability institutions, (ii) low female labor force participation and (iii) low performance in technology adoption and innovation.

## **CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS**

69. **The authorities have carried out consultations with stakeholders on each of the policy reforms supported by this operation.** Turkey has its own participatory processes underpinning policy formulation. Government policy is informed by regular consultation with stakeholders in various fora. Groups involved in this process include unions, employer organizations, chambers of commerce and industry, civil society organizations, academics, and private sector representatives. For instance, for the introduction of the auto-enrollment in the private pension system, in the year preceding enactment of the new legislation, the Government consulted with the industry in both formal and informal events, including public ministerial events, academic conferences on technical areas and a range of private meetings and seminars (including with overseas experts) to investigate different options and to explain the planned approach. In the case of long-term policy formulation in strategic areas, the government uses the preparation of the development plan as a consultation platform. Consultations on improving the investment climate have been conducted since 2001 under the platform of the Coordination Council for the Improvement of the Investment Environment. The legislative process in Turkey requires ensuring participation of all public stakeholders during the preparation of any draft legislation.

70. **The Bank has coordinated closely with the IMF on this program.** As discussed in the IMF Relations section, the staff of the World Bank and IMF collaborate closely, with exchanges on macroeconomic, fiscal, and structural reforms. The IMF’s most recent Stand-By Arrangement for Turkey was completed successfully in May 2008. The latest Article IV was completed in February 2017 and the next Article IV mission is planned for mid-October.

71. **The European Commission (EC) and the World Bank launched an initiative in 2010 seeking to increase opportunities for synergies in working with the Turkish authorities.** Areas of close collaboration include energy reforms, female employment, the business climate, foreign trade and Syrian refugees. The World Bank also maintains a close dialogue and collaboration with United Nations Children’s Fund (UNICEF) and United Nations Development Program (UNDP) in Turkey. Within the WBG, IBRD, International Finance Corporation (IFC), and Multilateral Investment Guarantee Agency (MIGA) maintain a close dialogue including in energy, transport and private and financial sector development areas.

## **5. OTHER DESIGN AND APPRAISAL ISSUES**

### **POVERTY AND SOCIAL IMPACT**<sup>31</sup>

72. **The policy actions supported by this DPF are expected to have overall positive poverty and social impacts.** The reforms supported by the RIG-DPF cover a wide array of policy areas, addressing a diversity of challenges and also reaching different kinds of beneficiaries. While the background paper on Poverty and Social Impact Assessment (PSIA, World Bank 2017) analyzes in detail implications of each one of the DPF-supported policies, from private pensions to access to finance, the overall finding of the analysis is that the package of reforms is likely to yield positive social and poverty impacts.

73. **Auto-enrollment is expected to have a generally positive impact on poor households.** Low-income contributors in Turkey are expected to benefit from the new policy. As per the assessment of the PSIA, 0.5 percent of private pension contributors earn less than the minimum wage, and 31 percent of contributors have earnings of between 1 to 2 minimum wages. While these are low baselines, it is likely that the number of low income earners enrolled in the private pension system will increase with the implementation of the new default option. Although individuals can opt-out of the private pension system two months after auto-enrolled, international evidence shows that opt-out rates are low, and lower than originally predicted (PSIA, World Bank 2017). The net impact on coverage of private pensions of the overall and poor population will ultimately depend on the take-up behavior of auto-enrolled individuals. The automatic enrollment scheme will also provide an opportunity for people in lagging regions to increase their participation in the private pension system.<sup>32</sup> Turkey’s current challenge is to increase coverage and protection of those not affected by the auto-enrollment default. The prior action currently affects workers in the formal sector, leaving out workers in the informal sector, workers older than 45, and the unemployed and inactive population. Finally, low contribution amounts may not secure an adequate retirement pension. Moreover, since the contributions and state subsidies are a proportion of earnings, high income workers will receive a larger subsidy in absolute terms.

74. **Increased supply of childcare is expected to have a positive but limited effect on female labor force participation.** A simulation of the impact of the tax exemption shows that

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<sup>31</sup> This section is based on the Poverty and Social Impact Assessment (PSIA) for the Resilience, Inclusion and Growth Development Policy Financing (World Bank, 2017).

<sup>32</sup> Poverty incidence is the highest Southeast Anatolia (Güneydogu Anadolu) and East Anatolia (Dogu Anadolu) regions. The share of contributors in these two regions are less than 7 percent of all contributors based on the 2015 data.

the policy has good potential to increase childcare supply,<sup>33</sup> leading to a 7 percent increase in the enrollment for children aged 3-5. However, given that the policy is not focused on reducing setup and regular costs for the centers, the change in fees is estimated to be negligible. Among households in the bottom 40 percent of the income distribution the enrollment rate is estimated to grow by only 3 percent (less than half than the average for all income groups). The reform is likely to increase women's employment by alleviating time constraints of mothers of children enrolled in the new services and by creating jobs in the new centers. However, the overall impact in terms of female employment is likely to be limited in line with the low fiscal cost. Going forward, while supply-side subsidies help expand access to child care services, complementary measures are needed to make those services affordable for low-income households.

**75. The package of active labor market policies, including flexible work arrangements and reforms aimed at reducing labor costs for employers can positively affect youth and female employment.** The incidence of young workers aged below 25 on total firm's workforce is slightly higher in low-paying firms and SMEs. The data suggests that government incentives might have a positive effect on youth employment, particularly in low-wage firms. However, the effect on youth employment in the total economy might not be as strong as expected, since almost 30 percent of the total workforce is concentrated in firms where the demand for young workers seems relatively lower (i.e. high-wage firms). Positive effects are also expected on female employment, although the share of women in total employment varies little across low-paying and high-paying firms. Flexible work modalities would be an important complement to other recent government policies aimed at reducing labor cost.

**76. Allowing workers under temporary protection to work in the formal sector mitigates the crowding out effect that refugees have on Turkish informal workers in host communities.** Syrians are overwhelmingly employed informally, making their arrival a contributing factor to the increase in informal labor in Turkey. The introduction of work permits for SuTPs in January 2016 is a positive step for formalizing their employment. The impact of SuTPs on locals has been largescale displacement of natives, particularly low educated workers and women, in the informal sector, with these subgroups experiencing declining earning opportunities. On the positive side, the increased demand for goods and services linked with the presence of refugees offsets some of the negative effects and creates new employment opportunities, with Syrian companies established in Turkey representing up to one-quarter of new companies. Socio-economic integration is less likely to happen through mainstream labor market programs unless conflict resolution mechanisms and social cohesion measures are in place for SuTP and host communities.

**77. Supporting access to finance for SMEs through the action on moveable collateral is likely to have a beneficial impact on job creation for workers in the bottom end of the wage distribution.** Micro-small and small-medium enterprises account for over two-thirds of total employment in registered firms in Turkey. In addition, the majority of employees in small-medium enterprises, especially micro-small, are paid very close to the statutory minimum wage. SMEs are also a good source of employment for youth and women, two relatively disadvantaged groups in the labor market. While existing SMEs may expand their workforce and create more

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<sup>33</sup> The PSIA 2017 states that in the 5-year period that the exemption is scheduled to last, the existing capacity of private child care centers would increase by 25 percent.

jobs and new SMEs may be created and enter the market, it is not clear *a priori* that greater access to credit will lead to the creation of better jobs. It would also be appropriate to monitor to which extent easing access to credit for SMEs can result in an increased systemic risk. In fact, while providing financing to SMEs under the new moveable collateral regime can become more attractive for the banking sector, at the same time banks can become more exposed to SMEs' risk of default.

**78. The unbundling and liberalization of TCDD is expected to benefit rail customers from higher connectivity to the railway network, and no socially adverse impacts are expected.** Liberalization and unbundling is likely to introduce greener transport modes with more efficient transportation options and, according to government plans, no labor retrenchment is envisaged. Some reallocation of staff between railway services is expected,<sup>34</sup> but this will not impact employees' rights and status. It is recommended that this action be monitored during supervision.

**79. Increasing the use of renewable energy brings economic and environmental benefits for the bottom 40 population and for society as a whole, with potential indirect adverse effects through land-take.** The new regulation is strengthening support for renewable energy through the establishment of renewable energy zones and renewable energy auctions. The auction modality will be contributing to renewable energy targets and green employment generation at a much lower cost to electricity customers than the existing FiT regime. Access to lower cost renewable energy systems will also help improve the competitiveness of local manufacturing, which now bears relatively high energy costs. However, the action may lead to re-purposing of large land surfaces, with a potentially negative impact on the livelihoods of the population currently using the land. It is important that there are guidelines in place for investors to avoid or minimize such environmental and social impacts of renewable energy investments. Currently MENR is developing guidelines for renewable energy investments, with the support of World Bank technical assistance.

## ENVIRONMENTAL ASPECTS

**80. The prior actions identified in the DPF are not expected to have any direct or significant negative environmental impacts.** Unbundling and liberalization of TCDD may have limited direct implications for greening the transport sector of Turkey. With the assumption of more efficient operation of railways, it can be expected that the railways sector will have a slightly larger share in the transportation network, which can be assumed to have positive environmental impacts. The regulation on the Renewable Energy Resource Areas is expected to speed up the applications and permits in the renewable energy sector, which will help Turkey to diversify its energy supply with renewables and is expected to have a positive impact on the environment. An important issue to follow up is the implementation of environmental impact assessment regulation and other related environmental legislations to ensure that the environmental impacts of the renewable energy projects are mitigated and biodiversity is conserved. The World Bank is assisting the Government in addressing these concerns and the

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<sup>34</sup> According to technical discussions between TCDD and World Bank Transport team and the public statement by Labor Unions in Railway Sector: <http://www.turkulasimsen.org/sayfa/index.php/2016/06/09/tcdd-calisanlarina-duyuru-tcddnin-yeniden-yapilandirilmasi-ile-ilgili-toplanti-yapildi/>

Government is preparing guidance notes to renewable energy project developers on environmental and social impacts and mitigation measures.

81. **The Government of Turkey has an environmental law and relevant environmental management regulations in place.** The environmental impact assessment and environmental management regulations have been designed to be in line with EU directives. However, these regulations are evaluating the impacts at the project scale and have limited influence on plans and policies. The Ministry of Environment and Urbanization has been working on a Strategic Environmental Impact Assessment Regulation. A draft has been prepared but legislation has not been enacted. When in force, the regulation will require government agencies to evaluate the environmental impacts during the planning phase.

## **PFM, DISBURSEMENT AND AUDITING ASPECTS**

82. **Turkey's legislative and institutional framework relating to public financial management is aligned with international good practices.** The public financial management (PFM) regulatory framework introduced through the Public Financial Management and Control Law (PFMC) in 2005 defines the principles, rules and structures for Turkish PFM systems including budget formulation and execution, financial and internal control systems, and internal and external audit structures. Turkish authorities express commitment to good and complete implementation of the PFMC, which brings about increased managerial accountability for physical and financial performance and results.

83. **The budget approved by the Parliament and related execution reports are publicly available on the Ministry of Finance (MOF) website.** The budget process is well developed and regulated by law, and orderly processes are followed in annual budget development. Each year, budgets and indicative targets for the following two years are prepared according to the functional, economic and institutional classifications defined under the PFMC Law. The PFMC Law has provided a framework for enhanced accountability, internal control and internal audit mechanisms at the institutions. As per the December 2016 Update of the Open Budget Survey Document Availability Tracker, Turkey made seven of the eight key budget documents available to the public in a timeframe consistent with international standards. The survey assessment states that Turkey could reach greater budget transparency by publishing the Pre-Budget Statement in a timely manner.

84. **The regulatory framework for public internal financial control is in place.** The central harmonization unit for Financial Management and Control (CHU-FMC) and the Internal Audit Coordination Board (IACB) published secondary and tertiary regulations to guide the implementation of PFMC for internal control and internal audit. However, there are continuing implementation challenges. Two major constraints for effective implementation are the lack of ownership and awareness at the administrations with respect to their responsibility in setting up internal control and risk management systems, as well as the lack of technical capacity to fulfill the requirements of the regulations. The CHU-FMC and IACB provide extensive learning events for public administrations and internal auditors respectively to address these challenges and to provide the necessary technical knowledge to the stakeholders for enhancing the internal controls and improving the effectiveness of the internal audit function.

## *Accounting*

85. **An automated online accounting system has been up and running since 2002.** A distinctive feature of the accounting system in Turkey is that MOF maintains the accounts of general budget institutions, i.e. ministries, and executes their payments through MOF accountants located on-site. The automated system supports general budget operations and reporting needs. Until 2016, the design of the accounting system did not enable preparation of financial statements on a line ministry basis and the MOF was preparing aggregated financial statistics for the general budget institutions. From 2016 onwards, the MOF started generating individual financial statements for general budget institutions.

86. **The accounting system at the general government level does not have an integrated system to monitor contracts, commitments and payables.** As a result, commitments are not fully and systematically captured. MOF is continuing to invest in improving the modules for commitment control and monitoring for capital expenditures funded from the general budget, as well as current expenditures, but these modules are not yet operational. The accounting system collects information at the payment order stage. Each ministry is responsible for monitoring and managing its commitments and accounts payable, with the MOF accountants processing payment orders. The Bank is providing technical assistance to the MOF to improve their commitment module.

## *Procurement*

87. **Turkey has moved decisively to upgrade its public procurement legislation and the existing legal framework is in compliance with international standards.** The current Public Procurement Law (PPL) has moved Turkey in the direction of compliance with EU standards, with an independent Public Procurement Agency overseeing public procurement and ensuring enforcement of procurement standards. The MOF is responsible for coordinating policy formulation and implementing public procurement. Turkey has achieved much progress in improving the legislative, regulatory and institutional framework for procurement, and in ensuring the integrity of the national public procurement system. An e-procurement platform (EKAP) was launched in 2010. It allows free access to economic operators for procurement notices and bidding documents, and electronic bid submission has been initiated for framework contracts in 2013. Nevertheless, exclusions and exemptions from the PPL are reducing the effectiveness of the existing public procurement system. Further improvements in public procurement are needed, including: (i) eliminating restrictions in the form of thresholds and preferences for participation by international bidders;<sup>35</sup> (ii) reducing the frequency of use of exceptions;<sup>36</sup> and (iii) streamlining the complaint review mechanism. New procurement legislation for the public utilities sector, including SOEs operating in relevant sectors, would help minimize exceptions from the PPL.<sup>37</sup> Turkey remains an observer in the World Trade Organization's Government Procurement Agreement Committee.

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<sup>35</sup> Public Procurement Agency 2016 Statistics show that around 74 percent of the total amount of public procurement contracts was open to foreign bidders and in 42 percent of these procurements a preference applied to national bidders/manufactured goods.

<sup>36</sup> The share of exceptions in the total public procurement amount was 8.17 percent in 2016.

<sup>37</sup> While there has been a working draft of a new public utilities procurement legislation to improve operational efficiency consistent with the relevant EU directive, it has not moved forward since 2009.



## *Auditing*

88. **The new TCA Law has expanded the scope of audits and introduced financial audit into the TCA mandate.** The law has significantly increased the number of reports to be submitted to the TGNA. It requires submission of the following four combined audit reports in addition to the statement of general conformity, which was the main report submitted to the TGNA traditionally.<sup>38</sup> These new reports are: (i) External Audit General Evaluation Report, (ii) Accountability General Evaluation Report, (iii) Financial Statistics Evaluation Report, and (iv) Reports on State Owned Enterprises. Additionally, TCA is required to conduct regularity audits (financial and compliance) and submit audit reports on the financial statements for relevant institutions.

89. **The new financial reporting and auditing requirements have led to some implementation challenges for the TCA as well as to the audited institutions.** MOF, responsible for keeping the accounts of general budget institutions (mainly ministries) and preparing and submitting the institutional financial statements to the management of such institutions, had not been able to generate financial statements for the year ended December 31, 2012. Even though TCA submitted institutional audit reports for central government and social security institutions, they issued disclaimers of audit opinions on general budget institutions, as they were not able to receive the ministerial financial statements. To address this issue, the TCA issued secondary legislation whereby MOF was provided a three-year transition period covering 2013, 2014 and 2015 for the preparation of ministerial financial statements. MOF provided the ministerial financial statements for 2015 to TCA, one year in advance of the proposed transition period. Consequently, TCA conducted the audit of general budget institutions and these audit reports, with the financial statements for the year ended December 31, 2015, are available on the TCA website.

90. **Reports submitted by the TCA are discussed at the Plan and Budget Committee during the budget discussions and most reports are available on TCA's website.** There is not a dedicated public accounts sub-committee at the Turkish Grand National Assembly and budget discussions usually take precedence in the parliamentary discussions at the Plan and Budget Committee. TCA reports are published on the institutional website. In the past, the audit reports of the State-Owned Enterprises were also made publicly available. These are currently not available in TCA's website as it has been assessed that the legal mandate of publishing such statements lies with the TGNA's State-Owned Enterprises Committee.

## *Foreign Exchange Control Environment*

91. **The latest safeguards assessment of the Central Bank was conducted by the IMF in June 2005 and did not uncover any material weaknesses in the Central Bank's safeguard framework.** The audit reports by independent auditors on the financial statements of the Central Bank provided clean audit opinions for 2012-2016. Past audits and generally positive assessments by the IMF indicate that there are no strong reasons for requiring additional safeguards, such as audit of the deposit account.

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<sup>38</sup> The word 'combined' was preferred instead of 'consolidated' since the latter is an accounting term which may be misleading in the context here.

## DISBURSEMENT AND AUDITING

92. **Disbursement and Implementation Arrangements.** The proposed loan will follow the Bank's disbursement procedures for DPFs. The untied finances will be disbursed against satisfactory implementation of the program and not tied to any specific purchases and no procurement requirements will be needed. Upon approval of the loan and notification by the Bank of Loan effectiveness, the Government will submit a withdrawal application. At the request of the Undersecretariat of Treasury, the IBRD will deposit the proceeds of the loan in the Undersecretariat of Treasury's account at the Central Bank, which will form part of the official Foreign Exchange reserves of the country. The Government will utilize the proceeds of the loan in foreign currency for either foreign debt servicing or for crediting the local currency equivalent into the treasury single account for financing budgeted expenses. Prior to that, the Borrower will pay a front-end fee amounting to 0.25 percent of the loan amount from its own resources. If, after deposit in this Central Bank account, the proceeds of the loan are used for ineligible purposes (for example, for goods or services on the IBRD standard negative list), the IBRD will require the Borrower to refund the amount directly to the IBRD, and the IBRD will cancel an equivalent undisbursed amount of the loan.

93. **Accounts, Auditing and Closing Date.** The administration of this loan will be the responsibility of the Undersecretariat of Treasury. The government will maintain accounts and records, or ensure that such items are maintained, showing that loan disbursements were in accordance with provision of the Loan Agreement. Given the IMF's positive assessment of the Central Bank, an audit of the deposit account for the proceeds of the loan is not considered necessary; however, IBRD reserves the right to request the audit of the deposit account if required. The Undersecretariat of Treasury will provide the Bank within 30 days a confirmation letter stating that the DPF funds have been received and deposited in the Undersecretariat of Treasury's account assigned by the Borrower that forms part of the Borrower's budget management system. The closing date of the loan will be August 29, 2018.

## MONITORING, EVALUATION AND ACCOUNTABILITY

94. **The specific expected results indicators, set out in Annex 1, will be used to monitor the implementation of the operation.** The Bank, in collaboration with the Turkish Authorities, will monitor and evaluate the program's achievement of these results.

95. **The Undersecretariat of Treasury will be responsible for coordinating among other relevant ministries and agencies.** Several other agencies are involved in the implementation of the reform program being supported by the DPF program, including the Ministry of Science, Industry and Technology, the Ministry of Labor and Social Security, the MOF, the Ministry of Family and Social Policies, the Ministry of Transport, the Ministry of Customs and Trade, TCDD, and TCA. Arrangements for monitoring results indicators are unchanged relative to previous DPLs and it is expected that coordination of monitoring and program implementation will remain adequate, and data collection timely.

96. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals

may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of the World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org).

## 6. SUMMARY OF RISKS AND MITIGATION

97. **The overall risk to the proposed operation is substantial.** Risks to the proposed DPF have been assessed using the Standardized Operations Risk-rating Tool (SORT), as summarized in Table 6. The main risks to the proposed program's outcomes are (i) political and governance risks, (ii) macroeconomic risks, and (iii) implementation risks.

98. **Political and governance risks.** A heavy domestic political calendar - including two local elections, two general elections, a presidential election and a constitutional referendum - was concluded in April 2017, reducing political uncertainty. Progress on key structural reforms is expected to gain momentum in the medium-term and be given precedence over political campaigning in the Government's agenda until 2019, when the next local, general and presidential elections are planned to take place. The geopolitical turmoil in the region and its implications for the east and south-east of Turkey, however, may slow down the progress on structural reforms in the short-term. Potential spillover effects due to the political instability in the neighboring region may pose a risk to the business climate. In this context, the Government's request for Bank support on reforms that enhance resilience, inclusion and productivity could send important signals to investors. An additional risk is represented by concerns regarding the rule of law that are being raised domestically and internationally in relation to some measures introduced as part of the state of emergency that is currently in force in the country.

99. **Risk Mitigation.** The stand-alone nature of the proposed DPF reduces the impact of political and governance risk for the supported policy agenda. The WBG, together with other development and private sector partners, will continue to monitor these risks closely and modify country engagement through the CPF to help address economic issues that arise out of this context, where its mandate and expertise warrant it.

100. **Macroeconomic risks.** Turkey showed remarkable resilience to exogenous shocks in 2016, yet persisting internal and external imbalances make Turkey dependent on external financing and thus vulnerable to changes in the global investment environment. As described above, there are several risks to the macroeconomic framework: (i) risks of reversal of the external capital flows in light of dependence of non-financial corporations on short-term capital inflows and their large open foreign exchange position; (ii) a higher than expected depreciation of the lira may impact the banking sector negatively through defaults of corporates with sizeable foreign exchange exposures, while the recent increase in guarantees provided by the Credit Guarantee Fund has put additional pressures on the banking sector; (iii) contingent liabilities and growth in quasi-fiscal activities that may put pressure on fiscal and debt sustainability in the medium term; (iv) external risks related to the geopolitical situation in the region that may result in reduction of external financing flows and decline in demand from the main trading partners; and (v) economic governance risks that may result in deterioration in macro balances.

101. **Risk Mitigation.** The Government has indicated that structural reform to boost confidence will be a key priority. The WBG, together with the IMF, will closely monitor developments. In addition, the WBG will step-up its TA and advisory program to bolster macroeconomic resilience and help the government to respond to emerging vulnerabilities. The WBG's engagement with the relevant counterparts on the implementation of the Financial Sector Assessment Program's (FSAP) recommendations affirmed the government's interest to advance this agenda with the support of technical assistance through close coordination with the IMF. Ongoing operations in the financial sector can be restructured, where relevant and feasible, to address emerging challenges, and new credit lines can be extended. Given expected increased pressure on the lira on the back of Turkey's high external exposure, IFC will promote currency swaps for real sector clients, PPP investments, and municipalities with large open foreign-exchange positions. In addition, IFC will closely coordinate with MIGA to respond to commercial lenders' increasing demand for risk guarantees. IFC will also stand ready to support banks to strengthen their regulatory capital.

102. **Implementation risks.** Some of the reforms supported by the proposed DPF are challenging and several of the newly initiated reforms require time to become fully effective. Successful implementation will require strong coordination and monitoring. Institutional capacity for reform implementation and sustainability may be affected due to coordination issues and institutional restructuring. Delays in decision-making have recently resulted in slowing reform implementation. These factors could exacerbate the intergovernmental coordination challenges, and have an impact on policy direction and on the sustainability of the reform agenda.

103. **Risk Mitigation.** Strong policy dialogue on the scope of this DPF through knowledge products is expected to mitigate implementation risks. Existing or upcoming capacity-building projects targeted at stronger coordination and monitoring are expected to contribute to addressing implementation challenges. A positive factor in this context is the government's continued desire to implement its development plan, which is in line with the DPF agenda. The institutions with which the WBG works have traditionally been strong.

104. As highlighted in the PSIA section, the poverty and shared prosperity impacts of policy measures supported under this DPF are expected to be positive. There are no significant risks arising from the program support on Turkey's environment, forests, water resources, habitats or other natural resources.

<b>Table 6: Summary Risk Ratings</b>	
<b>Risk Categories</b>	<b>Rating (H, S, M or L)</b>
1. Political and governance	Substantial
2. Macroeconomic	Substantial
3. Sector strategies and policies	Moderate
4. Technical design of project or program	Low
5. Institutional capacity for implementation and sustainability	Substantial
6. Fiduciary	Low
7. Environment and social	Moderate
8. Stakeholders	Moderate
<b>Overall</b>	Substantial

## ANNEX 1: POLICY AND RESULTS MATRIX

Prior Action	Status of the prior Action	Expected Results
<b><i>Pillar A – Increasing Domestic Savings and Enhancing Fiscal Transparency</i></b>		
<b>Prior action #1</b> The Borrower enacted the Law on Amending the Private Pension Savings and Investment System Law, specifically with respect to the introduction of auto-enrollment in the private pension system.	The Law no: 6740 on Amending the Private Pension Saving and Investment System Law no 4632 was published in the Official Gazette dated August 25, 2016 - no.29812.	<i>Increase in coverage of employees in the auto-enrollment private pension system</i>  <i>Baseline 0 (2016)</i> <i>Target 2,000,000 (2018)</i>
<b>Prior action #2</b> The Borrower, through the Turkish Court of Accounts, submitted to Parliament in 2016 audit reports (for the year ending in December 2015) comprising individual financial statements for all general budget institutions in accordance with the Law on Turkish Court of Accounts.	TCA conducted the financial audit of the general budget institutions and published the audit reports in its website.	<i>Availability of the TCA financial audit reports of the General Budget Institutions with financial statements</i>  <i>Baseline: 0 (2016)</i> <i>Target: 45 (2018)</i>
<b><i>Pillar B – Supporting the Economic Inclusion of Vulnerable Groups</i></b>		
<b>Prior action #3</b> The Borrower enacted the Law on Supporting Investments on Project Basis and Amending Various Laws and Decrees, specifically with respect to the introduction of tax incentives for private nursery schools (crèches) through amendments to the Income Tax Law.	The Law on Supporting Investments at the Project Level and Amending Various Laws No: 6745 was issued in the Official Gazette dated September 7, 2016 - no.29824.	<i>Increase female labor force participation rate</i>  <i>Baseline: 32.5 percent (2016)</i> <i>Target: 34.9 percent (2018)</i>  <i>Expansion of childcare provision capacity (net enrollment rate)</i>  <i>Baseline: 35.5 percent (2016)</i> <i>Target: 40 percent (2018)</i>

<p><b>Prior action #4</b> The Borrower enacted the Law on Amending the Labor Law and ISKUR Law, specifically with respect to making labor market programs more flexible through the introduction of various work contract modalities.</p>	<p>The Law Amending Labor Law and Iskur Law no: 6715 was issued in the Official Gazette dated May 20, 2016 - no.29717.</p>	<p><i>Reduction in unregistered female employment</i></p> <p><i>Baseline: 44.3 percent (2016)</i> <i>Target: 40 percent (2018)</i></p> <p><i>Increase youth labor force participation</i></p> <p><i>Baseline: 42.4 percent (2016)</i> <i>Target: 44 percent (2018)</i></p>
<p><b>Prior action #5</b> The Borrower, through its Council of Ministers, issued a communique on the introduction of work permits for foreigners under temporary protection, pursuant to the Council of Ministers' Decision No. 2016/8375, to support the inclusion of said persons in the Turkish labor market.</p>	<p>The Council of Ministers' Decision on Work Permits of Foreigners under Temporary protection no: 2016/8375 was issued in the Official Gazette dated January 15, 2016 - no.29594.</p>	<p><i>Work permits issued for foreigners under temporary protection</i></p> <p><i>Baseline: 5,089 (2016)</i> <i>Target: 20,000 (2018)</i></p>

<b><i>Pillar C: Addressing Structural Bottlenecks to Sustainable Growth</i></b>		
<b>Prior action #6</b> The Borrower enacted the Law on Industrial Property, specifically with respect to the establishment of a more sophisticated system for the protection and enforcement of industrial property rights through incentives for inventors to obtain patents for inventions, the provision of improved support for research and development activities, and the regulation of patents, utility models, trademarks, industrial designs and geographical indications.	The Intellectual Property Law was issued in the Official Gazette dated January 10, 2017 – no. 29944.	<i>Increase in number of patent applications</i>  <i>Baseline: 6,445 patent applications (from residents, 2016)</i> <i>Target: 8,500 patent applications, (from residents, 2018)</i>
<b>Prior action #7</b> The Borrower enacted the Law on Moveable Collateral in Commercial Operations, specifically with respect to the enablement of small- and medium-sized enterprises to obtain access to credit through the use of moveable assets as collateral.	The Law on Moveable Collateral in Commercial Operations was issued in the Official Gazette dated October 28, 2016 - no. 29871.	<i>The credit volume generated through movable collateral system</i>  <i>Baseline: 0 (2016)</i> <i>Target: TL 22 billion (2018)</i>

<p><b>Prior Action #8</b> The Borrower, through the Board of Directors of the Turkish Railways Company, issued the first network statement to complement the Law on Liberalization of Turkish Railway Transportation, as part of the legal framework for unbundling the railway company and enabling private train operators to operate in Turkey.</p>	<p>The network statement was issued on November 29, 2016 by the TCDD Board of Directors. The new Charter for TCDD infrastructure was issued in the official Gazette June 4, 2016 and TCDD Transport Company's commercial registration was done in June 17, 2016. The other critical regulations were issued between legislations on May 2015- August 2016.</p>	<p><i>Contract is signed between a new operator and TCDD infrastructure manager including the rights of access and the access charge levels for using the infrastructure.</i></p> <p><i>Baseline: 0 (2016)</i> <i>Target: at least 1 (2018)</i></p>
<p><b>Prior Action #9</b> The Borrower, through the Ministry of Energy and Natural Resources issued the Regulation on the Renewable Energy Resources Areas to establish large scale renewable energy resources areas.</p>	<p>The Regulation on the Renewable Energy Resource Areas was issued in the Official Gazette dated October 9, 2016 and no. 29852).</p>	<p><i>Renewable energy auctions for the RERAs are held.</i></p> <p><i>Baseline: 0 (2016)</i> <i>Target: 2 (2018)</i></p>



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4. Turkey's growth has been strong and inclusive as the Turkish economy has generated 7.6 million additional jobs since the global crisis. At the same time, female labor force participation rate has increased substantially with the help of active labor market policies from 23.6 percent to 32.9 percent. Moreover, we have made great progress in combatting informal economy and reducing poverty.
5. More encouragingly, Turkey's current account deficit has been on a declining trend. Although 2016 was an exception owing to the declining tourism revenues, the narrative of rebalancing for Turkish economy continues. Going forward, we aim to reduce current account deficit further to much more manageable levels. We have been implementing structural reforms that will help Turkey move up the value chain and boost savings rate. In terms of external funding, Turkey has continued to finance its current account deficit with FDI and medium to long term financial inflows despite unfavorable global financial conditions and geopolitical tensions in neighboring countries.
6. Turkey's strong fiscal position continues to anchor debt and deficit at prudent levels. The general government budget deficit has ranged from around zero to 1.5 percent of GDP in recent years. In 2017, a relatively expansionary fiscal policy has been pursued to support investments and job creation. The EU-defined general government debt stock to GDP ratio reached 28.3 percent in 2016, which is much lower than the Maastricht criterion and emerging markets average.
7. The Turkish banking sector has been resilient to shocks. The sector is well capitalized and has strong asset quality. It has no short FX position. Government maintains the macro-prudential framework, and has introduced credit enhancement schemes to support a more effective financial intermediation.
8. Household liabilities are relatively low when compared to peer countries and bear no currency risk as a result of measures taken in previous years. Although there is an open currency position in the non-financial corporate sector, the exposure is concentrated in large scale companies. Most companies that have short FX position also have significant export revenues, providing them with a natural hedge. Nonetheless, we are planning to introduce macro prudential measures to help companies manage short FX positions.
9. We have undertaken significant structural reforms despite the geopolitical turmoil in the Middle East region and its implications for the east and south-east of Turkey.



Besides, after the failed coup attempt we encountered last July, our government declared a state of emergency and introduced some measures to provide the security. Even under these circumstances, we are determined to initiate and continue making reforms in various areas. As outlined in our 10th Development Plan 2014-2018, a well-functioning and effective justice system is also very important in increasing the predictability in the economy and in developing a more appropriate investment climate. Our commitment to enhancing standards of democracy, improving transparency, boosting fundamental rights of freedom, developing quality of institutions, and strengthening rule of law has not changed which will also contribute to converging with the EU.

10. Our ultimate goals are to become a high income country and move up the global value chain. Great progress has been made recently in main reform areas aiming to support investments, enhance labor market flexibility, promote savings and incentivize R&D activities.

#### **I. Increasing Domestic Savings and Enhancing Fiscal Transparency**

11. We believe that a higher level of savings will provide sufficient internal resources to strengthen our economy and pave the way for better financial environment. Furthermore, we intend to develop a well-functioning public audit framework since it is essential to improve fiscal transparency and accountability and boost investor confidence.
12. The Law No. 6740 on Amending the Private Pension Saving and Investment System was published in the Official Gazette on August 25, 2016 for the purpose of setting an auto-enrollment private pension scheme. According to the Law, employees who are under the age of 45 and working under a service contract are automatically enrolled in the private pension system with an opt-out option since the beginning of 2017. Also, the Government will subsidize employees with an amount equal to twenty-five percent of employees' paid contributions to private pension account. Through these means, coverage of private pension will be enhanced and sustainability of the pension system will be improved.



13. Turkish Court of Accounts (TCA) conducts audit activities on behalf of the Turkish Grand National Assembly according to the Turkish Court of Accounts Law No. 6085. However, there have been some difficulties in the implementation of the Law in auditing procedures. For year 2012, TCA submitted financial audit reports for all general government institutions with audit opinions, but have excluded relevant financial statements. With an amendment in the Regulation on the Procedures and Principles related to the Submission of Accounts of Public Administrations, which was published in the Official Gazette on December 8, 2013 the Ministry of Finance was provided with a three year period to prepare individual financial statements of each institution and submit them to the TCA for auditing. Thus, TCA submitted 2015 audit reports for all general government institutions that contain individual financial statements to the Parliament in October 2016 for the first time.

14. One of the main targets of the 10th Development Plan is not only to increase savings but also to channel savings into productive investments. This will be encouraged through financial market instruments. In this context, we will try to i) improve diversification of financial products, ii) enhance the savings opportunities for small-scale investors, iii) facilitate access to capital market instruments, iv) increase the variety of products and services in financial markets, and v) disseminate financial education.

## **II. Supporting the Economic Inclusion of Vulnerable Groups**

15. Inclusive growth is only effective when it generates economic benefits and opportunities for every section of the society. Inclusive growth entails larger labor force participation rates and more equitable distributional policies. Improvement of labor force quality, elimination of barriers in access to labor markets, provision of better work conditions and prevention of informality especially for disadvantaged groups (such as women, disabled, youth, long-term unemployed and refugees) should be among the key priorities of inclusive labor market policies.

16. We attach utmost importance to the expansion of female labor force participation. Therefore, we are especially keen on developing policies that endorse gender



inclusive economic growth. In view of this aim, the Law on Supporting Investments at the Project Level and Amending Various Laws No. 6745 was published in the Official Gazette on September 7, 2016. This Law provides tax incentives for five taxation periods to private nursing schools by amending the Income Tax Law. It is a well acknowledged fact that increasing and improving the availability and accessibility of affordable childcare lead to higher female force participation.

17. Also, we have completed other working arrangements and modalities for the labor market. Law Amending Labor Law and İŞKUR Law No. 6715 which was published in the Official Gazette on May 20, 2016 allows temporary employment relationships to be established via private employment agencies and legalize the concept of telecommuting work arrangements. Under these schemes private agencies, acting as legal employers, are responsible for the payment of the salary, and social security premiums in line with and for the duration of the employment contract. Besides, these changes introduced distance or remote, home and mobile working to the Turkish labor system. Female and young labor force will be the primary beneficiaries of this program.
18. We are conducting policies for the smooth integration of approximately 3 million Syrians under Temporary Protection to the Turkish society. Our temporary protection regime includes labor market participation as well as access to accommodation, health care and education. The Council of Ministers' Decree No. 2016/8375 on Work Permits of the Foreigners under Temporary Protection was published in the Official Gazette on January 15, 2016. According to the Decree, foreigners under temporary protection can work in Turkey with a work permit and they can apply to Ministry of Labor and Social Security for a work permit 6 months after being registered with a "under temporary protection" status. In a workplace where work permit is requested, number of foreigners under temporary protection cannot exceed ten percent of the employees who are Turkish citizens. Foreigners under temporary protection cannot be paid less than the minimum wage rate.
19. As a future perspective and as it is also highlighted in our 10th Development Plan, formation of a labor market in which decent job opportunities are provided to all segments of the society is one of our primary goals. For that purpose, we aim to upgrade the skills of the labor force and improve the gender equality and occupational health and safety conditions. We are developing qualified and good



job opportunities for the society, particularly for the young and women, considering regional, local and sectoral labor force dynamics. More attention will be given to life-long learning activities to provide skills needed by the labor market. Furthermore, works on the development of an effective migration management system which supports the economy will continue.

### **III. Addressing Structural Bottlenecks to Sustainable Growth**

20. We aim to increase the productivity in Turkish economy by improving the business environment. We place great emphasis on the encouragement of innovative capacity, removal of financial barriers to firm growth and enhancement of competitive environment.
21. We believe that a well-regulated and enforced intellectual property rights system protects consumers and contributes to commercial life. In Turkey, this area was regulated with several decrees and many provisions under various laws. The Industrial Property Law No. 6769 was published in the Official Gazette on January 10, 2017 to establish a single legal basis for intellectual property rights in the country and harmonize with the European Union *acquis communautaire*. The law regulates trademarks, patents and utility models, application and appeal processes, industrial designs, registration and sanctions for violation.
22. We are encouraging the use of hybrid and electric vehicles via favorable tax differentiation. With the aforementioned Law No. 6745 and the of Council of Ministers' Decree No. 2016/9542 published in the Official Gazette on November 25, 2016 special tax rates were introduced.
23. We are determined to implement a sustainable growth strategy for energy sector aiming to enhance our energy supply security. We have set ambitious targets in renewable energy and energy efficiency. Turkey has set an ambition to generate 30% of its energy from renewable sources by 2023. In addition, Regulation on the Renewable Resource Areas has been published in the Official Gazette on October 9, 2016 in order to introduce renewable auctions and thus dramatically increase renewable energy development in Turkey.



24. We aim to set out a better financial and legal environment for facilitating SMEs' operations. Financial access is essential for the growth of SMEs. Although, movable assets constitute the most important part of the capital stock of Turkish SMEs, there was no legal ground for using such assets in accessing bank loans. Thus, the Law on Pledge on Moveable Properties in Commercial Operations No. 6750 was published in the Official Gazette on October 28, 2016. According to the Law the collateral agreement will be executed between the SME and the credit institution. The subject moveable asset needs to be registered in the Moveable Asset Pledge Registry.
25. In railway sector, we are committed to creating a more competitive environment. In 2013 we enacted the Liberalization of Turkish Railway Transportation Law No. 6461 for the unbundling of the TCDD which aimed to enable the private sector participation in railway infrastructure and transportation. All secondary legislations providing the basis for the liberalization of Turkish railways have been issued successfully. In addition, TCDD was unbundled into two entities as infrastructure and operation, and the new main status of the TCDD infrastructure was published in the Official Gazette on June 4, 2016. TCDD Transport Company's commercial registration, as a train operator, was completed on June 17, 2016. Finally, network statement of TCDD was published on 29 November, 2016 by the approval of Ministry of Transport, Maritime Affairs and Communications. TCDD will annually publish an updated network statement to set prices, terms, conditions, procedures and criteria for rail network access.
26. As stated in the 10th Development Plan, in order to overcome the productivity bottlenecks, we aim to take actions to increase productivity in manufacturing sector, improve business and climate environment, promote commercialization in priority technology areas, and boost technology development through public procurement.



27. On the basis of these achievements, we request the World Bank support for our structural reform program by approving the Turkey Resilience, Inclusion and Growth Development Policy Financing. We firmly believe that the reforms detailed in this Letter merit full support from the World Bank and the international community.

Yours Sincerely,

A handwritten signature in black ink, appearing to be 'Mehmet Şimşek'.

Mehmet Şimşek  
Deputy Prime Minister



## ANNEX 3: FUND RELATIONS ANNEX



INTERNATIONAL MONETARY FUND



Press Release No. 17/34  
FOR IMMEDIATE RELEASE  
February 3, 2017

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

### **IMF Executive Board Concludes 2017 Article IV Consultation with Turkey**

On January 11, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.<sup>1</sup>

Following a strong performance in 2015, growth has slowed. The July failed coup attempt heightened the spectrum of political uncertainty, and Russian sanctions have also negatively affected confidence. Growth remains consumption-driven. Investment is weak amid heightened uncertainty and a sharp deceleration of credit growth. Inflation has moderated but is still well above target. The current account deficit remains sizeable, as the decline in tourism offsets savings from low energy prices. Progress on structural reforms has been slow.

Fiscal policy turned expansionary in 2016. Higher government spending is driven by an increase in the minimum wage and related subsidies, hiring in the education and health sectors, as well as higher security outlays. The government granted a number of temporary tax reductions/exemptions and expanded investment incentives during the second half of the year to revive growth.

The central bank of Turkey (CBRT) eased monetary conditions, by cutting the overnight lending rate by 250 basis points in the process of narrowing the interest rate corridor between March and September 2016. After a sharp depreciation of the Lira in November, the CBRT raised the repo rate to 8 percent and partly withdrew the liquidity provided to banks in the wake of the failed coup attempt.

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

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Bank capital levels remain high, although some buffers are decreasing. Higher profits boosted capital adequacy, reflecting in part lower overnight borrowing costs and relaxation of prudential norms. Non-performing loans are increasing from a low level that partly reflects accommodating rules for loan restructuring. Credit growth slowed markedly in 2016, due to both demand and supply factors. Progress in strengthening the financial stability framework was assessed in detail during this Article IV consultation as part of the IMF's Financial Sector Assessment Program (FSAP), which analyzes financial sector health and associated policies. The FSAP's findings are summarized in the accompanying Financial System Stability Assessment (FSSA).

Growth is projected to be below potential in 2016–17. The political focus on transitioning to a presidential system; renewed questions over the future of the EU-Turkey relations; and tense security situation in the South-East and conflicts in neighboring countries are expected to prolong the uncertainty, keeping domestic demand subdued. Fiscal stimulus and the expected completion of the gradual lifting of Russian sanctions are expected to support growth. Over the medium-term, growth is projected to firm around 3.5 percent. Inflation is expected to stay above target and the current account deficit to remain sizeable.

### **Executive Board Assessment<sup>2</sup>**

Executive Directors welcomed the Turkish economy's resilience in the face of severe and increasing challenges and the authorities' efforts to avoid an excessive slowdown in the near term. At the same time, Directors cautioned that the economy faces considerable downside risks—with high inflation, external imbalances, and substantial reliance on external financing continuing to generate vulnerabilities—while dealing with complex geopolitical and security challenges. They underscored the overarching priority of rebalancing the economy through policies aimed at increasing domestic savings and raising potential growth, while ensuring strong and credible public institutions and policy frameworks that are clearly communicated.

Most Directors supported a near-term moderate fiscal expansion to address cyclical developments, given the current available fiscal space. However, Directors advised that a tighter fiscal stance is required in the medium term to reduce external imbalances and lower inflation. They encouraged the authorities to strengthen the fiscal risk management framework, given that contingent liabilities are increasing, in particular due to a continued expansion in infrastructure-related PPPs.

Directors welcomed the authorities' steps to simplify the monetary policy framework. Continued efforts in this area would further improve communications and enhance monetary

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

policy transmission and credibility. Directors emphasized that the authorities should remain vigilant and tighten monetary policy to address sharp lira depreciation, contain high and rising inflation, and counteract intensifying external pressures. Directors also recommended rebuilding international reserve buffers as conditions permit.

Directors welcomed that the banking sector remains well capitalized, and encouraged continued vigilance in light of a deterioration in asset quality. Directors cautioned that banks face substantially higher credit risks, and called for further strengthening of supervision and bank governance. Directors recommended that macroprudential policy should be strengthened, focusing on foreign exchange and other systemic risks, and not be used for demand management. They welcomed the FSAP's findings and recommendations, and highlighted the desirability of further strengthening the independence of financial sector supervisory authorities, deepening and broadening the risk assessment nature of financial supervision and follow up, and strengthening the role of the Financial Stability Committee to support more effective systemic risk oversight and management.

Directors encouraged the authorities to intensify the pace of structural reforms to promote economic rebalancing and boost productivity. They welcomed progress made to reform the voluntary pension system, and urged continued efforts to increase domestic saving. Directors also underscored the importance of improving the investment climate and labor market competitiveness. They commended the authorities for hosting a large number of refugees and for their efforts to integrate them into the labor market, while stressing the importance of continued international assistance.

#### ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Action	Poverty, Social, Gender	Environment	Comments
#1	Potentially positive	None	The new private pension auto-enrollment is expected to have an overall positive impact on poor households. It is likely that the number of low income earners enrolled in the private pension system will increase with the implementation of the new default option. The net impact on coverage of private pension of the overall and poor population will ultimately depend on the take-up behavior of auto-enrolled individuals. The automatic enrollment scheme will provide an opportunity for people in lagging regions to increase their participation in the private pension system. The prior action currently affects workers in the formal sector, while low contribution amounts may not secure an adequate retirement pension. Moreover, since the contributions and state subsidies are a proportion of earnings, high income workers will receive a larger subsidy in absolute terms.
#2	None	None	In promoting public sector transparency and accountability, this reform in principle has systemic benefits. Reforms of this type do not lend themselves to typical PSIA or environmental assessments.
#3	Potentially positive	None	Removing barriers to access childcare has good potential to increase childcare supply. The policy is expected to lead to a 7 percent increase in the enrollment for children age 3-5 and is predicted to have a positive effect on the participation of women in the economy. Overall impact, in terms of female employment, is likely to be positive but limited in line with the low fiscal cost.
#4	Potentially positive	None	The package of active labor market policies, including flexible work arrangements and reforms aimed at reducing labor costs can positively affect youth and female employment.
#5	Potentially positive	None	Allowing foreigners under temporary protection to work in the formal sector mitigates the crowding out effect that refugees have on Turkish low-skilled and informal workers in host communities.
#6	None	None	A direct effect of the action on job creation is through the creation of positions in firms that invest in innovation. These positions would mainly target high-skilled workers, typically in the top part of the wage distribution.
#7	Potentially Positive	None	Supporting access to finance for SMEs through the action on moveable collateral is likely to have a beneficial impact on job creation for workers in the bottom end of the wage distribution.
#8	None	Potentially Positive	Unbundling and liberalization of TCDD may have limited positive direct implications for greening the transport sector of Turkey. With the assumption of more efficient operation of railways, it can be expected that the railways sector will have a slightly larger share in the transportation network, with positive consequences from a climate change mitigation perspective. No socially adverse

			impacts are expected, as, according to government plans, no labor retrenchment is envisaged. Some reallocation of staff between railway services is expected, which will not have impact on employees' rights and status, hence no change in cities or type of firms.
#9	Potentially positive	Potentially Positive	The regulation on the Renewable Energy Resource Areas is expected to speed up the applications and permits in the renewable energy sector, which will help Turkey to diversify its energy supply with renewables and is expected to have a positive impact on the environment. An important issue to follow up is the implementation of environmental impact assessment regulation and other related environmental legislations to ensure that the environmental impacts of the renewable energy projects are mitigated and biodiversity is conserved. Indirect benefits for the bottom 40 population and society as a whole are likely to come through less pollution and a better environment.