UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE IN TURKEY: AN INSTITUTIONAL APPROACH

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PREFACE

The institutional endowment of a country determines government's regulatory choices, the public policies, incentives, and the direction of economic activities in the country and the level of the economic efficiency. The authors use this conceptual framework introduced by New Institutional Economics to examine how institutional endowment in Turkey influence economic and political structure. In this context, most elements of institutional endowments in Turkey are common to all sectors and reforms, (namely, legislative and executive institutions, nature of the judicial system, bureaucratic structure). They also observe the political economy of the change in Turkey. For that reason, they observe similarities and differences in the contests among groups with divergent interests for the different policy changes and reforms processes. Thus, they introduce a crucial guide for scholars, researchers, and investors around the world about the political and economic structure in Turkey.

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INTRODUCTION: THE POLITICAL ECONOMY OF INSTITUTIONAL CHANGE IN TURKEY

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Turkey has attempted to institutionalize economic change over the last two decades. In order to institutionalize economic change, it has implemented crucial reforms in the political, bureaucratic and legal spheres of the country. However, the traditional institutional structure in Turkey has constrained the success of the process of economic change and hence the reform effort came to Turkey with its costs. It is possible to say that the ongoing reform efforts have partly succeeded, but not led to institutionalize economic change.

Those who study economic change throughout history have devoted much of their attention to institutions. Because institutions shape the direction of economic change in long-term. In that case, an institutional analysis of long-term economic change includes understanding the changing initial conditions confronting diverse groups of individuals. Human beings over time have evolved institutions defined as written and unwritten rules to explain the world around them. On the one hand, while institutions determine the rules of play; on the other hand, they can ensure a credible commitment and reduce transaction costs by removing uncertainty in the economic, political and social life. Thus, a study on the role of institutions over economic change will be a notable attempt to understand the process of economic change in a country.

In order to understand the structure and condition of the Turkish economy today, it is needed to understand the institutional endowment surrounding the economic and political structure of the country and the change in this institutional environment. Understanding the process of change in the institutional endowment that determines Turkey's economic and political trajectory will provide a comprehensive basis for assessing the change, the reforms and the success of today's economy policies.

In this context, this book consists of three sections. The first section includes an institutional analysis of the general economic and political endowment in Turkey. As section 2 analyzes institutional lessons from economic change in Turkey, section 3 emphasizes on regulatory issues occurring in the process of economic change.

1. A FUNDAMENTAL BENCHMARK: THE INSTITUTIONAL FOUNDATIONS OF ECONOMIC CHANGE

Institutions are formal and informal rules devised by human beings. Formal rules are constitutions, laws, property rights and informal rules are sanctions, taboos, customs, traditions, and codes of conduct. All these rules influence economic change by constraining and structuring political, economic and social interaction. They define the way the game of economic change is played. In other words, institutions are the rules of the game. By defining a choice set for the agents in the markets, they determine transaction and production costs and hence the direction of economic change. Consequently, institutions are established to construct order and reduce uncertainty in the economy (North, 1991; 2005b).

Uncertainty is one of the most important issues over economic change. Uncertainty can be reduced by changing the institutional framework. A change in the institutional structure brings about altering incentives and has been an essential condition for the reduction in the uncertainties of the environment over time. Indeed, historically, institutional change increased incentives to invent and innovate and lowered transaction costs in the markets (North, 2005a). For that reason, institutions or the institutional environment in a country can play a crucial role over economic change.

As two principal arms of NIE, Transaction Cost Economics (TCE) and Positive Political Economy (PPE) are useful tools to analyze the institutional structure of an economic change (Spiller and Tommasi, 2005). TCE provides the underlying framework for understanding the interaction issues among institutions. On the other hand, PPE provides the framework for understanding the connection between institutions and politicians' incentives (Spiller and Tommasi, 2005: 517). Accordingly, a study that observes the effects of institutions over economic change needs to include what kind of institutions influences economic change from a new institutional perspective. In this study, we only engage in the political institutions of the policy-making processes such as the legislature, the bureaucracy-executive, and the judiciary[1]. Since a public and/or economic policy is an outcome of interaction between the executive (the IRAs) and the legislature and judicial review of the actions of both institutions (Tomain and Shapiro, 1997).

The form of political institutions influences the nature of economic policies and ultimately economic change. For example, a major cause of high transaction costs in the process of institutional change is the traditional understanding of unified state. By contrast, the explicit separation of powers within the institutional endowment can lower transaction costs and ensure a credible regulatory commitment. The regulatory discretions used by the legislature and the executive can determine regulatory governance options. A strong and independent judiciary can restrain administrative and legislative discretion in the regulatory process[2].

However, separation of powers is not enough fully to lower transaction costs and to ensure full credibility in the process of economic change. Transaction costs in the real world

[1] Undoubtedly, to understand the process of economic change and the performance of markets it is not enough to understand the formal rules of game. It is also needed to understand what the economic agents believe and/or the informal rules of game (Menard and Shirley, 2005).

[2] See to Levy and Spiller (1994) and Spiller (1995), for a detailed analysis about the regulatory governance and the institutional endowment.

are always positive. For example, it is possible that interest groups can capture bureaucracy and legislation. Likewise, the judicial process can be shaped by the personal opinions and ideologies of the judges (Gely and Spiller, 1990). For that reason, the regulatory structure has to be shaped in this connection.

The legislature decides the general regulatory outlook and agenda and hence it is the principal in the game. However, the political processes (politics) are an ambiguity world (Schwartz et al., 1994). Transaction costs in the politics market are high more than in the economic sphere and hence political markets are far more prone to inefficiency (North, 1990; 1993). Politicians can manipulate the institutional change for political ends and in that case, economic change is highly able to be politicized (Williamson, 1999). In order to impede the manipulation of economic change, discretion in the policy-making processes is delegated to the executive (the IRAs today) that has expertise and technical knowledge that the legislature desires to use. Nevertheless, the executive structure and process is established with the aim of bureaucratic agencies responsive to the will of the legislature (McCubbins, 1985). The delegation of policy making power to the IRAs reduces the political transaction costs of economic change (Majone, 2001). Consequently, the executive is the second institution that plays a role in the game. The legislature is principal and the executive is agent. While legislation determines administrative structure and process, the executive is obligated to perform the process (McNollgast, 1987).

The last institution that is determinant over economic change is the judiciary. The main task of the judiciary in the process of institutional and economic change is to review whether policies and contracts are compatible with the constitutional structure of the country. On the other hand, the judiciary can also play a role as a rule maker. For example, courts can annul and shift by reinterpreting regulatory laws (Rogers, 2001; Stephenson, 2003). In most cases, the implementation of regulations has legal effect only through the courts. The judiciary can nullify legislation or regulations enacted by the legislature (Landes and Posner, 1975). Likewise, lobbying by interest groups on the legislature and the executive for a special interest may be negated only through the courts by declaring this action null and ineffective (Cross, 2003).

2. UNDERSTANDING THE CHANGE IN TURKEY

Since the last three decades, Turkey has tried to implement an economic change compatible with *the economic institutions of capitalism* by reshaping its institutional environment. However, the traditional political and legal environment was not ready to this change. The pressure for the change was heavily from the international organizations, but not internal powers or institutional structure. The governments have intended to change the traditional structure, but not made an effort to align the institutional and legal structure with the guidelines of the international organizations. The reforms have been nullified in particular by the legal and bureaucratic institutional structure.

This book deals with institutions that determine the direction of economic change in Turkey. In doing so, it aims to reveal the success of the change process. In this context, the book is divided into three sections. Section 1 presents a general outlook about Turkey's institutional endowment. Section 2 focuses on some specific outcomes of economic change such as the position of the private interest groups and military towards the change. On the other hand, the section analyzes relation between foreign direct investment and institutional quality and debates the social outcomes of economic change. Lastly, section 3 includes an analysis of the transition to the regulatory state in Turkey.

2.1. A General Outlook of Institutional Endowment in Turkey

Section 1 provides distinctive insights concerning institutional structure in Turkey. The section consists of four chapters. In chapter 1, in order to understand Turkey's record in economic growth and institutional change during the century before 1980, Sevket Pamuk emphasizes a distinction between the proximate and the ultimate sources of economic growth in Turkey. After an overview of Turkey's record of economic growth during the century before 1980, he sketches a framework for understanding the linkages between institutional change and economic growth in Turkey. Afterwards, in order to gain additional insights into Turkey's absolute and relative growth record, he reviews world economic conditions, government economic policies, the basic macroeconomic outcomes and institutional change in Turkey during 1880 to 1980 in three sub-periods.

Pamuk concludes that Turkey's transition from a rural and agricultural towards an urban and industrial economy in the twentieth century occurred in three waves, each of which served to increase the economic and political power of urban and industrial groups. Increases in the economic and political power of these groups, on the whole, enabled them to shape economic institutions more in the direction they desired. Each of these waves of industrialization and economic growth, however, was cut short by the shortcomings or deficiencies of the institutional environment. The first of these waves occurred during the 1930s. After a series of legal and institutional changes undertaken by the new republic, a small number of state enterprises led the industrialization process and the small scale private enterprises in a strongly protected economy. Etatism promoted the state as the leading producer and investor in the urban sector. Ultimately, however, political and economic power remained with the state elites and these economic and institutional changes remained confined to the small urban sector.

In chapter 2, Tamer Çetin focuses on the role of institutions over economic change in Turkey from an institutional perspective. He especially focuses on the interaction among political institutions and economic change. In doing so, it aims to reveal the credibility and influence of political institutions on the process of economic change in Turkey. However, the role of political and legal institutional environment rather than the bureaucratic institutional structure over economic change is included in the sub-sections of the chapter.

In the end, Çetin argues that the 1980s and the 1990s had not exactly been able to bring about an economic change based on institutionalization. In the 1980s, Turkey initiated to experience transition to *the economic institutions of capitalism* and put liberalization to the forefront in setting economic policies. However, liberalization did not obtain a relaxation in the traditional state structure. Rather, while the legal and bureaucratic processes resisted economic change, the political processes led to a rent seeking society. The legal institutional structure resisted and continues to resist the change, in spite of the reform initiatives of the current government. Specifically, Danistay and the Constitutional Court have annulled laws concerning (de)regulation and privatization of public utilities. On the other hand, Turkey suffered from the loose political structure in the 1990s. Coalition governments have long dominated the political and economic institutional structure. As a result, the reform initiatives had brought about inefficient and unstable economic outcomes rather than a successful economic change.

In chapter 3, Ziya Öniş and İ. Emre Bayram assess the performance of the Turkish economy, questioning whether the currently observed unusual boom conditions will lead to a process of sustainable growth. Öniş and Bayram particularly focus on the economic performance between 2001 and 2008. This phase of Turkish neo-liberal transformation is placed in a broader historical and global context; at the same time, the performance of the economy is compared with that of other key emerging markets, based on selected macroeconomic indicators. Utilizing the East Asian experience as the principal benchmark for comparison, this chapter examines whether Turkey is on its way to accomplishing tiger-like development performance. Given the current challenges to sustainable growth, we conclude that it is premature to suggest that the impressive performance of the recent years will lead to durable success and tiger-like performance. In this chapter, while the focus is on the Turkish experience, they also probes the very nature of tiger-like performance itself, highlighting the fact that in setting standards for exceptional economic performance we need to extend our horizons beyond high rates of economic growth sustained over time, to broader indicators of social, political and human development.

Their comparative analysis involving other emerging markets has clearly pinpointed the weaknesses and vulnerabilities of the recent Turkish economic performance. Most importantly, the current account balance and dependence on foreign capital and global liquidity conditions can be considered the main challenges to the sustainability of long-term growth in Turkey. Furthermore, the decreasing influence of the EU anchor and its possible effects on FDI attraction and privatization revenues might further deteriorate the current account balance and macroeconomic stability. In addition to these factors, changes in the favorable global liquidity conditions due to the financial crisis in the US economy might affect the Turkish economy which is vulnerable to such external shocks. Last but not least, unlike between 2002 and 2006, the present government can hardly be described as enthusiastically committed to economic reforms and the EU accession process.

In the fourth chapter of the first section, E. Fuat Keyman attempts to explain why and how the Justice and Development Party (the AKP) has won two national elections and became the governing party with a majority rule in Turkey. He situates the AKP in a much more sociological, economic and political context, and attempt to analyze its conservative-liberal identity with reference to Turkey's recent global, European and democratic transformation. With such an analysis, Keyman demonstrates the limits of the AK Party experience and provide a number of policy-based suggestions to make Turkey a democratic, just and stable country with proactive and constructive foreign policy.

According to Keyman, whether or not the AKP and its conservative-liberal synthesis can create a democratic, just, stable and good governance of Turkey still remains to be answered. He argues that we know from the AKP experience that electoral victory and parliamentary majority in and by themselves do not constitute sufficient conditions for making this desirable vision of Turkey possible. What we do not know is to what extent this experience has a political will or normative commitment to democracy and its consolidation –and it is where the answer lies.

In chapter 5, Mehmet Asutay aims to deconstruct the functioning of political manipulation of economy (PME) in Turkey whereby it aims to pinpoint the country specific distinguishing characteristics. The analysis of Asutay renders support for the micro-level policies for political manipulation of the Turkish economy, rather than systematic manipulation of fiscal and monetary policies. The chapter shows that the functioning of PME may not necessarily refer to systematic manipulation of fiscal and monetary policies, but pinpoints the micro-level political tools as part of the dynamic political economy with having fiscal and monetary consequences.

2.2. Institutional Lessons from the Process of Economic Change in Turkey

The section section of the book presents lessons from the interaction between the state and the markets in the process of economic change. In chapter 6, Dilek Demirbaş examines the interest group theory of legislation to explain the relationship between trade policy and rent seeking activities in Turkey by running a testable economic model of the lobbying behavior of interest groups in the pursuit of wealth transfers. In this chapter, Demirbaş analyzes the Turkish case with a time series framework during the period 1960-2000.

Demirbaş finds that there is a long run relationship between business groups, bureaucrats and politicians in trade policy in Turkey. This relationship also explains long term stability among these three interest groups in terms of rent seeking. According to Demirbaş's findings, politicians-legislators in Turkey act not only as brokers who pair demanders and suppliers, but they act also as rent-seekers that try to maximize their benefits. Therefore, while any increase in government size and their payment increases rent seeking, any increase in the number of trade companies decrease rent-seeking as a result of high competition.

In chapter 7, Devrim Dumludağ focuses on the interaction between political, social and economic institutions and Foreign Direct Investment (FDI) in Turkey. For a decade, the relationship between institutions and FDI has been receiving growing attention. The link between the quality of institutions and FDI in developing countries, especially in transition economies, has led scholars to focus on the quality of institutions as determinants of FDI in developing countries. In order to attract higher amounts of FDI, numerous developing countries have liberalized their investment environment since 1980. Turkey is not an exception. However, not all countries succeed at attracting FDI as they expected. The volume of FDI flows differ among the countries. One of the countries which did not succeed at attracting FDI as expected is Turkey. In this chapter, Dumludağ explores how social economic and political institutions help explain the low level of FDI flows into Turkey by offering a political economy approach and applying a questionnaire survey for the recent period.

According to Dumludağ's results, institutional variables such as; low level of corruption, government stability, enforcement of contract law, functioning of judicial system, transparent, legal and regulatory framework political and economic stability, intellectual property rights, efficiency of justice and prudential standards have significant impact on FDI in Turkish economy. Findings also provide an explanation of the distribution of FDI across countries. The empirical results point to the importance of political and economic institutions for FDI.

In chapter 8, Fırat Demir attempts to provide a discussion of the fault lines that created and fed rent-seeking coalitions among several actors in the economy. These coalitions include the military, state bureaucracy, labor and private businesses. In particular, he explores the market distortions created by the Turkish military as it plays the role of a neo-mercantilist capitalist entrepreneur. Demir also analyzes the mechanisms through which the military managed to adapt to the liberalized market system of the post 1980s without facing any significant objections from other political or economic actors.

According to Demir, in the Turkish context, the pre-existing rent-seeking coalitions with their class relations survived the transition by adapting to the new set of conditions. The military, in particular, managed to adapt to the *liberalized* market system without any loss of political power while managing to increase its economic muscle using the special privileges it inherited. In this regard, looking at its business dealings, there is nothing celestial about the objectives or the functioning of the Turkish military. Consequently, given its active participation in the market through its (protected) direct and indirect business dealings, and given its use of political muscle to increase its members economic well-being at the expense of the rest of the society, and given its willingness to link to the domestic and international capital without any regard to the political or strategic sensitivities or nationalistic rhetoric it often raises in the domestic political arena, the Turkish military has become a part of the capitalist class (albeit a neo-mercantilist one) and it should be treated as such. As of 2009, Demir argues that it yet remains to be seen whether the ripening private domestic capitalist class and bourgeoisie will continue to tolerate this *blurring of the lines* and accept different forms of bribery through business partnerships *or* challenge the political and economic hegemony of the military and its coalitions with the *antediluvian fossils*.

In chapter 9, Metin Toprak and Mustafa Acar look into the historical trajectory of this dead-lock policy, linking the basis of the current deficiencies of democracy and market economy in Turkey at institutional level on one hand, and lack of tolerance and xenophobia at societal level on the other. They argue that the Republican era's Jacobean type of unification policies explains by and large not only economic backwardness, but also current social adjustment problems in Turkey. According to Toprak and Acar, in today's Turkey, penetration into or getting strong in economy, media, civil society and politics is still being done or shaped to a great extent by resorting to the state intervention, political maneuvering or manipulation rather than through democratic and economic competition.

In chapter 10, Engin Yıldırım aims to analyze whether Turkish industrial relations have undergone a transformation or a non-fundamental change. According to Yıldırm, without the momentum generated by the EU accession process, the minimal reforms in industrial relations that have developed in Turkey would not have occurred. Restrictive labor laws, employer hostility to unionization, a large informal economy and labor market, and strong state intervention have historically constituted the main elements of "the deep structure" of Turkish industrial relations. Yıldırım argues, as long as a lack of government support and employer recognition for basic labor rights continue to exist all recent changes and reform attempts would only constitute non-fundamental changes in the "deep structure" Turkish industrial relations.

2.3. Regulatory Issues in the Change Process

This section directly deals with current issues of the regulatory process in Turkey. In chapter 11, Tamer Çetin, M. Zahid Sobacı, Mehmet Nargeleçekenler and Erdal

Abdulhakimoğulları analyze transition to independent regulatory agencies (IRAs) in Turkey from two different viewpoints in detail. The first section of the chapter examines the meaning of political transaction costs and regulatory commitment in terms of independence of IRAs during delegation process of the discretion to IRAs in the Turkish experience. This section also contains lessons from the regulatory process of the Turkish energy industries. The second section only evaluates formal independence levels of IRAs in Turkey. Thus, the chapter reveals formal independence of IRAs in Turkey and presents a comparative analysis among them.

The chapter concludes that the transition to IRAs in Turkey includes some issues concerning their independence. This stems from the fact that these agencies are in conflict with the principles and means which dominate the current regulatory structure. In this sense the case of Turkey is compatible with the arguments of transaction costs and regulatory commitment regarding delegation of the power to IRAs. Although IRAs in Turkey are established, there have been the political interventions to IRAs and not a constitution-based protection for them. In particular, there are serious problems between EMRA and the government. The solution to these problems is to change Article No.123 of 1982 Constitution and to undertake necessary legal amendments which will ensure the legitimacy of the place these agencies have in the Turkish regulatory structure. However, the government is reluctant to do it. On the other hand, according to the results of empirical analysis, BRSA has the highest level of independence among IRAs. On the contrary, SA is the one which has the lowest level of independence. Independence levels of other agencies do not show significant differences. Consequently, necessary measures should be taken to improve formal independence level of SA.

In chapter 12, İzak Atiyas and Pınar Doğan present an overview of liberalization and privatization in the fixed line segments of the telecommunications industry in Turkey. Turkey was a relatively late participant in the global trend towards liberalization of the telecommunications industry. Monopoly rights of the incumbent operator were retained until the end of 2003 and the local calls market was effectively not liberalized until 2009. Even though the legal framework has been not far removed from that governing the telecommunications industry in the EU, and has indeed been converging towards it, its implementation and enforcement has been less than effective and market outcomes so far suggest that the degree of competition still leaves much to be desired. With a view to explain market outcomes, they review and evaluate the basic components of the regulatory framework such as authorization, access and interconnection, provides an assessment of the privatization policy that has accompanied liberalization and discusses the interaction between the two processes. Atiyas and Doğan also present a discussion of the institutional characteristics of the regulatory framework and political-economic factors that may help explain the sluggish nature of the development of competition.

Atiyas and Doğan argues that, although Turkey had the necessary preconditions for a successful liberalization in the early 2000s, both the evolution of the regulations and market outcomes in fixed segments suggest that the development of competition has been slow. Moreover, the lack of ownership of the liberalization agenda by the ministry seems an important factor that has delayed the development of competition. In that sense the Turkish experience suggests that delegation of regulatory authority is not a panacea in the absence of political intent and ownership.

In chapter 13, Tamer Çetin aims to review the process of institutional change and to assess the current institutional issues in the energy markets of Turkey. In this context, the chapter roughly consists of two sub-sections, including electricity market and natural gas market, respectively. The first sub-section analyzes institutional change in the Turkish electricity market. The section presents a historical background from the pre-reform structure of the market to the current structure and scrutinizes the main reasons for institutional change in electricity. This sub-section concludes by considering the main economic and institutional issues in the current market structure.

The remaining part of the chapter focuses on the natural gas market. The section begins with an historical background about traditional market structure and restructuring in the natural gas market. Later, it discusses regulation of the market. In this context, this section observes the Natural Gas Market Law's prominent properties, EMRA's regulatory discretions and the new market structure. This sub-section also focuses on current issues and future perspectives in natural gas. Finally, the chapter ends with a conclusion.

In chapter 14, Fikret Adaman and Murat Arsel analyze the relationship between globalization, development and environment in Turkey. They aims to formulate an explanation as to the existence of a paradox, evidenced by the near failure of the state in Turkey to put environmental policies into practice despite the existence of a set of detailed legal regulations and a strong state tradition, by addressing the political economy of the environment problem in an analytical framework. Adaman and Arsel present the stakeholders within the context of environmental policies in Turkey as those who will favorably or unfavorably be impacted by a given policy (and given, obviously, that the *status quo* remains unchanged), or have a say in the nation's political decision-making mechanisms (thus including environmental issues) even if they would not be directly affected by these environmental policies. Next, they discuss the characteristics of these different players and, to a degree, their links to one another. After assessing the players and their qualities, Adaman and Arsel address different positions and interactions within the context of the environment, from a political economy point of view. Finally, they attempt to take into consideration certain ideas for the future, and assess Turkey's stand regarding environmental problems in the globalized world.

According to Adaman and Arsel, one reality that must be kept in mind is that in Turkey's political arena, patronage based networks play a significant part in defining the relationships between the public and the civilians, and the elected and the bureaucracy. This structure is mainly built on "reciprocity" and rooted in settings far from transparency and accountability, relying mostly on Ottoman heritage, and as a result causing grave erosion in the public arena. With regard to the environment, it is clear that neither civil society—still on rather shaky feet—nor EU-based policies are likely to take a robust stand against this case of erosion. Furthermore, it would be beneficial to add that a plan for growth that does not pay much attention to environmental costs has quite a few supporters in Turkey.

In chapter 15, Ihsan Isik evaluates the current level of financial development and financial access in Turkey as compared to other countries in order to judge the success of financial, institutional, and legal reforms that have been at work for the past three decades in the country. The chapter shows that Turkish residents or firms do not particularly face excessive barriers in terms of physical access (proximity of branches or ATMs, or availability of on-line or phone services etc.). In terms of convenience, Turkey is actually better than more than half of the countries around the world. Turkish residents can access bank outlets easily, but they prefer not to use them.

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SECTION I. AN INSTITUTIONAL ANALYSIS OF THE GENERAL ECONOMIC AND POLITICAL ENDOWMENT IN TURKEY

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Chapter 1

ECONOMIC GROWTH AND INSTITUTIONAL CHANGE IN TURKEY BEFORE 1980

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ABSTRACT

In recent years, a growing literature has emphasized the contribution of the social and political environment, and more specifically of institutions defined as written and unwritten rules and norms, to long term economic change. This chapter explores the linkages between economic growth and institutional change in Turkey before 1980. It begins with an overview of Turkey's record of economic growth during the century before 1980. The second section sketches a framework for understanding the linkages between institutional change and economic growth in Turkey. In order to gain additional insights into Turkey's absolute and relative growth record, the third section then reviews world economic conditions, government economic policies, the basic macroeconomic outcomes and institutional change in Turkey from 1880 to 1980, in three sub-periods.

INTRODUCTION

Modern economic growth began in Turkey during the nineteenth century. Average or per capita incomes increased almost five fold during century before 1980. Other indicators of standards of living also improved significantly. Most importantly, life expectancy at birth doubled from around 30 years to 62 years during the same period. It would be misleading to judge economic performance only in absolute terms, however. The century until 1980, especially the period after World War II, witnessed rapid increases in the standards of living in most parts of the world. On the one hand, increases in per capita incomes in Turkey were close to but slightly above averages for the developing countries during this century. On the other hand, the income per capita gap between Turkey and developed economies of Western Europe and North America widened significantly from 1820 to World War I and even further until 1950 but narrowed somewhat since. In 1980 that gap was larger than and today it is slightly smaller than what it was before World War I.

This chapter will begin with an overview of Turkey's record of economic growth during the century before 1980. All figures and series presented below will refer to the area within the present day borders of Turkey. It will then examine the process of institutional change and link it to economic growth. In recent years, a growing literature has emphasized the contribution of the social and political environment, and more specifically of institutions defined as written and unwritten rules and norms, to long term economic change. In the second section, I will sketch a framework for understanding the linkages between the evolution of institutions and economic change in Turkey during the century before 1980. In order to gain additional insights into its absolute and relative growth record, the third section will then examine world economic conditions, government economic policies, the basic macroeconomic outcomes and institutional change in Turkey in three sub-periods. The concluding section offers some observations on the interaction between economic growth and institutional change in Turkey before 1980.

1. The Long Term Growth Record

Population growth and urbanization in Turkey began in the nineteenth century but did not gain momentum until after World War II. Turkey's population increased from 13 million in 1880 to 21 million in 1950, 45 million in 1980 and 72 million in 2010. Share of population living in urban centers with more than 5000 inhabitants remained around 25 percent or lower from 1880 until after World War II but has been rising rapidly since, to 44 percent in 1980 and to more than 70 percent by 2010. Not surprisingly, urbanization has been accompanied by large shifts in the labor force. Agriculture's share in total employment declined from about 80 percent both in 1880 and 1950 to 51 percent in 1980 and to less than 30 percent in 2010. Agriculture's share in GDP similarly declined from about 54 percent in 1880 and in 1950 to 26 percent in 1980 and to about 10 percent in 2010 (Altug, Filiztekin and Pamuk, 2008).

Modern economic growth arrived in Turkey in the nineteenth century. Table 1 summarizes the long trends in per capita GDP during the century before 1980 in three sub-periods on each of which I will spend more time in Section 3 below. Table 1 shows that while long term annual rates of growth of Turkey's GDP per capita were well below 1 percent until 1950 and sharply higher at more than 3 percent after 1950, they were remarkably close to global averages in each of the sub-periods. Turkey's long term growth rates lagged behind those of industrializing higher income countries until after World War II. Since then, however, they have been comparable to and slightly higher than those of Western Europe and the United States. Similarly, Turkey's rates of growth were below world averages until 1950 and have been slightly above them since 1950. In contrast, Turkey's growth rates have been slightly higher than the averages for the developing countries in all three of the sub-periods during the century before 1980. In short, Turkey's long term economic performance during the century before 1980 has been close to average. Clearly, Turkey has not been a poor performer, but neither has it been one of the miracle-producing economies in the twentieth century.

Table 1
Rates of Economic Growth in Turkey in Comparative Perspective, 1880-1980
(annual rates of increase of GDP per capita, in percent)

	Turkey	W. Europe+US	Developing Countries	World
1880-1913	0,7	1,5	0,6	1,1
1913-1950	0,8	1,3	0,5	0,9
1950-1980	3,1	2,9	2,8	2,6
1980-2010	2,3	1,5	2,4	1,7

Source : Maddison (2007), Pamuk (2006) and Altug, Filiztekin and Pamuk (2008); figures for the most recent sub-period are approximate.

It may be useful to look into Turkey's long term growth record in more detail. Per capita incomes in Turkey and the rest of the Ottoman Empire began to rise during the nineteenth century at rates below 1 percent per annum. Yet, the gap between the high income countries of Western Europe and the United States as a whole and the Ottoman Empire widened considerably during the century before World War I, due to the rapid rates of industrialization in the former countries. GDP per capita in the area within present-day borders of Turkey in 1820 is estimated at approximately 650 purchasing power parity adjusted 1990 dollars. This equaled about 52 percent of the level of GDP per capita in the high income countries of Western Europe and the United States. In 1880, per capita GDP in Turkey stood around 850 dollars which equaled about 39 percent of the per capita income in Western Europe and the United States and 147 percent of the GDP per capita income in the developing countries of Asia, Africa and Latin America, all calculated on a population-weighted basis for the same year. For 1913, GDP per capita within the present day borders of Turkey is estimated at 1200 dollars or at 29 percent of the GDP per capita of the high income countries and at 168 percent of the per capita income of the developing areas.

Per capita incomes declined sharply during both World War I and World War II even though Turkey was not involved in the hostilities during the latter. The economy recovered rapidly after both wars, however, attaining pre-war levels in GDP per capita by 1929 and 1948 respectively. If one takes a long term view, the annual rate of growth in GDP per capita is estimated at 0.7 percent from 1880 to 1950. As a result, per capita GDP in Turkey stood at 1620 dollars in 1950. This was equal to 24 percent of the per capita income of the high income countries and 188 percent of the per capita income in the developing countries in that year.

Turkey's long term growth rates rose significantly higher after World War II. GDP per capita is estimated to have increased at 3.1 percent per year until 1980. By 1980, GDP per capita exceeded 4000 dollars, again in purchasing power parity adjusted 1990 dollars, an increase of almost five fold since 1880. This figure corresponded to about 25 percent of the level of GDP per capita in the high income countries of Western Europe and the United States, and approximately 220 percent of the GDP per capita income of the developing countries for the same year. In other words, average incomes in Turkey increased more slowly than those in high income countries from 1820 until the end of World War II. Between 1950 and 1980, Turkey's economy grew more rapidly but it was not able to close the large gap. In contrast, Turkey's growth record during the century before 1980 was better than the averages for the Middle East, Africa and South Asia, but it lagged behind Latin America and Southern Europe. (Pamuk, 2006; Altug, Filiztekin and Pamuk, 2008).

2. Economic Growth and Institutional Change

For decades it was believed that economic growth results in part from the accumulation of factors of production and improvements in their quality through investment in machines and skill formation, and in part from increases in productivity derived from advances in technology and organizational efficiency. In recent years, however, a useful distinction is being made between the proximate and the ultimate sources of economic growth. The former relates to the contributions made by the increases in factor inputs and productivity as cited above. The latter refers to aspects of the social and economic environment that influence the rate at which inputs and productivity grow. A growing literature emphasizes the importance of institutions or written and unwritten rules of a society and policies such as property rights and their enforcement, norms of behavior, political and macroeconomic stability, which affect the incentives to invest and innovate. In this new perspective, the basic function of institutions is to provide certainty and incentives for economic activity, investments, technological change and innovations. Institutions and government policies can encourage accumulation and innovation or they can encourage other activities such as corruption, theft or seeking privileges for narrow groups. Long run economic change and economic growth are attained because the underlying framework persistently reinforces incentives for individuals and organizations to engage in productive activity. Investments in physical and human capital will not be undertaken, innovations will not be attempted unless the institutions provide clear incentives for such activities. Similarly, more complex economic structures will not emerge unless institutions can reduce the uncertainties associated with such structures. For these reasons, institutiosn are increasingly seen as more fundamental determinants of economic growth and and long-term differences in per capita GDP between countries than rates of physical or human capital accumulation or research and development themselves. Economic institutions also determine the distribution of income and wealth. In other words, they determine not only the size of the aggregate pie, but also how it is divided amongst different groups in society.

Institutional economics and economic historians have come to recognize that institutions do not change quickly. Institutions from the past often have an influence on the institutions today and thus on economic outcomes today. In short, the past does have an influence on the present and history does matter. Moreover, when institutional change does occur, it is usually not in the direction of most efficient outcomes. A society rarely arrives at or creates institutions that are conducive to economic growth. In most cases, institutions have favored activities that that restrict opportunities rather than expand them. Similarly, rather than reinforcing incentives towards productive activity, in most cases states acted as instruments for transferring resources from one group to another or promoting their own survival at the expense of others. In short, the process of institutional change has not always been favorable to economic growth (North, 1990; Acemoglu, Johnson and Robinson, 2005).

The process of how economic institutions are determined and the reasons why they vary across countries are still not sufficiently well understood. Institutional economics proposes a number of causes or determinants of institutions. Most important amongst them are i) geography or resource endowments, ii) religion or more generally culture and iii) social conflict or political economy. Ottoman economic institutions have been influenced by geography or resource endowments. For example, the land regime and fiscal institutions in Egypt were shaped to a large degree by the needs of irrigated agriculture. In the core regions of the empire, low population density tended to support peasant farms in the countryside. With the exception of Egypt, however, the geography or resource endowments of the areas covered by the Ottoman Empire were not very different from those of western Europe. For this reason, geography or resource endowments are not considered as a primary cause of the differences in economic institutions in the Ottoman Empire. For a long time, religion and/or culture have also been offered as a primary cause of the differences in economic outcomes between the Near East and western Europe. Max Weber and David Landes have offered prominent examples of this type of explanation. More recently, in a series of recent articles Timur Kuran has pointed to certain Middle Eastern institutions including ones rooted in the region's dominant religion, as past and in some cases also continuing obstacles to economic development. He has argued that these institutions did not ever cause a decline in economic activity but they turned into handicaps by perpetuating themselves during the centuries when the West developed the institutions of the modern economy (Kuran, 2003; 2004). Culture certainly has an impact on institutions but Kuran has tended to ignore the large body of evidence that Islamic societies changed their institutions over time and often circumvented or adapted the religious rules that appear to prevent economic change. As a result, he has overlooked change in Islamic societies and the varieties of Islam that emerged in response to the many different conditions. Once it is allowed that the so called Islamic rules can and do in fact change or be circumvented, it becomes necessary to understand why and how. For this reason, we believe it is best to turn to political economy for understanding the long term evolution of institutions in Middle East and more specifically in the Ottoman Empire and in Turkey.

Those in the recent institutional economics literature adhering to a social conflict or political economy explanation of economic institutions argue that because different groups and individuals typically benefit from different economic institutions, there is generally a conflict over the choice of economic institutions, ultimately resolved in favor of groups with greater political power. The distribution of political power in society is, in turn, determined by political institutions and the distribution of economic power. For long term growth, economic institutions should not offer incentives to a narrow elite but open up opportunities to a broader section of society. Economic institutions that provide incentives to invest in land, physical and human capital or technology are more likely to arise when political power is in the hands of a relatively broad group with significant investment opportunities. For this reason, political economy and political institutions are considered as key determinants of economic institutions and the direction of institutional change. The state can be a major player in this context as it maintains coercive power to enforce these rules. As the result of political struggles and alliances, the state and associated institutions moved to provide the legal framework that reinforced incentives for organizations to engage in productive activity

(Acemoglu, Johnson and Robinson, 2005; Rodrik, Subramanian and Trebbi, 2004; Helpman, 2004).

Shortcomings in education and human capital are also very important in understanding not only the growth performance but also the extent and direction of institutional change in Turkey during the century until 1980. Literacy rates during the late Ottoman era and in the during first decade of the republic in the 1920s were very low, estimated at or below 10 percent. By 1950 adult (above 15) literacy had risen to 28 percent, 47 percent for men and 13 percent for women. In 1980 adult literacy rates still stood at no more than 66 percent, 81 percent for men and only 50 percent for women. These literacy rates were lower than those prevailing in Latin America, South and East Asia. During the post-World War II period, Turkey, along with other Muslim majority countries, also lagged behind other developing countries with comparable levels of per capita income in indices measuring gender equality and socio-economic development of women. In addition, there existed large differences in educational attainment levels and more generally in human development indicators between Turkey's mostly Kurdish southeast region and the rest of the country. It is well documented that lower levels of human capital has a negative impact on rates of economic growth especially in later stages of economic development when skills and technology become increasingly important. The interaction between human capital on the one hand and economic growth and institutional change, on the other, is rather complicated and works both ways. It is true that levels of human capital influence the direction and extent of economic growth and institutional development. At the same time, patterns and extent of human capital formation also depend not only on levels of per capita income but also on the existing institutions (Altug, Filiztekin and Pamuk, 2008: 418-9).

The evolution of economic institutions in Turkey and their consequences for economic growth have not been closely studied. The next section examines structural change, industrialization and the basic macroeconomic outcomes in three sub-periods: the Ottoman decades before World War I, the interwar years or the single party era until the end of World War II and the import-substituting industrialization era after World War II and until 1980. I will thus seek to gain insights not only into Turkey's record of economic growth, but also into the evolution of the economic institutions that played a key role in these outcomes. Briefly, Ottoman economy was opening up rapidly to international trade and international investment during the decades before World War I. While the Ottoman state tended to resist or slow down these changes, European companies together with local merchants located in the port cities were shaping the institutions of an export oriented, primary producing economy. From the Ottoman era to the interwar period, Turkey underwent major political and institutional changes. These changes favored the emergence of a more closed, more national economy dominated by the new state elites. In the absence of a strong private sector, these elites adopted a state-led industrialization strategy during the Great Depression. Despite the rhetoric to the contrary, however, the new regime remained urban based in a country where the overwhelming majority lived in rural areas and engaged in agriculture. As a result, the benefits aof these policies and institutional changes did not reach large segments of the population. Pace of structural change and economic growth accelerated after World War II. With the transition to a more open political regime and urbanization, urban industrial groups began to take power away from the state elites. Industrialization and economic development began to be controlled increasingly by the private sector located in the major urban centers. The economic institutions began to reflect those changes. This transition, however, has not been smooth or easy. For most of the last half century, political and macroeconomic instability including three military coups and a series of fragile coalitions and the shortcomings of the institutional environment seriously undermined the economy's growth potential.

3. Three Different Periods

3.1. Open Economy during the Nineteeenth Century

For the Ottoman Empire the nineteenth century was a period of political, social and economic reforms designed and implemented by the center in order to keep the empire together in response to external and internal challenges. The reforms of *Tanzimat* (re-ordering) that began in the first half of the century in military, administration, education,law and elsewhere tended to increase the power of the central administration at the expense of the elites in the provinces. These changes brought greater internal security, strengthened property rights and tended to reduce state interventionism. One key outcome of these changes was the shift of economic activity in rural areas, especially in agriculture from the highlands towards the more fertile plains.

For the Ottoman economy the nineteenth century was a period of rapid integration into the world economy. Between 1820 and 1914 the foreign trade of the empire expanded by more than ten fold. This process was supported by a series of free trade treaties signed between the Ottoman central administration and the European countries from 1838 onwards. Ottoman exports consisted almost entirely of agricultural commodities, foodstuffs and raw materials. Rapid expansion of foreign trade also turned empire into an importer of manufactured goods, most importantly of cotton textiles, and also of foodstuffs, various machinery and intermediate goods. More than three-fourths of Ottoman external trade was directed towards industrialized Europe with Germany, France and Great Britain.

On the eve of World War I, the Ottoman economy remained predominantly agrarian. In the countryside, small peasant holdings coexisted with larger enterprises. Family enterprises with a pair of oxen and a plot of land large enough to be cultivated by a pair of oxen remained the basic unit of production. While the coastal plains were densely cultivated, scarcity of labor and availability of land prevailed in the interior regions. Commercialization of agriculture during the nineteenth century was accompanied by some shift from cereals and other subsistence crops towards cash crops and industrial raw materials. Manufacturing activity remained based mostly on artisanal forms. Modern factories using steam power such as tanneries, textile mills, flour mills, glass works, brick factories under private ownership began to emerge only towards the end of the nineteenth century. However, absence of Ottoman tariff autonomy and low tariffs on imports made it especially difficult for the new manufacturing enterprises to take root.

Another important dimension of nineteenth century globalization for the Ottoman economy was the large amounts of direct foreign investment by European firms. Close to 60 percent of this amount was invested in railroads until World War I. By linking the fertile agricultural regions to major ports, these railroads facilitated the commercialization of agriculture and integration of the Ottoman economy to world markets. European direct investment also went to other forms of infrastructure such as ports, utility companies, insurance and shipping. In contrast, foreign investment in agriculture, mining and manufacturing remained limited. (Pamuk, 1987: 55-81) Special treaties the Ottoman state agreed to sign with the European powers gave European citizens and companies special privileges such as separate courts and lower rates of taxation. These institutions created disadvantages for and discouraged the local citizens from pursuing economic activities in competition with the Europeans.

Per capita incomes were rising, albeit slowly at rates below 1 per cent per year in Turkey and in most other regions of the empire during the decades before World War I (Pamuk, 2006 and Altug, Filiztekin and Pamuk, 2008). These increases were based primarily on greater commercialization and export orientation of agriculture. In contrast, industrialization remained limited until World War I. Institutional changes during the nineteenth century were in the direction of opening up the economy to markets and global economic forces. These changes were shaped by the interaction between the Ottoman state and the European companies. The role of various domestic groups such as the landowners, both large and small, merchants and guilds in this process remained limited. While the Ottoman state tended to resist or slow down the process of globalization and the changes it brought, European companies to some extent together with local merchants located in the port cities were trying to shape the institutions of an export oriented, primary producing economy. Opening of the economy to international trade and investment under these circumstances proceeded rather slowly. As a result, Turkey was not transformed into one of the showcases of globalization such as Egypt where both the state dominated by the large landowners and the British colonial administration after 1882 actively shaped the institutions of an open economy with specialization in cotton. (Pamuk, 1992)

3.2. State-Led Industrialization in Response to the Great Depression

With the outbreak of World War I, Turkey began to move from an open economy towards a more closed, inward looking national economy. This process began with major demographic changes. The destruction and death that accompanied the Balkan Wars of 1912-13, World War I and the War of Independence, 1920-22, had severe and long-lasting consequences. Total casualties, military and civilian, of Muslims during this decade are estimated at close to 2 million. In addition, most of the Armenian populace of about one and a half million in Anatolia were deported, killed, or died of disease, after 1915. Finally, under the Lausanne Convention, approximately 1.2 million Orthodox Greeks were forced to leave Anatolia, and in return, close to half a million Muslims arrived from Greece and the Balkans after 1922.

As a result of these massive changes, the population of what became the Republic of Turkey declined from about 17 million in 1914 to 13 million at the end of 1924 (Behar, 1995; Shorter, 1985; McCarthy, 1983; Eldem, 1970). The population of the new nation-state had also become more homogeneous, with Muslim Turks and the Kurds who lived mostly in the southeast making up close to 98 percent of the total. Agriculture, industry and mining were all affected adversely by the loss of human lives and by the deterioration and destruction of equipment, draft animals and plants during the war years. GDP per capita in 1923 was approximately 40 percent below its 1914 levels (Özel and Pamuk, 1998).

The former military officers, bureaucrats and intellectuals who assumed the positions of leadership in the new republic viewed the building of a new nation-state and modernization through Westernization as two closely related goals. They strived, from the onset, to create a national economy within the new borders. The new leadership was keenly aware that financial and economic dependence on European powers had created serious political problems for the Ottoman state. At the Lausanne Peace Conference (1922-23), which defined, amongst other things, the international economic framework for the new state, they succeeded in abolishing the regime of privileges for the European citizens and companies. The parties also agreed that the new republic would be free to pursue its own commercial policies after 1929. The government saw the construction of new railroads and the nationalization of the existing companies as important steps towards the political and economic unification of the nation state inside new borders. The foreign capital stock declined sharply during the interwar period due to purchases of European firms and voluntary departures.

Despite its rhetoric to the contrary, the regime's priorities lay with the urban areas. It considered industrialization and the creation of a Turkish bourgeoisie to be the key ingredients of national economic development (Mardin, 1980). Nonetheless, the new regime abolished the much-dreaded agricultural tithe and the animal tax in 1924. This move represented a major break from Ottoman patterns of taxation and a significant decrease in the tax burden of the rural population. While this decision has been interpreted as a concession to the large landowners, the new leadership was more concerned about alleviating the poverty of the small and medium sized producers, which made up the overwhelming majority of the rural population. In the longer term, the abolition of the tithe and tax-farming helped consolidate small peasant ownership. The recovery of agriculture provided an important lift to the urban economy as well. By the end of the 1920s, GDP per capita levels had attained the levels prevailing before World War I (Özel and Pamuk, 1998).

The principal mechanism for the transmission of the Great Depression to the Turkish economy was the sharp decline in prices of agricultural commodities. These adverse price movements created a sharp sense of agricultural collapse in the more commercialized regions of the country, in western Anatolia, along the eastern Black Sea coast and in the cotton-growing Adana region in the south (Tekeli and Ilkin, 1977: 75-92; Tezel, 1986: 98-106). Earlier in 1929, even before the onset of the crisis, the government had begun to move towards protectionism and greater control over foreign trade and foreign exchange (Tezel, 1986: 139-62). As the unfavorable world market conditions continued, the government announced in 1930 a new strategy of etatism, which promoted the state as a leading producer and investor in the urban sector. A first five-year industrial plan was adopted in 1934 with the assistance of Soviet advisers. By the end of the decade, state economic enterprises had emerged as important and even leading producers in a number of key sectors, such as textiles, sugar, iron and steel, glass works, cement, utilities and mining (Boratav, 1982: 172-89; Tezel, 1986: 197-285; Tekeli and Ilkin, 1982). Etatism undoubtedly had a long-lasting impact in Turkey, and later in other countries around the Middle East. However, the initial efforts in the 1930s made only modest contributions to economic growth and structural change. For one thing, state enterprises in manufacturing and many other areas did not begin operations until after 1933. Close to half of all fixed investments by the public sector during this decade went to railroad construction and other forms of transportation. In 1938, state enterprises accounted for only 1 percent of total employment in the country. Approximately 75 percent of employment in manufacturing continued to be provided by small-scale private enterprises (Tezel, 1986: 233-7).

Available estimates suggest GDP per capita grew at average annual rates of more than 3 percent during the 1930s, despite the absence of expansionary fiscal and monetary policy. One important source of the output increases after 1929 was the strong protectionist measures adopted by the government ranging from tariffs and quotas to foreign exchange controls, which sharply reduced the import volume from 15.4 percent of GDP in 1928-29 to 6.8 percent by 1938-39. Import repression created attractive conditions for the emerging domestic manufacturers, mostly the small and medium-sized private manufacturers. There is another explanation for the overall performance of both the urban and the national economy during the 1930s, which has often been ignored amidst the heated debates over etatism. Thanks to the strong demographic recovery, agriculture—the largest sector of the economy, employing more than three fourths of the labor force and accounting for close to half of the GDP—did quite well during the 1930s (Shorter, 1985).

Although Turkey did not participate in World War II, full-scale mobilization was maintained during the entire period. The sharp decline in imports and the diversion of large resources for the maintenance of an army of more than one million placed enormous strains on the economy. Official statistics suggest that GDP declined by as much as 35 percent and the wheat output by more than 50 percent until the end of the war. In response, the prices of foodstuffs rose sharply and the provisioning of urban areas emerged as a major problem for the government. Under these circumstances, etatism was quickly pushed aside. Large increases in defense spending were financed by monetary expansion. High inflation, wartime scarcities, shortages and profiteering accentuated by economic policy mishaps soon became the order of the day. As declining production and sharply lower standards of living combined with increasing inequalities in the distribution of income, large segments of the urban and rural population turned against the Republican People's Party, which had been in power since the 1920s. The war years, rather than the Great Depression and etatism era, thus appear to be the critical period in the political demise of the single party regime.

To sum up, Turkey underwent very significant political and institutional changes during the interwar period. These changes favored the emergence of a more closed, more national economy dominated by the new state elites. In part because the private sector or the emerging Muslim bourgeoisie was still weak, the new state elites adopted the strategy of etatism or state led industrialization during the Great Depression. While many economies turned inward during this period, the Turkish experience was certainly more radical than most. It is clear that history and institutions inherited from the past contributed significantly to the emergence of etatism as the new strategy. The new policies focused mostly on the urban areas, however. As a result, the institutional changes and the increases in standards of living did not reach large segments of the population. Nonetheless, despite two world wars and the Great Depression, per capita levels of production and income in Turkey were 30 to 40 percent higher in 1950 than those prevailing on the eve of World War I.

3.3. Return to ISI after WWII

Domestic and international forces combined to bring about major political and economic changes in Turkey after World War II. Domestically, many social groups had become dissatisfied with the single party regime. The agricultural producers, especially poorer segments of the peasantry, had been hit hard by wartime taxation and government demands for the provisioning of the urban areas. In the urban areas, the bourgeoisie was no longer prepared to accept the position of a privileged but dependent class, even though many had benefited from the wartime conditions and policies. They now preferred greater emphasis on private enterprise and less government interventionism (Keyder, 1987: 112-4; Boratav, 2003: 93-101).

International pressures also played an important role in the shaping of new policies. The emergence of the United States as the dominant world power after the war shifted the balance towards a more open political system and a more liberal and open economic model. Soviet territorial demands pushed the Turkish government towards close cooperation with the United States and Western alliance. The U.S. extended the Marshall Plan to Turkey for military and economic purposes beginning in 1948.

Agriculture-Led Growth

The shift to a multi-party electoral regime brought Democrat Party to power in 1950. Undoubtedly the most important economic change brought about by the Democrats was the strong emphasis placed on agricultural development. Agricultural output more than doubled from 1947, when the pre-war levels of output were already attained, through 1953 (SIS, 2003). A large part of these increases were due to the expansion in cultivated area, which was supported by government policies and the Marshall Plan. The agriculture-led boom meant good times and rising incomes for all sectors of the economy. It seemed in 1953 that the promises of the liberal model would be quickly fulfilled. These golden years did not last very long, however. With the end of the Korean War, international demand slackened and prices of export commodities began to decline. With the disappearance of favorable weather conditions, agricultural yields declined as well. Rather than accept lower incomes for the agricultural producers, who made up more than two thirds of the electorate, the government decided to initiate a large price support program for wheat, financed by increases in the money supply. The ensuing wave of inflation and the foreign exchange crisis, which was accompanied by shortages of consumer goods, created major economic and political problems for Democrat Party, especially in the urban areas (Sunar, 1984). One casualty of the crisis was the political as well as economic liberalism of the Democrat Party. Just as it responded to the rise of political opposition with the restriction of democratic freedoms, in most economic issues the government was forced to change its earlier stand and adopt a more interventionist approach. It finally agreed in 1958 to undertake a major devaluation and began implementing a IMF and OECD-backed stabilization program.

Agricultural output began to increase more rapidly after World War II at about 3 percent per annum until 1980. This higher rate of growth was supported by rapid increases in the amount of land under cultivation. Thanks to the availability of land, the total area under cultivation more than doubled during the decade after World War II. After the land frontier was reached, a shift occurred towards more intensive agriculture in the 1960s. In this new phase, output rose more slowly but yields and land productivity increased more rapidly with the use of new inputs, agricultural machinery and equipment, fertilizers, irrigation and high yielding varieties of seeds.

The 1950s also witnessed the dramatic acceleration of rural-to-urban migration. Both push and pull factors were behind this movement, as conditions in rural areas differed widely across the country. The development of the road network also contributed to the new mobility (Zürcher, 1993: 235; Keyder, 1987: 135-40; Kasaba, 1993). Despite the large and persistent productivity and income differences between agriculture and the rest of the economy, the strength of small and medium-sized land ownership slowed down the movement of labor to the urban areas. Small and medium-sized land ownership combined with another Ottoman legacy, state ownership of land, to moderate urban inequalities during decades of rapid urbanization Many of the newly arriving immigrants were able to use their savings from rural areas to build low cost residential housing (*gecekondu*) on state lands in the urban areas. They soon acquired ownership of these plots. To this day, agricultural producers and their descendants, many of whom are now urbanized, continue to view the Democrat Party government and especially the prime minister Adnan Menderes, a large landowner, as the first government to understand and respond to the aspirations of the rural population. The Democrat Party also offered the first example of a populist economic policies in modern Turkey. Not only did it target a large constituency and attempt to redistribute income towards them, but it also tried to sustain economic growth with short-term expansionist policies, with predictable longer-term consequences.

Import Substituting Industrialization (ISI)

One criticism frequently directed at the Democrats was the absence of any coordination and long term perspective in the management of the economy. After the coup of 1960, the military regime moved quickly to establish the State Planning Organization (SPO). The idea of development planning was supported by a broad coalition: the Republican People's Party with its etatist heritage, the bureaucracy, large industrialists and even the international agencies, most notably the OECD (Milor, 1990).

The economic policies of the 1960s and 1970s aimed, above all, at the protection of the domestic market and industrialization through ISI. Governments made heavy use of a restrictive trade regime, investments by state economic enterprises and subsidized credit as key tools for achieving ISI objectives. The SPO played an important role in private sector decisions as well, since its approval was required for all private sector investment projects which sought to benefit from subsidized credit, tax exemptions, import privileges and access to scarce foreign exchange. The agricultural sector was mostly left outside the planning process (Hansen, 1991: 352-3; Barkey, 1990; Öniş and Riedel, 1993: 99-100).

The emerging ISI model of the 1960s represented a combination of the old and the new. State economic enterprises whose roots went back to the etatist era began to play, once again, an important role in industrialization. This role, however, was quite different in comparison to the earlier period. During the 1930's when the private sector was weak, industrialization was led by the state enterprises and the state was able to control many sectors of the economy. In the new ISI era, in contrast, the private sector began to take over. Big family holding companies, large conglomerates which included numerous manufacturing and distribution companies as well as banks and other services firms, emerged as the new leaders.

For Turkey, the years 1963 to 1977 represented what Albert Hirschman has called the easy stage of ISI (Hirschman, 1982). The opportunities provided by a large and protected domestic market were exploited, but ISI did not extend to the technologically more difficult stage of capital goods industries. The shortcomings of the education system played an important role in this outcome. Export orientation of manufacturing industry also remained weak. Until the end of the 1970s, Turkey continued to obtain the foreign exchange necessary for the expansion of industrial production primarily from traditional agricultural exports and remittances from workers in Europe. Nonetheless, the ISI policies were successful bringing about economic growth, especially in the early stages. GNP per capita increased at the average annual rate of 4.3 percent during 1963-1977 and at 3.5 percent per annum including the crisis years of 1978-79. Rate of growth of manufacturing industry was considerably higher, averaging more than 10 percent per annum for 1963-1977. A significant part of these high rates of overall growth was due to the shift of a large part of the labor force from the low productivity agricultural sector to the higher productivity urban sector (SIS, 2006).

While industry and government policy remained focused on a large and attractive domestic market during this period, they all but ignored exports of manufactures, and this proved to be the Achilles' heel of Turkey's ISI. The export sector's share in GDP averaged less than 4 percent during the 1970s, and about two thirds of these revenues came from the traditional export crops. A shift towards exports would have increased the efficiency and competitiveness of the existing industrial structure, acquired the foreign exchange necessary for an expanding economy and even supported the import substitution process itself in establishing the backward linkages towards the technologically more complicated intermediate and capital goods industries.

There existed an opportunity for export promotion in the early 1970's, especially in the aftermath of the relatively successful devaluation of 1970. By that time, Turkish industry had acquired sufficient experience to be able to compete or learn to compete in the international markets. For that major shift to occur, however, a new orientation in government policy and the institutional environment was necessary. The overvaluation of the domestic currency and many other biases against exports needed to be eliminated. Instead, the successes obtained within a protected environment created vested interests for the continuation of the same model. Most of the industrialists as well as organized labour, which feared that export orientation would put downward pressure on wages, favored the domestic market oriented model. Moreover, political conditions became increasingly unstable during the 1970's. The country was governed by a series of fragile coalitions with short time horizons. As a result, the government made no attempt to shift towards export oriented policies or even adjust the macroeconomic balances after the first oil shock of 1973 (Barkey, 1990: 109-67).

The Crisis of ISI

The short-lived coalitions chose to continue with expansionist policies at a time when many industrialized countries were taking painful steps to adjust their economies. Turkey's existing policies could be sustained only by a very costly external borrowing schemes. In less than two years it became clear that the government was in no position to honor the outstanding external debt stock, which had spiraled from 9 percent to 24 percent of GDP (Celasun and Rodrik, 1989). By the end of the decade Turkey was in the midst of its most severe balance of payments crisis of the postwar period. As rising budget deficits were met with monetary expansion, inflation jumped to 90 percent in 1979. The second round of oil price increases only compounded the difficulties. With oil increasingly scarce, frequent power cuts hurt industrial output as well as daily life. Shortages of even the most basic items became widespread, arising from both the declining capacity to import and the price controls. The economic crisis, coupled with the continuing political turmoil, brought the country to the brink of civil war (Keyder, 1987: ch. 8).

Perhaps the basic lesson to be drawn from the Turkish experience is that an ISI regime becomes difficult to dislodge owing to the power of vested interest groups who continue to benefit from the existing system of protection and subsidies. To shift towards export promotion in a country with a large domestic market required a strong government with a long term horizon and considerable autonomy. These were exactly the features lacking in the Turkish political scene during the 1970s. As a result, economic imbalances and costs of adjustment increased substantially.

Turkey began the post-World War II era with a strategy emphasizing agricultural development but settled on the ISI model, after a severe foreign exchange crisis compounded by policy mistakes. History certainly did matter in the shaping of Turkey's post-war ISI during the 1960s. The state enterprises from the etatist 1930s were accompanied and eventually led by the rising private sector in Istanbul and more generally in the north-west region of the country. While the inward oriented ISI model allowed for high and steady growth rates, rising real wages and agricultural incomes for almost two decades, the attractiveness of the large domestic market made it very difficult to shift towards exports. Political instability exacerbated the problems of the ISI strategy. The institutional environment deteriorated sharply during the 1970s. Another severe and costly crisis at the end of the decade paved the way for the radical opening of the economy to the forces of globalization in 1980.

4. CONCLUSION

This chapter has explored the linkages between economic growth and institutional change in Turkey during the century before 1980. It has emphasized the distinction between the proximate and the ultimate sources of economic growth. The former relates to the contributions made by the increases in factor inputs and productivity. The latter refers to aspects of the social and economic environment in which growth occurs. In this context, economic institutions are viewed as the key determinants not only of long-term economic growth, but also of how the total output or income is divided amongst different groups in society. I have also argued because there is generally a conflict of interest over the choice of economic institutions, political economy and political institutions are key determinants of economic institutions and the direction of institutional change.

During the nineteenth century, the Ottoman state and European interests interacted to change the institutions of a mostly agricultural economy and open it to foreign trade and investment. In the twentieth century, Turkey's transition from a rural and agricultural towards an urban and industrial economy occurred in three waves, each of which served to increase the economic and political power of urban and industrial groups. Increases in the economic and political power of these groups enabled them, more or less, to shape the economic institutions in the direction they desired. Each of these waves of industrialization and economic growth, however, was cut short by the shortcomings or deficiencies of the institutional environment. The first wave occurred during the 1930s. After a series of institutional changes undertaken by the new republic, a small number of state enterprises led the industrialization process and the small scale private enterprises in a strongly protected economy. Etatism promoted the state as the leading producer and investor in the urban sector. Ultimately, however, political and economic power remained with the state elites and these economic and institutional changes remained confined to the small urban sector.

Turkey's second wave of industrialization began in the 1960s, again under heavy protection and with government subsidies and tax breaks. Rapid urbanization steadily expanded the industrial base. The etatist legacy was important and the state economic enterprises continued to play an important role as suppliers of intermediate goods. Political and economic power began to shift away from the state sector, however. The new leaders were the large scale industrialists and the holding companies in Istanbul and the northwestern corner of the country. With the rise of political and macroeconomic instability in the 1970s, industrialization turned increasingly inward and short-term interests prevailed over a long-term vision, culminating in a severe crisis at the end of the decade. Turkey's inward oriented economic strategy that went back to the era of the Great Depression thus began to change after 1980.

Ever since the Young Turk era, governments in Turkey supported the emergence and growth of an industrial bourgeoisie. Helped by the growth of the urban sector and successive waves of industrialization, this private sector has been gradually wresting control of the economy away from the state elites in Ankara (Keyder, 1987; Buğra, 1994). For most of the twentieth century, the leading industrialists had been from the Istanbul region. The new economic strategy favoring a more open economy and export-led growth after 1980 widened the industrial base further to new centers across Anatolia. The rising bourgeoisie of these new industrial centers began to challenge the Istanbul-based industrialists in the 1990s. The AKP government of the recent years has been supported by these emerging elites in the provinces.

While economic power has shifted from Ankara to Istanbul and more recently towards new industrial groups in the provinces, the shift in political power and the move towards more pluralist politics have been far from easy or simple. Turkey's political system often produced fragile coalitions and weak governments which have sought to satisfy the short term demands of various groups by resorting to budget deficits, borrowing and inflationary finance. The political and macroeconomic instability also led to the deterioration of the institutional environment. Rule of law and property rights suffered, and public investment including expenditures on education declined sharply. The weak governments were too open to pressures from different groups or even individual firms or entrepreneurs seeking favors. As a result, the pursuit of favors or privileges from local and national governments was a more popular activity for the producers than the pursuit of productivity improvements or competition in international markets.

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Chapter 2

THE ROLE OF INSTITUTIONS OVER ECONOMIC CHANGE IN TURKEY

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ABSTRACT

Turkey has attempted to institutionalize its economic endowment for a long time. During this struggle, it has overcome violent stages and political clashes in the different terms including various features. In the 1980s, Turkey initiated to experience transition to *the economic institutions of capitalism* and put liberalization to the forefront in setting economic policies. However, liberalization did not obtain a relaxation in the traditional state structure. On the other hand, Turkey suffered from the loose political structure in the 1990s. Coalition governments have long dominated the political and economic institutional structure. As a result, the 1980s and the 1990s had not exactly been able to bring about an economic change based on institutionalization in the political, bureaucratic and legal spheres. Rather, while the legal and bureaucratic processes resisted economic change, the political processes led to a rent seeking society. In this context, the goal of this chapter is to analyze the role of institutional endowment in Turkey over economic change. The chapter especially focuses on the interaction among political institutions and economic change. In doing so, it aims to reveal the credibility and influence of political institutions on the process of economic change in Turkey.

INTRODUCTION

This chapter focuses on the role of institutions over economic change in Turkey. From an institutional perspective, political institutions are the major determinants of investment in a country and the main components for economic change. Transaction costs and credible commitment that are the most important indicators of the processes of change or transition depend upon the institutional setting and political institutions shape the institutional setting

(Menard and Shirley, 2005). In this chapter, political institutions are considered as the legislative, the executive, and the judiciary (Spiller, 1995; Levy and Spiller, 1994)[1]. For that reason, institutions approach over the economy presented and developed by new institutional economics (the NIE) is employed to analyze the institutional structure of interaction between the state and the markets in Turkey. Thus the chapter aims to reveal regulatory commitment and transaction costs of the interaction among and within the institutions playing a role in the process of economic change in Turkey.

The liberalization choice of Turkey in the process of political and economic change after 1980 has brought about regulation, deregulation, privatization and competition policies to become a crucial component of the regulatory agenda and the political sphere. However, there is academically almost no working concerning the regulation experience of Turkey and it has been ignored the regulatory side of the process[2] (Ercan ve Öniş, 2001). Although the liberalization process in Turkey began in the 1980s, transition to the regulatory process started via the establishments of Competition Authority (CA) in 1994 and Telecommunications Authority (TA) in 1999. Throughout the 1990s, privatization and regulation became part of development plans. The seventh plan, introduced in 1996, recommended the privatization of state monopolies and introduction of competition in network industries. It also recommended the establishment of independent regulatory agencies (the IRAs) in all network industries. The eighth development plan also gave some room to regulatory institutions. Similarly, international institutions like IMF, the European Union, OECD, and World Bank also encouraged an economic change based on regulatory reform. Consequently, the main reason for the delay of *de facto* transition in Turkey is the lag of institutionalization in the regulatory structure and/or of transition to the IRAs.

Another reason for the delay is that Turkey could not undertake necessary initiatives for the transition alone. Turkey has not been able to appropriate the separation of powers among institutions taking a role in the process of economic change. For that reason, economic change in the context of regulatory institutional structure has been carried out by the external pressure of international organizations as IMF, OECD and the European Union (Çetin and Oguz, 2007).

The institutional structure of economic change consists of political authority (the legislation), bureaucratic institutions (the executive) and the judiciary. These institutions constitute the political-institutional endowment of the country. By playing a crucial role in the process of economic change, these institutions affect investment decisions. The lack of regulatory commitment on capital assets, the arbitrary attitudes of political actors, the weak enforcement mechanisms, political instability, regime changes and the high political transaction costs influence investment decisions negatively. In this context, the political instability and weakness in the regulatory environment have restricted the attractiveness of Turkey as a country to invest (OECD, 2002a).

In this context, to begin with, the chapter analyzes the legislature as the first player of institutional structure in Turkey. Turkey suffered from the loose political structure especially in the 1990s. Coalition governments have long dominated the political and economic institutional structure. As a result, the 1980s and the 1990s had not exactly been able to bring about an economic change based on institutionalization. As a whole, the political processes

[1] For a deeper discussion regarding the institutions of regulation, see Çetin (2009).

[2] The detailed studies in this area are OECD (2002a), TUSIAD (2002, 2003), and Çetin (2007).

led to a rent seeking society. However, with the unique party government in the last two terms, the aftermaths of the coalition governments and political instability in the short history of the process of change in Turkey has expired and the current government has launched stronger efforts at institutional and regulatory reforms than have been endeavored so far (OECD, 2002a).

On the other hand, a prominent change occurring in the regulatory institutional structure in Turkey is the changing of bureaucratic environment. The executive in Turkey has long been shaped by the traditional bureaucratic structure. This structure had been dominant over the process of economic change until the end of the 1990s. By establishing Competition Authority in 1994 and Telecommunications Authority in 1999, Turkey transformed the institutional endowment of bureaucracy from the traditional patrimonial structure to the IRAs or regulatory state. However, this chapter does not include an analysis of alteration in the executive[3].

The last institution that affects the process of economic change is the judiciary. Contrary to the change that occurs in the other two institutional structures, the legal institutional structure in Turkey has not been able to carry out a radical change process so far. The judiciary in Turkey has still conserved its traditional characteristics. In this sense, while the first two actors of the institutional environment have a dynamic structure compatible with the nature of the process of economic change, the judiciary has presented a stationary position incompatible with the change. In the last section of the paper, it is observed the effects of the judiciary on the process of economic change in Turkey.

1. THE ROLE OF THE LEGISLATIVE POLITICS OVER ECONOMIC CHANGE IN TURKEY

The effects of politics on the economy are well recognized. A democratic political environment provides the necessary support for the realization of an institutionalized economic structure. The support includes a legal and regulatory framework introduced by the legislature, respected by the business environment and enforced by the executive. The main institutions of a democratic political society are the political parties, elections, electoral rules, political leadership, inter-party alliances, and legislatures (OECD, 2002b: 181). These institutions of politics determine political stability and the quality of institutional endowment. Political stability and the quality of institutional structure directly influence economic outcomes. Instability in the political sphere and the institutional structure bruise regulatory commitment and trigger transaction costs. Ultimately institutional environment determines investment decisions and economic development and/or growth.

The main features of the legislature in terms of the process of economic change in Turkey can be explained characteristically and periodically. These features include some distinctive components. Characteristically, a prominent feature of the legislative politics in Turkey is the tradition of distributive politics, which was inherited from the Ottoman State to the Republic of Turkey and has continued throughout the Republic (Bugra, 1995; TUSIAD, 2003). The

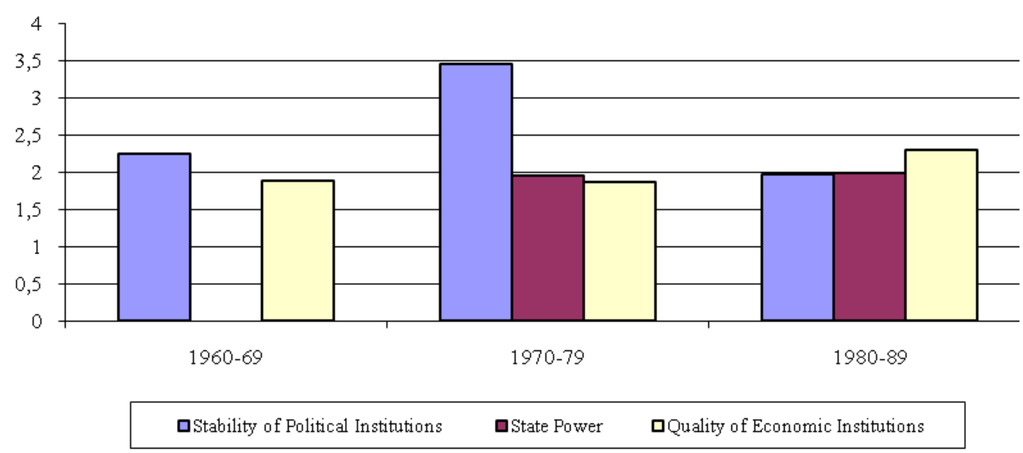
[3] For a detailed discussion of transition to the IRAs in Turkey, see Çetin et al., (2010).

second feature of the legislative politics is related to the election laws and the election system. These two features are the main characteristics of the legislative politics in Turkey.

On the other hand, there is the two distinct periods in the post-1980 Turkish politics in terms of the process of economic change. The first of these periods is the term of the coalition governments of the 1990s and the other is the term of the one party government of the AKP (The Justice and Development Party) since 2002. With the traditional state structure, these features of the legislative institutional environment have directly influenced the process of economic change in Turkey. For that reason, these two periods and features of the legislative politics are rather considerable to analyze the nature of the process of economic change in Turkey.

1.1. The Structural Characteristics of The Turkish Polity

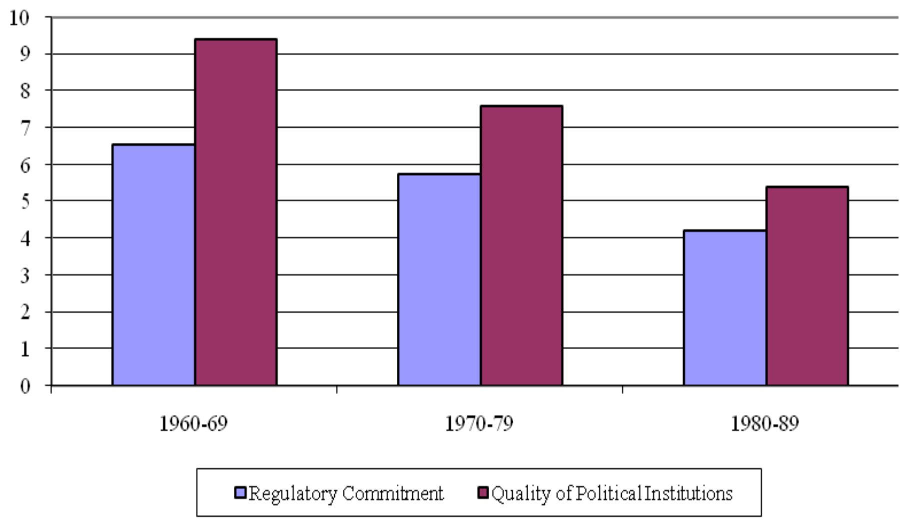
Turkey's transition to a more liberal market system in the 1980s has widely been discussed in the literature (Bugra, 1995; Heper, 2000; OECD, 2002a; 2002b; TUSIAD, 2002). Liberalization created a rent-seeking society rather than a credible economic and political institutional environment. The institutional endowment of the pre-1980 had continued during the 1980s and the 1990s as well. As shown in Figure 1, according to a study by Borner et al. (2004), while the stability of political institutions deteriorated and the state power on the markets increased, the quality of economic institutions partly improved. From privatizations to regulations, many economic issues have been solved in the political markets. As a result, political reforms have produced unexpected negative results and remained ineffective.



*There is no State Power data concerning the 1960-69 term.
Source: Data is from Borner et al., (2004).

Figure 1. The Progress of the Political and Economic Institutional Structure in Turkey (1960-1989).

As was focused on importantly by Mardin (2000), the key concept that explains Turkey's political structure is the center-periphery relation. The center-periphery model can be adapted to rent-seeking and credible commitment models in the Turkish case. Accordingly, the institutional structure in Turkey has a patrimonial state tradition that was inherited from the Ottoman Empire, where political and economic processes were determined in the center and public resources were distributed to the periphery by means of bureaucracy. The political center holds all the keys for change and works hard to reduce the level of resistance (Heper, 2000: 78). As shown in Figure 2, because the quality of political institutions under the patrimonial state tradition increasingly deteriorated, in spite of transition to a more competitive economic model, the economic and political institutional environment during the 1980s had deprived of a credible regulatory commitment for investors (Borner et al., 2004).

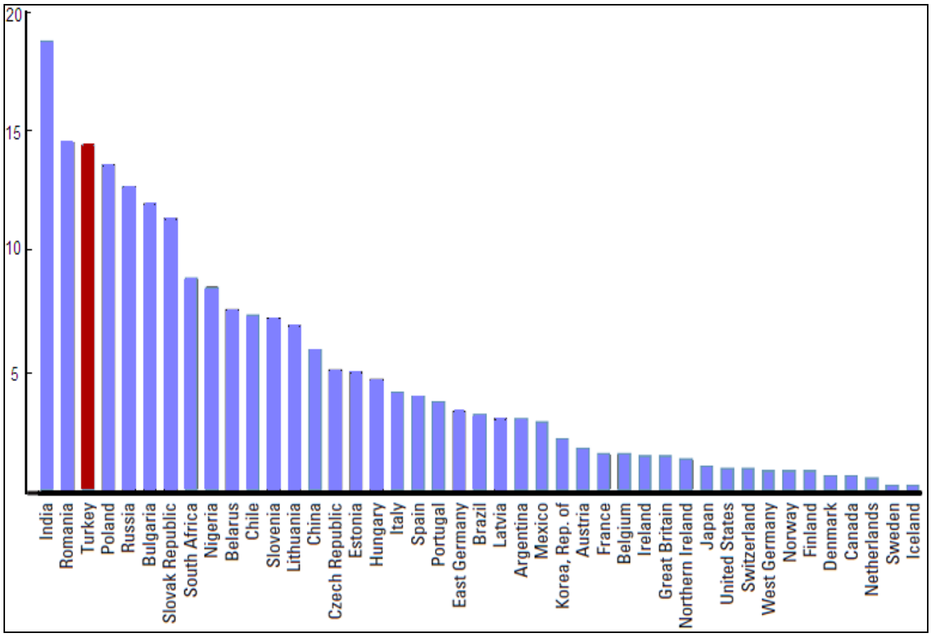


Source: Data is from Borner et al., (2004).

Figure 2. The Interaction between Regulatory Commitment and the Political Institutional Structure (1960-1989).

As another feature of the Turkish polity, the institutional environment in Turkey is deprived of a civil society. Transition to democracy in Turkey was directly shaped by the state elites, but not by businessmen or civil society. Status and welfare were distributed by offices. In this structure, bureaucracy has the greatest discretion in the policy-making processes and is the path to wealth. The emergence of an entrepreneurial middle class has been restricted (Heper, 2000: 78-79). The state is accepted as a father by the citizens. For instance a study[4] which was applied in 43 countries reveals that civil society in the transition countries such as Turkey was much more likely than one in most other counties in the world to say the state should own and manage business and industry. As indicated in Figure 3, Turkey among 43 countries has a very high overall score behind India and Romania (Anderson et al., 2005: 10). The score means that the opinion of civil society regarding the central role of political institutions in Turkey is deeply ingrained.

[4] The question included in the study is that who should manage business and industry in the country: owners, employees, owners and employees together, or the government.



Source: Anderson, et al., 2005: 10.

Figure 3. Understanding of the State and the Economy.

Patrimonial states can engage in significant coercive power in the policy-making processes. A highly centralization can lead to extremely weak and vulnerable structure in the political sphere. Businessmen surround the center. Thus, as business constitutes the periphery, the political authority and bureaucracy represent the center (Mardin, 2000). In this environment, the center-periphery relations shape the institutional structure. This tradition also continues to influence and reshape the Turkish politics today (Heper, 2000). Consequently, a regulatory policy in Turkey could lead to the rent-seeking processes (TUSIAD, 2002: 71).

As Demir (2010) pointed out in a chapter of this book, an important rent-seeking coalition in Turkey can be observed among the military, bureaucracy, and the market. Owning the constitutional privileges in the Turkish legal and political structure, the military has misused this privilege to increase its economic power in the economy. The military has consolidated its economic and political power by using the influence of OYAK Holding over the markets. According to its initial mission, OYAK was founded as a pension fund for its military members. However, its activities currently consist of insurance, investment banking, automotive, petroleum, iron-steel, and cement industries, tourism, food marketing, etc. At the present time, with this market power, OYAK Holding is one of the top-three companies of Turkey (the others are Koc and Sabanci). Although it has been declared that OYAK has never received any state aid, it continues to obtain important subsidies from the state institutions including tax exemptions, and legal protections that are used only by public offices. OYAK and the military have institutionalized their places in the market economy in favor of OYAK and its military members, and at the expense of the rest of the society. Thus the military has become a part of the rent seeking coalitions and a socio-economic class in the economic and political spheres[5].

In the early years of the Republic of Turkey public resources that were engaged to establish an entrepreneur class has been used for the political ends in the course of time. Populist and competitive political culture and the patrimonial state tradition in Turkey have introduced a distributive policy to interactions between the state and the markets. Distributional state continues to influence today’s economic and political institutional environment. In the last fifty years public funds were predominantly channeled to specific groups in Turkey. Because of the existence of distributive polity, governmental interventions in the markets deviated from well-defined political goals and converged to create and extract the rent-seeking activities. This tradition made rent-seeking, rent-extracting and rent-distribution an institutional component of the policy-making processes in Turkey. It has been a common feature for all political parties (Bugra, 1995; TUSIAD, 2002). Entrepreneurial incentives have been diverted to seeking unproductive, and sometimes destructive, rents in government rather than productive profits in competitive markets. The resources were transferred to the special interest groups or constituent chunks including farmers, public employees, industrialist, students and small enterprises rather than productive business (Pamuk, 2010). The institutional structure introduced a rent-seeking society and public funds are wasted in the rent-seeking processes (Ozcan and Cokgezen, 2004).

The electoral system in Turkey is also illustrative to understand the political institutional structure. Since the Constitution of 1982, a 10% electoral threshold has been applied throughout the country (Bacik, 2004: 823; Abdulhakimogullari, 2000). This rate is 8% in Liechtenstein, 5% in Germany, New Zealand, Romania, and Czech Republic, 4% in Spain, Bulgaria, and Sweden, 3% in Argentina and Greece, 2% in Denmark, 1.5% in Israel, and 0.67% in Netherlands (Atar, 2008). As an important aftermath of this structure, the preferences of enormous part of society have not been able to be represented in the public policy-making processes. Because of the electoral system, 3 or 4 parties can surpass the threshold and thus the remaining of voters cannot be represented in the public policies. In other words, the electoral system in Turkey impedes pluralism that is one of most important features of democracy in a country (Köker, 2006). The Constitutional Court interpreted this high rate not to be contrary to the Constitution[6]. Afterwards, the European Court of Human Rights in arbitration decided this threshold, not as contrary to the Human Rights, but as a high rate[7]. As a result, the current political structure shows that democratic components cannot be performed in the policy-making processes and the electoral system constitutes an institutional obstacle in terms of credibility of the public policies and/or the process of economic change.

1.2. The Years of Politics without Policy: The 1990s

Politics without policy is another aftermath of the electoral system in Turkey. Turkey’s political environment has long been defined by unstable coalition governments. The instability of coalitions made bargaining and strategic behavior an important component of

[5] For a detailed discussion about the role of the military and OYAK in the rent-seeking game, see Demir (2009).
[6] See the Constitutional Court decision no. E. 1995/54, K. 1995/59, Kt.18.11.1995.
[7] Grand Chamber, no. 10226/03.

the political life. The 1990s was particularly unsteady. There were eleven short-lived governments and seven of them were coalitions. In many cases, coalitions included parties with opposite world views. For example, the last coalition government of the 1990s included a leftist (DSP), a nationalist (MHP) and a liberal-conservative party (ANAP). This government could not implement any significant policy proposal because of conflicting opinions and beliefs. One of the harmful results of the incoherence was the unrelenting budget deficits, which went hand in hand with inflationary pressures (Öniş, 2003).

Governance by coalitions harms the stability of any regulatory policy. No government can take bold steps in this environment and political bargaining dominates the political market. The costs of decision-making are relatively higher in coalition governments because of widespread principal-agent problems (Martin and Vanberg, 2004). Interest groups use this system competently to extract rents. Regulatory capture by private interest groups fosters in this environment. There are two dominant channels for the capture. On the one hand, campaign financing and other ways of pecuniary gains influence political decision making. On the other hand, these groups may provide only beneficial information to politicians to persuade politicians (Figueiredo and Figueiredo, 2002: 161-2).

Coalition governments also increase transaction costs of the process of economic change. Coalitions are usually short-lived. So, interest groups spend more resources to get and protect their interests (Olson, 1999). Coalition parties may have conflicting policies toward some industries. The divergence among parties weakens the power of government. Allocating regulated industries among coalition parties harms the process of economic change too. For example, the previous coalition government distributed regulation authorities across parties. ANAP controlled the energy industry, MHP dominated telecommunications and the banking sector was mainly controlled by DSP. On the other hand, two prominent regulatory institutions, the Banking Regulatory and Supervisory Authority (BRSA) and the Competition Authority (CA), were established under the bargaining of coalition parties. The government could not appoint their board members for a long time after their law passed in the parliament because of political haggling. These parties had conflicting views about the role of state in the economy. Policy-making costs surged in this environment. Thus conflicting views of coalition parties delayed the institutionalization of economic change and contributed to the economic crisis in 2001 (TUSIAD, 2001).

The economic crisis of 2001 is another important example of conflicting views of the coalition parties on the economy. The governing parties had separate control areas and tried to maximize their benefits. The regulatory capture was widespread and bureaucrats found ways to seek their own gains within the system. This created a fragmented democratic and economic system. On the one hand, they tried to implement market-based institutions; on the other hand, they had no intention to let go their rent resources. The banking industry, because of rent seeking of political elites, was not adequately regulated. An ineffective regulatory framework was one of the reasons for problems in the banking sector that helped to trigger the 2001 crisis, causing vast welfare losses (OECD, 2002a: 9).

In the end of the lost decade, the aftermaths of rent distribution have been the duty losses of public banks and budget deficits. Public banks in Turkey have emerged as principle players of rent distribution. Both borrowing and lending operations of these institutions have heavily been politicized in the political processes and public banks like Ziraat Bank and Halk Bank helped the governments to transfer public funds to their own constituents including agricultural producers and small and medium sized businesses. The duty losses of these banks for 2000 and 2001 are shown in Table 1 (Alper and Onis, 2002).

Table 1. Securities Issued for the Duty Losses of State Banks (TL Trillion)

	Ziraat Bank	Halk Bank	Emlak Bank	Total
2000 Year-end	2,034	863	-	2,897
2001 January*	2,333	2,167	-	4,500
February	-	1,000	-	1,000
March	550	1,750	-	2,300
April	4,500	1,750	-	6,250
May	4,730	4,130	45	8,905
2001 Total	12,113	10,797	45	22,955
TOTAL	14,148	11,659	45	25,852

(*) USD 750 million securities dominated in foreign currencies were converted by the CBRT exchange rate of issuing day, January 3, 2001.
Source: Alper and Onis 2002.

Not only the banking industry, but also other tightly regulated industries and state monopolies were main targets of rent-extracting and rent-seeking activities. As in any other developing country, the state-owned monopolies in Turkey as well have been economically inefficient and politicians have manipulated this inefficiency for their own political ends. For example, the electricity industry has long been an arena for wealth transfers to the state and an important variable in political games[8]. As a whole, the political will, even if it existed, could not find its way to the market because of the resistance from special interest groups (Çetin, 2008; Çetin and Oguz, 2007).

Consequently, the nature of the electoral system was some degree responsible for the build up of economic instability. These banks are subsidized by the budge. The transfer of resources over public banks to interest groups through the budge affected specially the macroeconomic performance of the 1990s (see Table 2). The system brought about the high public sector deficits that characterized the decade. With flaming of competitive politics, the public sector borrowing requirement (the PSBR) increased. Thus, while the PSBR was about 5% of GNP in 1987, it reached 12% in 1993 and continued to increase up to 1999[9]. Inflation rates had been steadily high up to the early 2000s and FDI inflows had been lower than in the 2000s.

Privatizations turned into a policy game and political interest groups became part of a rent-seeking game (Ercan and Onis, 2001). An important consequence of privatizations in Turkey is the failure to remove the state from the market. Governments used privatizations to generate income without losing the control of the enterprises. This could not provide a full scale privatization. Many problems that plagued the state owned enterprises have persisted. As seem in Table 2, privatization policies from 1980 to 2004 have not been able to ensure a satisfactory level of investment for sustained growth. The failure to establish the link between the real economy and liberalization only consolidated existing rents and promoted rent-extracting (Aricanli and Rodrik, 1990: 1350). In the end, political preferences replaced efficiency considerations and the reform has stalled for a long time.

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[8] For a detailed discussion of the political game in the electricity market, see Çetin and Oguz (2007).
[9] According to the Maastricht criteria, the PSBR / GNP ratio should be lower than 3 %.

Table 2. Crucial Macroeconomic Indicators of Turkey the Post-1980

Years / Indicators	1980–1989	1991–1995	1996–2000	2001	2002	2003	2004	2005	2006	2002-2006
Inflation	51,7	78,8	74,1	54,2	45,1	25,3	8,6	8,2	9,6	19,4
PSBR/GNP	5,0	8,8	9,3	16,4	12,7	9,4	4,7	-0,4	-2,6	4,8
FDI inflows	n.a	756,6	846,4	3352	1.137	1752	2847	9673	19919	5646,6
Privatization Revenues	n.a	432	907	120	537	187	1283	8222	8096	3665

Source: Onis and Bayram, 2010.

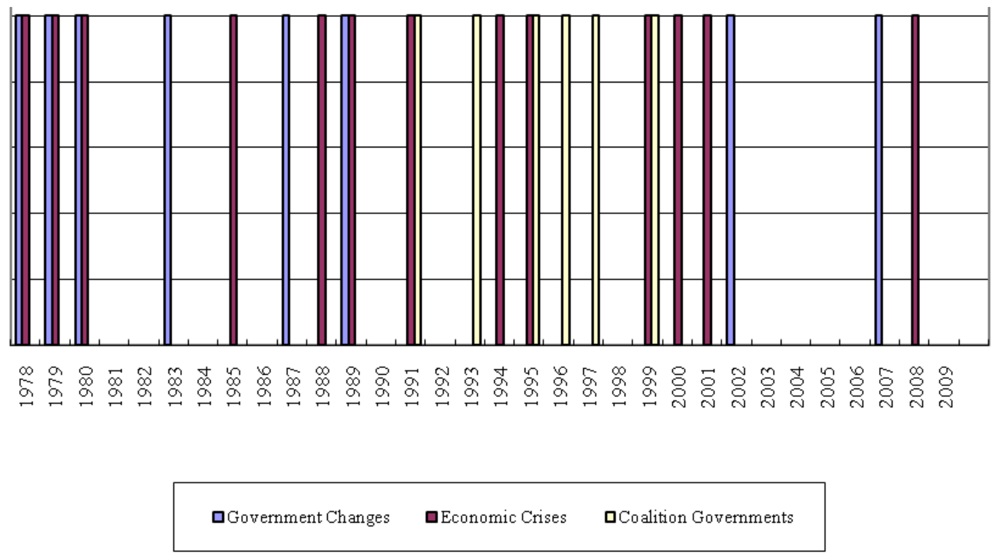
Because of deficiencies in the institutional environment, another feature of the 1990s is that Turkey had attracted only lower FDI inflows than the similar-featured countries. We can rank the reasons of why Turkey had a lack of success in attracting large FDI inflows as a fragmented political system and macroeconomic instability, cumbersome bureaucracy, a slow-performing legal environment and discrimination in the court decrees in particular against the foreign-sourced investments. As shown in Table 3, the result is much lower FDI inflows than in other countries at similar development levels (OECD, 2002b).

Table 3. Foreign Direct Investment (net inflows, as a percentage of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Turkey	0.49	0.34	0.43	0.45	0.34	0.29	0.29	0.07	0.06
Hungary	3.93	6.00	2.61	10.02	5.04	3.79	3.31	3.59	2.49
Poland	0.79	1.98	1.86	2.85	3.09	3.37	3.82	4.67	5.92
Czech Rep.	na	1.58	1.85	4.86	2.22	2.38	6.27	11.31	8.69
Korea	-0.14	-0.22	-0.41	-0.36	-0.45	-0.34	0.21	1.26	0.93
Argentina	1.43	0.88	1.02	1.59	1.96	1.88	1.66	7.98	3.71
Brazil	0.31	0.08	0.25	0.49	1.50	2.30	3.70	5.03	5.13
Chile	1.28	1.35	3.28	3.38	5.03	4.45	2.52	6.44	-1.56

Soruce: OECD, 2002b: 134.

In the end, Turkey faced three biggest economic crises (1994, 2000, and 2001) during this period. As depicted in Figure 4, there is a positive correlation between economic crises and political instability during the post-1980 term until 2002 (Kibritcioglu, 2001). Although it is possible to mention economic turbulences during the unique party government after 2002, it has not been occurred an evident economic crisis as well as in 1994, 2000 and 2001. Economic crisis in 2008 is a global crisis rather than a national-sourced crisis. With the 2002 elections in Turkey, the aftermaths of the coalition governments and political instability in the process of economic change in Turkey have slackened. The current government has launched stronger efforts at institutional reforms than have been endeavored so far. Consequently, *the years of politics without policy* of the 1990s expired and the current government has performed a notable economic performance at least as compared to the previous coalition governments[10].



Note: Yellow lines represent the coalition governments in the 1990s. While 1991, 1995, and 1996 years include two government changes, 1999 represents three government changes.
Source: http://www.tbmm.gov.tr/hukumetler/hukumetler.htm

Figure 4. Government Changes and Economic Crises in Turkey.

2. The Legal Institutonal Structure over Economic Change

Under an independent judicial review, economic change complies with a credible institutional change. Legislative and administrative processes with judicial review may provide substantial credible commitment in the institutional environments characterized by the explicit separation of powers (Spiller and Tommasi, 2005). In Turkey, another deficiency in the process of economic change stems from the legal system. Shortcomings in this area originate both from inconsistencies of institutions in the legal system and from capacity deficiencies in the commercial justice concerning *doing business*. In Turkey, there are unpredictabilities related to the legal processes that stem from internal conflicts between different sources of the legal structure. This sub-section is interested in the role of the legal institutional structure over economic change both in terms of the resistance of the judiciary against the change, and the effect of legal rules on *doing business* in Turkey.

[10] See, for a deeper economic analysis of the post-2002 term, Onis and Bayram (2010).

2.1. The Resistance of the Judiciary against the Change

The Turkish Constitution of 1982 includes uncertain approaches regarding regulation and privatization of public utilities, public interest, and independent regulatory agencies[11]. Interpreting the constitutional rules, the Constitutional Court can annul laws and regulations that they accept to be inconsistent with the Constitution. Almost all recent privatizations have been nullified by the related courts for technical and legal reasons (Ulusoy and Oguz, 2007). In a recent case, the Constitutional Court annulled the Social Security Reform Law in 2006 on the basis of constitutional provisions over the private privileges of civil servants. In this sense, the position of other administrative courts and Danistay (as an appeal court) is not also different from the Constitutional Court (OECD, 2008). For example, the first privatization of the state-owned oil company (Tupras) was annulled on the basis of public interest by the Ankara 10th Administrative Court[12]. This decree was approved by Danistay during the appeal process.

Furthermore, it is possible to find other cases from different areas. For example, the Constitutional Court and Danistay recognize all segments of the electricity such as generation, transmission and distribution as public utilities[13]. According to this opinion, all public utilities require the review of high courts. The Turkish public law deems long-term contracts for the provision of public utilities by private actors to be administrative contracts. For that reason, franchise contracts for the public utilities are accepted to be subject to public law. On the other hand, the Constitution requires Danistay's opinion over long-term franchise contracts in the public utilities prior to the agreement of contracting parties. Consequently, attempts to convert these franchise contracts that are subject to public law into private law contracts by the politicians have been nullified by the Constitutional Court and Danistay. Such decisions of Danistay and the Constitutional Court over long-term contracts concerning public utilities brought about uncertainty in particular for international investors. Additionally, the compulsory jurisdiction of the Constitutional Court and Danistay did not allow disputes concerning the contracts to be taken to international arbitration until the constitutional amendment in 1999 (Ulusoy and Oguz, 2007).

In a sense, this situation can also accepted as another reason of why Turkey had attracted only lower inflows of foreign direct investment until 2001 as compared to countries in East Europe and/or Latin America (see Table 3). Until 1999, disputes among the contracting parties were compulsory to be solved by the Constitutional Court and Danistay, but not international arbitration. All long-term franchise contracts including public utilities were only subject to the decree and/or review of the Constitutional Court and Danistay. Under this structure, franchise contracts and privatizations were nullified by the courts and FDI inflows were impeded. However, a constitutional amendment passed in Parliament in 1999 allowed international arbitration for disputes related to the franchise contracts and gave Parliament the authority to allow for the provision of public services through private law contracts. It is

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[11] In fact, institutional environment in Turkey is shaped by the Constitution of 1982 and this constitution is a conservative one. The Constitution contains serious restrictions on civic, political, and in some cases economic freedoms (Atiyas and Emil, 2005). In particular, there is a serious dilemma between political authority and High Courts about privatization of public utilities.

[12] See decision of June 3, 2004.

[13] Danistay annulled TOR (transfer of operating rights) contract of Aktas that has franchise rights in the electricity distribution, by reason of defective acts of the company (Ulusoy and Oguz, 2007).

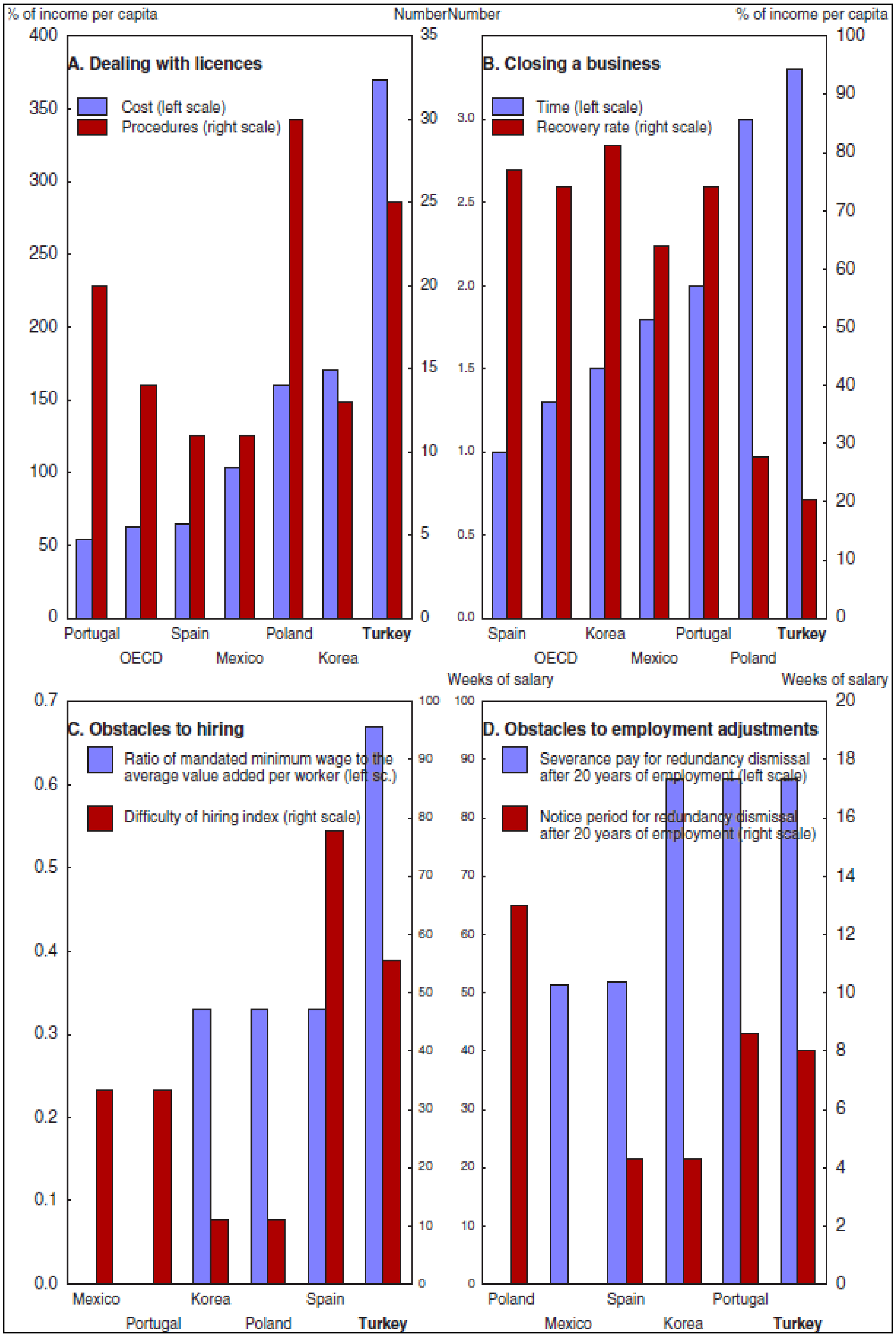
accepted that the constitutional amendment in 1999 opened the door for the franchise contracts to international arbitration and thus to privatizations (Ulusoy and Oguz, 2007). Consequently, privatization revenues in the post-2000 term have increased (see Table 2).

2.2. The Role of Legal Rules over *Doing Business* in Turkey

Large productive business possibilities in Turkey have been performed in informal areas. Although these business possibilities constitute a giant part of economic activity, they cannot nevertheless be transferred to the formal sector due to the legal constraints. As compared to domestic small companies, foreign investors face stricter business regulations. They have to fulfill additional requirements for listing on the Istanbul stock exchange and to bear additional restrictions on self-employment and nationality conditions for certain professional services. In particular, foreign investors wishing to start a business in sectors such as energy, media, air and sea transport, ports, fish processing in Turkey are compulsory to obtain a Certificate of Permission and a minimum capital requirement. In a sense, these restrictions mean entry barriers to the markets and at least, delay starting a business (OECD, 2002b: 130).

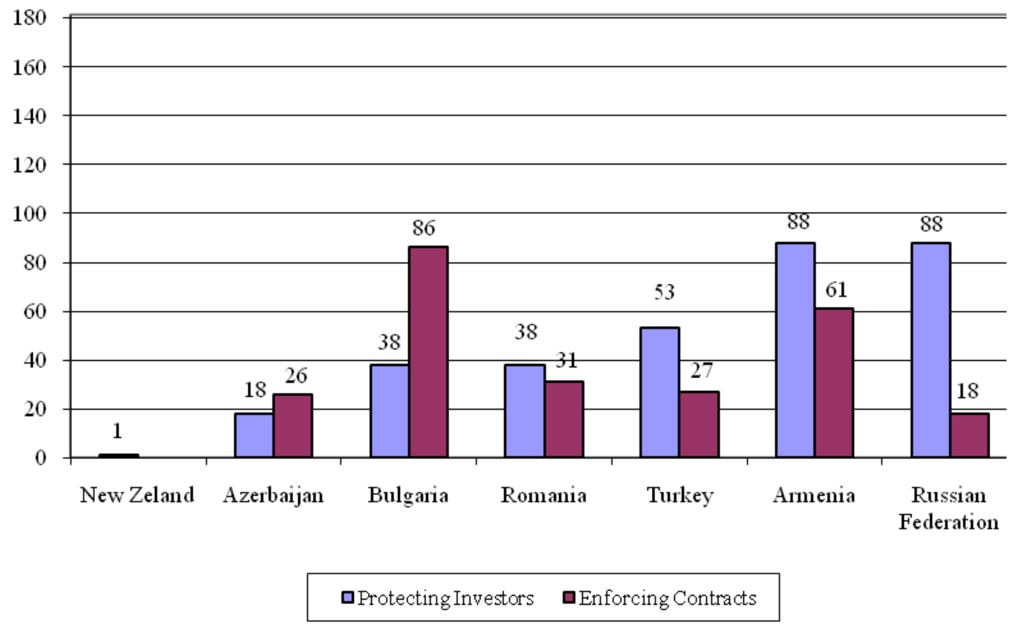
This regulatory framework brings about dilemmas for formal companies (in particular, foreign companies) complying with the law and forces lower productivity and informal or semi-formal enterprises to enter into the markets. Because, as shown in Figure 5, regulations in the markets make it difficult for entrepreneurs to fully comply with the law. When we look at the figure, we see that there are the most regulatory handicaps concerning legality, transparency, labour market rules, informal and semi-formal doing business. According to the legal rules, minimum wage/average wage ratios and labour tax wedges are very high. On the other hand, as compared to the OECD area in the figure, the rules regarding employment protection are too rigid and payments are the highest severance. For those reasons, operating that complies with the legal structure in the markets, and obtaining full access to modern capital, skilled labour, technology and foreign direct investment resources, is still too costly (OECD, 2008).

Consequently, as depicted in Figure 6, Turkey among 181 economies is ranked 53 overall for protecting investors and ranked 27 overall for enforcing contracts. Rankings in 2008 are 66 and 30, respectively (DB, 2009). If the legal constraints in front of doing business can be removed, the costs of doing business in the formal sector lower and these informal sources can be transferred to the formal economy. However, removing the constraints requites serious structural reforms. Whereas the coalition governments of the 1990s had not been able to present serious legal changes, it is expected that the current government would carry out a radical change in the legal sphere in context of Turkey’s membership process to the EU (Bacik, 2004: 827). According to OECD (2008: 50), the reform should contain a harmony of labour market regulations to OECD best-practices, the modernization of financial markets and free entry and exit into competitive product markets.



Source: OECD, 2008: 34.

Figure 5. Product and Labour Market Regulations.



Source: DB, 2009.

Figure 6. Protecting Investors and Enforcing Contracts-Global Rank.

The Turkish regulatory institutional system is undoubtedly undergoing a process of change in response to powerful domestic and external pressures (Öniş, 2003). The current government has initiated a range of crucial steps to strengthen the business world. In recent times, in particular, product market regulations have intensively been enforced. For example, the government initiated a serious change to protect investors by means of a new law (see Table 4). This reform requites that an independent auditor reviews transactions between the related parties before the transactions are approved (DB, 2009). Indeed, in Turkey, the protection of private property from private violation is rather strong. If the property of an entity is registered, the property rights cannot be seized by the other parties. If someone violates the property rights of the others, in order to overcome this issue, there are two methods in the Turkish legal and judicial system. Firstly, in case of a violation on the property, the local administration has the authority to apply an injunction to the violator. However, the violator has the right to sue against the injunction of the local administration in a court. Secondly, the injured party can demand compensation from the violator by a court process. Consequently, the legal-institutional structure protects the private property rights from private violations (Arat et al., 2001: 224).

Table 4. Reforms in Doing Business (2009)

Rank	Economy	Starting a Business	Dealing with Construction Permits	Employing Workers	Registering Property	Getting Credits	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business	Total number of reforms
1	Azerbaijan	+		+	+	+	+	+		+		7
2	Albania	+				+	+	+				4
3	Kyrgyz Rep.	+	+				+					3
4	Belarus	+	+		+	+		+	+			6
5	Senegal	+			+				+			3
6	Burkina Faso		+	+	+			+				4
7	Botswana	+					+	-	+			3
8	Colombia	+	+					+	+		+	5
9	Dominican Rep.	+			+			+	+			4
10	Egypt	+	+		+	+	+		+			6
11	Turkey						+					1
12	Russian Fed.											
13	Romania									+		1
14	Armenia		+							+		2
15	Bulgaria	+	-						+	+	+	4

Note: Economies are ranked on the number and impact of reforms, Doing Business selects the economies that reformed in or more of the Doing Business topics. Second, it ranks these economies on the increase in rank in Ease of Doing Business from the previous year. The larger the improvement, the higher the ranking as a reformer.

Source: DB, 2009.

However, institutional reform in the judiciary has not been deepened. For that reason, the regulatory institutional structure is still rigid and obstructive for the business sector. Still, as compared to its direct competitors in the emerging world and most other OECD countries, Turkey has *less attractive doing business in compliance with the law* in terms of labour and product market regulations. Reforms are yet not sufficient to attract more investment.

3. Conclusion

Institutional reform in a country is the main component of economic change. For a successful economic change that would be compatible with the needs of the time, the harmonization of political institutions to the change is especially a considerable issue. On the one hand, while the political authorities should follow technological and theoretical progresses that are pioneer for the direction of an economic change; on the other hand, the bureaucratic and legal institutions or organizations need not to resist economic change that takes account efficiency considerations. Since the legislature is principal, in one sense, the judiciary and the executive are agent. When the legislature as a principal determines policies, the executive as agent needs to be subject to the decisions of the legislatures. In this game, the role of the judiciary that needs to be independent in the context of separation of powers is to review decisions determined by the politicians in terms of the consistency with the constitution.

Although it is possible to say that Turkey preferred a process of transition to economic and institutional change, the experience shows that Turkey has not been able to succeed in achieving it. In particular, throughout the 1990s, economic issues had been tried to be solved in the political markets with the coalition governments rather than the entrepreneurial processes in the economy. Hence, politicians and bureaucrats employed the political processes to extract and to transfer artificial rents to themselves and interest groups. In these processes, public resources were transferred from effective areas to ineffective ones and thus wasted. On the other hand, the legal institutional structure resisted and continues to resist the change, in spite of the reform initiatives of the current government. Specifically, Danistay and the Constitutional Court have annulled laws concerning (de)regulation and privatization of public utilities. Clearly, it is possible to say that the interaction between political institutions in Turkey increase transaction costs and bruise credible commitment and hence introduce a strong resistance against economic change. As a result, the reform initiatives had brought about inefficient and unstable economic outcomes rather than a successful economic change.

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Chapter 3

TEMPORARY STAR OR EMERGING TIGER? TURKEY'S ECONOMIC PERFORMANCE IN A GLOBAL SETTING

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INTRODUCTION

The Turkish economy has experienced one of its most favorable phases of growth during the 2001-2006 era. The period following the crisis of 2001 witnessed a successful transformation of the Turkish economy, due to a combination of structural reforms and measures aimed at establishing macroeconomic stability. In the post-2001 period, the Turkish economy managed to achieve high rates of growth. Furthermore, this growth was accomplished in an environment of fiscal discipline and single-digit inflation, which marked a dramatic departure from the endemic instability and chronic inflation that had become a norm over the last few decades. Another striking feature involved large inflows of foreign direct investment, again representing a major contrast to previous years. Privatization also gathered momentum, with large-scale privatization of state economic enterprises during the latest phase of Turkey's on-going neo-liberal structuring process. The wave of regulatory reforms encompassing, among others, the banking sector, the Central Bank, government expenditures and revenues, as well as foreign investment legislation constituted the very foundations of this

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Authors' Note: *The article was originally published in New Perspectives on Turkey, No. 39 (Fall 2008): pp. 47-84 and is reptrinted in the present volume with the permission of the editors of the Journal. The article was written prior to the onset of the financial crisis. It focuses on the period from 2001 to 2008 and higlights both the strengths and weaknesses of Turkey's economic performance in the context of a highly favorable external environment of the pre-global crisis era. In retrospect, Turkey has been significantly affected by the global financial crisis. Our analysis of the 2001-2008 era provides a useful background towards understanding the pattern of Turkey's response to the global crisis* impressive performance. It is fair to say that Turkey made significant progress in terms of establishing an effective regulatory state during this period. This chapter examines the interaction of domestic and external influences that played a critical role in the recent transformation process. More significant, however, is the question whether the new institutional reforms towards establishing a regulatory state will be sufficient for generating outstanding performance on a durable basis. In other words, this chapter questions whether or not the Turkish economy can emerge as a "new tiger."

The basic premise of this chapter is that exceptional economic performance rests on the following set of interrelated conditions: (a) High levels of investment form the central ingredient of economic growth. (b) The ability to attract foreign investment is important. However, a balanced structure necessitates high levels of domestic investment to complement foreign investment. This, in turn, requires high levels of domestic savings. (c) The ability to sustain export orientation is essential. Export orientation is also critical for the ability to diversify exports in the direction of high-value added products with significant technology content. (d) The ability to devote resources to research and development as well as to education and human capital are key ingredients for success. The role of the state in development continues to be critical; an improvement of regulatory capacities of the state alone will not be sufficient for exceptional success. (e) Economic and political stability on a sustained basis forms a major underlying element of exceptional success. While the presence of an authoritarian regime is not a precondition for success, weak or unconsolidated democracies find it particularly hard to generate economic and political stability on a sustained basis, which, in turn, undermines their long-term growth potential. (f) Favorable regional dynamics, such as the EU enlargement process, embody a powerful transformative potential. External stimuli can help to generate a virtuous cycle of growth by creating a mutually reinforcing process of trade expansion, foreign investment flows and institutional improvement as part of the democratic consolidation process.

An assessment of the Turkish economy in the recent period necessitates a multi-dimensional analysis within the context of both its own historical development and the global setting. Based on this multi-dimensional approach, the principal sections of this chapter are organized along the following lines: The recent success in the Turkish economy will be evaluated based on its own historical standards, with particular reference to its early neo-liberal experience and instability in the 1990s. Achievements in terms of inflation control, attraction of FDI and success on the privatization front will be all the more striking when compared to Turkey's earlier experience in the economic realm (Section 2). Although the comparison of the two key periods in the history of the Turkish economy provides many insights into its continuities and ruptures, the assessment of the recent performance of the Turkish economy in isolation is still inadequate, and a better understanding requires embedding the Turkish experience in a broader global and comparative context. Before comparing Turkey to key emerging markets, the East Asian (EA) development success and the concepts of "Asian tigers" and "tiger-like performance" will be analyzed in order to use the EA experience as a benchmark for the assessment of long-term sustainable growth in the Turkish case. Examining certain macroeconomic and social indicators of the EA success, this section indicates not only the measures responsible for providing sustainable growth, but also alternative theories specifying the reasons for the EA miracle (Section 3). Based on the insights gained from the EA experience, this section extends the limits and geographical scope of our inquiry, assessing the recent performance of the Turkish economy in a comparative perspective. Not only the EA economies, but also a number of key emerging markets from Latin America (LA) and Central Europe (CE) constitute an essential part of this analysis. The similarities with LA neo-liberal restructuring and the effects of the EU accession process in the CE context provide additional perspectives for the comparison (Section 4). Although the assessment of the recent performance of the Turkish economy supported by inter-temporal and cross-country comparisons highlights its impressive nature, this section argues that there exist certain weaknesses and observable threats to long-term growth. The large current account deficit, low savings rates, and overall dependence on foreign and favorable global liquidity are particularly striking in this context. Furthermore, the weakening of external anchors and rising political instability emerge as major challenges to the sustainability of the recent economic success. However, we also argue that these challenges can be balanced by medium- and long-term opportunities—such as regional cooperation, the geo-strategic importance of Turkey with respect to energy pipelines, and a demographic structure based on an unusually young working population (Section 5). Even though the first sections of the chapter explicitly focus on conditions conducive or detrimental to sustainable growth, in order to have a complete picture of "development" we go beyond the strict economic measures of growth and deal with the social dimensions of long-term development, incorporating into the analysis such factors as unemployment, inequality, poverty, and "human development" (Section 6). The last section summarizes the main arguments.

1. The Turkish Neo-Liberal Experiment: The 2001 Crisis as a Turning Point

The Turkish neo-liberal experience started in 1980 with the January 24 program, under the auspices of the World Bank and the International Monetary Fund (IMF). The program rapidly reached its initial targets in terms of reducing inflation, achieving higher growth rates, and taking steps towards trade and financial liberalization.[1] With the crisis of the late 1970s, import-substituting industrialization (ISI) policies appeared to have reached their limits; thus, the January 24 program was not only a stabilization program in a conventional sense, but also a starting point for the structural transformation of the Turkish economy along neo-liberal lines. As a result of ISI policies, Turkey managed to sustain high growth rates, introduce planned development, achieve rapid industrialization and outperform most LA cases in the period between 1963 and 1977; however, its growth failed to match the performance of EA economies. Indeed, excessive, indiscriminate and long-term protectionism associated with the ISI era in the Turkish economy was an important contributor to export stagnation and the endemic balance of payments crisis which had emerged by the late 1970s.[2] The first half of the 1980s under neo-liberal structuring appeared to reverse the previous trend and represented

[1] For a detailed assessment of the period, see Ertuğrul & Selçuk (2001). According to the data provided by these scholars, the Turkish economy grew steadily by an average of 5.8% in the period between 1981 and 1988. See also Arıcanlı & Rodrik (1990) for a critical assessment of the Turkish neo-liberal experience.

[2] For an account of major policy phases and shifts in Turkish economic history, see Öniş & Şenses (2007) and Pamuk (2007). An important study which investigates the economic and political determinants of growth in Turkey from the nineteenth century to the present is Altuğ, Filiztekin and Pamuk (2007).

a certain progress towards establishing an externally competitive economy through a significant increase in exports. The ratio of total exports to GDP increased between 1980 and 1988, from 4.1% to 13.3%.[3] Moreover, the process was accompanied by a diversification of exports, involving a striking increase in the share of manufactured exports at the expense of agricultural exports. However, the success on the export front could not be sustained in the second half of the 1980s.[4] This pattern appears to be a rather typical feature of Turkish economic development. There have been a number of such periods of unusual economic progress in the post-war era. However, these periods tended to be relatively short-lived and were followed by periods of stagnation and crisis.

The second phase of Turkish neo-liberalism in the 1990s was characterized by a high degree of macroeconomic and political instability, lower growth rates, chronic inflation and weak budgetary performance. The appreciation of the Turkish Lira (TL) was the major driving force behind the slowing pace of exports and rise of imports, leading to an external deficit. The ratio of external deficit to GDP increased to 2% in 1989, 4% in 1990, and 6% in 1993. Towards the end of 1993, it was more or less obvious that the fiscal deficit and external balance situation became unsustainable.[5] Not surprisingly, given the size of the disequilibrium which had emerged, Turkey encountered its first crisis of the neo-liberal era in 1994—the TL was devalued twice, in January and April of 1994. Not only major shocks, but also chronic inflation turned out to be the essential characteristics of the neo-liberal era in the Turkish context. Due to the government's low level of credibility and its lack of commitment to the stabilization program, as well as the high degree of currency substitution (dollarization) and the high costs of borrowing, chronic inflation could not be reduced during the 1990s. Similarly, due to the serious interest burden on government expenditures, PSBR / GNP ratios reached extremely high levels by international standards, rendering inflation control all the more difficult.

In retrospect, the experience of the 1990s clearly illustrates the fact that the optimism surrounding the early phase of neo-liberal restructuring could not be sustained. Indeed, a number of analysts have pointed out the long-term institutional regularities which led to the reemergence of crisis-generating tendencies during the neo-liberal era. For example, in his analysis of Turkey-EU relations from an economic perspective, Mehmet Uğur, intending to explain why Turkey fell behind Central and East European countries (CEECs), even though Turkey's liberalization efforts predated theirs, has argued that liberalization in Turkey was introduced within an institutional environment marked by excessive discretion and pervasive rent-seeking. As a result of intensive lobbying and rent-seeking activities by various interest groups, these discretionary acts involved a frequent use of governmental decrees and relied heavily on extra-budgetary funds.[6] Similarly, Mine Eder has argued that, in contrast to the rhetoric of neo-liberal economic policies, populism survived in the form of de-

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[3] Ertuğrul & Selçuk (2001)

[4] For an explanation of the slow-down in export growth during the second half of the 1980s, see Öniş (1993).

[5] Ertuğrul & Selçuk (2001)

[6] See Uğur (2004). In order to indicate that Turkey falls behind CEECs, Uğur utilizes seven measures taken from the Transparency International and World Bank Governance Indicators. These measures are corruption perception, growth competitiveness, microeconomic competitiveness, quality of public institutions index, macroeconomic environment, company operations and microeconomic business environment. In almost all measures, Turkey falls behind the eight CEECs and is only able to outperform Bulgaria and Romania in some of these measures.

institutionalization, patronage politics, and charismatic leadership.[7] In short, the neo-liberal era was clearly not different from the previous periods in respect to the institutional environment, leading to corruption and rent-seeking activities.

In addition, there were two major turning points in the second half of the 1980s, which are crucial for understanding the institutional features of instability in the 1990s. The first dramatic change affecting the institutional dynamics and the patterns of incentives for the actors in the Turkish economy was the revitalization of political competition in 1987, which enhanced the role of the populist element in Turkish politics. After the 1980 military intervention, Turkey was ruled by a military government for three years, and all political parties and labor unions were banned.[8] Although general elections were held in 1983, the old political parties and leaders were not permitted to enter the competition. Without serious rivals, the Motherland Party (MP) emerged as the sole winner of the 1983 elections and established a majority government. The 1987 elections witnessed the re-emergence of political competition, with the entrance of the center-right True Path Party (TPP) as a follower of the Justice Party and the center-left Social Democratic Populist Party (SDPP) following in the footsteps of the Republican People's Party. Although the MP managed to satisfy the government majority due to the uneven nature of the electoral system in the 1987 elections, it was finally defeated by the TPP and the SDPP in the 1991 general elections, and a post-election coalition government was established. What appealed to the masses was the coalition's promise to improve people's living standards, which had been repressed by the wage rigidity of the post-coup authoritarian regime. Combined with the lack of budgetary discipline and loss of pace on the export front, this new populist element in the Turkish economy was responsible for creating institutional instability in the 1990s. The second key turning point is the capital account liberalization and the full convertibility of the TL in 1989. Arguably, this critical decision managed to postpone a possible financial crisis, but at the expense of a highly fragile pattern of debt-led economic growth.[9] Much more importantly, the decision of capital account liberalization was made without establishing the necessary institutional environment to supervise and regulate the high liquidity of international flows.[10] Speculative attacks in an environment of large budget deficits proved to be the key proximate causes for the successive crises of 1994, 2000, and 2001.

The post-2001 period represents a clear rupture from the unstable macroeconomic environment of the 1990s in terms of higher growth rates, lower inflation, fiscal discipline,

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[7] See Eder (2004). For a detailed account of Özal's economic legacy and the early period of Turkish neo-liberal era, see Öniş (2004).

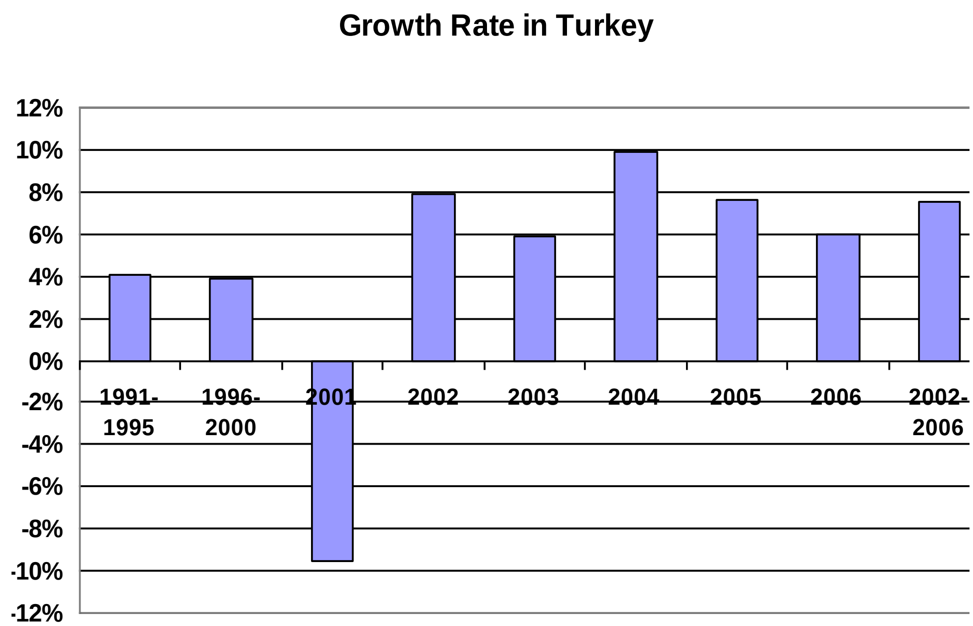
[8] Although beyond the scope of this paper, another interesting debate on the role of the military intervention in the neo-liberal era is whether military interludes have created a stable environment for reforms. One should be mindful of the fact that the authoritarian nature of the military rule allowed an implementation of repressive policies, reducing real wages and eliminating political opposition by shutting down former political parties, labor unions and other civil society elements, in a sense blocking the mechanisms of interest intermediation in the political process. In addition, it undermined the trust of key social actors and prevented the institutionalization of the party system, leading to discontinuity and fragmentation. For a detailed discussion of the argument, see Öniş (1997). It should also be taken into account that the military intervention and the interruption of the democratic process caused the deterioration of Turkey-EU relations throughout the 1980s and 1990s, preventing the EU from playing its role as an anchor not only in terms of democratization, but also economic development.

[9] See Öniş (2003) for a detailed discussion on the return of the populist element to Turkish politics and pre-mature capital account liberalization leading to debt-led growth.

[10] For pre-mature capital account liberalization, see Arıcanlı &Rodrik (1990).

attracting FDI, and success on the privatization front. The recent success of the Turkish economy in comparison to earlier periods can, first of all, be observed through growth performance data. Figure 1 clearly demonstrates that the post-2001 period outperforms the unstable 1990s with regard to the GDP growth. The average growth rate between 1991 and 1995 and between 1996 and 2000 appeared as 4.1% and 3.9% *per annum*, respectively. It should also be noted that in the 1990s growth was not steady and sustainable, as it was challenged by the immense recessions of 1994 and 1999, resulting in a negative growth of 6%. Especially the 2001 financial crisis and the following 9.5% recession is a clear indicator that the Turkish economy is vulnerable to financial shocks in the form of rapid outflows of speculative short-term portfolio investments, external shocks (such as the effects of the Russian crisis of 1998 on trade links in Turkey), and the overall dependence on foreign capital. Although similar vulnerabilities continue to exist at present, it is clear that the recent growth performance between 2002 and 2006 has outperformed the previous periods by a significant margin. On average, the Turkish economy managed to grow at a rate of 7.5% *per annum*.

An equally striking improvement can be observed for the inflation rate. While the early experience of the Turkish economy with the neo-liberal adjustment was characterized by chronic inflation, the post-2001 period has witnessed a serious decline in the inflation rate. The average inflation in the 1980s was 52% *per annum*; between 1991 and 1995, 78.8 % *per annum*, and between 1996 and 2000, 74.1 % *per annum* (Table 1). In contrast, the average inflation rate between 2002 and 2006 declined to 19.4% *per annum*. Much more importantly, the inflation rate was kept below the 10% threshold *per annum* for the consecutive years of 2004, 2005 and 2006. In contrast to the unstable macroeconomic environment of the 1990s, the achievement on the inflation front—that is, price stability—seems to be the major contributory factor to the macroeconomic stability and investor confidence.



Source: Treasury.

Figure 1. Growth rate in Turkey.

The third major indicator of macroeconomic stability in the post-2001 period is fiscal discipline. A major aim of the 1980 program had involved the achievement of fiscal discipline. In spite of an initial improvement, however, the program clearly failed to establish fiscal discipline over time. Table 1 highlights the fact that, following a modest success in the reduction of the PSBR ratio in the first half of the 1980s, there is a secular trend involving an increase of the PSBR ratio throughout the 1990s, reaching its peak during the 2001 crisis with more than 16% of the GNP. In the post-2001 era, in contrast, the PSBR / GNP ratio has declined by a tremendous margin, in line with the Maastricht criteria.[11] Hence, the government's commitment to fiscal discipline in the post-crisis era constitutes another element of macroeconomic stability.

In the post-2001 era, Turkey has also managed to attract significant levels of FDI, which represents a striking contrast with both the ISI era and the earlier phases of neo-liberal restructuring. In retrospect, it was not only the macroeconomic stability and rising investor confidence, but also the concrete prospect of EU membership that brought about a significant increase in the amount of FDI.[12] As can be observed from Table 1, following the EU Council's decision to initiate accession negotiations in December of 2004 and its confirmation in October of 2005, the amount of FDI inflows to Turkey has reached the level of 20 billion US$ *per annum*, higher than the total recorded for the period between 1980 and 2000 as a whole.

[11] According to the Maastricht criteria, the PSBR / GNP ratio should be lower than 3%.

[12] For a detailed analysis of Turkey's FDI challenges with specific reference to the EU accession process, legal requirements and the formation of a competitive framework, see Dutz *et al.* (2004).

Table 1. Crucial macroeconomic indicators of Turkey in the neo-liberal era

	1980–1989	1991–1995	1996–2000	2001	2002	2003	2004	2005	2006	2002-2006
Inflation	51,7	78,8	74,1	54,2	45,1	25,3	8,6	8,2	9,6	19,4
PSBR/GNP	5,0	8,8	9,3	16,4	12,7	9,4	4,7	-0,4	-2,6	4,8
FDI inflows	n.a	756,6	846,4	3352	1.137	1752	2847	9673	19919	5646,6
Privatization Revenues	n.a	432	907	120	537	187	1283	8222	8096	3665

Source: Inflation data are taken from IMF World Economic Outlook; PSBR/GNP data from the State Planning Organization; FDI data from the Secretariat of Treasury; and data on privatization revenues from the Privatization Administration of Turkey.

Key: The data for the periods are simple averages of yearly data. The data on inflation and PSBR / GNP are in percentages, whereas the data on FDI and privatization revenues are in millions of US$.

Parallel to the recent success on the FDI front, privatization revenues have significantly increased in the post-2001 era. In fact, privatization was a strong component of the post-1980 neo-liberal adjustment in Turkey, in the sense that privatization was perceived as a strong contributor to the economic performance, increasing efficiency, reducing the burden of the state stemming from SEEs, contributing to capital market development, and broadening property ownership.[13]. However, lack of the executive authority's strength and coherence, the depth of political and economic crises, and an unfavorable external environment were the reasons for the failure of early privatization attempts.[14] In this respect, the post-2001 period was crucial for privatization in terms of both confidence and macroeconomic stability due to favorable global liquidity conditions. The revenues gained in 2005 and 2006 almost reached the 10 billion US$ threshold, an amount equivalent to the size of the budget deficit.[15]

So far, our analysis of the Turkish economy has focused on indicators of recent success in terms of generating macroeconomic stability and an environment conducive to sustainable growth. Yet, a detailed account of the Turkish neo-liberal experience should also highlight transformations in the institutional structure of the economy, which have effectively contributed to the striking improvement in broad macroeconomic indicators. Three elements of institutional reform deserve particular emphasis. First of all, the commitment to fiscal discipline was clearly enhanced through transparency and accountability measures, as well as improvements in the tax administration. Secondly, the banking sector reform and the strengthening of the position of the Banking Regulatory and Supervisory Authority (BRSA)

[13] Ibid.

[14] See Ercan & Öniş (2001).

[15] It is not yet clear whether the recent large-scale privatization has increased efficiency. There are doubts whether the privatization of state monopolies, such as the Turkish Telecom Company, changes the monopolistic nature of the market and creates efficient competition. A case in point is the Argentine Telecom: while its privatization led to the compensation of the budget deficit and attracted FDI, no significant improvements in efficiency and quality were observed. For an overview of the Argentine Telecom experience, see Luigi Manzetti (2000).

helped to overcome the weaknesses of the Turkish banking system—one of the central elements of instability in the 1990s that had led to successive financial crises in 1994, 2000, and 2001.[16] Since 2001, the banking and financial system has been tightly regulated in line with international norms and assumed a more robust structure against possible financial crises. Thirdly, measures taken to enhance the autonomy of the Central Bank (CB) were critical to the success on the inflation front, by limiting the scope for "populist" government interventions.[17]

Clearly, a legitimate question needs to be raised at this juncture: if such institutional reforms were so crucial, why were they not implemented earlier? The following framework—which takes into account the role of external actors, crises and domestic policy coalitions, as well as their mutual interaction—may offer an explanation for this puzzle.[18] The dominant external actors were the EU and the IMF. The involvement of the IMF can be explained in reference to US geo-strategic interests. What is new and much more important in the recent Turkish context is the emergence of the EU as an external anchor in the post-Helsinki era. With the concrete prospect of EU membership, the incentives and conditionality provided by the EU turned out to be the most important determinant of political and economic change in Turkey. On a domestic level, the new policy regime was strongly supported by the key segments of big business as well as small and medium-sized interests.[19] The domestic actors believed in the necessity of a properly regulated macroeconomic environment in order to achieve stability and sustainable growth. However, this account does not explain why external and domestic actors changed their policy preferences. At this point, the role of crises should be embedded into the analysis, with respect to their effects on the incentives and interests of certain key actors in economic management. Namely, the East Asian Crisis of 1997 challenged the role of the IMF in many respects and led the IMF to support a certain level of state regulatory capacity. This shift in the policy paradigm can be observed in the IMF's insistence on the establishment of the Banking Regulation and Supervision Agency (BRSA) in Turkey. Similarly, it can be argued that the 2001 crisis changed the incentives of key actors in the Turkish economy, pushing them toward accepting the necessity for reform and structural transformation. However, one last question remains: why was it the 2001 crisis, and not the 1994 or 2000 crises, that led to a significant change in the incentives and interests of key domestic actors? The simple answer to the puzzle lies in the very depth and intensity of the 2001 crisis. It was undoubtedly far more detrimental in its effects and, unlike the previous crises, not only affected middle and lower classes, but also directly challenged the interests of dominant groups in the financial and real sectors of the economy.

Having analyzed the internal dynamics and differences of the Turkish neo-liberal experiment over time, this analysis has so far examined the positive developments in the Turkish economy. However, for a better assessment of this recent performance, it is necessary to compare the Turkish case with other countries' experiences. Thus, the following section

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[16] For an evaluation of the Turkish banking system in the 1990s with an emphasis on the lack of regulation and the role of the IMF in the reform process, see Alper & Öniş (2004). For a much more recent assessment of banking system reforms including their nature and limitations, see Bakır & Öniş (2008).

[17] For a detailed account of the reform process involving the Turkish Central Bank, see Bakır (2007).

[18] This framework has been developed in Öniş and Şenses (2007) and used as a basis for understanding major policy reversals in post-war Turkish economic history.

[19] Ibid. p 21.

will discuss the bases of the EA success, a striking element of which is a high rate of economic growth sustained over long time intervals.

2. The East Asian Development Experience and the Characteristics of Tiger-Like Performance

The EA economies were the clear winners of the post-war development, given that they achieved steady and high growth rates in an environment of low inflation, low inequality, and political stability. Numerous scholars have devoted their work to understanding the extraordinary growth performance of EA economies. These economies have been called "Asian tigers,"[20] based on their outstanding growth rates sustained over the long run. The concept of "tigerhood" or "tiger-like performance," then, turned out to be a trademark for those countries who achieved extraordinary success in long-run growth performance. That is why, in order to assess the recent performance of the Turkish economy in a global setting, the first step should be to clearly identify what we mean by the concept through analyzing the experience of EA countries.

What makes these EA economies distinctive? What are the economic measures and indicators that make them divergent from the rest of the world? Obviously, the foremost indicator is their growth performance. Eight of twelve hyper-performers or outliers are from East Asia.[21] Japan and the "Gang of Four" managed to sustain growth rates of around 5.5% *per capita* (PPP), whereas Thailand, Malaysia and Indonesia achieved 3.5% between 1965 and 1990.[22] The second characteristic of the EA development is their achievement of sustainable growth in a relatively low inflation environment. With the exception of Indonesia in the 1960s and South Korea between 1960 and 1980, all EA economies experienced inflation rates of less than 10% *per annum*.[23] Thirdly, EA economies are characterized by high domestic savings and investment. The data on the savings and investment level for 1995 indicate that all EA countries have 30-40% domestic savings, coupled with generally 2-3 % percent higher investments.[24] This not only allows them to invest and grow at high rates, but also makes them less vulnerable to global liquidity conditions and foreign capital dependence. We will discuss the issue of a low level of domestic savings and externally dependent growth in the Turkish case as a major challenge to sustainability of growth below.

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[20] In the literature, EA economies are categorized under four groups with respect to the date of their take-off phase. Japan by itself constitutes the first subset, emerging as the outperformer in the post-WWII context until the 1980s. Japan is followed by the "Gang of Four," namely South Korea, Hong Kong, Taiwan and Singapore, which started to grow in the 1960s and 1970s. The third group is composed of Thailand, Malaysia and, to some extent, Indonesia. This group started to grow in the 1980s, but could not achieve growth levels similar to those of the first two groups. The last group is composed of China only; although a latecomer due to its socialist regime, it has been the fastest-growing economy in the world for the past twenty years. For these terms and categorization, see Haggard (1995) and Rowen (1998).

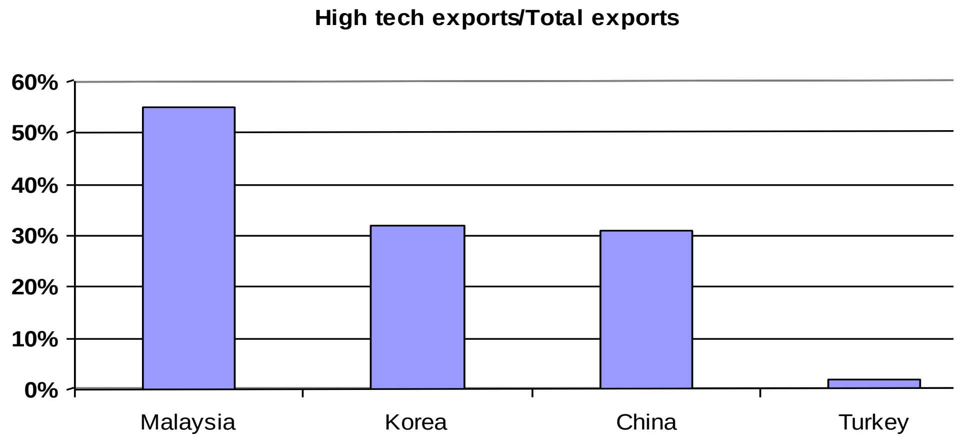
[21] Petri (1993), according to his calculation, has argued that it is a possibility of 1/1.000.000 that eight of twelve outstanding performers come from the same region. This is a clear expression of why we should pay particular attention to East Asia and regional dynamics. The other four successful countries are Botswana, Malta, Mauritius and Cyprus.

[22] Rowen (1998), p. 2

[23] For the exact figures, see Table 1.2 in Sönmez (2003), p.39.

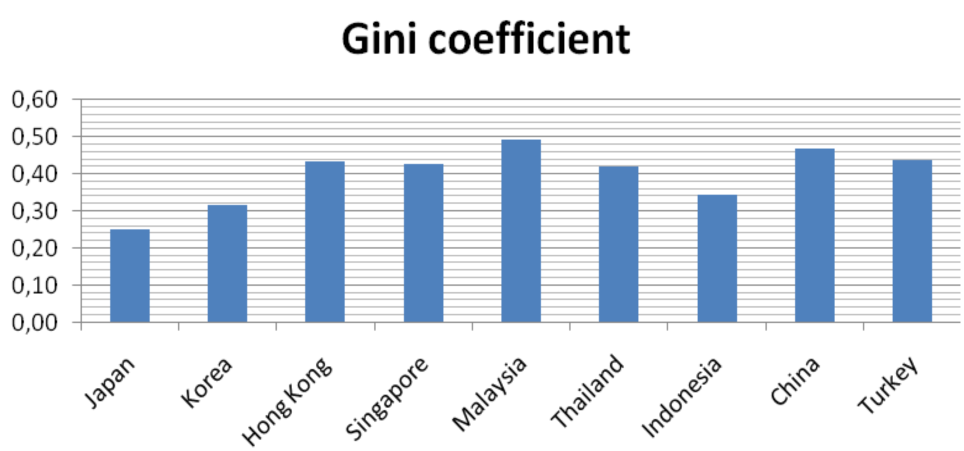
[24] Ibid., p. 40.

The fourth distinctive characteristic of EA economies to be taken into account is their export competitiveness in comparison to other developing countries. These economies managed to increase their exports significantly between 1960 and 1990. They diversified their exports and achieved a shift from low-technology to high-technology products (Figure 2). A comparison of Turkey with Malaysia, South Korea and newly rising China clearly indicates the differences in terms of export competitiveness. While Malaysia, South Korea and China are able to devote 55, 32 and 31%, respectively, of their total exports to high-tech products, only 2 % of total Turkish exports are products with high technology content.



Source: World Bank, World Development Report 2007.

Figure 2. Ratio of high technology exports to total exports.

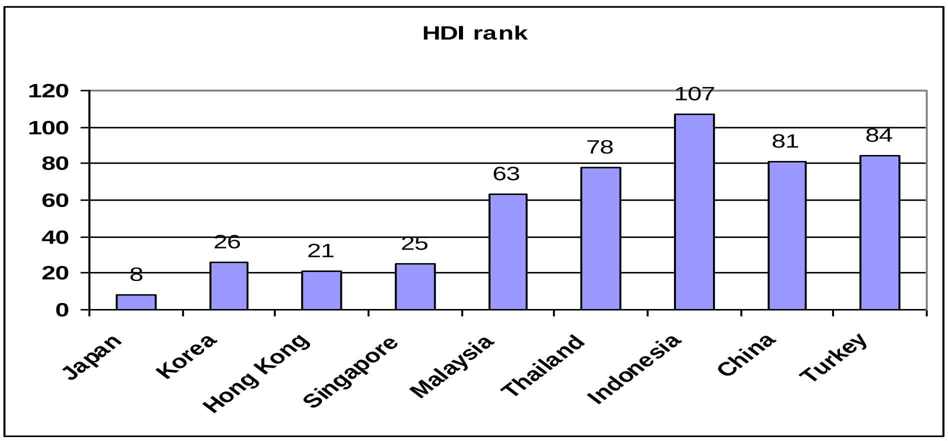


Source: UNDP, Human Development Report 2007.

Figure 3. Distribution of income in EA and Turkey.

Yet another dimension of EA development is its relatively egalitarian pattern of income distribution.[25] This observation needs to be qualified, however, given that Figure 3 portrays a mixed picture. While Japan and South Korea, as more egalitarian societies, have relatively low Gini coefficients, other countries are similar to Turkey in terms of income inequality, with coefficients higher than 0.35. Although the equality aspect of EA development is widely discussed in the literature, the recent data on the Gini coefficient supports the validity of the argument only for the Japanese and South Korean case, but cannot be extended to other cases.

The sixth and last aspect of EA development is its superiority in terms of broader indicators of development, rather than simply narrow measures of growth. Figure 4 demonstrates the ranks of EA countries and Turkey with respect to the Human Development Index.[26] The countries are ordered in line with their take-off phase, and the HDI ranking is quite representative of this four-subset model.[27] One can also look at government spending on education and the corruption index in order to gain a better understanding of the improvements in both human capital and business environment in EA economies. However, for the sake of clarity, these figures are omitted from our analysis.



Source: UNDP, Human Development Report.

Figure 4. HDI ranking[28].

Having examined the distinctive features of EA development, it is necessary to explain the nature of this distinctiveness in order to shed light on the dynamics of sustainable growth. Our treatment here will, of necessity, be very selective, as our objective is to single out the crucial elements of EA success, which will then be used as a basis for comparison with the recent Turkish experience.

The *neo-classical perspective* emerged with the critique of ISI, on the grounds that short-run efficient resource allocation leads to long-term growth. Therefore, "getting the prices

[25] For historical figures on income inequality, see Sönmez (2003), p. 326.

[26] The Human Development Index (HDI) is a measure provided by the United Nations Development Program (UNDP). The measure consists of three elements: life expectancy at birth, adult literacy, and GDP per capita (PPP).

[27] See footnote 20 for the four subsets of EA development. The HDI ranking is in line with this fourfold logic, with the only exception of China, which outperforms Indonesia with its recent development.

[28] The data on Taiwan are not provided by the UN and UNDP since the diplomatic status of Taiwan is disputed.

right" through market mechanism and minimum state intervention is an essential part of the neo-classical perspective.[29] From the 1970s onwards, economists have used this paradigm to examine the outstanding success of EA.[30] What makes EA economies distinctive to them is their effort to create an outward-oriented and export-competitive economy in contrast to inefficient domestic-oriented ISI strategies. Balassa has associated this export orientation with limited government intervention, stability of incentives, well-functioning labor and capital markets, as well as reliance on private capital.[31] High domestic savings, capital formation (both physical and human), stable exchange rates, and the ability to attract FDI were also considered as the main impetus for sustainable growth.[32] However, this perspective has been heavily criticized for being ahistorical, in the sense that it cannot satisfactorily explain the reasons for capital formation, technological improvement, and investment in human capital. Furthermore, this perspective has been criticized for underestimating the role of state intervention and political dimension.[33]

The *statist perspective* stems from the latter criticism, namely the neglect of the role of the state. In contrast to the neo-classical perspective, statists argue that the state has a strategic role in taming market failures and provides better allocation of resources in the long run.[34] This argument is based on the "infant industry principle" going back to Friedrich List.[35] Statists emphasize the "developmental" role of state because of its ability to make development its foremost objective and maximize economic growth by mediating market forces through various pilot agencies—for example, the Ministry of Trade and Investment (MITI) in Japan.[36] In order to answer the neo-classical critiques of ISI and state intervention in economics, statist scholars clearly emphasize the duality of subsidies and discipline. Furthermore, bureaucratic autonomy and public-private cooperation is examined in the EA context in order to indicate the complementary nature of state and markets.[37] Linda Weiss and John Hobson have presented a much more nuanced version of the statist perspective that does not reject markets, but works with them in tandem; they have argued that "its emphasis is on the *synergy* of competitive collaboration between guided markets, in the pursuit of developmental objectives. In sum, bringing the state back in does not entail kicking the society out."[38] In a sense, it is not a matter of whether the state should intervene or not; what is important is to find the appropriate balance between state and market. The statist perspective has been criticized for not achieving a consensus on what kind of intervention should be prescribed for developmental states.[39] Nevertheless, the statist perspective has significantly challenged the dominancy of the neo-classical paradigm in explaining EA

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[29] See So & Chiu (1995), p.4.

[30] For earlier studies from this perspective, see Balassa (1981), Balassa *et al.* (1982), Hughes (1980), Little (1982), and Patrick & Rosovsky (1982).

[31] See Balassa (1988), and So & Chiu (1995).

[32] Stubbs (2005), p.4.

[33] Ibid., p.4; Haggard (1990).

[34] So & Chiu (1995), p.12.

[35] For a renewed version of the infant industry argument within a historical and developmental perspective, see Ha-Joon (2002).

[36] The "developmental state" concept is used by Johnson (1982).

[37] See Amsden (1989) and Öniş (1991).

[38] Weiss & Hobson (1995), p. 138. For the argument about "bringing the state back in," see Evans *et al.* (1985).

[39] Stubbs (2005).

development. Studies within the statist perspective have provided much more detailed accounts and empirical analyses of the development trajectories of particular EA states.[40]

The *culturalist perspective* identifies the nature of EA development within a context of values, attitudes, practices and institutions that underpin particular policy choices for developmental strategy.[41] Culturalist scholars link certain traits of the more than two-thousand-year-old Confucian culture with the developmental aspects of EA countries. Confucian culture is thought to be conducive to the EA type of capitalist development.[42] From this perspective, Confucian culture is associated with obedience to legitimate authority, familialism, and respect for education, duty, hard work, and discipline.[43] It is argued that the reasons for the authoritarian nature of the government, family-oriented business structure, and policy choices concerning education and investment in human capital are the direct outcome of Confucian cultural traits. However, this perspective fails to explain why these Confucian societies failed to maintain comparable steady growth rates and development in the early part of the twentieth century, in marked contrast to their achievements in its second half.

Japan-centered explanations emphasize two central points: On the one hand, the former Japanese colonial experience in the region, although repressive, established the institutional features for long-term growth.[44] On the other hand, in the post-war era Japan played the leading role in the regional development through financial aid, being a role model for others, and, most importantly, through the transfer of industrial capacity to other economies, in line with its technological advancement and increasing cost of labor.[45] This perspective provides many insights into regional development and the role of external actors in the achievement of sustainable growth.

American hegemony explanations are based on dependency theory, arguing that the US and its strategic interests in the region during its fight with communism constituted a major force for providing financial aid to these newly industrializing countries. EA economies were encouraged to adopt some type of capitalism which the US imported to the region.[46] However, this approach has been criticized on the grounds that it cannot explain cases other than those of Japan, South Korea, and Taiwan. Yet, from a political economy perspective it is crucial for shedding light on the role of external influences and strategic interests in shaping economic policies.

The explanation of tiger-style economic performance requires a historical perspective that takes into account the complex interplay of external and domestic institutional and political forces. Since our aim is to use the EA experience as a basis for a comparison with the recent Turkish economic performance, we would like to highlight the following interrelated dimensions of the EA experience regarding conditions for sustainable growth: (a) high domestic savings and investment provide the resources for physical and human capital

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[40] For the leading studies, see Johnson (1982) on Japan, Amsden (1989) on South Korea, and Wade (1990) on Taiwan. For a review article, see Öniş (1991).

[41] See So & Chiu (1995), p.8.

[42] On Confucian culture and its effects on development, see Rozman (1992), Pye (1985), and Hofheinz & Calder (1982).

[43] Hicks & Redding (1983), and Stubbs (2005).

[44] See Stubbs (2005), and Kohli (1994).

[45] The "flying geese model" with Japan playing the leading role can be considered in this context. See the seminal article by Akamatsu (1962).

[46] See Arrighi (1996) and So & Chiu (1995).

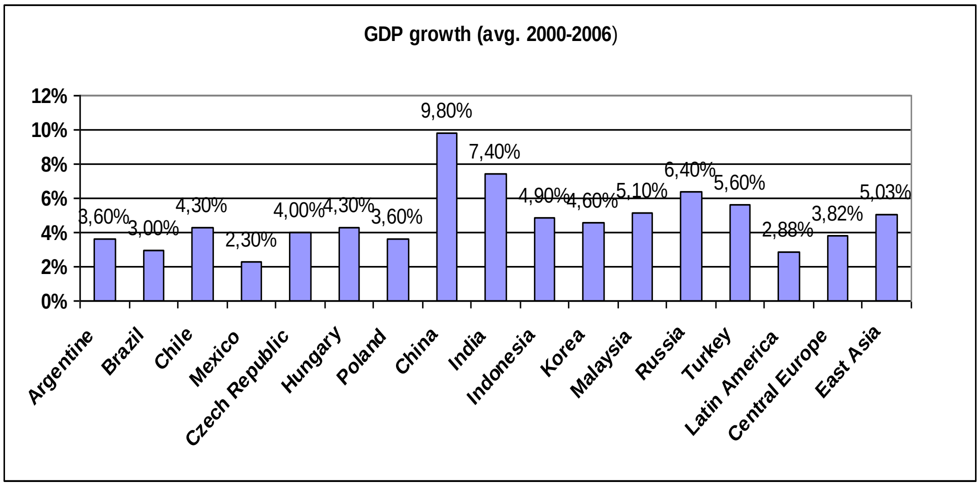
formation without the risk of running a serious balance of payment deficit; (b) in line with the latter, a lower degree of dependence on foreign capital and global liquidity conditions; (c) outward-oriented, export-competitive and technologically developed industrialization; (d) selectivity, discipline and dialogue in industrial policy, in contrast to perverse incentives and heavy and indiscriminate protectionism associated with typical ISI experiences; (e) the importance of a highly dynamic regional environment for attracting FDI; (f) single-minded focus on human capital development, *i.e.* education and health; and (g) relative stability of the underlying institutional and political environment or governance structure.

Although the insights gained from the EA experience provide fertile ground for a comparative analysis, our assessment of the recent Turkish economic success in a global setting incorporates also certain key emerging markets from Latin America, Central Europe, India and Russia. Our reasons for this are as follows: firstly, a broader comparison of the Turkish economy provides alternative venues for a theoretical debate; secondly, and much more specifically, there are strong similarities between the emerging markets in Latin America and Turkey in terms of their early experience with neo-liberal structuring; and, thirdly, the incorporation of CE emerging markets provides extra leverage with respect to the EU accession process, FDI attraction and democratization. Moreover, even though the EA model seems to be an outstanding example of sustainable growth, it might not be the best model for Turkey, given the illiberal nature of EA countries' governing structures and weak democratic credentials. Last but not least, tiger-like performance is not unique to EA countries. To the best of our knowledge, the term has recently been applied to the cases of Ireland and the Baltic states.[47] In this respect, the extended boundaries of our comparative analysis should provide a better outlook for the sustainability of Turkey's economic growth. In other words, we ask whether Turkey will emerge as a new tiger, but not necessarily an East Asian-style new tiger.

3. The Performance of Turkish Economy in a Global Setting

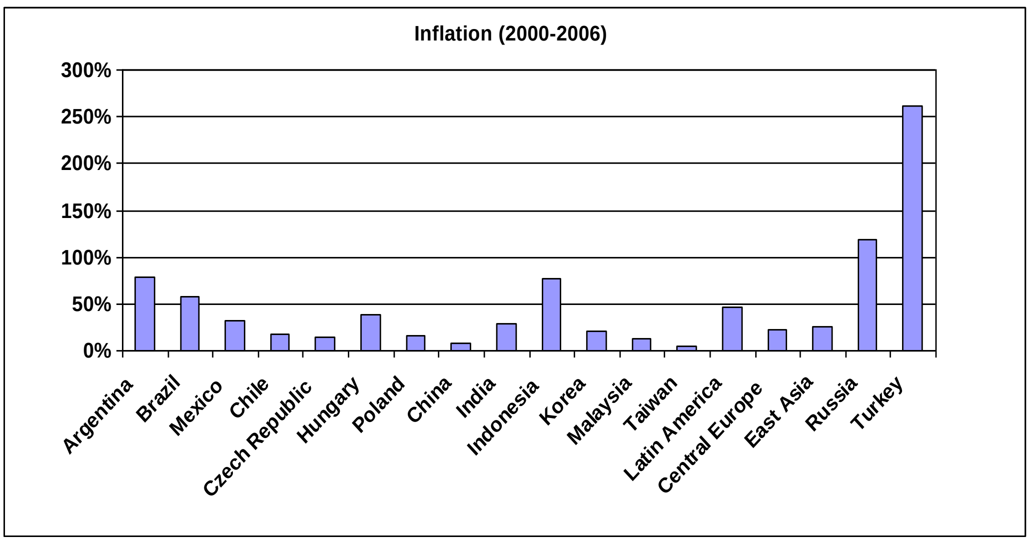
Embedding the Turkish experience in a comparative analysis enables us to better grasp the global trends affecting key emerging markets, as well as to better identify the achievements and limits of the recent reform process and structural transformation of the Turkish economy. The comparative data on growth between 2000 and 2006 indicate that Turkey achieved a successful growth rate higher than the regional averages and most of the emerging markets, with the exception of China, India and Russia with the growth rates of 9.8, 7.4 and 6.4% *per annum*, respectively. The fact that the GDP in Turkey fell by 9.5% in 2001 due to a major financial crisis makes the Turkish success in terms of growth performance even more striking. Thus, the growth performance data covering the period between 2002 and 2006 indicate a 7.5% average growth *per annum* for Turkey. This comparative data also indicates that EA countries continue to be the outstanding performers of growth, exceeding LA and CE.

[47] For an analysis of Irish success and the term "Celtic tiger," see O'Hearn (2000).



Source: World Bank, World Development Report 2007.

Figure 5. GDP growth in a global setting [48].



Source: IMF, World Economic Outlook Database.

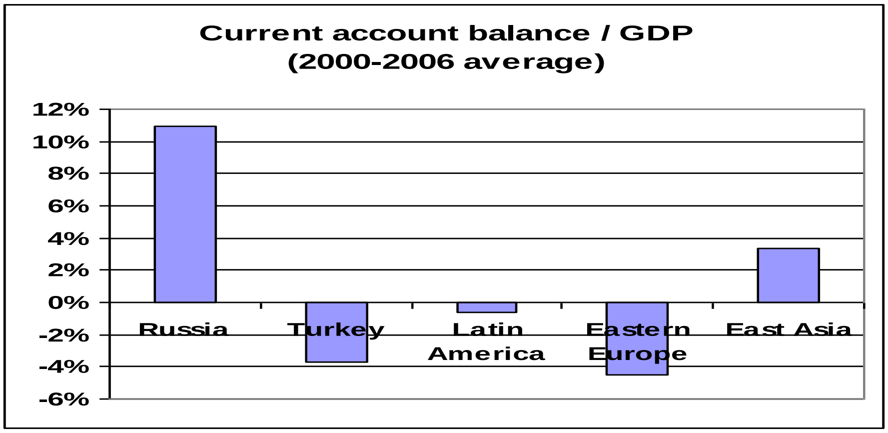
Figure 6. Cumulative inflation (2000-2006) in key emerging markets[49].

As we have argued above, Turkey has also achieved significant success on the inflation front. However, a cross-country comparison indicates a less impressive picture. In relative terms, Turkey appears to be the worst performer among the key emerging markets, followed by Russia, Argentina and Indonesia (Figure 6). Even the recent trend of the 10% inflation threshold is well above the emerging market averages. In a global environment characterized

48 The regional growth rate was calculated as the weighted average of the countries located in particular regions.
49 Regional inflation was calculated as the simple average of the countries in particular regions.

by low inflation rates, Turkish policy-makers should not feel over-confident about their achievements concerning inflation.

Comparative data on current account balance (CAB) highlights another weakness of the recent Turkish economic performance. While EA countries and Russia register current account surpluses and LA countries maintain balanced current account positions, Turkey and CE countries tend to display serious current account deficits.



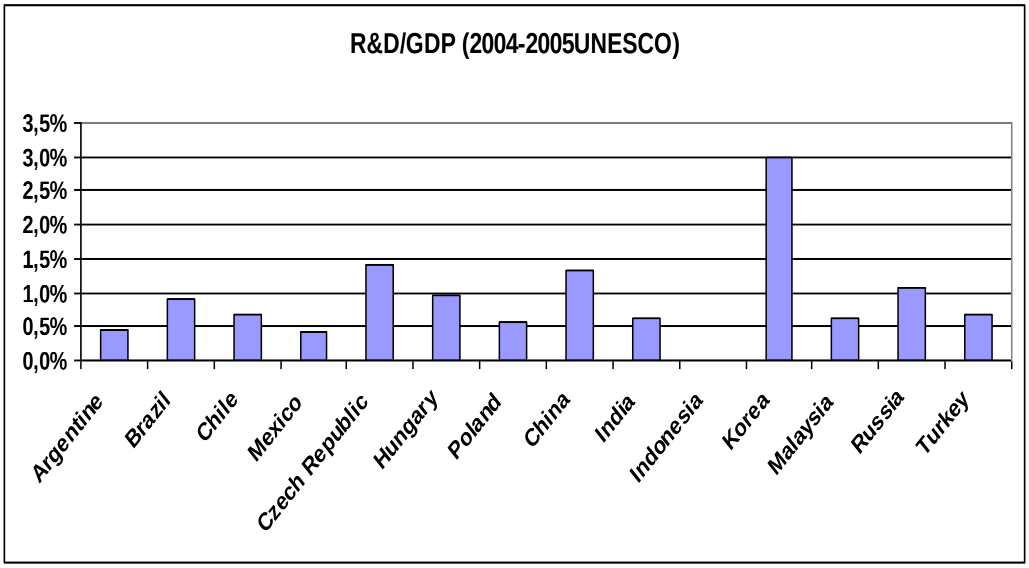
Source: IMF, World Economic Outlook Database.

Figure 7. Current account balance as a ratio of GDP in key regions[50].

Arguably, EA countries followed a much more cautious current account balance policy after the East Asian Crisis in 1997. Similarly, LA countries such as Argentina are careful not to become dependent on foreign capital and short-term portfolio investment, having experienced a major economic crisis in 2001. However, Turkey seems to be unaffected by its earlier experience of current account deficit and dependence on short-term portfolio investment. The current account deficit and the dependence on foreign lending seem to be some of the major challenges to sustainable growth in Turkey, especially as favorable global liquidity conditions are in the process of serious reversion.

The fourth lesson to be drawn from the EA experience and the international comparison of key emerging markets is the importance of an externally-competitive and export-oriented economy. EA economies both diversified their exports and enhanced the level of technology required for their export products. In other words, they succeeded in transforming their economies from low-value added products to technology-intensive high-value added products. Figure 8 indicates the research and development (R&D) expenditures as a share of the GDP. Countries like Korea, the Czech Republic, China, and Russia spend more on R&D activities, which in turn enhances their long-run growth and technology-intensive export competitiveness. Turkey's performance is more modest in this respect, more in line with LA countries, Poland and India.

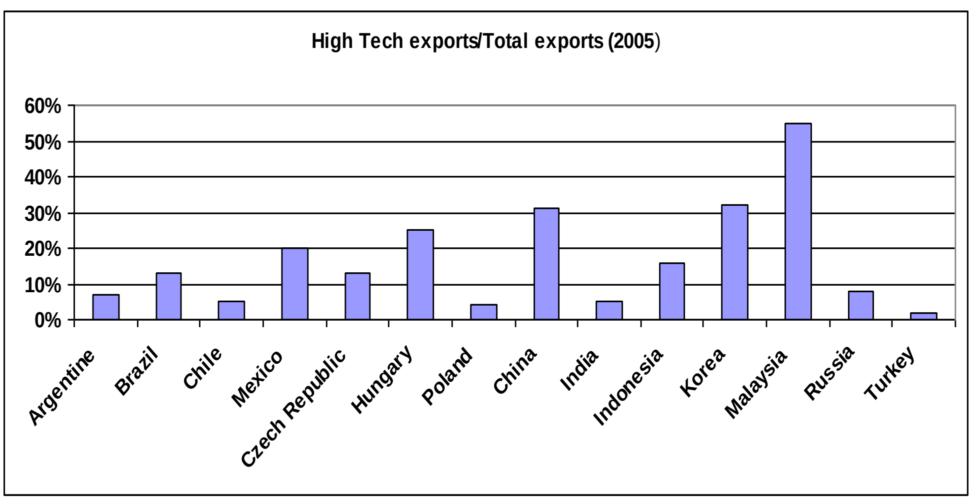
[50] The regional CAB / GDP ratio was calculated as the weighted average of the countries in particular regions.



Source: UNESCO, 2004-2005.

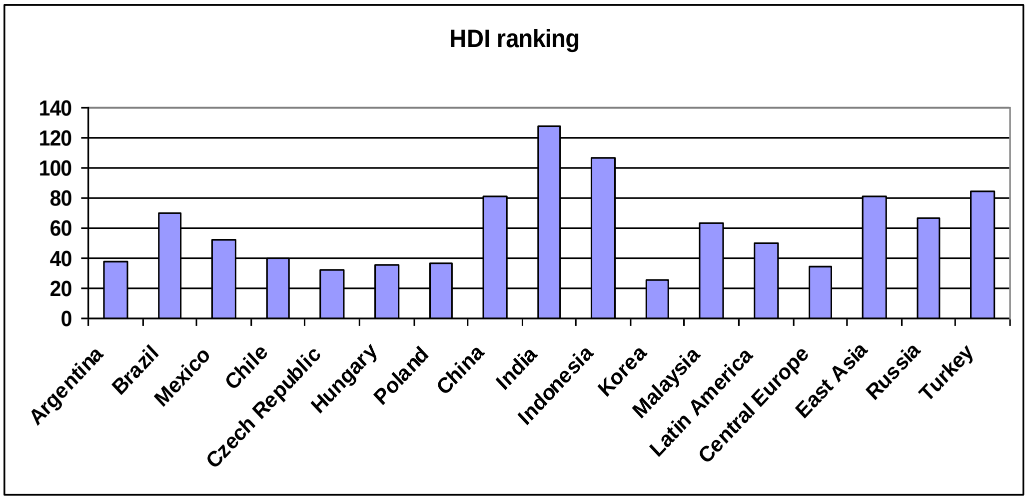
Figure 8. R&D expenditures as a share of GDP.

Similarly, there are clear differences between the key emerging markets with respect to their export products. Figure 9 indicates that the exports of countries such as Malaysia, Korea, China, Hungary and Mexico are largely comprised of high-tech products. In contrast, Turkey has a low figure in this regard. It should also be noted that there is no direct short-term correspondence between R&D investment and high technology exports, due to the long-term effects of these investment, the disadvantage of being a late-comer, and other factors such as FDI. An analysis of the key regions enables us to see that EA countries and, to some extent, CE countries managed to increase their R&D investment and their high technology exports.



Source: World Bank, World Development Report 2007.

Figure 9. Share of high technology exports in total exports.



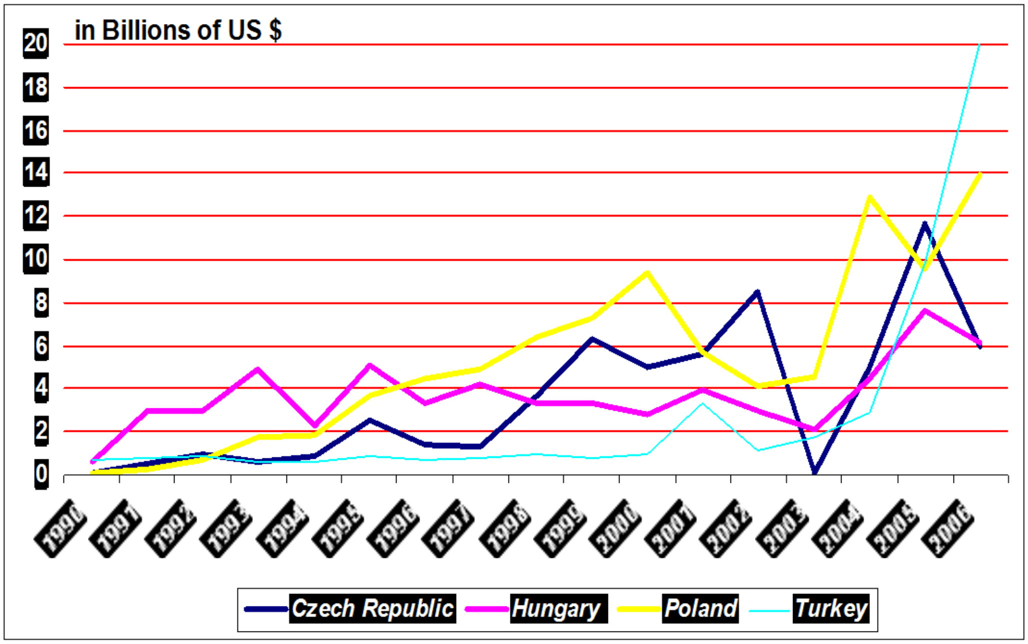
Source: UNDP, Human Development Report 2007.

Figure 10. Human development index (Ranking).

Last but not least, beyond the strict limits of economic growth, one should also take into account the broader aims of development. The Human Development Index (HDI) is the appropriate measure to use in this context. According to HDI data, while Turkey boasts great success in GDP growth, such success cannot be demonstrated in terms of human development. All LA and CE countries perform significantly better than Turkey. Only India and Indonesia perform worse than Turkey (Figure 10). Even China as the newly emerging tiger seems to be ahead of Turkey in this respect. The status of Turkey in terms of HDI should be enhanced, not only by focusing on the growth side, but also by investing in human capital—namely, education and health. Sustainable growth in the longer term can only be achieved via an improvement of human capital.

Moving beyond the interpretation of basic data for international comparisons, three crucial points deserve further emphasis. First of all, the EA and LA economies, and much more explicitly Russia, have been very sensitive to their current account balance after having experienced serious financial crises due to the speculative outflow of short-term portfolio investment. Turkey and CE economies, however, appear to follow a different path. Nevertheless, in a changed environment where global liquidity conditions are less favorable, these economies will find themselves much more vulnerable to external shocks.

Secondly, further comparative analysis between Turkey and CE countries is required in regard to the EU accession process and the amount of FDI attracted. Although Turkey started its neo-liberal adjustment in the post-1980 period, having transformed itself from a socialist rule to a liberal market economy, a decade later it was not Turkey, but CE countries that managed to attract a significant level of FDI and to become EU members. The relative failure of Turkey in terms of attracting FDI and becoming an EU member is quite paradoxical in comparison to those three CE countries—namely, the Czech Republic, Hungary, and Poland. Turkey only recently managed to attract significant levels of FDI, following the EU Council's decision to initiate accession negotiations in December of 2004 and the confirmation of this decision in October of 2005. This also indicates the role of the EU as an external anchor, as well as the vicious and virtuous cyclical nature of Turkey-EU relations. In the unstable macroeconomic environment of the 1990s, Turkey failed to receive the EU's strong signals in the direction of full membership, which, in turn, constituted a significant obstacle in terms of preventing Turkey from sustaining macroeconomic stability, promoting investor confidence and, hence, attracting FDI on a significant scale. In contrast, the post-2001 experience corresponds to a virtuous cycle. As Turkey made important strides towards satisfying the economic and political components of the Copenhagen criteria, the macro-environment became progressively more conducive to attracting FDI on a large scale and the parallel process of implementing an ambitious privatization program.[51]



Source: Compiled from the UNCTAD database.

Figure 11. FDI inflows into Turkey and three CE countries.

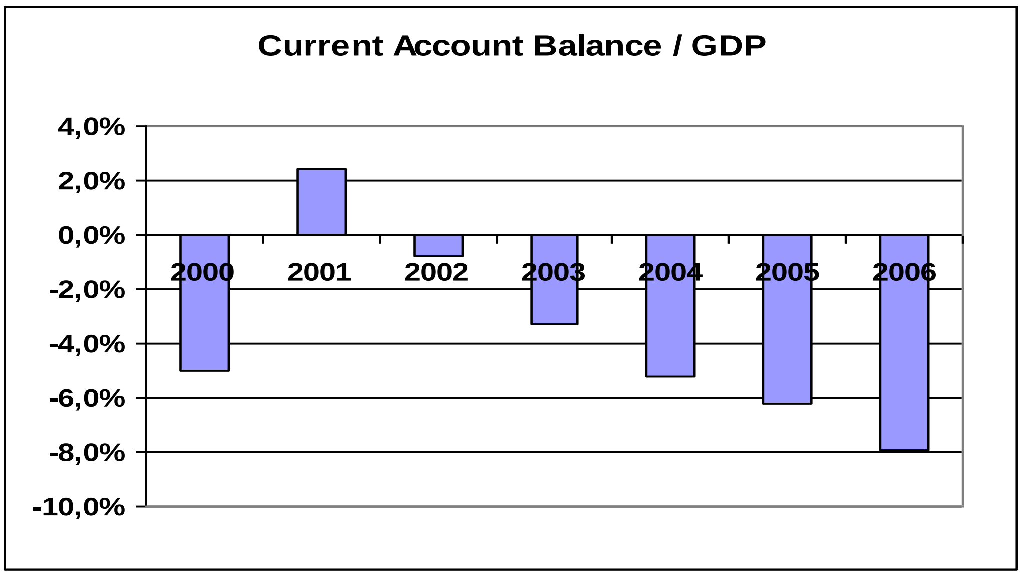
Thirdly, deducing lessons from the CE experience and the EU accession process is crucial for the democratization of Turkey. The EA experience constitutes a benchmark for sustainable development. However, with their repressive and authoritarian regimes EA countries fail to satisfy Western democratic credentials. Even the democratic regimes of the region appear to be "illiberal democracies" by the standards of European or Western democracies. What Turkey seeks in the long run should not only be sustainable growth, but also better democratic credentials in terms of governance, rule of law, political rights, and civil liberties. In this respect, the role of the EU as an external anchor and learning from the experience of CE countries are all the more important.

[51] For a detailed assessment of the EU's role in shaping the political economy of Turkey, see Öniş and Bakır (2007).

4. SUSTAINABLE GROWTH: CHALLENGES AND OPPORTUNITIES

Although our analysis of the performance of the Turkish economy in the recent period indicates that Turkey has achieved an outstanding success in comparison to its earlier experience in the neo-liberal era and modest success in comparison to the key emerging markets, a detailed and balanced account of the Turkish economy should also identify the challenges and possible opportunities for sustainable growth. Turkey will achieve sustainable growth and deliver a “tiger-like” performance only to the extent to which it will be able to overcome its challenges and capitalize on its opportunities.

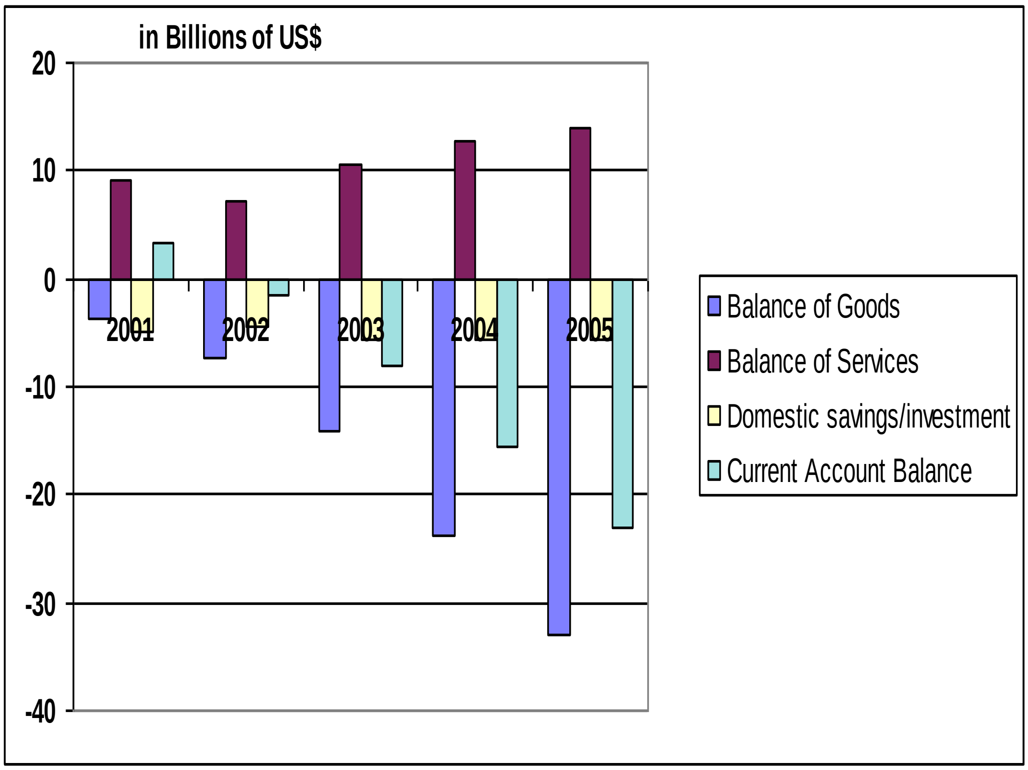
A. Current Account Deficit: The foremost challenge to the sustainability of growth and macroeconomic stability in the Turkish economy is the high level of the current account deficit (CAD). Figure 12 clearly indicates that the current account deficit has increased tremendously in the post-2001 era, not only in terms of the amount, but also as a percentage of the GDP. The early experience of the Turkish economy has proved that the current account deficit might turn into a balance of payment crisis in an open economy, where capital account is liberalized and full convertibility is guaranteed.



Source: IMF, World Economic Outlook.

Figure 12. Current account balance as a percentage of GDP.

Figure 13, on the other hand, enables us to recognize the components of the CAD in the Turkish economy and the factors leading to the CAD. The large bulk of the CAD stems from the deficit in commodities trade—that is, the difference between exports and imports. Turkish exports have experienced considerable diversification in the post-1980 period, from primary to manufactured goods, with textiles, iron, steel and manufactured foodstuff representing the major growth industries in the early years of neo-liberal reforms. More recently, during the post-2001 era, manufacture of motor vehicles has emerged as a major export industry. Yet, these transformations have failed to keep in check the increase of the trade deficit during the same period. A number of factors explain the phenomenon. First, export growth and diversification could not be accomplished in a sustained manner. Secondly, Turkish exports display a high degree of import dependence. Thirdly, the Customs Union has created a certain bias in favor of imports. Last but not least, the appreciation of the TL undermines the international competitiveness of Turkish goods.[52] The second component of the deficit is due to the imbalance between domestic savings and investment. Turkey's domestic savings have been traditionally lower than the gross fixed capital investments, which need to be compensated by foreign capital, in the form of short-term portfolio investment, credit channel, or FDI (Figure 14).[53] The lower level of domestic savings does not only create the CAD, but also hampers investment in the long run. The EA economies, in contrast, have managed to sustain domestic savings of 35-40%, which rendered their investment and growth at least partially immune to external shocks and global liquidity crises.

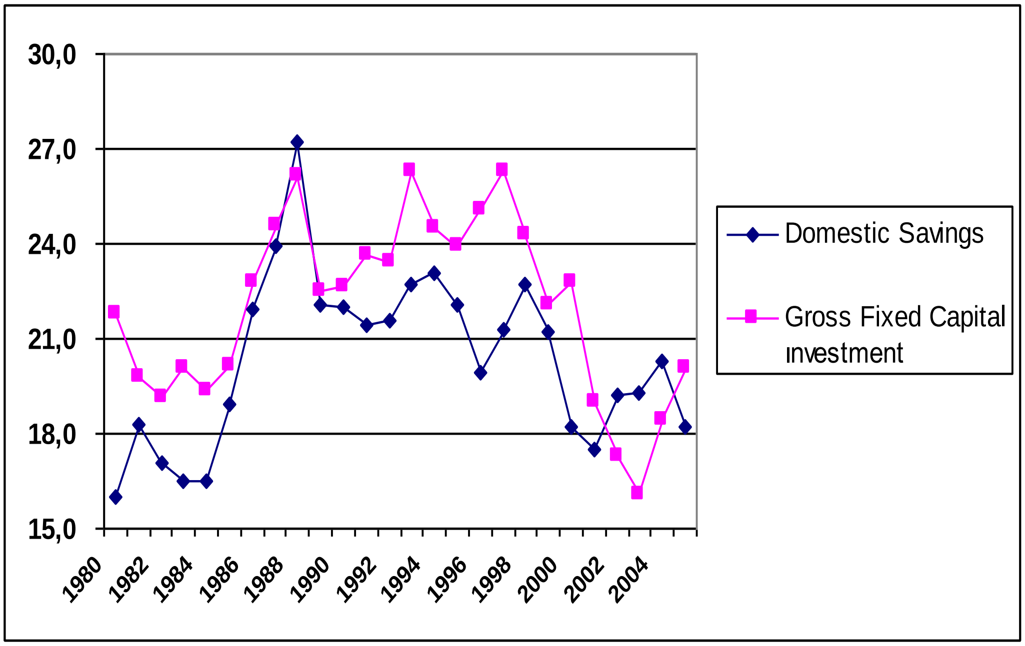


Source: State Planning Organization and Central Bank of Turkey.

Figure 13. The components of the current account balance in Turkey.

[52] For the details of the argument and recent assessment of the CAD in Turkey, see Eşiyok (2008).

[53] Based on the CB data, Eşiyok (2008) has indicated that 50% of the recent CAD is compensated through FDI.



Source: State Planning Organization.

Figure 14. Domestic savings and gross fixed capital investment in Turkey.

B: Externally dependent growth: The CAD and low domestic savings make the Turkish economy dependent on foreign capital and global liquidity conditions. The sub-prime mortgage crisis and the possible recession in the US economy may affect the Turkish economy in a number of ways: due to the change in favorable global liquidity conditions, it will be much harder for Turkey to attract foreign capital through credit, portfolio investment and FDI channels. Equally importantly, Turkey will indirectly be affected through the trade linkages with the EU; with the US recession having a direct impact on the EU, Turkey will feel the repercussions.

C: Slowing pace of FDI and privatization: Although the most recent data are not available as of yet, many Turkish economists warn that the recent boom of FDI and privatization is over. This is partly due to the nature of the FDI that has entered Turkey in recent years. The FDI did not come to Turkey in the Greenfield investment form, but mostly in the form of mergers/acquisitions and privatization. Once the opportunities for large-scale privatization have been exhausted, it might prove more difficult to attract FDI.

D: Decreasing influence of external anchors: One of the reasons for the recent improvement in Turkey's economic performance was the specific short-term influence of the IMF in the stabilization program and reform process, as well as the long-term anchor role played by the EU. The EU anchor not only increased confidence in the overall stability of the economy and the amount of FDI and privatization, but also provided incentives for further reforms in line with membership prospects. However, the end of the stand-by agreement with the IMF and the unwillingness of both EU and Turkish policy-makers to come to an agreement due to the Cyprus issue, the dominance of right-wing Christian Democratic leaders suspicious of Turkish membership because of cultural concerns and immigration issues, and a weakening of the Justice and Development Party (JDP)'s commitment to the EU accession process in its second term—these have all led to the deterioration of relations between Turkey and the IMF and Turkey and the EU; in the long run, this makes the Turkish economy much more vulnerable to external shocks.

E: Political instability: Although this chapter focuses on the economic dimension of the Turkish success in recent years, it is obvious that political stability is a critical condition for sustainable growth. One of the reasons for the recent successful performance of the Turkish economy was, of course, the majority government of the JDP. Poorly governed by successive coalition governments in the 1990s, Turkey was in need of political stability. In spite of initial doubts, the JDP showed considerable commitment to the implementation of the new stage of neo-liberal reforms.[54] The government relied on a stabilization program initiated under the auspices of the IMF and the political entrepreneurship of Kemal Derviş in the first term. During its first term in office, the JDP projected the image of a pragmatic and reformist party. However, its recent performance has increasingly raised questions about the true nature of its policies, and there has been a growing polarization of the political environment over the course of 2007 and 2008, with potentially damaging consequences for economic performance.[55] The degree of polarization in recent Turkish domestic politics has once more indicated that Turkey has not yet emerged as a fully consolidated democracy. The trial involving the closure of the JDP, a party which received almost half of the votes in the recent elections, constituted a major threat to economic and political stability.[56] Furthermore, recent allegations involving a planned military intervention on the part of retired generals and other high-ranking public figures, which has resulted in yet another major controversial court case, have clearly demonstrated that democracy is not yet the "only game in town." There is no doubt that such uncertainties tend to undermine the trust of key economic actors and create a downward bias in terms of economic performance, which can be clearly detected from the recent behavior of key macroeconomic indicators. Rising interest rates and inflation, as well as the slowdown in FDI and overall growth, highlight the negative bias created by the recent wave of political uncertainties, although it is too early to predict the extent and the depth of the downward bias exerted by this unfavorable set of political developments.

F: The need for second-generation reforms: Most analysts of the Turkish economy have acknowledged the JDP government's success in maintaining fiscal and monetary discipline and implementing important regulatory reforms, building on the process which had already started in the aftermath of the 2001 crisis. Nevertheless, it has been acknowledged that the same government has been less successful in terms of designing and implementing the next-generation reforms aimed at longer-term industrial restructuring. Arguably, an active industrial policy has been the missing link in the armory of the JDP's policies.[57] A

[54] For a detailed discussion of the JDP in Turkish politics, see the edited volume by Yavuz (2006), in particular his introductory chapter and the chapter on the political economy perspective by Öniş (2006).

[55] On the JDP, moderate Islam, and secularist opposition in Turkey, see Somer (2007).

[56] Fortunately, the final decision of the Constitutional Court in July of 2008 did not involve the closure of the party. Instead, the governing party received a serious warning for violating the principles of the secular constitutional order. If indeed the party had been banned from politics, the outcome could have been a much higher degree of political and economic instability, especially if the decision had been associated with the suspension of negotiations with the EU altogether.

[57] Indeed, this was the main theme of the TUSIAD-KOÇ (Turkish Industrialists' and Businessmen's Association and Koç University) Economic Research Forum Conference entitled "Turkey's Search for Industrial Policy in the Light of International Experiences," held on December 25, 2007 in Istanbul.

comprehensive education and tax reform also constitute key components of these second generation reforms.

All these factors indicate the interactive nature of challenges in terms of achieving sustainable growth for the Turkish economy and the vicious and virtuous cyclical nature of economic development. The more the Turkish economy is able to overcome these challenges, the less likely it will turn back to the vicious cycle and unstable macroeconomic environment of the 1990s, and the more likely it will converge with the developed economies of the world, just as EA countries managed in the past and, more recently, CEECs.

The threats and challenges to the sustainability of high growth rates highlighted so far should not lead us to disregard the significant opportunities for economic growth in the medium term. Turkey's role as an energy transit country and its growing economic and political influence in the surrounding regions, particularly in the Black Sea region, assumes a major significance in this context. The revenues generated through pipelines as well as trade and investment linkages with the surrounding regions constitute an important avenue for future economic growth. The growing economic significance of Turkey as a pivotal country in its immediate neighborhood is increasingly related to its role as an energy transit country in the broader context of European energy security. In this context, as argued by Aliboni (2006), the Black Sea Economic Co-operation Project initiated in 1992 is likely to become progressively more important as the EU itself increasingly becomes an "insider" in the Black Sea economic space. The direct involvement of the EU in the Black Sea region might enhance the role of Turkey, and this may in the medium term facilitate a revitalization of the EU anchor. Turkey's growing trade and investment links with the Middle East and North Africa as part of a pro-active foreign policy towards the region is likely to important repercussions on Turkey's future growth prospects.

Another medium- and long-term opportunity for Turkey is its demographic dividend. Turkey has a relatively young population, which in the future is expected to increase labor participation rate and domestic savings. Figure 15 indicates that the bulk of the population is less than 25 years old and likely to continue its education. In time, it is expected that this young segment of the population will become a part of the production/employment process, which will not only lead to economic growth, but also to an increase in domestic savings. A recent report prepared by Rijckeghem and Üçer (2008) estimates that the reduction in the youth dependency ratio is likely to increase domestic savings by about 5% of GDP. It is critical, however, that this young labor force will have access to significant education opportunities. Without a major upgrading in the quality of the labor force, the demographic dividend can easily turn into a liability than an asset.

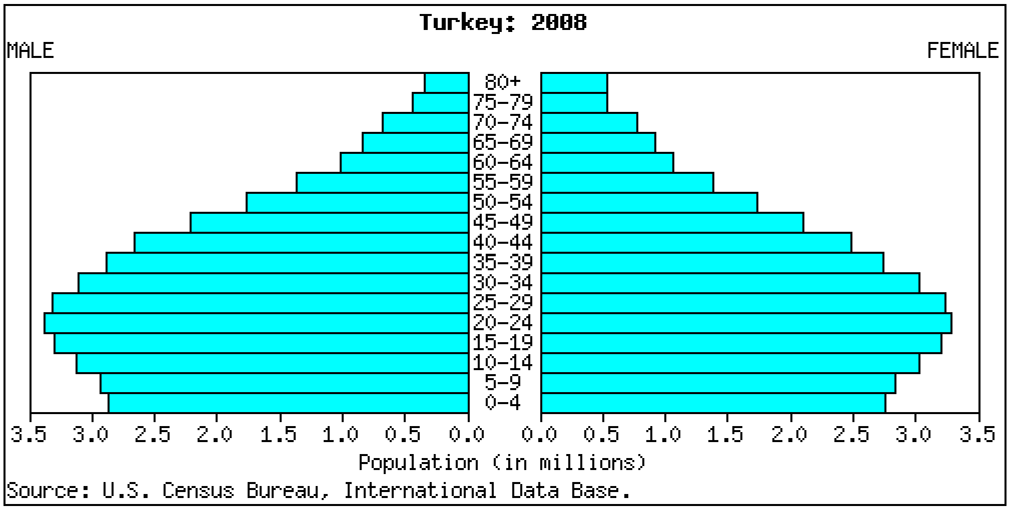


Figure 15. Population in Turkey according to age groups.

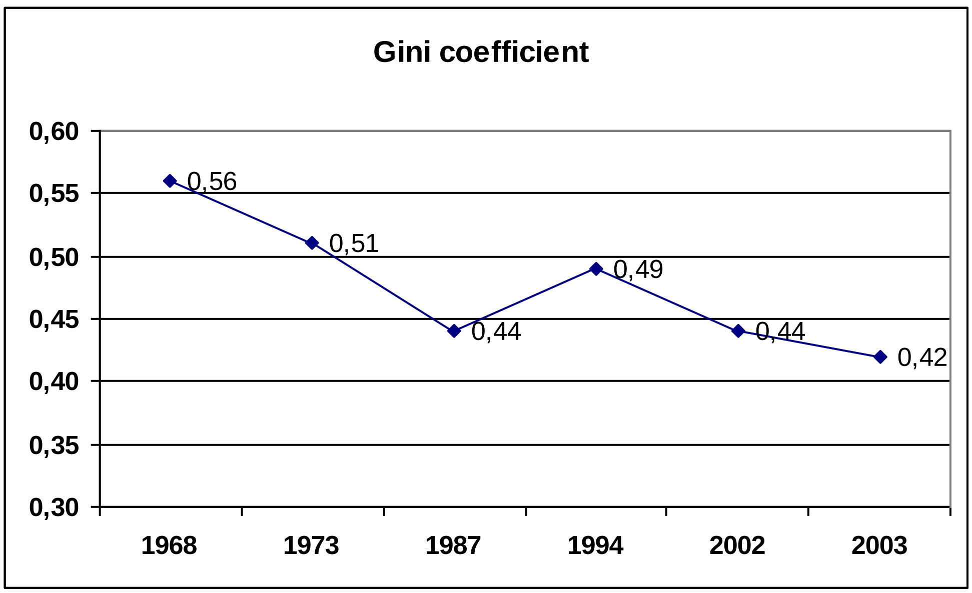
Also, the growth of entrepreneurship, as well as its spread across the country beyond the confines of the Marmara region, constitutes important positive developments from the perspective of longer-term growth. The so-called Anatolian tigers, emerging as the winners of the neo-liberal restructuring in Turkey, have not only widened the geographical boundaries of investment, but also created new employment opportunities in Turkey's peripheral regions (Öniş 2006). The emergence of this Anatolian bourgeoisie and the rise of Anatolian cities can be seen as an opportunity to overcome uneven regional development and unemployment in the periphery. Parallel to this development, big business in Turkey has been transformed over time from inward-oriented entities to outward-oriented firms whose operations are increasingly global in nature. Indeed, many of the major conglomerates have established themselves as exporters of capital, which points towards the growing maturity of Turkish industrial capital. The transnationalization of big business in Turkey represents a striking aspect of the recent globalization of the Turkish economy and an important source of longer-term economic dynamism.

5. Extending the Limits of Analysis: The Social Dimension of the Turkish Economy

So far, our analysis of the recent performance of the Turkish economy in terms of inter-temporal and cross-country comparisons has only dealt with the improvements and challenges concerning the strict economic measures of macroeconomic performance and growth. Nevertheless, a complete and balanced assessment of the recent performance of the Turkish economy necessitates incorporating the social dimension into the picture: unemployment, inequality and poverty. The experiences of EA economies have demonstrated that sustainable growth was accompanied by a relatively even distribution of income, creating employment for the masses and reducing poverty.

Achievements in terms of growth in the recent period have not been matched by an equally striking increase in employment. According to recent statistics, the overall unemployment ratio in Turkey is 11.4% and 11.6%, for 2007 and 2008, respectively.[58] The figures are much worse for non-agricultural unemployment and youth unemployment. While non-agricultural unemployment in 2007 was 14.2%, youth unemployment reached 21.7%, which is likely to create disillusionment and associated social problems, such as a high crime rate and social unrest.

Turkey can be considered a moderately unequal society with respect to income distribution as measured by the Gini coefficient. Inequality in Turkish society does not reach the levels of LA countries, but is higher than in European countries and such EA cases as Japan and South Korea.[59] The latest available datum for the Gini coefficient is 0.42 (Figure 19) for 2003. More interestingly, Figure 16 indicates that there has been a secular decline in income inequality in Turkish economic history since 1968. Even in the neo-liberal era, the Gini coefficient was generally falling, which makes the phenomenon quite paradoxical.[60] Yet, a better distribution of income and a democratic mechanism for interest intermediation may not only contribute to sustainable growth, but also to political stability.[61]



[58] The data are taken from the State Institute of Statistics.

[59] See Figure 7.

[60] Cizre-Sakallıoğlu and Yeldan (2000) only focus on the changes in the period between 1987 and 1994, in which the Gini coefficient rose by 5%. However, the secular decline needs an analysis that considers the post-1968 period and explains the puzzle of how the Gini coefficient decreased in a neo-liberal structural transformation. A possible answer to this paradox is the transformation of the Turkish economy from a rural/agricultural to an urban and industrial/service-based economy, which reduced rural–urban inequality. A strong component of inequality stems from rural-urban differences; the more economy and society are urbanized, the less society will be unequal. Another explanation takes into consideration the fact that the expansion of the neo-liberal coalition over time created new ways to distribute resources. The JDP's electoral coalition with its cross-class constituency, the rise of small and medium-sized enterprises and the practice of informal redistribution mechanisms might all have played a role in the reduction of the Gini coefficient.

[61] It is important to note that such democratic demands can easily turn into populist demands and avenues for rent-seeking, as frequently observed in Turkish politics and economic history. However, it is not democracy *per se*, but Turkey's own democratic deficits which have created an environment in which patronage politics and populism have been associated with corruption and an inefficient allocation of resources. See Öniş and Şenses (2007).

Source: Duygan and Güner (2006).

Figure 16. Gini coefficient in Turkey.

Poverty[62] is the third dimension of our analysis focusing on the societal aspects in the assessment of the recent performance of the Turkish economy. Extreme poverty is almost absent in the Turkish context.[63] However, the data provided by the CIA World Factbook and the UNDP statistics indicate that there are serious levels of moderate poverty and poverty adjusted to PPP.[64] In order to maintain steady growth rates in a politically stable environment, policy-makers in Turkey should also consider the social aspects of economic polices and pay greater attention to unemployment, inequality and poverty.

6. CONCLUSION

The central objective of this chapter has been to confront the question of whether the recent Turkish growth experience represents a sustainable process. We have compared the performance of the Turkish economy in the post-2001 era not only to its performance in the previous era of neo-liberal reforms, but we have also placed it in a broader global context. In this context, the benchmark is not confined to the experience of East Asian "tigers," but also includes other emerging markets in Latin America and Eastern Europe. Comparisons with its own past have been helpful in terms of highlighting the achievements of the Turkish economy in recent years. Comparative analysis involving other emerging markets has clearly pinpointed the weaknesses and vulnerabilities of the recent Turkish economic performance. Most importantly, the current account balance and dependence on foreign capital and global liquidity conditions can be considered the main challenges to the sustainability of long-term growth in Turkey. Furthermore, the decreasing influence of the EU anchor and its possible effects on FDI attraction and privatization revenues might further deteriorate the current account balance and macroeconomic stability. In addition to these factors, changes in the favorable global liquidity conditions due to the financial crisis in the US economy might affect the Turkish economy which is vulnerable to such external shocks. Last but not least, unlike between 2002 and 2006, the present government can hardly be described as enthusiastically committed to economic reforms and the EU accession process.

Can Turkey emerge in the medium-term as a new tiger, or will it remain a temporary star? So far, this analysis has portrayed a balanced account of the Turkish economy, emphasizing both the positive achievements in the recent period, as well as its weaknesses and major challenges to long-term stability and growth. Turkey can emerge as a new tiger if,

[62] The meaning of poverty and its measurement is a controversial issue. The World Bank defines two measures: extreme poverty measured by the income of less than 1 US$ per day, and moderate poverty (less than 2 US$). Both of these are absolute measures of poverty and do not take price levels into account. That is why some scholars use price-adjusted (PPP) measures of poverty. In addition, some introduce the concept of relative poverty, measured as earning less than a half of the income earned by the median person in terms of distribution of income.

[63] Actually, these numbers are disputed. The data provided by the UNDP claim that 3% of extreme poverty remains, whereas the data by the State Institute of Statistics indicate that extreme poverty is non-existent in the Turkish case.

and only if, it can manage to overcome the challenges and capitalize on medium- and long-term opportunities. In this respect, the externally dependent growth should be reduced with an increase in domestic savings and exports—to exceed imports—leading to a decrease in the current account deficit and the vulnerability to external shocks and global imbalances. The global financial crisis of 2008 has clearly exposed the limitations of this pattern of a rather unbalanced and externally dependent growth. The EU accession process should continue to be the major objective of the government, creating incentives and conditionality for further reform and structural transformation with real membership prospects. The EU accession process does not only empower domestic actors to achieve economic reforms and increase investor confidence, but also provides certain incentives for further democratization in Turkey. Both as a normative ideal and a contributor to long-term development, democratization is likely to be an essential component of sustainable growth and political stability. In contrast to the EA experience and similar to CE countries, Turkey's targets should aim beyond sustainable growth and incorporate measures of democracy and governance. Last but not least, Turkey can become a new tiger to the extent that it can manage to sustain growth by reducing inequality in society, creating employment, and eliminating poverty. In short, the performance of the 2001-2006 era ın terms of growth rates, the reduction of inflation, FDI attraction, privatization revenues and the reform process have all contributed to the initial phase of tiger-like performance. Yet, this initial phase should be complemented by longer-term development strategies designed to overcome the challenges to sustainable growth. Otherwise, Turkey may yet again experience one of its short-lived growth phases and remain a temporary star rather than an emerging tiger, due to the myopic bias of politicians and other economic actors.

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[64] UNDP: 27%; CIA World Factbook: 20%. See the UNDP Human Development Report 2007 and CIA World Factbook.

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Chapter 4

MODERNITY IN TRANSFORMATION: TURKEY UNDER THE AKP GOVERNANCE

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ABSTRACT

This chapter attempts to explain why and how the Justice and Development Party (the AKP) has won two national elections and became the governing party with a majority rule in Turkey. The electoral success of the AKP and its impacts on Turkish society goes much beyond the domain of party politics, insofar as the very identity and political success of the party has to do with (a) the much deeper process of transformation that Turkey has been undergoing recently in terms of its economy, its culture and its international relations, and whose historical context is not only national but, global, regional and local; and (b) the inability of the social democratic center-left party (the CHP), the nationalist party (the MHP), the Kurdish party (the BDP), and the other center-right parties (the ANAP and the DP) to cope with this transformation.

In this chapter, I will situate the AKP in a much more sociological, economic and political context, and attempt to analyze its conservative-liberal identity with reference to Turkey's recent global, European and democratic transformation. Such an analysis will also demonstrate the limits of the AK Party experience and provide a number of policy-based suggestions to make Turkey a democratic, just and stable country with proactive and constructive foreign policy.

INTRODUCTION

Achieving consecutive electoral victories as a political party *vis-a-vis* its opponents (gathering 47 %, almost half, of the votes in the 2007 national elections), playing a crucial role in the transformation of Turkey into one of the key and pivotal actors in world politics and global political economy, but at the same time, creating strong scepticism and fear among the secular elites and secular middle classes for the future of the secular regime and their life style, the AKP experience since 2002 has constituted the most significant era in Turkish politics, democracy and modernity. It is in this era that Turkey has undergone significant changes and transformations, lived and felt in each and every sphere of life, ranging from proactive foreign policy to dynamic economy, from the beginning of the full accession negotiations with the European Union (EU) to being one of the architects of the inter-civilizational dialogue initiative. The country at the same time faced serious problems from terror, violence and societal polarization to the assassinations, murders, human right violations, and from creating a strong majority government capable of bringing about stability and good governance to the emergence of the risk of "political impasse" as a result of the party closure cases, postmodern military quo attempts and increasingly conflictual patterned interactions between the state elite and government. While the adjective "new" has been used frequently to delineate the power of these significant processes of transformation, such as "the new Turkish Republic", "the new middle class", "the new era in Turkey", and "the new Turkey", the AKP experience has also involved significant attempts aimed at pulling Turkey back from these processes. In this sense, the AKP experience has been an illustrative and telling case of a major swing between transformation and retreat, between change and status quo, and between proactivism and scepticism.

The aim of this chapter is to provide an historical-institutionalist and political-economic analysis of the AKP experience in terms of its electoral success, its mode of governance and its transformative capacity, as well as the recent challenges coming to it from the military, legal bureaucracy, and the secular segments of society. In doing so, I will suggest that this experience and the electoral success of the AKP has to do with both (a) the recent changes in world politics and international relations, which constitutes the global context of this experience, and (b) the recent transformation of Turkish modernity, whose multi-dimensional and multiplex impacts and ramifications have been making Turkey a much more "complex society". The second half of the chapter concerns the limitations, internal contradictions of, as well as the challenges to, the AKP experience. In this context, I will argue that both the AKP's highly instrumental approach to democracy, and the existence of weak opposition parties have given rise to fear, anxiety, and uncertainty about the future and identity of Turkey. In conclusion, I will suggest that the solution to the problem of vulnerability of Turkish modernity to major swings lies in democratic consolidation, i.e. consolidating Turkish democracy in such a way that, as Charles Tilly suggests, the state elite, and the political, economic and civil society actors view democracy as a regime in which "political relations between the state and its citizens feature broad, equal, protected and mutually binding consultation" [Tilly, 2007; 14]. Democratic consolidation, going hand in hand with sustainable economic and human development, and the political and normative commitment to the principle of living together, is the key to making Turkey a democratic, just and stable society. What Turkey needs today is a democratic, just and good governance, aiming at solving societal problems through democratic deliberation/consultation and participatory decision-making.

1. The Electoral Success

Both on the evening of November 3, 2002, and July 2, 2007, as the election polls were opened and the results started to be announced, a political earthquake shook the Turkish politics. In the November 3, 2002 national election, the three governing parties that had formed the coalition government after the 1999 national election, as well as the two opposition parties, failed to pass the 10 % national threshold; thrown outside the parliament, they all found themselves as the complete losers of the election. The sole winner of the election was the AKP. By receiving 34.2 % of the popular votes and with the aid of the undemocratic 10% national threshold, the party gained 66 % of the parliamentary seats (that is, 363 of 550 seats) and constituted a strong majority government. Although the AKP had come into existence as one of the two parties that emerged from within the constitutionally-banned *Virtue Party* whose Islamic identity and discourse has been seen by the Supreme Court as a threat to the secular foundation of the Turkish Republic, the AKP's electoral success, leading to its majority government, was welcomed by a large part of Turkish society longing for political stability and effective governing. On the evening of July 22, 2007, the election results created another political earthquake. This time, the ruling AKP won "a landslide victory, receiving 47% of the vote, the largest share for a single party since the elections of 1957, and it was only the second occasion since 1954, in which the incumbent party significantly increased its vote share in a subsequent election" [Polat, 2009; 130]. Despite a number of serious attempts undertaken by the military, judiciary, opposition parties, media, and civil society organizations to confront the AKP's mode of governance on the basis of the party's alleged intentions to make Turkey a moderately Islamic society by dismantling the secular foundations of the political regime --the attempts whose concrete manifestations were observed in the widespread resentment in secular segments of society to the announcement of Abdullah Gül as the AKP's candidate for the new president of Turkey-- the July 22, 2007 election resulted not only with the fortification of the power of the AKP government, but also in the elimination of all the attempts aiming at refraining Abdullah Gül from presidency. The AKP won against the actors and discourses defining themselves as the "defenders of secularism," reinforced its majority government and societal support; soon after the election, Abdullah Gül became the new president of Turkey.

Since 2002, Turkey has been governed by the AKP government. The confrontation against the party, on the basis of the claim that the AKP became the centre of anti-secular activities, continued and in 2008, involved a closure case brought against the party by the Prosecutor General. Yet the Constitutional Court's verdict was "not to close the AKP", and the closure case did not alter the enduring power of the AKP as a majority government. If the AKP remains a powerful, dominant, and even a hegemonic actor in Turkish politics, despite all of these criticisms, confrontations and military and judiciary attempts, then the question to be answered here is, in what way has the AKP created its electoral success, and to what extent can it sustain its power in Turkish society in a time when Turkey, in a changing world, faces severe economic problems of recession, unemployment, poverty, and growth, as well as serious risks in the areas of social unity and living together. In seeking an adequate answer to this question, it is necessary to analyze both the "complex process of transformation" that Turkey has been undergoing in recent years, which is rendering its governance extremely difficult, and also the peculiarities of "the global context" in which the national elections, giving rise to the fortification of the power of the AKP, took place.

The strategy that brought about victory to the AKP in these elections was based on "change and transformation"; that is, to lead the transformation process of Turkey, whose sources have been both domestic and international. Its claim was to lead this process in such a way that pull back from change and retreat to the existing, weak, instable political system would be prevented. The AKP differentiated itself from the other political parties by defining itself as a "centre-right party" with the conservative-democrat identity. However, I would suggest that the *modus vivendi* of the AKP was what can be called a "conservative-liberal synthesis", founded upon an attempt to articulate liberal market values with community/tradition-based norms.[1] The conservative-liberal synthesis, which had framed the South Asian countries' economic development processes and their exposure to global economy during the 1990s, was first employed in Turkey by the Islamic-oriented economic actors, such as the *Independent Business and Industrialists Association* (known as MUSIAD) and province-based *Industrial and Trade Associations* (known as SIADs). The AKP accepted this synthesis as a way of differentiating itself from the previous Islamic-oriented parties, as well as from the other centre-right and centre-left political parties, and defined itself as a centre-right party operating in the parliamentary democracy and secular constitutional structure.[2]

What had determined the attitude and the orientation of the Turkish electorate in both elections was the economic crisis/stability and the immediate need to solve the problems of unemployment and poverty. In this sense, the majority of the Turkish electorate chose the AKP because of its claim that its economic program, based on a conservative-liberal synthesis, was much more adequate and feasible for finding effective solutions to severe economic problems. The conservative-liberal synthesis operates on the basis of four principles:

i. **An effective post-developmental state** which is proactive, market-oriented and reform-based in its interaction to society, but at the same time "caring" and assuming a supervisor role in its relation to economy. In this context, the AKP claims that in its governing, it will change the existing state structure which is detached from society and blind to its needs and demands, and which therefore functions as a closed, ineffective and undemocratic system of rule, and instead create an effective and post-developmental state;
ii. **A regulated free-market** which is growth oriented and enriching. The AKP argues that it promotes a free-market economy and sees it as the basis for growth, to the extent that it contributes to further industrialization of the Turkish economy and its consolidation on the basis of financial stability and a strong economy;
iii. **Social justice** which is to be established both in terms of the distribution of wealth and welfare services, and with respect to the domain of recognition in which social segments will not be discriminated in terms of their different cultural beliefs. At this level, focusing on poverty, the AKP's economic program differentiated itself from the other parties, and linked itself with different segments of society in need of help and caring; and
iv. **Proactive foreign policy** which indicated a major shift in Turkey's foreign policy behaviour, and aims at giving it a proactive, multi-dimensional, constructive quality. Proactive foreign policy, as will be analyzed in detail later, means the increasing "soft power" role of Turkey in world politics and international relations. The AKP

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[1] For detail, see Onis and Keyman [2003], and Keyman and Onis, [2007].
[2] I have provided a detailed analysis of MUSIAD and SIADs in Keyman and Koyuncu, [2005].

saw economy, security and identity as relational, and considered them as intertwined sources of Turkey's economic modernization process and proactive role.

Working on the basis of these principles, the conservative-liberal synthesis allowed the AKP to claim that it could govern the transformation process of Turkey better than others, and make Turkey strong and stable in the globalizing world. In what follows, I will offer an historical-institutionalist and political-economic analysis of the AKP experience by taking into account the question of transformation and the global context. This analysis, I believe, also allows us both to approach the AKP without ideological prejudices and to see the possibility of the emergence of certain contradictions, limitations and democratic deficits in the course of its governing Turkey.

2. Transformation and Turkey as a "Complex Society"

At this point, it is useful to pause our discussion of the AKP experience, and turn our attention to the history of modern Turkey from the perspective of the question of transformation, for it is through an analysis of the on-going and complex process of transformation that we can understand how the AKP has achieved electoral victory by putting into practice its conservative-liberal synthesis.

The history of modern Turkey has usually been analyzed either with reference to the concept of "rupture", which indicated that the declaration of Turkey as a new, independent and modern nation-state in 1923 constitutes a "rupture" in history, or by placing a strong emphasis on the continuities between the new regime and the Ottoman Empire. The studies in which rupture is emphasized view the history of modern Turkey as a process of nation-state based modernization since 1923. On the contrary, in the studies where continuity is emphasized this history is seen as a process of top-down, state-centric and authoritarian modernization, whose sources and origins can be traced in the late-Ottoman Empire.[3] All of these studies provide valuable, but nevertheless partial accounts of modern Turkey. Here I suggest that there is another way to study modern Turkey. Insofar as the history of modern Turkey is a history of "modern nation-building" and "nation-state building" defined along "a will to reach the contemporary level of civilization", it is also "a process of transformation"; transformation of a traditional society into a modern society, which was to be achieved by the state through a project of modernity, premised on the equation of modernity with progress, that is, on the making of a modern nation through the introduction and the dissemination of Western reason and rationality into what was regarded a traditional and backward social formation. According to Şerif Mardin, the process of transformation in the making of modern Turkey involved: (i) the transition in the political system of authority from personal rule to impersonal rules and regulations; (ii) the shift in understanding the order of the universe from divine law to positivist and rational thinking; (iii) the shift from a community founded upon the "elite-people cleave" to a "populist-based" community; and (iv) the transition from a religious-community to a nation-state [Mardin, 2006; 19]. These transitions were necessary and realized as the pre-condition for Turkey to live as an advanced and civilized nation in the midst of contemporary civilization.

I have explored elsewhere the ramifications and manifestations of the process of transformation of Turkey into a modern society through the realization of a nation-state, capitalist economy, national identity, and industrialization, and suggested that modernization as a process of transformation, even though it has involved significant ruptures in history, still continues.[4] The first rupture was the transition to parliamentary democracy in 1945-1950, and since then Turkey's modernization entailed a significant reference to the question of democratization. Despite frequent regime breakdowns and significant democracy deficits, the history of modern Turkey has been, and today remains as, a process of modernization with democratization since 1950. Turkey`s exposure to globalization occurred in the 1980s primarily but not only in the area of economy, also in culture and politics. Since then, globalization has constituted the world-historical context of the transformation process of Turkey, as it has brought into existence the squeeze of "the national", i.e. the nation-state, national economy, national identity, between the global forces and local dynamics. The discourses of minimal/effective state, free market rationality, and identity/difference have gained power and popularity, and increasingly become the focus of politics. Globalization has generated significant and system-transforming impacts on politics, economy and identity in Turkey, and it has become impossible to understand and govern the country without reference to globalization. Thus, since the 1980s, and especially since the 1990s, the process of modernization involved globalization, and acted as modernization with democratization and globalization. In the year 2000, Turkey has faced a new rupture as the country has been granted candidate status for the full membership of the EU by the European Council in the Helsinki Summit of December, 1999. This decision has also led to the deepening of Turkey's European transformation, as it demanded that Turkey should initiate a democratic and constitutional reform process to further and upgrade its democracy. Since 2000, Turkey has been undergoing a process of European transformation, covering almost all the areas of the governing structure and the state-society/individual interactions. Since October 3, 2005, Turkey-EU relations have been taking place in the form of "full accession negotiations", and, despite the existing problems of uncertainty and lack of trust, the process of transformation of Turkey has had a strong and effective "EU-anchor".

Two points can be extrapolated from this brief account of the history of modern Turkey. The first is that the process of transformation is an ongoing, multi-dimensional, multiplex and complex one, insofar as it involves;

i. 1923-the present: the process of modernization,
ii. 1950-the present: the process of democratization,
iii. 1980-the present: the process of globalization,
iv. 2000-the present: the process of Europeanization.

It can be suggested, in this sense, that the present nature of Turkey is characterized by the simultaneous and intertwined existence of all four these processes --modernization, democratization, globalization, and Europeanization-- as well as their impacts on the economy, politics, and identity. These processes and their impacts, which together constitute Turkey's transformation into a much more "complex society", require an attempt to go beyond the bifurcated programme of modernization, an attempt to fill the disjuncture between

[3] For detail, see Kasaba, [2008].
[4] See Keyman, [2008].

state power and social forces, and a call for flexible, pragmatic and reform-oriented governance. In other words, the present nature of Turkey, in Ulrick Beck's terminology, cannot be reduced to a social formation of "simple modernity"; instead, we can talk about a "reflexive modernity" whose context is no longer national, but also global and regional, and in which social transformation has multi-dimensional sources and multiplex structure, as well as multi-causal and simultaneously existing relations.[5]

Moreover, this complex sociology of Turkey has been complicated further by the multiplication of political cleavages as a result of the multi-dimensional process of transformation. Since 1923, throughout the process of transformation of Turkey, a number of political cleavages, each corresponding to the different dimensions of modernization, have occurred. These political cleavages can be listed and categorized in the following way:

i. 1923-the present: the centre-periphery cleavage
ii. 1950-the present: the left-right cleavage
iii. 1980-the present: the global-national cleavage
iv. 2000-the present: the identity-citizenship cleavage

The present nature of Turkish politics contains in itself all these cleavages, simultaneously and in an intertwined fashion. They together require an understanding of Turkey as a complex society whose good and just governance entails an attempt to cope with all of these cleavages at the same time. This means that today the question of governing Turkey should be posed, more precisely, as that of "governing a complex" society, going through the processes of modernization, democratization, globalization and Europeanization, bringing about complex challenges, risks, but also potentials, emerging from within the centre-periphery, left-right, global-national and identity-citizenship cleavages.

In fact, in addition to its main functions of defining the AKP and differentiating it from other parties, the conservative-liberal synthesis has also been a response to the question of "governing Turkey as a complex society." The AKP has developed and implemented its response by positioning itself in politics and in front of the electorate as a globalist and pro-EU "centre-right party" with a conservative-democrat political identity, and attempted cope with these cleavages by locating itself both in the centre and in the right-axis of politics, allying with globalization and Europeanization. In doing so, it has also claimed to be the main actor and carrier of the process of transformation of Turkey. The AKP has made use of transformation, such that it was not regarded as a challenge but instead a positive vehicle by which to increase its electoral support, its political power and its societal (both domestic and global) legitimacy and acceptance. It is in here that the success of the AKP lies, and confronted with the reactionary nationalisms and politics of the opposition parties. As the AKP has become more powerful, and its societal acceptance as the main and only actor in responding to the governance of Turkey as a complex society has expanded, the opposition parties have increasingly reacted by taking a highly sceptic position on globalization and Europeanization; they placed a strong emphasis on the risks that the process of transformation poses to Turkey, and developed reactionary and security-oriented reactions to the AKP and its conservative-liberal synthesis. However, as the results of the 2002 and 2007 elections have demonstrated, the reactionary and sceptical politics of the opposition parties has not brought

[5] See U. Beck, [2000], and also U. Beck, [2006].

any success; instead, the AKP has increased its votes to almost 47 % --as mentioned before, the largest share for a single party since the elections of 1957.

3. THE GLOBAL CONTEXT

Of course, the multi-dimensional and multiplex transformation process that Turkey has been undergoing cannot be understood without reference to the global context. In fact, it is the global context that has played an effective and constitutive role in Turkey's transformation into a "complex society", and also made a significant contribution to the widening and deepening of the power and societal support of the AKP. In what follows, I will provide a brief analysis of the global context of the AKP experience.

In his influential work on world politics in the post-Cold war era, *The Grand Chessboard: American Primacy and its Geostrategic Imperatives*, published in 1997, Zbigniew Brzezinski suggests that: "Turkey and Iran are not only important geostrategic players but are also geopolitical pivots, whose own internal condition is of critical importance to the fate of the region. Both are middle-sized powers, with strong regional aspirations and a sense of their historical significance" [Brzezinski, 1997; 124-35]. Of course, there have been radical changes in Turkey, as well as in world politics, since Brzezinski penned this description of Turkey in 1997. Yet, as I will elaborate in what follows, Brzezinski's diagnostic statement about Turkey, and his important reminder that there is a link between "internal conditions" of a country and its "foreign policy behaviour/identity" has remained true. Turkey's "geopolitical pivot" and regional power role in world politics has become even more important in recent years. Turkey has been expected to initiate a proactive, multi-dimensional and constructive foreign policy in many areas, ranging from contributing to peace and stability in the Middle East, to playing an active role in countering terrorism and extremism, from becoming a new "energy hub" to acting as one of the architects of "the inter-civilization dialogue initiative," aiming at producing a vision of the world, based on dialogue, tolerance and living together.[6] Thus, there has been an upsurge of interest in, and a global attraction to, Turkey and its contemporary history. Moreover, the global attraction to the country has stemmed not only from the geopolitical identity of Turkey, as a strong state with the capacity to function as a "geopolitical security hinge" in the intersection of the Middle East, the Balkans and the Caucasian regions, but also from its cultural identity as a modern national formation with parliamentary democratic governance, a secular constitutional structure, and a predominantly Muslim population.[7]

The end of the Cold War meant the end of the "buffer state" identity of Turkish foreign policy – an identity which was based mainly on the geopolitical position of Turkey in world

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[6] The terms, proactive, constructive, as well as multi-dimensional foreign policy, indicate a change in Turkish foreign policy behaviour from its buffer state identity during the Cold War, where it had tended or prefered to be "reactive, passive, bilateral and security-oriented, to its pivotal state identity in the post-Cold War, and Post-September/11 era, where we have a more active, more multi-dimensional (even in the way it approaches to its bilateral relations, as in the case of Turkey-Greece relations, the Cyprus problem, and Turkey-Middle East relations) and more construvtive and problem-solver in its relations both with its border contries and with its regional and global affairs.

[7] For a more detail about the recent Turkish foreign policy activities, see L.G. Martin and D.Keridis, [2004].

politics.[8] Since the 1990's, Turkey has been in search of a new identity, and, as Ahmet Davutoğlu has pointed out correctly, this new identity has been requiring much more active, constructive foreign policy behaviour. Furthermore, as the world has become more globalized, more interdependent, and more risky, having "strategic depth", this new foreign policy identity entailed the employment of not only geopolitics but also identity and economy [Davutoglu, 2001]. Thus, geopolitics, modernity and democracy have become the constitutive dimensions of Turkish foreign policy today. This development in Turkey's foreign policy identity and behaviour has been perceived in global academic and public discourse as Turkey becoming a "key and pivotal actor of world politics"[Larrabee and Lesser, 2003]. What is important here is that it is the increasing role and visibility of "soft power" --rather than "hard power" stemming from its military and geopolitical capabilities-- that has framed the proactive, constructive and multi-dimensional activism in Turkish foreign policy, and has given meaning to its "strategic depth," at the same time creating a global interest in, and global attraction to Turkey.[9] Of course, the soft power-quality of Turkish foreign policy has derived from Turkey's interesting and important journey in modernity, despite its continuing deficits in making itself multicultural, democratic and plural; from its political commitment to democracy, despite its deficit in making itself consolidated and deepened; from its economic dynamism, despite its deficit in making itself an economy which is sustainable in terms of its success in human-development; and from proactive, problem-solving and dialogue-based good neighbourhood diplomacy, despite its deficit in making itself also realistic and effective. All of these qualities of the recent Turkish foreign policy, as I will elaborate on in the following pages, have not only given rise to an upsurge of interest in Turkey, but also paved the way for the country to be perceived as a key and pivotal actor whose regional power status involves strong soft power capabilities in addition to its traditional geopolitical importance. As it has been pointed out by many foreign policy analysts, there is no doubt that today Turkey is a regional power and a pivotal actor in global politics, with its geostrategic importance, its modernity, its democracy, and its economy --all of which have constituted the political and discursive basis of the proactive, multi-dimensional and constructive identity of Turkish foreign policy.[10]

The global context, in which Turkey has become one of the key actors of world politics, is what has come to be known as the "post-September/11 world." In fact, if the post-Cold war era constitutes the historical context in which Brzezinski wrote *The Grand Chessboard***,** it is "the post-September/11 era" that gives meaning to the global changes and transformations which have also made Turkey an important player of world politics.[11] As Lenore Martin suggested in her introduction to *The Future of Turkish Foreign Policy*, "[t]he tectonic forces that reshaped international relations at the end of the twentieth century –the collapse of the Soviet Union, ethnic conflicts in the Balkans and Eurasia, the growing stridency of Islamic

[8] For a detailed analysis of both the nature and the end of the buffer state identity of Turkish foreign policy, see Rubin and Kirişçi, [2002].

[9] The concept of soft power refers to a co-optive, non-coercive and consent-based power, rather than a command-based, coercive and hard power. State power gains legitimacy in the eyes of others through its soft power whose sources include diplomacy, economy, culture, identity. Through soft power, the state gets the other state to "want what it wants". Soft power involves consent. For detail, see J. Nye, (2004). For an important account of the role of soft power in Turkish foreign policy, see Insight Turkey, special issue, *Turkey's Rising Soft Power*, vol.10, no.2, 2008.

[10] See Martin, [2004].

fundamentalism, globalization of national economies, and increasing demands for democratization and civil society- also thrust Turkey into an increasingly pivotal role on the geopolitical stage. The aftershocks at the beginning of the twenty-first century, the events of September 11, 2001, the global spread of anti-Western terrorism, the U.S. invasion of Iraq, and the cracking of consensus in NATO and the UN threw up additional challenges for Turkey that have confirmed and complicated its critical role"[Martin, 2004; 3]. Similarly Graham Fuller in his new work on *The New Turkish Republic*, defines Turkey as a pivotal state in the Muslim world, and argues that, with its proactive foreign policy drawing global attention and attraction, Turkey is becoming a regional power in the post-September/11 world [Fuller, 2007].

It should be noted, however, that global changes and transformations have brought about risk and uncertainty in our globalizing world, and led Stephen Larrabee and Ian Lesser to call their recent work on Turkish foreign policy as *Turkish Foreign Policy in an Age of Uncertainty* [Larrabee and Lesser, 2003]. This means that the proactive, constructive and multi-dimensional Turkish foreign policy, and the global attraction to Turkey that has emerged with it do not necessarily lead Turkey to become more democratic, more globalized, and closely integrated to Europe. It is likely that Turkey functions, and will continue to function, as a "globalized pivotal state" on the grand chessboard of the post-September/11 world. Yet it is also possible that Turkey, in the post-September/11 world, would become a more nationalist and inward-looking strong state in its reaction to risks and uncertainties, as in the case of the recent rise of nationalism and the increasingly security-based foreign policy discourse concerning the Kurdish issue and the problem of Northern Iraq. Larrabee and Lesser suggest in this context that:

"Turkey may be a pivotal state in Western perception, but uncertainties in transatlantic relations may make the very concept of the "West" unclear as seen from Ankara. Above all, Turkey faces daunting political, economic, and social pressures, with implications for the vigour and direction of the country's foreign and security policies. The range of possibilities is now quite wide, from a more globalized Turkey, more closely integrated in Europe and the West, with a multilateral approach toward key regions, to a more inward-looking and nationalist Turkey, pursuing a more constrained or unilateral set of regional policies"[Larrabee and Lesser, 2003; iii].

Relying on Larrabee and Lesser, it can be argued that whether Turkey becomes globalized or an inward-looking nationalist state is a choice that Turkey and domestic forces in Turkey make in terms of democracy and modernity. A Turkey with a consolidated democracy and multi-cultural modernity can maintain its soft power and pivotal state status in the post-September/11 world. On the contrary, a Turkey focusing solely on geopolitics, security and unilateralism in its foreign policy behaviour, as well as in its domestic politics, would be a more inward-looking and nationalist Turkey.

The recent discussions about Turkish foreign policy have also involved the question of whether or not there is a need to have a "main axis" on which the proactive state behaviour would gain realism, effectivity and efficiency. Four options are worth emphasizing here: (a) proactive foreign policy with Turkey-EU relations as its main axis (*integration*); (b) proactive foreign policy with Turkey-US relations with its main axis (*security*); (c) proactive foreign policy with Turkey-Eurasia relations was its main axis (*autonomy and security*); and (d)

[11] For the importance of September/11 on foreign policy, see Smith, Hadfield and Dune, [2008].

proactive foreign policy without a main axis (*autonomy and pragmatism*).[12] These options have been put forward, voiced and defended by a number of actors having different visions of Turkey and Turkish foreign policy. To be realistic and effective, a viable Turkish foreign policy, relying more on Turkey's soft power, as well as attempting to make Turkish modernity multi-cultural and plural, and Turkish democracy consolidated and deepened, should accept and put into practice Turkey-EU relations as the main axis of proactiveness and constructiveness.[13] Compared with the other options, Turkey-EU relations are economically, politically, historically, culturally and geographically-constructed relations of deep integration with a system-transforming capacity in the areas of democracy, identity, security and economy. Today, despite the existing problems of the lack of trust and the increasing feeling of ambiguity and insecurity about the future of these relations, the EU-full membership anchor should still be considered and taken into account by the Turkish state and the AKP government as the main axis of a viable Turkish foreign policy.

To substantiate this brief analysis of the changing identity and behaviour of Turkish foreign policy, in which the AKP played the dominant role, it is useful to pause and look at the basic characteristics of the post-September/11 world, which in fact constituted a foundation for the increased global attraction to Turkey. This attraction to Turkey can also be observed in the emergence of a number of identity-based perceptions that have been attributed to Turkey in the global academic and public discourse in the post-September/11 world. All of these identity-based perceptions have entailed expectations from Turkey to become proactive, constructive and multi-dimensional in its foreign policy behaviour and orientation. Moreover, these identity-based perceptions of Turkey, and the expectations that have occurred in them, concerning the "soft power role" of Turkey in the post-September/11 world, have created an increased support and strong legitimacy of the AKP experience at the global scale in international relations.

It would be no exaggeration to suggest that the current state of international relations has been increasingly marked by the September/11 terrorism and its devastating impacts on our world. Today it is possible and necessary to define the world in which we live as the post-September/11 world. A quick glance at the recent discussions on global politics about the impacts of the September 11, 2001 terrorist attack reveals that there have been important ruptures, which this terrorist act has created, in world affairs. These ruptures, brought about a number of fundamental and radical ambiguities in world affairs and global politics, have altered the current state of international relations or the existing structure and dynamics of the international system so much that it is possible to define the nature of the present as "international relations in the post-September/11 era." A point of clarification is worth emphasizing at this point. Unlike the neoconservative ideology of the Bush administration that has tended to characterize the post-September/11 era as a totally "new stage," "new condition" or "new epoch" in international relations, I suggest that to speak of the nature of the present world affairs and global politics as the post-September/11 era should entail the

[12] These options have been put forward in Turkish academic and public discourse and debate on the question of what should be the main axis, or the main foundation of Turkish foreign policy in its proactive, constructive and multi-dimensional operation in the post-Cold War era in general, and in the post-september/11 world in particular. I have also extrapolated these positions in my research on 'Turkey in a Globalizing World' (see footnote.7). For a detailed account of these positions, see Abramowitz [2000], Martin and Keridis [2004], Larrabee and Lesser, [2003], Fuller and Lesser, [1993], and Keyman and Onis, [2007].

[13] I have elaborated this point in E.F. Keyman and Z. Onis [2007].

recognition of “continuities and changes” in international relations. In other words, to speak of the post-September/11 era is to recognize the novelty of the crucial impact of the September/11 terrorism on international relations without losing sight of the continuing fundamental problems of the existing international system in terms of security, social justice and democratization.

These ruptures are namely those of “the emergence of the world risk society” and “the changing nature of American hegemony.”[14] In what follows, I will briefly delineate these ruptures. Today we live in a world risk society which involves the feeling of ambiguity, uncertainty and ontological insecurity about the nature, as well as the future of international relations; such a feeling has also been derived from the fact that terrorism is a serious and real danger that operates as a globalized act of violence and intimidation directed mainly toward the innocent. The September/11 terrorist attack and its continuation in Istanbul, Madrid, London, Bali and Egypt have given rise to the idea of the world risk society. It should be pointed out, however, that the idea of risk society is not new. The recent environmental hazards and accidents on the one hand, and the increased number of devastating financial crises in different parts of the world on the other, have already demonstrated that we live in a globalizing world in which modern societies are becoming a risk society.[15] Likewise, the September/11 terrorism has generated an important change in the way in which the American foreign policy acts with a hegemonic vision of the world. It has resulted in the reconstruction of hegemony on the basis of the privileged status of (a) military power and security over economic power and social justice, (b) unilateralism over multilateralism, (c) politics as a friend-foe relationship over politics as negotiation, (d) hard power over soft power, and (e) community and security over liberty and freedom. With this change, the new American foreign policy operated as a neo-conservative ideology of power and domination, and has attempted to reorganize global politics and world affairs through the acts of war and occupation [Chomsky, 2003].

These radical transformations have constituted what has come to be known as the “post-September/11 world.” It is in this historical context that there has also emerged an upsurge of interest in, and a global attraction to Turkey and its modern history --a history that has demonstrated that a secular, democratic, constitutional democracy is possible in a social setting where the population is predominantly Muslim. The post-September/11 world involved not only the rapid spread of inhuman and deadly terrorist attacks throughout the world, but also their link to Islam and thus the codification of Islam as a foe, as a dangerous Other, and as a potential terrorist. Moreover, in this world, we have seen that war and occupation have become the main strategy of the US-foreign policy in its global war on terrorism. Thus, not only has international relations since 11 September 2001 been framed increasingly by a “clash of civilizations” discourse, war and occupation have brought about the increasing power of state-centric politics in global affairs. The codification of Islam as the negation of secular modernity and liberal democracy is fundamental to this discourse, and has led to the suggestion that success in the ongoing global fight against terrorism depends to a large extent on the possibility of articulating Islam with modernity and democracy. In political and academic discourse, this suggestion has been formulated in a variety of forms, ranging from the idea of “exporting democracy through war and occupation, leading to

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[14] For detail see, Appadurai, [2006], and also U. Beck, [2006].

[15] See Lechner and Boli, [2004].

necessary regime change in failed states" to calls for "global democratic governance" capable of establishing an effective foundation for the coexistence of different cultures and civilizations in a manner that involves tolerance, respect, and responsibility as the guiding principles of social interactions in international, regional, and intra-national relations.

In the post-September/11 world, Turkey and its historical experience of modernity has constituted a significant case for the possibility of the coexistence of Islam and democracy.[16] As a social formation with a large Muslim population, Turkey has succeeded in establishing itself as a modern nation with a strong secular state structure, transforming its political system into a multi-party parliamentary democracy and creating a free-market economy. Moreover, as a social formation located at the intersection of the East and the West, Turkey's identity has always been marked by its will to "reach the contemporary level of civilization," understood as Westernization and Europeanization [Keyman and Onis, 2007; LaGro and Jorgensen, 2007]. In other words, even though Islam has remained a significant symbolic reference in the formation of cultural identity in Turkey, its modern history has been characterized by Westernization as a site of secular modernity, economic progress, and democracy. Moreover, despite the existence of a number of regime breakdowns and democratic-deficit problems in its multi-party system, Turkey has nevertheless persisted in its commitment to parliamentary democracy and its norms. It is this commitment that accounts for the ability of political Islam not only to find for itself a place in the multi-party parliamentary democracy in Turkey, but also to enlarge that place so as to become the governing party of a strongly secular state, as in the case of the recent majority governments of the AKP and its increased societal support and political power.

Of course, the Turkish experience of modernity and democracy has not been without serious problems and recursive political, economic, and cultural crises. In fact, the history of modern Turkey can be described as one of "success and failure" -- successful in establishing the necessary institutional structures of modernity, such as a nation-state, modern positive law, parliamentary democracy, market economy, and citizenship, but at the same time a failure in making modernity multicultural, consolidating democracy, creating a stable and sustainable economy, and enshrining rights and freedoms in the exercise of citizenship. Yet, it is precisely because of its constant and persistent commitment to secular modernity and democracy, as well as to Westernization and Europeanization that Turkey has become one of the crucial actors in global politics. The deepening of Turkey- EU relations, the European Council's historical decision at its December 2004 summit to begin full accession negotiations with Turkey, and finally the start of these negotiations on 3 October 2005 cannot be explained without taking into account the increasing importance of Turkey in today's highly insecure world. Similarly, Turkey's ability to experience the coexistence of Islam with modernity and democracy in a generally peaceful manner has also been central to Turkish-American relations in the recent years. In its unilateral act to restructure the Middle East region through war and occupation, the Bush Administration has approached Turkey and its experience of modernity as a "model" for the region [Abramowitz, 2000]. The recent interest in Turkey, especially in terms of the possibility of Turkey's full accession to the EU, can also be observed in most of the Islamic countries. In fact, a quick glance at the growing study and debate about Turkey in the global academic and public discourse reveals that Turkey is

[16] See for example Turam, [2007], Jung and C. Raudvere [2008], and Aydın, [2005].

perceived as an important, even pivotal, actor in international relations, both regionally and globally.[17]

Indeed, in the post-September/11 world, Turkey has been playing a proactive and pivotal state role in numerous and varying areas of world politics, each of which constitutes a crucial domain of global conflict and security, global governance, and global political economy.[18] These areas of conflict, governance, and political economy can be listed as follows: i) The occupation of Iraq and the Kurdish question in relation to Northern Iraq; ii) the Iran problem and the future of the Middle East region; iii) the Russia question and the future of Eurasia; and, focusing on Europe, iv) the crisis of multiculturalism and the question of Islam in Europe. The country has a central position also in the discussions about the clash of civilizations in global politics, the global democratic governance and the question of Europe as a global actor, and the Mediterranean politics and identity. One should also mention the global political economy and global energy politics as among the areas where Turkey's ascending presence and role can be felt. The country's presence and influence is also to augment in most of these areas with its recent membership of the Security Council of the United Nations. Moreover, these roles have brought about a number of identity-based perceptions that have been attributed to the role of Turkey in the post-September/11 world. Firstly, as a modern nation-state formation with democratic governance and a secular constitutional structure, Turkey is a *"model country"* for the possibility of stability and peace in Iraq in particular, and in the Middle East and Islamic world in general. In fact, with its more than a century long modernizing reform and constitutional democracy experience, Turkey is the most successful example in the world today of a secular democracy with a Muslim society. Secondly, Turkey's modern history constitutes both *an "alternative to the clash of civilizations thesis"* (as in the case of the *Inter-Civilization Dialogue Project*, led by the United Nations, Spain, and Turkey), and a *"significant historical experience"* from which the Islamic world, in particular countries such as Malaysia, Morocco, Indonesia, can learn in their attempts to democratize themselves. Particularly instructive may be the AKP and its ability to establish an electoral victory through its claim to be a "conservative-democratic centre right party." Thirdly, with its ability to sustain, and even deepen, its secular democracy in a peaceful manner, along with its "dual identity as both a Middle Eastern and European country," Turkey's recent governance by the AKP has made Turkey a *"pivotal state/regional power"* in the process of fighting against global terrorism without making Islam the focal point of opposition. Fourthly, in the deepening of Turkey-EU relations and the beginning of full accession negotiations, there is an increasing perception, especially among economic and foreign policy actors, that Turkey is a *"unique case in the process of European integration"* with the ability to help Europe to become a multicultural and cosmopolitan model for a deep regional integration, and a space for the creation of a post-territorial community on the basis of post-national and democratic citizenship, as well as a global actor with a capacity to contribute to the emergence of democratic global governance. The possibility of Europe to gain these qualities depends to some extent on its decision about the accession of Turkey to the EU as a full member. Fifthly, with its dynamic economy, recursive growth rates, and young population, Turkey has become one of the important, but not pivotal (such as India,

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[17] See for example, Cornell, [2001], Abramowitz [2000], Keyman and Onis[2007], LaGro and Jorgensen [2007], and G.E. Fuller and I.O. Lesser, [1993].

[18] For a general account of these areas see Williams, [1998], and Smith, Hadfield, and Dunne [2008].

Brazil), *"emerging market economies* of today's economic globalization. Moreover, although Turkey does not produce oil or natural gas, it has recently begun to act as an *"energy hub"* for the transmission of natural gas between the Middle East, the post-Soviet Republics and Europe.

The recent global attraction to Turkey, giving rise to these identity-based perceptions, has resulted not only in the increasing global support for the AKP experience, underlining its importance and functionality for fighting against terrorism, resisting against the clash of civilizations, and creating stability and normalization in international relations, but also in the strengthening of the power of the AKP in Turkey *vis-a-vis* the opposition parties with regard to the question of how to govern a complex society. Further, this global attraction and support has been a strong benchmark for the Constitutional Court in reaching the verdict against the closure of the AKP. The global academic and public discourse saw the closure of the AKP not simply in terms of the question of democracy, but, more importantly, as a case whose ramifications go beyond Turkey and disseminate throughout the Muslim world and Europe in particular, international relations in general. While conceiving the discourse and activities of the AKP as becoming increasingly against the secular regime, the Constitutional Court decided against the closure by taking into account the party's strong role in starting the full accession negotiations between Turkey and the EU, as well as its soft power, and proactive role in the post-September/11 world.

4. In Conclusion: The Question of Democracy

However, it should be pointed out very clearly that the enduring dominance of the AKP experience in Turkey has not been without problems, confrontations, tensions, and even calls for non-political and undemocratic interventions into politics. In fact, the more the AKP become the dominant actor of Turkey's recent transformation, the more it has been subject to criticism, scepticism and reaction, especially with respect to its conservative-liberal synthesis, its instrumentalization of democracy, and its political and normative position toward secularism. In the face of such reactions and criticisms, the AKP experience, rather than solving the problem of the bifurcated nature of Turkish modernity, as well as the disjuncture between state power and social forces, has recently tended to reinforce this problem, and led Turkey to pull back from the democratic and economic reform process, retreating to the state-centric politics. The recent turn in the AKP's mode of governance toward (i) a strong security-oriented political discourse from an economic growth and good governance-based political discourse, (ii) a group interest and "us versus them"-based politics from a service and reform-oriented mode of governance, and (iii) a reactionary nationalist and communitarian language of polarization from a more accommodating and encompassing language of living together has indicated that the conservative-liberal synthesis on which the party acts and operates lacks a strong commitment to democracy and its consolidation. In other words, the power of the AKP, stemming from its transformative role in Turkey's modernization and foreign policy, has not paved the way to the consolidation of democracy. On the contrary, the more the AKP become powerful, the more its relation to democracy has become instrumental, and hence the democracy deficit of the AKP experience has occurred, demonstrating that the normative commitment to democracy and the strong will for consolidating Turkish democracy constitute the limit of this experience. The AKP has not furthered and upgraded Turkish democracy, and instead, the AKP experience has involved what can be called the "instrumentalization of democracy"; first, by reducing democracy to parliamentary majoritarianism, second, by privileging a specific and religious right-claims and freedoms over the others, even to the degree of discrimination.[19]

The democratic deficit of the AKP means that there is no guarantee that the conservative-liberal synthesis, operating with a claim to the coexistence of Islam, modernity and liberal market norms on the one hand, and a proactive foreign policy behaviour in the post-September/11 world on the other, would bring about electoral victory with which to form a strong majority government. Yet there is no guarantee that the conservative-liberal synthesis would lead to democratic consolidation, sustainable economic development and societal coexistence in Turkey. In this sense, there is no guarantee that, despite its enduring electoral success and political power, the conservative-liberal synthesis would lead to a democratic, just, stable and good governance;

i. which will establish a reciprocal and democratic relationship between the state and society, so that the disjuncture between strong but ineffective state power and changing society/social forces can be solved, and that Turkey can put into practice a democratic modernization programme rather than the existing bifurcated one;
ii. which will cope effectively with the increasing political and social polarization that has been generating severe negative obstacles to the possibility of living together in a plural and multi-cultural society;
iii. which will fight against the problems of poverty, inequality, exclusion, othering, gender inequality, and uneven regional development, in a way to make Turkey a socially just society successful not only in the area of economic growth, but also, and more importantly, in the area of human development; and
iv. which will prepare Turkey as a democratic and stable country, strong in the full accession negotiations with the EU, and as a full member, capable of making important contributions to Europe in the areas of economy, security and social cohesion.

Whether or not the AKP and its conservative-liberal synthesis can create a democratic, just, stable and good governance of Turkey still remains to be answered. We know from the AKP experience that electoral victory and parliamentary majority in and by themselves do not constitute sufficient conditions for making this desirable vision of Turkey possible. What we do not know is to what extent this experience has a political will or normative commitment to democracy and its consolidation –and it is where the answer lies.

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[19] We have seen this tendency of the AKP in "the head scarf affair, as well as in its approach to the demands of Alevis and non-Muslim religious minorities for their religious rights and freedoms, and to the social security and organization rights of the workers.

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Chapter 5

DECONSTRUCTING THE FUNCTIONING OF POLITICAL MANIPULATION OF THE ECONOMY IN TURKEY

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ABSTRACT

As evident in the related literature, the political manipulation of the economy is a prevalent norm; however its functioning may differ in each economy. This paper, thus, aims at taking the analysis a step further by investigating the nature, distinguishing characteristics, and mechanisms through which political manipulation of the economy are exercised in Turkey, thereby it identifies the country specific differences in the way political business cycles are exercised. The analysis renders support for the micro-level policies for political manipulation of the economy, rather than systematic manipulation of fiscal and monetary policies as suggested by political business cycles modelling. However, such policies still have macroeconomic consequences, which create disequilibrium in the economy.

Keywords: Political manipulation of economy (PME); Political business cycles (PBCs); Distinguishing characteristics of PBC/PME; Functioning and working mechanisms of PBC/PME; Turkey.

INTRODUCTION

The literature on political business cycles (PBC) or the political manipulation of economy (PME) suggests that due to the myopic nature of individual voters and their retrospective voting attitudes, incumbent governments manipulate the economy to create better economic conditions in the pre-election period to enhance the likelihood of re-election. Such political manipulation of the economy is considered to be 'opportunistic' (Nordhaus, 1975).

While a large number of PBC/PME studies on Western European democracies have found evidence for the presence of PBC/PME, academic interest in studying PME in developing countries including Turkey is not common. Edwards (1994) renders support to this by suggesting that the available literature has focused on industrialised countries due to modelling issues and unavailability of political and economic data. In other words, macroeconomic oriented electoral business cycles, found in the industrialised democracies, may not necessarily fit into developing countries. As an indication, all the studies aimed at finding PBC/PME in OECD countries excluded Turkey in their analyses, despite the fact that Turkey is a member of the OECD.

Due to the nature of economy and polity in developing nations, the functioning of PME in these countries can be different, as the mechanism through which it is exercised might demonstrate variation from one country to another. In other words, "while [politico-economic] interactions are undoubtedly present everywhere; the detailed mechanism seems to be different from one country to another" (Lafay, 1981: 398). It is, therefore, importantly useful and necessary to employ an interdisciplinary approach to find how PME is exercised by investigating its nature, distinguishing characteristics, and mechanisms through the use of public funds in each country. This paper, hence, aims to deconstruct the functioning of PME in Turkey thereby it aims to pinpoint the country specific distinguishing characteristics of PME. In doing so, the study covers election periods mainly until and including 2002 parliamentary elections. However, occasional references are made to 2007 parliamentary elections in search for evidence for the substantiation of argument put forward by this study.

Elections and their impact on the economy are a generally recognised matter in Turkey. Before every election, it is commonplace to see comments in the newspapers analysing the government's economic moves as politically-oriented. *Seçim ekonomisi* (*election economy*), as a particular term, implies the increased government expenditures and monetary circulation in the economy during election process. In addition to macroeconomic manipulation, and manipulation of other economic instruments such as agricultural pricing and the prices of State Economic Enterprises (SEEs) produced and distributed goods and services, the construction and maintaining of new roads, the commencement of many projects such as hospitals, dams, and motorways are left to the election period. In analysing the PME in Turkey, it is important to note that the introduction of multi-party politics paved the way for hunting for votes by competing political parties, as in other parliamentary democracies. This has resulted in pursuing populist policies for electoral gains by politicians at the expense of public funds.

Studying PBC/PME in Turkey has been subject to only a handful number of studies, which investigate either the impact of politics on monetary and fiscal policy or some other economic and financial instruments for economic voting argument (see: Bulutay and Yildirim, 1969; Çarkoğlu, 1997; Özatay, 1999; Öniş, 1997; Teletar, 2003; Akarca and Tansel, 2006; Asutay, 2004 and 2005). These studies render strong and satisfactory evidence for the existence of populist cycles or populist patterns of macroeconomic policy in Turkey for various periods. However, such strong evidence could not be located with studies aiming at analysing voter preferences by also including economic variables (see: Özcan, 2000; Başlevent, *et al.*, 2005; Esmer, 2002).

1. DISTINGUISHING CHARACTERISTICS OF POLITICAL MANIPULATION OF THE ECONOMY IN TURKEY

Theoretical formulation of politico-economic interaction is based on the political and economic structure of the industrialised democracies. For instance, Downisan theoretic for PME is based on two political parties, issue voting and macroeconomic policy options. However, this is a contested issue for Turkey and many industrialised democracies, as elections are contested by more than two political parties, and the governments most of the time are coalition governments.

As opposed to the theoretical formulation, in the case of Turkey, there is a difficulty in comparing the policies of political parties over economic and most of the political issues, as due to centralist orientations as well as the straight jacket imposed by the Kemalist regime, the official regime in Turkey, they seem to be suggesting similar policies.[1] Öniş demonstrates such convergences in policy issues among the main parties (Öniş, 2000: 297). Thus, Eurocentric voting theories or Downsian voting motives, based on the assumption of policy differences among political parties, do not easily fit the Turkish case.

Spatial theory, for instance, assumes that voters choose the candidate who best represents their policy options (Downs, 1957: 38-40), according to which choice is made on Euclidean policy spectrum. However, due to non-presence of economic policy options in the elections, it seems that this is not sufficient to explain voting behaviour in Turkey. This is because, voting behaviour is mostly marked with symbolic politics rather than systematic policy issues, which emphasise emotion and affection, while it objects to Euclidean distances on preference spectrums. Consequently, voting behaviour is determined as a function of anger (Lewis-Beck, 1988), anxiety and enthusiasm (Markus and Mackuen, 1993), and preference direction and intensity (Rabonowitz and MacDonald, 1989); or personalising and politicising (Sears and Lau, 1983). For example, anger, may have played an important role in the 2002 elections due to the perpetuated failure of the traditional left and right oriented parties, and anxiety and enthusiasm (due to capture of the leader of the Kurdish insurgent movement) can be accounted for the limited success of the senior coalition member of the incumbent government in the 1999 elections. Also "[t]he seismic Turkish election of 3 November 2002 was a peaceful, democratic expression of the deep anger felt by Turkish voters toward a political establishment known more for economic populism, clientelism, and corruption than

[1] Kemalism is the archaic and eclectic political outlook developed from the worldview of M. Kemal Atatürk, who was the founder of the Republic of Turkey. His understanding of politics and governance was influenced by the late 19th and early 20th century authoritarian and ultra nationalistic political developments in the world, which resulted in the establishment of a very strong state (in the form of Republic of Turkey in 1923) aiming at political and social engineering of the society. Such a political outlook was later transformed into a political ideology, namely Kemalism, which has been the official regime of the country since the early 1930s and it establishes the demarcation lines in the freedoms of the society. It is a peculiar ideology and is a hybrid of Jacobinism, fascistic nationalism and collectivism. Being an authoritarian regime, for instance, it favours a closed étatist economic system. Although Kemalism remains the official regime of the country enshrined and still protected in the Constitution, Turkey, with a pragmatist attitude and hence *de facto* unconstitutionally, has moved into a liberal open market economic system since 1980. However, Kemalism remains an important political tool in the hand of establishment to continue to politically, socially and economically engineer the society. For the economic and political legacy of Kemalism see: Mehmet (1983); Kansu (1997); Pollis, (1989); Cooper (2002); Altan, (2005).

for democratic accountability" (Öniş and Keyman, 2003: 95). The results were, therefore, product of "the electorate's anxious search for new options" (Özel, 2003).

Regarding PBC model selection, Turkey's realities necessitate the utilisation of opportunistic variant of PBC/PME, because partisan models of PBC has difficulties to fit into developing nations, as the left-right spectrum in developing nations do not fit into the political structure of the industrialised Western countries (Schuknecht, 1999). This is a particular case in Turkey, as it is difficult to distinguish political parties on left-right spectrum in the European traditional sense. It is interesting to note that the left-wing Republican Populist Party (RPP, Cumhuriyet Halk Partisi or CHP) has more right-wing attitudes than the conservative parties despite identifying itself with the left, as it is at the centre of state politics and proud to be the party of the official regime. Thus, the demarcation line, in reality, is drawn by the distance parties have in relation to the state.

Another technical distinguishing factor in the case of Turkey is the fact that elections take place unscheduled or endogenously. While this creates difference between Turkey and countries where the election date is exogenously determined (France and the USA), it implies similarities with most of the European parliamentary democracies. The theoretical implication of this is that the electoral cycles in the fiscal and monetary policy and instruments are not in the form of convex curves in the Turkish case.

Unlike the industrialised democracies where PME is exercised over macroeconomic policies and business cycles, in Turkey it does not necessarily take place through macroeconomic policies, and elections, most of the time, are marked with non-economic issues. Macroeconomic issues as policy outcomes are hardly discussed in the elections in Turkey, since political factors in various forms still determines the political positioning of parties and individuals, which is imposed by the official regime of the country. While politicians may make remarks about unemployment during election campaigns in terms of providing 'job and soup', even the governments in their budgets hardly discuss the issue of job creation as an employment policy. In the 2006 budget discussion, for instance, the Turkish Prime minister only spelled out two sentences about unemployment. As a result, micropolicies in the sense of influencing the *egotropic* voting attitude remains the underlying instrument for the PME in Turkey, which has macroeconomic consequences due to being funded from public budget.

Consequently, in Turkey, the functioning of PME is based on micropolitics in manipulating the economy, as in other developing countries. The citizens are part of this process by expressing their demand in terms of individual gains in the election period. Thus, *pocketbooks* or *egotropic* voting, as opposed to *sociotropic* voting based on the general state of the economy, can be an important dimension through which PME is exercised by the governments (see, among others, Kiewiet, 1983), including in Turkey. This is due to the fact that political manipulation of the macroeconomy has national economic consequences, while the use of public funds for electioneering purpose has an individual level economic impact. However, such micropolicies are financed through the public budget as part of fiscal and monetary policies and have, in the end, macroeconomic consequences. It is also important to stress that the political consequences of macroeconomic manipulation might be uncertain in having impact on voters' decisions during casting their votes, while micropolicies have much lesser uncertainty in this regard.

2. Generating and Functioning of Political Manipulation of Economy in Turkey

The relevant literature indicates that PME is mostly modelled through government's opportunistic attempts to manipulate policy options; namely economic growth, unemployment and inflation. However, as discussed, in the developing countries the parameters of political manipulation can be entirely different, which may even include the use of social funds.[2] Thus, micropolitics is an important instrument through which PME functions in developing economies including Turkey, where civil society and democracy have not been fully internalised in the individual preference expression, including the awareness of and reaction to the general state of the economy in the voting decision-making.

The following section, thus, discusses the creation and functioning of PBC in Turkey in an attempt to illustrate the ways and mechanisms in which, and through which, governments engage in the PME in Turkey. However, in doing so this study assumes that the government utilises micropolitics oriented policies based on 'pocketbook' voting behaviour, as the national economy has always been underperforming and therefore governments cannot rely on the performance of the economy to convince the voters to act in a *sociotropic* manner. As a result, it is strategically fruitful for governments to involve themselves in micropolitics in the sense of a localised and patronage system to *buy votes*.

2.1. Rent Seeking Activities as a Source of Political Manipulation of the Economy

Since the Turkish state for most of the modern period was, and in some part still is, the producer, controller and the distributor of resources in the economy (Unbehaun, 2005), it could be considered as a rentier state, as its economic and politico-social interactions was characterised by various stages of corporatism. The last stage of which is neo-corporatism after the 'emerging social corporatist' period of 1960-1980s (Bianchi, 1984).

Shambayati defines the characteristics of rentier state as the states in which underdeveloped productive sectors are dominant, where "develop[ing] extractive capacities" (Shambayati, 1994: 309) is failed. Therefore, such states are mainly distribution oriented, where patron-client relationship between state and business is dominant, and hence "government bureaucracy itself becomes the means through which demands are satisfied", and also "rentier states often lack the information necessary for the formulation of a coherent economic policy" (Shambayati, 1994: 309).

While it is difficult to state that Turkey is entirely a rentier state as indicated in Shambayati's definition due to having a strong private sector, some of these features,

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[2] For example, Schady (1999) investigates the impact of political influence on the allocation of discretionary funds from the Peruvian Social Fund (FONCODES) during election periods. His analysis reveals that the expenditure of the fund increased significantly before elections; and secondly the projects of the fund were directed at poor provinces, as well as provinces in which the marginal political impact of expenditures was likely to be great.

however, can be located among characteristics and the operation of the Turkish state, as in Turkey also “political considerations become the basis of economic decisions” (Shambayati, 1994: 309). Therefore, whatever the content of rent-seeking activity might be, it is related with the “irrational allocation – from an economic perspective - of public resources” (Shaker, 1995: 12). While political patronage is an important aspect of the rentier understanding, it was particularly important in the import-substitution policies of the 1970s and export-led growth of the 1980s in Turkey (Waterbury, 1992).

The source of the rentier state and rent-seeking activities has to be found in the large role of the government in the economy. In investigating the growing nature of the government expenditures, it can be seen that consolidated government expenditures as a ratio of GDP was 16.8% in 1970, 22% in 1980, which, due to economic liberalisation and also off-budget expenditures declined to 17.5% in 1990. However, due to economic and financial crises and the increasing nature of rent and patronage distribution, consolidated budget-GDP ratio went up to 36.5% in 2000, 42.7% in 2001, and since then it follows a decreasing trend with 32.5% in 2005.[3] Taking into account that the Turkish state is not a welfare state in terms of providing welfare benefits beyond health and education, government expenditures are considerably high. Such large government expenditures imply that the government produces rents to be distributed to their supporters, and, therefore, “those in government have access, directly or indirectly, to an immense amount of resources in relation to the resource base of society, which they can distribute” (Özbudun, 1988: 40). This, in turn, explains the reasons for the greed of the political parties for power, as “the costs of being out of power are high” (Turan, 1988: 104). Therefore, “the complex and variable nature of interest group politics in Turkey is largely the result not only of the interconnections between government, party, and group leaders but also in the ways they interact to advance or inhibit the representation of different socio-economic and political interests” (Bianchi, 1984: 355). The state, as a result, became the arena for competition between various segments of the private sector as the source of rent creation (Barkey, 1990). Those groups, which have interest in the continuation of rent-seeking activities through large public sector, have prevented economic reform in the country (Cooper, 2002). Shaker (1995), therefore, argues that the slow development in the privatisation policy in Turkey is due to the power exerted by the civil and military bureaucracy and other interest groups.[4]

The patronage system of political parties as well as their special interest seeking activities can imply the redistribution of wealth and income in the country. Therefore, “the redistributive and the distributive functions of government received increasing emphasis” after multi-party politics integrated the mass electorate to national political life (Turan, 1988: 82). Since being in government means that a political party can distribute the resources to its supporters, constituents exert power to get their parties into the government no matter how, as they cannot afford to lose. This creates a tendency and incentive for parties to get into power. The redistribution of resources among constituent supporters is clear when an opposition party replaces the incumbent one, as the new party in government immediately channels the resources to its own supporters. This indeed continues during the incumbency either in the

[3] Data for the calculations in this section were retrieved from the CBRT statistical delivery system available at: <URL:http://www.tcbm.gov.tr>.

[4] It should also be noted that the 1997 ‘postmodern’ military coup was also result of re-equilibrating the distribution of rents in Turkey, which enormously deviated from the preferences of the regime in the society during Özal (1983-1991) and Erbakan (1996-1997) governments.

form of ideological, religious, or regional communitiarism links. For instance, despite having ideological roots in Islam, in the case of the incumbent government of JDP (Justice and Development Party, AKP), "being Karadenizli [coming from Blacksea region of Turkey] brings together the supporters of AKP together as a priori political identity. Thus, public funds and sources are controlled, channelled and shared through regional communitiarism" (Tosun, 2006 [electronic edition]). This provides the governments with opportunities to fund loyalties that turn into votes in the election, which evidences the importance of micropolitics for electioneering purpose.

2.2. Use of Individual and Group Specific Micropolicies: Patronage System

The electoral history of Turkey indicates that the micropolitics oriented patronage system is an important strategy to *buy* votes for the incumbent governmental parties in Turkey. It can therefore be mentioned that the possibility of manipulating some micro-level government policies for electoral purposes might be more likely than the entire manipulation of fiscal and monetary policies for electioneering purpose.

Before delving into the use of the patronage system by political parties for electoral purpose, it is important to define it: "distribut[ing] state resources, and manipulat[ing] economic outcomes in ways that disproportionately benefit select groups and classes whose strength and support the elite relies on to maintain its rule" (Waldner, 1999). Although Waldner terms this as "popular sector incorporation" in his analysis of political history, the definition directly refers to the use of patronage by the political parties to remain in government.[5]

The patronage system can be traced back to the founding years of the modern republic (Sayarı, 1977; Eisenstadt and Roniger, 1984). When the Republic was established in 1923, it inherited mainly an agricultural economy, and therefore, *tithe* was the main source of revenue for the state. The ruling elite decided to remove the *tithe* in 1925 under the disguise of being an old-fashioned fiscal means. However, as Keyder explains, *tithe* in reality was removed at the demand of the landlords and developing bourgeoisie, as the new Republic was a *bourgeoisie* nationalist revolution (Keyder, 1979). By removing the major source of revenue, the Republic lost its chance of industrial development, as capital shortage in the public and the private sector was the main economic problem. This implies the establishment of the *patronage* system from the initial years of the Republic.

Under the *étatist* regime adopted by the new Turkish elite from 1929 onwards, patronage was extended to other areas and new constituencies. Therefore, the landlords and the new bourgeoisie, around the new regime benefited from a closed economic and political regime. For instance, Buğra (1994) demonstrates the extent of the patronage in the early years of the Republic by revealing how the state directly provided opportunities to certain 'families' to

[5] Although patronage and clientelism are sometimes used interchangeably to mean the same thing, this paper does not aim to show whether patronage or clientelism has been the determining source of political manipulation of economy through political participation, and therefore it uses 'patronage' as a general concept to mean the use of public funds for individual political purposes by politicians and political parties.

establish business. Such patronage creates loyalty to the establishment, and it counts on that loyalty in its perpetuation.

The introduction of multi-party politics in Turkey has provided unceasing opportunities for PME for political gain. “Given the importance of political patronage in retaining supporters and winning new ones, governing parties in Turkey had often sought to manipulate public policy to influence electoral outcomes” (Sayarı, 1992: 39). Most studies on the subject, therefore, perceive PME through political patronage (Sayarı, 1992; Hale, 1981; Özbudun, 1981; Turan, 1988). For instance, Turan offers examples of the Democrat Party (DP), during its reign in government in the 1950s, by stating that “allocating scarce commodities […] to those […] who were of friendly disposition to the DP; making hard currency and import quota to business dependent on their making substantial contributions to the party; [...] making government employment available in general only to sympathizers of the party, were some examples of partizan use of resources available to governments” (Turan, 1988: 75). In evidencing the continuation of the patronage system, Sunar (1990: 755) states that “[n]o coalition that expects to win electorally or govern effectively can afford to overlook the weight of the so-called ‘petty bourgeois’ groups (*e.g.* the middle peasantry and urban self-employed lower middle class) in Turkey. This means that coalitions anchored in business (center-right) or in labor (center-left) must strike a bargain with the large petty bourgeoisie”.

The patronage system is further expanded and sustained with the interruptions in the political system, as after each military coup, when politics was being re-engineered to fit into the requirements of the civil and bureaucratic elite, new coalitions are formed with new constituents by the new political parties. In this process, the use of public funds in the creation of new period elites has been possible through different coalitions under each government. As an example, consider MP (Motherland Party, ANAP), which was formed after the military coup of 1980 and remained in office for two terms until 1991. It is generally claimed that MP managed to create a large coalition of constituents from various political and social backgrounds. However, its success is attributed to its unceasing distribution of resource allocations through a large patronage-clientelistic system. “In the case of [the] MP, the need to allocate resources for patronage-oriented government expenditures become all the more pronounced due to the electoral calendar of 1987-1988… The impact of increased public expenditures before the electoral contests of 1987-1988 was reflected in steep rises for most products and services, which defied the government’s rhetoric regarding the immanency of a decline in annual inflation figures” (Sayarı, 1992: 39). While economic liberalisation under MP governments hurt certain sectors in the society, including the agricultural producers and small-scale manufacturers or artisans, the way Prime minister Özal of MP “placated various interests is by directing some of the growth in the economy into compensatory payments to select constituents within a narrow coalition” (Waterbury, 1992: 210), which, indeed, was facilitated by the election system. In other words, “the liberalization of the capital account and the design of a program for the reduction of import tariffs helped to finance a politically motivated ‘populist cycle’” (Akat, 2000: 267).

In the post-2002 election, after the re-engineering of the political sphere by the 1997 post-modern military intervention,[6] JDP, as a new party, came into power after about eighteen

[6] The indirect military coup of 1997 was dubbed ‘postmodern’ in Turkey, because the army, instead of suspending the democratic process entirely and assuming power, as it had done previously; indirectly put a national coalition of selected political parties into government.

months of its formation. This new party expands the patronage system left from MP by further bringing the periphery into the centre. In other words, it represents the preferences and demands of the Central Anatolia, namely the new bourgeoisie. This implies that the interest of these new constituents have to be served during its term in government, but at the same time, during elections, additional funds have to be directed to these new constituents to renew the loyalty. The result, hence, is the perpetuation of an unceasing patronage system, as "democratically elected governments … have typically initiated populist cycles in order to establish broad electoral support" (Öniş, 2003: 3).

The patronage policies discussed, so far have related to the co-optation tactics and mechanisms of right wing or conservative political parties. This is due to the fact that since the onset of the multi-party system in 1950, the left-wing parties managed to be only included in governments as coalition partners and were not able to form single majority government. However, this should not be perceived that the RPP, the founding party of the Republic and the centre-left party in Turkish politics in the post 1950 period, has not involved itself in formal and informal patronage relationships, as among others Sayarı (1977) and Özbudun (1981) attribute patronage relationship exclusively to only right-wing governments. On the contrary, the RPP directly involved itself in extensive patronage during its reign in power to re-engineer the political, social and economic life in order to create legitimacy for the new Republic. Secondly, while it is true that the RPP has failed to become a single party government, it has been a senior or junior government partner in a number of governments. Also the RPP has ruled in quite a large number of Turkish municipalities. Thus, it has always had its own opportunities to extend patronage to its supporters. Güneş-Ayata examined the local governments under the RPP in two Anatolian towns in the late-1980s. He observed that patronage or "clientelistic relations in the RPP have expanded and flourished…, despite the universalism emphasised in its ideology" (Güneş-Ayata, 1990: 180). As a result, it is fair to argue that regardless of political orientation, patronage is an essential instrument of political participation and establishing political loyalties in Turkish politics.

As to the individual or group oriented patronage, targeting social groups with financial means prior to election is mostly exercised over wage earners and pensioners. For instance, the coalition government of the 1999-2002 period increased the pensions twice in the election year with a generous additional rise immediately prior to the 2002 election (Radikal, 2003).

An important group oriented patronage spending is the agricultural sector, and it is a fact that such manipulative policies can easily be observed in the agricultural sector. This is due to the fact that for some agricultural products, such as poppies, hazelnuts, tea, tobacco and sugar beet, SEEs remain to be the major buyer. The government, as a result, determines the purchasing prices of such products. If the harvest period is close to the election, then the agricultural sector is given additional incentives by the government to gain electoral support through higher purchasing prices for these products. An analysis of the trend of the prices of such products can directly reflect political manipulations. For example, Birtek and Keyder (1975: 446) provide an insightful study in which they analyse "the transformation of the Turkish peasantry in terms of the effect of economic policy on different segments of the agricultural population". Their analysis illustrates that the traditional peasant population had stopped their support for the prevailing single party rule in the first free multi-party election in 1950, as the economic policies of the monoparty incumbent governments did not favour the traditional agricultural sector. To further explain the politics of agricultural price support in Turkey, Gürkan and Kasnakoğlu (1991) attempt to explain the variations in the extent of protection provided to the producers of four selected agricultural crops (wheat, barley, cotton, and tobacco) in Turkey. They found indirect evidence for the existence of political business cycles during election years in relation to agricultural price support. In addition, the influence of general economic conditions as well as political orientation on the behaviour of the policy makers is evident in their study. For instance, they found that the agricultural sector tends to be less protected during military regimes. Their findings illustrate the importance of the role of the state and the impact of governmental economic policies on the voting behaviour of the agricultural sector.

The discussion so far evidences that the state remains at the centre of resource creation and allocation, which implies that "the costs of being out of power are high" (Turan, 1988: 104) for any political party. During government terms, given election promises to constituents have to be fulfilled with such "immense amount of resources in relation to the resource base of society, which [the political parties] can distribute" (Özbudun, 1981: 40). An important issue in this rent-distribution and patronage system is that since coalitions represent broad interests and patronages, governments in their attempt to deliver rents to all these constituents have caused economic instability and crisis as Öniş and Riedel (1993) argue. It is therefore important to mention that the 1994, 2000 and 2001 currency and financial crises are not merely due to the disequilibriums in the economic and financial system, but the roots of these crises lies in the political system, which is based on patronage system through the distribution of rents by the governments and the state apparatus, as "different groups in society [aim to] obtain a greater share of the 'rents', associated with easy access to state resources" due to electoral politics (Öniş, 2003: 3).

The use of micropolitics with the use of public funds for electioneering purpose is, therefore, mainly due to the indifference of individual voters in internalising economic matters in their vote decision-making. The non-primacy of economic issues in the voting process is due to the rigid political differences in the society. In other words, the legitimacy of the politics in Turkey does not directly or fully come from the will of the general public, but through various sectors of the society, to which each political party has a particular appeal during elections. In Turkey, "where resources are scarce and the state is a crucial factor in resource allocation", political parties operate "an exclusive allocation system in their own interests", regardless of their political orientation (Güneş-Ayata, 1990: 181). This directly refers to the patronage and clientelistic systems in existence, representing, on the electoral side, the political participation process and PME on the side of the government, since the formation of the modern Republic, which sustained the patronage system it inherited from its predecessor, the Ottoman Empire.

2.3. Region Specific Micropolicies

In addition to 'group-specific' patronage system, governments use public funds for electioneering purposes for 'region-specific' micro-level policies. Such micropolicies can be in the form of public works expenditures, in terms of commencing construction works and big projects prior to elections, and increased transfer programmes such as utilising the off-budget or special funds to target certain social groups in certain districts or regions prior to elections, who are vulnerable to political manipulation during election periods. Since, "the allocation of state resources for these projects is controlled by elected party governments" (Sayarı, 1977:

108), “ruling parties have often used this power to broaden their grass-root electoral support by rewarding rural communities which vote for them with … [such] public works” (Eisenstadt and Roniger, 1984: 86).

As part of the micro-level policies, politicians indulge in undertaking minor *pork barrel inducements* projects like local public constructions, which are usually confined to particular districts but commercialised nationally to help the local candidate in the election, at the same time improving the popularity of the party. It is, therefore, very often, so obvious to see in the pre-election period how local governments immediately commence road maintenance activities. The replacement of pavements prior to each election has become a matter of joke in metropolitan cities such as Istanbul. It is indeed common to see the commencement of all large constructions with big ceremonies immediately squeezed into schedule prior to elections. In the 1970s, governments even faked such projects, which had not been continued, despite the plans and projections and ceremonies.

The development of the periphery in Turkey has always been considered as being lesser important, and therefore the periphery owes ots development to regional specific political patronage and clientelist micro-level policies for vote buying purposes. Sayarı (1977: 108) states that increasing party competition has resulted in “rising levels of public investment for rural development projects”. As an example, Unbehaun (2005) examines political participation and the impact of this on the development of Datça, a small town in Turkey, through clientelism from 1923 to 1992. He successfully explores how Datça has changed over the years from being a rural town into a developing town due to patronage until the 1980s and later with political clientelism since the economic liberalisation period. Unbehaun (2005), thus, demonstrates that public resources have been directed from central government to Datça through clientielism and they are distributed in the town through the patronage system.

Such political strategies in manipulating the economy are not only confined to Turkey, as Kohno and Nishizawa (1990) reveal that government expenditure for public construction increases prior to elections in Japan. In addition to such micro-level opportunistic policies, Robbers and Legg (1991) found that Greek governments manipulated budgetary disbursements for their electoral profiteering.

Buying votes, thus, has also been through regional oriented micro-level and fragmented policy benefits such as administrative favours, including changing the administrative status of locality from town to city administration; financial support for local developments such as the provision of good quality seeds to agricultural cooperatives; distributive disbursements for public works such as quality asphalt roads, new schools and health centres; and through building personal election machines such as establishing good relations with the important people of the town who could be rich businessmen, religious leaders, tribal leaders; or appealing to the ethnic zealots for their votes, such as being apologetic in Kurdish cities, but demonising the Kurds in Turkish nationalism oriented cities.

2.4. Use of the SEEs’ Resources for Political Gains: Vote Factories

The use of economic resources for political gain through patronage systems can be observed in other areas of economic policies as well. Despite recent privatisation attempts, SEEs or the state owned industrial companies, remain important producers, distributors, banks and sometimes as the largest buyer or the monopsonist. It is, therefore, still normal to hear increases in the prices of steel or iron or even sugar announced by the government.

To understand the magnitude of the state's involvement in the economy, the Privatisation High Council (PHC) (n.d.) reports that "since 1985, state shares in 244 companies, 29 energy generation and distribution units, 22 incomplete plants, 6 toll motorways, 2 Bosporus bridges, … have been taken into the privatization portfolio". By investigating the nature of these companies, it becomes clear that the state is involved heavily in the economic activity from production to distribution and service provision in the sectors such as cement, agricultural oriented chemical industry, petroleum distribution, tourism, iron and steel, textile, sea freight, banking industry, telecommunication, tobacco and alcohol production. While this can be reasoned through 'late developmentalism' attempt on the side of the state, it renders an understanding of the opportunities that have been available for governments in providing patronage oriented electoral benefits to their supporters.

The existence of SEEs provides additional 'out of budget' spending opportunities for governments to politically manipulate the economy. As Cooper (2002: 120) states, both the general public and the politicians in Turkey have interests in the running of the economically inefficient and large public sector. This is because, it renders PME without much suspicion regardless of its economic consequences, but also it provides gains for the individuals through the politically redistributive oriented patronages. For instance, Waterbury states that, despite being liberal in outlook, and therefore promising selling of the SEEs, the Democrat Party in the 1950s "discovered the political advantages of the public sector and sponsored as a significant expansion of the SOE [SEE] ('vote factories' as they became to be known') and a doubling of the managerial corps" (Waterbury, 1992: 206). The use of SEEs in the form of 'vote factories' in creating employment opportunities for partisans, using pricing and purchasing policies remained as an important aspect of politically manipulating the economy, after the formation of the modern Republic. Due to providing politically oriented employment opportunities, SEEs have become a source of hidden unemployment and partisan employment.

SEEs, hence, provided, and still provide to a certain degree, another opportunity for governments to manipulate the prices of the goods produced by SEEs for electioneering purpose. In an economy where inflation was a prolonged and continuously increasing phenomenon until recent times, the prices of such goods were needed to be increased to avoid losses, but governments avoided increasing the prices in the pre-election period to prevent any harm being done to their election popularity.

It should be noted that Turkey embraced the privatisation policies in the mid-1980s as a result of economic liberalisation and structural adjustment policies prescribed by the IMF. The potential consequence of privatisation would have been to reduce inefficiency, through particularly reducing hidden unemployment as a result of partisan policies, and to reduce the resource allocation power of the governments, in particular for patronage reasons. Reduction in the rent-creation and distribution activities of the governments was expected as a result. However, due to the impact of military and civil elite, governments have faced difficulties in the privatisation programmes and sometimes they did not show enough enthusiasm for privatisation themselves either (Shaker, 1995). This is related to rent-creation for the elite themselves and for the government and their patronage system, as suggested by Cooper (2002) electorates and politicians have particular interest in keeping a large and inefficient public sector. Thus, existence of SEEs provide governments with "immense amount of resources in relation to the resource base of society, which [the political parties] can distribute" (Özbudun, 1988: 40). Despite the fact that the privatisation programme commenced during the MP government in mid-1980s, the party did not show enough enthusiasm, as Waterbury states "the electoral coalition that has kept the Motherland Party in power does not in any direct sense benefit from the economic reforms" aiming at privatisation, as MP "use[d] public expenditures and the SEO [SEE] sector to shore up its narrow coalition" (Waterbury, 1992: 210-211).

As argued before, the delays in the privatisation programmes are related to populist economic policies. A recent example has been the potential privatisation of electric distribution network in the South of the country, completion of which was expected in 2006. However, as the Prime minister later revealed, the consequences of privatisation would lead to increased electrical prices, thus the voters would make the government accountable for such price increases (Yaşar, 2007; Tuncer, 2007). The privatisation of electric distribution network in the Aegean region of the country resulted in conflict concerning the price increases between the government and the newly privatised companies, which caused electric cuts. The expectation of price increases due to privatisation was substantiated in the case of Turk Telekom (Turkish Telecommunication Company) privatisation as well, as the private management immediately opted for huge price increases. As a result, further privatisation of electric distribution network package was deferred for a later period after the election in the Summer of 2007. However, this means that infrastructural investment in electric distribution network will now be carried out from public finances, which initially was left to the private sector under the privatisation package (Yaşar, 2007).

Such populist policies related to privatisation do not only cause delays in the privatisation packages, but the populist policies have undermined the entire objective of privatisation. This is due to the fact that a cabinet by-law adapted before the 2007 election, as part of the populist policies, aimed at providing contractual job opportunities for 21,193 people in various public sector departments in 2007, who have already been or will be made redundant by the newly privatised former SEEs (Yeni Şafak, 2007). Despite its social oriented nature, such policies run against the objectives of privatisation. However, taking into account the elections in autumn 2007, the government seems to prevent any reactionary voting from the various sectors of the society, which would have been affected by the privatisation policies.

Consequently, about twenty years after privatisation policies were taken up, by 2007 there were still a number of SEEs operating in Turkey, which are included in the privatisation portfolio, along side other such facilities as part of the bureaucratic perk, such as guest houses and holiday resorts for the staff of the ministerial departments. Indeed, privatization so far represents a sure reduction from over 244 SEEs, some of which were the largest conglomerates in Turkey. However, the perpetuated existence of these facilitates maintains governments' attempts at PME through the use of the resources of these SEEs.

2.5. Employment Provision for Political Gains

The literature indicates that, in addition to inflation and economic growth, PME takes place over unemployment policies, as PBC is based on the trade-off between unemployment and inflation, which provides an opportunity for governments to exploit during the election period, by increasing employment at the expense of inflation.

In the case of Turkey, as mentioned earlier, PME does not take place systematically through policy options over business cycles. Therefore, the unemployment policy is not a particular policy issue to be considered by the public as well as by the incumbent governments. Nevertheless, the provision of employment to constituents and potential voters has always remained at the centre of patronage in Turkey. This is conducted through micropolitics in the constituencies and not through systematic job creation oriented employment policies.

An example of such employment provision related vote buying activity is depicted in news coverage, which claims that the incumbent government was in the process of enacting a by-law through which to recruit new civil servants (another 36,000) before the 2002 autumn elections, while over 392,000 civil servants recruited before the 1999 elections have not been fully appointed (Yeni Şafak, 2002). Taking into account that this was just a couple of months before the November 2002 election, it indicates the nature of PME through reinforcing egotropic voting attitudes in buying votes. This is a continuous process; as the current government also announced that about 100,000 civil servants will be recruited for various governmental departments and they will be appointed within 2006 (Sabah, 2006) as a perapation for the 2007 elections. In a later decision, the government revealed that about 200,000 public sector contractual employees in various departments such as SEEs, local governments and central government would be given permanent contracts (Tuncer, 2007). All these populist policies are related to the autumn 2007 elections. Thus, recruiting such numbers of civil servants will contribute to enhancing loyalties for the government, and the provision of employment opportunities for such number of people will be expected to reinforce the egotropic voting attitudes in favour of the incumbent government in the coming elections. Thus, the economic rationale for job creation has to be judged against the hidden political expectations.

While the 'vote factories' nature of SEEs has been discussed previously, it should be noted that local governments have always been another sources of partisan employment and populist spending (Tuncer, 2007). This role in particular after the early 1980s increased due to the expansion in the power and control areas of local governments, but also due to the pressure created with the privatisation of SEEs, as local governments implicitly assumed the provision of partisan oriented job opportunities in the post privatisation period.

As the discussion implies, employment provision is not a result of macroeconomic policy-making, but rather a localised and electioneering oriented attempt by the government to increase its votes in the election. It should also be noted that in the provision of jobs, local governments and local SEEs are the main areas of employment for the loyal voters or party members, as it seems that most of the appointments and petitions with the local MPs, in their parliamentary offices, is over job opportunities.

2.6. USE OF OFF-BUDGET (EXTRA BUDGETARY) FUNDS

Off-budget funds were originally created in the 1970s to finance the difference occurring in the petrol import bill due to exchange rate differences. However, throughout the 1980s a number of such additional funds were created to provide the government with flexibility to respond to the economic needs. While the creation of such funds outside budget and away from parliamentary accountability contradicted with the budgeting principles in Turkey (Oyan and Aydın, 1991), it provided a golden opportunity for the pragmatist governments in the 1980s to spend away from parliamentary scrutiny.

Throughout the 1980s, governments created and operated such funds through by-laws. In the case of certain funds, a percentage of certain taxes were earmarked to finance them, which were additionally levied on taxpayers. In most cases, funds were directed for helping or supporting a particular social and economic group or even for a specific industry that was believed to have national importance. Among these funds, the largest were Fund for Mass Housing Project; Social Solidarity Fund (SSF), which aimed to provide financial help for those individuals facing difficulties; Fund for Supporting the Civil Defence Industry, a sector of national importance; and Apprenticeship Fund, which aimed at helping artisans and small enterprises to employ apprentices. As they were operated outside the consolidated budget, it was claimed by opposition parties that no one knew the number of such funds, the magnitude of the funds accumulated in them and how such funds were utilised. The opposition in the early 1990s claimed that the number of the funds were about 125.

To give an understanding of the enormity of resources accumulated in these funds, the following statistics can be offered: the total amount of off-budget funds was 1.3% of the GNP in 1984, which increased to 7.49% in 1988. Also, the ratio of the incomes of 104 funds to consolidated budget increased sharply from 22.1% in 1984 to 60% in 1990 (Oyan and Aydın, 1991). This clearly indicates the enormity of funds which were available for political patronage in the country. Since the governments in the early 1990s were forced to bring these funds into the accountability system of the parliament, they were internalised in the consolidated budget to fit to the unitary nature of the budget. However, a small number of them still remain as off-budget activity with about 0.15% of the GNP, which indicates an enormous reduction in the magnitudes of such funds. However, they provided and still provide, albeit in a smaller magnitude, with government an opportunity to utilise additional funds for electioneering purpose.

In the past, in particular in the 1980s, governments were constantly accused of using these funds for partisan reasons through patronage systems. This is because, such funds had become sources of vote buying mechanisms, and, therefore, funds were distributed to the earmarked social groups with patronage oriented political activities. This was made particularly easy, as the decision to allocate the funds to the deserved individuals were left with local governors, who are the agents of the government.

Regardless of political orientation, "successive governments have found ways of undertaking substantial spending outside the budget" (Akat, 2000: 270) for their electoral ambitions and populist patronage spending. Therefore, the official budget deficits have never reflected the true magnitude of the deficits in the country, which probably contributed to the underperformance of the fiscal and monetary policies, as these polices failed to take into account the funds accumulated and distributed by off-budget funds.

3. CONCLUSION

The empirical and discursive findings in the literature on Turkey demonstrate that governments are involved in the political manufacturing of business cycles by use of fiscal and monetary policy outcomes. However, this paper suggests that the form with which the political manipulation of the economy takes place demonstrates differences.

A newspaper item from an Istanbul based daily prior to April 1999 election summarises the discussion articulated in the preceding section. The title of the news story is: '*Thanks! Election Approaches*', which reveals that "in the weeks to the general and local elections, payments to the agricultural producers that had been in arrears for months have been paid; the infrastructure constructions that had been halted have commenced and some of them have already been completed; additional efforts put into the completion of the ongoing investments; charitable activities of the local mayors from the local budget are accounted" (Milliyet, 1999). As argued above, these are non-systematic micro-level policies pursued by governments to influence the voting decisions of voters by manipulating their *egotropic* behaviour in perceiving the government performance.

The electoral economy is a continuing process in Turkey as in anywhere else. Indeed, recent politico-economy attitudes of the incumbent government (AKP government) in the pre-2007 parliamentary and pre-2009 local government election periods provide strong indications that PME or electoral economy has become a norm, which involved widespread and open 'vote buying' strategies in its primitive forms in the Anatolian cities. In addition to the deferred privatisation policies due to the government's fear of being kept accountable for the post-privatisation price increases and also potential large redundancies, the government also deferred the implementation of the new Social Security Law, again, as a precaution against the reactions from the voters in the 2007 elections, which was passed under the directives of the IMF for fiscal reform. Furthermore, among other electoral economy policies, the Prime minister directly intervened after the announcement made by the Social Housing Administration (TOKİ-Toplu Konut İdaresi), a public sector organisation, regarding increments in the monthly instalment payments for the 2007, which, consequently, was reduced to half from the 8.8% initial increase (Tuncer, 2007). The government's reduction of VAT on a large number of food items by 10%, and its declaration of wheat purchase base price being 13.3% higher than last year (4 fold higher than the expected inflation) both in June 2007 are among the most recent examples of PME in Turkey in the face of coming election (Hürriyet, 2007; Radikal, 2007). In the pre-2009 local government elections, free distribution of domestic appliances through various public and private agencies in Anatolian periphery was an explicit 'vote buying' exercise.

As the preceding discussion demonstrates, the functioning of the PME indicates that incumbent governments prefer to manipulate the *egotropic* voting behaviour through micro-level policies, which has been encouraged and sustained through patronage and clientelist policies with the provision of personal gains for attracting votes by the governments throughout the history of modern Turkey. This *egotropic* voting behaviour as part of micropolitics, is sustained by using fiscal and monetary outcomes by the incumbent governments. This indeed also indicates the economic cost of democratic exercise, as the economic performance of the country in the post-election periods demonstrates huge economic costs of the extravagant 'vote buying' exercise. The chronic financial and economic crises in the Turkey until recent years, one way or another, can be explained by these 'populist' policies aiming at the maximisation of political gains of the incumbent government. Considering that most of the parties until the current government failed to return to office after elections, the disequilibrium created in the economy without even any return of the incumbent resulting in only inefficient use of public funds with important long-term economic costs to the society. It is inefficient and costly because, the allocation of public expenditures is made according to the fear of losing the approaching elections, and not according to its merits or priorities, but with the simple purpose of getting more votes. In other words, political priorities replace economic ones in the economic sphere. This, in return creates economic and social costs to the society. It is, therefore, important to note that the creation and consequences of PME must be moderated through economic and political strategies and institutions to mitigate its adverse impact on the society in creating disequilibrium.

The use of micropolicies as opposed to systematic manipulation of business cycles should not be interpreted as an argument for the absence of PBC/PME for electoral gains, as the latter is macroeconomy oriented. On the contrary, the objective of the preceding discussion is to demonstrate the manner in which such manipulation is exercised or manifested in Turkey. It, further, suggests the manner in which, for instance, government expenditure is used by the incumbent government for boosting its popularity for winning an election. This is different than the way PME functions in industrial democracies, but has the similar macroeconomic consequences. This is because; for example, recruiting thousands of new employees in various state departments directly refers to increased costs to the government. Thus, the natural consequences of the micro-level policies are macroeconomy related, the consequential result of which is the manipulation of macroeconomic variables.

In concluding, all these virtually indicate that several factors by working interactively prevent PME to be systematically exercised through macroeconomic policies in Turkey. By deconstructing the political economy of elections in Turkey, this study shows that the functioning of PME may not necessarily refer to pre-election systematic manipulation of fiscal and monetary policies, but pinpoints the micro-level political tools as part of the dynamic political economy with having fiscal and monetary consequences in the post election period.

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SECTION II. INSTITUTIONAL LESSONS FROM THE PROCESS OF ECONOMIC CHANGE IN TURKEY

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Chapter 6

THE INTEREST GROUP THEORY OF LEGISLATION AND TRADE POLICY IN TURKEY: A TIME SERIES STUDY FOR 1960-2000

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ABSTRACT

In this chapter, the interest group theory of legislation is examined in order to develop an explanation for trade policy and rent seeking activities of interest groups in Turkey. The intention is to concentrate on the positive side of the economic theory of legislation, rather than the normative side. In other words, the issues to be considered in this study are not whether a given law is 'good' or 'bad', but rather how this law was passed. In order to develop a testable economic model of the lobbying behaviour of interest groups in the pursuit of wealth transfers, the demand and supply factors have been developed to generate the volume of legislation in a time series framework in Turkey during the period 1960-2000. We found that there is a long run relationship between business groups, bureaucrats and politicians in trade policy in Turkey. This relationship also explains long term stability among these three interest groups in terms of rent seeking.

Keywords: The Interest Group Theory of Legislation, State, Time Series Study and Developing Countries.

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INTRODUCTION

For many public choice scholars, in heavily regulated economies, the outcomes of public policy are significantly influenced by the activities of interest groups, which consistently seek government transfers. The behaviour of interest groups in the competition for wealth transfers generates a rich set of empirical predictions about government behaviour. Such competition mostly results in a kind of political 'equilibrium' and in that model some group benefit at the expense of others. In that respect, the *Interest Group Theory of Legislation* is concerned with the origins of the legislation system and the role of legislators in promoting wealth-transfer programs (Tollison, 1982, 1998). Therefore, this theory produces many testable explanations of the behaviour of interest groups taking the economic rent as endogenously determined since regulators or legislators are all considered to be rent-seekers like firms or individuals

A large number of works have appeared dealing with the Interest Group Theory of Legislation on the empirical side. The most well known studies are; Stigler 1971, 1976; Peltzman 1976; Crain and Tollison 1976; Crain 1977; McCormick and Tollison 1978; 1981; Shughart and Tollison 1986; Appelbaum and Katz 1987, Rowley, Shughart and Tollison 1987; Rubin, Curran and Curran 2001; Frey, Kucher and Stutzer 2001; Epstein and Nitzan, 2004; and Bodenstein and Ursprung, 2005).

Although the interest group theory of legislation is a rapidly growing literature, almost everything that has been published in that field to date is based on the USA legislation system, which is completely different from either European or developing countries' legislation systems. According to Tullock (1980), the approach can also be applied to non-democratic countries world-wide with minor adjustments. Following Tullock's suggestion the aim of this study will be to apply the interest group theory of legislation to Turkey. The Turkish State is a semi-democratic country. Therefore, the supply and the demand functions of the Turkish legislation system will be very different from democratic countries' supply and demand functions.

In order to obtain these functions for Turkey the first aim of this chapter will be to examine lobbying and protection in developing countries and then will be to concentrate on the demand and supply factors that generate the volume of legislation in Turkey in a time series framework between 1960-2000. Before an empirical research, interest group politics and trade policy in developing countries will be reviewed in section 2. In section 3, the political economy of interest groups and trade policy will be evaluated with theoretical background specifically in Turkey. Empirical analysis will be presented in section 4 and conclusion in section 5.

1. INTEREST GROUP AND TRADE POLICY IN DEVELOPING COUNTRIES

Since legislation is a political-bureaucratic process, it is sensible to assume that producers or other interest groups can put some pressure on the regulators to increase their share in rent seeking. Particularly, in developing countries, as Kimenyi mentioned, "the degree to which successful rent-seeking takes place within governments is likely to be determined by the principal-agent relationships, which in turn depends on the constraints imposed on the leaders by the political system" (Kimenyi 1987: 189). Reforming the institutions of governance and removing barriers that hinder the efficient functioning of markets are the most effective ways for poor countries (Kimenyi, 2007). The reason is that politicians in semi-or-non-democratic societies are faced with different constraints. The nature of rent seeking associated with interest groups also differs significantly. In developed-democratic societies interest group theories exhibit many examples of the bureaucratic-authoritarian type, although the pressure group approach totally inapplicable. In these closed authoritarian systems, the bureaucratic central administration dominates, so that, the level of public goods is determined on the supply side by a bureaucratic regime rather than the welfare-oriented demand approach of citizens. The reason is that "in a pluralist democratic country, *a single bureau* maximises its budget, whilst in a bureaucratic-authoritarian case the *entire government acts like a single bureau with large budget*" (Findlay and Wellisz 1984: 97). If we assume that some developing countries have mild authoritarian-semi democratic systems, it might be possible to apply the interest group theory of legislation with some modification to developing countries.

It is known that a common feature of economic policies in developing countries is the high degree of government intervention in the economy. "The politicians, planners and bureaucrats control economic policy substantially in developing countries" (Findlay and Wellisz 1984:142). By restructuring property rights these policies allow regulators to transfer benefits from one group to another. In particular, in developing countries, small groups such as civil servants, the military and politicians benefit from an extremely high standard of living although the majority of the population have not experienced any significant gains. For example in Turkey or in many African countries, military staff, bureaucrats and politicians live in state houses at the expense of public taxes, either paying no rent or very little, or they pass special bills to increase their salaries very quickly. It is claimed that the accepted formula for sharing rents among these well-organised interest groups maintains institutional stability among these interest groups (Kimenyi and Mbaku, 1993). As a result, even if the effect of government regulations in developing countries significantly differs from developed counterparts, there is still some common ground to analyse such well-organised bureaucrats, business groups and unorganised voters. Wellisz and Findlay (1984) developed a Theory of Trade protection for developing countries. For them, the level of protection for manufacturing industries in most developing countries is very high, as the lobbying equilibrium in terms of costs and benefits of lobbying is determined as a result of interest group politics.

As one of the most important examples of government intervention through legislation and regulation in developing countries is *protectionist trade policy implementation,* the next section focuses on the political economy of interest groups in trade policy in Turkey.

2. The Political Economy of Interest Groups and Trade Policy in Turkey

Although Turkey is classified as a developing country, it does not belong either to the pure bureaucratic authoritarian state or to the democratic pluralist system. Indeed, Turkey is a semi-democratic country. In Turkish history, on the one hand, State domination was/is usually represented by a bureaucratic central administration established by revolutionary military interventions. On the other hand, democratic institutions that have flourished over the years appear to be in charge. The equilibrium in Turkish trade policy can be considered as the result of rent-seeking activities among well-organised and weakly organised interest groups. If there are some changes in the share between interest groups, once a new sharing formula is accepted, a new rent-seeking equilibrium can be achieved and stability can be obtained again. As a result, legislation and regulation tend to concentrate on rent generated sectors, such as the foreign trade sector, which provides rent-seeking opportunities for both domestic manufacturers and importers. Consequently, economic legislation for the benefit of the trade sector (even when such legislation reduces economic efficiency) can be seen as an effective method of protecting the unique equilibrium between the civil/military bureaucrats, politicians and business groups in semi-democratic Turkey.

In terms of restrictive trade legislation, there are three types of interest groups in the political market place in Turkey. These are; *military-civil bureaucrats* and *politicians*, who extract rents in the form of outside income and to be elected again; and *business groups* (manufacturers and importers), who extract rents in the form of benefits by means of lobbying for legislation, and *voters*, who is a group composed of a large number of individuals and do not play an active role in order to affect the politicians.

The trade regime is determined by the collaboration of the business groups, politicians and bureaucrats. The production function of legislators and bureaucrats reflects their own ‘preferences’, which consist of ideology, self-interests of the governing group, international obligations, etc. Because of this it is assumed that lobbying expenditures enter the production function and the voters’ preferences are reflected in the production function.

Even if protectionism has been, and still is, an important tool in the trade regime, we can analyse the ‘market’ for trade legislation as a consequence of Turkey’s semi-democratic structure. Based on the interest-group theory of legislation, enacting laws, decrees and administrative resolutions for the benefit of a single firm or sector for trade, over time, depend on factors influencing the demand for and supply of trade legislation. Business groups are the lobbying groups because they are the ones who benefit from restrictive trade legislations the most. As business groups *lobby* the government and bureaucrats they are the potential winners since they have a greater chance to increase their profit with wealth transfers that they obtain as a result of lobbying. Since they are more likely to overcome the free rider problem, they demand protection by passing legislation. Business groups are well protected by politicians and bureaucrats, who have traditionally held a powerful role (as a result of the monistic state tradition). Therefore, business groups enter the market as demanders for protection, whereas voters favour free trade. Like in many semi-democratic countries, in Turkey the costs of forming and of policing a free trade lobby are greater than the costs of forming and policing a lobby of protection seekers. As Olson (1965) claims, the cost of forming a lobby, other things being equal, is an increasing function of the number of members. The larger the group is, the more costly its communication. Moreover, as the size of the group increases, the free rider problem becomes more severe. In this case it is voters or legislation suppliers who are the ones who constitute large and unorganised groups. On the other hand, politicians and bureaucrats act as wealth-brokers, who transfer wealth from weak groups to well-organised groups.

In equilibrium, the outcome of individual choices made by voters, politicians-bureaucrats and business groups match with each other. In this setting, *bureaucrats* are interested in maximising their budget and put pressure on politicians to get more from the budget by persuading them that a large budget will secure more votes. On the other hand, *voters* are not well informed about the issues on which they are voting unless those issues have an immediate and direct consequence for their income. Therefore, they vote for politicians to secure their welfare level. *Business groups* express their wishes through lobbying (campaign) for legislation on the demand side of the market. Since politicians-bureaucrats act as wealth brokers, who transfer wealth from weak groups to well-organised groups, rent-seeking equilibrium is established in trade policy through restrictive trade legislation, which consists of rules administrated by an agency that is prepared by the government to regulate a particular industry. This relationship can be observed better in a model that has been inspired by Appelbaum and Katz (1986, 1987). In their model, there are three groups; voters, business groups and brokers (the bureaucrat-legislator group).

2.1. Theoretical Background of the Model

Voters

Voters support for legislators is based on the change in their welfare, ***w*** that these legislators' policies create for the voters. The voters' support of the legislators is represented by a probability of support function, β. In the Turkish case, it is assumed that while free trade increases voters' welfare, protectionist policies imposed by the politicians and bureaucrats increase business groups' benefits. Therefore, the protectionist policies come about as a result of lobbying activities and protectionist policies then lead to an increase in welfare amongst business groups:

$$\beta=\beta(w),\ \beta(w)\geq 0 \tag{2}$$

Where *w* is the money value change in voters' welfare as a consequence of politicians' policy. Politicians' decisions may end up with a transfer of wealth to ($w>0$), or, away from ($w<0$) voters. It is assumed that the voters' group is composed of a large number of individuals. As a result of high organisation costs or the free rider problem they are not organised easily, and do not play an active role in order to affect the politicians.

Business Groups

Like Appelbaum and Katz (1986, 1987), we also assume that politicians-bureaucrats' trade policy results in an indivisible rent, *S*, for which firms may compete. In order to simplify the analysis it is assumed that this rent is independent of the other activities of firms and does not affect other markets. In order to compete for this rent, each firm expends resources trying to increase its probability of winning the rent.

It is assumed that of each unit spent by firms on rent seeking, a proportion ($1-\alpha$), where $0 \leq \alpha \leq 1$, is socially wasted (for example, advertising, lobbying etc.). A certain portion of this expenditure α, will reach the politicians-bureaucrats in various forms (these may include political contributions, future employment in the benefiting company/industry, direct cash and non-cash payments, financial advice or information etc.).

Hence, if x_i is the amount spent by the firm, then $(1-\alpha)x_i$ is socially wasted, whereas αx_i is the transfer to the legislator. It is only the actual amount transferred to the legislators rather than the total rent (which includes the wasted component) which influences the legislators' behaviour. Hence the probability of the firm *i* winning the rent P_i is taken to be an increasing function of the amount reaching the legislators from firm *i*, ($\alpha \mathrm{x_i}$) and a decreasing function of the amount reaching the legislators from all other firms, ($a\,\overline{\mathrm{x}}$), so that $P_i = P_i(\alpha \mathrm{x_1}, \alpha \mathrm{x_2}, .. \alpha \mathrm{x_n})$, where *n* is the number of firms. Specifically following Tullock (1980a) the probability is given by;

$$P_i = \frac{\alpha \mathrm{x_i}}{[(n-1)\alpha \overline{\mathrm{x}} + \alpha \mathrm{x_i}]} = \frac{x_i}{(n-1)\overline{x} + x_i} \tag{3}$$

Where $\overline{\mathrm{x}}$ is the mean rent seeking done by all other firms. Here, it is assumed that firms take the rent to be awarded as given. Thus, given Cournot-Nash behaviour and expected profit maximisation, each firm will solve the problem:

$$Max\pi_i = P_i(S - x_i) + (1 - P_i)(-x_i), \tag{4}$$

Which using (3) can be written as:

$$Max \frac{Sx_i}{(n-1)\overline{x} + x_i} - x_i \tag{5}$$

This yields the first order condition:

$$\frac{\partial \pi_i}{\partial \mathrm{x_i}} = \frac{S(n-1)\overline{x}}{[(n-1)\overline{x} + x_i]^2} - 1 = 0\,, \tag{6}$$

Since by symmetry all firms behave in the same way, in equilibrium we have $x_i = \overline{x} = x$ for all *i*. Substituting this symmetry condition we can solve for x and get:

$$x = \frac{S(n-1)}{n^2} \qquad \text{for all firms,} \tag{7}$$

Thus, for a given number of firms the total amount spent by firms on lobbying is:

$$R = nx = \frac{S(n-1)}{n}\,, \tag{8}$$

Of which $(1-\alpha)\frac{S(n-1)}{n}$ is wasted and $\alpha \mathrm{S(n-1)/n}$ is the total transfer to the legislators. In order to accomplish these total transfers, the size composition of interest groups and the volume of imports play very important functions. If the number of business groups increases the total transfer for each firm will decrease as a result of high competition among them. Similarly, if their import shares increase they will be rewarded with more legislation to increase their benefit. As a result of this transfer, bureaucrats' and politicians' income will increase. In other words, αS(n-1)/n=f(I).

Brokers (Politicians and Bureaucrats)

The brokers' aim is to maximise their own income. Thus, their behaviour, like the behaviour of business groups, is taken to be motivated by self-interest rather than benevolence.

Let the brokers' wages and salaries be given by BWSB and their opportunity cost salary in alternative occupation be B. Then, assuming risk neutrality, their expected utility is;

$$E(U)=\beta(w)(BWSB+\alpha R)+[1-\beta(w)]B \tag{9}$$

Where R is given by (8) and β(w) the welfare function of voters, then the rent S is transferred from consumers to the winning firm; thus,

$$w=-S<0 \tag{10}$$

It shows that voters' behaviour affects the legislators and bureaucrats' expected utility through political support as captured by the probability function (3), firms' behaviour also affects E (U) directly through the transfers αR. We assume that $BWSB - B + \alpha R \geq 0$. Otherwise, E (U)<V, then the opportunity cost of being a legislator-bureaucrat is higher.

To maximise their expected utility, the broker chooses a policy given by the rent S, which maximises (9) subject to (6), (8) and (10). In other words, the broker acts as a leader and takes the voters' and firms' reaction functions into account when choosing the optimal policy, S.

The maximisation of the brokers' expected utility yield the Kuhn-Tucker condition:

$$\frac{\partial E(U)}{\partial S} = \beta'(S)\left[BWSB - B + \alpha\frac{(n-1)}{n}S\right] + \beta(S)\alpha\frac{(n-1)}{n} \leq 0 \leq S \tag{11}$$

Where the notation

$$\frac{\partial E(U)}{\partial S} \leq 0 \leq S \tag{12}$$

Denotes

$$\frac{\partial E(U)}{\partial S} \leq 0,\ S \geq 0, \text{or} \frac{\partial E(U)}{\partial S},\ S = 0 \tag{13}$$

In addition I also define,

$$B(S)=\beta`(w),\ (\beta`<0) \tag{14}$$

The first term in (11) represents the marginal cost of S and captures the decrease in the regulator's expected income due to decreased political support. The second term is the marginal benefit of S and captures the increase in the brokers' expected income due to increased rent seeking by firms. The brokers' optimal policy balances these two effects:

If the elasticity of the probability function is defined as:

$$\delta = \frac{\partial \beta}{\partial \mathrm{S}} \frac{\mathrm{S}}{\beta} > 0 \qquad \text{if S} > 0 \tag{15}$$

and I can write first order condition as

$$\frac{\alpha(n-1)}{n} - \delta\left[BWSB - B + \frac{\alpha(n-1)S}{n}\right] \leq 0 \leq S. \tag{16}$$

Given a variable elasticity of β the legislator may choose a policy S, on either the elastic or inelastic portions of the β function. From this model, we obtain that an increase in BWSB decreases the rent, whereas an increase in B increases it. If BWSB-B>0, the optimal solution must be on the inelastic part of the probability function, whereas if BWSB-B<0, it will be on the elastic portion. This implies that if the β function is everywhere elastic and BWSB>B, then the legislators'-bureaucrats' optimum position will be at S=0. The rationality for this is that if the electorate is highly responsive to the imposition of a transfer away from it, then, if being a legislator carries a higher salary than being non-legislator, the legislator will do nothing to jeopardise his job.

2.2. Empirical Application of the Model

We now estimate a simpler model by applying a modified version of Appelbaum and Katz's (1986) reduced-form approach to the Turkish trade legislation system. In this model suggested that voters are on the supply side and business groups are on the demand side. Therefore, it is assumed that the Turkish legislators' *productive process*, such as the size of government (GY) and the bureaucrats'-politicians' wages and salaries (BWSB) highlight the *political and economic environment*, such as population (POP) and the number of voters (VOT/POP) that reflect the facts underlying the *demand for legislation*, *transfers and regulation*, such as the number of private firms in manufacturing (N) and imports (I) in the Turkish trade legislation system. The slope of the supply curve of legislation is a function of the organisational cost facing voters, whereas the position of the supply curve of legislation is a function of the 'technical proficiency' of any given legislative process. A given supply curve will shift depending on the degree of technical proficiency. Some variables, such as Imports (I) and the number of private firms (N) are the control variables for the demand for legislation.

Based on these supply and demand functions together with the brokers' expected utility we can now consider this simplest version and estimate them in a reduced form.

$$R = f(BWSB, GY, N, I, VOTP, POP) \tag{17}$$

Where R is the number of restrictive trade legislations; BWSB is the bureaucrats' and legislators' wages and salaries' as a share in the government budget; GY is the size of government; N is the number of private firms in manufacturing industry; I is Imports carried out by business groups; VOTP is the ratio of the number of voters to total population; POP is population.

3. EMPIRICAL ANALYSIS

3.1. Data

Testing the model requires endogenous information on legislation. The data we use are the number of laws, decrees and administrative resolutions passed annually that create, maintain or modify a foreign-trade restriction for the benefit of a single firm or sector. The dependent variable corresponds to the period 1960-2000. The data were collected from *Official Papers*. The number of legislation included in the data set was those which explicitly identified their promoters, who are firms. Legislation in favour of government's non-profit organisations and legislation promoted by foreign governments for the purpose of compliance with international agreements was ignored. In addition to this, legislation, which had no identified promoter but was concerned with a small number of products, was added to the series. With these adjustments the number of pieces of restrictive legislation on foreign trade passed was approximately 3000 during the study period 1960-2000.

We consider that (BWSB) is a very important variable in the sense of affecting the volume of legislation. It is expected that if there is an increase in bureaucrats' wages and salaries, the volume of legislation will decrease, since the opportunity cost of obtaining outside income will be lower. On the other hand, if there is a decrease in their salaries the volume of legislation will increase, in order to protect their welfare level by passing legislation that benefits some interest groups. Therefore, a negative sign reveals this basic relationship.

The size of government (GY) in GDP is chosen as a control variable (see Murrell, 1987). We predict that greater government size allows senior bureaucrats to employ more staff. Since it will be difficult to monitor larger budgets, more income will be allocated to staffing the bureau. This will also yield more rent seeking (nepotism, corruption, etc.). In addition, the size of government influences the ability of interest groups to capture rents. If the size of government is big enough interest groups increase their lobbying activities.

The number of private firms (N) in the manufacturing industry determines the demand for legislation, because if the number of firms increases there will be more rent-seekers. So, if more rent-seekers appear it means that there will be a smaller share for each firm in order to capture rents (see Becker 1983: 371). Therefore, we expect a negative sign for the variable N, the number of private firms in the manufacturing industry.

Here, the imports variable (I) is employed as an explanatory variable for rent-seeking activities, since it also reflects the state's protectionist trade regime approach. Government protected private manufacturing industries by quotas and tariffs. During the last forty years, Turkey experienced an Import Substitution Policy from 1960 to 1979 and showed a certain dependency on foreign intermediate and capital goods for use in domestic manufacturing industry. Therefore, except for a couple of years during the 1960-2000 period, Turkey experienced a very large trade deficit. Since many industries depend on imported goods and most of the rent-seeking activities are created through controls, the higher the Imports, the higher the number of restrictive regulations required. For this reason, the sign of the coefficient is expected to be positive.

From the perspective of *the economic theory of legislation*, voters are the suppliers of legislation, regulation and transfers. They can be either organised or unorganised. If voters are unorganised they will be the main suppliers of legislation. If they are organised or semi-organised and if too much legislation is passed, voters will not elect politicians in the next election.

From the *public choice* perspective, voters are classified as short sighted and a very badly informed group (Olson 1965, 1982). In addition, they are the main suppliers of trade legislation. From this perspective the ratio of the VOTERS to POPULATION, (VOTP) variable is expected to be positively related with the amount of restrictive trade legislation passed. More voters will help politicians to create more rent seeking, because interest groups will invest in a supply of votes for politicians in exchange for a higher probability of getting a favourite bill passed.

We also include population (POP) in order to show that the larger population means that more suppliers will be at present and the costs of transfers will be lower.

In this model we aim to provide a testable model of the connection between rent seeking and the main Turkish interest groups. In particular, we examine if there is casual evidence of the existence of pervasive rent seeking in trade legislation. Our hypothesis is that rent-seeking creation continued even after the 1980 export promotion policy, but the import substitution period (1960-1979) witnessed more rent-seeking activities than the post 1979 era. This rent-seeking creation was mostly in the form of restrictive trade legislation.

The model estimated was:

$$R_t = \alpha_0 + \alpha_1 BWSB_t + \alpha_2 GY_t + \alpha_3 N_t + \alpha_4 I_t + \alpha_5 VOTP_t + \alpha_6 POP_t + \varepsilon_t \quad (18)$$

Since the variables are numbers, population or votes, it is considered that there is no need to use their logarithmic forms. Where;

α_0	Intercept
R	The amount of restrictive trade legislation passed per year, Official Papers, 1960-2000.
BWSB	The ratio of wages and salaries of bureaucrats-politicians to budget Government Finance Statistic Yearbook, 1960-2000.
GY	Government Size (Government Expenditure/GDP), Government Finance Statistic Yearbook, 1960-2000.
N	The number of Manufacturing Companies (1960-2000 from SPI (State Planning Institution), 1960-2000
I	Import with current process from International Financial Statistics, 1960-2000.
VOTP	The number of votes for legislators during the period to POP from SPI

(State Planning Institution), 1960-2000
POP Population from International Financial Statistics, 1960-2000.
ε Residual

3.2. The Methodology: Cointegration Analysis

In this section, we will test the hypothesis that trade legislation during the period 1960 to 2000 in Turkey can be explained by interest group activities. Using time series data, our main intention is to apply the interest group theory of legislation to Turkey to see if this theory works for a semi democratic State by testing the null hypothesis of non-cointegration between the amount of restrictive trade legislation and the response variables, against the alternative hypothesis. In order to test the hypothesis, we apply the Engle-Granger two-stage approach.

Engle-Granger

Since standard regression analysis requires that data series are stationary, the first step is to identify the order of integration of each of the variables. Therefore, we apply the unit root test. TABLE 1 shows the Dickey and Fuller (1979, 1981) test results:

Table 1. The ADF Test for Order of Integration

	Levels		1st Differences		Order of
Variable.	ADF	CV	ADF	CV	Integration
R_t	-2.18(3)	-2.97	-6.22(0)	-2.97	I(1)
$BWSB_t$	-2.53(0)	-2.97	-5.45(0)	-2.97	I(1)
GY_t	-1.73(1)	-2.97	-9.53(0)	-2.97	I(1)
N_t	-0.31(0)	-2.97	-5.11(0)	-2.97	I(1)
I_t	-1.55(3)	-2.97	-9.72(2)	-2.97	I(1)
$VOTP_t$	-0.44(1)	-2.97	-5.31(1)	-2.97	I(1)
POP_t	-0.37(0)	-3.56	-4.67(0)	-3.59	I(1)

As can be seen from TABLE 1, all of the variables are stationary in their first differences. Therefore, we conclude that all the variables appear to be integrated of order one. On the basis of this information, we can now estimate the Engle-Granger cointegration test first stage estimation.

The Engle-Granger First Stage (Long Run) Estimation

As all of the variables are I (1), we can now estimate the model and test for its existence of a long-run equilibrium relationship. This exists only if the variables are cointegrated.

As can be seen from TABLE 2, the signs of all variables are as expected. The volume of trade legislation as a proxy for the rent-seeking variable can be explained by bureaucrats' and politicians' wages and salaries, government size, the number of business groups, imports, the number of voters to population and population. In this model, while politicians-bureaucrats are brokers who maximise their salaries and budget size, business groups demand such legislation to maximise their profit, and, finally, voters supply legislation to try and maximise their welfare. From our test, we obtained negative signs for BWSB, N, and positive signs for GY, I, VOTP and POP. These results support the argument that demand and supply factors lie behind the interest group theory of legislation in the Turkish case.

Table 2. Turkish Trade Legislation
Dependent Variable is R (The volume of restrictive trade legislation)

Regress	Coefficients	R^2	0.55
α_0	80.11 (0.65)	$\bar{R}^2$	0.47
$BWSB_t$	-200.20 (-2.14)	DW	2.31
GY_t	562.32 (2.30)	F	4.74
N_t	-0.01 (-2.17)	SC	0.35
I_t	0.01 (1.77)	FF	0.06
$VOTP_t$	0.83 (1.66)	N	1.41
POP_t	3.33 (0.82)	H	0.71
		ADF t-val. ADF c.v.	-5.87 Lower 5.75 Upper 5.68

Notes: t-statistics are in parentheses. Asterisks donate significant at 5%. $\bar{R}^2$ is the adjusted coefficient of multiple determination. DW is the Durbin-Watson statistic, F is the F statistic-ratio, SC is the serial correlation, FF is the functional form, N is the normality and H is the heteroskadasticity.
*ADF c.v. has been taken from Charemza and Deadman (1997) at 5 % significance level.

TABLE 2 also shows that we have cointegrated relationships for the legislation model, since the ADF test statistic is higher than ADF critical values at 5 % significance level. It means that the residual-based ADF test statistic for the error term ensures that we reject the null hypothesis of no cointegration at the 5% significance level, in favour of the alternative hypothesis that there is a cointegrating relationship between the variables. Therefore, we can go to second stage of cointegration analysis, which is the error Correction Mechanism.

The Engle-Granger Second Stage: ECM (Error Correction Mechanism)

If a set of variables is cointegrated, then there exists a valid error-correction mechanism in order to describe their short run relationship. So, we can apply Error Correction Mechanism (ECM). A negative sign for the ECM term shows that adjustment is made towards restoring the long-run relationship. Short-run adjustments are therefore guided by, and consistent with the long-run equilibrium relationship. Equation (18) in first difference in ECM is as follows:

$$\Delta R_t = a_1 ECM_{t-1} + a_2 \Delta BWSB_t + a_3 \Delta GY_t + a_4 \Delta N_t + a_5 \Delta I_t + a_6 \Delta VOTP_t + a_7 \Delta POP_t + e_t \tag{19}$$

As expected, the Error Correction Mechanism has a negative sign and is statistically significant and less than -1. This means that adjustments are made towards restoring the long-run relationship and can also explain the short-run relationship between variables in order to determine dependent variable, R. However, the coefficients for GY, N and I are not statistically significant; therefore, they are not meaningful.

Table 3. ECM Results for the Turkish Trade Legislation

Dependent Variable is ΔR_t		
31 observations used for estimation from 1961 to2002		
Regress	Coefficient	T-Ratio
ECM_{t-1}	-0.97	-4.59
$\Delta BWSB_t$	-217.20	-2.99
ΔGY_t	202.33	0.77
ΔN_t	-0.01	-1.25
ΔI_t	0.01	1.32
$\Delta VOTP_t$	0.61	1.73
ΔPOP_t	7.20	0.17
R^2 = 0.59 $\overline{R}^2$ = 0.47 DW= 2.00 F -Stat= 4.66 SC = 0.14 FF= 0.12 N= 2.44 H = 1.14		

4. Conclusion

This approach, based on the interest group theory of legislation, offers an empirical explanation for Turkey by studying its legislature as an institution primarily guided by private interests.

In that context, this chapter provided both theoretical analysis and empirical evidence about traditionally established institutional stability among civil and military bureaucrats, and business trade groups in a semi-democratic country, Turkey. Since bureaucrats in a semi-democratic state are less constrained in their use of inputs, they are able to employ inputs from which to derive utility. In a strong state, civil and military bureaucrats have not only a distinctive power, but they also hold a monopoly formation in the supply of legislation. Although the state is strong in Turkey, governments are soft to interest groups' lobbying. Business groups enjoy government protection from competition in exchange of rents for government officials; bureaucrats also protect themselves by paying off supporters, legislators, business groups etc. This payoff takes the form of increased budgets using public resources in order to increase their benefits.

As we have analysed, there is a long run relationship between business groups, bureaucrats and politicians in trade policy in Turkey during the period 1960 and 2000. This relationship also explains long term stability among these three interest groups in terms of rent seeking. Politicians-legislators act not only as brokers who pair demanders and suppliers, but they act also as rent-seekers that try to maximise their benefits. Therefore, while any increase in government size and their payment increases rent seeking, any increase in the number of trade companies decrease rent-seeking as a result of high competition. On the other hand imports, VOTP and POP are explanatory variables for higher rent seeking.

One of the most important implications of this model is that a reduction in rent seeking and social waste in many semi-democratic countries may be obtained with an increase in the salary of the politicians-bureaucrats. In those countries such as Turkey, in many cases the salary of politicians-bureaucrats is much lower than private sector salary level. Thus, a higher salary for the legislator is an effective substitute for consumer responsiveness. The Turkish case represents a very good example for semi-democratisation, wherein exit and entry by firms is determined by the strong state. Therefore, the small number of business groups benefits from rent seeking more when they are in collaboration with the state. When competition increases more firms enter the market and decrease the share of existing rent that is set by the legislators-bureaucrats. On the empirical side, we obtained these results by applying the Engle-Granger cointegration approach to identify the long-run relationship between variables. Our findings also confirm that there was a long-term relationship between rent-seeking activities and interest groups in Turkish case during the period 1960-2000. From this perspective

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Chapter 7

THE QUALITY OF INSTITUTIONS AND MULTINATIONAL CORPORATION: THE POLITICAL ECONOMY OF FOREIGN DIRECT INVESTMENT IN TURKEY

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ABSTRACT

The major focus of this chapter is on the relationship between political, social and economic institutions and Foreign Direct Investment in Turkey. For a decade, the relationship between institutions and Foreign Direct Investment has been receiving growing attention. The link between the quality of institutions and FDI in developing countries, especially in transition economies, has led scholars to focus on the quality of institutions as determinants of FDI in developing countries. In order to attract higher amounts of FDI, numerous developing countries have liberalized their investment environment since 1980. Turkey is not an exception. However, not all countries succeed at attracting FDI as they expected. The volume of FDI flows differ among the countries. One of the countries which did not succeed at attracting FDI as expected is Turkey. This chapter explores how social economic and political institutions help explain the low level of FDI flows into Turkey by offering a political economy approach and applying a questionnaire survey for the recent period.

INTRODUCTION

Since 1980, with the liberalization of developing economies, the volume of FDI has grown significantly. The recent experience of a number of countries – especially in Central Europe and East Asia – has shown that FDI can play a crucial and catalytic role in the

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development process (FIAS, 2001:vii). Hence, FDI is perceived by many governments of developing countries as one of the most stable components of capital flows and an important factor for economic growth. As the FDI-promoting effect of good institutions may be an important channel of their overall effect on growth and development, to study the links between FDI and institutions has become relevant.

In order to attract higher amounts of FDI, numerous developing countries have liberalized their investment environment since 1980.[1] Turkey is not an exception. However, Turkey, which has one of the most liberal encouragement laws of Foreign Direct Investment in the world, did not receive a satisfactory amount of FDI until 2005. The issue becomes more interesting when a number of international institutions, scholars and government officials in the mid-1990s announced that Turkey has a potential of 30 billion dollars FDI inflow, whereas the country received only 800 million dollars annually during the decade (Garten, 1996; DPT, 2000). The inadequate flow of FDI is not a characteristic of the 1990s; the level of FDI inflows to Turkey has remained low since the 1920s.

In this chapter I follow several ways to analyze the impact of political and economic institutions on FDI in Turkey. The chapter comprises both political economy approach and empirical analysis for recent period. For this purpose, I conduct a questionnaire survey to the 52 executives of MNCs operating in Turkey.

1. Patterns of Foreign Direct Investment in Developing Economies

This chapter focuses on one of the most stable of the international capital flows, Foreign Direct Investment. According to one of the oldest definitions of Foreign Direct Investment, by Kindleberger, FDI is referred to as long-term capital flow and differs from portfolio investment by taking place in kind, through the exchange of property (patents, technology or machinery) and by acquiring control of a company (Kindleberger, 1969:2). It also differs from other kinds of international capital movements in that direct investment proceeds by the reinvestment of profits and accompanied by varying degrees of control, plus technology and management.[2]

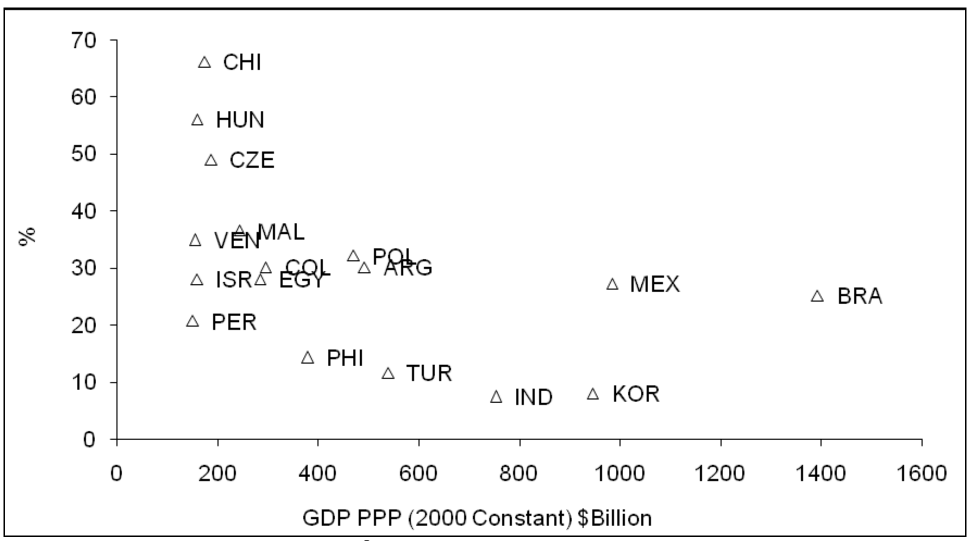
[1] Policy changes still continue. For instance, a total of 205 policy changes were identified by UNCTAD in 2005. In terms of regional distribution, Africa accounted for 53 policy changes, followed by Asia and Oceania (48), developed countries (44), South-East Europe and the CIS (39) and Latin America and the Caribbean (21). Most of the changes in 2005 made conditions more favorable for foreign companies to enter and operate. The types of measures most frequently adopted were related to sectoral and cross-sectoral liberalization (57 policy changes), promotional efforts (51 policy changes), operational measures (22 policy changes) and FDI admission (19 policy changes). For detail information; see: World Invest Report, 2006.

[2] However, some definitions put more emphasis on the “control” factor. OECD recommends that a direct investment enterprise be defined as an incorporated or unincorporated enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise….An effective voice in the management, as evidenced by an ownership of at least 10 percent, implies that the direct investor is able to influence, or participate in the management of an enterprise; it does not require absolute control by the foreign investor” (OECD, (Organization for Economic Cooperation and Development); *OECD Benchmark Definition of Foreign Direct Investment*, 3d Edition (Paris: OECD, 1996), p.8. For a detail study about definitions of FDI, see R. E. Lipsey, “Foreign Direct Investment and the Operations of Multinational Firms: Concepts, History and Data.

Investing abroad by MNCs constructing subsidiaries called “Greenfield Investment”, whereas, these firms may also invest abroad, a common form in developed countries, by investing in established firms, through mergers and acquisitions, or through privatization programs (called as Brownfield Investment). Several developing economies have received this form of FDI due to the privatization programs took place especially after 1980.

With the increasing globalization, changes in government policies in trade and investment environment facilitate FDI into developing economies. Due to their growth performances and huge market sizes, many of these economies became attractive for many MNCs. Since 1980, economies of many developing economies have been growing significantly, their industries are structurally changing and their markets are promising but volatile. Comprising more than half of the world's population, many developing economies are often featured with strong market demand and high growth rates. The recent progress they have made in economic liberalization, especially after 1980 is noteworthy. In many of these countries the entry of MNCs is welcome as it represents an inflow of foreign savings into the country, supplementing domestic savings and directly increasing the level of investment.

However, the FDI performances of these countries vary. Figure 1 shows the FDI stock as percentage of GDP in some of the developing economies. Czech Republic, Hungary and Chile are the most successful countries receiving FDI stock over 50 percent of their GDP. On the other hand, Philippines, Turkey, Korea and Indonesia receive low level of FDI stock when compared to their market sizes.



Source: UNCTAD (2006), WDI (2006).[3]

Figure 1. FDI stock as percentage of GDP in selected developing economies–2005.

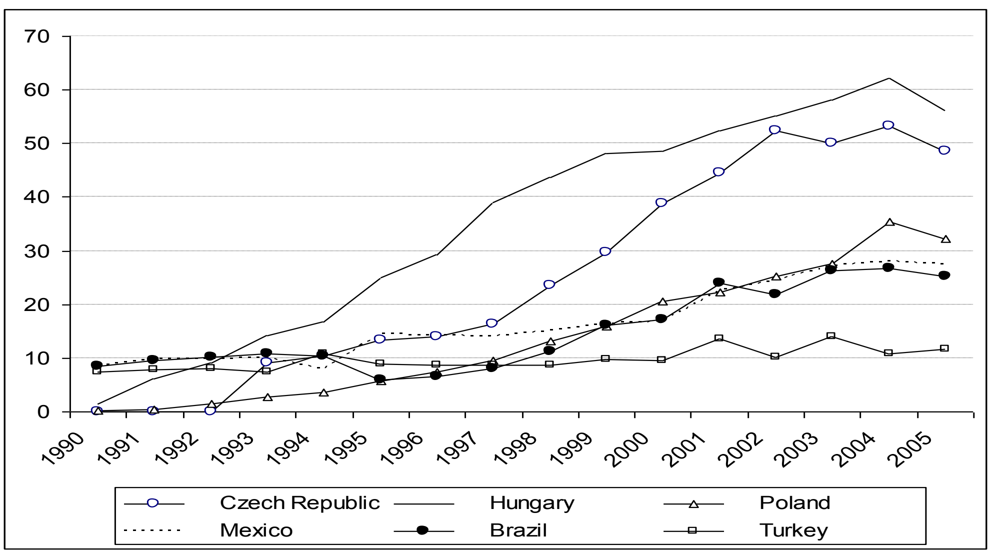
Working Paper 8665 National Bureau of Economic Research 1050 Massachusetts Avenue Cambridge:NBER, MA 02138 (December 2001).

[3] Selected developing countries are; Argentina, Brazil, Chile, Colombia, Czech Republic, Egypt, Hungary, Indonesia, Israel, Korea (South), Malaysia, Mexico, Peru, Philippines, Poland, Turkey, Venezuela.

2. FDI PERFORMANCE OF TURKEY IN A COMPARATIVE PERSPECTIVE

Despite several efforts, Turkey has never been able to attract the substantial FDI inflows that would be expected from a nation with a strategic location between Europe, the Middle East and Central Asia. Turkish FDI levels have stagnated during the 1990s while total FDI worldwide increased by a factor of 12. This lack of interest by multinational companies becomes even clearer when FDI inflows are adjusted for the size of the economy. Over the last decade, the average of FDI inflows to middle-income countries in Europe was 1.1 percent of GDP compared to less than 0.5 percent in Turkey. As shown in the following figure, this disparity is considerably greater when Turkey is compared to the countries investors consider to be its main regional competitors: Hungary, the Czech Republic, and Poland.

Figure 2 reveals the inward FDI stock levels of selected emerging economies as a percentage of GDP. Comparing Turkey with other emerging economies such as Brazil, Mexico, Hungary, Czech Republic, and Poland, it can be argued that the inward FDI performance of Turkey is ineffective. The level of FDI stock in Turkey remained stagnant at approximately 10 percent during the 1990s, fluctuated after 2000 and reached approximately 12 percent in 2005. Whereas inward FDI stock of all other countries increased significantly. Hungary and the Czech Republic are the most successful countries at attracting increasing inward FDI stock.



Source: UNCTAD, Handbook of Statistics, 2006.

Figure 2. Inward FDI Stock as percentage of GDP in Selected Emerging Economies.

The transition economies of Central and Eastern Europe, although entering the competition in the beginning of the 1990s, attracted more FDI in comparison to Turkey in the period.

Another way to view Turkey's relative FDI performance as a host country is in terms of two indices developed by UNCTAD: The FDI Performance Index.

Table 1. The Inward FDI Performance Index – Rankings

Selected Countries	2003-2005	2002-2004	2001-2003	2000-2002
Czech Republic	32	25	13	10
Hungary	40	46	33	27
Poland	57	75	68	56
Mexico	75	79	61	64
Brazil	82	62	46	37
Argentina	83	82	82	85
Turkey	95	111	110	109

Source: UNCTAD, 2006.

The Inward FDI Performance Index ranks countries by the FDI they receive relative to their economic size. It is the ratio of a country's share in global FDI inflows to its share in global GDP.[4]

According to the inward performance index, Turkey ranks at 95 with a score of 0.917. This low score indicates that Turkey receives less FDI than its relative economic size. Interestingly, Turkey's performance was relatively better at the end of 1980s. Turkey had a rank of 70 with a score of 0.502 in the period 1988-1990. During the 1990s, Turkey's position moved backward. According to the matrix of the FDI performances of the countries, Turkey takes place within the list of countries that have high FDI potential but low FDI performance (UNCTAD, 2006:6).

These statistics reveal that Turkey, which has a vast market potential in the world, received low levels of FDI inflows until 2005. Compared to many developing countries that have attracted and benefited from significant inflows of FDI, Turkey did not succeed in increasing FDI inflows even though significant increase in FDI flows due to globalization process in the 1990s. Plus, the low level of FDI inflows is not a characteristic of the recent period. Turkey, from the beginning of the Republican Era, attracted low level of FDI inflows.

Below, offering a political economy approach, I evaluate the FDI performance of the country, the attitudes of government to FDI, and the relationship between economic conjuncture and FDI.

3. Political Economy of FDI in Turkey – the Pre-1980 Period

During the 1970s and earlier, Turkey like many other developing countries adopted an inward-looking import substitution strategy, combined with widespread state ownership of companies throughout the manufacturing sector and some important services. The provisions of Law No. 6224, encouragement law of FDI, seemed liberal and compared favorably with the investment laws of many countries. However, between 1951 and 1980, a total of $230

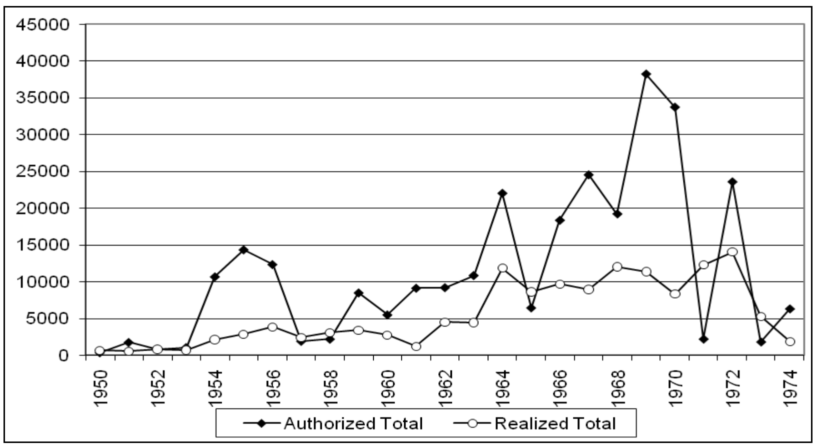
[4] The index captures the influence on FDI of factors other than market size, assuming that, other things being equal, size is the "base line" for attracting investment. These other factors can be diverse, ranging from the business climate, economic and political stability, the presence of natural resources, infrastructure, skills and technologies, to opportunities for participating in privatization or the effectiveness of FDI promotion.

million in capital came through this channel.[5] Since its inception in 1954, the flow of private capital into Turkey remained far below expectations.

"The Law No. 6224", enacted in 1954, was in force until 2003 with minor changes and brought very liberal provisions. It abolished restrictions on the transfers of profits, dividends and interest to ten percent of the capital as well as the restriction of foreign direct investment in certain specified areas of economic activity.[6]

The government by enacting law no. 6224 aimed at an increase in FDI with the purpose of reducing the shortage of foreign exchange that took place in the country in 1953 and 1954. Increasing FDI inflows, in the end, would help to decrease the balance of payment deficits.[7] However, the laws that were enacted subsequently in the first half of the 1950s did not attract FDI as expected[8].

As seen in Figure 3 the amount of realized FDI did not exceed $15 million annually between 1950 and 1974. In spite of the subsequently enacted FDI laws, the inflow of FDI was below $5 million annually in the 1950s. The obvious increase in FDI inflows took place in the 1960s, yet again; the realized investment was below $15 annually. What is interesting here is the big difference between the realized and authorized investments during the whole period.



Source: Erdilek, A. *Direct Foreign Investment in Turkish Manufacturing* (Tubingen: Mohr,1982), Appendix.

Figure 3. Inward FDI with current prices – (US Dollars-thousand).

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5 The statistics of FDI flows between 1950 and 1980 differ in various studies. The State statistics (DPT) and the World Bank, UNCTAD statistics differ to a large extent in this period.

6 However, the law included an ambiguous article which was used by governments as a tool to deny investment permission to some foreign investors. According to this article, foreign investment should contribute to the economic development of Turkey and should be in a field of activity open to Turkish private enterprise. In addition, foreign investment should not entail any monopoly or any special concessions. See: K. Oksay, *Türkiye'de Yabancı Sermaye Yatırım Kılavuzu* (İstanbul: Doğan Kardeş, 1967)

7 Also there are other views about the law's timing. For instance, according to Eralp foreign encouragement laws coincided with the period when the local bourgeoisie was attempting to collaborate with the Multinational Corporations. See A. Eralp, "Türkiye'de İzlenen İthal İkameci Kalkınma Stratejisi ve Yabancı Sermaye" in *METU Studies in development*, Special Issue (1981) p.623.

8 From 1950 onwards, foreign direct investment entered into Turkey according to four main categories. These were Laws No. 5821 and No. 6224, long-term credits of the Turkish Industrial Development Bank of Recovery and Development, Petroleum Law No. 6326 (which was enacted on March 1954), special Law No. 7462 about the Ereğli Iron and Steel Factory (which was enacted in 1960).

One of the reasons for this divergence was the political and economic instability. During 1958-1960, under the economic stabilization program designed by the IMF and the OECD, the Turkish economy was still too risky for new FDI. Most of the investors preferred to wait for the suitable time after taking the investment permission.[9] For instance, the ratio of realized investment of authorized investment was only 30 percent between 1951 and 1965. Most of the time foreign investors tried to receive permissions before their competitors, and after, preferred to wait for the appropriate time to invest. The divergence between the actual and realized investment gives a significant idea about the political and economic instability for the period.

In the 1960s, substantial demand for domestic commodities (due to significant increase in real wages) and the growth of the domestic market are expected to encourage the inflow of FDI to Turkey. However, in the 1960s both authorized and realized foreign investments continued to be statistically insignificant, in spite of significant growth of domestic market.[10] In this period, called the golden age of ISI, the economic growth rate was seven percent and the manufacturing sector's growth rate was between 11 and 12 percent (Herschlag, 1968). MNCs mostly invested in the manufacturing industry especially between 1950 and 1980 in developing countries. In Turkey, like in other countries, operations of foreign firms mostly concentrated in the manufacturing industry.

In 1960, with the military intervention, the new regime sought to quicken the pace of development by relying to a great extent on state plans in which, the ISI strategy was institutionalized. With the establishment of the State Planning Organization (SPO) in September 1960, the development plans were based on long-term models rather than short-term policies and were obligatory for the public sector and only problem-solving for the private sector.[11] They maintained the coordination between the economic sectors and the agents, achieved economic growth and economic stability, and encouraged the inflow of foreign investment.[12]

4. 1970 – 1980 PERIOD: A CHANGE IN ATTITUDE TOWARDS FDI

The 1970s witnessed several economic and political instabilities in both Turkey and in the world. In developing countries, the easy stage of ISI came to an end and the foreign exchange crisis and increasing dependency of imports led them to shift towards export promotion. Plus, most of the developed and developing countries were negatively affected by

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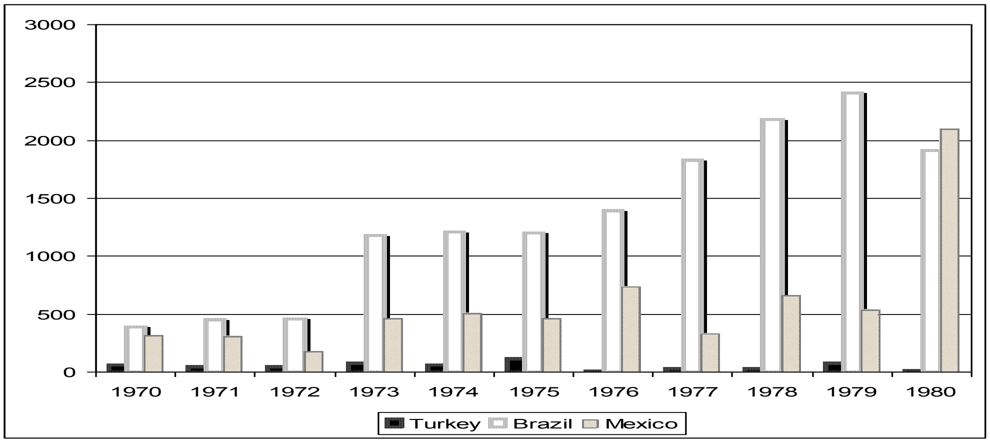
[9] Until 2003, foreign investors had to apply for investment permission. After receiving permission they had a chance to either invest at the time, or wait for a period of time or abandon the process. Therefore, the authorized FDI and the actual FDI used to be different generally.

[10] This fact can be strengthened by reference to the proposed first five-year development plan about foreign direct investment. The five-year development plan forecasted the need of $50 million annually FDI inflow since the beginning of the plan in 1963. However, not only realized investment but also authorized investment had not reached the $50 million level since 1951. See Devlet Planlama Teşkilatı, *First Five-Year Development Plan, 1963-1967* (Ankara: Turkish Republic Prime Ministry, 1963) pp.237-239.

[11] In 1967, Law 933 amended Law 6224, abolishing the Committee to Encourage Foreign Investment, and transferring the FDI authority to the SPO.

[12] In the first development plan, the balance of payments effect received focus rather than the technological and employment effects of FDI. Plus, in this plan, for the first time the problem of low realized investments was mentioned.

the 1974 oil crisis.[13] However, FDI flows in the world continued their steady increase. During the 1970s, the FDI inflows to Turkey continued to be statistically insignificant and fluctuated.[14] Figure 4 shows the FDI inflows to Turkey in comparison with those of Brazil and Mexico.



Source: UNCTAD, 2006.

Figure 4. FDI inflows US dollars with current prices (million dollars).

Although governments in these countries took active measures towards FDI in the 1970s, Brazil and Mexico attracted much more FDI than Turkey. In Brazil, until the late 1970s, the entry of foreign investment was encouraged and promoted by various incentives and very few restrictions were imposed on such inflow. With few exceptions, all sectors of manufacturing industry were open to foreign investments through wholly foreign-owned subsidiaries. Foreign investments increased considerably during the period 1976 -83, from 9 billion to $ 22.3 billion (UNCTAD, 2006). In Mexico, during the 1950s and 1960s, with the growing demand for a variety of consumption goods and intermediate products, the government followed a policy of import substitution, and foreign and domestic companies were given many incentives, including duty-free import of machinery, permission to import used equipment, tax concessions, and a high level of protection through tariffs and quantitative import restrictions (Grosse, 1989; Bennett and Sharpe, 1985).

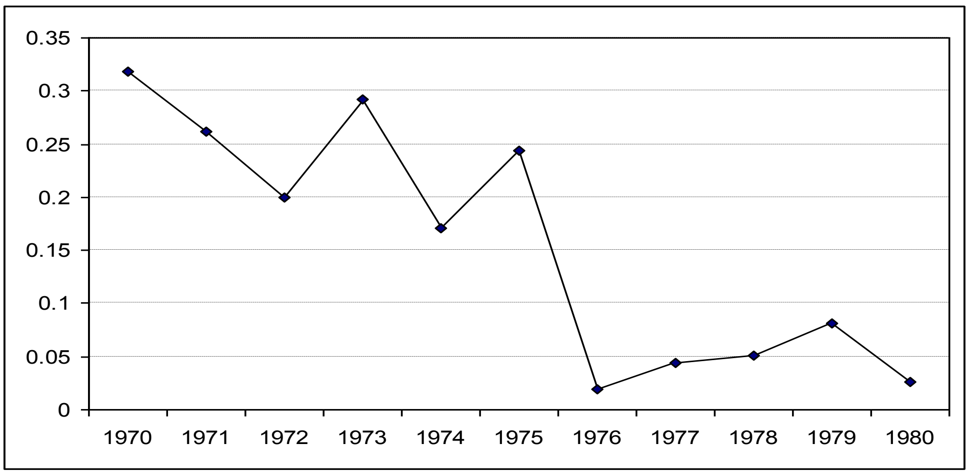
However, in Turkey the picture was somewhat different from that of Brazil and Mexico, except growing government intervention which was problematic in the Turkish case. In addition to the economic and political instability in the 1970s, although Law No. 6224 remained in effect, the attitudes of governments towards FDI changed in this period. After

[13] However, owing to the remittances sent by workers in Europe, with the support of the foreign exchange reserves and an accommodating monetary policy, Turkey did not experience the negative impacts of the oil crisis simultaneously with other countries in 1974 and the growth rate of the economy reached 8.9 percent in 1975 and 1976. Yet, borrowing abroad and expansionary policies only delayed the crisis. Turkey found itself in its most severe balance of payments crisis in 1978 and 1979. See Ş. Pamuk and R. Owen, *A History of Middle East Economies in the Twentieth Century,* (Cambridge: Harvard University Press, 1999).

[14] By 1976, 106 firms containing foreign capital were operating in Turkish economy. This amount began to decrease slightly after that year. By the end of 1977 the number of firms with foreign capital was 99. 86 of these firms were operating in the manufacturing sector. 11 firms were operating in the service sector, one in

1971, the non-party government under the premiership of Nihat Erim adopted new measures which indicated a shift from the liberal foreign investment policy. The new government announced that future applications for FDI would be judged on provision for majority Turkish ownership, capacity for export, ability to induce an inflow of technology, and utilization of economies of scale (Ashkin, 1972). In reality, the demands of the Turkish governments had not been met by the MNCs. The Turkish government's demand for increases in export commitments increase in local content and restrictions on the local credits available to FDI firms were harshly criticized by the MNCs operating in Turkey. They found the Turkish government's demands irrational (Erdilek, 1982:22).

Figure 5 shows that inward FDI stock as percentage of GDP fluctuated during the period. Plus, especially in the second half of the 1970s, the ratio of FDI to GDP was below 0.1 percent, which is an insignificant ratio.



Source: UNCTAD, 2006.

Figure 5. Inward FDI Stock as percentage of GDP in Turkey.

The foreign firms were quickly affected by the new improvements and the regulations of the Turkish governments. Figure 5 reveals that after 1972 the level of inward stock of FDI as a percentage of GDP had begun to fall, especially sharply after 1975.

One of the reasons for the fluctuations was a scarcity of foreign exchange. In the 1970s the scarcity of foreign exchange, especially after 1976, obstructed transferring profits and obtaining imported inputs. The inputs of the MNCs, as well as domestic companies, mostly relied on imported intermediary and capital goods.

Due to the scarcity of foreign exchange, firms containing foreign capital had difficulties in obtaining foreign exchange. The imports of foreign firms depended mostly on intermediary and capital goods. This can be explained by the inadequacy of local producers in producing commodities which require technology, management skill, and economies of scale. This picture also shows the failure of the ISI strategy as the firms became more dependent on foreign inputs in the later step of the model.

mining, and one in agriculture. In 1979, the number of firms decreased to 91. See Taner Berksoy, S. A. Doğruel and F. Doğruel ,*Türkiye'de Yabancı Sermaye* (İstanbul: Tüses, 1989).

5. An Evaluation of the 1950-1980 Period

As mentioned, the provisions of Law No. 6224 seemed liberal and compared favorably with the investment laws of many countries. However, between 1951 and 1980, a total of $230 million in capital came through this channel.[15] Since its inception in 1954, the flow of private capital into Turkey remained far below expectations. Therefore the inflow of foreign capital can not be increased only by liberal regulations alone. If the inflow of foreign capital is below the expected level, the reason must be sought elsewhere.

One of the reasons is that, in this period of Turkey actually lacked the political and economic stability to provide an attractive investment environment for investors. In the 1960s and 1970s, several coalition governments and two military coups showed Turkey to be politically unstable in its second experiment with democracy. The period 1974-1979 also witnessed rising political instability and widespread violence between political factions and ideologies, which drastically worsened the environment for FDI.

Another problem involved an article of Law No. 6224, concerning the contribution of FDI to the economic development of the country. According to Law No. 6224, foreign companies could realize investment in all sectors of the economy, provided it aided the country's economic development. It was not clear, however, how this was to be determined. Many representatives of foreign companies claimed that the SPO used this provision as a tool to discriminate against MNCs (Erdilek, 1982:67).

6. The Role of the Bureaucracy

A regulatory framework is only as good as its implementation. Administrative barriers that reduce the efficiency of the regulatory system due to inefficient administration or procedures can have an enormous negative impact on foreign investors. An inefficient bureaucracy often results in investment plans that become outdated for the investor, unnecessary costs for management time not efficiently used, and expensive equipment and employees that are idle.

In Turkey, bureaucratic procedures surrounding the investment process were often lengthy, unnecessarily cumbersome, and unpredictable. The administrative procedures did not reflect international best practice. For instance, acquiring establishing a firm permit or a trademark registration could take many months or even years.

In most of developed countries, the bureaucracy tends to be somewhat autonomous from political pressure and to have an established mechanism for recruitment and training. The institutional strength and quality of the bureaucracy is another shock absorber that tends to minimize revisions of policy when governments change. However, in Turkey, there has been a disparity between the governments and the bureaucracy when FDI is considered.

Therefore, although governments seemed to favor FDI inflows, the ambiguous arts of the FDI laws were used as tools to hinder FDI by the Turkish bureaucracy. For instance, Article 1 of Law No. 6224 implied that FDI had to benefit the economic development of the country. This vague law over the years became open to use as a tool for the bureaucracy and sometimes for the government to discriminate against some FDI activities. Hence, especially for foreign firms, the SPO and the red tape of public institutes were responsible for the low inflow of FDI. There was, in other words, a clear discrepancy between the law and its bureaucratic implementation.

In a closed economy in which foreign economic relations are subject to extensive state control, each connection with foreigners also involves an encounter with the state authority. Many foreign investors accused the Turkish bureaucracy of straight and simple violation of the law in order not to implement its various provisions. For instance, the bureaucracy did not allow the capitalization of intangible rights reduced and even stopped royalty payments in the 1970s.

One of the important obstacles for foreign firms was the long waiting period to receive permission from the Council of Ministers. In the 1970s, the average time between a firm's application for permission and its publication in the Official Gazette was about two years. Another problem was the SPO's unwillingness to process the FDI applications quickly enough. The SPO often increased the red tape for the application procedures for foreign firms so that the permissions for foreign firms would be delayed at least for three or four months. The SPO officers denied that the SPO was anti-FDI and blamed the delays on political facts and a shortage of expert personnel. The last fact was the main problem of the institutions, which were responsible for evaluating FDI applications. For instance, there were only a few experts in the Ministry of Commerce's (MOC) FDI division and they were fired for political reasons when the new government came into power. Hence, with no skilled employees, as the chief of the MOC's FDI division stated, his division was no longer capable of evaluating the FDI applications on a technical level.

Lack of consistency of the implementation of laws and regulations in different municipality authorities is another area that requires attention. Before 1980, at some point investors might receive two contradictory permits from different authorities in Turkey. However, lack of coordination between administrators or policy-makers on the national and municipal levels results in inconsistent behavior of the administration. Laws and regulations were not applied by local administrators on the same standard as on the national level. Local politicians in some cases might delay the issuance of necessary permissions for unrelated reasons. A prospective foreign firm could be forced to get as many as 23 signatures from various official authorities in order to receive FDI permission, which could take as long as three years (Dumludag, 2002:87).

7. POST 1980 PERIOD – A CHANGE IN THE ATTITUDE TOWARDS FDI

1980 marks a turning point for many developing countries including Turkey. After 1980, most of these countries integrated into the international economy through liberalizing their economies. The governments, especially in Latin America, suffering the negative impacts of hot money transactions turned towards FDI, as a reliable foreign source, in order to realize sustainable growth rates. In these countries, FDI laws including several restrictions were

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[15] The statistics of FDI flows between 1950 and 1980 differ in various studies. The State statistics (DPT) and the

replaced by new laws offering significant incentives to foreign investors. As a result of opening economies, and governments' positive attitudes, FDI inflows were significantly increased into developing economies.

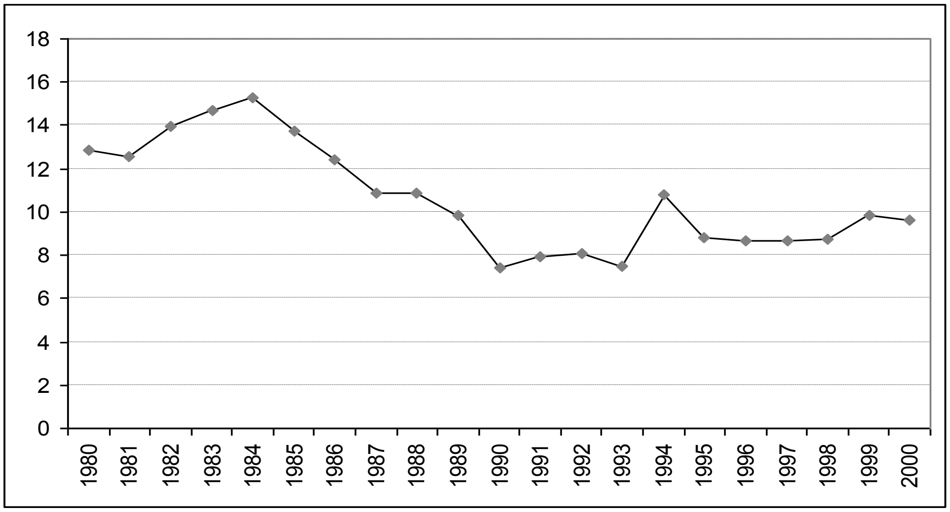
In the same way, with the 24 January 1980 program, Turkey's integrated into the world economy through several measures. The economy became much more open to international trade and later, financial markets. The government launched an economic stabilization and structural adjustment program aimed at encouraging a private-sector-led, export-oriented growth. The program included a flexible exchange rate, incentives to promote exports, deregulation of interest rates to promote domestic savings, reform of state enterprises, and import liberalization. Plus, quantitative restrictions on imports were also removed, and tariffs were significantly reduced. When the Turkish Lira became convertible, the country received significant amount of portfolio capital flows. However, Turkey's integration with the world economy through FDI continued to remain weak in comparison to other developing countries.

In Turkey, after 1980 the attitude of governments' toward FDI issue changed dramatically. Governments, in order to attract foreign firms, revised the regulations concerning FDI. Before, there had been a lack of a strong and efficient organization dealing with the FDI application process. In the 1980s, all restrictive regulations about FDI implemented in the 1970s were eliminated. The negative attitudes of the public and of the bureaucracy softened gradually. With decree No: 8/168, a newly created Foreign Direct Investment Department, within the SPO, acquired the consolidated authority which had been previously split among several different government agencies to manage the relations with foreign firms (Erdilek, 1986:173). Law No. 6224, encouraging FDI, still remained in effect with minor but important changes and the red-tape was by and large reduced. For instance, the 49 percent foreign ownership limit, which was introduced in 1971, was removed in this period. Also new measures were taken in the foreign employee regulation. Plus, a significant change took place in the public opinion. Since 1980 there has been a great interest of the public in the FDI issue. This is an important development when the excited discussions about the FDI issue in the parliament and public in the 1960s are considered. And finally, in 1980, in order to inform the public about issues regarding FDI, a foreign investors association (YASED) was established.[16] YASED held conferences in order to change the suspicious attitude in the public towards FDI.

Although significant measures were taken in order to attract FDI inflows in the 1980s, the amount of FDI increased annually but not as expected. The graph in figure 6 demonstrates FDI inward stock as percentage of GDP in Turkey, which after a short period of acceleration from 13 percent in 1980 to 15 percent in 1984, began to decrease considerably by the end of the 1980s. The share of FDI inward stock stagnated in the 1990s.

World Bank, UNCTAD statistics differ to a large extent in this period.

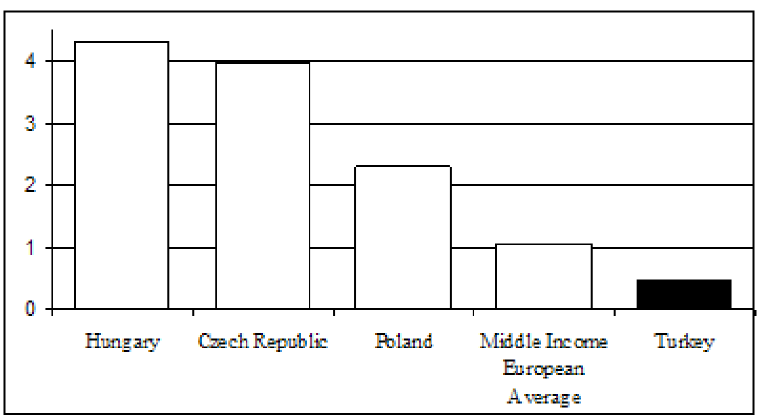
[16] The name of the organization was changed to International Investors' Association in 2005. (Logo remains the same).



Source: UNCTAD, 2006.

Figure 6. Inward FDI inward stock as share of GDP in Turkey.

There are several reasons for the substantial increase in the first half of the 1980s. The Turkish government transformed the repayment of commercial credits borrowed from foreign financial agents into foreign direct investment. Also an export-oriented strategy and increasing trade relations between Turkey and countries in the Middle East attracted foreign firms motivated by vertical strategy.



Source: FIAS, 2001.[17]

Figure 7. Average FDI Inflows as a percentage of GDP, 1990-99 (%).

The level of FDI inflows with current prices as US dollars, continued to remain low in the 1990s. The average of FDI inflows was $170 million during the 1980s. This can be considered as a success when the $227 million total FDI inflow to Turkey is considered. However, after 1980 FDI flows into developing countries increased rapidly.

[17] Middle income European countries include Albania, Belarus, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, FYR, Poland, Romania, Russian Federation, and Slovak Republic.

In the 1990s average annual FDI inflow of $770 million fluctuated between $680 and $980 million. A comparison of the FDI levels of Turkey, Brazil and Mexico gives an idea of Turkey's performance during the period.

In the 1990s the inflow of FDI to Turkey reached 1 billion annually. However, when we compare Turkey with other developing countries such as Brazil and Mexico we see that Turkey was not successful at attracting FDI in relative terms. For instance, Brazil attracted two times greater FDI than Turkey in 1990; in 2000, the ratio reached 1:40. The ratio between Mexico and Turkey was 1:1.5 in 1990; however, the ratio reached 1:15 to the disadvantage of Turkey.

In the 1990s countries of former communist regimes entered into the competition for FDI. With faster and more thorough reforms in many of them, very well educated workers, technical, and scientific personnel, success in fighting inflation, greater geographic proximity to the EU as well as, in total, a very large and unsaturated market, led Central and East Central countries to receive more FDI flows than Turkey. Hungary, Poland and the Czech Republic became major targets of FDI – not only from Western Europe but from the USA and to some extent from Asia as well.

The failure of Turkey's FDI performance in this period can be explained by several economic and non-economic factors.

The 1990s called the lost decade in Turkey due to severe, subsequent economic crises. The political and economic instability obstructed higher amounts of inflow of FDI. While in the 1970s executives of foreign firms typically complained about the negative attitude of governments, in the 1990s they mostly complained about the macroeconomic and political instability (Erden, 1996). In this period, Turkey had 9 coalition governments in 10 years. By this way there was no chance for government's ability to carry out its declared programs, and its ability to stay in office.

Economic growth was increasingly infrequent, with sharp rises and falls, including a financial crisis in 1994, followed by a severe recession. Inflation accelerated and exceeded 100 percent in 1994.[18]

In this period, governments, in order to diminish public budget deficits, attracted portfolio capital transactions rather than promoting FDI inflows. The importance of FDI as a source for sustainable growth rates lost its importance. Attracting FDI remained shadowed by hot money. The lack of success in reducing the inflation rate, as well as instability in government, contributed to reinforce the perception of Turkey as an unstable and unpredictable place to invest. In sum, the Turkish Government was unable to facilitate and promote an attractive investment environment through stable and market oriented economic policies. Financial crisis and continuous economic and political instability deterred not only foreign investors but also local entrepreneurs.

8. Recent Period: Structural Change

At the end of 1999, Turkey adopted a three-year economic stabilization and structural reform program with the support of the International Monetary Fund (IMF). However, after

[18] On the other hand, inflation may not be a serious problem in some cases. For instance, Brazil, Mexico and Argentina attracted significant FDI inflows although high inflation took place in these countries in the 1980s.

the subsequent crises of November 2000 and February 2001, the program collapsed. The support of the IMF and the World Bank continued and structural reform and economic stabilization programs continued. Turkish governments decisively adopted administrative reforms and the Turkish Parliament approved a sweeping revision of the country's codes to bring them closer to European Union norms.

Significant reforms were approved especially in the financial sector. In order to strengthen the quality of economic institutions, new measures were adopted. At the end of the period the rate of inflation decreased to fewer than 10 percent. The economy experienced high growth rates while there was no progress in diminishing the unemployment level.

The coalition government and succeeding AKP government paid special attention to inward FDI and approved legislative revisions concerning FDI. A new FDI encouragement law was enacted in 2003, the complicated entrance procedures were simplified, and for the first time, the state accepted to work in accordance with non-governmental organizations and the private sector in order to improve the investment environment for foreign investor.

Plus, in support of these efforts, Foreign Investment Advisory Service of the World Bank has been asked to analyze the business climate in Turkey and prepare this report which indicates the government willingness to attract more FDI inflows to Turkey. For this purpose Foreign Investment Advisory Service (FIAS) prepared a report, based on extensive field work consisting of surveys and interviews that declared that administrative barriers hinder more FDI flows into Turkey.

In this period, for the first time, remarkable measures were taken showing the decisive attitude of governments towards attracting FDI. As mentioned, the existing law of FDI, which dated back to 1954, was replaced by the new foreign investment Law No. 4875 in June 2003.[19] This law replaced the old FDI approval and screening system with a notification and registration system, bans nationalization without fair compensation, guarantees national treatment to foreign investors, does not restrict FDI in any sectors or impose any performance requirements, eliminates the old minimum capital limit, grants foreign investors full convertibility in their transfers of capital and earnings, allows them to own property without any restrictions, and recognizes foreign investors' right to international arbitration.

Second a Coordination Council for improving the investment climate (CCIIC) consisting of government and private sector representatives was established. The council included government and private sector representatives and aimed to improve the investment environment in Turkey. For this reason the council formed several technical committees for in-depth study of individual issues that concern the improvement of the investment environment.

Third, for the first time under the presidency of the prime minister of Turkey, the Advisory Investor Council held its first meeting in 2003. The council consisted of the chief executive officers or chairpersons of 15 foreign affiliates such as Citigroup, Siemens and Toyota. The council held its first meeting, chaired by the Prime Minister, in March 2004, identifying 13 key areas on which the government was advised to focus its efforts to improve the FDI environment. After its second meeting, chaired by the Prime Minister, in April 2005,

[19] Since the new FDI law, 6,000 new FDI firms were established in Turkey. Between 1954 and 1999, the cumulative of foreign firms was 4,192. However, most of the newly established firms are small and medium scale and most of them are far away to be called as MNCs. By 2005, most of the foreign firms concentrated in major cities; Istanbul, Ankara, Izmir, Antalya, Bursa and industry centers Kocaeli, Tekirdağ and Bursa.

the council commended the government for its progress in improving the FDI environment, drawing attention to 10 important issues that needed to be worked on.

In sum, although FDI received attention from the governments since 1980, the intense efforts in order to increase the FDI inflow have taken place since 2001. The coalition government and succeeding AKP government approved legislative revisions concerning FDI. A new FDI encouragement law was enacted in 2001, the complicated entrance procedures were simplified, and for the first time, the state accepted to work in accordance with non-governmental organizations and the private sector in order to attain a higher level of FDI inflow.

However, these concrete efforts did not increase the FDI inflow as expected. The FDI inflow was $982 million in 2000; it reached $3.2 billion in 2001. However, the increase of FDI inflow did not continue, rather, it fluctuated. The inflow was $1 billion in 2002, $575 million in 2003 and $2.7 billion in 2004 (UNCTAD, 2006). These data suggest that the inflow of FDI remained far below the expected $30 billion potential inflow level.[20]

Having examined the relationship between economic and political context and FDI in Turkey, and having analyzed the comparative FDI performance of Turkey in detail, below, the results of questionnaire survey are interpreted in order to reveal the role of institutional variables as determinants of FDI inflows in Turkey.

9. THE ROLE OF INSTITUTIONS - THE QUESTIONNAIRE SURVEY

Empirical research on the impact of host country institutions on FDI has demonstrated that the general institutional, social and legal framework influences FDI.

To meet the needs for an in-depth and exhaustively researched analysis of the non-economic variables such as potential risks to international business operations, several organizations created statistical models to calculate risks and backed it up with analyses that explain the numbers and examine what the numbers do not show. The result is a comprehensive system that enables various types of risk to be measured and compared between countries.

However, in Turkey studies on FDI rarely treat the role of institutions on FDI and rather they focus of the main determinants of FDI.

In a recent study, Foreign Investor Advisory Service of the World Bank (FIAS) conducted reports, mentioning the importance of institutions. FIAS of the World Bank Group was asked in September 2000 to study the FDI environment and make recommendations for its improvement, as part of the World Bank Group’s 2001-2003 Country Assistance Strategy for Turkey, which stressed the importance of FDI repeatedly and underscored the role of FIAS in improving Turkey’s FDI environment.

FIAS, with the support of the Turkish government and with cooperation of the private sector, prepared two studies: A Diagnostic Study of the Direct Foreign Investment

[20] This chapter focuses on FDI in Turkey until 2006. This is because FDI inflows to Turkey, in 2006, reached $20 billon for the first time in history. It is too late to say that Turkey will attract over 20 billion dollars continuously. This increase, as the share of mergers and acquisitions is considered, may be a temporary increase. Hence, in order to propose a complete analysis, a couple of years should pass.

Environment in Turkey in February 2001, and Turkey: Administrative Barriers to Investment in June 2001 (FIAS, 2001).

The reports pointed administrative barriers political and economic stability, slow and partial judicial system as an impediment to new investments and suggested workshops and establishment of study groups focusing on the issues company registration, sectoral licensing, land access and site development, taxation and incentives, intellectual property rights, investment legislation and investment promotion.

According to the first report, the Turkish administration has been fixated on control instead of service and enforcement. This control, combined with lack of accountability and transparency, and exercise of discretion, has resulted in widespread corruption. The second report focus on the list of issues relating to company registration and reporting, location and operation of FDI companies; among the operational issues are taxation, trade and customs regime, and intellectual and industrial property rights.

The analyses of these issues are followed by specific recommendations including the establishment of an Investment Promotion Agency (IPA) for reform. Its conclusions emphasize the need to build the political will required for an action plan with broad support and to monitor improvements as that plan is implemented.

10. THE QUESTIONNAIRE SURVEY[21]

In my empirical analysis, I engaged in substantial fieldwork in 2006. I applied a questionnaire survey to explore the mechanisms linking political institutions to FDI flows, and interviewed representatives of Multinational Corporations (MNCs) operating in Turkey. In these interviews I asked both open-ended and closed ended questions regarding the factors were important in multinationals selecting investment locations, and I followed up these questions with specific questions on how they evaluated the importance of specific policies and institutions. Also, I had the opportunity to conduct interviews with some of the representatives of nongovernmental organizations.

The questionnaire examines the impact of institutional variables on FDI. The case study of how institutional variables affect FDI in Turkey is a result of field work of twenty weeks. The questionnaires were sent in October 2006 and the receiving of the results was completed in February 2007. The questions examine for the period between 2001 and 2006.[22] The answers of the questions are converted to numeric values from (very low: 1 to very high: 5, very unimportant to very important 1:5). The questionnaire survey was drafted in such a manner as to follow a systematic comparison of the surveys of the World Bank and UNCTAD.

The MNCs firms are at the top 500 big (according to initial capital stock) MNCs in located on the website of the Treasury. All participants in the study were guaranteed complete

[21] The results of the questionnaire survey were presented at several conferences at Tartu University and the seventh European Historical Economics Society conference at Lund University. Also the empiric study took place in Devrim Dumludag "Türkiye'de Doğrudan Yabancı Yatırım Hareketlerinde Kurumların Rolü" in *Türkiye'nin Küreselleşmesi: Fırsatlar ve Tehditler*, ed. Ibrahim Öztürk, Istanbul: ITO yayınları, 2008.

[22] I was concerned if the respondents reply the survey considering only the year 2006. In order to minimize this, at the questionnaire, the importance of regarding the period 2001-2006 essentially mentioned. However, there is no guarantee that all respondents act in accordance to this fact.

confidentiality in their responses. Hence, in-keeping with this confidentiality clause the data presented in this chapter is based upon the summary statistics drawn from the database of survey respondents.

The questionnaire sent by mail to 300 executives of MNCs. However, 52 executives return their surveys. 18 firms replied that they were either unable or unwilling to participate in the study, most stating company policy and/or confidentiality issues as reasons for their nonparticipation. A further 40 questionnaire packets were returned unopened and given the fact that these firms had recently relocated.

In the survey, 40 of 52 respondents were general managers; five of them were finance managers, four of them marketing managers and three of them assistant general managers.

Thirty-seven percent of the firms belong to financial intermediation; manufacturing is the second largest sector with a share of 27 percent to which the respondents belong. The transport, storage and communications sector is the third largest sector with 12 percent. Wholesale and Retailed Trade has eight percent, whereas, construction sector has a share of four percent. Other sectors, including agriculture, electricity, real estate, wholesale and retail have 12 percent in total.

On the other hand, the sectoral distribution of MNCs operating in Turkey by 2006 was about; 40 percent of the MNCs in Turkey operate in the financial intermediation sector, the transport, storage and communications sector has a share of 38 percent, very close to financial intermediation. Third largest sector MNCs belong to is manufacturing with a share of eleven percent. The wholesale and retail trade sector has a share of five percent.

The sectoral distribution of respondents firms is similar with the sectoral distribution of total MNCs in Turkey, except the second largest sector is manufacturing with 27 percent in the questionnaire survey, whereas it is the third largest sector with a share of 11 percent. On the other hand, the transport, storage and communications sector is the second largest sector with 38 percent in Turkey it has a share of 12 percent in the survey.

11. The Role of Institutional Variables

In Turkey for foreign investors, political and macroeconomic instability are seen as the most significant facts that hinder higher inflows of FDI. Stability is a crucial factor when it comes to FDI because it is a way that investors measure the security of their investment. It indicates the likelihood that the government in power will be destabilized in unconstitutional or by violent means. Where investors are uncertain about a country’s political and economic stability they adopt a “wait and see” attitude.

In the survey, political instability has a mean of 4.37 and macroeconomic instability has a mean of 4.35. Stability is a crucial characteristic of an economy that investors want to see prior to establish their investment in a host country. Political and economic stability enhances the amount of predictability and the ability to forecast future events. In Turkey, some link political stability with a single-party government rather than with coalition parties ruling the country. However, indicators of political stability are government effectiveness, regulatory quality, and the rule of law. Most investors, when creating a business plan or project proposal, want to be able to estimate costs, competition, regulations, and potential returns. Government effectiveness is a measure of the government's ability to stay in office and carry out its declared program(s), depending upon such factors as the type of governance, cohesion of the government and governing parties, approach of an election, and command of the legislature. Economic stability can be captured in macro-economic indicators, such as inflation and growth. It can be argued that only if the country can provide a politically and economically more stable and open environment, can more specific efforts, targeted at improving the investment environment directly, be effective.

Table 2. Barriers to Foreign Direct Investment in Turkey

(General)	Number of Responses	Mod	Mean	Standard Deviation
Political instability	52	5	4.37	0.817
Macroeconomic instability	52	5	4.35	0.738
Exchange rate risks	49	4	3.92	1.017
Inflation	47	4	3.89	0.759
Insufficient development of financial markets	49	3	3.22	1.066
Slow progress of privatization program	48	3	3.02	1.101
Possible obstacles against EU membership process	47	2	2.89	1.088
Competition from Central and East European Countries	48	3	2.88	1.044

High means of exchange rate risk and inflation reflect that respondents consider the 2001-2006 period when answering the survey. If the survey had been applied five years earlier the mean scores would be much higher. However, the exchange risk and risk of inflation with mean scores of 3.92 and 3.89 are welcome as deterrent indicators for investors.

Insufficient development of financial markets has a 3.22 mean score. Progress in establishing financial infrastructure and capital markets is important for foreign investors because it facilitates access to local capital markets. The better developed markets encourage business to set up operations, as they can access complementary local finance more easily, and face lower transaction costs for local financial services such as the payment system. However, foreign investors may substitute locally raised capital for capital raised on international capital markets, which would lead to a reduction of recorded FDI inflow. Nonetheless, the received consensus is that the former effect dominates over the latter.

Although in many studies the positive effect of privatization on FDI is emphasized, interestingly the slow progress of privatization programs does not have a priority as an obstacle of higher FDI inflow with a mean score 3.02.

Privatization is a signal to multinational investors that a country is ready to foster a competitive market economy. FDI can also be very useful to a nation's privatization process by bringing in additional management expertise and marketing channels. Given that Turkey needs significant FDI to enhance its infrastructure and to achieve its privatization goals, it needs a good environment for privatization and private participation in infrastructure. It also needs to privatize to attract even more FDI.[23]

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[23] A FIAS study on "Facilitating Foreign Participation in Privatization," for a sample 36 countries implementing privatization programs concluded that every dollar of privatization revenues attracted on average an

Also possible obstacles against EU membership do not have a priority as an obstacle for higher FDI inflow with a mean score of.

Interestingly, respondents do not identify Central and East European countries as primary competitors of Turkey. However, during the FIAS field mission in 2000, more than 50 foreign and domestic firms interviewed identified Hungary, Poland, and the Czech Republic as primary competitors of Turkey for FDI attraction. This finding is also supported in the study of the Loewendahl and Loewendahl (2001).

Table 3 demonstrates significant results regarding institutional variables. Anti-competitive practices by the government (with a mean 3.98), consistency and predictability of officials' interpretations of regulations (with a mean 3.92), unstable and unreliable, non-transparent legal and regulatory framework (with a mean 3.84) problems with recognition of patent rights (with a mean 3.81) and corruption (with a mean 3.80) are significant facts hindering the higher level of FDI inflows for foreign investors.

Table 3. Barriers to Foreign Direct Investment in Turkey

Institutions, Administrative Barriers	Number of Responses	Mod	Mean	Standard Deviation
Anti-competitive practices by government	47	4	3.98	0.872
Consistency/predictability of officials' Interpretations of regulations	51	4	3.92	0.744
Unstable and unreliable, non transparent legal and regulatory framework	50	5	3.84	1.131
Problems with recognition of patent rights	48	4	3.81	0.915
Corruption	45	4	3.8	1.079
Start up procedures	49	3	3.76	0.99
Too many days to resolve a commercial Dispute in the country's courts	46	3	3.59	0.884
Lack of enforcement of laws and Contracts effectively	50	4	3.54	1.014
Complex, slow and expensive property registration process	48	3	3.54	0.824
Delays in the courts	48	3	3.5	0.968

Beyond the establishment of markets as basic institution for the exchange of goods and services, regulatory institutions such as a competition policy are required. While liberalization has been rapid throughout the developing countries including Turkey, the process of designing and implementing competition policy has been far more complex (P.G. Hare, J. Batt, M. Cave, and S. Estrin, 1999:1-30).

Governments in the less reformed countries continue to protect the markets of their local firms, even at the sub-national level. Studies, especially those focusing on transition economies reveal that only successful implementation has a strong positive relationship with the economy-wide intensity of competition, whereas the mere existence of rules does not.

Unstable and unreliable, a non-transparent legal and regulatory framework with a mean 3.84 is regarded one of the most important deterrent factors by respondents. This is because an efficient legal infrastructure reduces institutional uncertainties for foreign investors,

additional 88 cents in FDI. See F. Sader, Facilitating Foreign Participation in Privatization, FIAS Occasional Paper no. 8, Washington, DC, 1996.

facilitates the establishment and enforcement of contracts and in various other ways reduces the transaction costs of doing business in an economy. Turkey has fallen behind many other developing countries in effective liberalization of its legal framework, and in its enforcement practices to reap the benefits of the rapid globalization that is transforming international economic relationships.

Poor implementation of existing legislation is one the main problems in Turkey. Missing implementing rules and administrative guidelines, inconsistent application of laws, incompetent bureaucrats in charge, and lack of judicial enforcement are the issues mentioned most frequently by foreign investors in interviews. The rule of law refers to the enforceability of contracts, something on which foreign investors place great importance. Investors want to know that their rights and their business will be protected when operating abroad. Corruption diminishes the rule of law, most simply because some businesses do not operate within the law and this reduces fair competition.

In the perspective of foreign investors, legislative reform in Turkey does not appear to be sufficiently reliable. Adopted laws are often not implemented on time.

One of the executives replied the question about the newly enacted laws: "Are you satisfied with the progress in the judicial system? By giving an answer, governments may carry on enacting laws; however, we are suspicious about the way they are interpreted." Another point frequently raised by investors is a lack of confidence in the impartiality and quality of the commercial courts. Plus, most of the executives mentioned that unstable, non-transparent legal and regulatory framework make the Turkish business environment difficult to operate. Some argued that recently enacted law about the recognition of patent rights are not applied with sensitivity.

Corruption is another issue raised by investors. Corruption within the political system that is a threat, especially in the long-run, to foreign investment by distorting the economic and financial environment, reducing the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability, and introducing inherent instability into the political process.

While the recent government efforts to curb corruption deserve much praise, investors suggested that they do not trust in the impartiality of administrators in critical cases, especially in customs administration and municipal level procedures such as site development. Corruption is marked in the Transparency International's year 2000 corruption perceptions index (CPI) Turkey ranks 50th among 90 nations listed.

Most of the executives I interviewed mentioned that corruption is a deterrent factor for foreign firms. I asked whether corruption may make things easier in the first steps of the investment process. In other words, I asked the question whether corruption is effective in the short-term or not. All the answers emphasized that large corporations pay special attention to the institutional organization of the corporations. An institutionalized corporation pays special attention to certainty when operating in another country. Corruption makes things uncertain in a business environment which in the end may have negative affect on all firms operating in the long run.

The weakness of the judicial system and enforcement of contracts and the recognition of property rights create a feeling of insecurity and arbitrariness. Under such circumstances, the long-term commitment of substantial investment funds seems risky if plans are challenged or overturned from day to day, or whenever an official is replaced. The weakness of the judicial system causes the increasing and unrestrained power of such officials. Plus, in countries in which the enforcement mechanisms are weak, the share of informal economy is large, in parallel. In other words, compliance with the formal institutions is too costly and the government does not have the power to effectively enforce its costly rules in these countries.

Table 4. Transparency International Rankings

Rank	Country	CPI Score 2005	CPI Score 2000
1	Iceland	9.7	9.1
	Finland	9.6	10
2	New Zealand	9.6	9.4
4	Denmark	9.5	9.8
5	Singapore	9.4	9.4
6	Sweden	9.2	9.4
47	Czech Republic	4.3	4.3
48	Brazil	3,7	3.9
49	Mexico	3.5	3.3
	Peru	3.5	4.4
	Turkey	3.5	3.8
50	Poland	3.4	4.1
51	India	2.9	2.8

Source: Transparency International 2006.

It is important to improve the enforcement of dispute resolution and "conflict of interest" legislation. However, in Turkey the executives that I interviewed emphasized that some of the laws in Turkey are ambiguous and therefore difficult to enforce. The rule of law is perceived as weak by foreign investors. This problem can be improved by creating an independent dispute resolution mechanism or by improving the legitimacy of those responsible for regulating legal disputes and contracts.

Not only are the administrative procedures time-consuming; enforcement procedures for commercial cases at the courts take much longer than many other countries. Table 5 shows that cases in Turkey and in several emerging economies take often more than a year. This is worse than in Poland (an average of 6 months, though in Warsaw up to 40 months), Hungary (80-90% solved within 1 year) and Czech Republic (average of 1.5 years). However, it is essential to note that the key policy strategy of these nations has been to recognize the problem and take action to improve the situation, while Turkey has only recently recognized the problem.

The protection of intellectual property rights (IPR)is particularly important for producers with a high rate of innovation like computer software developers or pharmaceuticals, as well as producers of products with well-known trademarks like some beverages, cloths, or automobiles. As globalization has taken hold, good IPR protection is becoming more and more important to attract world-class technology and the export-oriented plants that have to use it.

Table 5. Doing Business in 2005 – Selected Developing Economies

	Protecting Investors			Enforcing Contracts		
Economy	Rank	Disclosure Index	Investor Protection Index	Rank	Procedures (number)	Time (days)
Argentina	96	6	4.7	65	33	520
Brazil	58	5	5.3	117	42	616
China	114	10	4.3	59	31	292
Colombia	33	7	6	141	37	1,346
Czech Rep.	81	2	5	55	21	820
Egypt	114	5	4.3	157	55	1,010
Hungary	114	2	4.3	11	21	335
India	33	7	6	173	56	1,420
Indonesia	58	8	5.3	144	34	570
Malaysia	3	10	8.7	78	31	450
Mexico	133	7	4	82	37	415
Peru	18	7	6.3	106	35	381
Philippines	151	1	3.3	50	25	600
Poland	43	7	5.7	111	41	980
Singapore	2	10	9.3	23	29	120
Turkey	58	8	5.3	69	34	420
Venezuela	162	3	2.7	125	41	435

Source: The World Bank, 2006.

As in other dimensions of the business environment in Turkey, the major problems in IPR protection are caused not so much by inadequate laws as by a lack of effective enforcement. Internationally known brand names and trademarks are increasingly subject to illegal exploitation and pirating. Since 1992, the US Treasury has listed Turkey on its Priority Watch List, under its Special 301 provision for continuous violation of intellectual property rights (FIAS, 2001).

Whole legal framework for intellectual property rights is relatively new in Turkey, and much effort has been spent on fulfilling obligations stemming from the membership of the World Trade Organization (WTO) and the accession to the European Union (EU).

In the survey, administrative barriers such as complex, slow and expensive property registration process and too many days to resolve a commercial dispute in the country's courts have 3.59 and 3.50 mean scores. The mean scores are significant although these indicators stay behind the several institutional variables at the list.

12. The Quality and Integrity of Public Services

The overall quality and efficiency of services gives an idea about the legislation, infrastructure, and the sensitivity towards protecting property rights. As they find these services attractive, they inform the quality of the services to the foreign investors outside the country.

The overall quality and efficiency of services delivered by the following public agencies or services: (1 very bad to 5 very good)

Table 6. Functioning of Institutions and Public Services

Indicators	Number of Responses	Mod	Mean	Standard Deviation
Property rights	49	3	3.14	0.89
Labor regulations	49	3	3.04	1.06
Business licensing	47	3	3.02	0.737
Tax regulations/administration	49	3	2.69	0.713

When the quality and integrity of public services are considered, it can be argued that indicators such as property rights, labor regulations and business licensing have moderate mean scores except for the quality of tax regulations and administration. Property rights has a mean score 3.14; labor regulations; 3.04, and business licensing 3.02. Executives, during the interviews, mentioned that tax regulations were complex, inefficient and hence, a deterring factor for FDI inflows.

Table 7 demonstrates that whereas indicators belonging to infrastructure have high mean scores, administrative and legislative issues have relatively low scores. Communication service is at the top of the list with a mean score of 3.87. Electric power has a mean score of 3.51, while transportation service has a score of 3.40 and the quality of roads has a mean score of 3.22. On the other hand, the quality of the functioning of government comes after the indicators of infrastructure with a mean score of 3.16. The score of 2.86 for the parliament and 2.65 for the judicial system reveal that foreign investors are suspicious about the quality of legislative and administrative functioning.

Table 7. Infrastructure and Legislation (1 very bad 5 very good)

Indicators	Number of Responses	Mod	Mean	Standard Deviation
Communication service	52	4	3.87	0.793
The electric power	51	4	3.51	1.189
Transportation service	52	3	3.4	0.774
Roads	50	3	3.22	1.016
Functioning of government	51	3	3.16	1.007
The parliament	50	3	2.8	0.857
Judicial system	52	3	2.65	0.861

As seen from the survey, the functioning of the judicial system and the predictability of rules and regulations are perceived as significant by respondents. In order to get specific results, I asked questions regarding the year 2001 and the year 2006, in order to see whether any progress had taken place in five years on these specific issues. In order to get specific results, I offered specific statements and asked if the respondents agreed with the statements or not.

Table 8. Statement: "In general, information on the laws and regulations affecting my firm is easy to obtain"

Years		2001 2006				
Number of firms	Agree	Disagree	No Idea	Agree	Disagree	No Idea
51	15	12	24	37	4	10

The responses to the statement reveal that there was progress in obtaining information on the laws and regulations affecting respondents' firms. Considering the year 2001, 15 respondents stated that receiving information on the laws and regulations, whereas regarding the year 2006 the number of respondents agreeing with the statement reached 37. Twelve respondents disagreed with the statement for the year 2001 whereas this number decreased to four for 2006. The number of indifferent respondents decreased from 24 for 2001, to 10 for 2006.

Table 9. Statement 2: In general, interpretations of regulations affecting my firm are consistent and predictable

Years		2001 2006				
Number of firms	Agree	Disagree	No Idea	Agree	Disagree	No Idea
51	8	27	16	22	17	12

Especially during the interviews, one of the important tasks that executives faced was the interpretations of regulations. Most of the executives stated that, although significant changes took place in many areas such as the legislative and judicial system, and different interpretations of laws affect their operations negatively. However, the table demonstrates that over the years, the number of respondents considering the interpretations of regulations as predictable and consistent increase significantly. Regarding 2001, eight respondents believed in the consistency and predictability of regulations whereas, by 2006, the number increased to 22. While the share of respondents decreased, the number of indifferent respondents, only slightly changed.

These results suggest that for the respondents, access to the information of laws and regulations, and the predictability and consistency of the regulations regarding their business improved during five years.

13. PREDICTABILITY

However, according to respondents, while the predictability and consistency of regulations related with their business increased, in general they are skeptical about the certainty and predictability of the general policy changes in the country.

Table 10. Changes in economic and financial policies are (1:highly unpredictable 5: highly predictable)

Indicators	Number of Responses	Mod	Mean	Standard Deviation
Changes in rules, laws and regulations	51	3	2.37	0.999
Changes in economic and financial policies	50	3	2.22	0.996

The lowest mean scores in the survey are related to the predictability in changes of rules, laws and regulations (2.37 mean score) and changes in economic and financial policies (2.22). Law-making procedures often lack participation of the people subject to it. Business organizations in Turkey complain that they are often not consulted when important legislation for the business environment is being drafted; this is again indicates that most officials do not see investors as a constituency which they should heed. The business community feels left out in the democratic process of discussing changes in the legislation.

In sum, in the questionnaire survey, I had a chance to see the impact of more institutional variables on FDI. What I find is that institutional variables have significant impact on FDI inflows. In addition, the questionnaire survey results are compatible with other surveys of institutional corporations.

14. Conclusion

In this chapter, my results point out that institutional variables such as; low level of corruption, government stability, enforcement of contract law, functioning of judicial system, transparent, legal and regulatory framework political and economic stability, intellectual property rights, efficiency of justice and prudential standards have significant impact on FDI in Turkish economy.

The results of the chapter are encouraging in the sense that efforts towards raising the quality of institutions (especially in the Turkish case) may help developing countries to receive more FDI, hence help them to enjoy of higher GDP per capita. The findings presented in this chapter, when incorporated with the existing works on FDI, provide an explanation of the distribution of foreign direct investment across countries. The empirical results point to the importance of political and economic institutions for foreign direct investment.

The political economy approach and the empirical study in this chapter reveal that the nature of the interaction between MNCs and each country is the result of a more complex set of factors than only market size or market related variables orientation. It takes place within the host country’s unique economic, social, and legal structures; it involves institutions.

Generally, legal infrastructures, including legal system development and enforcement, are generally weak in most developing countries. Bribery and corruption are obviously more invasive in emerging markets than advanced economies. It is generally less difficult to enact and develop various laws, but political, social, historical or cultural factors often impede the implementation and enforcement of these laws. The roles of law and judicial systems differ among countries. The gap between the law on the books and the law in practice can be vast. Legal standards tend to be ideals, not necessarily achievable.

Then, what new or strengthened institutions will increase the attractiveness of an economy to FDI inflows? Which political institutions provide FDI to attract higher levels of FDI flow?

Recently, Turkey has made considerable progress in modernizing its business legislation. In the first half of the 1980s there were major reforms, and a second wave that began in the mid-1990s is still underway. While there are some gaps in the body of laws and regulations, poor implementation of existing legislation is the main problem. Missing implementing rules and administrative guidelines, inconsistent application of laws, incompetent bureaucrats in charge, and lack of judicial enforcement are the main problems.

In order to increase the quality of institutions in order to enjoy high economic growth rates and receive high levels of FDI inflows the state should adopt several policies such as introduction of independent regulatory agencies in various fields such as competition, banking, and telecommunications; adoption of modern legislation to protect industrial property rights; invitation of all relevant business association to comment on draft legislation.

Therefore, institutional reform –adapting institutions to perform new roles and functions in harmony with social needs – is a key ingredient of successful reform for developing countries, including Turkey.

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Chapter 8

A POLITICAL ECONOMY ANALYSIS OF THE TURKISH MILITARY'S SPLIT PERSONALITY: THE PATRIARCHAL MASTER OR CRONY CAPITALIST?

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"The nationalist not only does not disapprove of atrocities committed by his own side but he has a remarkable capacity for not even hearing about them" (George Orwell).

"Considered from this aspect then, OYAK represents a unique model, the likes of which are not to be found elsewhere in the world and one whose successful results have a proven track record" (OYAK Annual Report, 2007: 1).

"It is out of question to cancel the OYAK membership at will" (OYAK Holding Membership Regulations, http://www.oyak.tr).

"There are only two families in the world, as my grandmother used to say: the haves and the have-nots" Sancho Panza in *Don Quixote de la Mancha*, Miguel de Cervantes.

"Big industry created a class, which in all nations has the same interest and with which nationality is already dead" (Marx and Engels, 1964: 76).

ABSTRACT

The Turkish economy has gone through a radical transformation since the early 1980s and has been pointed out both as the poster child and the scare crow of IMF and World Bank sponsored liberalization programs. Among the failures of the neoliberal experiment, persistence of corruption and crony capitalism stand out. What this chapter attempts to do is to provide a discussion of the fault lines that created and fed rent-seeking coalitions among several actors in the economy, including the military, state bureaucracy, labor and private businesses. In particular, the chapter explores the market distortions created by the Turkish military as it played the role of a neo-mercantilist capitalist entrepreneur. The chapter also analyzes the mechanisms through which the military

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managed to adapt to the liberalized market system of the post 1980s without facing any significant objections from other political and economic actors.

INTRODUCTION

The Turkish economy and its political/institutional infrastructure went through a series of changes following a military coup in 1980. The new economic paradigm under the guidance of neoclassical economic theory and the flagship of neoliberalism required a complete liberalization and deregulation of both goods and capital markets based on the assumption that free markets inevitably generate the most optimal allocation of resources. The economic coup engineered by the International Monetary Fund (IMF) and World Bank (WB) and wholeheartedly embraced by the military junta of the time was believed to bring about macro and micro-economic stability, higher investment, capital accumulation and employment, and faster growth. On the political side, the new economic model also claimed that as people became *free to choose* in the market place without the interventions and restrictions of the state, they would also demand a more democratic and less bureaucratic (*a.k.a.* smaller) government. Ironically, however, the liberalization, deregulation, and privatization plans and the required limits on labor's bargaining power proved difficult for the supporters of this plan under a democratic regime. Therefore (as elsewhere such as in Chile) a military coup made it easier for the pro-free market (but apparently not pro-democracy) policy makers. Thus, the structural shift from the Import Substituting Industrialization regime to free market model took place under a military dictatorship that, seeing organized labor and civil society as an obstacle for free-market reforms, imposed strict restrictions over labor union rights and shredded labor's bargaining power during 1980-1983 (including severe restrictions on union activities and collective bargaining rights, closing the second largest labor union, DISK, etc.).[1] Furthermore, changes under military dictatorship became institutionalized through the 1982 constitution and the accompanying changes in labor law, tax codes, etc. As a result, even after the partial re-transition to democracy in November 1983 considerable restrictions over labor's bargaining power persisted together with a continuing ban on the political parties established before the coup. Although, the return to the multi-party democracy took place with the elections of 1987, the political background (that of being implemented under the military rule) of the policy shift led to a strong commitment to the non-reversibility of the course of the reform program (Cizre-Sakallioglu and Yeldan, 2000:494-497; Öniş and Webb, 1994:128-184).

In retrospect, after three decades of failed policies (in both economic and political terms[2]), what is surprising in the Turkish context is the reluctance of policy makers to question the validity of the assumptions built in the economic (and political) programs Turkey adopted since 1980s. Few scholars have noticed the limitations posed by the institutional characteristics and the political environment of the country in determining both the nature of

[1] For further analysis of labour market response to structural adjustment, see Boratav (1990), Boratav and Yeldan (2002), Demir and Erdem (2010), Öniş (1988), Şenses (1996), Yeldan (1995).

[2] For a discussion of the economic failures, see Demir (2004 and 2009a).

the structural adjustment process and the following economic performance.[3] In this respect, the current chapter focuses on the role of the military-business relationship in creating a fertile environment nurturing rent-seeking and corruption leading to an un-transparent and crony-capitalist market system. The paper also argues that in semi-democracies like Turkey where there exists a strong state hegemony over the society with its military and bureaucratic institutions, lack of democratic accountability and transparency in economic and political affairs further deteriorated the already fragile democratic infrastructure in the country.

1. THE MILITARY, THE BUSINESS AND THE FREE MARKET FAIRY TALE[4]

The role of military in semi-democracies like Turkey is a popular field of research for academicians. In this respect, the Turkish military as a political actor has long been a focus of attention. Yet, as I wrote back in 2004 "its role in the country's *civilian economy* is left almost completely unexplored" (Demir, 2005: 676). Unfortunately, little has changed since then. The lack of academic research is also not limited with the military's direct involvement in the market through its semi-private corporations and business dealings (which I discuss next) but also extend to the allocation of military expenditures from the central budget.

Despite the ups and downs in the economy and shrinking public spending on basic accounts like health and education, the military expenditures have continued to have a dominant share in the central budget (Günlük-Şenesen, 1995, 2002, 2004, 2009). In this respect, as an indicator of its political power and autonomy, the military is almost completely free from any civilian control over its budget.[5] Although any spending from the central budget is subject to parliamentary approval, in practice defense budget is the only item that passes without any discussion or criticism in the parliament despite the fact that it accounted for at least 14% of the budgetary (non-interest) expenditures during 1998-2008 (Günlük-Şenesen, 2009:173). In fact, up until 2003, based on an article put into the constitution under the military government in 1971 and further extended in coverage in 1985, the military expenditures and military owned public assets were not subject to the auditing of Turkish Court of Accounts (Sayıstay). This article was removed and all military spending was finally opened to the auditing of Sayıstay in 2003 as a part of constitutional changes in accordance with the EU legislation despite strong resistance from the military (see e.g. Akyeşilmen, 2009:15; Alpay, 2004; Altan, 2004; Cemal, 2003; Karakaş, 2009). As a last step, in 2008, an

3 For an analysis of the relationship between politics and the economic liberalization programs of the 1980s, see e.g. Boratav (1993), Cizre-Sakallıoğlu and Yeldan (2000), Öniş (1998).

4 This section is partly based on Demir (2005).

5 Another sign of its political power is that the Chief of Staff is appointed directly by the president and is subordinated to the prime minister instead of the ministry of defence. Likewise, up until July 2009, the military courts could prosecute civilians and were fully responsible for prosecuting military personnel who commit any crime including ordinary ones as well as the military related. In one controversial example of the effects of this dual judicial system was during the Şemdinli trial in 2006 when the civilian courts sentenced two non-commissioned officers (who were caught red-handed in November 2005 in a bookstore bombing in Şemdinli, Hakkari) to 39 years in prison, only before the military court released them all (BBC, 2006, 2007; Today's Zaman, 2009a). For an in-depth discussion of the sources of the Turkish military's autonomy, see Bayramoğlu (2004), Cizre-Sakallıoğlu (1997); Kardaş (2004, 2009) and the collection of articles in İnsel and Bayramoğlu (2004) and Bayramoğlu and İnsel (2009).

extra-budgetary fund, National Defense Industries Support Fund (that was established in 1986 and with its $2.5 billion annual revenue was bigger than the aggregate total budget of ten ministries in 2007) was also opened to Sayıstay's inspection (Onaran, 2008).[6] In addition to the direct budgetary allocations, looking at some other economic benefits it enjoys, the military, among 50 other public offices (including the parliament, ministries, courts, police force, etc.), controlled 28% of the total 209,663 public housing units and 20% of total 2,099 other accommodation units (such as holiday resorts and guest houses) in 2009. Compared to the number of personnel, this means that there are 0.8 public housing units available for each military personnel (given a total of 57,220 public housing units available for 73,657 personnel including the ministry of defense, gendarmerie and coast guard) while there is only 0.14 and 0.05 for each personnel of the ministry of justice (with 13,114 public housing units for 94,651 members) and the ministry of education (with 44,096 public housing units for 852,052 members), respectively (Akay, 2009: 159).[7]

However, despite constitutional changes, there is still no sign of increased scrutiny over the size and allocation of the military budget, as also admitted by the minister of defense (Gönül, 2007). For example, it took only 20 minutes to pass the military budget in the parliament in 2007 with no discussions (Akyeşilmen, 2009:15). Furthermore, there is evidence that the military continues to restrict any attempts of civilian control and supervision over its budget.[8] In fact, there is no public disclosure of even the exact salary levels of the military personnel (Akay, 2009: 128). Therefore, given this lack of transparency surrounding the military, the total amount of military spending is controversial and the official figure is a true understatement of its actual size (Günlük-Şenesen, 1995, 2002, 2004, 2009).

On the other hand, apart from direct military spending channels through budgetary means, there exist two unique channels through which the military is directly involved in market activities. These are the Armed Forces Trust and Pension Fund (or OYAK with its Turkish abbreviation), and the Foundation for Strengthening the Turkish Armed Forces (TSKGV), which are not included in the computation of defense budget.[9]

OYAK, as a pension fund, was established by the Parliament in 1961, after the first military coup, to provide *economic benefits* for military officers. The article one of law of OYAK (law number: 205) stated that; 'The Armed Forces Mutual Assistance Foundation was founded to be bound to the Ministry of National Defense, and to provide members of Turkish Armed Forces with social assistance set out herein… The Foundation shall be subject to

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[6] Policy makers in Turkey increasingly referred to extra-budgetary means to finance government expenditures, which are free from the supervision and control of the parliament (while there were 47 EBFs in 2001, their number dropped to five by 2007. Yet, their total revenues amounted to more than $16 billion in 2007 when the general budget revenues were $142 billion). The scale of rent distribution among various groups is hidden by the use of these funds.

[7] For a discussion on this point, see İnsel (2004: 51).

[8] It is reported that in an incidence in 2003 the military prevented Sayıştay inspectors' access to military barracks using an internal legislation dated 1969 (Sarıibrahimoğlu, 2008). For a discussion, see Akay (2009), Akyeşilmen (2009), Hür, (2009a), and Karakaş (2009).

[9] TSKGV is a sister corporation established in 1987 that has major shares in 18 defense related companies, whose range of production is diversified from aircraft artillery to missiles and telecommunication systems. In 2006, its total revenues amounted to $37 million and total assets to $350 million in current dollars (Tercuman, 2007). The total sales of its firms, on the other hand, exceeded $600 million in 2005. Similar to OYAK, TSKGV enjoys certain legal privileges such as exemptions from foundations tax, income and inheritance tax (on donations) and stamp duty. For a discussion of TSKGV, see Akça (2004, 2006), Bayramoğlu and İnsel (2009), Günlük-Şenesen (2002, 2009).

provisions of private law under this Law, and shall become a corporate body with financial and administrative autonomy.' However, the Board of Representatives of this *private corporate body*, according to the same law, is presided by the Minister of National Defense, or in his (her) absence by the Chief of General Staff. The general assembly, on the other hand includes the Minister of National Defense, the Minister of Finance, the Chief of The General Staff, Commanders of Land Forces, Naval Forces and Air Forces, General Commander of the Gendarmerie, etc. As of 2008, six of the nine members of the board of directors (of this private pension fund) were military affiliated (four active and two retired generals).

In contrast to its initial mission statement (to be only a *pension fund*), OYAK has long been a conglomerate consisting of vast holdings with activities including insurance, investment banking, automotive, petroleum, iron-steel, and cement industries, tourism, food marketing, etc.[10] For almost a decade OYAK has been ranking in the top-three conglomerates in the country, and despite its persistent denials (see for instance its Annual Report, 2008:3, where it claims to "have never received any aid from the state or any other organization) continues to enjoy several unique and generous sets of subsidies from the state including tax exemptions[11], and legal protections that are enjoyed only by public offices.[12] In addition, the military members (army regulars, defense ministry employees, etc.) pay compulsory fees from their monthly salaries. Specifically, a 10% compulsory levy is directly cut from the net salary of around 202,000 serving military personnel.[13]

At the end of 2008, OYAK had shares in fifty companies (forty-six of which were majority stakes). Many of these subsidiary companies of OYAK are affiliated (or jointly-owned) with domestic and international corporations including (ownership shares in parenthesis) French car giant Renault (49%), tire company Goodyear (till 2005), AXA (50% till 2007), DuPont, Mobil, Shell, Koç, Sabancı, etc. In addition, OYAK enjoys regional and national monopolistic and oligopolistic market power in many of its businesses such as in cement and car industries where its total market shares reach 11% (making it the second largest cement producer after the Sabanci group) and 15% (making it the market leader). In addition, till recently it owned a major bank (Oyak Bank), and as of end of 2008 its portfolio management company was ranked 2nd in net sales (and 8th in total assets and number of active accounts) among all brokerage firms. In this respect, the business performance of OYAK with

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[10] For a detailed list of OYAK affiliated companies see OYAK web page: http://www.oyak.org.tr.

[11] According to Article 35 (of OYAK Law), the exemptions of the Foundation include foundations tax, income and inheritance tax (on donations made to the Foundation and the assistance provided to its members or to their legal heirs), stamp duty, income tax (on dues collected from the permanent and temporary members), and expenditure tax.

[12] According to the article 37 (of OYAK Law), "the entire property as well as the revenues of and credits to the Foundation shall enjoy the same rights and privileges as State property. Offences against them shall be subject to the same legal action as offences against State property."

[13] Despite the fact that these mandatory fees are a major source of cash flow for OYAK, these "share holders" have little saying in the management or auditing of this *private* holding, given that the board of directors are appointed and not elected (Talu, 2009: 135). TEMAD (Turkish Retired Non-Commissioned Officers Organization) publicly complained and filed a court suit against the OYAK management for excluding them from the board of directors and auditors. TEMAD president is reported saying that there is no non-commissioned officer in the boards of directors of any of the OYAK firms, instead it is secretly decided which general will serve in which company's board of directors prior to their retirement (Milliyet, 2005). Moreover, reserve officers, who are admitted as temporary members during their draft service, face a mandatory 5% cut in their salaries for OYAK without enjoying the same benefits full time army officer have (they receive only a limited life insurance benefit).

annual real profits growing more than 100% at times during the 1980s and 90s poses serious questions regarding the involvement of the military in the economy.

The presence of such a large hybrid military-business holding helps shield the military from the negative effects of economic downturns while the rest of the society has no such safety net. This also correlates with the continuous resistance by the military against the civilian attempts to reduce the size of the military spending in the face of a growing debt burden and ensuing austerity measures (Günlük-Şenesen, 2004). The reduced public spending on basic accounts such as education and health did not have any direct impact on the military thanks to its relative autonomy in determining its own budget and spending decisions without any effective supervision by the government.[14] This absolute autonomy, combined with the benefits provided by OYAK prevented the military from directly experiencing the negative effects of the structural adjustment programs and successive economic crises.

Another example of the moral hazard problem created by the special status of OYAK is the privatization experience of Turkey during the 1990s and 2000s. Despite its quasi-public status and its claim to be only a pension fund, OYAK has been a frequent bidder in privatization auctions and acquired majority shares in several cement companies (Niğde, İskenderun, and Elazığ Çimento), a major bank (Sümerbank), a paper processing firm (SEKA Çaycuma) and the largest iron and steel plant of the country (Erdemir). In addition to certain questions regarding the objectivity of the privatization agency in choosing among the bidders, one of which is directly affiliated with the military, there have been several other issues with the privatization process that need to be addressed.

One such questionable case is the sale of Sümerbank, which then included five other failed banks (Egebank, Yurtbank, Yasarbank, Bank Kapital, and Ulusal Bank that were merged into Sümerbank in 2001 under the directorship of Banking Regulation and Supervision Agency (BRSA)). Sümerbank was sold to the OYAK group to be merged into Oyak Bank in August 2001 and had 135 branches with 3,198 employees at the time of its transfer. Despite its $1.6 billion asset size that put it in the top 6 among private banks, Sümerbank was sold *without an auction* at a "cherry pick price" of $38,000 (52,000 YTL). Making the deal even more controversial was the fact that for the transaction BRSA lent a one year loan of $488.2 million (672 trillion Turkish Liras) to OYAK (as a part of transferred deposits for capital adequacy requirements) at a 15% interest rate for the first 5 months (BRSA, 2001).[15] This was at a time when the interbank interest rates were over 80% and deposit rates were above 60%, and the consumer inflation was 70% (for those last 5 months of 2001). Besides, the Turkish lira depreciated by around 8% during this period which would correspond to around $39 million loss for the public. The acquisition of Sümerbank made

[14] As a recent example of the military's ability to increase its economic benefits at the expense of the rest of the society, in 2007 there has been a change in the military personnel law that extended the publicly provided economic benefits (including health insurance) to the military families raising the age limit to 25 (from 19) for male children while eliminating the age limit for the female children up until marriage (Akyeşilmen, 2009:15; Haber 7, 2006). The age limit of children for non-military families, however, is 18, and can only be extended up to 25 in case of university attendance for both genders.

[15] As an admission of the below the market rate offering at 15%, it was stated in the agreement that for the second six-month period, the interest rate would be calculated as the average lending rate of the largest five banks. Also, in case the balance sheet profit of the merged bank (Oyak Bank + Sumerbank) exceeded 110 trillion liras ($76.4 million) as of December 31, 2001 (and ($67.3 million) as of December 31, 2002), 50% (37.5%) of the portion that was above this amount would be paid as additional interest to the Savings Deposit Insurance Fund (administered by BRSA) (BRSA, 2001).

OYAK Bank, which at the time was a small size bank with a size 13 times smaller than Sümerbank, an important market player (Oyak Bank had only 11 branches and 488 employees just before the acquisition in 2001).

In less than six years, that is between the sale of Sümerbank in August 2001 to Oyak Bank and the sale of Oyak Bank to ING in March 2007, the Oyak Bank grew from 11 branches to 360 with the number of employees reaching 5,581. At the time of its sale in 2007, Oyak Bank ranked 5th among all private banks in total number of branches, 7th in total assets (reaching $8.3 billion), and 8th in total credits (reaching $5.2 billion). Back in March of 2001, on the other hand, among all private banks it ranked 33rd in total assets (totaling only $395 million) and 30th in total credits (totaling $107 million) (Turkish Banking Association online database). Its share in the total assets of the banking sector was then a bare 0.3%. As such, it is clear that Oyak Bank became a leading market player thanks to its acquisition of Sümerbank (as correctly predicted by the head of BRSA at the time of the sale[16]). At the end, the OYAK group sold Oyak Bank to the Dutch banking and insurance group ING for $2.7 billion in March 2007. According to OYAK Group's CEO, "The sale of Oyak Bank is important both as a strategic success and in terms of the liquid financial potential that it generated for OYAK. Expressed in US dollars, the earnings from the Oyak Bank sale correspond to nearly all of the gains secured by OYAK during the years of 1961 – 1999. We purchased Oyak Bank for USD 36,000. In just five years' time we transformed it into an asset worth USD 2.7 billion. By selling it, we increased our members' assets by more than 50% in a single stroke" (Ulusoy, 2007a: 17). In addition, according to the sale agreement, the BRSA required that the new joint bank (of Oyak Bank and Sümerbank) would not be re-sold [to another party] for a minimum of five years. In case it was, BRSA would receive 25% of the sale price, which itself suggested that Sümerbank was highly underpriced. The five year probation period was expired in August 2006, and as admitted by its chairman, the OYAK group started looking for a potential buyer right after that date (Türker, 2008).[17]

In addition to the special privileges provided at the expense of the public and private sector that helped secure such gains, OYAK frequently used its special status as a military owned company to gather public support for its participation in some privatization programs. For example, in 2005, OYAK purchased the majority stake (46%) of the privatized (world's 13th largest) iron-steel company, Erdemir, for $2.9 billion. Prior to its privatization, the public was bombarded with a PR campaign by the ultra-nationalist groups calling for a Turkish firm to buy such a strategically important company.[18] Some nationalist NGOs, newspapers, labor unions and chambers of occupations such as the Union of Chambers and Stock Exchanges of Turkey (TOBB) and Ankara Chamber of Trade (ATO) were even calling for public protests

[16] Head of BRSA, Engin Akçakoca, in his speech during the transfer ceremony stated that "I believe that the sale of Sümerbank is a correct step for the OYAK group to reach the size it has long deserved" (Sabah, 2001).

[17] Given the fraud allegations in the sale of Sümerbank, it is reported that inspectors under the orders of the Prime Minister (PM) started an investigation in 2005. According to the classified inspection report that was submitted to the PM Erdogan, the inspectors failed to obtain a complete record of all the assets that were transferred from Sümerbank to Oyak Bank. It is also reported that the investigators could not verify whether the sale price was valued correctly since there were no other offers to be compared (Özay, 2007).

[18] Interestingly, despite the nationalistic rhetoric, it is revealed that OYAK-Renault is possibly the only car manufacturer that does not buy its iron and steel supplies from Erdemir but chooses to import them from a French company located in France despite the obvious cost disadvantage (Çiftçi, 2005).

against its possible sale to a foreign firm.[19] Moreover, during a meeting (prior to the sale of Erdemir) with OYAK dealers in Antalya in 2005 the CEO of OYAK (Coşkun Ulusoy) (wearing a t-shirt with the colors of Turkish flag) is reported saying that "strategical organizations [such as Erdemir, Turk Telecom and Tupras] should not be privatized… Foreign firms that buy [Turkish] firms and banks have connections to foreign governments. In other words, our state is selling and foreign states are buying. This makes me sad as a Turk. If they needed to be privatized, it should be the Turkish firms that are buying" (Bulut, 2007).[20]

However, according to press reports, it took only a few months for the OYAK Group to start negotiations for a partnership with the multinational steel giant Arcelor-Mittal that later acquired 25% of firm in the stock market.[21] Likewise, the same OYAK had no problem selling its Oyak Bank (that dealed with all financial transactions of the Turkish army including all personnel payments and private financial transactions of its personnel and enlisted army conscripts) to ING.[22] From 2005 up until its sale, no other bank or financial institution were allowed to open branches or have ATM machines within the military barracks. In response to growing public criticism against the sale of Oyak Bank and increasing share of foreign ownership in the banking sector, especially after such nationalist statements, OYAK Group responded claiming that the sale of Oyak Bank would not have any significant effect on the market given its limited market share (around 3%). More interestingly, especially in view of the resistance by the military to the legislative changes for the European Union (EU) membership of Turkey, the chairman of OYAK, (retired lieutenant general) Y. Türker, defended their sale decision arguing the following: "Isn't entering EU one of our goals as a country? Isn't one of four main items that will have free mobility in EU finance, capital, [and] resources?" (OYAK Dergisi, 2008:5).

Moreover, some of the criticisms against the sale of Oyak Bank to ING regarding the sensitive information held by the bank were rebuffed, calling the critics "un-informed, ignorant people". Accordingly, "the claim that secrets of the army will be available to the foreigners is not correct. If the claimants could think of this possibility, it is not possible for the OYAK management including high ranking military commanders not to think of the same" (Türker, 2008:6). As clearly implied by this statement of its chairman, OYAK is *NOT*

[19] The fact that labor union (Turkish Metal) opposition to the privatization of Erdemir stopped overnight after its sale to the OYAK group raised questions about the union's motivations. That is, whether it was because of their interest in worker rights, class struggle, or plain nationalist reaction? (Karakaş, 2006). Likewise, the very same Turkish Metal Union silently accepted a 35% wage cut for its 13,000 members working in Erdemir in 2009 (Küçük, 2009; Radikal, 2009). While this was claimed to be because of the global economic crisis, just recently CEO of Oyak, C. Ulusoy, had claimed that the crisis had not affected Oyak group.

[20] Up on wide-spread criticism of C. Ulusoy and OYAK management for the sale of OYAK Bank to ING despite such earlier nationalistic statements during the privatization of Erdemir, C. Ulusoy put out a statement in OYAK web page in June 2007 with the following similar (allegedly the original) text of that 2005 speech: "I certainly didn't want strategical organizations such as Turk Telecom, Tupras, and Erdemir to be privatized. Friends, these are strategical organizations…These are founded by sweat, tears… and lives … and now we are selling them. If needed to be sold, they must be in our hands… It is as if the Turkish government is saying that I don't want [them], is there any other country that wants? Come and take. Either foreign state institutions or disguised special institutions [controlled by other countries] are entering the auctions. These points sadden [me] as a Turk" (Ulusoy, 2007).

[21] Evrensel (2005), Zaman (2005b).

[22] The examples of sale of OYAK firms to foreign companies can be multiplied. See for example, the sale of cement firm, Elazig Altinova, to Cementir in 2006.

a private company.[23] Besides, the manner in which the OYAK management responds to its critics also fits more a military organization then a private pension firm. In 2007, OYAK sued five journalists and economists (Prof. Aydın Ayaydın, Prof. Güngör Uras, İbrahim Haselci, Metin Münir, and Yiğit Bulut) for $2 - 4 million each for criticizing the purchase of Erdemir by the OYAK group claiming that the journalists in question "damaged the reputation and economic interests and relations of the holding". It also sent a warning letter to an economist, Prof. Deniz Gökçe, threatening to sue if he continued to write negative comments about the holding. In the complaint, one of the journalists, Metin Münir, is even implicitly accused of being a foreign "spy" [24] (Referans, 2006).

2. THE TURKISH MILITARY-BUSINESS EMPIRE: A TERRESTRIAL OR A CELESTIAL ONE?

Figures 1 and 2 show the growth of OYAK Holding during the 1990s. They suggest that the increasing power of quasi-private military owned corporations in the economy not only generated a distorted market structure but also led to the legitimization of unfair competition against other market players who do not have the same privileges OYAK and its affiliates enjoy. Looking at the profitability figures, we see that real net profits of OYAK steadily increased from around $76 million in 1988 to as high as $1.9 billion in 2007. In comparison, its average balance-sheet profits in constant 2005 dollars increased by a product of 1.8 from 1960s to 1970s and 1.03 from 1970s to 1980s. In contrast, its real profits increased by 7.2 times from 1980s to 1990s. Even during 2000-2008 that includes two crises periods of 2001 and 2007-8, average real profits jumped up by 2.4 times compared to the 1990s. In fact, between 1990 and 2007 when the average annual real GDP growth was 4%, the average real growth rate of OYAK Holding's profits in dollars (liras) was 17% (16%) (during the 1990s, it was 15%). Thus, it is not far-fetched to argue that OYAK has been one of the main benefactors of the economic liberalization programs. Such figures may also hint one of the unexplored dynamics behind the strong commitment of successive governments (and military generals) to the non-reversibility of economic liberalization programs.

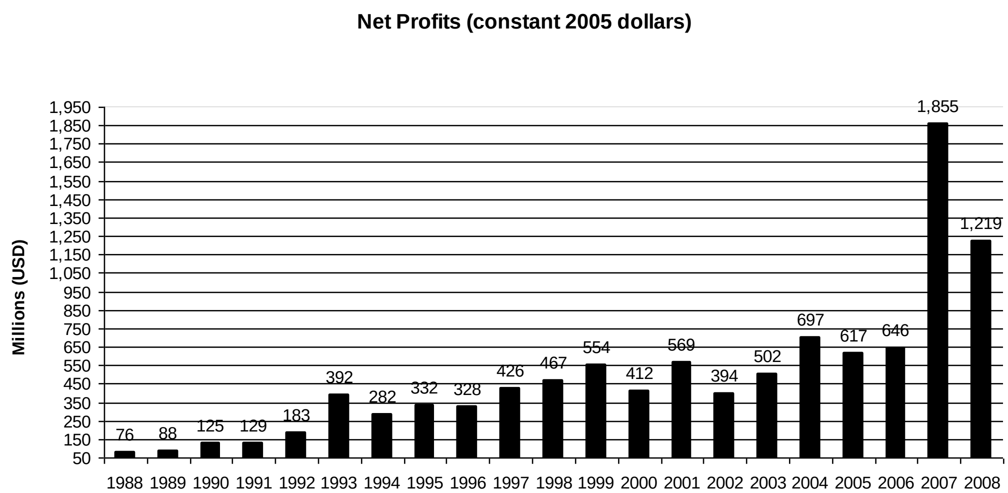
Even without the special privileges provided to OYAK, the system creates a suitable environment for serious moral hazard problems. To list a few, there is no public disclosure regarding the military's access to classified economic decisions (directly through National Security Council or indirectly through its own institutional means) that may have direct effects on OYAK's operations in the market. For example, was the military informed of the devaluation decision on February 23, 2001 that ended the crawling peg exchange rate regime (adopted under the IMF sponsored anti-inflation program)?[25] The devaluation led to the depreciation of the currency by 40% overnight and was preceded by a sharp fall in the stock market together with skyrocketing interest rates as high as 5,000% in the interbank money

[23] This probably explains the insistent claims of OYAK that "OYAK is not a part of Turkish military forces", or that OYAK "has never received any aid either from the state or any public institution (OYAK Annual Report, 2008).

[24] In 2007, the court rejected the complaint and dropped all charges.

[25] It is reported that the portfolio manager of OYAK Holding admitted that, thanks to her "gut-feeling", she moved to the dollar from Turkish lira right before the devaluation (Hür, 2009a).

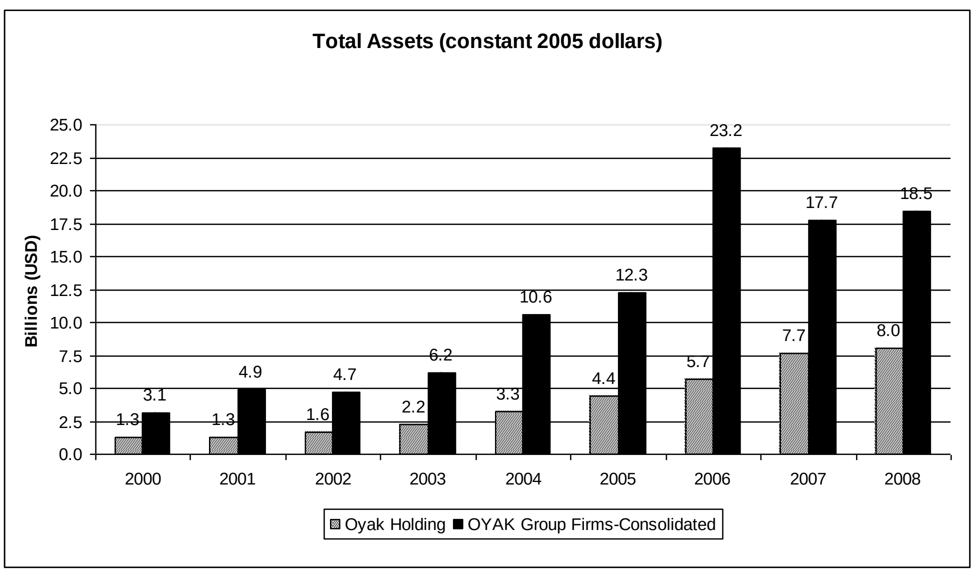
market. Given that OYAK owned a major bank and a brokerage firm at the time, the extent to which such a move could lead in terms of profit margins is undeniable. Likewise, whether in practice the market rules and regulations (such as insider-trading laws, anti-trust laws, etc.) are equally applied by the BRSA, Capital Markets Board, and the Competition board, among others, to those firms and financial institutions that are owned by OYAK?



Source: OYAK Holding Annual Financial Statements.

Notes: The figures 1 and 2 are in constant US dollars deflated by the US Wholesale Price Index (2005 =100).

Figure 1. OYAK Holding Net (Actuarial) Profits.

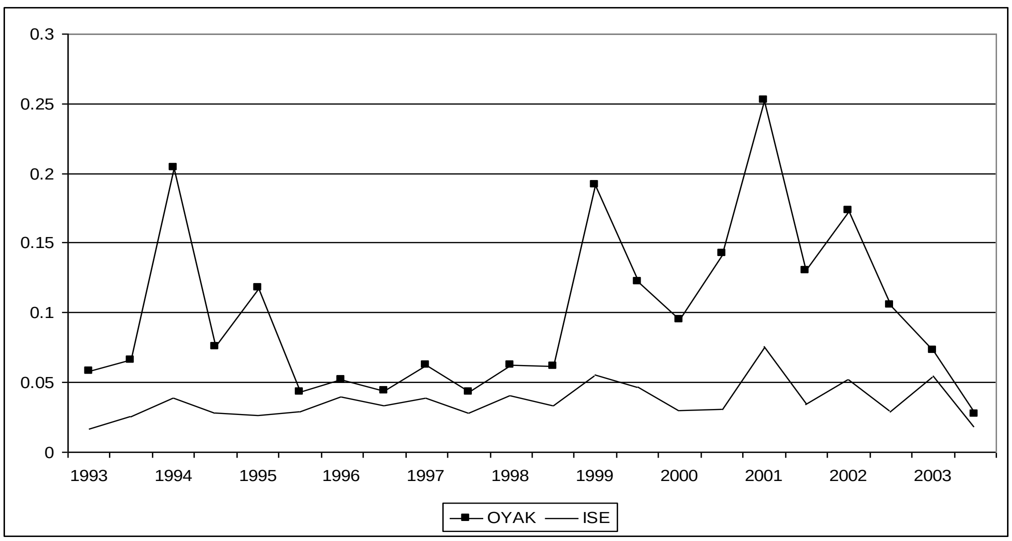


Source: OYAK Holding Balance Sheets, Various Years.

Figure 2. OYAK Holding Total Assets.

Given the lack of detailed data (that are not available except for those OYAK firms that are publicly traded), it is very difficult (if not impossible) to have definite answers to these questions.[26] However, looking at the available income statement data, we can see that financial revenues (that include revenues from deposits, stocks, bonds, portfolio transaction profits, investment fund interest earnings, and foreign exchange transactions) on average accounted for 33% of total revenues of OYAK during 2000-2008. Focusing on 2001, we see that more than 31% of financial revenues (that accounted for 40% of total revenues that year) came from one single account that was the foreign exchange transactions.[27]

In figure 3 we compare the median net financial profits from non-operational activities (including *foreign exchange transactions*, interest earnings and dividends from participations) to sales ratio of eight OYAK owned publicly traded real sector companies with other non-financial firms traded in the Istanbul stock exchange market (ISE) using semi-annual data between 1993 and 2003. The figure shows the importance of financial profits and can be used as an indicator of the degree to which *real sector firms* are involved in the *financial sector* investments.[28]



Source: Istanbul Stock Exchange online data dissemination system. Available at: http://www.imkb.gov.tr

Notes: OYAK refers to the median of eight OYAK owned firms including Adana Cimento, Aselsan, Bolu Cimento, Hektas, Mardin Cimento, Nigde Cimento, Tukas, and Unye Cimento. ISE refers to the median of non-financial publicly traded firms at Istanbul Stock Exchange. The financial profits are net of losses and expenses from other operations and include all non-operational profits excluding interest expenses. Sales are on a net basis.

Figure 3. Median Financial Profits/Net Sales Ratio of OYAK Owned firms vs. Istanbul Stock Exchange.

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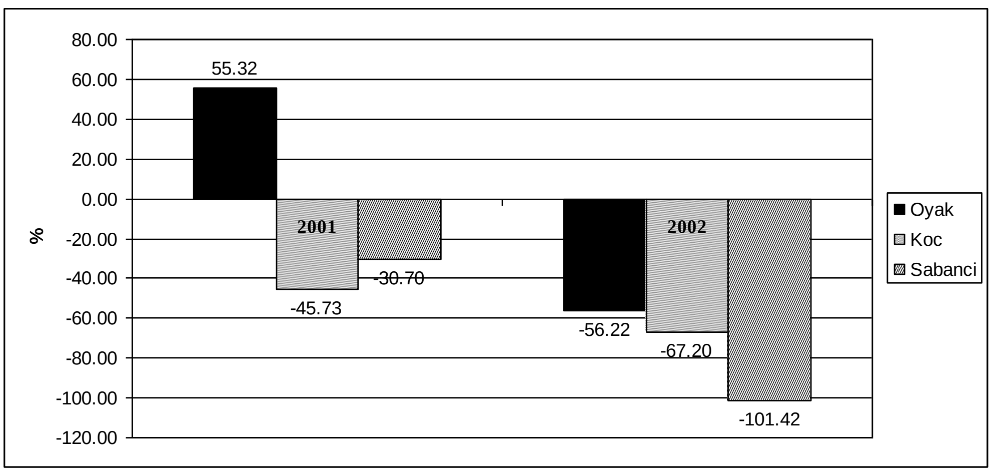
[26] OYAK Holding did not disclose its financial statements prior to 2000, and even after that the details of its annual statements and their aggregates are not publicly available.

[27] For this, we use annual income statement data acquired from OYAK holding rather than the annual reports from its web page.

[28] For an in-depth discussion on this point, see Demir (2009b).

Accordingly, between 1993 and 2003 on average the median net financial profits to net sales ratio of these eight firms was 274% higher than the median among 152 publicly traded firms. In fact, the median (mean) financial profits/net sales (*fpns*) ratio for OYAK firms reached as high as 20% (19%) and 25% (36%) in the first half of 1994 and 2001, which are also the dates for the two of the most serious economic crises when the domestic currency was devalued by 39% and 40% overnight on April 6, 1994 and February 23, 2001 respectively.[29] Accordingly, the OYAK firms exceeded market median in *fpns* ratio by a 5.24 times in 1994:1 and 3.32 times in 2001:1. Furthermore, OYAK holding's performance also surpassed its rivals such as Koç and Sabancı holdings during the 2001 crisis and its aftermath in 2002. According to figure 4, which shows the growth rate of real net profits (in Turkish Lira) of OYAK in comparison with Koç and Sabancı holdings (before taxes) in 2001 and 2002, OYAK performed significantly better than the other two with a miraculous 55% growth rate in 2001. Looking at the revenue and expense accounts of TSKGV, similar to OYAK, we also see that on average 71% of all revenues of the foundation came from three sources: the stock market earnings, foreign exchange transactions, and interest earnings between 1987 and 2000 (Günlük-Şenesen, 2002:55).



Source: OYAK Holding balance sheets and Istanbul Stock Exchange online data dissemination system. Available at: http://www.imkb.gov.tr

Figure 4. Real Annual Growth Rate of Net Profits in 2001 and 2002 (in constant 2005 Turkish Liras).

Another sign of the economic (and political) importance of the military in the market is that it is a very common practice to hire retired high ranking military officers with no past business experience (or economics knowledge) as advisors or members of boards of directors of private firms.[30] In a widely publicized case during the banking crisis of 1999 (when six banks failed due to high level of fraud) it was revealed that most of the failed banks had

[29] When we exclude Aselsan from the dataset, the median (mean) becomes 19% (18%) for 1994:1 and 31% (42%) for 2001:1.

[30] For a list of former military officers and their new jobs at prestigious private firms, see Atsiz (2005), and http://www.arastiralim.net/batik-isadami-generallerin-listesi.html.

several high ranking military officers in their boards of directors.[31] Accordingly, General Muhittin Fisunoglu (former commander, Land Forces, 1990-93), General Teoman Koman (former commander, Gendarmerie, 1995-97), General Vural Beyazit (former commander, Naval Forces, 1992-1995)[32] entered the board of directors of Sümerbank, Interbank and Etibank, respectively, upon retirement. Likewise, General Guven Erkaya (former commander, Naval Forces, 1995-97) served as an advisor to the owner of (failed) Bank Ekspress and Kanal 6.[33] However, when these banks failed, only their civilian managers were prosecuted for fraud and the former generals were left completely untouched (Yeni Aktuel, 2007). Ironically, to clear their names, the former generals started playing the ignorance and incompetence card. For example, after the bank failures, M. Fisunoglu responded to a question (regarding his expertise to be able to serve in the board of directors of Sümerbank) saying that "one doesn't need to have the technical knowledge [on banking] to serve in a board of directors". He further admitted that when he was first offered the job his initial response to the owner of the bank (Hayyam Garipoglu) was: 'I am not a banker", to which he received the reply that "…then you will act as an elder brother to us". He apparently had no problem with such a vague answer from a businessman since he stated that: "I then found the offer attractive" (Milliyet, 1999). Likewise, trying to prove his innocence during his interrogation at the State Security Court for the Etibank fraud, General Vural Beyazit also claimed that "I don't understand banking" (NTV, 2001).[34] Yet, Hayyam Garipoglu, who was given a 27 years prison sentence for his role in the Sümerbank fraud, complained publicly that "he found it strange that the generals who served with him on the board of directors were not prosecuted". Accordingly, he stated that "even though we had the signatures of each of the members of board of directors on every credit decision that I am accused of [fraud], there was no court case against him [M. Fisunoglu]" (Zaman, 2006).

Regarding the corruption scandals involving the military, a retired Lieutenant General claimed in an interview that the reason he was retired instead of being promoted to Chief General position was his involvement in the disclosure of a recent corruption scandal in the army. Accordingly, upon his disclosure of the production flaws in the military ambulances purchased from a private company, the company sent one of their representatives who turned out to be one of the retired lieutenant's former commanders in the army. The former commander, current businessman, in return threatened the Lieutenant with early retirement instead of promotion, which then came out to be the case (Süsoy, 2004). Likewise, in 2006 two Lieutenant Colonels and 23 soldiers were prosecuted for fraud involving $454 thousand in a military construction project (Radikal, 2006). In a more publicized case, the former general of Naval Forces (1999-2001), İlhami Erdil, was sentenced to two and a half years in jail (that was the *lowest* permissible sentence) in 2006 by the military court for corruption and

[31] During 1997-2004, 22 banks failed in Turkey with a cost of $46 billion to the public (Savings Deposit Insurance Fund, 2004).

[32] It was reported that up on his departure from Etibank, V. Beyazit went on to the payroll of CNR Fuarcılık firm (Yeni Safak, 2001).

[33] Both firms belonged to Korkmaz Yigit, who was jailed for theft for 3 years.

[34] In another controversial example of the business interests of retired soldiers, retired General Staff Chief of Operations Lt. Gen. Koksal Karabay (who was in charge of the Turkish Special Forces when some of his soldiers were detained by the US forces in Iraqi Kurdistan) is reported to be a major partner in an affiliate of the private security firm, Black Hawk, to be set up in Eastern Turkey close to the Iraqi border in 2007. According to the news reports, the partners of the firm also included provincial governor and a retired ambassador (Çölgeçen, 2006).

bribery involving millions of dollars (Akıner, 2007; Yenişafak, 2006). The examples of corruption and bribery scandals involving high level active and retired officers can be multiplied (Çetin, 1999; Radikal, 2001, 2008; Özfatura, 2004, Sabah, 2008; NTV, 2007; Taraf, 2009a, b; Baransu, 2009). Therefore, it was no coincidence that there were popular calls by former generals to the military to make it a rule for soldiers to disclose their wealth upon promotion and retirement (Düzel, 2001). In fact, even the chief of staff, General Huseyin Kivrikoglu, issued a statement in 1999, which was widely ignored, calling retired generals not to work in private companies (Sabah, 1999; Yeni Aktuel, 2007).

Last but not the least, since 2008, there have been a series of high-profile detentions under the investigation into an ultra-nationalist group called Ergenekon (a secret criminal network whose members are accused of having planned and staged coup-attacks and assassinations) including three retired generals, colonels, captains, former police chiefs, head of Ankara Chamber of Commerce, former chairman of the Higher Education Board, university professors , journalists, businessmen and mafia bosses "on charges of forming and leading a terrorist group and seeking to overthrow the government". Furthermore, according to recently disclosed conversation transcripts (in the Ergenekon trial) involving businessmen and high ranking military officers, there is evidence that the military-business partnerships go beyond those that are publicly visible. For example, the owner of one of the three largest business groups in Turkey, M. E. Karamehmet of Çukurova holding, was recorded in 2003 asking a high-ranking military officer for favors regarding his firms and business dealings (Baransu, 2009). M.E. Karamehmet was also recorded asking Gendarme Intelligence Head L. Ersöz for help in his dealings with the BRSA regarding his bank, Pamukbank (Taraf, 2009a, b; also see Today's Zaman, 2008).

Furthermore, as revealed during the Ergenekon trial, rent seeking coalitions also extend to the labor unions and chambers of trade as well. The former (and current *honorary*) head of Turkish Metal Union (that discreetly accepted the sale of Erdemir to OYAK - despite its initial objections and protests against the privatization plan - and the subsequent 35% pay cut for its workers in 2009), Mustafa Özbek, for example, is recently reported to be involved in the Ergenekon plot offering 8 trillion liras ($6 million) from the union budget as a funding source to the coup-plotters. Besides, Mr. Özbek himself is discovered to have millions of dollars of personal wealth (including two 5-star hotels, a TV station and more than 60 real estates in Turkey and abroad), despite the fact that he had no prior occupation other than being the head of the union for 33 years (Bianet, 2009; Haber7, 2009). Likewise, during the arrests over the Ergenekon plot, the police found *unaccounted* 2.5 million Euros in the home of the head of Ankara Chamber of Trade (Sinan Aygün).

In this picture, the inability of domestic pressure groups to prevent the military's involvement in politics and economy resonates with the lack of external pressure from international financial organizations such as IMF or WB. Despite repeated IMF agreements and multiple Structural Adjustment Programs with the WB, there has been no publicly disclosed criticism by these twin institutions of the military budget, its un-transparent nature, or the unfair competition and market distortion created by OYAK. What is equally surprising is the lack of any systematic research in academics on this issue.[35] Similar questions apply to the corruption scandals involving active and retired military officers. Although a quick search

[35] Günlük-Şenesen (1995) raised a similar issue regarding a general lack of interest among economists on economic impacts of Turkish military spending.

in Google revealed over 1.3 million web sites (in July, 2009) involving the word 'OYAK', the academic work done on it is limited with only few studies (e.g. Akça, 2004, 2006, 2009; Demir, 2005; Karabelias, 1998, 2008; Parla, 1998; Yüksel, 1999).

Turning to the private businesses that have to compete with OYAK on uneven grounds, there have been only some minor criticisms, none of which were raised loudly. One such case came shortly after the military's decision in 2005 to ban all banks from military barracks and direct all salary and wage transactions to Oyak Bank. As such, Oyak Bank (up until its sale) became the only banking service provider within military bases. There has been some press reports suggesting that private banks were highly critical of this yet had to remain silent because of fears from the military (Zaman, 2005a). Similarly, when Coskun Ulusoy, the CEO of OYAK Group, claimed in 2005 to have surpassed Koç and Sabancı holdings (that are the larges two holdings in the country) in profitability and productivity, Bülend Özaydınlı, the CEO of Koç holding reportedly replied back saying that 'apple and pear' cannot be compared equally.[36]

One exception appears to be the European Parliament (EP). According to the EP provisional report on Turkish accession, "… the [Turkish] army has much more power than is acceptable for a constitutional state. The National Security Council epitomises the political power of the military. The defence budget is separate from the national budget and is completely outside parliamentary control. The army has an unparalleled power over business, education and the media" (EP, 2003). In 2009, the EP again stated it "regrets that no progress has been made on establishing full systematic civilian supervisory functions over the military and on strengthening the parliamentary oversight of military and defence policy." It also "regrets that the Turkish government has not presented any comprehensive anti-corruption strategy; underlines the need to strengthen parliamentary oversight over public expenditure and the need for new legislation in respect of the Court of Auditors" (EP, 2009).

Although part of the explanation on the Turkish side lies in the institutional and historical setting of the country, the silence of researchers and international organizations on the subject deserves further discussion. To mention a few of the domestic reasons for this general lack of interest, we can list the following: Turkish military has staged three coups with only ten year intervals in 1960, 1971, 1980, and a semi-coup in 1997, and routinely issued ultimatums to the democratically elected governments.[37] As the founding institution of the republic in 1923, the military sees itself as the guarantor and supervisor of the national interests with changing emphasis on the so called national threats, namely fundamentalism, communism, and the ethnic Kurdish separatism.[38] It is a very common practice among high ranked military officers to make political statements and warnings (or even threats to the media and politicians) in press conferences (see, for example, Taraf, 2008, and for a discussion see Bayramoğlu, 2004; Balancar and Elmas, 2009). So much so that the subject matters of the official public statements of military officers range from philosophy and political science to economics and sociology and includes topics as far as labeling "post-modernism" as a danger to the existence

[36] Economist Ege Cansen was among few journalists that criticized OYAK and its involvement in the market through its majority owned firms as well as its participation in privatization auctions (Cansen, 2005).

[37] For a discussion, see Balancar and Elmas (2009).

[38] For an in-depth analysis of the Turkish military as a separate class and the historical, institutional, political and economic sources of its autonomy and hegemony, see İnsel (2004), İnsel and Bayramoğlu (2004), Laçiner (2004a), Bayramoğlu and İnsel (2009), and Karabelias (2008).

of Turkish state.[39] A most recent example of this was during a special press conference by the military involving 36 generals in June 2009 where the Chief of General Staff criticized and denied the legitimacy of newly released reports showing detailed military plans for a coup (Milliyet, 2009).[40] These, together with the existence of repressive political, bureaucratic and legal mechanisms against independent research and analysis created a suitable environment for self-censorship, keping the researchers away from such *sensitive* subjects.[41] To this self-censorship, we also need to add the unquestioned loyalty to Kemalism and the military, which are seen by the state bureaucracy and certain segments of the academia as the only modernizing forces in the Turkish development experience (Bayramoğlu, 2004; İnsel, 2004; Laçiner, 2004a). As a result, many social scientists claiming to be on the Left, or Right side of the spectrum share a common consensus in never questioning the role of the military in economy or politics.

To give a concrete example, despite the presence of a strong anti-corruption camp in the Turkish academia, only few academicians ever raised questions regarding the corruption scandals involving the army, military budget, or the business interests of the military and the crony-capitalist environment its business organizations create (not to mention the military's frequent interventions in the political system and repeated human rights violations).[42] Instead,

[39] Işık Koşaner, the current commander of land forces (and likely future Chief of Staff), in a recent speech criticized and demonized post-modernism. For a discussion, see Berktay (2009). Also, for an example of the chiefs of military staff's references to politics, philosophy, constitutional rights, etc., see Başbuğ (2009). Other examples can easily be found from the Turkish Military Forces web site (www.tsk.org) including the transcripts of the speeches (and press declarations) made by the chiefs of staff.

[40] In one widely circulated news report, the details of persistent military interventions in political system became public. According to the transcripts of a briefing in 2004 given to the PM R.T. Erdoğan (RTE) by the Deputy Chief of General Staff Commander İ. Başbuğ (İ.B) (current Chief of Staff), the following conversation took place (Kılıçgedik, 2009):

İB: You said you took lessons from your experiences, but your actions don't confirm that.

RTE: I changed by improving myself. The media distorts. Black turns to white. We are respectful of the definition of secularism.

İB: It is very dangerous that you emphasize [in your speeches] the concept of "being from Turkey" instead of Turkishness.

RTE: We have no problem with the central tenets of Turkey. We are sad to hear that you are concerned on this.

İB: We are curious whether you see democracy as a tool to transform Turkey into a liberal Islamic country.

RTE: We don't accept the danger of fundamentalism. Islam is my own person reference point not that of the party.

İB: You did not ask [consult] us about the [new] Public Management, Higher Education Council and municipal borders legislations.

RTE: We are not against warnings or demands. We followed your opinions on the Public Management legislation.

İB: Encouraging separatism should be avoided. [Changes in legislations for accession to] the European Union membership can be slowed down.

RTE: If we cannot become a member in 2004, we will have the B-plan in place. In case it doesn't happen, we are having talks with Russia.

[41] As a recent display of military's power and influence, in 2006 a state prosecutor (Ferhat Sarıkaya) who, after the Şemdinli incidence in Van, implicated in his indictment the Chief of General Staff (Yaşar Büyükkanıt) for terrorism, abuse of power and fraud was immediately disbarred (by the Supreme Board of Judges and Prosecutors-HSYK) from all his legal powers and rights as a lawyer and prosecutor (Keskin, 2006). It was later claimed that Ferhat Sarıkaya was disbarred following an order from the General Staff (Today's Zaman, 2009b, also see Balancar an Elmas, 2009: 189-190). In fact, the military is so much immune from political control that in 2004 it could rename a military headquarter in eastern Turkey after General Mustafa Muğlalı, who was tried and sentenced first to capital punishment that was later reduced to 20-year in prison for the murder of 33 Kurdish peasants in 1950. The military headquarter is located in the very same region where the 33 peasants were ordered to be shot dead by the general (for a recent discussion, see Hür, 2009b).

[42] It is very common for the Turkish military to sue anybody who criticizes its involvement in politics or economy using different articles of the Turkish penal code (TCK). For example, in 2005 General İlker Başbuğ sued journalist Rahmi Yıldırım (who wrote that "the pashas who are the unyielding defenders of Ataturk principles

many who claim to be on the left (including academicians, labor unions, newspapers, etc.) have become defenders of a national capitalist class and the military, reminding the corporatist ideology with an alliance of the military, capitalists, labor and state bureaucracy (Laçiner, 2004b). As a result, even a pro-military, pro-dictatorship and ultra-nationalist newspaper (Cumhuriyet) could be portrayed by the same groups as a *torch* against the *imperialist centers* defending the independence and enlightenment ideals of the republic. Thanks to all these factors, it is no surprise that the academic research on the military's economic and political interventions attracted only limited attention.

3. CONCLUSION

The failure of the free market-oriented reforms under the flagship of neoliberalism in uprooting rent-seeking coalitions and crony-capitalism in Turkey should not catch us by surprise. As discussed more than half a century ago by Polanyi, "there was nothing natural about *laissez-faire*; free markets could never have come into being merely by allowing things to take their course. … *laissez-faire* itself was enforced by the state" and that "*laissez-faire* was not a method to achieve a thing, it was the thing to be achieved." (p. 139). Yet, like its predecessor, the neoliberal *liberal creed* ignored this basic rule and fantasized that if we just "let them do" and "let them pass" the markets would self-regulate. Instead, in the Turkish context, the pre-existing rent-seeking coalitions with their class relations survived the transition by adapting to the new set of conditions. The military, in particular, managed to adapt to the *liberalized* market system without any loss of political power while managing to increase its economic muscle using the special privileges it inherited (and skillfully created). In this regard, looking at its business dealings, there is nothing celestial about the objectives or the functioning of the Turkish military. What is surprising is that even though "researchers often refer to the Turkish officer corps as a ruling elite, they avoid treating the military as a socio-economic class" (Karabelias, 2008:1; also see İnsel, 2004 and Laçiner, 2004a). Given its active participation in the market through its (protected) direct and indirect business dealings, and given its use of political muscle to increase its members economic well-being at the expense of the rest of the society, and given its willingness to bond with the domestic and international capital without any regard to the political or strategic sensitivities or nationalistic rhetoric it often raises in the domestic political arena, the Turkish military has become a part of the capitalist class (albeit a neo-mercantilist one) and it should be treated as such.

While in a democracy, the military cannot play the role of an opposition party, or claim to be the final arbitrator on subjects ranging from philosophy to constitutional law; it is equally true for it not to play the role of a capitalist entrepreneur. Otherwise, the inevitable result is the blurring of "the lines between the private and public economy, and between the economic and the political" (Parla, 1998: 49). As of 2009, it yet remains to be seen whether the ripening

and revolutions are in fact the defenders, actors and soldiers of the capitalist order") using Article 301 of TCK for insulting the army with a maximum three year sentence. The charges were cleared only in 2009 after the court dropped the case (Keskin, 2009). Likewise, the military frequently uses the Article 318 (previously 155) of the penal code ("dissuading people from military service" with a maximum sentence of three years) to intimidate its critics. Some recent high profile court cases, among others, included Professor Ali Nesin (in 2000), singers Bülent Ersoy (in 2008) and Zuhal Olcay (in 2000), and journalists Perihan Mağden (in 2006) and Gökhan Gencay (in 2005).

private domestic capitalist class and bourgeoisie will continue to tolerate this *blurring of the lines* and accept different forms of bribery through business partnerships *or* challenge the political and economic hegemony of the military and its coalitions with the *antediluvian fossils*.[43]

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[43] Engels, referring to the conflicts and struggles among the military, government and the bourgeoisie wrote that: "in an atmosphere of daily modernisation, and amongst thoroughly modern capitalists and workers, we find the most wonderful antediluvian fossils alive and active: feudal lords, seignorial courts; country squires, birching, central government officials, local government officials, craft corporations, conflicts of authority, bureaucracy with penal powers, etc. And we find that in the struggle for political power all these living fossils are banding themselves together against the bourgeoisie, whose property makes it the most powerful class of the new epoch and who is demanding that the former should surrender political power to it in the name of the new epoch" (Engels, 1865).

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Chapter 9

AUTHORITARIAN NATIONALISM AND DISCRIMINATION ENDING WITH IMMISERISING MODERNIZATION: ECONOMIC AND SOCIAL CONSEQUENCES OF THE REPUBLICAN POWER ELITE'S FIGHT

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ABSTRACT

In recent years, there has been a growing literature -known as endogenous growth- revealing the fact that human resources are the main constituent of economic growth. Turkey has implemented for a long time a state policy by which human resources have been weakened and paralyzed. This chapter looks into the historical trajectory of this dead-lock policy, linking the basis of the current deficiencies of democracy and market economy in Turkey at institutional level on one hand, and lack of tolerance and xenophobia at societal level on the other. We argue that the Republican era's Jacobean type of ultra-nationalist unification policies explain by and large not only relative economic backwardness, but also ongoing political, economic and social adjustment problems in Turkey.

INTRODUCTION

The Ottoman heritage has a crucial impact on the outlook of modern Turkey's human resources, economic potential, and urbanization level. Nevertheless, one should underline an important differentiation between Ottoman era and Republican period with respect to dealing with human resources. What differentiates Turkey from the Ottoman Empire is not just geography, but even more importantly, it is the differentiation of human resources in various industries and state bureaucracy (Karaçalı, 2007). Ottoman nation ("millet") system was abolished in the Republican era (Mazower, 2001; Glenny, 1999). Authoritarian, nationalist and discriminatory policies first against non-Muslims, and then against conservative-religious Muslim bourgeoisie in recent decades depleted Turkey's human resources and harmed its development potential. This study critically evaluates the Republican state policies towards various social segments inherited from the Ottoman Empire and its detrimental consequences on the composition and quality of human resources. It also briefly touches upon the emergence of the Muslim bourgeoisie over the last 2-3 decades. Throughout the study, it is implicitly assumed that economic development has a causal relationship with social development, and hence human development.

During the Ottoman period, the dominance of "devshirmes" –i.e. non-Muslim boys recruited in their early ages and educated to become bureaucrats in the state bureaucracy-, as well as non-Muslims in economic activities was remarkable. Şerif Mardin states that in the Ottoman period, the state made a choice between political power and economic power, and decided to hold the political power; besides, there was no alternative to substitute for the non-Muslim bourgeoisie (Mardin, 1999: 210). Even though bureaucratic positions, starting from 18^{th} century on, were started to be filled by Muslims, same trend was not observed in industrial sectors, leaving non-Muslims' dominance intact. Ottomans could not transform the insufficient role and functions of the 'Muslim' and 'Turk' elements as the basis of the state structure and society. Steps (Çavdar, 1992) taken from 18^{th} century on to slow down, stop, or even reverse the apparent deterioration in the human resources were futile (Toprak, 1999).

The founding fathers of modern Turkey were bought into the idea of creating an ethnically and religiously homogenous nation-state. Due primarily to their background as soldiers, they adopted a security-focused approach not only for the state affairs, but also for the social life as well. Inevitable consequence of this approach, of course, was a full-fledged state control and command over individual social life. Modern Turkey's founders adopted a radical discourse based on total rejection of Ottoman understanding of the nation, state, and religion; hence tried basically isolationist, inward-looking modernization and nation-building based on uniformity in all aspects: unitary political establishment based on one-religion, one-language, one-nation, one-legal structure, and one-geography. However, new state had neither qualified human resources, nor physical capital accumulation and natural resources to reach its goals (Sachs, 2004; Toprak, 2002).

Turkey's human loss during World War I (1914-18) and the subsequent Independence War (1919-22) is estimated to be around 1.8 million. The loss of qualified, dynamic and highly educated human resources of this size has been a serious handicap for Republican Turkey (Gökaçtı, 2002). Another handicap as to the size and composition of human resources inherited by the Republic was the loss of remaining qualified population due to population exchange (based on a protocol added to 1923 Lausanne Treaty) during World War I and afterwards (Tezel, 1986; DIE, 1973; Bostancı, 1996). This deterioration in the population manifested itself in the reduction of population size, change in ethnic composition, and a remarkable decline in the rate of urbanized population.

There has been no slavery or serfdom in the Republican era, but small-scaled peasantry has been the dominant form of social formation (Altan, 1994; Tuna, 2002). Turkey's total population within its 1923 territory fell from 16.3 million in 1914 to 13.6 million in 1927, which corresponds to a 17% decline. Accordingly, there was a sharp increase in the rural population at the outset of the Republican era while urban population deteriorated considerably due to population exchange. In 1914, Turkey -excluding Kars and Artvin provinces- had a population of 15.9 million, 80% of which was constituted by Muslims, 11% Anatolian Greeks [Rum], and 8% Armenians.

In the Ottoman period, vast majority of the skilled labor force working in the productive sectors were non-Muslims, or the "minorities" as they are called in the context of nation-state. Emigration or forced migration of the non-Muslims -to Armenia, Greece and other Western countries-, population exchange, etc. eventually led to a situation where even the manufacturing industries in Turkey could not work properly. Similarly, agricultural production also deteriorated both qualitatively and quantitatively in many parts of Anatolia. As a result of voluntary and forced migrations, only 110 thousand Anatolian Greeks and 77 thousand Armenians –almost all of which resided in Istanbul- were left in Turkey, hence 99% of the population in the country was then Muslim as of 1927.

Population exchange required that all Greeks -except for those residing in Istanbul as of 10 October 1918- were to leave Turkey, while all Turks -except for those living in Western Thrace- were to leave Greece. As a result, roughly 1.5 million Anatolian Greeks migrated to Greece, while 379 thousand Turks migrated to Turkey (Derin, 1940). This huge population movement inevitably affected rural-urban population structure as well as skilled-unskilled labor composition. To put it bluntly, Turkey was effectively squeezed into a peasant society (Süreyya, 1931). The most apparent feature of this change in population composition during 1914-1927 period was that urban population remarkably declined.

Excluding Kars, Artvin and Hatay, there were only 52 cities with a population of 20,000 and higher in 1912, and only 17.8% of 14.2 million total population lived in these cities. Population of these 52 cities declined in this period by no less than 35%. It is important to note that literacy rate according to 1927 census was 10.6% (DPT, 1963). 81% of the labor force was employed in agriculture, 5% in industry, 9% in construction, and 5% in trade (Ceyhun, 1979). Ismet Inönü's statement fits very well into this picture when he said, "We are a peasant government established in Anatolia," "we love villagers" (Avcıoğlu, 1987).

Given the fact that majority of the population lived in rural areas, one can argue that Turkish society's level of development practically meant the development level of the villages. In light of this, general outlook of the villages before World War I can be described as follows: the villages were isolated from the outer world, living by and large as closed small communities. As being predominantly closed economies, monetary and market-based transactions did not even constitute 20% of total economic activity. Since the peasants produce primarily for self-consumption, there was little room for innovation in agriculture.

State-peasant relations were by and large limited to tax and military services. Due to limited state resources, public services -like piped-water, stabilized roads and bridges, and electricity- in general did not reach the villagers. Almost 80% of Turkish villages were set up in an environment that was not so healthy. It is estimated that 14% of people suffered from malaria, and 9% from syphilis; 72% of the villagers were infested with lice. Households without toilet and other health-related facilities were 97%. Only 7% of the people living under such conditions were literate. General outlook in the cities –except for a few big cities such as Istanbul and Izmir- were not quite different from the villages. "Level of education in the country was very low" (Cillov, 1970).

1. ECONOMIC STRUCTURE AND DOMINANCE OF NON-MUSLIM MINORITIES AT THE OUTSET OF MODERN TURKEY

The average annual growth rate of the Ottoman economy in the period of 1889-1915 was 2%. Since annual population growth in the same period was around 1%, real per capita GDP grew by 1%. However average annual growth in the developed countries was 3-4% in this period. According to 1914 figures, agriculture accounted for 61% of GDP, mining 0.5%, manufacturing industry 11%, construction 2%, and trade 8% (DIE, 1973).[1] As regards to the general outlook of Anatolian industry, 1913 industry census revealed the following: there were 560 holdings with 10 or more workers within Turkey's 1923 territories. Total employment in these holdings reached 35,000. Out of 264 holdings covered by the census, 70.3% was involved in the food sector, 11.9% in the textiles, 8.3% in the leather products, 6.1% in the paper products, 2.2% in the chemical, 0.8% in the wood, and 0.3% in the soil products (Ökçün, 1970).[2]

The figures about Ottoman industry were based on industry census of 1913 and 1915. The two censuses covered only Western Anatolia -where industry was dominant- and included only those holdings with 10 or more employees. Among the holdings covered, 55% were located in Istanbul and vicinity, 22% in Izmir, and remaining 23% in other provinces (Alacaklıoğlu, 1974).

When the Balkans were lost, Ottoman state was deprived of the tax revenues coming from the region. According to 1907 figures, the Balkans' share in Ottoman GDP was 22% while that of Istanbul was 10%, Anatolia was 49%, Syria was 9%, Lebanon was 2%, Jerusalem was 2%, and Iraq was 6%.

Another important feature of Ottoman industry was related with the ownership structure: industrial holdings were almost totally belonged to minorities (DIE, 1973). A German report of the time states that only 15% of the capitalists and employees were Turks in 1914 (Yerasimos, 1989; Kepenek and Yentürk, 1995). In 1921 Ankara Government had a manufacturing industry census in the regions under its control. But since it did not include Istanbul and Western Anatolia -including industrial centers such as Adana and Bursa- made this census reflect rather the artisan-industry type of possessions. Anatolian industries seemed by and large family holdings. When family size and low level of school attendance of children at the time are considered, one concludes that wage-earning workers were at the initial stages of development.

According to 1921 census results, total employment in 33.1 thousand holdings reached 76.2 thousand workers. Sectoral breakdown of the employment was as follows: 46.3% textiles and wearing apparels, 23.6% leather processing, 10.5% metal ware, 7.9% woodwork, 5.9% food, 4.7% tile, and 1.1% chemical industry. Average number of employees per holding was highest in tile (5.1), lowest in textiles and wearing apparels (1.8) (DIE, 1973; Kepenek and Yentürk, 1995).

When the agricultural land areas are considered, it seemed that in 1913 land was highly fragmented or broken into small pieces where larger-sized land pieces were owned by the landlords who had basically no managerial and entrepreneurship capacity: 39% of agricultural

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[1] Arithmetic errors in this source have been corrected.

[2] Mentioned by Yakup Kepenek and Nurhan Yentürk (1995).

land was controlled by feudal lords, 26% by landlords, and 35% by peasants. 87% of farmers had 35% of the agricultural land, while 8% of them were landless. Feudal lords and landlords together constituted 5% of the farmers. However, it is questionable whether these figures accurately reflect the reality. This is because, if average household size is taken to be 5-6 persons, and given that 80% of the population lived in the villages, then peasant population reaches only 5-6 million, which is not plausible (DIE, 1973; Kepenek and Yentürk, 1995).

Parallel to foreigners' investments in transportation, trade, industry and agriculture, considerable developments were observed in banking as well. As Ottomans' first bankers, *Galata Bankers* had a predominant effect on Ottomans' external economic relations. Besides, wage workmanship was emerged in port, railway and mining enterprises –to which foreign investments were directed- where large number of workers was needed. Hence, union activities started soon.

Galata Bankers undertook banking activities (Kazgan, 2006; Kazgan, 2005). Ottoman Bank was set up first by the British capital in 1856, and then later in 1863, with inclusion of the French capital, changing its name to Ottoman Imperial Bank. The bank was also given the authority to issue bank notes. In the following years almost all countries which developed commercial relations with Ottomans had a chance to open up branches of their banks in the Ottoman territory. The first bank with domestic capital, Ziraat Bank, was born in 1863 when agriculture-credit cooperatives –set up by Mithat Pasha in 1888- were transformed into a bank.

Railways were established mainly by foreign capital. German capital took the lead in this field by a share of 57%, followed by French (23.5%) and British (20%). Ottoman agriculture was opened to the market with the construction of railways. Ottoman maritime lines were also controlled by foreign capital. Due to capitulations –commercial privileges guaranteed to the foreigners- and cabotage rights, domestic navigation was not under protection (Kepenek and Yentürk, 1995).

Land road construction did not show a bright outlook. One would say Ottomans did have an advanced telegraph system with respect to the standards of the time. In addition to Ottomans' own postal services network, foreigners also had their own.

In the last period of Ottoman State non-Muslims qualitatively had a considerable weight in Turkey's social and economic life. They mostly lived in the urban cities and involved in non-agricultural sectors. Muslims, on the other hand, lived primarily in the rural areas and involved in agriculture and animal husbandry. Non-Muslims had an important weight in both external and domestic trade. According to Annual Books of Provinces ("Vilayet Salnameleri"),[3] out of 18 thousand businesses which involved in domestic trade, 15% belonged to Turks in 1912, 49% to Anatolian Greeks, 23% to Armenians, and 19% to Levantines, other non-Muslims and Muslims.

In 1922 in Istanbul 4% of the businesses involved in foreign trade, 3% of transportation firms, 15% of wholesalers and 25% of retailers belonged to the Muslims. 12% of roughly 6,500 manufacturing businesses –including artisans- belonged to Turks, 49% to Greeks, 30% to Armenians, and remaining 10% belonged to other groups. Out of 5,300 self-employed professionals like doctors, engineers, accountants etc., 14% were Turks, 44% were Greeks and 22% were Armenians.

[3] A primitive version of today's budget application, which shows income and expenditure flows.

Among 3,300 manufacturing businesses in Western Anatolia, 73% belonged to Anatolian Greeks and 85% of 22 thousand workers in those businesses were non-Muslims. Anatolian Greek and Armenian farmers were leading in the export-oriented agricultural production and introduction of the new techniques. Literacy rate as well as education and health conditions of the non-Muslims were much better than that of the Muslims.

During 1900-11 period, the share of Turks in total mining production fell gradually while that of foreigners increased from 50% to 75%.[4] The fact that mining production was predominantly subjected to international trade obviously had an important role in this change (Ökçün, 1969; DIE, 1973). French-based foreign capital in mining industry had relatively much bigger share (80%) compared to other countries, followed by British (14%), and German (6%). French capital was invested mostly in coal, zinc and manganese; British capital in chrome and borax, German capital in chrome and hard coal. These investments were initiated starting from 1885. In terms of the royal licenses held, minorities took lead in 1870-84 while foreigners replaced them after 1885. In parallel to this, foreigners became dominant in the production as well (Ökçün, 1969; DIE, 1973).

2. New Turkey's Economic Model: Creation of A National Bourgeoisie and Systematic Discrimination Against Non-Muslims

Turkish government organized an economic congress in Izmir to show the Western countries the route (Afetinan, 1987) it intends to follow (Cem, 1989). In his opening speech, Mustafa Kemal, founder of the Turkish Republic, defined the participants of the congress as "representatives of the nation" and criticized Ottomans harshly. He accused Sultan Muhammad II (Fatih, or "the Conqueror"), Sultan Selim I ("Yavuz") and Suleiman the Magnificent ("Kanuni") of exploiting the nation for their personal interests (Kipal and Uyanık, 2001). 1,135 delegates representing industry, agriculture, trade, and labor participated in Izmir economic congress, which lasted 16 days. Some of the civilian and military bureaucrats participated in the congress as representatives of the private sector. For example, writer Aka Gündüz and Rukiye Hanım represented labor force (Kipal and Uyanık, 2001), while General Kazım Karabekir represented industrialists. Industrialists and farmers dominated the congress, hence the decisions taken were geared more towards their interests. In essence, the congress was more of a consulting nature and proceeded as a brain-storming on economic policies the new state would implement. There are some who argue that Izmir economic congress was, in a sense, forced by the decision of the Istanbul-based merchants to organize an economic congress in Istanbul, a city under invasion by the British forces at the time (Avcıoğlu, 1987).

There are many implications of the ruling elite of new Republic having organized an economic congress within just a few months of its foundation. Before commenting on this, one should point out to the function of the Lausanne Peace Conference in this process. It is interesting to note that Lausanne Treaty was signed just 4 months after Izmir Economic Congress. In other words, Lausanne talks coincided with the timing of the congress. One of

[4] Shares are for mines other than coal, and calculated by using nominal values.

the top economic issues in the agenda of Lausanne talks was the customs tariffs the new Turkish state would impose. Upon demands raised by especially England and France, the new state could get the permission to change the existing tariff rates only after 5 years. Accordingly, tariffs –mostly specific taxes- initiated in 1 September 1916 continued to be imposed as they were until 1929. It is true that many of the privileges given to foreigners were abolished with Lausanne, but it is also true that some privileges still continued to exist. In other words, Lausanne Treaty made impossible for Turkey to use customs tariffs and other trade barriers for protectionist purposes (Aktan, 1978). These limitations came to an end in 24 August 1928. Accordingly the Turkish government was able to impose protectionist policies from 1929 on (Boratav, 1977).

In light of the above, it would be misleading to call the first ten years of the Republic as a period of "liberal economic policies." Establishment of monopolies on the importation and exchange of certain industrial products, attempts to provide domestic industry with various incentives, widespread nationalizations -including railways-, and discriminating practices against non-Turks in various economic activities (Birdal and Ulutan, 1992) indicate that the government interventions were quite common in this period as well. Therefore, this period can be considered as a learning period for the government on how to reorganize the society from top to bottom; hence the liberal outlook in the economy in this period may be related with government's other priorities and limitations required by the Lausanne Treaty, rather than being a deliberate choice of the government.

In accordance with the general implications of nation-state, foreign capital left the country in the early years of the Republic. The most important economic regulation initiated in the 1923-32 period was the Industry Promotion Act [Teşvik-i Sanayi Kanunu], which guaranteed extensive exemptions and privileges to private industrial and mining firms. This act was an extended form of the previous legislation and intended to be effective during 1927-42 period. It was expected that over this 15-year protection, private sector would grow strong. Among the incentives provided with this law were allocating building plots to some industrial firms, provision of tax exemptions and exceptions, cheaper transportation, production premiums, and purchase guarantees by the state. The law proposed that those firms utilizing incentives should employ Turkish workers, except for managerial and accountant positions. According to 1927 industry census conducted by experts Camille Jaquart –from Belgium- and Celal Aybar, out of 65,245 businesses 43.6% were involved in agriculture, animal husbandry, fisheries and hunting products. Mining industry, mine processing and machinery production and maintenance followed this with a share of 22.6%. As regards to employment, 43% of total employment was accounted for by agriculture, followed by textile industry (18.7%). 36% of the enterprises employed just 1 person, while another 36% employed 2-3 persons. Unfortunately, 96% of industrial firms did not have spinning power supply. Electricity generating motors provided 53% of the spinning power. During the census, there were 642 foreign employers, 702 foreign white-collar workers, and 347 foreign blue-collar workers in Turkey (DIE, 1973).

Extensive nationalization attempts and discouraging attitude of the government against foreign firms led to capital flight. In 1926, government imposed new taxes and increased the scope and rates of the existing ones. Since there were limited long term external credit possibilities, government investments in cooperation with foreign firms boosted demand for domestic credits, resulting in demand pressures in financial and foreign exchange markets. Foreign capital was allowed only on the condition that they find a Turkish partner. Out of 201

Turkish joint stock companies established in 1920-30 period, 66% had foreign shareholders. The share of companies with foreign participation in total capital reached 43% on the average. These companies were concentrated more in textiles, food, cement, and electric-gas industries.

Turkey took a series of harsh steps in 1923-29 period to homogenize the society. Depriving itself of what was thought to be natural for an “empire” once –e.g. multi-ethnic, multi-cultural, multi-jurisdictional-, Turkey tried to reorganize the state as a new entity based on single-nation, single-culture, single-jurisdiction, and single-language. New Republican administration, following the 1st 10-year period of establishment, was deeply affected by USSR’s centrally planned economic model. The Great Depression added more on to this process. Ismet Inönü, Prime Minister of the time, stated very often the necessity of state’s active involvement in the economic affairs. As such, The First Five-Year Industrialization Plan was prepared and implemented with the guidance of Soviet experts in 1934-38 under Inönü administration. The cost of implementing this plan was proposed to be 45 million Turkish Liras (TL), but the actual cost was much higher, reaching TL 100 million. The plan focused more on the consumer goods. Following the same central planning approach, The Second Five-Year Plan (Derin, 1940) was prepared but could not be implemented due to eruption of World War II.

Union and Progress [İttihat ve Terakki] Party’s dream of creating “national bourgeoisie,” which goes back to the late Ottoman period, now seemed more feasible with the Republic (Keyder, 1989; Toprak, 1995). In his speech delivered in 18 January 1923 in Izmit, Atatürk expressed his thoughts about national bourgeoisie: "We would like, Gentlemen, to have more and more millionaires and even billionaires in our country. We hope that they set up banks, railways, factories, companies, and other industrial plants, so that we no longer need foreign capital.” (Genelkurmay Başkanlığı, 1988).

The nationalist, anti-foreigner mentality being suspicious of the foreign capital continued throughout the Republican era. In a speech he delivered during the election campaign in 17 April 1954, Ismet Inönü commented on the new legislation promoting foreign capital, “Yes the law has been passed, but they say nobody [foreigners] came and settled in Turkish soil yet. That’s true. But you opened the door. When and how do they come in? Nobody can predict this … Foreign Capital Act is a law that will kill our trade, industry and economy… No country will say openly that they want capitulation... In the past foreigners exploited Turkey thanks to capitulations. Now if our own citizens will suffer from unplausible, insecure methods while foreign capital will live under special legal protection, then this means we force ourselves to become foreigners… Petroleum Act is a capitulation. By this legislation, the country has been pushed towards an unknown destiny. We did not find this country out of the blue.” (Altuğ, 2008).

This hostile attitude of the state towards non-Muslims generated its reflection in the society in the form of xenophobia. Population exchange proposed by the Lausanne Treaty (Kasaba, 2005) and Armenian –forced- emigration created a vacuum in terms of entrepreneur-bourgeoisie class. Contrary to expectations, this hole was not filled in by Turks, but mostly Jews. Modern Turkey wanted to replace non-Muslim subjects, who constituted Ottoman bourgeoisie, with a new Muslim class who has organic relations with the state and intended to be bowed down to the political power (Selçuk, 2007; Duman, 2007; Karaman and

Aras, 2000).[5] The Settlement Act of June 1934 mentioned some measures likely to be taken against non-Turkish speaking people when necessary. Not surprisingly, in a short while Jews had to immigrate in July 1934 to Istanbul first and then Palestine following a series of plundering attacks against their property (Bali, 2008).

Atatürk and Inönü were two major figures who played a determining role in the Republican Turkey's ruling until the free elections of 1950. Atatürk died in 1938, while Inönü continued to be among the prominent political figures until early 1970s. The following indicates how strong was the suspicion and discrimination against non-Muslims in Turkey and adopted by the governments as a state policy for decades:

(i) Negative attitude by Union and Progress Party against non-Muslims in the late Ottoman period (Akçam, 2008),

(ii) 1924 population exchange as an indication of Atatürk period's -ethnic and religious based- human resource policies adopted by the new republic,

(iii) *Wealth Tax* ["Varlık Vergisi"] imposed on non-Muslims by Inönü government between 11 November 1942 and 15 March 1944 (Aktar, 2000). In regards to the wealth tax, Uzeyir Garih, a prominent Jewish businessman, made this remarkable statement: "We suffered a lot. There were people who died, people who left the country for good, people who lost everything they had and became morally collapsed. My family went through very tough times as well. Despite everything, today I would say it was not the wealth tax per se, but the way it was implemented was terrible..." (Özgürel, 2001). In the same manner, another well known businessman of the Jewish origin, Ishak Alaton said: "We could save only my mother's violin from the wealth tax, and nothing else." (Alaton, 2009).

(iv) Massive negative attitude against the non-Muslims continued even after the country switched to multi-party democracy in 1950. In 6-7 September 1955, there were organized massive attacks against non-Muslims living in Izmir, Istanbul and Islands in the vicinity of Istanbul. There is little doubt today about the nature of these attacks against non-Muslims: they were part of an organized plan executed by the secret forces of the "deep state."

(v) In addition, it is interesting to note that security forces made a special effort regarding the Cyprus War which erupted during Ecevit-Erbakan coalition government in 1974. A retired General, Sabri Yirmibeşoğlu, comments on this, saying: "... Let me give you another example: 1974 military operations in Cyprus. If there were no Special War Department, could that operation, I mean both operations, be that succeseful? Special War Department moved on before the operations. Officers of Special War Department were sent to the Island disguised as bankers, journalists, or civil servants; they organized the resistance, made the people conscious of the danger. Weapons were moved into the island with small boats." By the same token, in an interview he gave to journalist Fatih Güllapoğlu, General Yirmibeşoğlu -who was the Secretary General of the National Security Council and also worked for Special War Department [Özel Harp Dairesi] at the time of the disastrous 6-7 September (1955)

[5] This hostile attitude was not only directed to non-Muslims but also non-Turk descent. In 1930, Ismet Inönü stated that "Only Turks can claim ethnic and race-based demands. No one else has this kind of rights". *daily Milliyet*, 31 August 1930. Then minister of Justice Mahmut Esat (Bozkurt) declared this approach very directly: "We live in a country named Turkey which is the freest in the world. Your congressman (himself) could not find any place more convenient than here to express his beliefs. So I will not hide my feelings. Turk is the only master and owner of this country. Non-Turks have only one right in this country; to be servant, to be slave. Let friends and enemies, and also mountains know this truth!". *daily Milliyet*, 19 September 1930. Source: Hatice Hür, "Osmanlı'dan Bugüne Kürtler ve Devlet-4", [Kurds and the State from the Ottoman to the Present-4], *daily Taraf*, 23 October 2008.

Events-, said: "6-7 September events were perpetrated by the Special War Department. It was a magnificent organization. It hit its target well." (Güllapoğlu, 1991). It is highly likely that there are interlinkages between the aforementioned Special War Department and the Ergenekon Terrorist Organization (ETO) which is under trial right now.[6] It seems that Ergenekon and its predecessors acted as the operation-execution unit of the ultra-nationalist, isolationist, xenophobic deep state forces who perpetrated several destabilizing actions in the country over the last half century, including several plots and fatal attacks against non-Muslims and Muslims alike.

(vi) Following the Greek attacks against Turks in the island of Cyprus in 1963, Turkish Government issued a decree in 1964, asking Turkish citizens of Greek origin who also carried Greek passport to leave Turkey. It is estimated that approximately 30 thousand people left the country on this occasion (Demir and Akar, 1999). As a result, state got rid of the remaining Anatolian Greeks who somehow managed to survive after 6-7 September events. This Statutory Decree was abolished later in 5 February 1988 (Aksu, 2003). With regard to this Decree, the then Minister of Foreign Affairs Mesut Yilmaz said, in his speech in Turkish Grand National Assembly during budget talks in 18 April 1988: "… 1964 Decree is not legally defensible; moreover, it is not in compliance with diplomatic reciprocity … The Decree restricted the property rights of the Turkish citizens of Greek origin, who acquired property in accordance with 1930 Turkey-Greek agreement. While doing this, it brought a status for them even worse than 3rd country citizens. In other words, Atatürk made an agreement with Greek in 1930, providing some special rights –not provided for foreign citizens- to Turkish citizens of Greek origin. Now you declared in 1963 this agreement as null... In order for this to be in compliance with reciprocity principle, Greek is supposed to have done the same to the Greek citizens of Turkish origin."

(vii) Another serious discriminatory action in the following years against non-Muslims was put into practice based on 1935 Foundations Act [Vakıflar Yasası]. All foundations of the religious communities were asked in 1936 to submit to the government the list of their property. These lists handed over to Directorate of Foundations [Vakıflar Genel Müdürlüğü] by the foundations are known to be 1936 Affidavit. Starting from 1960s, this affidavit played as an important database when confiscating the non-Muslims' property. Lastly, in 1974, the right of non-Muslim community foundations to acquire property by following the legal procedures –deed of consent by the Governorships and official title deeds- was cancelled. The Court of Appeals made a judgment in 1974, saying that non-Muslim foundations cannot acquire property. Upon this decision, state started to nullify the title deeds acquired from 1936 to 1974 (Özuzun, 2002).

In fact, the main reason behind asking for the list of real estates of foundations in the first place was to confiscate the property of Muslim religious communities in support of the old regime, the Caliphate. But in the course of time, these records were started to be used by and large only against non-Muslims. Starting from 1972, Directorate of Foundations asked non-Muslim foundations to show their charter documents [vakıfname]. Since these foundations

[6] Interrogations on Ergenekon case started in mid-June, 2007, when the police found several hand-grenades in a small shantyhouse ["gecekondu"] in Umraniye, Istanbul. As the investigations deepened, it became clear that they were related with an underground, Gladio-type, paramilitary terrorist organization which is responsible for many provocative destabilizing operations. Hence, the Ergenekon case is called by some as "the case of the century." No doubt, the Ergenekon case will be a turning point in Turkish history on the road to a real, civilian, and pluralist democracy.

were established by the Ottoman Sultans' imperial order [ferman], they did not have any "valid" documents. As a result, Directorate of Foundations started to confiscate all the property acquired by non-Muslim foundations after 1936, saying that they did not appear in 1936 Affidavit (Oran, 2008).

From time to time the hostile policy executed against the "minorities" starting from the days of Union and Progress Party administration up until today passed beyond religious-based discrimination, turning into ethnic discrimination. Even though not massive, at individual level this ethnic and religious discrimination-based security policy still manifests itself today in the form of unresolved murders, bombing and provocative operations. Ethnicity, religions and sects have been considered as handy tools to provoke or manipulate the social segments against one another or against outsiders.[7]

Even today the Minister of Defence could argue without any hesitation that it was necessary for Turkey implement nation-building policies –e.g. to expel non-Muslims, including Armenian emigration of 1915; otherwise we could not have a nation-state today (Aköz, 2008a and 2008b). This argument by the Defence Minister summarizes very well the official state view on this issue. Defence Minister V. Gönül, when speaking at a memorial ceremony for Atatürk at the Turkish Embassy in Brussels while visiting there for the EU Defence Ministers Troika meeting, he said: "Another 'very important' step of Atatürk, though not remembered very well today, was Turkey-Greek population exchange: "If Greeks continued to live in Western Anatolia and Armenians continued to live in many parts of Turkey, could there be the same nation-state? I don't know how I can tell you the crucial importance of this exchange, but if you look at the old balances, its importance would become very clear. … We cannot ignore today the contribution to nation-building of those who consider themselves the victims, especially the victims of emigration, in the ongoing struggle in the South Eastern Anatolia." Mr. Gönül also mentioned at one point of his speech that he realized, when he served as the governor of Izmir, that there was not a single Muslim among the founders of Izmir Chamber of Commerce: "All of them were Levantines" he said. He also reminded that before the foundation of the Republic, Ankara was constituted by "4 neighborhoods: Jewish, Muslim, Armenian, and Greek. In short, it is worth-noting –and equally saddening- that the defence minister of a country, which is currently in the process of joining the European Union, still supports and legitimizes the idea of religious and ethnic isolations and conflicts of the past for the sake of today's nation-state.

Indeed, it is quite engrossing to hear such –with today's standards- indefensible or intolerable, religiously and ethnically discriminating arguments from top level officials of a country which has a long history of interaction with Europe. In this case, in psychologists' terms, one might think that it seems necessary to go back to modern Turkey's "childhood." Could it be that the historical roots of today's ethnic and religious discrimination policies go back to the reaction to *devshirme*[8] tradition? At this point one should point out an apparent policy difference between Ottoman state and modern Turkey. The Ottomans pursued a policy where religious, geographical, ethnic, and cultural differences are recognized, tolerated and harmonized. Republican Turkey, on the contrary, attempted to separate, increase awareness of

[7] The Case of Ergenekon Terror Organization reveals the fact that since the days of the Progress and Union [Ittihat ve Terakki], this sort of an isolationist approach had been welcomed and appealed widely within deep circles of the state.

[8] An old Ottoman tradition which involves recruitment of non-Muslim boys to educate and train them as soldiers or state bureaucrats.

and divide the society along the lines of socio-cultural differences, and use different social segments against one another whenever needed.

In recent years, upsurging ethnic-nationalist and Islamist tendencies in Turkey have captured more and more attention, not only in Turkey but also in the West as well. Suspicious and hostile attitudes emerging in the West recently towards Islam and Muslims get exceedingly reflected in Turkey. The special interest towards the family history of those converted Muslims in Turkey of the Jewish and Christian origin is also noteworthy. It is quite revealing to see in the official papers -even as recent as 2004- a statement “no religious conversion has been detected in his/her lineage” in the paperwork used during official security investigation for those who are considered to be employed as public servant. There is a voluminous literature investigating the Jewish-convert [“dönme” or Sabetaist] background of even some presidents, prime ministers, ministers, prominent businessmen and artists.[9] To blame someone of coming from a non-Muslim origin has become now so legitimate that, the current President of the country, upon blamed -by one of the Republican People’s Party (CHP) Izmir Deputies- of coming from a convert lineage, had to explain his family tree and rejected the blame. Nobody paid much attention to the fact that this reaction itself indirectly accepts the legitimacy or credibility of such a racist blaming.[10]

3. Using Islam as a Tool in Politics, Economy and Civil Society Movements and Its Consequences

It may seem difficult to understand by the Westerners, but it is important to note that the suspicious, isolationist, discriminating policies by the state were not directed against only non-Muslims: Muslims got their share as well. This became clear especially in recent decades when a Muslim middle class, sometimes called as religious-conservatives or Islamist capitalists, started to emerge. The interaction between state, Muslim middle class, Islam and economic-social life is a complicated process. Two things must be differentiated at this point: One is the hostile attitude of the state bureaucracy towards newly emerging Muslim bourgeoisie. The other is using religion as a tool by the Muslim circles to promote their own economic and social agenda and its negative consequences.

The history of using Islam as an input in political and economic arena in modern Turkey goes back to the second half of 1960s. A lot of other factors also contributed to the emergence of an Islamist discourse (Yenigün, 2006). Islamic segments started to appear in politics thanks to democracy, but they could not repeat the same success in economic field. There are two important reasons for this: first, since resources are distributed by the state and mostly to the supporters –crony capitalism once again-, those with apparent Islamic identity could not get their share from rent-distribution by the political establishment. Secondly, there was no commercial and industrial experience and accumulation in the Islamic circles inherited from

[9] It is interesting to note that those who defend the idea of ethnically pure Turkishness [“Türklük”] are now put on trial in the context of Ergenekon Terror Organization case, the leadership of which is assumed by the high-ranking generals, according to the bill of indictment.

[10] Abdullah Gül, in a press statement in 21 December 2008, declared to the journalists, saying “We are from Kayseri, we are Muslims, and we are Turks.” *daily Vatan*, 21.12.2008.

the past either. In fact peasant-dominant Anatolian geography did not allow an early accumulation of industrial-entrepreneurial skills by the Muslim subjects.

Regarding the relationship between Muslims and the state, it is another complicated, sad story. To make it short, one can say that the negative, isolationist, defamatory attitude -once directed against non-Muslim population and businessmen- targeted after a while the Muslim elements as well both in single-party and multi-party period. Starting from Atatürk and afterwards, the tendency of each government to create its own rich[11] indicates in fact how distorted and deficient was the political power elites' perception of democracy and market economy. This understanding did not see wealth, market economy and democracy as a process of accumulation; rather, the meaning ascribed to such terms seems to be proportionate to the self-interests one could acquire during the time his team holds the power.

Interestingly enough, Western understanding of these concepts was adopted when they hold the opposition seats, away from power. Once taking the office, however, it became a different story: distributing public resources among relatives and friends was regarded as a gift of democracy. It seems that all the acquisitions of humanity following the Enlightenment did not mean much to these power elites who did not have a strong intellectual and market experience, who did not have a long urbanized past, and who came from villages or suburbs. They probably did not have any idea about what that huge acquisition on market and democracy meant. Accordingly, throughout the Republican period, governments preferred a comprador-intermediary class, rather than an independent capitalist bourgeoisie in its true sense. This is because they did not have enough background on the necessity of an independent bourgeoisie or intellectual class, neither had they such a tendency. Isbank [Türkiye İş Bankası] played a major role in transferring funds in the process of creating new statist national bourgeoisie (Ahmad, 1995). State apparatus has been considered as a mechanism to collect resources and distribute them as rents in accordance with the discretion of the government, rather than doing this according to certain, predetermined set of rules.

The rise of Muslim middle class in economic sense started with Turgut Özal governments who came to power three years after the 1980 military coup. While being follower of a religious sect himself, Özal did his best in both initiation of the Islamic banking and facilitating to do business for those who have strong religious beliefs and sensitivities. Some writers argue that interest-free banks strengthened Islamic circles economically (Fuller, 2008;

[11] As an example of such evaluations, see Taha Kıvanç, "Züğürdün Çenesi" [Indegent's Chin], daily *Yeni Şafak*, 14.06.2005. T.Kıvanç quotes the following from monthly economic magazine *Turkishtime*: "Look who entered the scene and when: 1920s: Koç, Çukurova, Sönmez, Santral Mensucat. 1930s: Sabancı, Sapmaz, Vakko. 1940s: Yaşar, Eczacıbaşı, Ercan, Transtürk. 1950s: Akkök, Kutlutaş, Borusan, Bodur, Tekfen, Enka, E.C.A., Profilo, STFA, Alarko, Akın, Deva, Tamek, Altınyıldız. 1960s: Anadolu Endüstri, Özsaruhan, İzdaş. 1970s: Ekinciler… Turkishtime also mentions the stars of the new period: Tay Group, Astaş, Turkuaz, Fine Grup, Emrullah Turanlı, Abalıoğlu... Turkey has been familiar with the fact that each period has its own rich. In his book Çankaya written in a colorful style, Falih Rıfkı Atay talks about the rent-seekers of the newly designed Ankara of Atatürk period. One of the most prominent riches of Ismet Inönü –known to be the National Chief, ["Milli Şef"]- period was Rıza Temelli, his brother; his relatives-in-law, the Sohtoriks, are also known to be among the leading armatures of the period. Adnan Menderes put forward his party's target as "to create a millionaire in every neighborhood"... The riches of Süleyman Demirel's period and the favorites of Turgut Özal are known by their names... Fine, what about the now ruling Ak Party? Whom are they making rich?... *New Money* magazine [Yeni Para dergisi] provides a detailed list, "Ak bosses of the business world," which enumerates those businessmen who are among the shining stars of Ak Party rule who grew very fast." Crony-capitalism practices are obviously the major obstacles before rationalization, secularization and institutionalization of a country's economic, social and political structure.

Yavuz, 2005). MUSIAD (Association of Independent Businessmen, an organization whose membership is known with their religious-conservative tendency) who grew up during the Özal period, is an umbrella organization of SMEs in terms of the average business size of its members (Çınar, 2005; Doğan, 2006). It is true that there are some big business holdings among its members –e.g. Ülker, Istikbal, Çalık- but the typical MUSIAD membership fits well into SMEs. From 1989 when Özal left the seat as prime minister until end-2002 when AKP ascended power, Islamist capital did not grow much but stayed stable. The 28 February 1997 "postmodern" military coup tried hard to bash these holdings.[12] However, the fact that vast majority of MUSIAD members were SMEs on one hand, while the bigger ones were at the same time TUSIAD –secular businessmen organization which has quite friendly relations with the political establishment- members, allowed them to develop the ability to better resist against such attacks. As a result, there was no business group with an apparent Islamic sensitivity which went bankrupt or seriously injured in this period. On the contrary, in accordance with the universal economic law, asserting that "market intervention has its own unintended consequences," military bashing accelerated the speed with which conservative Muslim businesses grow and better interact with the outside world.

Political activities of Islamist community (Kristianasen, 1997; Uzgel, 2006) followed the political movement as MNP-MSP-RP-FP-SP[13] path and AKP was set up by those MPs who were left without a political party upon FP was shut down. Later AKP declared that it gave up the Islamist view and will follow a different "conservative-democratic" path.[14] Therefore, political activities of the Islamists, despite the efforts to be stopped by several military interventions or court judgments directly or indirectly, got even stronger over time. As such, the leadership and core staff of the existing government are constituted by those who came from the Islamist "National View" [Milli Görüş] background.

Economic activities of Islamists are by and large governed by joint stock holdings known by the public as the "Islamist capital." At this point, one should mention the "green capital bubble" of the 1990s as a terrible experience of Turkish Muslim community. In the late 1980s and early 1990s, a lot of so called "holdings" appeared in the conservative and nationalist central Anatolian cities. They initiated several investment projects by using the funds they collected primarily from Turkish migrant workers living abroad. Even though it was not allowed by Turkish capital market regulations, these holdings worked practically as joint stock companies open to the public and operated in an unregistered way without giving account to any official body. Funds collected by these companies, until they reach the cash register of the ultimate investor were ripped off, falling down to 50-70% of the initial amount due to mediating expenses and commissions. Being economically inefficient on one hand,

[12] In 28 February 1997, Turkish Armed Forces initiated a para-military intervention process –known as the "postmodern coup"-which eventually culminated to forcing the civilian government to resign and maneuvering the formation of a minority government instead. Reminding of Mc-Carthy period pressures and irregularities, military and civilian intelligence bodies started to keep a record in that period of the persons, companies as well as NGOs known to have Islamist identity. Military intelligence units included in their watch list non-Muslims' missionary activities.

[13] The political parties of the religious Muslims which were all shut down by the Constitutional Court in the course of time starting from late 1960s until early 2000s.

[14] The founder and president of Justice and Development Party [Turkish acronym: AKP] R.T. Erdoğan stated many times openly or indirectly that they put off their Islamist shirt ["milli görüş," or national view] which meant they gave up political Islamist ideology. As an example of this, see R.T. Erdoğan, "Milli Görüş gömleğini 28 Şubat'ta çıkardık" [We put off milli görüş shirt in 28 February], daily *Akşam*, 14 August 2003.

ignored by legal scrutiny on the other, these companies caused thousands of individual investors to lose all their money. Reminding of the well known Ponzi games, the way these companies operate can be described as follows:

Let say a person collecting money on behalf of one of these holdings in a small district of a German city. Assume he collected 100,000 German Marks (DM).[15] He deducts, 5-10% commission as his share and gives the rest to "city representative." He deducts his share and gives it to Germany representative. After getting his share, Germany representative send the rest of the money to Turkey. So the mediating expenses amounts to 15-30%, hence the holding in Turkey is left with 70 thousand DM at the end of the day.

Since there is a serious competition among alternative holdings, it is important for them to offer higher rate of return so that they could collect new funds. While collecting new funds, the company gives reference to the rate of return it distributed to the shareholders in the past(!). Once upon a time the rate of return reached as high as 20-40% in terms of the original money, DM. In our example, 30% profit over 100 thousand DM corresponds in fact to 43% rate of return since the actual amount invested –after deducting the mediation expenses- was 70 thousand DM. It is obvious that such an investment and profit-distribution policy does not make sense economically and cannot be sustained. As any other Ponzi game, this "green holding game" was over when they could no longer get new money coming in at the turn of the century. The result was that several holdings went bankrupt and thousands of shareholders lost everything they once trusted them eagerly.

With this bad experience, Turkey learned, with a big pain leaving behind, that such a system among Islamists based on just personal trust was quite susceptible for abuse. This adventure of the green capital gave the society a serious lesson about the likely negative consequences of using religion for commercial interests.

In addition to political and economic areas, Turkish society had another bad experience on using religious values by Islamists' in NGO activities. Some officials of Light House [Deniz Feneri] -a charity organization which collects and distributes aid to the poor, weak, and the needy- are charged of fraud, using the money they collected for their own account, and only when there was an internal dispute among themselves the public at large heard of it.

Though they are not legal according to Turkish legislation, *tariqats* –sufi Islamic sects- can be thought of as Islamic NGOs. They were quite common in the Ottoman period, but the single-party regime shut them down officially in 1925. Nevertheless, they continued to exist in the underground. The problem is, since they were officially nonexistent, nobody inspected them, so they continued to exist actually without any government investigation or normal legal detection. Upon complaints, the public hear from time to time about some malpractices of these organizations –exploitation of its members financially or otherwise, deviant practices or thoughts not in compliance with the formal religious teachings, etc.

As these examples indicate, it is noticeable that the religion of Islam is being used intensively in politics, commerce, and NGO activities, as a valuable input. One would think that this is because there is no sign to show that Anatolian peasants have any other valuable asset than Islam to use as "social capital."

Taking advantage or even abusing Islam in almost every aspect of social life by the religious groups seems, ironically, to play an important role in the normalization of the perception of religion in Turkish society. Therefore, Turkey has entered in a period now

[15] When this game was played, the prevailing currency in Germany was still German Mark!

where people get more and more suspicious of those who are in the habit of using Islam to pursue their own non-religious agenda. In this context, the label “Islamist” has been giving way to more secular-ideological concepts like nationalist and conservative.

When we take into account the fact that religion is an important value not only at individual but social level as well, one would argue that some sort of regulation is needed because religion generates some positive as well as negative externalities. The lack of regulation and scrutiny in this field leads to the risk of abuse. In this regard, public authorities in Turkey seem to have a serious neglect and disregard in terms of preventing abuses of religion. Even worse, it is doubtful whether they are even aware of this problem.

4. Capitalists in Turkey, Human Development and the Power of Islamist Capital

Starting from the late Ottoman period until 1980s, Turkey has pursued a policy that weakened its human resources. Multi-ethnic, multi-cultural, multi-religious and partly urbanized social structure of the Ottoman period gave way, in the Republican period, by and large a uniform, single-nation, single-religion, single-ethnicity and largely peasant society. Foreign direct investments, degree of openness to international trade, and cultural interaction with the West in the Ottoman state was way ahead of the Republican Turkey. It has been passed over a 100 years since 1908 Union and Progress coup. This must be long enough time to evaluate the consequences of authoritarian policies directed at creating a uniform society. Today, according to UN 2009 figures, Turkey ranks 79th among 182 nations in terms of human development index (HDI: .806). The determining factors in this ranking are income per capita, level of education, and life expectancy at birth. R&D expenditures as percent of GDP for 2000-2005 period was 0.66% in Turkey as compared to 2.68% in the USA, 2.49% in Germany, 3.15% in Japan, 1.14% in Italy, 0.67% in Iran, 0.40% in Mexico, 1.44% in China, and 1.17% in Russia (UNDP, 2009).

Relatively insufficient R&D expenditures are not the only problem. Moreover, there are problems in the processes to turn R&D expenditures into production of final goods and services. As such, studies in the literature focusing on this problematic situation have found interesting results. Analyses of R&D expenditures and endogenous growth models indicate that the ratio of R&D related production to researchers has a positive effect on economic growth. In other words, increasing number of researchers does not automatically accelerate economic growth; only when final production leads to increased number of production workers intended positive effect comes in. This finding clearly calls for industry-university cooperation. This explains why, during the last century, developed countries failed to accelerate growth rate despite their increased investments on new researchers (Thompson, 2003).

Departure of non-Muslims from the country played a decisive role in deceleration of human development and diminishing the quality of human resources. This was because non-Muslims constituted the vast majority of the entrepreneur class in Turkey: most of the merchants, industrialists, and bankers were non-Muslims, who were also way above the average in terms of the level of education and political experience.

As of 2008, there are 13 companies from Turkey among the world's biggest 2000 companies compiled by the Forbes magazine. Among these 13 companies 5 of them are directly or indirectly public companies which have been privatized recently (Forbes, 2009).

In terms of the degree of integration with the world economy, Turkey is one of the leading countries in the Muslim world. Based on 2008 figures, 23 out of 100 biggest economic enterprises in Islamic countries belong to Turkey, according to the ranking made by the *Dinar Standard*. Only two of them belong to entrepreneurs known to be conservative. When we exclude 6 public enterprises, 15 private companies left in the list (Dinar Standard, 2009).

In Turkey, there are two major business associations. The senior one, TUSIAD, is known to be the club of the rich who are strongly pro-secularism and Western-oriented. The junior one, MUSIAD, is known to be an Islamist association whose membership profile is constituted by mostly SMEs, and dominant ideological orientation of the entrepreneurs is rather religious-conservative. These businessmen would like to handle their relations with the West not on the system of values, but rather economic and commercial relations (Öniş, 2005; Keyman and İçduygu, 2005; Buğra, 1998; Gumuscu, 2008).

TUSIAD has 578 members as of end-2008. Vast majority of TUSIAD members are holding companies whose headquarters are located in Istanbul and other few metropolitan cities (TUSIAD, 2009). Its members are involved in many different areas of commerce and industry. In Turkey, the term "Bosses' Club" is used to designate TUSIAD. Even though the official nationwide businessmen association in Turkey is TOBB (Turkey Union of Chambers and Exchange Markets) –all TUSIAD members are also members of TOBB and its affiliates at provincial level-, TUSIAD's remarks and comments on the outlook of economic and foreign affairs capture a special attention. But it is hard to say the same for MUSIAD, even though it has a much larger membership which is 4,103 as of end-2008. As mentioned earlier, a considerable portion of these is SMSs in various provinces throughout Anatolia (MUSIAD, 2009).

This comparison between TUSIAD and MUSIAD can be repeated between The Banks Association of Turkey (TBB), which represents all conventional commercial banks, and The Participation Banks Association of Turkey (TKBB), which represents interest-free banks, or so-called Islamic banks. TKBB member banks accounts for 3-4% of Turkish banking system; accordingly, TKBB's weight in shaping the country's economic and social agenda is proportionate to this share, i.e. negligible.

It is true that Özal and Erdoğan governments promoted the emergence of a conservative Muslim bourgeoisie. No doubt there has been some success: there are now many holdings whose ownership has strong religious-conservative tendencies. Nonetheless, one cannot talk about a bright, fantastically good success story: due to inadequate initial endowment, the process has been somehow slow, stumbling over from time to time. On the other hand, this relatively lower performance of the Islamists in economic spheres is partly compensated by their relatively stronger position in political arena. Moreover, democratic visibility of Islamic segments seems to cause an illusion on their economic power and visibility: many think that Islamic circles are as powerful in economic sphere as they are in politics, which is dubious. But it is noteworthy that stable political dominance of the religious-conservatives, combined with acquisitions and mergers in the media recently, provide them with better tools for self-defence and pursue their interests more effectively. In short, economic power of the religious-conservative bourgeoisie is small, but steadily growing.

5. Conclusion

In today's Turkey, penetration into or getting strong in economy, media, civil society and politics is still being done or shaped to a great extent by resorting to the state intervention, political maneuvering or manipulation rather than through democratic and economic competition. One can argue that, starting from the early days of the Republic up until 1980s there has been systematic homogenization and unification policies on the basis of religion and ethnicity. The most detrimental consequence of this unification policy was observed in depletion of human resources: non-Muslims left the country, urban population fell down by 35%, proportion of non-Muslim population declined from around 20% to almost 1%; non-Muslims had been subjected to harsh, isolationist and discriminatory policies for decades. Ironically, this isolation and deactivation policy became an integral part of the power elites over time, and used as an instrument to suppress internal opposition as well, harming internal stability and generating unintended negative consequences. Attempts at directing or shaping the religious affairs, commercial activities and social life in accordance with the preferences of political power elites have been the biggest obstacle before democracy and market economy to get mature and deep-rooted in Turkey.

One might think that the reason behind discriminatory policies had to do with the perception that without state support, Turks did not have any chance to be successful in economics and politics against non-Muslims on the basis of competition, because Turkish community had lower level of education, business experience, hence entrepreneurial skills. At least equally important was the heavy influence of popular ideological values of the time -like positivism, secularism, nationalism and nation-state- on the mentality of the founding fathers and the subsequent power elites of the Republic.

1915 Emigration Law against Armenians,[16] 1923 Lausanne Treaty (population exchange) against Greeks, 1936 Affidavit against non-Muslims, 1942 Wealth Tax mostly against non-Muslims, 6-7 September 1955 causalities against Anatolian Greeks, 1964 Government Decree against Anatolian Greeks, 1974 Court of Appeals' decision against non-Muslim foundations and the subsequent confiscations,.. are all examples showing that negative attitude against non-Muslims in Turkey goes much beyond suspicion. It is ironic that Ottomans saved the Jews of Spain from a possible genocide in 1492, and lived with their non-Muslim subjects in harmony for centuries in a multi-ethnic, multi-cultural environment. The discriminatory policies against non-Muslims by Republican Turkey are in a sharp contrast with Ottoman attitude towards non-Muslims: modern Turkey obviously did have a serious mental break on how to deal with non-Turk, non-Muslim subjects.

In an effort to create its own intelligentsia and bourgeoisie, the Republican regime introduced several reforms and conducted various projects by state directly and indirectly. One might think that the objective of the policies immiserising non-Muslims and forcing them to leave the country was to develop Muslim bourgeoisie. But the story does not end

[16] According to Turkish sources dead toll reached 300 thousand between 1914-18, as opposed to 1.5 million according to Armenian sources. Arnold Toynbee gives 600 thousand as the number of Armenians killed between 1914-16. http://news.bbc.co.uk/2/hi/europe/6043730.stm [Accessed: April 12, 2009]; http://www.britannica.com/EBchecked/topic/35323/Armenian-massacres [Accessed: April 12, 2009].

here, there is more to it: the idea that intellectual and economic assets of the country can easily be transferred or redistributed by government decisions opened the door for all the elected governments in later periods to adopt a similar policy aiming at creating their own rich and suppress the opposition rich. Once directed against non-Muslims for decades, the same discriminating and isolationist policies were used over time against religious Muslim businessmen of different political views. As such, one can see similar tendencies even in the current government -whose ruling period is the second longest in the Republican era- with respect to its policies towards the business world.

As far as the human resources are concerned, sending a lot of students abroad for graduate study, a policy initiated by late Özal, has triggered a change of mentality in the last quarter century. Today there are virtually thousands of men and women in bureaucracy, government institutions, academia, media, and politics who received their masters and PhD degrees in Western countries. This is a new generation, more open minded, better internalized the idea of freedom, democracy, pluralism, and market economy. Those working in bureaucracy from this generation contributed a lot to European Union membership process. Ironically, Turkey is now surmounting the narrow-minded, isolationist internal bureaucratic structure with this new generation educated in the West. The children of prominent political figures, including current prime minister, politicians, bureaucrats as well as businessmen are getting higher education in the US and other Western countries.[17] It exceeded tens of thousands over the last 25 years who had higher education in the West and returned. Lastly, one would expect that the lessons brought about by the misuse of Islam in trade, politics, and NGO activities over the last 10-15 years will contribute positively to the formation of more rational, truly secular, and institutionalized political and economic structures in Turkey. This view is supported by many studies (European Stability Initiative, 2005).

In conclusion, it has become more clear than ever today that isolationist, suspicious and discriminatory policies directed against non-Muslims in Turkey over almost a century were absolutely wrong, inefficient, and detrimental for the wealth of human resources in the country. By the same token, it was absolutely wrong to use state bureaucracy and military to bash emerging Muslim bourgeoisie in the late 1990s. Both policies amounted to depletion of human resources, immiserising modernization, and slowing down the pace of development. Today, with more rational and supportive policies in terms of openness, foreign investments, integration with the world, pluralist democracy and market economy, Turkey is obviously going through a process of recovery. In a sense, the country is in the process of compensating the huge loss in human resources by sending abroad thousands of students for higher education. Similarly, the EU membership target no doubt serves as one of the most important anchors in this direction. Recent “democratic opening” aiming at finding a peaceful solution to Kurdish problem as well as problems of non-Muslim minorities combined with the new Turkish foreign policy -based on “zero-problem” with the neighbors and establishing a balance between East and West- nicely complete the picture. A stable, pluralist democracy based on supremacy of law combined with a free market economy based on competition, free trade and free flow of investments will no doubt contribute to achieve much faster growth, improvement of human resources, and betterment of the living conditions.

[17] A voluminous literature on the relationship between education and economic growth had risen as early as 1963. See, for instance, Alexander-Frutschi (1963).

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Chapter 10

TURKISH INDUSTRIAL RELATIONS: TRANSFORMATION OR A NON-FUNDAMENTAL CHANGE?

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ABSTRACT

Restrictive labor laws, employer hostility to unionization, a large informal economy and labor market, and strong state intervention have historically constituted the main elements of "the deep structure" of Turkish industrial relations. It is against this background that the chapter aims to analyze whether Turkish industrial relations have undergone a transformation or a non-fundamental change. Without the momentum generated by the EU accession process, the minimal reforms in industrial relations that have developed in Turkey would not have occurred. As long as a lack of government support and employer recognition for basic labor rights continue to exist all recent changes and reform attempts would only constitute non-fundamental changes in the "deep structure" Turkish industrial relations.

INTRODUCTION

In recent decades, industrial relations systems in many parts of the world have undergone a process of transformation as a result of increasing global economic competition and the emergence of new social and political tendencies. A new discourse revolving around the key concepts of competitiveness and flexibility have come into existence, which has dislocated relatively stable and predictable patterns of industrial relations. The decline of trade unionism and class identity and politics, the rise of new managerial approaches epitomized in human resources management, informal employment, irregular patterns of work and the spread of privatization and subcontracting have constituted the main changes within the world of industrial relations.

Industrial relations systems bear the imprint of their historical, political, legal, economic and social contexts. Major changes in a particular industrial relations system usually tend to occur as a response to significant political or economic shifts (Kuruvilla and Ranganathan 2008; Kuruvilla 1996). In the advanced societies, industrial relations evolved in tandem with industrialization, whereas the experiences of colonialism and the struggle for independence were crucial in the institutionalization of industrial relations in the developing world (Kuruvilla and Mundell 1999: 6). Although the non-existence of a colonial past sets Turkey apart from most developing countries in terms of evolution of industrial relations, weakness of important industrial relations institutions has been a common feature both in Turkey and in the developing world. It is argued that peripheral states are likely to have substandard mechanisms of industrial relations because of the weakness of the important industrial relations institutions (O'Hagan 2002: 38). This observation is also valid for Turkey where a substandard industrial relations regime has been in existence for many years.

Erickson and Kuruvilla make a distinction between the transformation and non-fundamental change of industrial relations systems. They assert that an industrial relations system "can be said to have undergone transformation when the network of basic assumptions and principles underlying that system or its 'deep structure' changes" (1998: 3).

Restrictive labor laws, employer hostility to unionization, a large informal economy and labor market, and strong state intervention have historically constituted the main elements of "the deep structure" of Turkish industrial relations. It is against this background that the chapter aims to analyze whether Turkish industrial relations have undergone a transformation or a non-fundamental change. To this end, we first offer a historical sketch of development of industrial relations in Turkey. Then, we consider labor market condition and industrial relations actors and processes. We move on to examining the current challenges of Turkish industrial relations system and finally offer an assessment of whether recent changes indicate a transformation.

1. HISTORICAL DEVELOPMENT OF INDUSTRIAL RELATIONS

Although rudimentary forms of industrial relations existed in the last decades of the Ottoman Empire and in the early decades of the Turkish Republic (from 1920s to 1930s), it can be plausibly argued that it was in the second part of the 1940s that industrial relations in the modern sense of the word came into existence. The formation and consolidation of a new Turkish nation state largely determined industrial relations' trajectory through its official ideology and single party regime. As the official ideology of the Republican Turkey, Kemalism represented an "eclectic and superficial imitation of German *sozialpolitik,* Italian corporatism and Soviet economic planning" (Bianchi 1984: 140).

What shaped the contours of Turkish industrial relations in the early Republican period were the lack of the democratic traditions and the late economic development. Authoritarian tendencies of Turkish political tradition paved the way for the development of state corporatism based on the systematic denial of the classes in the early years of the Republic This approach stemmed from the existence of a state tradition that views organizations of civil society as potential threats against the state as they tend to occupy a position beyond the control of the state (Parla and Davison, 2004: 81).

Early Republican elites and intellectuals were preoccupied with the problem of how to undertake industrialization without causing antagonistic class relations. With this problem in mind, the state promulgated labor law in 1936, which did not allow labor organizations to operate. Almost all major industrial organizations were set up and directed by the state during rapid industrialization efforts in the 1930s. The emerging working class was tightly controlled by the state which, to this end, implemented various welfare measures in its industrial establishments.

The end of the World War II signaled the demise of old political order in many respects. One of the landmarks of democratization was the multi-party elections in 1946. Prior to the election, the ban on class-based organizations as well as political parties was lifted. In the immediate aftermath of this amendment, many labor organizations emerged in major cities. The government was taken aback by the rapid growth of unions, some of which were under the influence of newly established left-wing political parties. In order to reaffirm its control over labor, the ruling Republican People's Party (RPP) passed the Trade Unions Act in 1947.

Although the Act allowed the formation of unions and the right to undertake collective bargaining, the unions were subjected to government inspection and denied the right to strike. What was envisaged through these provisions was a labor movement under close government scrutiny. The 1947 Act could be seen as a devise to preempt autonomous development of labor movement. In the late 1940s and early 1950s, the governments of the time encouraged the unionization in the state economic enterprises so that they could have the political support of the workers. The managers of these enterprises promoted the fortunes of unions disposed to the party in power. The organization drive resulted in the establishment of Confederation of Turkish Trade Unions (Türk-İş) in 1952. From in its inception, Turk-İş followed a policy of harmony of class interests and non-partisan unionism as it believed the best way of improving the interests of labor was to cooperate with the day's government.

In this period, the unions did not feel the need to mobilize workers to advance their interests. They were under the influence of the state, which affected their outlook to labor problems. In a crucial moment of their formation, the labor movement was unable to assert its political independence from the state because of its weakness and inexperience. Instead, the unions turned to political tutelage for their survival and development. When a serious problem arose at the workplace the union would not discuss it, but rather would lobby politicians and bureaucrats to solve it. The outcome was union movement that was more concerned with political maneuvers than with worker-management relationship at the point of production. Since the state was the major employer and the unions were usually organized in the public sector, they depended, to a great extent, on the goodwill of the state to function. The workers, however, sometimes adopted the "hidden forms of resistance" like absenteeism and high labor turnover due to restrictions on the right to strike and trade unionism (Özeken 1948, Ekin 1968, Koç 1994).

The acceleration of economic growth and industrialization in the 1950s and 1960s brought about important changes in industrial relations. Though the state dominated the manufacturing industry with its large enterprises, the private sector showed a remarkable growth. One of the most salient consequences of the economic transformation in this period was the commencement of large scale migration and urbanization which have influenced working class formation. With the development of capitalism and the concomitant emergence of a working class in the 1960s came a new form of corporatism justifiably called "state initiated societal corporatism" whereby the state established various bipartite and tripartite commissions under its own tutelage (Bianchi 1984: 155).

Within the post-1960 socio-economic order based on import substitution and parliamentary democracy, the working class emerged as an important social force. Between 1960 and 1980, the Turkish working class became a political and social force to be reckoned with. The state implemented labor-friendly policies by recognizing the right to strike in 1961 and forming a loosely centralized collective bargaining system. The shift in state's policy can be attributed to the desire to create an orderly industrial relations system and maintain the control over labor by encouraging collaborative class relations. The creation of a modern industrial relations system in state-owned enterprises and large private sector establishments was facilitated by rapid economic growth. The changing stance of the state towards labor should be seen in the context of import substitution industrialization (ISI) usually associated with labor-inclusion policies (Kuruvilla 1996). The main labor organization, Turk-İş continued its policy of conciliatory bread and butter unionism and cooperation with management, which was awarded in the form of higher wages, fringe benefits and union shop practices in the public sector. The state continued regarding unions as organizations that should contribute to industrial development and national unity (Bianchi 1984: 233).

An important development of the period was the foundation of Confederation of Revolutionary Trade Unions (DİSK) by a breakaway group of four leftist unions from Turk-Is in 1967. The main reason for this split was a series of ideological disputes stemming from the "non-partisan" and bread and butter unionism of Türk-İş. Rapid industrialization, democratic reforms and increasing urbanization as a result of internal migration paved the way for the emergence of an assertive working class especially in the large private sector establishments. Turk-İş failed to satisfy raised expectations of workers many of whom were recent migrants with high expectations. These workers found the radical unionism of DİSK with its high wage settlements attractive. DİSK affiliated unions were located primarily in privately-owned industries where bitter conflicts between employers and workers were common especially in times of economic and political instability. During the 1970s, DİSK pursued a militant trade unionism and organized large scale collective actions including mass strikes. Influenced by a mixture of socialism and leftist nationalism DİSK was critical of widespread economic inequality and growing influence international capital (Jason-Mello 2006: 181).

In the late 1970s, the country was in the throes of economic bankruptcy and plunged into political violence. The number of strikes, strikers and work-days lost reached record levels. Under these dire conditions, new economic measures based on export orientation and open economy were announced in January 1980. When the military took over power through a coup in September 1980, new economic policy was implemented in full swing. The economic reforms aimed to restructure an inward-looking economy by attracting foreign capital, encouraging exports and restricting the role of the state. Within this context, Turkish industrial relations was redesigned to be in line with export-oriented industrialization (EOI) model. Labor rights were curtailed and trade unions, particularly militant ones, were suppressed. The military government suspended activities of DİSK together with several other smaller labor organizations. The disciplining of organized labor was accomplished through political means which aimed to shift the balance of power against labor. In the 1980s, the state dismantled the institutions, rules and regulations associated with the ISI model of development by creating a new set of institutions with the aim of institutionalizing the export-led development. EOI requires cost containment to achieve competitiveness, which generally involves workers suppression, especially in its initial stages (Kuruvilla 1996). Considering this, the suppression of labor in Turkey under EOI came as no surprise.

Türk-İş's hopes that under the civilian rule anti-labor measures could be reversed were dashed as the Motherland Party (ANAP), which came to power in 1983 following the military's decision to return its barracks, revealed its determination to continue strict stabilization policies involving a high degree of wage restraint. In sharp contrast to pre-1980 governments the ANAP governments pursued fiercely anti-union policies which gave rise to a harsher climate for labor particularly in the public sector. In a reversal of earlier policies that encouraged or remained indifferent to unionization, the ANAP administration implemented active deunionization policies in the public sector. The basic tenets of the policy was the recruitment of labor on the basis of special individual contracts, the employment of seasonal and temporary workers, the expansion of scope of the so called non covered personnel who can not join a trade unions and the increasing use of contractors.

Taking advantage of the state's assault on the working class, employers in the private sector generally adopted aggressive policies towards labor. Deunionization was one of the main items on the employers' agenda. Contracting out, dismissals of union members constituted the backbone of deunionization attempts. Many workers previously employed in large state-sector firms saw sharp reduction in wage levels, employment security and welfare benefits as many of these firms were being privatized. While the state adopted a highly negative stance towards organized labor, discontent among workers was slowly building up as falling real wages and rising inflation aggravated their economic grievances (Çetik and Akkaya 1999: 214).

Although the workers took a heavy beating under the military rule and were subjected to various anti-labor measures, they were able to fight back and improve its material situation from the late 1980s to the early 1990s. The discontent of workers became clear towards the end of the 1980s and they increasingly began to undertake wildcat industrial actions. These were followed by massive strikes in the public and private sectors. The short-term outcome of these activities was substantial increase in the wages, which compensated for the losses of the preceding decade. Employers' reacted to pay increases through large scale labor shedding and the increased hiring of temporary, fixed contract workers who are not covered by collective agreements. The laid off workers were replaced by new ones at prevailing minimum wages.

The most important long term consequence of the restructuring was the establishment of a new industrial relations system in 1983. In addition to the new constitution (enacted in 1982) which contained stringent regulations for labor unions and union activities, a rather restrictive Trade Unions Law (2821) and Collective Bargaining, Strike and Lockout Law (2822) were enacted in 1983. The new legislation imposed extensive restrictions and administrative controls on unions and involved detailed juridification and bureaucratization of the collective bargaining process and of strike activity. These laws have remained in force without major changes and constitute the main legal framework of the present industrial relations system.

2. LABOR MARKET IN TURKEY

Turkish labor market has been influenced by IMF and World Bank induced structural reforms since the 1980s, which has seen a restructuring through growing informal and subcontracting activities. The Turkish civilian labor force consists of around 20 million people. Of these around 11 million (54 percent) are wage and salary earners (PRA 2009: 8). Turkey has a very low overall employment rate with 48 percent which largely emanates from low female employment rate (Bakır, Taşıran and Tayman 2009: 1). Some 95 percent of all enterprises are classified as micro enterprises employing 1 to 9 persons and overall 99 percent of all enterprises and 80 percent of total employment are accounted for by small and medium-sized enterprises (SMEs) – defined as enterprises with fewer than 250 employees (PRA 2009: 13).

Regarding sectoral distribution of employment, it can be seen that the services sector accounts for nearly 50 percent of total employment in the economy. Although the share of agriculture has declined over the years, it is still relatively high at about 24 percent. Industry accounts for a further 21 percent of total employment, while construction constitutes about 5 percent of total employment (PRA 2009: 8). Although Turkey achieved impressive economic growth in the early and mid 2000s, this growth was not reflected in creating new jobs. The country's unemployment rate fluctuated around 10-12 percent in recent years but according to the latest unemployment figures, the rate hits 15.5 percent, the highest in the history of the Republic (TURKSTAT 2009). Privatization has also resulted in significant job losses. Employment in state-owned enterprises has declined by 65 percent, amounting to 430,050 job losses in the last 25 years (Bakır, Taşıran and Tayman 2009: 1). Large state-owned telecommunications, steel and refinery companies were among the privatized enterprises.

The informal economy continues to play a significant role in Turkey's economy. It is estimated that its size as percentage of GNP for 1998-2004 period was fluctuating between 26 percent and 37 percent (PRA 2009: 7). Undeclared employment has continued to be one of the major issues in the Turkish labor market, accounting for around 47 percent of total employment. Only a small portion of labor force is lucky enough to find a stable job in modern parts of the economy, whereas the others work without being registered with any social security agency because of informal nature of work. Various researches show the existence of a large group of workers with low wages and working in irregular jobs in insecure conditions (Öke and Kurt 2003; Buğra and Keyder 2003, Adaman, Buğra and İnsel 2009).

3. INDUSTRIAL RELATIONS: ACTORS AND PROCESSES

The state plays a dominant role in determining the basic characteristics of industrial relations in Turkey as the public sector still employs around 40 percent of all wage earners in spite of recent privatizations. Furthermore, around 70 percent of all unionized workers are employed in the public sector. On the other hand, it is not just the state's role as a major employer that puts it at the centre of industrial relations in Turkey. A very detailed legislative framework enables the state to influence the contours of industrial relations.

There are two types of labor unions in Turkey, each of which is divided into rival confederations with significant political and policy differences. The first type includes unions organizing mainly blue collar employees under the jurisdiction of Labor Act and operating on the basis of Trade Unions Act and Collective Bargaining, Strike and Lock-Out Act. The second type involves unions organizing public servants who are under the jurisdiction of Public Servants Act and operating on the basis of Public Servants Trade Unions Act. There are three main confederations organizing blue collar employees: Türk-İş, Hak-İş, and DİSK. In addition, there are three major confederations organizing public servants: Türkiye Kamu-Sen, Memur-Sen and KESK.

Table 1. Number of trade unions and union members in Turkey

Confederations	Number of affiliated trade unions	Number of trade union members	Political Leanings
Türk-İş	33	2.230.015	Centrist
Hak-İş	7	429.091	Conservative
DİSK	19	422.785	Moderate Left
Independent	33	123.771	
Total	92	3.205.662	

Source: ÇSGB, Labor statistics, 2009 (http://www.csgb.gov.tr/images/articles/editor/Ocak2009_1.xls accessed on 06.07.2009).

Although the table 1 shows that there are more than 3 million union members, this figure does not accurately reflect real membership figures for various reasons. Unionization rate is estimated to fluctuate between 8 percent and 12 percent of workers employed under the jurisdiction of the labor law and the corresponding rate among public servants is about 50 percent (Bakır, Taşıran and Tayman 2009: 17-8). The labor legislation does not allow pensioners and students to join union. Hence the membership of labor confederations is restricted only to unionized workers.

Table 2. Number of trade unions and members in public servant trade union confederations

Confederations	Number of affiliated trade unions	Number of trade union members	Political Leanings
Turkiye Kamu-Sen	11	357.841	Moderate Nationalist Right
Memur-Sen	11	314.701	Conservative
KESK	11	223.460	Moderate Left
Others	28	35.433	
Total	61	931.435	

Source: ÇSGB, Labor statistics, 2009 (http://www.csgb.gov.tr/images/articles/editor/ek.doc, accessed on 06.07.2009).

One of the challenges met by the labor movement in the 1990s was to lift restrictions on public servants' unions that had been in place since the early 1970s. A new law on public servants' unions, adopted in June 2001, is not in line with the EU *acquis* or the relevant ILO Conventions ratified by Turkey. This law contains a number of provisions that impose significant constraints on the right to organize in the public sector. Membership is not open to all categories of public servants, and certain categories are banned from membership by the Public Servants Trade Unions law, which affects more than 450.000 public servants. The law stipulates that trade unions can be established on the basis of service activity. In each service activity, public service trade unions with the highest number of members and the confederation to which it is affiliated have the right to represent employees in what is termed "consultative collective negotiations", which is restricted to financial issues, covering salaries and other allowances, compensation and bonuses. This falls far short of the definition of collective bargaining contained in ILO Convention 98, and in practice, leaves the power of decision making with the government. Public officials are thus not covered by collective agreements and do not have the right to strike.

As far as employer organizations are concerned, they are also divided on the basis of enterprise size and organizational aims. The Confederation of Turkish Employers Associations (TİSK) is the major employer organization specializing in industrial relations and employment issues, whereas Turkish Industrialist and Businessmen Association (TÜSİAD) and The Turkish Union of Chambers of Commerce and Bourses in (TOBB) usually concern themselves with fiscal and other macro economic matters. While TÜSİAD represents large capital, TOBB is mainly the representative of small and medium-sized capital. The interests of state-owned and state-controlled undertakings are in principle represented by specific employer organizations, but these organizations in turn belong to the national confederation TİSK, which acts on behalf of Turkish employers as a whole.

Industrial relations in Turkey are currently governed by above mentioned two laws on trade unions and collective bargaining and strikes enacted in 1983. Compared to the pre-1980 period, one of the most important changes was the introduction of the threshold system to determine unions eligible for undertaking collective negotiations. The new system does not allow the establishment of regional and workplace based unions and trade unions are obliged to organize 28 branches of economic activity as defined by the law. Although the law formally recognizes freedom of association and the right to undertake collective bargaining and strike, it imposes many restrictions.

Table 3. Collective bargaining coverage, by number of agreements concluded, 2001–2006

	Number of workers covered	Coverage rate (%)*	Coverage rate for all workers (%)**
2001	775,478	29.3	17.0
2002	255,059	9.4	5.4
2003	629,240	22.4	13.0
2004	325,386	11.2	6.5
2005	587,456	19.7	11.5
2006	304,392	10.0	5.8

Notes: Figures shown pertain to the number of collective agreements concluded in the given year.

* number of employees covered by collective bargaining as a proportion of employees with right to bargain (i.e. number of unionized members);

** number of employees covered by collective bargaining as a proportion of all employees.

Source: Bakır, Taşıran and Taymaz 2009: 20.

Although Turkish unions are organized on the basis of industry and union structure is centralized, collective bargaining is based on workplace not industry. According to Collective Agreements, Strike and Lockouts Act, an authorized union may conclude a collective agreement covering only one establishment, or it may conclude the collective agreement so as to cover more than one establishment belonging to different employers, provided it meets the bargaining requirements in each of these establishments or enterprises (Dereli, 1998: 275). The latter form is known as the multi-employer agreement or group agreement. Collective bargaining is heavily restricted and to be recognized as a bargaining agent a union must represent more than half of the employees in an enterprise and 10 percent of all employees in the branch of activity. The Law does not recognize "industry-level" collective bargaining. The most common form of collective bargaining in Turkey is therefore enterprise-level collective bargaining. The public sector accounts for about two thirds of these agreements. Agreements have limited duration, generally two years and cover individual establishments, several establishments in one enterprise, or at a multi-employer level. Collective agreements are applicable only to members of the trade union concerned and to non members who may benefit from the collective agreement if they pay a monthly "solidarity due" to the union.

Regarding strikes, labor activism in Turkey reflects patterns suggested by Valenzuela (1989) who claimed that transition to democracy increases labor activism, which is followed by a relative acquiescence.

Table 4. Strikes in Selected Years, 1985–2006

	Number of strikes	Number of workers involved	Number of work-days lost
1985	21	2.410	194.296
1987	307	29.734	1.961.940
1990	458	166.306	3.466.550
1996	38	5.461	274.322
2000	52	18.705	368.475
2001	35	9.911	286.015
2002	27	4.618	43.385
2003	23	1.535	144.772
2004	30	3.557	93.161
2005	34	3.529	176.824
2006	26	2.061	165.666

Source: ÇSGB, various years, Labor Statistics.

It can be suggested that Turkish industrial relations appears to free from large scale industrial action with the exception of periods between 1987-1991 and 1995. The above table vividly illustrates the lack of confidence on the labor side to challenge employers and the state. Strikes are prohibited in many sectors which are not considered essential under ILO standards and are subjected to many restrictions. The right to strike is withheld from workers employed in banking, energy, public transport, military establishments and health and education services. It is estimated that roughly one–fifth of all unionized workforce is involved in these industries and services which are subject to compulsory arbitration (Dereli 1998: 314).

Turkish industrial relations is marked by an interventionist tradition with a strong tendency to use the legal system to deal with industrial problems. It is characterized by the absence of an economic, political and social environment that is favorable to collective bargaining. An outcome of this has been the lack of autonomous or voluntarist arrangements for the solution of disputes between the actors of the system. For a successful dispute settlement system it is essential that all parties involved have sufficient organizational capacity to act on behalf of the constituency they represent. Both Turkish unions and employer associations have weak control over their members. It is also important that the distribution of power between the parties should not be too uneven. The weakness of the Turkish labor movement constitutes an important barrier in the development of a successful conflict resolution mechanism as employers do not see any need for the use of mediation services in a situation where they are able to impose their own terms.

One of the major problems in Turkish industrial relations is the lack of trust between the industrial relations actors. The labor side is particularly distrustful towards the state and employers. For labor, employers are bent on exploiting their weak position in the labor market with utter disregard for social rights. In their turn, employers tend to regard unions as reactive, outdated bodies that are not in touch with economic realities.

4. Current Challenges

The segmented and dual feature of the Turkish labor market has created important differences in terms of working conditions, wages and fringe benefits and job security between those employed in the formal sector and those working in the informal sector. Formal processes of industrial relations do not exist in the informal sector. The same differences also exist between unionized and non-unionized workers within the formal sector where compliance with the labor legislation is relatively low.

Although trade unions in Turkey are directly affected by the recent process of economic restructuring, they have not usually been able to develop strategies and policies in response to challenges posed by globalization. There have been many cases of anti union practices which are often subjected to ILO investigations and I(C)FTU reports. Turkish trade unions have faced enormous problems as a result of employers' deunionization activities, the spread of new management techniques, privatization and reduction of labor rights. Governments have moved to restrict privileges enjoyed by organized labor for many years especially in the public sector.

Employer hostility and restrictive legislation is the main culprit for non unionization. For example, it was claimed that 15.531 workers were fired for joining a union between 2003 and 2005 (Turk-Is 2006: 5). Similarly, employers dismissed more than 45.000 workers affiliated to Turk-İş and DISK between 2003-2008 (Bakır and Akdoğan 2009: 93).In a research conducted among the 1.150 largest firms in Istanbul Chamber of Industry list in 2000, 41 percent of the companies were non-unionized, this rose to 50 percent in 2005. Only in 38 percent of companies there were unions entitled to undertake collective bargaining (Uyargil et al. 2006: 74).

There has been a union revival literature which has identified three main strategies for union revitalization: organizing model, service model and partnership model (Heery 2002, Baccaro et al. 2003, Bacon and Blyton 2004). While unions pursuing organizing model promote involvement of members in their activities and organize campaigns to attract non-members, those adapting service model consider themselves as service providers to their members. The partnership model involves unions' cooperation with employers to achieve and sustain competitiveness of the workplace. These models are mostly derived from the experience of unions in the developed world. In addition, for the developing countries, social movement unionism emphasizing human rights and social justice in the wider society is promoted as the way forward for unions in these societies (Waterman 1998).

The organizing challenges faced by Turkish unions are enormous, which include the need to make significant inroads into the informal sector and harder to organize segments of the economy. Informal sector workers have long been outside the purview of unions. Furthermore, the union movement lacks a capacity to mobilize workers in modern sectors of industry where it is mostly organized. As a result, Turkey has been able to implement IMF-induced structural adjustment programs without causing widespread discontent among organized labor. Unions tend to adapt to "a myopic strategy leading them to concentrate on the interests of their limited membership" (Adaman, Buğra and İnsel 2009: 168). Turkish unions seem reluctant to organize workplaces where they think they have little chance to undertake collective bargaining. This creates a kind of vicious circle for unions. It would be, however, unfair to accuse the unions of short-sightedness as they have "institutional reasons" for not concerning themselves with non-unionized workers. Many unions have a membership rate just above the legal thresholds to undertake collective bargaining and this makes them very anxious to maintain their present membership base at all costs.

Union members do not usually involve in organizing new workplaces. Workers who want to unionize usually apply directly to the union. It is unusual for a union to organize workers by activities in the workplace. Secrecy is the rule for a successful organizing campaign. If management and employers become aware of workers' unionization efforts, they almost always immediately fire them. If employers are unable to prevent unionization of their workforce, they prefer a more moderate and cooperative union. In a recent research, it was found that 10 percent of the unionized workers had joined the union by "the decision of the employer" (Adaman, Buğra and İnsel 2009: 184). Adaman et al. point out that some managers and employers allow unionization of a small part of their workforce if unions do not attempt to organize the rest.

Turkish unions have pursued various strategies in their attempt to revitalize without much success. Few unions in, for example, food and oil industries have recently made efforts to develop strategies based on the organizing and partnership models. These unions' initiatives have so far not been very effective as they have failed to mobilize their rank-and-file. Furthermore, the fractured nature of the labor movement and its inability to organize joint initiatives because of personality and ideological differences has resulted in a significant weakness among the ranks of labor.

The unions lack vast mobilization capacity as illustrated by their failure to organize mass meetings against the new labor law and social security arrangements. The realization of social movement model is also extremely difficult in Turkey in view of weak civil society. A weak civil society means that unions do not have many well-organized potential coalition partners including leftist political parties, which are often considered valuable allies for unions.

We suggest that historical legacies are also important in accounting for unions' lack of initiatives in the Turkish context. In addition, economic conditions and the political and institutional context impinge on whether unions make revitalization attempts. The role of trade unions in Turkey cannot be fully understood without a consideration of the long tradition of a strong and dominant state active in industrial relations. In consequence, the unions still expect the state to intervene directly and solve their problems. This can be summarized as "reform trade union law first, and then organize" mentality. Throughout the 1980s, the Turkish state actively intervened in industrial relations in the direction of controlling and weakening or trade unions and the system of collective bargaining. The legislation imposed extensive restrictions and administrative controls on unions and involved detailed juridification and bureaucratization of the collective bargaining process and of strike activity. This has lead to increasing member apathy towards union activities, which, in turn, has facilitated the consolidation of an unaccountable leadership. The research has illustrated the existence of widespread distrust among union members towards their organization (Buğra, Adaman and İnsel 2004: 42, Urhan 2004: 276, Urhan 2008: 159). It is interesting to note that it is among the former members that distrust and criticism of unions reach the highest level.

In an attempt to convince employers and the state to encourage unionization, Türk-İş has asserted that unionization is "a proof of democratization of the country in the context of European Union membership process" (Türk-İş 2006: 20). It has also argued that unionization is good for business and national economy by acting as a kind of mediator between management and workers (Turk-Is 2006: 8). Appealing employers and the state through the above arguments has, nonetheless, hitherto, not produced any favorable concrete outcomes for the unions. The weakness of public policy in curbing overt and covert anti-union and union avoidance strategies has been a dominant feature of industrial relations in Turkey.

Inter-union rivalry has also intensified particularly between Türk-İş and Hak-İş affiliates as well as between trade unions affiliated to Türkiye Kamu-Sen and Memur-Sen confederations. Since Hak-İş and Memur-Sen are ideologically close to the ruling Justice and Development (AKP) Party government, it is not surprising that these organizations have decided to take advantage of this. With the backing of the government, they have achieved rises in their membership at the expense of rival organizations.For example, a Hak-İş affiliate; Tarım Orman İş (The Agriculture and Forestry Workers Union) began poaching workers from a rival Türk-İş affiliated union, Orman-İş (The Forestry Workers Union). As a result, Tarım Orman İş was able to increase its membership from 837 to 18.000 in just three months[*]. and Similar developments have also occurred in local services sector (Evrensel 28 July 2004).

It can be suggested that the AKP may have a desire to strengthen Hak-İş and Memur-Sen in order to create friendly labor organizations that will not oppose the government in every occasion and use these organizations as leverage against other labor confederations.

The current AKP government has further changed the distribution of power in industrial relations against labor in recent years (Uçkan 2007: 121). For example, the postponement of legal strikes has been a telling feature of Turkish industrial relations under the AKP government (Aydın, 2004: 365-421). Turkey has not usually been a strike-prone country since the 1980s with the major exception of the period between 1989 and 1994. Despite the insignificance of strikes, the AKP government did not hesitate to use its legal powers to

[*] This union was later closed down by the labor court because of violations of some provisions of the Trade Union Act .

postpone strikes deemed "damaging national economy". It is also important that strike postponement usually amounts in practice to strike prohibition in Turkey. A legal strike may be postponed by order of the Council of Ministers for sixty days if it is likely to be prejudicial to national security and public health. However upon the expiration of sixty day postponement period workers can not go on the strike, in other words, following the postponement period collective agreement should be concluded by either parties or the Supreme Arbitration Board. Therefore, strike postponements greatly erode the right to strike in Turkey.

The government twice postponed a strike in the glassware sector for 60 days by 5.000 workers tied to Kristal-İş (The Glass, Cement, Ceramic and Soil Industries Workers' Union) on the grounds of 'threatening national security and public health' in 2003 and 2004. The union protested to the government and accused it of implementing policies dictated by employers. The union took the case to the Council of State, which ruled that the postponement was a breach of relevant laws. The Minister of Justice defended the government's decision by using the same arguments put forward by the employers who successfully lobbied the government arguing that the strikes would damage the economy, as they would risk losing their export markets. Eventually, the government postponed the strike once again. Kristal-İş took the issue to the international arena. More significantly, Guentur Verheugen, the then EU commissioner responsible for the enlargement, in his reply to Kristal-İş's letter regarding the issues stressed, 'the candidate countries should respect basic human, cultural and social rights as specified in the Copenhagen criteria. The right to strike is one of the fundamental social rights' (Kristal-İş 2004: 391). Notwithstanding these criticisms, the government did not waver to postpone another strike in the tire industry for 60 days on the grounds of "national security" in 2004.

Turkey's membership process to the EU has been an important factor in recent changes in the Turkish industrial relations. The establishment of an Economic and Social Council (ESC) in 1995, the enactments of Public Servants Trade Union Act in 2001 and a new Labor Law in 2003 and discussions about new Trade Unions and Strike, Collective Bargaining and Lockout Laws may be seen as the major examples of the EU's influence on Turkish industrial relations. As a matter of fact, the EU pressurizes Turkey to establish full trade union rights including the elimination of restrictive thresholds for forming a trade union and the elimination of the requirement of 10 percent threshold for a trade union to be eligible for collective bargaining at company level and restrictive provisions relating to the right to strike and to collective bargaining.

It is the new labor act that has come to symbolize the process of changes in the institutional structure of Turkish industrial relations. The adoption of the new labor law was welcomed by the Commission of the European Communities (CEC) which viewed it as an "important step towards meeting international standards" (CEC, 2005). In the preamble of the new labor law, the Turkish Parliament makes an explicit reference to need for adopting social legislation in line with the EU accession requirements. Interestingly, the Parliament maintained regulations that violate EU requirements should be eliminated incrementally rather than adopting all the requirements immediately. Although the new law has introduced a number of changes in accordance with the EU Directives, but there is a need for further reform in the Labor Law and related regulations to comply fully with the *acquis*. The EU Commission's Regular Reports about Turkey point out that more detailed legislation should be adopted in all areas for full alignment with the relevant Directives including transfer of undertakings, posting of workers, young people at work, health and safety for fixed term and temporary employment, European Works Councils, information and consultation of workers (CEC 2008: 88).

Despite the implementation of neo-liberal policies, Turkey had an over-regulated labor market coupled with tougher dismissal and flexibility arrangements under the abrogated labor law which was heavily criticized by employers for its rigid provisions. Turkey had high scores in the OECD Employment Protection Legislation (EPL) index for regular employment due to high severance payments and unfair dismissal compensation. Turkey ranked second for the late 1990s in the EPL index (Taymaz and Ozler, 2004: 18). It now occupies the tenth place in the EPL index. The EPL index does not accurately reflect the situation in Turkey. The informal sector, which accounts for a substantial proportion of Turkey's labor force, is not covered by the EPL.

Harmonizing the Turkish labor law with the EU and arranging less protective and more flexible forms of work and employment were the justifications for the new labor act of 2003. The Minister of Labor and Social Security asserted that the new labor code had two aims: "social protection and competitiveness" (ÇSGB, 2005: 31). The Law, by taking into account the relevant EU legislation, contains provisions regarding non-standard employment, collective redundancies, flexible working time, temporary employment relationship, and transfer of undertakings, employer's obligation to inform employees, employment protection, and effective implementation of occupational health and safety measures. The new Labor Law has provided a legal basis for "atypical" employment relationships, namely part-time and fixed-term employment. This is the most welcomed aspect of the new Act by employers.

On the other hand, employers criticize some aspects of the new Act. TİSK believes that Turkey should evade social policies that may damage its competitiveness and weaken its economic power (TİSK, 2004: 3). It also maintains that accepting EU *acquis* in social policy is not necessary for membership; the necessary condition is the Copenhagen criteria (TİSK, 2004: 73).

Before the enactment of the new labor law, a job security law modeled on ILO convention 158 (ratified by Turkey in 1994) concerning termination of employment at the initiative of employer had been enacted in 2002. This law was later incorporated into the labor law. Employment protection provisions of the new law, which provide workers with the reinstatement right in case of wrongful dismissal, do not cover establishments employing less than 30 workers that leave more than 40 percent of workers registered at the Social Security Agency (SGK) out of protection. The new Labor Law has thus provided extensive flexibility to small establishments, while reducing the coverage of employment protection in these companies, which employs the bulk of the workforce. Even for those workers covered by the employment protection, employers tend not to take reinstatement applications seriously. Out of 11.173 applications for wrongful dismissal, courts awarded reinstatement in 17 percent of all the cases (Turk-Is, 2006: 10). But only 3 percent of these were implemented as employers prefer paying a small fine to reinstating workers.

The CEC strongly urges Turkey to ensure effective implementation and application of the new Labor Law on the ground (CEC, 2008: 94-97). While alignment is relatively advanced on health and safety at work, substantial efforts are still required in areas such as maximum weekly working time, social dialogue, gender equality and antidiscrimination (EC, 2008: 135). For instance, average weekly working time is quite long, and there has been an effective lobbying against implementing the relevant Directive's provision regarding the maximum average weekly working time (48 hours). According to Turkey Statistics Organization (TÜİK) household labor force statistics, 41 percent of all paid workers work 50 hours or longer in a week (Taymaz and Ozler, 2004: 23).

One of the areas where the CEC gives a special emphasis is related to social dialogue. Turkey has a variety of social dialogue institutions and mechanisms from enterprise to national level. Although tripartite consultative boards and regulatory commissions have long been institutionalized, their impact has been relatively minor in terms of social dialogue both at national and local levels. Turkey has ratified all the basic ILO conventions in the field of right to organize and tripartite consultations such as ILO Conventions No 87, No 98, No 144 and No 142. The legislation that governs industrial relations has stipulations for social dialogue at the workplace level. Other platforms for social dialogue include the administrative bodies of various state agencies which design and deliver services directed to labor market participants. Union representatives have a say on matters such as annual leave, discipline health and safety.

Social dialogue in Turkey is mainly constrained by the lack of genuine belief in its necessity by governments and weakness of labor. Social partners, especially the labor side, feel that they are simply consulted rather than actually taking part in the decision-making process.

It is not just the quality of social dialogue that has come under attack. For example, KESK president argued "it is not correct to support social dialogue while the state and üemployers show no respect for labor rights." For him, the current way of social dialogue as implemented in the EU is "talks between elites without masses" (Tombul quoted in Birgün, 29 September 2005: 9).

Sectoral social dialogue implies consultation joint action and negotiation at the sectoral bipartite level. No social dialogue exists in most private enterprises, which is likely to hinder the full implementation of EU *acquis* at enterprise level. Bipartite social dialogue in the Turkish private sector is limited to collective bargaining at the enterprise level. In the absence of formal representational structures, collective bargaining has remained almost the sole method of employee influence at enterprise and establishment levels.

In the absence of a broad-based statutory participation system in Turkey, collective bargaining seems to have served as a platform for a limited participation of labor. A useful development for collective bargaining in Turkey would arguably be the extension of its scope to cover wider issues such as training, productivity, quality, job enrichment, and work organization. Recently, in some sectors, notably in the metal working industry, the largest trade union (Turk Metal) and the Metal Employers Association (MESS) have formed joint councils, which deal with issues related to occupational health and safety, training and productivity (MESS 2005:9). A similar attempt at sectoral bipartite social dialogue has been made in the construction industry between the main union (Yol-İş) and employer association (İNTES) in the context of establishing a joint training centre for construction workers (Yol-İş, 2006: 22). Bipartite dialogue at national level has also begun to develop between Turk-Is and TISK with the encouragement of the EU. However, these bipartite efforts are of very recent origin and their effectiveness has yet to be seen.

The success of the bipartite social dialogue depends on, to a certain extent, workers' trust in their union and leadership. In this regard, many Turkish unions have a problem of credibility in the eyes of their members. For example, the Turk-Metal union is known for its autocratic leadership that is willing to cooperate closely with employers and managers to the detrimental of labor (Nichols and Suğur 2004: 181). Not surprisingly, such unionism creates doubts among workers when the union and management engage in bipartite activities.

5. CONCLUSION

The roots of state's dominance in Turkish industrial relations lie in the early decades of the Republic where a bureaucratic-authoritarian single party state armed with a variant of corporatist ideology dominated the whole political and economic scene. Although economic adjustment suggests a retreat of the state from the management of industrial relations, the state remains a major actor affecting the transformation of labor institutions. Governments have played a pivotal role in determining the character and scope of industrial relations, which involves the formal process of labor incorporation, the enactment of labor laws, the resolution of industrial disputes and the rights of workers and employers.

The deregulation of labor markets, legislative changes and the spread of neo-liberal politics have resulted in increased power of capital over labor. The overemphasis on harmony in the Turkish polity has constituted a serious barrier to the development of pluralistic policy-making structures through participation of civil societal elements. The government tends not to treat the unions as fully-fledged social partners.

Turkish industrial relations scene is characterized by high unemployment, large informal labor market, long working hours, lower wages, low union density and low levels of collective bargaining coverage and strike activity. In short, the "deep structure" of Turkish industrial relations reflects a state dominated and heavily juridificied system in which relatively weak social partners have historically exerted limited influence.

Turkish trade unions should design strategies that facilitate "internal social dialogue" with their members and other unions rather than relying on the benevolence of the state. New strategies and organizational forms, new linkages and coalitions are what unions require. Nonetheless, a weak and divided union movement operating under unfriendly laws is unlikely to take initiative in remapping Turkish industrial relations.

Turkey has embarked upon changing its institutional structure regarding employment and social affairs. The new Labor Law has introduced a number of changes in accordance with the EU directives, mainly those provisions that help to establish flexible employment relationships, but there is an apparent need for further reform in the Labor Law and other regulations to comply fully with the EU standards. There are, however, important barriers resulting form the existence of large informal sector that would inhabit the full and effective implementation of the labor legislation.

Throughout the 1980s, the Turkish state actively intervened in industrial relations in the direction of controlling and weakening or trade unions and the system of collective bargaining. While the new Labor Act reflects employer concerns to increase labor market flexibility in its provisions, it offers unions little. The abolition of the restrictive provisions on union activities may help empower unions but this will require a concerted political campaign, which currently appears unlikely in the near future. Without the momentum generated by the EU accession process, the minimal reforms in industrial relations that have developed in Turkey would not have occurred. The EU membership process has not, however, on its own so far transformed the "deep structure" of Turkish industrial relations. As long as a lack of government and employer support for basic labor rights continue to exist all recent changes and reforms attempts would only constitute non-fundamental changes in Turkish industrial relations.

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SECTION III. CURRENT ISSUES OF THE REGULATORY PROCESS IN TURKEY

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Chapter 11

THE POLITICAL ECONOMY OF INDEPENDENT REGULATORY AGENCIES IN TURKEY*

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ABSTRACT

The chapter analyses transition to IRAs in Turkey from two different viewpoints. Main reasons for delegation of the regulatory discretion to IRAs are to reduce political transaction costs and to ensure a credible commitment. In this context, the first section of the chapter examines the meaning of political transaction costs and regulatory commitment in terms of independence of IRAs during delegation process of the discretion to IRAs in the Turkish experience. This section also contains lessons from the Turkish energy industries. The second section only evaluates formal independence levels of IRAs in Turkey. Thus, the chapter reveals formal independence of IRAs in Turkey and presents a comparative analysis among them.

Keywords: independent regulatory agencies, delegation, independence, accountability.

INTRODUCTION

Independent regulatory agencies (IRAs) are relatively the new players of the regulatory process, especially in regulation of the public utilities that have a crucial role in realization of long-term infrastructure investments and economic development in a country, and a new

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organizational form for public administration in Europe and Turkey. It is observed that the creation of IRAs is synchronous with statist policies being replaced by regulated market economy. In this context, it is noted that, as a result of privatization and liberal biases, regulation policies took the place of 'positive state' and that they have been effective in the rise of 'regulatory state' (Majone, 1994).

The efficiency of the regulatory process in the regulatory state model is based on well-defined rules of the game. Regulatory commitment and political transaction costs are the basic tools to evaluate the efficiency of a regulatory process. Political and institutional structure of regulation shapes regulatory commitment and interaction among players (mainly the Legislature, the Executive-IRAs, and the Judiciary) in the supply process of regulation affects the magnitude of political transaction costs (Levy and Spiller, 1996). Arbitrary interventions to the regulatory process increases transaction costs and reduce regulatory commitment. In a regulatory process that has a credible regulatory commitment, such interventions cannot destabilize the system.

In addition, the institutional structure of regulation in a country determines directly economic and indirectly political development level of the country. However, every country has a distinctive regulatory-institutional endowment and all countries, especially developing countries, should establish the regulatory-institutional structure by taking into account this feature of regulation (Laffont, 2005). Because transaction costs of the regulatory process that can redirect economic and political development depend on regulatory institutions (Martimort, 1999). As conflicts of interest between institutions increase political transaction costs, belief in regulatory commitment decreases them. If commitment is not credible, characterization of optimal policy or equilibrium is extremely difficult even if not impossible. However, credible commitment limits the extent to which a party can engage in opportunistic behavior and hence provides a basis for reliance. When commitment is not fully credible, firms have greater difficulty making long-term plans and weaker incentives to make long-term and irreversible investments (Baron, 1995: 16). Thus, credibility and transaction costs of the regulatory institutional endowment can determine the direction of economic development.

For those reasons, in order to avoid the negative outcomes of arbitrary discretions and the high political transaction costs and to ensure a credible regulatory commitment, governments have established IRAs and delegated the regulatory discretion to them. It is accepted that delegation of power to IRAs reduces political transaction costs significantly (Majone, 2001b; McCubbins, 1985).

Consequently, IRAs are seen as a reflection of the changing role of the state in economic and social areas. They can also determine political development by affecting social, political and administrative areas more and more. However, in countries which have little experience in delegating functions to 'arm's length' institutions, IRAs are a controversial topic. Turkey is not exception to this trend.

Turkey has reshaped its own regulatory institutional structure recently by establishing IRAs. However, the change of the traditional patrimonial state model to the regulatory state model in Turkey has caused high political transaction costs during transition to IRAs (TUSIAD, 2002). The political authority has not wanted to delegate the political property rights to IRAs. Although IRAs in Turkey is *de jure* established, such conflicts *de facto* impede IRAs to institutionalize by increasing transaction costs of transition to IRAs.

In this context, the chapter consists of three sections. The first section focuses on main reasons for delegating the discretion to IRAs. The second section scrutinizes political economy of transition to IRAs in Turkey; place of IRAs in the change and some conflict cases between the independent regulator and the government in energy markets in terms of independence of the regulatory agency. The third section includes an empirical analysis of formal independence levels of IRAs in Turkey.

We argue that policies of the political principals concerning IRAs are consistent with and originate from its short-term political pragmatism than economic considerations. Politicians strive to reinforce their own positions in the relationship between the political principal and IRAs. This approach to IRAs in Turkey injures independence of IRAs. In the end, the polity of the incumbent government increases transaction costs of the regulatory process and frustrates a credible commitment in transition to IRAs.

1. Rationale for Delegation of Discretion to IRAs: Political Transaction Costs and Credible Commitment

IRAs represent the best examples of delegation to non-majoratirian institutions (Majone, 2001b). They are organizationally separate from governments and headed by unelected officials. Because of these characteristics, IRAs differ from classical administrative organization. Most scholars have focused on how and why elected politicians delegated their competencies to IRAs, formal institutional design of IRAs and consequences of creating IRAs (Thatcher, 2002; Majone, 2001a, 2001b; Epstein and O'Halloran, 1999).

The main aim of such agencies is to purify areas of energy, telecommunications, transportation, and banking from the influence of politicians and private actors that are active in these sectors. IRAs, in the context of depoliticized state, are seen as the guaranty for objective and unbiased administration of these sensitive sectors.

Furthermore, it is possible to find a number different rationale for delegation of discretion to IRAs, ranging from expertise, flexibility, stability to public participation, transparency, public interest and blame shifting (Thatcher, 2002; Majone, 2001b; Epstein and O'Halloran, 1999). For example, IRAs are closer to the regulated sector than ordinary bureaucracy and can more easily gather relevant information. IRAs can easily adapt to technology or technical knowledge. For that reason, IRAs have *expertise* related to regulatory issues. IRAs' autonomy makes them more able to *flexibly* adjust regulations to changing conditions. IRAs provide a stable and predictable regulatory environment. *Stability* means that rules will not be subject to sudden and unexpected change. The decision making process of IRAs is more open and *transparent* than that of ministerial departments and is thus more sensitive to diffused interests such as those of consumers. In addition, IRAs enable politicians to shift *blame*, when regulatory failures occur or when unpopular decisions are taken.

However, these functional advantages that IRAs have are not sufficient to explain delegation to these agencies and to analyze them. By pursuing Majone (2001a, 2001b), we directly focus on two much more important rationales; political transaction costs and regulatory commitment. Although the first rationale affects heavily the second, both political transaction costs and regulatory commitment actually influence each other, in turn, and both of them determine efficiency of the regulatory process together. Accordingly, the most important function of IRAs has to reduce political transaction costs and to ensure a credible commitment in the regulatory process (Thatcher, 2002).

1.1. Political Transaction Costs

In the real world, we can see a great deal kind of transaction costs existing with different forms in different areas, if we define transaction cost as cost of transacting or exchange in any market like a used-car market or the politics market. Then it can roughly be mentioned three forms of transaction costs; search costs, bargaining costs, and enforcement costs. Additionally, transaction costs are positive when there are hostile, many, and unfamiliar parties, unique good or service, unreasonable behavior, delayed exchange, numerous contingencies, high costs of monitoring, and costly punishments (Cooter and Ulen, 2004).

However, we only interest in transaction costs that exist in the regulatory process and define these as political transaction costs. The regulatory process means interaction within the institutional endowment or governmental-politics structure that plays a prominent role particularly in regulation of public utilities. The regulatory institutional endowment consists of political processes that define the property rights, redistribute the wealth and determine the direction of the economy. Especially, the political processes (politics) are an ambiguity world (Schwartz et al., 1994). Transaction costs in the politics market are high more than in the economic sphere and hence political markets are far more prone to inefficiency (North, 1990). Politicians can manipulate regulation for political ends and in that case, regulation is highly able to be politicized (Williamson, 1999). Then, the politicians have not to be the only regulatory policy-maker in the regulatory process. Instead, the regulatory policy-making discretion has to be shared in more credible institutions. Because institutions or the political institutions of regulation can play a crucial role in reducing transaction costs (North, 1991).

In that case, political transaction costs -the cost of operating the political process and, in particular, the cost of reaching and enforcing political agreements- may be the reason why political principals choose to delegate policy making powers to IRAs rather than making themselves it (Majone, 2001a). The relationship between political authorities and bureaucrats is commonly understood as one of principal and agent. The politicians are the principals and the bureaucrats are the agents (Moe, 2006). Thus, the relationship between regulatory institutions playing a role in the regulatory process reveals political transaction costs of regulation.

The transaction cost approach of new institutional economics accepts that cost of transacting in the real world is positive. The institutions and the organizations that constitute the economic, the political and the social system exist to eliminate these transaction costs from the related processes. According to this approach presented by Coase (1937) and developed heavily by Williamson (1975), the reason for the organization of the economic and the political hierarchies like firms, governments and regulatory agencies is the minimization of transaction costs. For that reason, the institutions are rather pervasive in the real world (Majone, 2001a: 59).

As a result, the level of transaction costs in the regulation game that depends upon the institutional design and political institutions of the regulatory process in a country are among the foremost factors that shape the design (Menard and Shirley, 2005). Interactions among related groups affect the magnitude of political transactions costs (Levy and Spiller, 1996). A major cause of high political transaction costs is the traditional understanding of unified state. Divided government can relatively reduce political transaction costs. In this connection, the judiciary, the executive and the legislators need to change their attitude toward regulatory institutions. Nevertheless, the traditional structure of politics even in divided government weakens independence of IRAs. IRAs can be manipulated by the principal-political authority. Or, a strong government does not tolerate regulators to conflict with its policies. In such cases, independence of IRAs can be injured and thus, transaction costs of the regulatory process can increase.

1.2. A Credible Regulatory Commitment

Efficiency in regulation of public utilities is a crucial factor in realization of investments requiring high and sunk-fixed costs and hence in economic development or economic growth of a country (Laffont, 2005). In this sense efficiency of regulation depends on whether there is a credible commitment on the investments. Governments can politicize the pricing process on the capital costs and expropriate the firm's sunk assets by altering legislations or regulations (Levy and Spiller, 1996; McChesney, 1987). However, at least, firms expect to gain a fair rate of return on their investment costs. They will not be able to invest now and hereinafter if this return is not committed or if their assets are expropriated by the incumbent government. It should be expected that governments use this discretion where institutional costs are so low and the expected utility of the use of such arbitrary discretion is too large (Levy and Spiller, 1996). The problem of regulatory commitment in regulation of public utilities is a consequence of the very nature of the regulatory policy-making processes (Majone, 2001a: 61). As mentioned before, if there is no a credible regulatory commitment on capital assets of investor, firms cannot realize long-termed and sunk-cost investments (Baron, 1995).

Governments, by establishing IRAs, can send a strong signal to the private sector that it will not interfere in operational affairs related to the market processes for political ends. So, governments can ensure a credible commitment through delegation to IRAs. Delegation of regulatory discretions to IRAs is a feasible and popular method for a credible regulatory commitment. However, there are some necessary conditions in order to ensure regulatory commitment in a system with IRAs. One of them is independence of IRAs. Independence of IRAs is the crucial component of an efficient regulatory process. Independence of IRAs reducing political transaction costs is a precondition of a credible commitment in the regulatory process (Majone, 2001a: 58). Therefore, an agent who needs to comply with the directions of the principal politicians cannot very likely ensure a credible regulatory commitment. Independence of an agent *…means not only that the principal's and the delegate's preferences may be different but also, and this is the key point, that in general it is not in the principal's interest to minimize such difference* (Majone, 2001b: 109-10).

In order to ensure a credible regulatory commitment, on the other hand, legitimacy of IRAs has to be guaranteed procedurally and substantively by political principals. *Procedural legitimacy implies that the institutions are created by democratically enacted statutes, or duly ratified treaties, which define the institutions' legal authority and objectives; that their heads are appointed by democratically accountable executives; that decisions are taken according to well-defined procedures, which may include a duty to give reasons and the possibility of judicial review. Substantive legitimacy depends on such factors as expertise, problem-solving capacity, and accountability by results. Both procedural and substantive legitimacy depend to a large extent on good institutional design* (Majone, 2001a: 77). In the end, in order to establish a credible commitment, it is needed that the regulatory institutional endowment has to be credible.

The uncertainty created by the ill-defined political property rights in the regulatory policy-making process can also impede the regulatory commitment. Political property rights are the rights to exercise public authority in certain policy areas. Political property rights can be altered by delegating important powers to non-majoritarian institutions like IRAs. The fully transfer of political property rights to IRAs is the guarantee of independence of the agent. The guarantee is particularly strong when the legal basis of the transfer is not a statute but a constitutional provision (Majone, 2001a). For that reason, regulatory discretions and responsibilities of politicians and IRAs in the regulatory process need to be defined and be protected by the Constitution of the country. On the other hand, the strength of the constitutional rules that protect private or political property and contract rights against a governmental intervention does not only ensure independence of the agent, but can also establish a credible commitment or prevent the political attraction of rent-extraction strategies on returns to private capital (McChesney, 1987).

Another argument for the credible commitment is the time-inconsistency or the political uncertainty problem in the policy making process (Majone, 2001a; Moe, 1990). In modern democracies, principals are elected for a particular time period at regular intervals. While today's politicians can exercise the political property rights at present, other ones with different and perhaps opposing interests can acquire the right at next elections. Then today's political preferences are most probably subverted legally by tomorrow's political authority (Moe, 1990). In such cases, elected politicians cannot ensure a credible commitment in long-run policies and the political property rights amounts to the discretionary powers. IRAs can solve such a time-inconsistency problem. But, it is needed to pay attention that the policy making power has to be delegated necessarily to IRAs, but not an administrative agent. Because, when short-run policies in the institutional endowment of the regulatory process deviate from the stable long-run policies, only an independent delegate can provide the credible commitment in the long-term (Majone, 2001a).

2. Independence and Accountability Dilemma of IRAs

Although it is accepted that delegation of powers to IRAs and their independence are the preconditions to reduce the political transaction costs of the regulatory process and to ensure a credible regulatory commitment, it has been devoted considerable attention over the years to the ‘‘delegation problem,’’ the question of whether and how elected politicians can control the exercise of delegated policy-making authority by unelected bureaucrats (Spence, 1999; Lupia and McCubins, 1994; Spiller, 1990). Much of that attention has focused on the ways politicians try to influence agencies indirectly by designing the agency's environment so as to steer the agency policy into a particular policy direction. Because, IRAs have to be, on the one hand, independence from the legislature, on the other hand, accountable to it. Independency and accountability indicates the existence of a dilemma.

Although it is accepted that independence of IRAs is the precondition of a credible regulatory commitment (Majone, 2001a; Calvert et al., 1989), the independent regulators can pursuit their self-interests rather than public interest (Sigman, 2001; Figueiredo et al., 1999;

Niskanen, 1975). IRAs can deal with to maximize their own budget and want more autonomy, positive recognition and publicity. They can manipulate their informational advantages to benefit, including higher transfers and rewards. In such cases, bureaucrats can lead to over-investment in the state-owned firms and over-capitalization in the operation of bureaucracy (Okten and Arin, 2006: 1539). In addition, private interest groups can manipulate the regulatory agenda and informational advantages of IRAs (Fiorina, 1986; Stigler, 1971). Or, IRAs can be subject to the pressures of the principal-politicians (Sigman, 2001). Because of such circumstances, IRAs have to be independence, but at the same time, accountable as well.

The solution of the dilemma is not simple. Still, both independency and accountability are the necessary conditions of an efficient regulatory process. To begin with, it needs to consider control of IRAs by the legislatures. As mentioned above, IRAs can tend to pursuit their self-interests, interests of private interest groups in the economy rather than public interest. In both cases, the regulatory process cannot ensure the credibility. In order to exclude such contingencies from the regulatory process and ensure accountability of IRAs, the principal politicians use some tools to control the agencies.

The best-known version of these tools is the so-called structure and process hypothesis. By using structure and process mechanisms, the legislature can control the activities of IRAs. But, this method generally injures independence of IRAs, does not provide accountability and does not solve the deviation problem of IRAs from public interest. According to the hypothesis, the legislatures exert *ex ante* influence over next decisions of IRAs by imposing on the agency a particular organizational structure and decision-making process (Spence, 1999: 413-14). For instance, politicians can structure the IRAs so as to define their regulatory discretions. By determining the agency's mission, establishing its internal organizational structure, and choosing its location within the larger executive branch via the structural arrangements, politicians can control the regulatory discretions of the agency through structural choices and force the agency in favor of a specific policy orientation.

On the other hand, according to the process part of the hypothesis, politicians can control the decision-making processes of IRAs by increasing the transaction costs in this stage via procedures, but not to solve the problem, in which IRAs could neglect public interest in their decisions due to procedural openness (Spence, 1999: 417). As is seen, IRAs can be controlled by the structure and process policies, but cannot indeed be independent when they are subject to continuous political oversight[1]. For accountability, instead of direct control or congressional dominance, it can be preferred transparency of activities of IRAs in the regulatory process. In order to ensure accountability, the main condition is transparency, but not political control.

The transparency in the regulatory process means the mandatory disclosure of necessary information by the related regulatory institutions to attain a clear regulatory aim (Weil et al., 2006). If IRAs disclose necessary information concerning their regulatory activities, it can be established accountability of IRAs without political control. For that reason, the relevant laws must obviously specify delegated discretions, roles, duties, responsibilities, and decision-making processes of IRAs. The legal structure must also clearly determine discretions, duties

[1] However, active congressional reversal is not necessary; all that is needed is the threat of legislative action (Carrol, Spiller and Teece, 1999). Legislative action on the regulatory discretions of the independent agencies is sufficient to injure the independence of IRAs.

and responsibilities of the legislature and the judiciary in the regulatory processes. The determinant of whether IRAs use their regulatory discretions or independencies is the composition of the legislature and the executive determining the threat of congressional reversal and organization of the judiciary, including the threat of judicial reversal[2] (Carrol et al., 1999). Accordingly, on the one hand, IRAs have to accountable and on the other hand, the legislature and the judiciary need not to interfere with the discretions of IRAs. Thus, IRAs can be both independence and accountable. In this sense the Turkish experience is an exemplary case. In terms of independence and accountability of IRAs, transition to IRAs in Turkey has considerable problems.

3. THE POLITICAL ECONOMY OF TRANSITION TO IRAS IN TURKEY

Since the 1980s, Turkey has preferred transition to a more liberal market economy[3] and thus an institutional structure supporting this system and changing the traditional state structure. Regulatory endowment has changed radically with transition to a more liberal market system for the last decade. The change has brought together difficulties of transition. In particular, transition to IRAs has never been easy and has still some problems.

The regulatory institutional structure in Turkey has been characterized by the center-periphery relationships (Mardin, 2000). The structure of state or the regulatory endowment has a patrimonial tradition. The regulatory institutional environment creates opportunities for rent-seeking behavior among the politicians, bureaucracy, and businessmen. Thus, regulatory outcomes have depended on political processes rather than economic processes. Regulatory capture by politicians is considerably prevalent. Politicians tend to use cross subsidies and tolerate institutional inefficiencies especially in power plants and facilities for political reasons (Cetin and Oguz, 2007a). Public founds is transferred via the traditional bureaucratic structure to the private interest groups. Entrepreneurial incentives have been diverted to seeking unproductive and sometimes destructive rents in political processes rather than productive profits in competitive markets (Akyüz and Boratav, 2003: 1560). Businessmen relied on the traditional bureaucracy rather than the entrepreneurial processes in the markets. This structure gave rise to a rent-seeking society (Demir, 2005; Özcan and Çokgezen, 2003; TUSIAD, 2002).

Deregulation and liberalization attempts in this traditional-institutional structure also caused unexpected results. The institutional structure has played a crucial role in transferring the economic surplus to the private interest groups and in creating artificial rents (Demir, 2004: 864-5). In contrast to the expected results from liberalization, deregulation efforts and privatization of the public assets during 1980s turned into a rent-seeking game and interest

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[2] Because of the preferences of the legislature and the executive are systematically aligned with each other, in systems characterized by unified government control over the bureaucracy will be stronger than in systems characterized by divided government (Spiller, 1990). Thus, delegation to IRAs requires a system of division of powers. As is in the independence of the judiciary, in order to ensure the independence of IRAs, it is needed that no institution within the regulatory institutional environment controls IRAs. Under those circumstances, we can expect agency independence from delegation to IRAs (Carrol et al., 1999: 81).

[3] Transition to a more liberal market economy in Turkey includes not only deregulation and privatization attempts but also the abandonment of the import-substituting industrialization and more outward-oriented policy (Pamukcu, 2003; Aricanli and Rodrik, 1990).

groups became an important part of the game (Ercan and Onis, 2001). Paradoxically, the failure to establish the link between the real economy and liberalization attempts only consolidated existing rents and promoted rent-extracting (Aricanli and Rodric, 1990).

In the end, the incompetence of the traditional institutional structure, the AKP (the Justice and Development Party) government winning in the 2002 elections (and again in the 2007 elections) and the pressures of the international organizations like World Bank, European Union, and IMF encouraged transition to IRAs in Turkey.

Since 2002, the AKP government has been a majority one. In contrast to the previous coalition governments, the AKP government emphasized in its party program that EU reforms will be continued and it will accelerate transition to IRAs. IRAs in Turkey are listed in Table 3. However, as discussed below, the AKP government has been *de facto* reluctant to solve the constitutional legitimacy problems of IRAs and has attempted to control especially the Energy Market Regulatory Authority (EMRA) among IRAs.

3.1. The Place of IRAs in the Turkish Regulatory Institutional Structure

Although IRAs have been given political, organizational and financial autonomy by related laws, since Turkey does not have long tradition of IRAs like other continental countries such as France and Italy do, the place of these agencies in the Turkish regulatory structure is controversial (Gozler, 2009; Atay, 2009). In Turkey, there are different opinions among law and economics scholars about the place of IRAs in the regulatory structure. While some scholars find talking about IRAs in Turkey as a fantasy considering main basics and principles dominating the Turkish regulatory structure, some try to place these agencies somewhere in current structure (Cetin and Oguz, 2007a, 2007b; Sosay and Zenginobuz, 2006).

There is not yet a general law related to IRAs in Turkey. Each IRA has been regulated by an industry-specific law. The current government tried to enact a general law in its first government period. However, by enacting this draft law, the government aimed to control IRAs as a part of the traditional bureaucratic. It gave up enacting the draft law because of the pressures (Gozler, 2009: 243).

Instead, the government, in order to control IRAs, attempted to apply to the different political methods. In this sense the conflicts between the government and EMRA are particularly exemplary. For instance, energy policies of the government increased and go on to increase transaction costs of the transition to an IRA tradition specifically in energy markets by injuring independence of IRAs. This situation has also impeded realization of the private-sector investments in the electricity distribution and generation markets so far by bruising ensuring a credible regulatory commitment during the reform process of the electricity industry (Cetin and Oguz, 2007a).

3.2. The Constitutional Legitimacy Problem of IRAs

To begin with, there is the lack of constitutional protection and a legal ambiguity concerning the place of IRAs in the administrative structure during transition to IRAs. The Turkish Constitution does not contain any descriptive statement about IRAs. Therefore, the place of IRAs in the bureaucratic structure is not sufficiently clear. This constitutional uncertainty gives rise to a legitimacy issue. Besides, this situation leads to the discretionary political interventions in the agencies. No governments have attempted to ensure a constitutional openness on this issue. The incumbent government is reluctant to solve this problem as well.

For that reason, it is necessary to state the problems concerning IRAs by taking into account whether they have a constitutional legitimacy. According to the Turkish Constitution, Turkey is a unitary state and the regulatory structure must be designed in accordance with this feature of the constitutional structure in the country. In other words, in order to ensure the integrity between the central and the local administrative units, articles 123 and 127 of the Constitution stipulate central government's supervision on all administrative organs (Atay, 2006). The integrity between the units in a unitary state structure is fulfilled by two means the so-called hierarchy and administrative tutelage. Hierarchy refers to ranking in the administrative structure and means that the officers in the structure are bound to each other step by step and degree by degree from highest rank to lowest rank where all obeys orders from superiors. Hierarchy ensures integrity not just among the institutions of central administration but also among various organizations and units in the same legal personality.

Administrative tutelage is a legal mean which ensures the integrity between central administration and the institutions of decentralization which arise as a result of implementation of decentralization system. In other words, administrative tutelage is authority of supervision over decentralization institutions of central administration in order to secure the integrity of state and harmonious working of public utilities in the country.

However, IRAs in Turkey are not under supervision of hierarchy and administrative tutelage, in spite of the constitutional obligation in relation to the administrative institutions. On the other hand, supervision obligations in the specific laws concerning IRAs are not compatible with each other. While a part of IRAs, including the Telecommunication Agency (TA), the Capital Agency (CA), and the Public Procurement Agency (PPA), are audited by Sayistay (the Supreme Court of Accounts), another group of IRAs, consisting of EMRA, SA, and TTAMRA, is audited SSB[4] (the Supreme Supervision Board of the Prime Ministry). The establishing laws of TA, EMRA, SA, and TTAMRA do not contain that financial accounts of these agencies are overseen by SSB and Sayistay, respectively (Sosay and Zenginobuz, 2006)[5].

Furthermore, there is also not the integrity relevant to the appellation procedure for IRAs. The first level appellate court is Danistay, the Council of State, for EMRA, BRSA and CA. However, local administrative courts are assigned as the first level of appellation for some IRAs. Besides, the legal structure gives Danistay a prominent role specifically in regulation of the energy markets (Cetin and Oguz, 2007c).

Such features of IRAs are the most important ones that distinguish these institutions from other administrative institutions in Turkey and this situation causes them to be likened to an 'island' in administrative organization. Consequently, those features of IRAs give rise to the constitutional legitimacy problem in Turkey which has unitary state structure in determining the place of such institutions in administrative organization. As is seen in Article No.123 of

[4] SSB is essentially established to supervise the financial accounts and the activities of the state-owned enterprises in Turkey.

[5] For an opposite opinion, see Gozler (2009: 248).

the Turkish Constitution[6], only centralization and decentralization are possible in Turkey. 1982 Constitution does not allow any other organization type (Atay, 2006).

It is not possible to include IRAs in centralization considering the features they have. This results from the fact that hierarchic control is implemented in centralization. In 1982 Constitution, local administrations which emerged as a result of implementation of decentralization principle in terms of location are defined and stated by their names. Consequently, it is not possible to think IRAs among local administrations. Additionally, the features these agencies have do not allow such placing. Because, local administrations are subject to central administration's administrative tutelage control in Turkey.

There are also functionally decentralized organizations which emerged as a result of implementation of decentralization principle in terms of functions but these organizations do not have a direct place in 1982 Constitution. These were established on basis of phrase in Article 123 stating that public legal personality can be established by law or authority given clearly by law.

There are definite differences between IRAs and functionally decentralized organizations. First of all, while functionally decentralized organizations undertake a specific service, IRAs do not. IRAs are institutions which regulate sectors that are sensitive for society. Additionally, organs of functionally decentralized organizations can be assigned and removed from office by executive power. As a result, it is not possible to talk about independence of functionally decentralized organizations. While IRAs are out of control of administrative tutelage, operations of functionally decentralized organizations are subject to central administration's administrative tutelage control. Consequently, it is not possible to place IRAs among functionally decentralized organizations.

Since IRAs cannot be placed among central and local administrations because of features like their public legal personality, organic and functional independence and autonomy and since they cannot be included into functionally decentralized organizations; they can be seen as a fourth category or model besides local administrations, functionally decentralized organizations and professional associations which have public institution characteristics.

Under these conditions, the legal ambiguity also brings about a resistance from the judiciary toward IRAs on many issues. The related courts cannot find any legal basis for their decisions on events concerning IRAs. For example, in a recent and important decision the Constitutional Court has chosen a middle road[7]. It recognized their independency, yet confirmed that they are within the public administration structure. In other words, it is accepted by the Constitutional Court that they are both independent institutions and public ones. Naturally, this constitutional ambiguity goes on to increase the costs of transactions for IRAs and to deepen the commitment problems (Cetin and Oguz, 2007c). First thing to do is to change the Article 123 of Constitution and to accept IRAs as a third administrative structure besides structures of centralization and decentralization.

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[6] According to Article No.123, "administration forms a whole with regard to its structure and functions and shall be regulated by law. The organization and functions of administration are based on the principles of centralization and decentralization. Public legal personality is established either by law or authority given clearly by law."

[7] See the Constitutional Court decision no. E.2002/100, K.2004/109, KT. 21.09.2004.

3.3. Accountability of IRAs in Turkey

The legal structure in Turkey is not sufficiently clear and consistent about mechanisms of accountability of IRAs. This legal insufficiency weakens accountability of IRAs. An important uncertainty source concerning accountability of IRAs is interested in reporting requirements regarding their regulatory activities. According to the Law No. 4743, enacted in 2002, all IRAs in Turkey have to present a report about their regulatory activities once a year to the Planning and Budget Committee the Parliament. However, the content and the scope of the report or information are controversial. Firstly, this obligation in the Law No. 4743 is specified in laws concerning only the CMB and the BRSA. Even so, both the Law No 4743 and the laws concerning these two agencies do not include what kind of information must be reported and in which form it will be presented to the Parliament[8].

Secondly, again, according to the Law No. 4743, all IRAs are obligated to submit reports concerning their annual activities to the Council of Ministers by the end of May. The same law does not specify the content of the reports. In addition, the scope of the report obligation to the Council of Ministers is uncertain. The reporting requirements included in the law related to each IRA vary. For example, although the specific law concerning CA coerces it to publish annual reports including the regulatory activities and developments in the field of the agency, it does not lay down the contents and the addresses of the reports. Likewise, CMB, BRSA, and EMRA are also responsible to present annual reports with their financial accounts to the related Ministries. In addition, CMB, when the related Ministry required it, must present an analysis concerning the market. BRSA also disclose the needed information to the Undersecretariat of Treasury, the State Planning Agency, and the Central Bank, when they want.

The information disclosure to the public has also some problems, as well as accountability to the principal politicians. In this sense it is not possible to find a consistent structure among the laws. While provisions regarding transparency and accountability requirements of SA, the TTAMRA, TA, and EMRA to the media and/or the public does not contain clear obligations, the specific laws related to CMB, BRSA, CA, and PPA lay down more strictly transparency and accountability requirements to the media and/or the public (Sosay and Zenginobuz, 2006). These components indicate that there are the serious ambiguities and inconsistencies concerning accountability of IRAs to the political principals. Consequently, the ambiguity and the inconsistency impede the transparency that is a crucial ingredient in terms of accountability.

3.4. Independence of IRAs and a Case on Independence

It is possible to mention two kinds of independence concerning IRAs. These are independence from the legislature and from the special interest groups. Because IRAs in Turkey have not a long history, independence from the special interest groups is not yet debated. Instead, independence from the legislature is discussed. IRAs in Turkey have financial independence. They are independent from the government budget and are funded

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[8] Although the law concerning BRSA contains a provision related to its obligation to provide a report and an analysis of its annual activities to the Parliament, it is also insufficient.

from license fees, permits and levies (OECD, 2002). However, (in)dependence issue between IRAs and the political authorities are controversial.

IRAs are not *de jure* under the authority of any ministry. They are only related to relevant ministries. This relation is not like a bureaucratic order. They are within the structure of the bureaucratic body and, at the same time, outside the direct control of the political authority. This ambiguity can *de facto* restrain their ability to stay at the arm's length from the government. In order to understand better the issues regarding independence of IRAs, it needs to look at the *de facto* interactions between IRAs and the political authority. In this sense the interactions between EMRA and the government are especially remarkable.

Energy policies of the current government have clearly injured independence of EMRA. As was in other markets, the current government adopted a liberal tendency in energy markets and independence of IRAs in its election programs. However, the liberal bias of the government in energy has been deviated from its beginning point. A conflict case occurred over the pricing of electricity. EMRA defended regional pricing as a competitive pricing method based on costs[9] and because of illegal and inefficient use of electricity in Turkey. In short, regional pricing in the Turkish electricity market is a necessity for economic considerations. Nevertheless, the government opposed to this pricing method with political considerations. As shown in Table 1, a political rationale of the government is that illegal use of electricity is widespread in Eastern and Southeastern regions of Turkey where the government has a high constituent potential. Although EMRA attempted to introduce regional pricing to the market in 2003, the government pursued political pragmatism and insisted on the existing national pricing, because politicians from these two regional pressured the government to continue national pricing.

As a result, other regions in Turkey continue to subsidy the illegal use in the Eastern and the Southeastern regions. The illegal use rate is as much as 75 % in some parts of this region. In this connection, government aims to transfer $2.5 billon to these regions as subsidized electricity until 2011 via the new price equalization mechanism. In the new system, the profits of western distribution companies will be transferred to the Eastern and Southeastern distribution companies. In ten cities where illegal use is highest, the current government had the highest votes in nine in the 2002 elections. On the other hand, in western cities with the lowest illegal use rate, the government could not take the first place in elections, with the exception of three. This reveals the political preference to overlook illegal use and see it as a cross-subsidy tool.

There are also some other political reasons for the government to oppose EMRA's regulatory decisions in electricity. Electricity prices in Turkey have some taxes and levies. Although the electricity law and EMRA stipulate to abolish cross-subsidies or non-economic costs on electricity prices, the government insists on to impose a 2 % levy for the Turkish Radio and Television Corporation (TRT), the state-owned broadcasting company. The government also ignores insistently a cross-subsidization from household users to industrial users; because of household consumers have more votes. In addition, the government cancelled electricity debts of farmers, although it is contrary to EMRA's regulatory decisions, EU's electricity directives, and economic considerations.

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[9] The regional pricing would reduce prices in regions where there is little illegal use, mostly western Turkey. However, the prices in southeastern and eastern Anatolia would rise, because of high levels of illegal use (Cetin and Oguz, 2007a).

Table 1. Illegal-inefficient Use Rates in Some Regions

Regions	Cities	Illegal-Inefficient use rate (2005)	AKP' votes (%) (2002)
East and Southeastern Anatolia (The highest 10 cross-subsidized cities)	Mardin	75,8	15,43*(1)
	Van	66,2	25.86*(1)
	Hakkari	65,6	6.81 (4)
	Batman	65,6	20.62*(1)
	Diyarbakir	65,2	15.96*(1)
	Sanliurfa	60,2	22.90 (1)
	Sirnak	59,9	14.02*(1)
	Bitlis	55,1	17.67*(1)
	Mus	53,3	16.90*(1)
	Agri	50,9	17.70*(1)
Other cities (Cross-subsidizing cities)	Mersin (Akdeniz)	19,9	18.07 (3)
	Istanbul (Marmara)	13.3	37.20 (1)
	Kocaeli (Marmara)	12,5	42.85 (1)
	Mugla (Ege)	11,3	13.17 (3)
	Tekirdag (Marmara)	10.4	17.01 (2)
	Edirne (Marmara)	9.8	8.73 (5)
	Antalya (Akdeniz)	9,5	21.16 (2)
	Kırklareli (Marmara)	9.0	12.54 (4)
	Bilecik (Marmara)	7.0	24.88 (1)
	Izmir (Ege)	6,8	17.17 (3)

Source: www.tedas.gov.tr and www.belgenet.com.

* In these cities DEHAP (a regional nationalist-separatist party) was took the first place but it could not reach national minimum votes, so it could not enter the parliament. AKP took the second place in elections, yet it gained the first place in terms of parliamentary seats.

- Figures in parentheses show AKP's place in terms of votes.

Energy policies of the government show that political pragmatism weight than economic efficiency considerations and independence of EMRA. The government does not appear eager to delegate regulatory discretion on pricing to an independent regulator. This situation also brings about opportunities for rent seeking in electricity market. In this process, wealth is redistributed among interest groups and rent-seeking activities are encouraged via energy policies by the government. The political insistence on cross-subsidies impedes to introduce competition to the market. Political pragmatism of the government on electricity prices has impeded directly the regulatory discretions of EMRA, although the electricity law gives the right to regulate electricity prices to EMRA. As a whole, energy policies of the government injures independence of EMRA, postpones privatizations, leads to regulatory capture of politicians, and triggers economic inefficiencies (Cetin and Oguz, 2007a).

The electricity law enacted in 2001 stipulated generation and distribution companies to be privatized within two years. The law gave the authority to the Privatization Administration. In 2004, the government changed the timetable of privatization in electricity generation and distribution by publishing a strategy paper to express a new policy, in spite of determination of the law and EMRA. The strategy paper reflects the government's political preferences over electricity markets. However, the strategy paper has not any constitutional and legal base. The government preferred to dominate electricity markets by means of the paper. According to the paper, it was decided the distribution privatizations to be completed before the end of 2006. Notwithstanding, it was postponed one more time and uncertainty dominates privatizations at the moment (Ulusoy and Oguz, 2007). Thus, while the government has succeeded in some crucial privatizations such as Turk Telekom (the State Telecommunications Monopoly) and Tupras (Turkish Petroleum Refineries Company), privatizations in electricity distribution and generation segments has not been fulfilled. In the end, the strategy paper of the government also increases political transaction costs for the regulatory process by injuring both independence of EMRA and regulatory commitment in the electricity market.

Another case for conflict between government and EMRA occurred in the natural gas market. As in the case of electricity, Natural Gas Market Law (NGML) also gave the regulatory discretions over the Turkish natural gas market to EMRA. The law annulled BOTAS's, the state-owned company, monopoly rights on imports, distribution, storage and the sale of natural gas. BOTAS has to reduce its share in the market to 10 % and to transfer the rights over the import facilities and contracts to private sector participations until to reduce its market share 20 % by 2009. In addition, the law gave the discretion to sign new contracts to EMRA.

However, the government signed a new contract with Egypt via the Ministry and declared BOTAS as part of the contract, although EMRA stated that there is not a shortage in natural gas. The legal legitimacy of the contract is exactly controversial. According to NGML, even if EMRA and MENR reach an agreement, BOTAS cannot be part of the contract. This case has led to a conflict one concerning who has the regulatory power in natural gas. Political pragmatism of the government in this case also weakens independence and authority of EMRA and gives rise to additional transaction costs in the energy markets (Cetin and Oguz, 2007b).

Apparently, contrary to its own party program and all the global trends, the government deals with to introduce a more state-oriented energy market and restricts the regulatory discretions of EMRA. All these cases indicate that the government insists on political pragmatism in regulation of the Turkish energy markets at the expense of not only independence of EMRA, but also high transaction costs in the regulatory process.

4. Formal Independence Levels of IRAs in Turkey: Empirical Analysis

4.1. Data and Method

In order to evaluate the formal independence of IRAs in Turkey, index of IRAs' independence developed by Gilardi (2002) is utilized. This index focuses on formal independence of IRAs. This can be divided into five main dimensions, namely the agency head status, the management board members' status, the general frame of the relationships with the government and the parliament, financial and organizational autonomy and the extent of delegated regulatory competences.

Each indicator is numerically coded on a scale of 0 (lowest level of independence) to 1 (highest level of independence). Under every indicator, there are choices showing possible situations regarding this indicator.

In this study, multidimensional scaling analysis is used to determine the formal independence of IRAs in Turkey. Firstly, multidimensional analysis is introduced in 1938 and later has been popular (Jobson, 1992; Takeuch et al., 1983). The goal of multidimensional scaling is to find a representation of the objects in a low-dimensional space. Thus, complex relationship among the objects in multidimensional data matrix can be presented and interpreted easily by multidimensional scaling. In addition, multidimensional scaling can be used to introduce similarity and dissimilarity (Takeuchi et al., 1983: 410).

Applying multidimensional scaling analysis is important to identify data's measurement. Because, technical of distance matrix is chosen according to measurement type of data (Jobson, 1992: 585). Multidimensional scaling analysis is utilized from distance matrix. Consequently, we must calculate distance matrix suitable to data's type. If measurement of data is interval or ratio, it is the most used Euclidean distance that can be calculated for i and j unit as follows:

$$d_{ij} = \left[\sum_{k=1}^{r} (X_{ik} - X_{jk})^2 \right]^{1/2} \quad (1)$$

Where $X_{i1}, X_{i2}, ..., X_{id}$ is element of vector X_i, and $X_{j1}, X_{j2}, ..., X_{jd}$ is element of vector X_j for $k = 1,2,...,r$.

After applying multidimensional scaling, we must compare configuration distance with distance obtain from original data for suitability. Stress measure is used for compare suitability to finding results with original distance matrix. Stress measure can be calculating as follows (Hair et al., 1998).

$$Stress = \sqrt{\frac{(d_{ij} - \hat{d}_{ij})^2}{(d_{ij} - \bar{d})^2}} \quad (2)$$

Where $\bar{d}$ is mean distance ($\sum d_{ij} / n$), d_{ij} is original distance, and $\hat{d}_{ij}$ configuration distance for between i and j. So, the more $\hat{d}_{ij}$ is close d_{ij}, the more stress value is small. The stress measure is used to compare suitability between original distance and distance obtained from solution. Therefore, lower stress measure indicates better solutions (Timm, 2002: 546).

4.2. Results

As a result of the multi-dimensional scaling analysis, it is seen that among alternative dimensions, three-dimension case is the most suitable one. Iteration implemented for three-dimension solution and result of Young's Stress test, which gives goodness of fit, are shown in Table 2.

Table 2. Young's Stress Test Result

Iteration	S-stress	Improvement
1	0,08968	-
2	0,06588	0,02380
3	0,06284	0,00303
4	0,06269	0,00016

S-stress test stops when recovery is below 0,001. The stress test value (0.06269) found in third iteration shows that goodness of fit is at high level.

The values given according to indicators used in the evaluation of IRAs' independence show also similarities and dissimilarities between related agencies. The coefficient of Stimulus coordinates is used for the evaluation of such similarities and dissimilarities. In the context of this study, similarities and dissimilarities point out independence levels of IRAs. The agency which has the highest positive Stimulus coefficient is the most independent regulatory agency in Turkey.

When Table 3 is analyzed, it is seen that the highest positive value (1.2193) in the first dimension belongs to BRSA. After a complete examination of indicators measuring independence of institutions, it is found that BRSA is the one which has the highest level of independence among IRAs. On the contrary, SA is the one which has the lowest level of independence in the first dimension. This results from the fact that, SA takes a negative and low value (-3.6921) in the examination of calculated similarities. To sum up, while BRSA is the most independent IRA in the first dimension, SA is the least independent one. Independent levels of other agencies do not show significant differences.

Table 3. Stimulus Coordinates (similarity as to dimension)

Stimulus Numbers	Stimulus Name	Dimesions		
		1	2	3
1	Banking Regulation and Supervision Agency (BRSA)	1,2193	-1,5876	0,3444
2	Capital Markets Board (CMB)	0,8124	0,0870	0,1443
3	Telecommunication Authority (TA)	0,1564	-0,1164	-0,6434
4	Energy Market Regulatory Authority (EMRA)	0,4053	-0,4418	1,2125
5	Competition Authority (CA)	0,5554	-0,2245	-0,0488
6	Sugar Authority (SA)	-3,6921	0,2993	0,2121
7	Public Procurement Authority (PPA)	0,4909	0,6703	-1,0105
8	Radio and Television Supreme Council (RTSC)	0,7207	-1,7506	-0,0989
9	Tobacco, Tobacco Products and Alcoholic Beverages Market Regulation Authority (TTPABMRA)	-0,6683	-0.1108	-0,1116

Table 4 is a matrix showing the distances among agencies. For example, first column demonstrates the distances between the BRSA and itself and the BRSA and other agencies.

Table 4. Optimally Scaled Data Disparities

	Optimal Disparities Among Independent Regulatory Agencies								
	BRSA	CMB	TA	EMRA	CA	SA	PPA	RTSC	TTPABMRA
BRSA	0,000								
CMB	1,677	0,000							
TA	2,444	0,830	0,000						
EMRA	2,544	1,567	1,712	0,000					
CA	2,017	0,000	0,277	1,171	0,000				
SA	5,025	4,469	3,992	4,344	4,275	0,000			
PPA	1,817	1,659	0,626	2,356	1,275	4,392	0,000		
RTSC	3,183	1,935	2,065	2,175	1,586	4,803	2,655	0,000	
TTPABMRA	2,662	1,722	0,719	1,484	1,347	3,153	1,578	2,305	0,000

If the first column is analyzed, it is seen that BRSA is the most distant agency to SA (5,025). Actually, this is another way to confirm that BRSA has the highest level of independence since SA has the lowest level of independence. An interesting point is the closeness between the distance values of CMB and CA. The fact that calculated distance value is equal to 0,000 shows that independence levels of these two agencies are very close to each other. Another interesting point is that SA is the most distant agency to any agency.

The matrix of optimal distances between IRAs can be also modeled as a graph. Although it is found that appropriate model for this study must be three dimensioned, the distances are drawn for two-dimension case since it is not easy to understand and to comment on three-dimension case. In Fig. 1, it is seen that the BRSA is the regulatory agency with the highest independence level in Turkey as it is the closest one to the ideal point. On the contrary, SA has the lowest level of independence since it is the most distant one to the ideal point.

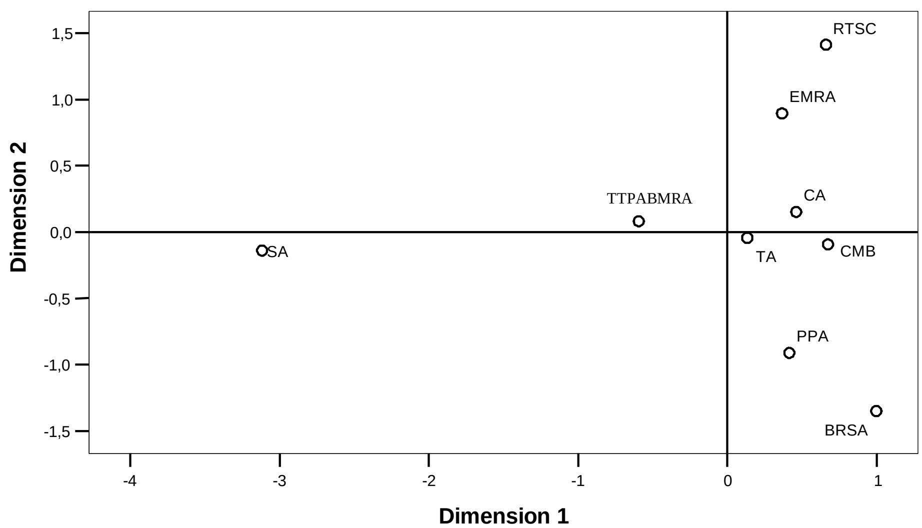

Figure 1. Derived Stimulus Configuration for Independent Regulatory Agencies.

5. CONCLUSION

Transition to IRAs in Turkey includes some issues concerning their independence. This stems from the fact that these agencies are in conflict with the principles and means which dominate the current regulatory structure. In this sense the case of Turkey is compatible with the arguments of transaction costs and regulatory commitment regarding delegation of the power to IRAs. Although IRAs in Turkey are established, there have been the political interventions to IRAs and not a constitution-based protection for them. In particular, there are serious problems between EMRA and the government. The solution to these problems is to change Article No.123 of 1982 Constitution and to undertake necessary legal amendments which will ensure the legitimacy of the place these agencies have in the Turkish regulatory structure. However, the government is reluctant to do it.

The government's reluctance to change the constitutional and legal structure concerning IRAs and its political pragmatism over energy policies has increased political transaction costs of the transition to IRAs in Turkey. The political interventions to EMRA and the delay of the privatizations have injured the credibility of the regulatory process in terms of the private-sector investors in the market. In the end, these issues lead to the failure of energy policies of the government in Turkey.

On the other hand, according to the results of empirical analysis, BRSA has the highest level of independence among IRAs. On the contrary, SA is the one which has the lowest level of independence. Independence levels of other agencies do not show significant differences. Consequently, necessary measures should be taken to improve formal independence level of SA.

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Chapter 12

GLASS HALF EMPTY? POLITICS AND INSTITUTIONS IN THE LIBERALIZATION OF THE FIXED LINE TELECOMMUNICATIONS INDUSTRY IN TURKEY[1]

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ABSTRACT

This chapter reviews Turkish experience with reform of the fixed line telecommunications industry. It provides an account of earlier incoherent attempts to privatize the incumbent operator in the absence of any regulatory framework or political consensus. It also describes the regulatory framework emerged in early 2000s and discusses the various political-economic and institutional factors behind its weak implementation, and hence its limited success in promoting competition.

INTRODUCTION

As of the end of 2008, the market shares of the incumbent operator in the Turkish fixed line telecommunications in voice and broadband segments remains very high, even though a regulatory framework that aimed at promoting competition was adopted as early as 2000 and the elimination of the incumbent's monopoly rights was envisaged by the end of 2003. This chapter attempts to review policy making in the fixed line telecommunications industry and explores political and institutional dynamics that may explain the limited success of the liberalization process.

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The Turkish experience reveals an interesting interplay between privatization, liberalization, and regulation. Policy making towards the fixed line telecommunications industry in the 1990s focused primarily on privatization, which if successful, would have created a partially privatized monopoly without a transparent regulatory framework that would curtail monopoly behavior and open the industry to new entry and competition. Perhaps fortunately, these attempts failed due to a lack of cohesiveness at the political level as well as deficiency in policy making capacity, in particular in creating the necessary legal infrastructure that would have enabled the privatization policy to survive the constitutional challenges.

By contrast, in the 2000s it appeared that Turkey got it right: it first established a European Union inspired regulatory framework and privatized only afterwards. Nevertheless, the weakness in the implementation of the regulatory framework led to relatively poor market outcomes. The chapter attempts to explain this limited success by looking at the role of privatization, political ownership, sequencing of reforms, the quality of regulatory institutions, including de facto (as opposed to de jure) independence and transparency The chapter also addresses the question of whether, given the problems associated with the implementation of the regulatory framework, the privatization of the incumbent fixed-line operator was a good idea to begin with.

The chapter is organized as follows: Section 2 provides a brief historical overview of early privatization attempts in the fixed-line telecommunications industry. Section 3 discusses the evolution of the regulatory framework and documents the very slow pace of development of competition followed by a discussion on the factors that may explain it in Section 4. Section 5 reevaluates the problem of privatization under imperfect regulation. Finally, Section 6 concludes the chapter.

1. PRIVATIZATION IN CHAOS: POLITICAL PATRONS VERSUS PRIVATIZORS AT ALL COST

Attempts to restructure the fixed-line telecommunications industry in Turkey actually started not through liberalization or establishment of a regulatory framework, but from the outright privatization of the incumbent operator.[2] A review of those attempts provides interesting input on the political economy of the whole liberalization experience.

The incumbent operator, Türk Telekom A.Ş. (TTAŞ), itself was separated from the Ministry of Transport (MT) and formed as a state economic enterprise and a joint stock company in 1994 (Law No. 4000).

The placement of privatization of TTAŞ on the economic policy agenda followed significant growth and modernization of the fixed network, largely thanks to an ambitious modernization and investment program launched by the government during the 1980s. This was as part of an overall strategy to re-orient the government away from manufacturing and services towards infrastructure investments. The results were impressive: for example, the

[2] For background information on the Turkish telecommunications industry see Yilmaz (2000), Ulusoy (2002), Atiyas (2005), Burnham (2006), Atiyas and Renda (2007). Ardiyok (2003) presents a discussion of the early privatization efforts.

penetration rates (main lines per 100 inhabitants) rose from about 2.6 percent in 1980 to 12.1 percent in 1990 and 21.4 percent in 1995.[3]

The fact that initial attempts to privatize TTAŞ were undertaken without the establishment of a regulatory framework meant that there were no measures to limit its monopoly power and to promote competition. However, most of the laws that attempted to implement privatization were taken to the Constitutional Court by opposition parties and many important components of these laws did not survive constitutional review. Hence, Decree Law No. 509 (1993) allowed the company to transfer up to 49% of its shares to third parties with the approval of the MT. This decree-law was cancelled by the Constitutional Court because the authorizing law had been cancelled.3 TTAŞ was then established through law no. 4000 in 1994. However, a critical article of this law, which authorized the MT to determine the rules and procedures to sell 49 percent of TTAŞ' shares was cancelled by the Constitutional Court, on the basis that giving such authority to the Ministry amounted to a transfer of legislative authority to the executive and that such procedures had to be specified in law. Then Law No. 4107 was enacted in 1995 that enabled the privatization of up to 49 percent of TTAŞ.[4] Critical articles of this law were also cancelled by the Constitutional Court, basically on the basis that it gave too much discretion to the administration (in this case, the Privatization High Council) in determining the valuation and sale conditions of TTAŞ.

These challenges forced the governments to develop a less ad-hoc and more structured approach to privatization. A new phase was launched with Law 4161 (1996), which established a Value Assessment Committee that would include representatives of the Treasury, the MT, and the Capital Markets Board. This law was also taken to the Constitutional Court for cancellation, but most of it survived constitutional review. This was followed in 2000 by the enactment of the landmark Law No. 4502 which envisaged the termination of TTAŞ' monopoly rights by 2003 and which finally established the Telecommunications Authority (TA) in charge of developing sector-specific regulations. Then, Law No. 4673 was enacted in May 2001, this time stipulating that 1 percent golden share would be retained by the Treasury, employees would be entitled to a 5 percent share and the rest would be available for block sale or IPOs. This law stipulated a 45 percent limit on foreign ownership. This limit was later removed through Law No. 5189 adopted in June 2004.

Law No. 4161 formed the basis of the first actual attempt to sell 20 percent of shares of TTAŞ in 2000. The privatization decision was taken by the Cabinet in 1998. The decision stated that 20 percent of TTAŞ shares would be privatized through a block sale to a strategic investor (or a partnership) that owns a telecommunications infrastructure. In the event, no investor participated in the tender and it was cancelled in September 2000.

This was hardly surprising since even though Law No. 4502 was recently enacted, there was complete uncertainty regarding how its provisions would be implemented. Specifically, by the time TTAŞ was to be tendered, not a single secondary legislation related to the fixed-line segment was passed. Furthermore, the concession agreement that TTAŞ would eventually sign with the Ministry (and obligations that would thereby be imposed on TTAŞ)

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[3] See Atiyas (2005) for details.

[4] The authorizing law, which gave wide powers to the government to issue decree-law in diverse fields including social security and privatization, was cancelled by the Constitutional Court because, among other things, in the Court's view it amounted to transfer of lawmaking authority from the parliament to the executive.

was not yet ready at the time of the tender. Moreover, the fact that the tender did not confer any control rights to the purchasing group aggravated the risks generated by the regulatory uncertainty.[5]

The whole episode was not a smooth political operation. The MT (who oversees the telecommunications industry) was opposed to the privatization of TTAŞ and frequent clashes occurred between the MT on the one hand and the Minister of State responsible for privatization and the president of the Privatization Administration (PA) on the other.[6] Among other disagreements, the MT did not want to grant any control rights to the new partner whereas the PA insisted that no one would buy TTAŞ otherwise.[7]

There was a fiscal-macroeconomic dimension to the problem as well. In 1999 Turkey had launched a major disinflation program and the privatization of Türk Telekom became an important part of the stand-by agreement signed with the IMF. When the auction failed in September 2000, this caused serious concerns because the sale revenues (estimated at about $ 2-2.5 bn) were seen as an important part of the adjustment program. Then, towards the end of 2000 and early 2001 Turkey fell into a severe financial crisis (in fact, some commentators claimed that the failure to privatize Türk Telekom was one of the triggers that contributed to the decline of investor confidence, causing a collapse in short term capital inflows).

The failure to privatize prompted further bickering. In the end, the MT conceded and in December 2000 the cabinet of ministers issued another privatization decision this time increasing the ratio of shares to be tendered to 33.5 percent and taking several measures to ensure some degree of control rights to the strategic partner (including allowing strategic partner representation in the Board of Directors and the need to obtain the approval of the strategic partner in key strategic decisions, and selecting the General Manager of the company from among the names nominated by the strategic partner). The tender was announced in December 2000. This tender failed to raise any investor interest as well, and was cancelled in May 2001. The general consensus was that the modifications in the governance arrangements were not sufficient to ease investor worries about control and regulatory uncertainty. These developments prompted the government to enact law No. 4673 mentioned above in May 2001. The granting of a single golden share to the state was seen as a compromise that addressed the worries of the establishment about losing control in what was seen as a strategic company.[8]

What explains this very chaotic experience and the underlying lack of a cohesive policy? Part of the answer lies in the prevalence of coalition governments in most of the 1990s up until 2002. Coalition partners often had different views about the role of publicly owned enterprises in the economy, and these differences were especially heightened towards the end of the 1990s. For example, the coalition government that was in power between 1999 and 2002 consisted of three political parties. The MT belonged to the Nationalist Action Party (MHP) that had a statist and nationalistic ideology, which was also paralleled with a tradition of using public resources for partisan purposes. By the end of 1990s TTAŞ had became one

[5] The drying up of international financial resources in the wake of 3G auctions in Europe was possibly another reason for lack of participation. See Ardiyok (2001).

[6] "Telekom, caused rift between Ministers", the daily Milliyet, September 4, 2000.

[7] "Bayar [The President of the PA] states that it is unavoidable to grant control rights to the strategic investor in sensitive issues", the daily Milliyet, October 23, 2000.

[8] A critical article in that law, vehemently opposed by the Minister of Transport, transferred the authority to issue authorizations to the Telecommunications Authority. See the discussion below.

of the extreme examples of politization and patronage and the MT clearly displayed a lack of willingness to reduce or relinquish control over TTAŞ. As a result, over-employment was very high and most of the managerial positions came to be filled with members of the MHP.[9] Allegations of excessive partisanship in hiring prompted the President of the country to launch an investigation, but the investigation found no wrongdoing. After the financial crisis, and a new stand-by agreement with the IMF, several managers were replaced (daily Milliyet, July 12, 2001) and eventually the Minister had to resign as well. An important indicator of the extent of over-employment in TTAŞ is perhaps the steep reduction in the number of employees that occurred after 2001: The number of employees was reduced from almost 70,000 in 2001 to below 27,000 by 2008 (TTAŞ Annual Report 2002-2003 and 2008).

During the same period the Minister of State responsible for privatization belonged to the pro-market Motherland Party (ANAP) which upheld privatization throughout the 1990s.[10] The PA was under the authority of this Minister, which explains the relentless pursuit of privatization by the PA. Reflecting the overall pro-privatization sentiment of the 1990s this attitude neglected problems of market power associated with natural monopolies and tried to rush privatization past purposes of raising the government revenues on the one hand, and removing the state ownership in the economy, on the other. As a result, considerations such as development of competition and the consequent long term productivity growth were almost completely disregarded.

One should note, however, lack of cohesiveness in privatization policy was a result of not only political conflicts, but also lack of policy making capacity. Clearly in the 1980s and 1990s governments wanted to pursue privatization, but could not create the legal infrastructure that would survive the constitutional review. This lack of capacity constrained privatization policy independently of the political dynamics and the conflicts among the coalition parties.

Starting in 2002, the privatization of TTAŞ entered a new phase. The elections of July 2002 produced a single party government, which had a stronger preference for market orientation and privatization than the previous government. In November 2003 a Cabinet Decision stipulated that at least 51 percent of the company would be privatized through a block sale and the rest as public offerings. With the passage of Law No. 5189 in June 2004, the upper limit on foreign ownership was removed. Another Council of Ministers Decision issued in October 2004 stipulated the block sale of 55 percent of TTAŞ sales and that the tender process would start by the end of 2004. This time the tender process moved more smoothly, and the tender was held in July 2005. Oger Telecoms Venture Group (a consortium led by Saudi Oger and Telecom Italia) won the tender and the sale was concluded.

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[9] It was reported that several family members and locals from the Minister's village found employment in TTAŞ (The daily Radikal, May 3, 2001). A member of the Minister's party who ran as mayor and lost was given appointed as Deputy General Manager. The Minister's statement on the issue was: All parties provide jobs to those who run as candidates for member of parliament or mayor and lose. Should I have left them and chosen other people instead? Is not the brother of a Minister human as well? (quoted in Radikal, May 30, 2001).

[10] The ideological differences should not be overemphasized; ironically, the same Minister displayed a very protectionist attitude when he opposed the reform of tobacco policy pursued by the Minister of State responsible from the economy (who was appointed under the initiative of the third party of the coalition, namely the Democratic Left Party). He considered the reform proposal as harmful for his constituency at the tobacco growing province of Aydin, from where he was elected as a member of the Parliament. After his clash with the Economics Minister on this issue he had to resign.

2. THE LIBERALIZATION PROCESS

In contrast to efforts of "privatization without liberalization" prevalent in the 1990s, the 2000s witnessed an apparent effort to develop a regulatory framework with a view to liberalize and enhance competition in the telecommunications industry. Nine years after the passage of the landmark law in 2000, the degree of competition in services provided over fixed networks is still quite limited TTAŞ has almost unchallenged dominance in the provision of most voice and data services and prices, especially in broadband services, are higher than in many countries in Europe. This section provides an overview of the evolution of the regulatory framework and the main market outcomes in the fixed segments of the telecommunications industry.

The emergence of a regulatory framework for the telecommunications industry in Turkey started in the year 2000 when Law No 4502 was adopted by the parliament. One can argue that Turkey's commitment to the World Trade Organization guidelines to liberalize basic telecommunications services, as well as her efforts towards accession to the EU played a role in the adoption of the law.

Law No. 4502 was basically an amending law and it introduced changes to Law No. 406 and the Wireless Law (Law No. 2183, originally dated April 1983). First, it envisaged that the monopoly rights of TTAŞ would be terminated on December 31, 2003. As will become clear below, in the Turkish context termination of monopoly rights did not mean full liberalization, as new entry could still be prevented by a restrictive licensing regime. Second, it established the Telecommunications Authority (TA) as an independent administrative agency with power to design and implement secondary legislation. In particular, the TA was authorized to issue regulations for the telecommunications industry, determine operators which are responsible to provide interconnection and roaming services, regulate or set tariffs, monitor compliance and impose fines in case of non-compliance. Initially, the authority to issue licenses remained with the Ministry of Transport. The TA started functioning in August 2000. Later, partly as a result of pressures from the IMF, licensing authority was also transferred to the TA through Law no. 4673 (May 2001).

The timing of the law had an important impact on future developments. The original regulatory framework laid out in Law No. 4502 was inspired by the 1998 regulatory framework in the European Union (EU). It did not contain the .competition law-based logic of the new EU regulatory framework that was launched in 2003. The secondary legislation put out by the TA has been increasingly modeled after the 2003 package. Nevertheless, the framework law, as laid out by Law No. 4502, has put significant constraints on how closely the TA can emulate the 2003 framework and significant divergences existed, especially in the area of authorizations, as discussed below. Many of these discrepancies between the Turkish and the EU framework have been eliminated recently, by the adoption of the Electronic Communications Law in November 2008.[11] The key components of the regulatory regime prior to enactment of the new law are discussed below.

[11] As of December 2009, secondary legislation was still in the process of amendment in accordance with the requirements of the new law.

2.1. The Regulatory Framework

The decision making body of the Telecommunications Authority is the Telecommunications Board that consists of 7 members, including a Chairman and a Vice Chairman. The Chairman of the Board is also responsible for the general management and representation of the Authority. Board members are appointed for a period of 5 years and can only be dismissed before expiration of a term by the Council of Ministers for inability to work due to serious illness, professional misconduct or criminal offences.

Article 14 of Law 4502 (amending article 5 of Law No. 2813) sates that the TA is an "independent budget entity having public legal personality and administrative and financial autonomy." The TA has independent sources of finance, including frequency fees, pre-determined contributions from operators, any fines it levies on operators and revenues obtained through consultancy and training.

Turkey also has a Law on the Protection of Competition, which was enacted in 1994. The critical articles of the Competition Law are modeled after Articles 81 and 82 of the Treaty Establishing European Community.

The division of responsibilities between the TA and the Competition Authority (CA) is not clear cut. Article 7 of the Wireless Law (No. 2183, as amended by Law No. 4502, Art. 16) provided the TA with the authority to investigate anti-competitive practices in the telecommunications industry. It also stated that the CA should take the TA's opinion into consideration before taking any decisions on the telecommunications industry. Hence effectively Turkey had a system of concurrent powers.

The Authorization Regime Until recently, the authorization regime in Turkey was governed by the Ordinance on the Authorization of Telecommunications Services and Infrastructure (Official Gazette, 26.08.2004, hereafter referred to as the Authorization Ordinance). The ordinance outlined a regime of individual licenses. The main text of the ordinance described the different kinds of authorizations and the conditions through which they are granted. The specific types of authorizations required for different types of services were described in individual annexes. Over the years several changes have been made to the Ordinance, most of which had to do with addition of new annexes to cover the authorization of new services.

The licensing regime was the area which was most divergent from the EU regime. In the EU the Authorization Directive[12] stipulated two types of authorizations: The first is rights of use, limited to cases where operators use a scarce resource such as frequencies, numbers, or rights of way. The second type is general authorizations, which should not require any explicit administrative decision or act, and where any procedural requirements are limited to notification only. In the case of Turkey, individual licenses are limited to narrowly denied services or activities. Because the boundaries of these activities are not always clear, the licensing regime adds to regulatory and legal uncertainty. In fact, the Council of State (the Turkish High Administrative Court) has cancelled two authorizations ("cable platform services" and "fixed telecommunications services") in the past on the grounds that they provided operators with the opportunity to provide more than one service (such as voice and data). Hence in practice the authorization regime has acted as a serious barrier to entry.

[12] Directive (2002/20/EC) on the authorization of electronic communications networks and services.

Authorization for fixed telecommunications services" deserves special attention. This is the authorization that alternative operators would need to obtain to provide local telephony services. This was authorized three-and-a-half years after the monopoly rights of TTAŞ were removed, in August 2007. It was cancelled by the Council of State in January 2008. The authorization was revised by the TA and finally published in November 2008. Licenses have been issued in May 2009. Hence in fact it has taken more than five years since the removal of monopoly rights of TTAŞ to allow alternative operators to enter the local telephony business.

Access and Interconnection The TA has issued an Ordinance of Access and Interconnection first in May 2003; this was replaced with a new Ordinance in June 2007. The main logic of the regime was similar to that in the EU. The TA carries out market analyses, on the basis of which it identifies markets susceptible to ex-ante regulation as well as operators with significant market power (SMP). On the basis of this analysis it imposes obligations on operators. According to Art. 7 of the Ordinance, the TA could impose access obligations on SMP operators in case the operator does not allow access to other operators or requests unreasonable conditions and when the TA deems that this prevents competition or harms users. Article 8 stated that SMP operators have interconnection obligations. The TA can impose interconnection obligations on any operator if that operator does not allow access to other operators or requests unreasonable conditions and when the TA deems that this prevents competition or harms users. Other obligations that the TA can impose on SMP operators include non-discrimination, transparency (including obligation to prepare sufficiently unbundled Reference Interconnection Offers), cost orientation (if the TA decides that interconnection tariffs are not cost-oriented, then it can directly determine these tariffs), accounting separation and cost accounting and carrier selection and pre-selection.

Operators are free to conclude interconnection agreements. In case an agreement cannot be a reached within 3 months, a party can request dispute resolution by the TA. In case the parties still fail to reach an agreement, the TA may impose the terms of an agreement. In the interim period, the TA can take temporary measures, including the determination of interconnection tariffs.

The TA also issued a Communiqué on Principles and Procedures Regarding Unbundled Access to the Local Loop (UALL) in July 2004. According to the Communiqué Türk Telekom had to meet all reasonable requests for full or shared access to the local loop, except when this would require building infrastructure for new access networks. The communiqué did not address bitstream access but stated that the Authority may issue additional regulations for this. It also requires Türk Telekom to publish a reference unbundling offer. The Communiqué was going to be effective on July 1, 2005. It took until May 2007 before operators actually started to sign UALL agreements with TTAŞ (see below).

Law No. 4502 also gave the TA the authority to publish “standard reference interconnection tariffs which relevant operators may, as appropriate, incorporate in their standard terms and conditions”. The TA has actually published standard reference interconnection tariffs (SRIT) regularly. Even though these tariffs are not binding, it is understood in the industry that in case of dispute resolution, these would be the tariffs that the TA would impose. Hence the SRIT actually has been one of the critical means through which the TA implemented its interconnection policy.

2.2. Implementation at a snail's pace and market outcomes

Even though and despite the stated shortcomings, Law No. 4502 provided a useful starting point, its implementation and the resulting market outcomes in the fixed-line industry are generally viewed as disappointing. This section reviews the evolution of two important segments of the industry, namely, voice telephony and the broadband market.

The development of competition in the long distance and international call market has been extremely slow. The licenses were granted 4 months after the termination of monopoly rights of Türk Telekom. However, these licenses could not become operational because it took a long time to conclude interconnection agreements with TTAŞ. Originally, TTAŞ was supposed to have completed technical preparations for Type B and Type A licenses by November 2004 and May 2005 respectively,[13] but this never materialized. Operators holding Type B licenses concluded first interconnection agreements with Türk Telekom in March 2006. Five operators holding Type A licenses (Superonline, Global Iletisim, Borusan Telekom, Koc.net and Dogan Telekom) were able to sign interconnection agreements with TTAŞ in July 2006. Hence, the time lag between the granting of the licenses and their operationalization was almost a remarkable two years.

The interconnection policy was not used to speed up the development of competition either. The initial offers of TTAŞ were very high (about 2.7 and 3.7 Eurocents/min for in-zone and out-zone areas, respectively), and many operators refrained from signing agreements with Türk Telekom and applied for dispute resolution by the TA. Finally, in September 2004 the TA announced the first SRIT.

The rates determined in the SRITs are listed in Table 1. For comparison, the table also lists the EU averages of call termination on the fixed incumbent's network taken from the European Commission's Implementation Reports, as well as more recent SRIT determinations of the TA. Initially there was a large gap between the tariffs determined by the TA and the EU average: the tariff for October-December 2004 was higher than not only the EU average of 2004, but even the Commission's recommended best practice back in 1998 (which was 0.9-1.8 Eurocents for single transit and 1.5-2.6 Eurocents for double transit).[14] This large gap was eliminated only after beginning of 2008.

Table 1. Standard Interconnection Tariffs set by the Telecommunications Authority

	Call origination and call termination on TTAŞ network				EU Average		Exchange rate
	In-zone area (per min)		Out-zone area (per min)				
Effective during	Ykr	Eurocent	Ykr	Eurocent	Single Transit	Double Transit	Eurocent/Ykr
01.10.2004 31.12.2004	4.10	2.21	5.90	3.18	1.01	1.61	1.8577

[13] Type A is for operators which will use carrier pre-selection. Type B is for operators using carrier selection on a call-by-call basis.

[14] See European Commission Implementation Report, 1998

01.01.2005 30.09.2005	3.40	1.86	5.10	2.78	0.94	1.39	1.8321
01.10.2005 01.03.2007	2.00	1.23	3.70	2.28	0.86	1.25	1.6232
01.03.2007 01.04.2008	1.89	1.01	3.00	1.60	0.87	1.18	1.8736
01.04.2008 01.05.2009	1.71	0.82	2.70	1.30	0.86	1.16	2.0743
Since 01.05.2009	1.71	0.81	2.70	1.28	NA	NA	2.1133

Sources: Information and Communications Technologies Authority, European Commission 12th Implementation Report (2006), Annex 2, Figure 22, and 14th Implementation Report (2009), Annex 2, Figure 86.

Cullen International (2008) reports that as of early 2008, the share of TTAŞ in overall fixed telephony services is 91 percent by traffic and 81 percent by revenue. The share (by minutes of traffic) in national calls is 91 percent and in international calls it is 78 percent.

It can be said that TTAŞ has responded to the threat of entry by reducing long distance and international tariffs quite aggressively, prompting allegations of margin squeezes from alternative operators.[15] Table 2 provides data on fixed line call tariffs in comparison to EU averages. The table shows that monthly rental fees are lower than the EU average. Also, international calls seem to be lower than the EU average. By contrast, local calls charges are higher than EU averages when expressed in PPP, possibly reflecting the fact that TTAŞ did not face any competition in this segment.

Table 2. Fixed line call tariffs (€, April 2008)

	Türk Telekom	Türk Telekom PPP(*)	EU 27 Average
Standard Monthly Rental residential users (incl. VAT)	6.75	12.825	15.00
Standard Monthly Rental business users (incl. VAT)	6.75	12.825	18.60
3 minute local call	0.11	0.209	0.14 (**)
10 minute local call	0.36	0.684	0.38 (**)
3 minute residential long distance call	0.13	0.247	0.26
10 minute residential long distance call	0.44	0.836	0.77
10 minute international call to UK residential users	0.57	1.083	2.50
10 minute international call to USA residential users	0.57	1.083	2.00

Source: Cullen International (2008), Figure 38, 40, 41, 42, and 45.
(*) PPP adjustment rate: 1.9.
(**) European Commission, 14th Implementation Report (2009).

[15] One important change occurred in the summer of 2004, when TTAS reduced its international call tariffs by 50-70 percent. Another occurred in the beginning of 2007, when TTAS announced that fixed monthly fees and local call tariffs were increased by about 23 percent and 18 percent, respectively, whereas tariffs of domestic long distance and international calls and calls to GSM operators were reduced by another 50-60 percent. The fact that TTAS reduced tariffs in the competitive segments and increased tariffs of calls where it still held effective monopoly position caused an outrage. The TA approved the tariffs. There was no formal analysis to back the decision, but it was argued that TTAS had not increased local call charges for years even though the inflation rate was above 10 percent.

In order to appreciate how slow the development of competition in fixed voice services has been, it will be informative to place Turkey in an international comparative perspective. Table 3 provides data on the market share of new entrants in the two most competitive segments of the markets for voice telephony, namely domestic long distance and international calls, after 4 years of liberalization. In the long distance market, with a market share of 9 percent of new entrants, Turkey comes last among the OECD countries for which data are available. In the UK, new entrants also had 9 percent market share after 7 years of liberalization, but this is possibly to be expected since the UK was an early liberalizer. In the international calls market, the market share of new entrants is lowest for Turkey, except for the cases of the UK, New Zealand and Spain. Again, low market shares in the UK and New Zealand are to be expected as these are among the first countries to liberalize their markets.

Table 3. Market shares of new entrants 4 years after liberalization (% of call minutes)

	Domestic Long Distance		International	
	(1) year of liberalization	(2) market share	(3) year of liberalization	(4) market share
Australia	1991	12	1991	28
Austria	1998	47	1998	56
Belgium	1998	15	1998	49
Canada	1990	18	1992	33
Czech Republic	2000	25	2000	Na
Denmark	1996	37	1996	56
Finland	1993	60	1993	41
France	1998	36	1998	26
Germany	1998	36	1998	54
Greece	2001	21	2001	29
Hungary	2002	na	2002	Na
Ireland	1998	na	1998	25
Italy	1998	25	1998	50
Japan	1986	22	1987	27
Korea	1996	17	1996	27
Luxembourg	1998	12	1998	28
Mexico	1996	27	1996	29
Netherlands	1997	24	1997	38
New Zealand	1990	21	1990	21
Norway	1998	29	1998	34
Portugal	2000	na	2000	25
Spain	1998	18	1998	17
Sweden	1994	17	1992	25
Switzerland	1998	45	1998	57
Turkey	2004	9	2004	22
United Kingdom	1985	9	1986	14
United States	1984	38	1984	27

Sources: Columns (1) and (3): Boylaud and Nicoletti, Table 1
Columns (2) and (4): OECD Communications Outlook 2005, Tables 2.3 and 2.4
Notes: In cases where data for 4th year after liberalization is not available data for a year earlier is adopted. For UK and the US data is for 1991. Data for Turkey is from Cullen International 2008.

The degree of competition in fixed broadband services is even lower. As of 2008, there were more than 70 internet service providers (ISPs) in the market, and share of TTAŞ in fixed retail broadband connections was about 95 percent (4.3 million out of a total of 4.5 million). Most of the alternative operators were engaged in pure resale and the number of bitstream connections was a mere 8 thousand (Cullen International, 2008, Table A.23 and A.25). The alternative operators share in revenue was a mere 15 percent (Table A.23).

TTAS started to provide ADSL access in 2003, as the sole provider of that service. In February 2004 the TA instituted a resale arrangement for a small portion of the ADSL ports installed by TTAŞ (with a margin allowed to resellers of 18%), but this attracted little enthusiasm from private ISPs. In October 2004, the TA Board decided to launch bitstream access. The TA's approach was to regulate bitstream access through a retail-minus methodology. However, the commercial realization of bitstream access was significantly delayed both by legal challenges by TTAŞ[16] and because it proved that fixing margins did not stop TTAŞ from preventing entry through non-price tactics. In that period, only one ISP applied to the TA for dispute resolution in May 2006, and this was concluded in an agreement in February 2007.

These problems seem to have pushed the TA to take a more structured approach to the issue of wholesale broadband access and in March 2007 the TA requested TTAŞ to prepare reference offers for wholesale broadband products. Availability of bitstream access began only after the TTAŞ came up with reference offers and bitstream became commercially available only in 2008.

In the meantime, TTAŞ' draft reference unbundling offer was put up for consultation on December 2005 and finalized in November 2006. Two ISPs, Netone and Superonline, signed UALL agreements with TTAŞ in May 2007.[17] As of May 2009 monthly rental fees are a bit over €8, which is about €1 cheaper than the EU average.[18] As of the end of 2008, there were no UALL products yet offered by alternative operators.

The initial intent of the TA was somewhat in line with the "ladder of investment" approach (ERG, 2005, Cave, 2006).[19] The TA wanted to take quick action on pure resale and bitstream and have especially bitstream readily available to ISPs even before TTAŞ reference unbundling offer would be ready. However, TTAŞ success in challenging the TA decisions,

[16] It may be informative to describe briefly the nature of the legal challenge initiated by TTA¸S. Control of retail tariffs is governed by the Tariff Ordinance put out by the TA in 2001. This Ordinance outlined the procedures TA was to follow in the approval and auditing of telecom tariffs of operators with significant market power. It did not give the TA the authority to set retail tariffs, reflecting TA's desire not to be too intrusive in retail markets. TTAŞ' challenge against the TA's effort to regulate bitstream access through a retail-minus approach was based on the allegation that TA had authority to approve tariffs offered by TT, but not to dictate tariffs and the decision was struck down by an administrative court on these grounds. Hence the TA was found to be inconsistent with the Tariff Ordinance it adopted back in 2001.

[17] http://turk.internet.com/haber/yazigoster.php3?yaziid=18324.

[18] Data from www.cullen-international.com.

[19] The ladder of investment refers to the idea that there is a migration by new entrants from pure resale to bitstream access, and unbundled access, suggesting that entrants are moving up the investment ladder, from those steps with lowest investment to those with higher investment.

as well as TA's initial tendency to see bitstream purely as a matter of pricing seems to have delayed bitstream from becoming a commercial reality.

Another issue that is often raised by alternative operators is the possibility of Wholesale Line Rental (WLR). WLR allows alternative suppliers to rent access lines on wholesale terms from the incumbent operator, and resell the lines to customers. In combination with Carrier Pre Selection (CPS), WLR enables the alternative operator to end the billing relationship between the incumbent operator and the customer and allows the alternative operator to provide a single bill that covers both line rental and telephone calls. WLR has been imposed as a remedy in all EU 15 (Western European) countries except for Belgium, Germany and Finland. It is imposed as a remedy in many newer member states of the EU as well, including in Cyprus, Lithuania, the Former Yugoslav Republic of Macedonia, Malta, Poland and Slovenia.[20]

While the TA has been intervening in wholesale broadband markets by mandating TTAŞ to provide various forms wholesale products, the TA has refrained from intervening in the retail broadband market. Retail broadband markets have been subject to various inquiries by the CA. As mentioned above, the telecommunications industry is also subject to general competition law enforced by the CA. While Law No. 4502 did not provide a clear demarcation of the division of labor between the TA and the CA, and while initially the two authorities had some disagreements about their respective spheres of authority, it can be said that the CA refrains from adjudicating cases that involve allegations of anticompetitive behavior in areas that are under the ex-ante regulation enforced by the TA and instead concentrates in markets that are not subject to ex-ante regulation, especially the retail broadband internet market. The Competition Authority also has a decision regarding the privatization of TTAŞ whereby it has required that the cable TV network had to be separated from TTAŞ before the sale.

In a recent decision[21] which is representative of CA enforcement of competition law in the fixed line telecommunications industry, the CA has decided that TTAŞ has abused its dominant position by executing a price-squeeze against its competitors in the retail broadband internet market and imposed a fine of 12.4 million TL (about €8 million). In another decision,[22] the CA has informed TTAŞ that it has to provide naked DSL services. Naked DSL services prevent TTAŞ from tying data and voice services and therefore allow consumers to subscribe only to TTAŞ data services.

2.3. The new Electronic Communications Law

A new Electronic Communications Law (ECL) was adopted by the Parliament in November 2008. Overall, the ECL has brought the Turkish regulatory framework closer to the 2003 framework of the EU. For example, it explicitly mentions market analyses and identification of operators with significant market power, reflecting the competition-law based spirit of the EU framework. The law also changes the name of the regulatory authority to Information and Communications Technologies Authority (ICTA). Perhaps the most

[20] Data obtained from www.cullen-international.com.
[21] Decision No. 08-65/1055-411, Official Gazette dated 17.6.2009.
[22] Decision No. 09-07/127-38, Official Gazette dated 27.4.2009.

important innovations of the ECL are in the areas of authorizations and transparency of the regulatory authority. Regarding authorizations, the law does away with the existing individual licenses regime and adopts a regime that consists of general authorizations and rights of use, as in the EU framework. One would expect that this change would imply a reduction in regulatory barriers to entry in the future. The law also states that "making those Board decisions that concern operators and consumers, as well as the reasoning and procedures behind those decisions, open to public opinion" is among the duties and competencies of the ICTA. If implemented, this is potentially a major step towards improving the transparency and accountability of the regulatory authority (see also the discussion below).

Since the publication of the ECL, the ICTA has issued a series of regulations to implement it. Again, the main spirit of the secondary legislation is to bring the Turkish framework closer to the 2003 framework of the EU. The new Ordinance on Authorization in the Electronic Communications Sector was adopted in May 2009, doing away with the over-complicated individual licenses regime and introducing a two-tiered regime consisting of general authorizations and rights of use. In September 2009 the procedures for identifying operators with SMP were renewed and the new rules explicitly introduced something similar to the "three criteria test" that characterizes the EU regime of SMP designations. In March 2009 the ICTA also adopted an ordinance that regulates the protection of trade secrets and publication of market information. In effect, the ordinance authorizes the ICTA to make public information such as number of subscribers, traffic volumes, net sales incomes, market shares, investment volumes, number of subscribers switching operators, and quality indicators, presumably to enhance consumers' information about the market.

3. WHAT EXPLAINS TURKEY’S (LIMITED) PERFORMANCE ?

This section discusses the institutional and political-economic factors that may explain Turkey’s less than perfect performance in the liberalization of and promotion of competition in the fixed-line telecommunications industry. Establishing a regulatory framework prior to privatization One important issue emphasized in the literature is the order of two important components of liberalization in telecommunications, namely, establishment of a regulatory framework and privatization.[23] There are two arguments that favor the establishment of a regulatory framework prior to privatization: removal of regulatory uncertainty and promotion of competition.

First, in the absence of a regulatory framework private investors need to be compensated for the risks associated with regulatory uncertainty. This in turn implies lower willingness to pay (on average) for the utility. Another consequence of such uncertainty is that it can also lead to lower investments post-privatization. Second, in the absence of regulation monopolies have little or no incentives to provide access to potential entrants. Therefore, a regulatory framework that ensures access in reasonable terms and on non-discriminatory basis is a precondition of development of competition .in fact, this is true regardless of the ownership structure.

These arguments are also supported by empirical studies. For example, Wallsten (2002) uses telecoms data from 197 countries for the period 1985 to 1999 and finds that establishing a regulatory authority before privatizing the firm enhances investment and sector performance (in terms of telephone penetration, telecom investment and mobile cellular subscriptions). Also, it substantially increases the price investors are willing to pay for the .rm. For the same sample period, with a special focus on (86) developing countries' telecoms markets, Fink et. al. (2003) also find that the sequence of reform matters. They find that liberalizing the sector after privatization leads to lower performance: in such cases the penetration rate is lower than in the cases where the reforms are introduced at the same time.[24]

In a more recent study, Knyazeva et. al. (2006) analyze preconditions of the success of ownership reforms in the telecoms industry, and show that the quality of institutions (political stability and regulatory environment) has a significant positive effect on the changes in performance, as measured by efficiency growth, after privatization. In fact, quality of institutions has a positive impact on performance regardless of the ownership structure. They find that the efficiency improvements after privatization are more pronounced in the presence of better institutions and accompanying regulatory reforms.

In this context, the failure of the earlier attempts to privatize TTAŞ can be explained not only by the government's determination not to relinquish control but also by absence of regulatory framework, which created uncertainty about what type of regulatory obligations the incumbent would face post-privatization. It is very likely that this uncertainty reduced the potential buyers' willingness to pay for TTAŞ. It could be argued that after the passage of Law No. 4502 and the ensuing secondary legislation the uncertainty was partly removed, which possibly explains the success of privatization in 2005.

This sequencing of events could also lead one to conclude that the authorities finally got the order of reform right: establishment of regulatory framework in 2001 and privatization in 2005.[25] We would argue, however, that this conclusion is only partially correct, as the correct sequencing would lead to better market outcomes only if the regulatory framework is not only legislated but also effectively implemented. Even though Turkey ended up following the correct sequencing and the general evolution of regulatory framework has been in the right direction (that is, towards the EU model), the implementation has been extremely slow and enforcement has been weak. Moreover, in a number of instances, measures that would enhance competition were delayed in an almost deliberate fashion (e.g. competition at the local level). The weakness in implementation was demonstrated by the slow pace in the emergence of competition as documented in the previous section. Effective implementation (for example, well designed and coherent secondary regulations and their effective enforcement) ultimately hinges on a number of factors that are generally labeled under "quality of regulatory institutions."

[23] See, for example, Wallsten (2002), Fink et. al. (2003), Li and Xu (2004).

[24] See also Li and Xu (2004). Their data is not restricted to the developing countries (177 countries during the period 1990 to 2000) and yet they find a similar result: countries that implemented more aggressive programs of reforms perform significantly better than those with less aggressive reform policies.

[25] See for example, Bagdadioglu and Cetinkaya (2007): they argue that the sequencing of restructuring, regulation and privatization is properly implemented in Turkish telecommunications sector and that enough time is not passed for the realization of the benefits of privatization.

Quality of regulatory institutions There are various attempts to define and measure quality of regulatory institutions.[26] One of few ones that includes Turkey (albeit only recently) is the Annual Regulatory Scorecard published by the European Competitive Telecommunications Association. The scorecard provides an overall score for the relative effectiveness of the regulatory environment for 20 European countries, since 2002.[27]

The assessment is based on selected key criteria, including: (1) overall institutional environment (legislative framework, National Regulatory Authority's (NRA) powers, independence, dispute settlement and appeal systems), (2) key enablers for market entry and network roll out (numbering, rights of way, etc.), (3) the NRA's regulatory processes, (4) application of regulation by the NRA, and (5) regulatory and market outcomes (degree of service-based and infrastructure-based competition, market shares, prices). It turns out that Turkey performs poorly in all of these dimensions and has the lowest overall score in the sample.

Table 4 shows the ECTA scores for 2008 as well as the year of establishment of the NRAs of various countries. Table 5 presents the detailed breakdown for each component and the scores obtained by Turkey.

Table 4. ECTA Scores (countries ranked according to the overall score)

Country	Overall Score	Components of the overall score					NRA's est. year (*)
		Institutional Framework	Entry Enablers	Efficiency of NRA	Application of Regulation	Market Conditions	
UK	374	73	76	62	62	101	1984
Netherlands	361	66	80	52	58	105	1997
Norway	361	66	76	62	43	114	1987
Denmark	344	78	73	40	50	103	1991
France	323	76	57	50	56	84	1996
Italy	302	78	57	43	41	83	1996
Ireland	301	73	54	62	59	53	1997
Finland	301	62	71	59	31	78	1988
Portugal	287	62	40	50	33	102	1981
Hungary	281	71	52	54	33	71	NA
Austria	282	62	43	47	33	97	1997

[26] See for example, Gutierrez (2003a,b), who constructs a regulatory framework index, which includes an equally weighted sum of six elements; independence from the incumbent, independence from the government, accountability, clarity of its roles and objectives and transparency and participation in regulatory process.

[27] The scores are computed through a comparative quantitative analysis, whereby the data is based on responses to a comprehensive questionnaire by the National Regulatory Authorities, ECTA members, and other stakeholders.

Germany	280	43	66	57	21	93	1996
Spain	266	73	40	40	44	69	1996
Sweden	265	57	59	47	12	90	199
Belgium	253	33	54	33	53	80	1992
Slovenia	250	62	47	47	28	66	200
Greece	246	78	35	40	28	65	1995
Czech	192	71	31	24	17	49	200
Poland	179	47	26	35	13	58	200
Turkey	139	57	9	21	12	40	2000
Minimum	139	33	9	21	12	40	
Average	279.35	64.4	52.3	46.	36.	80.	
Median	281.50	66.00	54.00	47.00	33.00	81.50	
Std. dev.	60.84776	12.33	18.76	11.94	16.47	20.80	

Source: ECTA Scorecard 2008.
(*) Obtained from various sources.

The scores for 2008 (6th scorecard) range from 374 (UK) to 140 (Turkey), with an average score of 279 (median: 282). Turkey scores particularly bad for the "regulatory" results.[28] Turkey scores the minimum in all criteria, except for the institutional framework.

One can note a positive correlation between the overall regulatory score and the age of the NRA, possibly reflecting learning due to experience. Although the quality of the NRA[29] is not the sole determinant of the qualities of the regulatory environment,[30] for criteria (2), (3) and (4) it seems to matter a lot. It is possible that NRA age has an important impact on its quality. Hence, the table shows that the correlations between the categories "entry enablers" and "efficiency of NRA" on the one hand and NRA age on the other are particularly strong. The worst performers in the category of "entry enablers", namely Turkey, Poland, and the Czech Republic (that also have the lowest overall score) have established their NRAs relatively recently (in 2000). The correlation between NRA age and "the overall score" is also strong. Note that the best performer overall, namely the UK, has one of the oldest NRAs.

[28] The 2008 report distinguishes between institutional and regulatory results, whereby the former mostly represents the criteria (1) listed above, and the latter represents the rest.
[29] By the term .quality. we mean both the quality of the rules designed by the NRA as well the quality and effectiveness of their implementation and enforcement.
[30] As noted by ECTA, other institutional players are Governments, legislators and judiciary bodies.

Table 5. Breakdown of ECTA 2008 scores for Turkey
(W: weak, N: Neutral, S: Strong)

1. Institutional Framework		2. Entry Enablers		3. Efficiency of NRA		4. Application of regulation by NRA		5. Economic Market Conditions	
NRA enforcement powers	W	Rights of way	W	Efficiency of dispute settlement	W	Technology neutrality	W	Voice Services	W
NRA independence	W	Numbering	W	Enforcement record	W	Operational conditions	W	Broadband Services	W
NRA scope and scale of resources	S	Frequencies	W	Transparency of regulatory process	W	Non pricing condition / prevention of leveraging	W	Mobile Services	W
Dispute settlements	S			Market Analysis process	N	Accounting separation	N	Business Services	W
Effectiveness of appeals procedure	S								
Transposition of framework	S								

Source: ECTA Scorecard 2008.

The relative weakness of Turkey particularly stands out in regulatory transparency. Turkey stands as the only country that performs weakly under this category. Except for four countries that are ranked as "neutral" (Greece, Slovenia, Czech Republic and Belgium), all countries perform well (strong) in this criteria. This is not surprising: until very recently, the regulatory authority in Turkey was not obliged to publish its decisions (and in practice many Board decisions were not made public). Furthermore, it was also not obliged to provide any reasoning or justification for its decisions. Even though it did engage in public consultations prior to adopting secondary legislation and market analyses, it has not made these consultations public. It has also not disclosed how it responded to the concerns raised in these consultations.

A similar point applies to "NRA independence"; Turkey is one of the few countries that perform weakly (the other two are Germany and Poland). It is generally believed that NRA independence is an important determinant of regulatory quality. As Edwards and Waverman (2006) show, regulatory independence is particularly important when the government retains ownership, as governments may face a commitment problem in creating a regulatory environment which does not favor the publicly owned incumbent. Using time series data for EU15 countries, they show that public ownership of the incumbent telecom operators has a positive effect on the interconnection rates (which entrants pay to incumbents to terminate calls);[1] however, the presence of institutions which promote the independence of NRAs mitigates this effect.[2]

For the purpose of comparison, we have computed the Edwards-Waverman European Union Regulatory Institutions Independence (EURI-I) index[3] for the case of Turkey. Turkey's score turned out to be 6.3,[4] which is close the EU15 average (computed for 2003). Interestingly, according to this index, Turkey scores better than the UK (5.75), which has the highest overall score and which has been reported as "strong" for regulatory independence in the ECTA scorecard (ever since the scorecard has been published). Hence in terms of regulatory independence, it would seem that there is a divergence between the ECTA score and the EURI-I index. This is because, as previously noted, the ECTA score is calculated on the basis of responses to a questionnaire by various stakeholders, whereas the EURI-I index is calculated on the basis of objective criteria such as funding, terms of appointment of board members, and whether the authority is multisectoral or not. We think the latter reflects a de-jure assessment of independence whereas the former captures a de-facto assessment of independence. The contrasting scores for Turkey and the UK, for example, reflect the fact that de-facto independence can seriously diverge from de-jure independence. This also underscores the fact that procedural and legal measures may be neither necessary nor sufficient for actual independence.

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1 See Bauer (2005), who also shows that the interconnection rates are higher in countries where the incumbent operators are under full or partial state ownership.

2 They also find that the regulatory independence has no effect on interconnect rates when the incumbent is operation fully privatized.

3 The EURI-I index is an equally weighted sum of 12 institutional elements, each measured as a dummy or categorical variable (e.g., funding, terms of appointment, experience) on a 0.1 scale. Hence it was relatively straightforward to calculate this index for the case of Turkey.

4 To be able to compare the Turkish score with the EU15 index, we have computed Turkey's score for 2003. If the score were to be computed for a more recent date, the only significant change in the elements that determine the index would be the "NRA experience": updating would imply that the score would increase by one point to 7.3.

Indeed, in the case of Turkey, it has often been asserted in the media that the regulatory authority has not been able to act in complete independence from the Ministry and that appointments to the Board have been not fully based on merit.[5] In fact, the fact that the Ministry has not shown political ownership of the liberalization process is probably one of the important factors that explains the slow pace of competition. Further but perhaps even more revealing evidence of the regulator's lack of independence is its contrasting attitude in its interconnection policy in fixed versus mobile industry. In the mobile industry both the Ministry and the regulatory authority seemed keen to support the entry and growth of new operators, one of which was a subsidiary of TTAŞ. As discussed in Atiyas and Dogan (2007) the TA was much more aggressive in its interconnection policy in the mobile segment and the termination charges imposed on Turkcell, the dominant player in the mobile segment, was among the lowest in the EU.

It is very likely that privatization of TTAŞ itself also played a role in the slow pace of emergence of competition. The government was concerned about raising as high revenues as possible from the privatization transaction. This has slowed down the introduction of measures that would result in the erosion of monopoly rents, as reflected in the relatively high interconnection tariffs in the earlier phase of the liberalization process, delays in the commercial operationalization of licenses for long distance and international voice services and the delay in the authorization of entry into the local call business.

Finally, professional capacity is an important dimension of regulatory quality although it may be hard to measure it in any objective manner. The fact that a number of authorization attempts were cancelled by the Administrative Court can be construed as evidence of weakness in the capacity to design credible secondary legislation. A stronger legal capacity would have formulated the licenses in such a way that the higher court would not overrule them and there would be no resulting damages to the credibility of the authority. The fact that TTAŞ was able to frustrate TA's initial attempts to launch bitstream access may also be taken as an indicator of lack of capacity. One could also argue that the lack of transparency alluded to above partly results from a deficiency of technical and professional capacity. The reluctance of the authority to publish any reasoning or justification for its decisions reflects its concern that justifications may be technically not well grounded and that they could be vulnerable to legal challenges through appeals.

4. The Privatization Question Redux

Given the problems associated with the implementation of the regulatory framework, one may ask the question whether privatization of Türk Telekom was a good idea to begin with. In fact, TTAŞ privatization was criticized by many on the grounds that it amounted to a transformation of public monopoly to a private monopoly.

In contrast with earlier studies that support the benefits of privatization,[6] some studies have been arguing that retaining public ownership in the fixed line telecommunications may

[5] See for example Serdar Güçlü, "Telekomda 'To Be or Regulatory Captured'", published at http://www.turk.internet.com/haber/yazigoster.php3?yaziid=10765, 26 August 2004.

[6] See, for example, Bortoletti et. al. (2002). Based on a sample of 31 firms from 25 countries, they find that privatization of telecoms firms is associated with higher profitability, output and efficiency.

achieve more desirable market outcomes. For example, with a special focus on developing countries, Auriol (2005) argues that privatization of telecoms leads to a substantial reduction in employment and real output (by and large, the decrease in the latter effect is dominated by the former, which leads to an increase in labor productivity), as well as a price increase. She argues that in increasing returns to scale industries, like fixed line and long distance telecommunication markets, public ownership may be preferable due to allocative inefficiency combined with the critical budgetary conditions.[7]

Knyazeva et al (2006) use cross-country data to study the effects of institutional development and ownership reforms on efficiency growth in the telecommunications industry. They show that when one accounts for the sample selection bias, which is due to the endogeneity of the privatization decisions,[8] privatized sectors exhibit weaker performance improvements than sectors remaining public over their sample period of 1999-2000. This result is in contrast with most of the earlier cross-country studies on privatization. Knyazeva et al (2006) argue that the transfer of ownership to the private investors does not necessarily eliminate the incentive problems within the firm and that privatization can be associated with additional costs. Furthermore, presence of a rent-seeking government may also be an additional burden on the recently privatized enterprise.

While there may be arguments in favor of retaining public ownership in a "perfect" second-best environment, where policy makers are not only social welfare maximizers but also fully capable in designing and implementing regulatory policies to achieve that end, the regulatory environment in Turkey was far from perfect prior to the privatization of TTAŞ. There are a number of reasons why one might believe that privatization was the right thing to do in Turkey even though the regulatory framework was less than perfect. These are discussed below.

Economic theory would suggest that one of the main implications of privatization is profit orientation, which in turn means stronger incentives for cost reduction. The case of TTAŞ seems to confirm this expectation. Anecdotal evidence suggests that there have been significant efficiency gains after privatization. This is especially true in the context of restructuring of the labor force, both in terms of reduction in the total number of workers and in terms of improving overall skill mix through new hires (Türk Telekom, 2008). It is also likely that TTAŞ may be experiencing more flexibility in procurement because it is less subject to government monitoring and bureaucratic rules and this may create additional capacity to reduce costs. Even though actual development of competition has been lacking, especially in international comparison, the threat of potential competition seems to have made an important impact on domestic long distance and international retail prices. As discussed in section 3.2, there have been several rounds of steep reductions in these prices.

A discussion of whether privatization has been beneficial or not also requires some conjectures about what would have happened if TTAŞ remained under public ownership. One could in principle envision, for example, a situation where TTAŞ would be politically instructed to act as a social welfare maximizing incumbent operator[9] that oversees and

[7] Auriol points to China and Vietnam as countries that followed the winning strategy, which is to keep the fixed line operator public and monopolistic while fostering (regulated) competition in the mobile segment.

[8] There is a self-selection problem as factors like past performance, initial institutional conditions, and macroeconomic conditions can affect both (future) efficiency improvements and the privatization decision.

[9] For theoretical analyses, see, for example, Sertel (1988) and Fjell and Heywood (2002).

promotes the development of competition in the industry. However, the discussion above suggests that the political and institutional dynamics behind the public ownership of TTAŞ was not conducive to this kind of behavior. First, TTAŞ was used as a vehicle for partisan patronage over the years and as a result suffered from significant over-employment. Second, TTAŞ' attitude towards liberalization and competition was outright hostile. Even while under public ownership, TTAŞ used every available instrument, most importantly legal challenges against regulatory interventions, to block the development of competition.

The telecommunications industry has been experiencing rapid change in terms of technology. The speed of innovation in products and services is very high, and the introduction of these new products and services into the Turkish market is likely to have an important positive welfare effect. It has been argued that the presence of a strong potential of innovation is an important argument for private ownership (Shleifer, 1998).

Finally, and on a positive note, the prospect of competition in the telecommunications industry is stronger now than a few years ago. With the complete liberalization of fixed line services and implementation of unbundled access to the local loop, it is likely that alternative fixed line operators will be able to better compete with TTAŞ. Moreover, with fixed-mobile convergence TTAŞ is experiencing increased competition from mobile industry.

5. Conclusion

Earlier attempts to privatize TTAŞ failed due to a lack of cohesiveness at the policy making level, typically with different coalition partners pursuing different agendas. It seems there was also a lack of capacity to create the necessary legal infrastructure for the privatization policy to survive constitutional review. Perhaps not differently from many developing countries, privatization was driven by revenue maximization motives, which ignored long term productivity growth and competition, as reflected by the complete absence of a proper regulatory framework. Ironically, this absence of a regulatory framework and the ensuing regulatory uncertainty probably further hindered the privatization prospects of TTAŞ in that era.

Partly thanks to the failure of earlier privatization attempts and partly as a response to external pressures, such as her commitment to the WTO guidelines, Turkey appeared to have the necessary preconditions for a successful liberalization in the early 2000s, i.e., once Law No. 4502 was adopted. The legal framework, while not completely in conformity with that in the EU, had most of the necessary basic components: in particular, an independent regulatory authority that had significant amount of discretionary power in crucial areas such as access and interconnection and retail tariff control. Moreover, through the same series of events Turkey ended up with the right sequencing approach, that is, establishing regulatory framework prior to privatization.

From a formal point of view, there were some important safeguards that would insulate the regulatory authority from political interference: the authority had independent sources of finance, the members of the governing body were appointed for fixed terms and could not be removed, its decisions could not be overturned by the Ministry and could only be appealed at the high administrative court. Indeed, progress has taken place: some prices have come down and there has been some limited entry by new players in the market. However, this chapter has argued that both the evolution of the regulations and market outcomes in fixed segments reflect that the development of competition has been extremely slow. In hindsight, the Turkish experience confirms that quality of effectiveness of the regulatory framework requires more than de-jure forms of independence. It also underscores the importance of transparency as well as of professional and technical capacity.

In hindsight, it seems that the lack of ownership of the liberalization agenda by the Ministry seems an important factor that has delayed the development of competition. In that sense the Turkish experience suggests that delegation of regulatory authority is not a panacea in the absence of political intent and ownership. The Turkish experience also suggests that problems in implementation may prevent the full exploitation of benefits that may result from correct sequencing of reforms.

There are a number of reasons to be more hopeful for the future. The implementation of the legal infrastructure has reached a level of maturity especially in terms of unbundled access and full liberalization of voice services; hence barriers to competitive growth in broadband as well as voice services have been significantly reduced in the last few years. The new Electronic Communications Law has introduced a number of important changes and has moved the Turkish regime closer to the EU framework. It has also introduced some institutional changes (such as requiring the regulatory authority to publish its decisions with justifications) which will likely increase the degree of transparency and accountability of regulatory interventions.

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Chapter 13

INSTITUTIONAL CHANGE IN THE TURKISH ENERGY MARKETS[1]

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ABSTRACT

By enacting the Electricity Market Law in February 2001 and the Natural Gas Market Law in May 2001, respectively, Turkey began reforming the institutional environment of the Turkish energy industry. The aim was to unbundle the state-owned monopolistic structures of the markets by separating vertically. The new legal structure has de jure changed the pre-reform institutional structure of the energy markets. In other words, the legal change has aimed to introduce competition to the Turkish energy industry. In order to ensure this objective, as an independent regulatory agency with full regulatory discretions over both the electricity market and the natural gas market, Energy Market Regulatory Authority (EMRA) was established. In this context, the chapter aims to review the process of institutional change and to assess the current institutional issues in the energy markets of Turkey.

INTRODUCTION

Turkey has been pursuing a regulatory reform in the energy markets for the last decade. In this context, it has recently restructured the electricity and natural gas markets. The regulatory reform has aimed to direct the markets to a more competitive environment. As an independent regulatory agency with full regulatory discretions on the markets, Energy Market Regulatory Agency (EMRA) was established. The aim of this chapter is to review institutional change and the effects of reform for the energy markets.

The chapter analyzes both the electricity and natural gas markets, and consists of eight main sections. The first section introduces a historical background from the pre-reform

[1] This chapter is heavily based on Cetin (2008a and 2008b).

structure of the market to the current structure for the electricity market. The second section analyzes the main reasons for institutional change in electricity. The section scrutinizes rationales for the reform, as the economic reasons, the political and legal reasons, and accession to the EU and external factors. The third section presents an institutional outlook of the new market structure. The outlook comprises the crucial properties and components of the reform like the 2001 Law, EMRA, and the disintegration of monopolistic structure. The fourth section reviews the main economic issues in the current market structure. These issues are problems related to existing contracts, lack of excess supply, stranded costs in generation and wholesale segments, retail tariffs and cross subsidies, vertical integration and disintegration, and the "Strategy Paper" of March 2004.

The remaining part of the chapter focuses on the natural gas market. The fifth section begins with an historical background about traditional market structure and restructuring in the natural gas market. The sixth section discusses regulation of the market. In this context, this part observes the Natural Gas Market Law's prominent properties, EMRA's regulatory discretions and the new market structure. The seventh section focuses on current issues and future perspectives in natural gas. Finally, the chapter ends with a conlusion as the eighth section.

1. Historical Background of Electricity Market

Figure 1 presents a historical development of the structure of the Turkish electricity market, including the structure after the Electricity Market Law of 2001 as well.

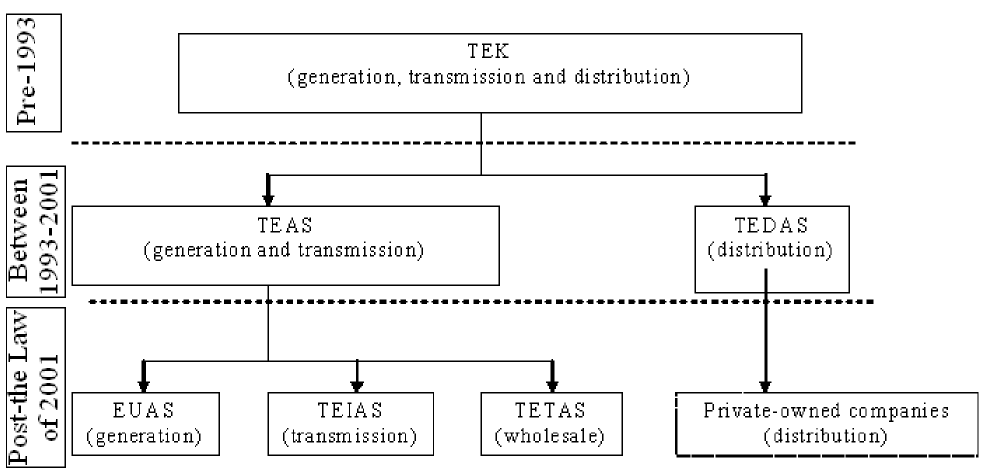

Figure 1. Historical Development of the Market Structure.

1.1. The Structure before 1980

Electricity in Turkey was firstly generated in 1902 in Tarsus by a foreign group. This first enterprise was properly a private one and installed capacity of electricity generation was 2 kWh. Afterwards, a consortium consisting of the Ottoman Company (Osmanlı Anonim

Şirketi), GANZ Company, Banque de Bruxellese and Banque Generale de Credit begun to generate electricity in Silahtarağa Plant in Istanbul as of 1914. This privileged consortium was expropriated in 1938 by the new Republic of Turkey. The term 1930-1950 was an interventionist period to the Turkish electricity market [Kulali, 1997].

Municipality Law enacted in 1933 gave right municipalities to establish and to operate electricity plants. In order to plan and to regulate electricity utilities by the state, Electricity Office of Studies (Elektrik İşleri Etüt İdaresi - EİEİ) was established in 1935. By the period 1938-1944, all of foreign and domestic private enterprises in the country, with the exception of Kayseri Electricity Company (Kayseri ve Civarı Elektrik Türk A.Ş.), had been expropriated. Electricity production in this term was carried out by the plants municipalities and different state-owned enterprises had. In 1950, the installed capacity reached 407.8 MW, electricity production reached 789.5 GWh, per capita electricity production 38 kWh, and per capita annul electricity consumption reached 32 kWh. The ratio of the population able to use electricity in this term had reached 23%. 97 of average installed capacity in the term 1930-1950 were by thermal power plants. In this period, growth rate of electricity production was 10.7% and growth rate of installed capacity was 9%, as growth rate of national product decreased by 2.9%.

During the period 1950-1960, large and regional coal-fired and hydroelectric plants rather than small and domestic diesel-fired power plants were established. Tuncbilek and Soma coal-fired power plants were constructed and begun to generate electricity in 1956 and 1957, respectively. General Directory of State Hydraulic Works (Devlet Su Isleri - DSI) in 1953 and Turkish Coal Enterprises (Turkiye Komur Isletmeleri - TKI) in 1957 was established. In addition, an important feature of the term is the realization of the participation of private sector to electricity facilities. This participation does not include foreign capital. Thermal installed capacity reached from 389.9 MW in 1950 to 860.5 MW in 1960 and hydraulic installed capacity from 17.9 MW in 1950 to 411.9 MW in 1960. In 1960, electricity generation was 2815.1 GWh and per capita annual consumption was 86 kWh, as total installed capacity was 1272.4 MW.

The term 1960-1980 was years of planned economy for electricity policies in Turkey. In particular, the third development plan (the period 1973-1977) adopted an energy policy controlled by the state. However, although Seyitomer, Aliaga ve Hopa thermal and Keban hydroelectric power plants were in operation in the 1970s, electricity demand could not be met in the third planning period. Besides, during the planned term, growth rate of energy generation decreased, as energy consumption increased. Towards the 1980s, dependency of electricity to imports reached 50 %. In the term before 1980, high and sunk-cost energy investments were realized by the state resources. Although there is the share of the private enterprise in these investments, they are rather limited. Energy policies dominated by the development plans impeded almost all the participation of the private sector to energy investments.

In 1980, thermal installed capacity reached 2987.9 MW, as hydraulic installed capacity reached 2130.8 MW. The share of thermal power plants in electricity generation decreased to 62%. Per capita annual electricity consumption reached from 32 kWh in 1950 to 459 kWh in 1980. The ratio of the population able to use electricity in 1980 had reached 79.9%. In the term before 1980, growth rate of electricity generation became 11.2%, as growth rate of installed capacity was 7.4% [Yilmaz and Uslu, 2007].

1.2. The Structure after 1980

Until the middle of 1980s, the Turkiye Elektrik Kurumu (TEK), a vertically integrated monopoly owned by the state, dominated all production, transmission and distribution segments of the Turkish electricity industry. As shown in Figure 1, in 1993, this institution was vertically unbundled two separate state institutions in parallel with deregulation and liberalization policies of the term after 1980. One of them is Turkey Electricity Generation and Transmission Company (Turkiye Elektrik Üretim İletim Anonim Sirketi - TEAS) and the other is Turkey Electricity Distribution Company (Türkiye Elektrik Dağıtım Anonim Şirketi - TEDAS). The both companies began operation in 1994 [Ozkivrak, 2005].

In the term after 1980, the state-controlled economy policies in Turkey replaced with more liberal policies in accordance with the global economic change. This change also influenced energy policies of the governments and Turkey initiated to bring into force privatizations in electricity market after 1980. During the 1980s and 1990s, various laws in relation to the electricity market were passed to encourage the initiatives of private sector to electricity generation and distribution facilities. With these legal regulations, it was designed some concession agreements for the participation of private-sector actors into the electricity generation and distribution investments, the so-called Build Operate Transfer (BOT), Build Operate (BO) and Transfer of Operating Rights (TOR) contracts. However, as discussed below, these concession contracts brought about some issues and could not be showed the expected impact over energy investments, in spite of the aim of protecting investors from financial risks.

The Law no. 3096 enacted in 1984 began the first deregulation initiatives and introduced the implementations of privatization to the Turkish electricity market by unbundling the vertical structure of the market. The Law encouraged the private participations to private in the all segments of the market. Two private companies, Kepez Elektrik and CEAS, granted a concession to operate in transmission facilities in Antalya and Adana, Mersin, Hatay, and Osmaniye, respectively. Afterwards, with the Law passed in 1984, the private sector initiatives were only allowed to operate in generation and distribution segments of the market. The first privileged contract could be in force in 1996, because of some constitutional and bureaucratic issues taking place while passing the Law no. 3096.

The Law no. 3096 enjoyed heavily two methods to transfer the state owned public utilities in generation and distribution segments of the electricity market to private sector participations. As expressed above, these methods are BOT and TOOR, including franchise rights for the owners. With an additional law, (the Law no. 4283) enacted in 1997, it was introduced a new contract method the so-called BOO to encourage private investments especially in operation of new thermal energy plants. All these franchise contracts have guaranties obtained by Treasury and tax exemptions.

However, the Constitutional Court and Danistay (an administrative high court) adjudicated that all electricity utilities are public utilities rather than a private ones and must be subject to public law by taking into consideration the Turkish administrative law and the Turkish Constitution. In spite of subsequent some legal amendments, the Constitutional Court voided the struggles to convert the franchise contracts from public law to private law[2]. Accordingly, the Constitutional Court and Danistay annulled the franchise contracts and

[2] See: CC Decisions, 9.12.1994, E.1994/43, K.1994/42-2; 28.06.1995, E.1994/71, K.1995/23.

privatization of electricity utilities again and again until the beginning of the 2000s [Ozkivrak, 2005; Ulusoy and Oguz, 2007].

In the end, the decisions of the Danistay and the Constitutional Court over the franchise contracts in the electricity and the lack of international arbitration for international contractors in case of any legal dispute impeded the implementation of the expected investments and privatizations by causing an ambiguity in terms of foreign investors. The Law no. 3096 could not provide a favorable legal environment for successful privatizations. Therefore, the government passed a constitutional amendment[3] related to these issues in 1999. Thus, the constitutional amendment of 1999 enabled;

- Parliament to provide public utilities via private law contracts,
- International arbitration for international investors in case of any dispute in the franchise contracts,
- A restriction in the Danistay's advisory role.

Law no. 4493 and Law no. 4501, which were enacted after the constitutional amendment, altered the legal endowment of the franchise contracts in the electricity market. The Law no. 4493 converted BOT contracts to private law contract status and the Law no. 4501 obtained the opportunity to include directly the international arbitration in the contracts. As a result, although the Law no 3096 allowed the implementation of privatizations through BOT and TOR contracts by private participations in the electricity market and some private entrepreneurs signed electricity generation agreements with the Ministry of Energy and Natural Resources (MENR), most of them have not been implemented. In additional, the franchise contracts of KEPEZ, CEAS and AKTAS (Istanbul Anatolian region) in distribution market were recognized as TOR contracts. However, the franchise contracts of KEPEZ and CEAS were cancelled unilaterally by MENR. In a decree[4], Danistay repealed the franchise contract of Aktas due to faulty operations of the company [Ulusoy and Oguz, 2007].

1.3. The Market Structure before the 2001 Reform

As mentioned above, the TEK was vertically separated into two different companies the so-called TEAS and TEDAS, generation-transmission company and distribution company, respectively. In doing so, it was aimed to introduce competition to the market gradually. The distribution segment of the market was split into 29 distribution regions in 1996 and the TOR concessions for distribution utilities were sold at an auction to the highest bidder in the subsequent year[5].

However, the controversial structure of the franchise contracts, fiscal constrains, the constitutional restrictions over the legal regulations and the interventions of the judiciary to the initiatives of privatization in generation and distribution segments of the market had

[3] Law no. 4446 of August 14, 1999.

[4] See Danistay 10th Chamber Decision no. 1993/1752 of April 29, 1993.

[5] With the cabinet decisions, the franchise rights of the TOR contracts were granted to private distribution companies by MENR. However, the Danistay repealed the validity of the cabinet decrees. Thereupon, MENR annulled unilaterally these contracts by taking the Danistay decree into consideration (Ulusoy and Oguz, 2007; 5026).

continuously impeded a participation of private sector with full competition. The typical BOT, BOO and TOOR[6] contracts, signed between the private initiatives and TEAS or TEDAS and included privileged "take or pay" obligations with fixed guaranties and a fair revenue over capital costs of the privileged company at least for 15-39 years, failed to ensure a structure for the aimed competition *in the market* [Atiyas and Dutz, 2005; 191].

2. Main Reasons for Institutional Change in Electricity

The problems of the previous market structure triggered transition to the reform in the Turkish electricity industry. It is possible to find some reasons for the reform of the Turkish electricity market as follows. We can align economic, political, legal and external reasons for the reform, respectively.

2.1. The Economic Reasons

The structure of electricity prices in Turkey was a main economic reason for the reform of the market. Since, electricity prices in Turkey are subject to various taxes and levies that are not directly concerning the market activities or the cost structure. For example, a 3.5% levy for Turkish Radio and Television Corporation (TRT) was imposed on the prices for end-users of electricity[7]. In addition, electricity prices are subject to the municipality consumption tax that is 1% for industry users and 4% household consumers. Furthermore, the VAT rate for electricity in Turkey is 18% then and now [OECD, 2005; 30].

Another economic reason for the reform is the increasing demand in electricity demand and the lack of supply from the indigenous sources. As of 1998, electricity generation from the indigenous sources covered 39% of electricity demand. Turkey was dependent on imports in electricity consumption with 61% [Yigitguden, 1999].

A reason that triggers the reform was fiscal constraints. The government decelerated that budget deficits do not allow to meet future energy demand and the financing by private sector is needed to meet it [Erdogdu, 2007]. On the other hands, financial structures of public entities, TEDAS and TEAS, which dominated the market, were rather fragile. For example, only the duty losses of TEAS were 656 million dollars as of 2000. This partly originated from high cost BOT contracts. In addition, the earlier privatization attempts were largely unsuccessful.

The national tariff structure of electricity prices involving significant cross-subsidies from industry users to household users and from a region to another region were another reason for the reform [Çetin and Oguz, 2007b; OECD, 2002].

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[6] In Turkey, one electricity distribution region and two power plants are operating under the TOOR (OECD, 2005; 131).

[7] Although the new Electricity Law of 2001 forbids and EMRA does not prefer it, this levy on electricity prices is still in force and applies a 2%.

2.2. The Political and Legal Reasons

As in any other developing country, the state-owned monopolies in Turkey as well have been economically inefficient and politicians have manipulated this inefficiency for their own political ends [Erdogdu, 2007]. For that reason, the main reason behind the poor performance and then the financial weakness was political interventions and pressures on the public electricity utilities. In such an environment, the managements who do not know the distinctive properties of electricity industry were frequently employed to management of these companies. Thus, the instable governments have intervened in all regulatory policies of the market like price, investment and employment. Political considerations were generally preferred more in determining these policies rather than economic considerations. As in the other public utilities, the political interventions and instability brought about crises in the electricity industry as well[8] [Ozkivrak, 2005].

Another reason for the reform was the failure of the Law 3096 and the previous legal structure. The legal and bureaucratic endowment of the market and the political domination on the market caused the liberalization goal to deviate from the aimed point and discouraged privatizations. For example, anyone who wants to operate a generation plant was needed;

- to obtain a permission from the State Planning Organization,
- to obtain a guarantee from the Treasury,
- to negotiate the Ministry,
- to obtain a recommendation from the Ministry,
- to obtain a decree from the Cabinet and, in the end,
- to sign an electricity sale contract with TEDAS.

These procedural conditions were also in force for the transfer of operating rights in any distribution region. This institutional structure of the market clearly constituted barriers to entry [Ulusoy and Oguz, 2007].

2.3. Accession to the EU and External Factors

Turkey is a candidate country for full accession to the European Union (EU). For that reason, Turkey needs to fulfill its obligations during the membership process into the EU. In this context Turkey requires to reshape the structure of the electricity market according to the electricity directive issued by the European Parliament in 1996. The main goal of the electricity directive of 1996 is to introduce competition to the competitive generation and supply to end users segments of the electricity market and to regulate the monopolistic transmission and distribution segments in the internal market of the EU. In this sense, it is possible to mention four main components for the reform. These are market opening, vertical separation, third party access, and public service obligations and regulation.

By the directive, all member states should open a determined and later, increasingly expanding percentage of its market within the next six years. Accordingly, each member state

[8] In Turkey, it is found a positive correlation between economic crises and political instability. See Kibritcioglu (2001) for more information about this issue.

needs to designate its own set of eligible consumers. However, according to the directive, consumers who use electricity more than 100 GWh will be recognized as eligible consumers in all member states.

On the other hand, the directive stipulates the member states to unbundled vertically their own markets. Accordingly, it is needed the vertically integrated monopolies in each member state to separate the management of the generation, transmission, distribution, and non-electricity activities. In order to impede discrimination during the vertical separation, each member state is obligated to establish an independent transmission system operator (TSO). The main responsibility of a TSO is to ensure dispatch of any generator under fair, impartial and transparent conditions by means of this system.

Another goal of the directive is to enable access of third parties to transmission network again under fair conditions. Accordingly, consumers and generators directly sign a contract with each other by negotiating transmission and distribution companies for access the transmission and distribution networks. In order to ensure a fair pricing for all parties, access prices to the network is regulated by the independent regulator agencies. In case of a single buyer model, this single buyer pays the generator the regulated price minus network charges. Thus, the prices of end users equal to the contract prices due to the generator can compensate the consumer.

As a result, from a social point of view, the directive stipulates the member states to implement some obligations for their electricity markets. These obligations are security of supply, regularity on service, quality performances, price stability, and environmental protection. However, the feature of the obligations would be determined by the member states [Atiyas and Dutz, 2005; 189-190].

As a candidate country to the EU, Turkey was coerced and is coerced to take into considerations the obligations of the electricity directive of 1996 and reformed its electricity market. However, although the reform is a precondition for Turkey's membership into the EU, the only effective external pressure was not from the EU. In addition, the pressures of some other international institutions like IMF, World Bank and OECD were effective in triggering the reform of the electricity market [Ozkivrak, 2005; Erdogdu, 2007].

3. An Institutional Outlook of the New Market Structure

3.1. Properties of the Electricity Reform

In the end, the Turkish government reformed the electricity market by passing a law in 2001. With the law, the market was again unbundled an independent regulatory agency was established. This sub-section observes the features of the reform. The government aimed to meet the following objectives by reforming the market. These are:

1. to diversify of primary energy sources,
2. to increase use of domestic energy resources, including increasing the share of renewable energy sources in electricity generation,

3. to establish a liberal and competitive electricity market compatible with the EU directives,
4. to enable a good investment environment for new generating capacity as well as transmission and distribution networks,
5. to unbundle and privatize the state-owned companies,
6. to establish an environment-friendly power system, and in this context, investing in environmental retrofitting projects for the existing power plants,
7. to develop regional interconnections and participating in regional markets,
8. to increase efficiency in electricity generation and consumption,
9. to decrease the cost and end-user prices of electricity [OECD, 2005; 131].

3.2. The Electricity Law of 2001

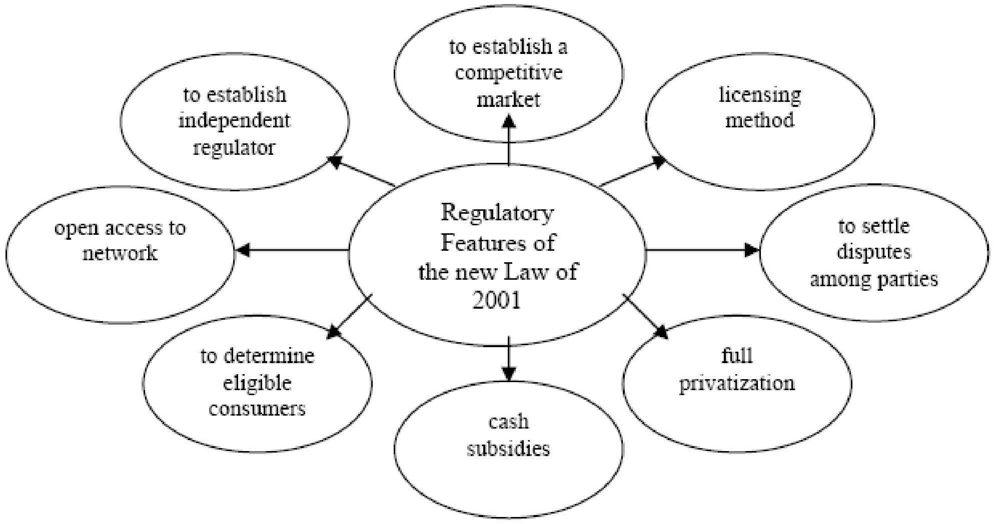
The Electricity Market Law enacted in February 2001 reformed the Turkish electricity market. The Electricity Market Law is the main law regulating the electricity market. The new Law enacted in February 2001 was in force on 3 March 2001, but implementation of the Law was subject to a two-year transition period. The main aim of the Law of 2001 is to introduce competition to the market, protect consumers, ensure an efficient market regulation, and encourage private sector participation without treasury guarantees.

Regulations concerning all segments of the market are subject to the new Law. However, we can express that the Law has two main components. These are general provisions related to regulation of the market and the legal structure governing EMRA. The first component of the Law constitutes the operation of the market, including market activities and licensing, as the second part contains the duties and regulatory discretion of EMRA. Besides, the Law of 2001 is fully compatible with the EU Electricity Directive of 2003 [OECD, 2005; 143].

Furthermore, by following Ozkivrak [2005], we can define the key features of the new Law as in Figure 2. Firstly, the new Law vertically unbundled the market as three different public utilities. These are a generation company (the Turkiye Elektrik Uretim A. S. / TEUAS), a transmission company (the Turkiye Elektrik Iletim A. S. / TEIAS) and a state-owned wholesale company (the Turkiye Elektrik Taahhut ve Ticaret A. S. / TETAS). The Law stipulates to obtain a different license for each market activity.

The Law aims to introduce competition to competitive segments of the market, generation and retail sale. However, there are some restrictions over competition in generation for the transition period to full competition. For example, the total market share of a private generation company can not exceed 20% of the published figure for the total installed capacity in Turkey in the previous year. Any transmission company cannot engage in another market activity and distribution companies cannot generate electricity more than 20% of consumption in their own regions, given the preceding year [OECD, 2002; 114].

All companies are needed to obtain a license for each market activity. The obligations concerning the contract, including how prices are to be regulated, how long license periods are, what conditions related to cancellation of a license are, how disputes are to be solved by the regulator, are clearly set on licenses.



Source: Ozkivrak [2005].

Figure 2. Regulatory Features of the New Law.

In addition, the Law aims:

- to establish an independent regulatory agency,
- to give place to eligible consumers
- to support cash subsidies to consumers,
- to ensure open access to transmission and distribution networks,
- to establish a national competitive electricity market ,
- and in the end, to fulfill full privatization.

3.3. The Independent Regulator: EMRA

The Electricity Law of 2001 established the Electricity (now Energy) Market Regulatory Agency as an independent regulatory agency. EMRA has a board with 9 members. The main features of EMRA are as follows:

- to set up a new licensing structure,
- to grant licenses related to the market activities,
- to determine secondary legislation,
- to ensure third party access (TPA) under fair conditions,
- to apply a new transmission and distribution code,
- to regulate prices and tariffs for transmission, distribution and wholesale activities,
- to control the operations of all market participants,
- to protect consumer rights,
- to apply sanctions to faulty parties,
- to solve disputes between the parties in the market.

EMRA is an independent institution in the sense of administrative and financial from political and private interest groups. It collects its own incomes from licensing fees and from a surcharge on TPA tariffs. When EMRA's revenues exceed its expenditures, the surplus is transferred to the state budget. The regulatory discretions of EMRA relation to energy markets has been expanded with the subsequent some laws, including the Natural Gas Market Law enacted in May 2001 and the Petroleum Law enacted in 2003.

3.4. Unbundling and the New Structure of the Market

As mentioned above, the new Law *de facto* split the vertically integrated structure of the market into three state-owned public utilities and *de jure* enabled new entries into all segments of the market, with the exception of transmission. The current structure of the market with the historical development is depicted in Figure 1 above. TEIAS is a state-owned company, which responsible for the implementation of transmission activities, including the balancing market and financial reconciliation. The main responsibility of TETAS is to facilitate the financing of the costs of stranded contracts of the preceding period.

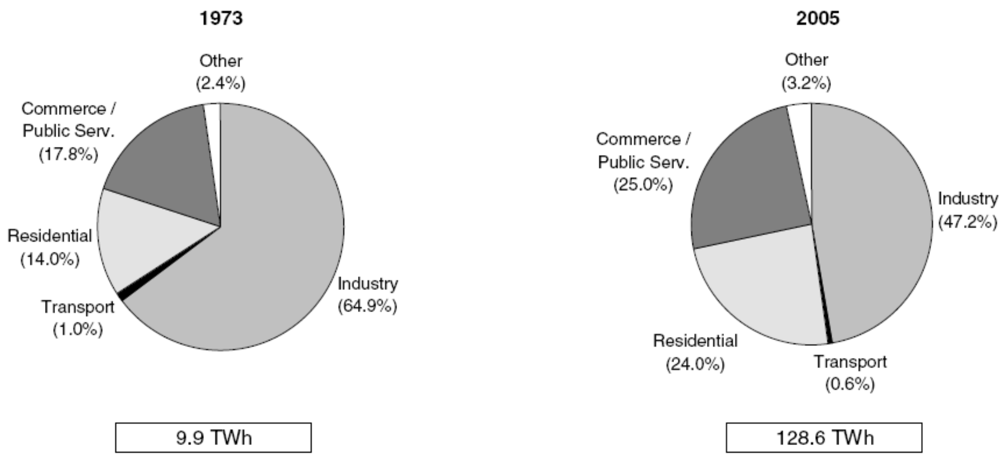
Under the new market structure, by the new Law, all market activities are only subject to the Electricity Law of 2001 and in responsibility of EMRA. Generation, distribution, wholesale, and retail activities can only be fulfilled within the electricity market and under EMRA's audit [Atiyas, 2006; 12]. In this case, according to the new Law, the market activities in all segments are as follows.

Generation

With the enactment of the new Law in 2001, the Turkish government *de jure* introduced competition to generation segment of the Turkish electricity market. According to the new Law, the total share of a generation company cannot exceed 20% of Turkey's total installed capacity. Although companies performing the market activities in generation segment may get in touch with distribution ones, this affiliation must not to bring about a control over them [Ozkivrak, 2005].

However, the expected investments in generation from the regulatory reform have not yet performed. The electricity indicators have not gave a good signal. Electricity generation capacity of Turkey is not adequate to meet its own energy demand. Electricity interruptions are still locally seen. Big shopping centers and some households have their own co-generators fuelled by diesel [OECD, 2005; 134].

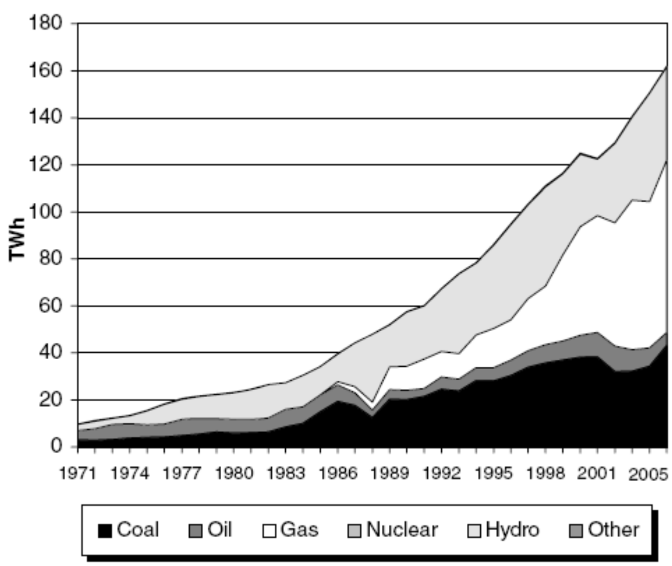
In 2005, as shown in Figure 3, the net electricity generation is 155.5 TWh compared to the total final electricity consumption of 128.6 TWh.



Source: IEA, 2007c; 571.

Figure 3. Total Final Electricity Consumption by Sector.

On the other hand, as shown in Figure 4, more than 45% of electricity generation in Turkey is provided from natural gas. The main reason for the share of natural gas in electricity generation is the 2001 economic crisis that reduced gas demand in other sectors [Çetin and Oguz, 2007a].



Source: IEA, 2007c; 571.

Figure 4. Electricity Generation by Fuel.

However, as seen in Table 1, the net maximum electricity generating capacity in 2005 is 34.78 GW. Hydropower has the highest share in electricity generation with 35%. Natural gas, lignite, hard coal and oil, following hydropower have 33%, 18%, 5%, and 9% shares, respectively. Although non-hydro renewable resources have been increasingly bigger share in electricity generation, they have still a negligible share at 34 MW as of 2003 [OECD, 2005; 134].

Table 1. Net Maximum Electricity Generating Capacity (GW)

	1974	1980	1990	1995	2001	2002	2003	2004	2005
MAIN ACTIVITY PRODUCERS									
Classification by Fuel									
Total Capacity	**3.31**	**4.52**	**15.12**	**19.61**	**24.96**	**28.11**	**31.05**	**32.44**	**34.78**
Nuclear	-	-	-	-	-	-	-	-	-
Hydro	1.44	2.12	6.75	9.85	11.62	12.14	11.94	11.99	12.34
of which: Pumped Storage	-	-	-	-	-	-	-	-	-
Geothermal	-	-	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Solar	-	-	-	-	-	-	-	-	-
Tide, Wave, Ocean	-	-	-	-	-	-	-	-	-
Wind	-	-	-	-	0.02	0.02	0.02	0.02	0.02
Other (e.g. Fuel cells)	-	-	-	-	-	-	-	-	-
Combustible Fuels	1.87	2.40	8.35	9.74	13.30	15.93	19.07	20.42	22.41

Source: IEA, 2007c; 585.

On the other hand, Table 2 gives the current and future figures for sectoral electricity demand by years. The figures show that electricity demand in all of the sectors will also increase in the following years until 2020.

Table 2. Sectoral Electricity Demand by Years (TW)

	2003	*2005*	*2010*	*2020*
Industry	53.2	64.7	101.1	227.8
Residential and services	52.2	60.5	94.1	195.3
Agriculture	3.7	4.0	5.0	7.4
Transport	0.9	1.1	1.7	4.0
Net demand	**110.0**	**130.2**	**201.9**	**434.6**
Gross demand	**141.2**	**163.2**	**242.0**	**499.5**
Gross consumption per capita (kWh)	1 994	2 232	3 085	5 692

Source: OECD, 2005; 133.

Transmission and Third Party Access

According to the Law of 2001, although transmission facilities will be fulfilled by a state owned monopoly, TEIAS, private sector-owned generation companies would construct private direct transmission lines. The only restriction on this case is that EMRA's granting of generation licenses is conditional on no any congestion in the transmission and distribution lines linking the new plant to the network or directly to consumers[9]. TEIAS is a responsible company from transmission assets, system operation and maintenance, planning and building of new investments for transmission facilities, balancing the market activities physically and financially.

[9] A congestion in the grid is most likely to be solved via some type of auctions between the companies that would benefit from the transmission investments (Atiyas and Dutz, 2005; 193)

The new Law stipulates a third party access regime for access to national transmission and distribution networks. According to the TPA regime, the third parties are needed to be enabled under fair and transparent conditions an open access to transmission facilities performed by the state owned TEIAS. The probable disputes between parties will be solved by EMRA. For those reasons, in the new model, TEIAS is a system operator compatible with the EU electricity directives and administrator of needed settlements for access of third parties to transmission facilities [Atiyas and Dutz, 2005; 194].

With the Law of 2001, legal and functional separation of transmission facilities from generation has strengthened the vertically unbundling, TPA to transmission, and hence, introduction competition to the market. EMRA has to approve tariffs and conditions for access to transmission network *ex ante* and to monitor and present a report to the Commission on the evaluations related to especially supply-demand balance of the market. As a result, ownership rights of all transmission facilities owned and operated by other companies are needed to be transferred to TEIAS. Likewise, the franchise rights of Kepez Elektrik and CEAS were annulled by the Ministry and their property rights were transferred to TEIAS in June 2003, because of both companies had failed to operate efficiently them and it is legally a necessity [Atiyas and Dutz, 2005].

Distribution

A main aim of the Electricity Market Law was the implementation of privatizations in distribution as soon as possible, although it has not yet been possible. Nevertheless, the government and EMRA have tried to implement privatization of distribution assets owing to the provisions of the Law as well. In the Turkish electricity market, distribution facilities have been dominated by TEDAS and seven regional distribution companies. As shown in Figure 5, distribution network is divided into 21 regions based on energy demand, geographical nearness, administrative structure, and some technical and financial components. As one of them has been operated presently under a type TOOR contract, the government has aimed to privatize other 20 distribution regions owned by TEDAS [OECD, 2005].

According to the Law, obtaining a generation license, any company engaging in distribution facilities has right to construct and to operate generation facilities in the region specified in its license. However, electricity generation of distribution companies cannot exceed 20% of consumption in this region in the previous year. Although TEDAS will heavily perform distribution and retail facilities of electricity until competition will be fully introduced in the market, TEDAS and private companies having a retail sale license are needed to segregate both facilities each other [Ozkivrak, 2005; 1344].

There have been some serious issues delaying the implementation of privatizations in the distribution market. A major issue is losses and illegal use of electricity [OECD, 2002; 107]. The rate of electricity losses in the distribution networks is four times as high as the average for other IEA member countries. The rate reached 21.5 in 2000, but declined to 19.5% in 2003 and 18% in 2004. Approximately half of the losses in electricity results from illegal use. The government aims to reduce the losses and to facilitate needed investments and efficiency considerations by applying policies to privatize distribution assets [OECD, 2005; 139].

The new Law stipulates TEDAS to issue distribution and retail sale tariffs and MENR to approve them, but not EMRA. Tariffs have been sustained at uniform levels regardless of the differences between east-west regions because of the national pricing rather than the cost-based regional pricing. EMRA and the new Law intend to convert this price structure to a new one, including the regional pricing. In addition, the government deals with to develop an equalization mechanism. The equalization mechanism includes the cash subsidies between east and west regions under the audit of the council of Ministers [OECD, 2002].

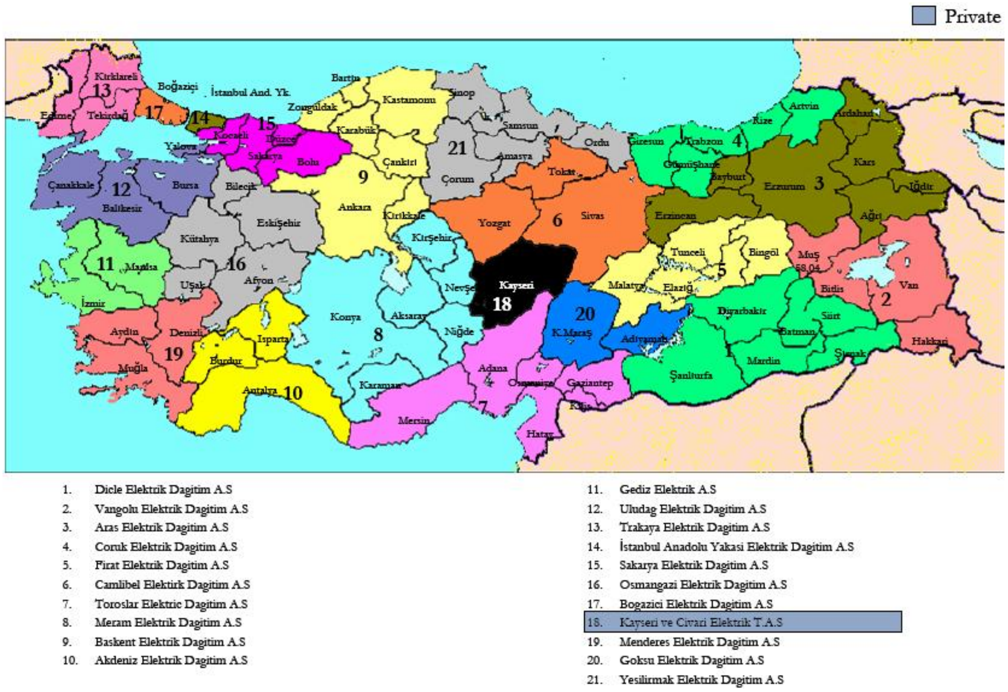


Figure 5. Turkey's Electricity Distribution Companies.

Market Opening and Eligible Consumers in Wholesale and Retail Segments

The Electricity Law enacted in 2001 gave place to the components of market opening and eligible consumers for a competitive electricity market. The Law enabled eligible and non-eligible consumers to connect directly with their own suppliers. Eligible consumers can *de jure* buy electricity from any generation, distribution, wholesale and retail company directly by signing a contract with them, as non-eligible ones can purchase only distribution or retail companies at rates regulated by EMRA. In addition, they can *de jure* directly access to the transmission grid. Open access or market opening is a crucial factor to ensure a competitive electricity market. By ensuring market opening, it is provided third parties to access to distribution and transmission networks in a competitive environment. However, access to the grid is implemented via regulation by EMRA and prices and the conditions are regulated by EMRA [OECD, 2002; Ozkivrak, 2005]. Besides, eligible consumers have the right to sign a contract to purchase electricity with TETAS under the regulated price and tariff conditions [OECD, 2005].

According to the Law, the initial eligibility threshold for eligible consumers is 9 GWh for each year. The Law gave the right EMRA to re-determine the eligibility threshold every year up to full market opening aim has been reached. Thus, eligible consumers started to alter their own suppliers as of 3 March 2003. In January 2004, EMRA re-determined the eligibility threshold as 7.8 GWh. Accordingly, market opening is 29%[10]. In October 2004, the figures of eligible consumers who signed a bilateral contract with a new supplier reached approximately to 270 [OECD, 2005; 146-147].

Although wholesale and retail markets are opened to competition, market activities in these segments have been subject to regulation. For example, share of wholesale companies in the market cannot exceed 10% of total consumption. On the other hand, although wholesale companies can purchase electricity from the state-owned generation companies, eligible consumers have not the right to do so [OECD, 2005; 143].

There are some limitations on competition in retail segment as well. For example, although retail companies can engage in retail sale without any restrictions relation to regions, distribution companies obtaining a license for retail activities can sell electricity to eligible consumers only in the region where a distinct distribution company fulfills the market activity, including provisions concerning retail activities in its retail license [Ozkivrak, 2005].

With the new Law, TETAS has been a dominant wholesale company in the market. Since the enactment of the new Law, all energy sale and purchase contracts of TEDAS and TEAS have been took over by TETAS. This case means all BOT, BOO and TOOR projects and export and import contracts to be executed by TETAS. The Law stipulated EUAS to sell all electricity generated by it to TETAS. But, the dominant role of TETAS in the electricity market has still continued, because of this case did not expire in 2007 [OECD, 2002; 113].

4. Main Issues in the Current Market Structure

4.1. The Problem of Stranded Costs and Disintegration

A major problem of the electricity market is stranded costs stemming from investments implemented by the long-termed BOT, BOO and TOOR contracts of the previous regulatory model. Some contracted BOT projects are given in Table 3. Because such costs in the electricity markets cannot be recovered in a competitive electricity market some non-competition ways are engaged in to solve the problem[11]. For example, the government subsidies, a charge on consumers, and bundling with stranded benefits are some of these ways. Turkey preferred the latter approach among them. For that reason, the new Law temporarily allowed affiliation between TEAS in generation and TETAS in trade to recover stranded costs within this temporary time. By choosing this way, it was aimed prices not to rise. On the other hand, the bundling way is technically easer than recovery methods.

[10] In 1999, this rate was 20% (OECD, 2002; 22).

[11] In such cases, less competitive applications can easily ensure the recovery of stranded costs or higher privatization revenues for the state budget.

Table 3. Contracted BOT Plants

NAME	TYPE	CAPACITY (MW)	CONTRACTED GENERATION(GWh)
Mazı I	Wind	39.2	131.9
Kapıdağ		35.3	87.7
Bandırma		15.0	49.6
Datça		28.8	84.3
Kocadağ II		26.3	80.5
Çeşme		12.8	36.0
Germencik	Geothermal	25.0	187.2
Yukarı Akçay	Hydro	2.0	15.0
Arıt		9.0	46.0
Pamuk		19.8	81.4
Keklicek		17.0	42.2
Suşehri Projesi		11.4	59.2
Lamas III-IV		41.0	198.0
Aralık		16.0	50.8
Kavşak Bendi		140.0	652.3
Çamlıhemşin		42.0	195.0
Akköy I		65.0	259.0
Boyabat		510.0	1290.0
Yedigöze		250.0	785.6
Akköy II		190.0	679.0
Andırın Enerji Grubu		41.0	147.4
Keban Deresi		5.0	31.5
Fımıs		7.3	36.0
Çaldere		8.0	35.0
Kovada III		2.8	56.7
Kdz. Ereğli	Gas	206	1413
Yalova		307	2297
Kirklareli		75	597
Eskisehir		199	1391
Konya-ilgin	Coal	425	2835

Source: MENR.

Finally, an important disadvantage of the method used to recover stranded costs is obstruction of competition up to recovery of stranded costs. Because, the dominant role of TEAS in generation and TETAS in trade has still went on. For that reason, competition in generation and wholesale segments is dependent on how long the dominant role of TEAS and TETAS continue. True competition in generation and later wholesale would only materialize, as generation assets are privatized, as the dominant role of TETAS was removed by the competitive entries to wholesale activities, hydropower was released in the market again, and as the excess of expensive BOT projects is met [OECD, 2002; 114-115].

Although the new Law disintegrated industry into generation, transmission, distribution, wholesale and retail segments, the transition to competition has brought about some problems. TEUAS in generation, TEDAS in distribution and TETAS in trading are currently state owned monopolies. It appears rather difficult these public utilities to privatize and competition to introduce to these segments in a near future.

4.2. Lack of Excess Supply

A crucial problem of the new structure is the lack of excess supply. As seen in Table 4, in Turkey, the excess in the supply of electricity has not been provided up to now and the future projections regarding this issue are not optimistic. Since, it does not seem possible that the supply can the demand as well, while the demand is estimated to increase until 2010. This case impedes competition in the market and erodes EMRA's competitive policies.

Table 4. Energy Production-Consumption and Import Expectations

YEARS	2000	2005	2010	2020
Consumption	79.671	129.625	171.339	298.448
Production	27.593	34.116	47.329	70.238
Import	52.078	95.509	124.010	228.210
Consumption/Production Rate (%)	34,6	26,3	27,6	23,5

Source: The Undersecretariat of Foreign Trade, Turkey, 2002.

On the other hand, Turkey has been dependent on imports in energy, because of insufficiency of the supply. In addition, the ratio of consumption/generation is not expected to increase but decrease in the future. It appears that the state owned assets or the governments will go on to dominate the market, because of the excess supply would not be provided cheaply in the future. Furthermore, the secondary legislation has not enough incentive firms to implement their activities in plants on time. Although there are 118 applications for wind plants in 2005, most of them did not correct even the feasibility reports needed to give sufficiency to firms.

Consequently, while excess supply would facilitate transition to competition, the existing lack of supply increases the dominant role of the state in the electricity market. This also gives rise to the government to intervene in the market and hence, postpones competition to introduce all segments of the electricity market [Oguz and Çetin, 2005].

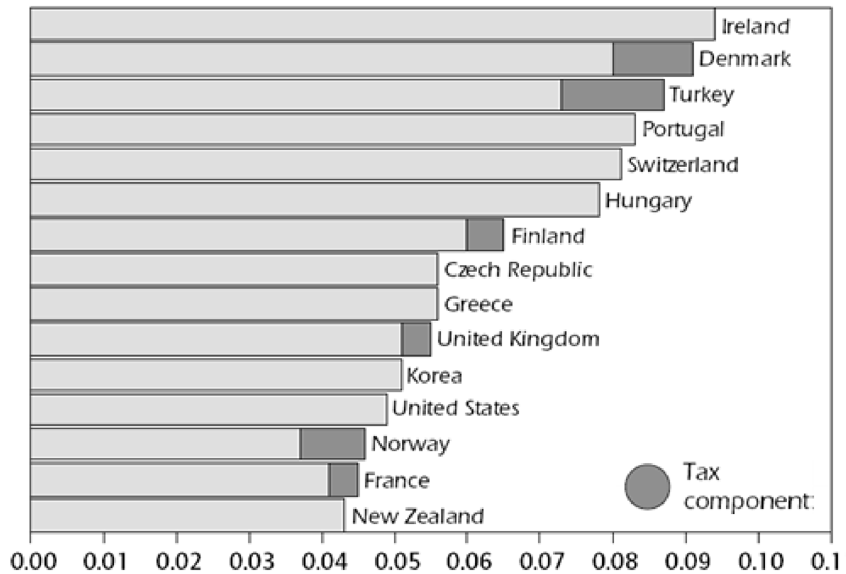
4.3. Retail Tariffs and Cross Subsidies

Electricity prices in Turkey contained before the reform and at present go on to contain cross-subsidies between consumer groups, specifically from industrial users to household users, between different geographical regions, and between various public enterprises, in spite of the government's initiative to remove from the market them during the competitive market reform of 2001. However, it is not expected that at least regional cross-subsidies will go on up to 2010.

As the case of another cross-subsidy, various taxes and levies have continued to cover the electricity prices, although the new Law prevents inclusion of such costs on electricity prices[12]. For example, as mentioned above, a 2.5% levy for TRT, and a 1% the municipality tax means a cross-subsidy from electricity users to TRT and the municipalities by means of the electricity prices. Additionally, an 18% the VAT rate for electricity in Turkey are rather

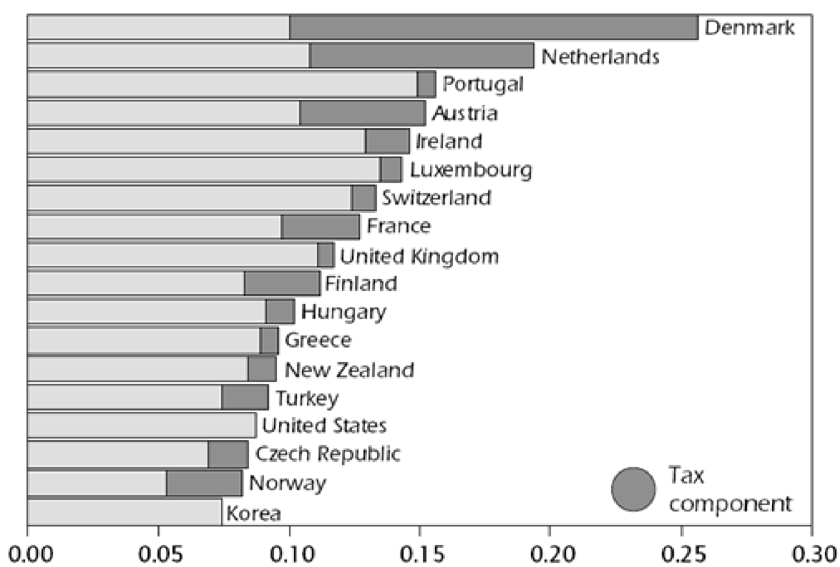
[12] The surcharges of EMRA on electricity TPA tariffs are an exception to this application.

high especially for the industrial consumers compared to other OECD countries, but mid or lower levels for household users, as shown in Figure 6 and 7. Furthermore, when electricity prices for industry users are compared with ones of other OECD countries in figure 6, it is seen that Turkey is at the highest third level. This case has weakened the rivalry power of the industrialists in Turkey against the international competitors.



Source: OECD, 2005; 140.

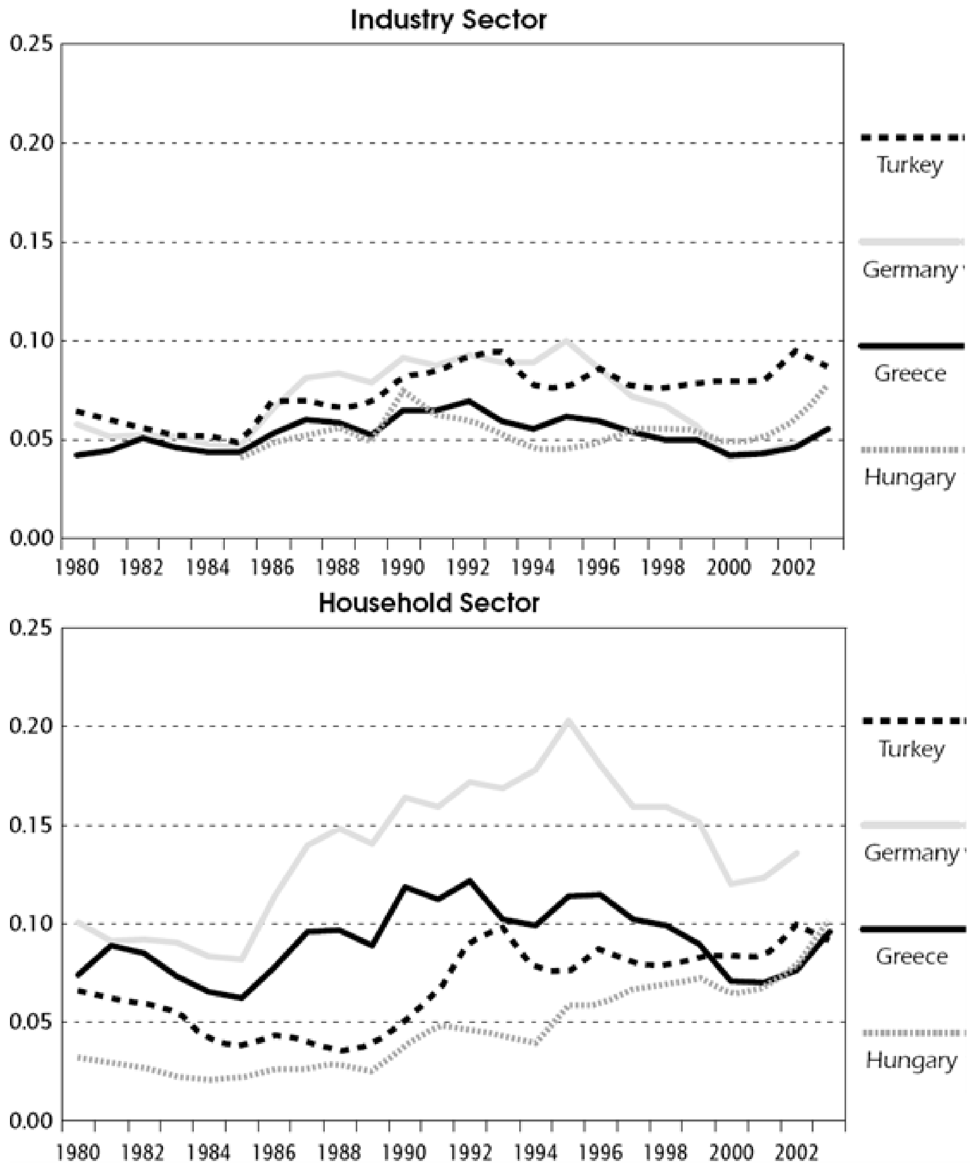
Figure 6. Electricity Prices and Tax Components for Industry Consumers in IEA Countries (US$/kWh).



Source: OECD, 2005; 140.

Figure 7. Electricity Prices and Tax Components for Household Consumers in IEA Countries (US$/kWh).

On the other hand, it is seen in Figure 8 that electricity prices for both industry and household consumers have been stable since the mid-1990s. However, when it is compared electricity prices for industry and house users in Figure 8, it appears that they are nearly same. This case means a cross-subsidy from the industrial users to the residential consumers of electricity.



Source: OECD, 2005; 141.

Figure 8. A Comparison for Electricity Prices between Turkey and Some Other Selected IEA Countries (1980-2003) (US$/kWh).

Another problem concerning electricity prices in Turkey is that wholesale prices are currently high, because of the ongoing existence of prices determined according to the previous BOT and BOO contracts. At present, the wholesale prices are approximately $ 0.052

per kWh. However, it is estimated prices to decline gradually, if 40% share of the previous contracts in total generation decreases [OECD, 2005].

A vital problem relation to electricity prices in the current structure is pricing method. In Turkey, it is engaged in uniform pricing method throughout the country. However, both the new Law and EMRA have preferred a cost-based regional pricing, due to the cost of supply varies from region to region. EMRA will regulate prices for the end users by using the so-called "price equalization mechanism" during transition to the cost-based regional pricing. With this mechanism, all supply costs will be taken into account; the price will be determined according to these tariffs; and cash subsidies will be made for the distribution companies confronting a supply cost exceeding the uniform national price [OECD, 2005; 141-142].

4.4. The "Strategy Paper" of March 2004

A Strategy Paper was enacted in March 2004 by High Planning Council at the initiative of government. The Paper introduces a detailed strategy to implement privatizations in the electricity market. The main idea of the Paper is to give the regulatory power to the government to implement privatizations at the expense of reduction in the regulatory discretion of EMRA over the market. The Paper is focused on distribution rather than other market activities and postponed the transition from the national pricing to the regional pricing, in spite of EMRA's insistence on the regional tariffs. It has impeded competition almost in all segments of the market and revealed the divergence between EMRA and the government over the regulatory issues [Ulusoy and Oguz, 2007]. We can summarize the differences of opinion between EMRA and the government arising in the Strategy Paper as follows.

The Paper gave priority involvement of distribution companies to generation and also retail activities. Accordingly, TEDAS will go on to dominate the electricity market by remaining a public monopoly and retaining property of the distribution network. Private companies will be needed to follow both all the related regulations of MENR via TEDAS and EMRA because they are needed to sign TOR contracts with TEDAS and to obtain a license for distribution activities from EMRA. This case will at least cause overregulation in the market instead of competition. Thus, the Paper impeded disintegration in the market by constructing a barrier to the unbundling end against EMRA's opinions [Ulusoy and Oguz, 2007; 5031].

Although the Law gave the right EMRA to re-determine the eligibility threshold every year up to full market opening aim has been reached, the Paper fixes the threshold at 7.8 GWh up to the beginning of 2009 and envisages the implementation of full market opening by the beginning of 2011 [OECD, 2005; 147]. For that reason, competition in the retail market is *de facto* seriously restricted until 2009, in spite of *de jure* status of the market. Because, according to the Strategy Paper, thresholds for eligible consumers will remain fixed and non-eligible consumers cannot purchase electricity from suppliers other than the distribution company in their regions. However, while it is expected that welfare losses from delays in the implementation of competition in the retail market are not significant ones, it is anticipated that welfare losses arising in the wholesale activities are more important. Such welfare losses can be prevented by reducing eligibility threshold to rates that would cover most consumers than residential and small commercial users [Atiyas, 2006; 19].

5. Traditional Market Structure and Reasons for the Restructuring in Natural Gas

The pre-reform structure of the Turkish natural gas market had been dominated by Turkey's state-owned gas company, BOTAS. BOTAS's dominant role in the market impeded introducing competition to the market. On the other hand, while Turkey's gas consumption has increased rapidly with economic growth over the last decade, gas production has depended on imports. The lack of competition and dependency of natural gas on imports triggered the reform process in 2001.

5.1. The Market Structure before the Reform

As shown in figure 9, the pre-reform structure of the market was shaped heavily by BOTAS. It was founded for transportation of Iraq's crude oil in 1974. In 1995, its activities related to natural gas were expanded. Accordingly, BOTAS's discretions are to accomplish drilling, production, transportation, storage, and refining of imported gas, to construct natural gas pipelines, to acquire or lease existing pipelines, to transport natural gas via the pipelines, to buy and sell natural gas transported in the pipelines. As a state-owned company, it has monopoly rights on transmission and distribution segments, gas imports and exports, wholesale trading, and storage activities [BOTAS, 2004].

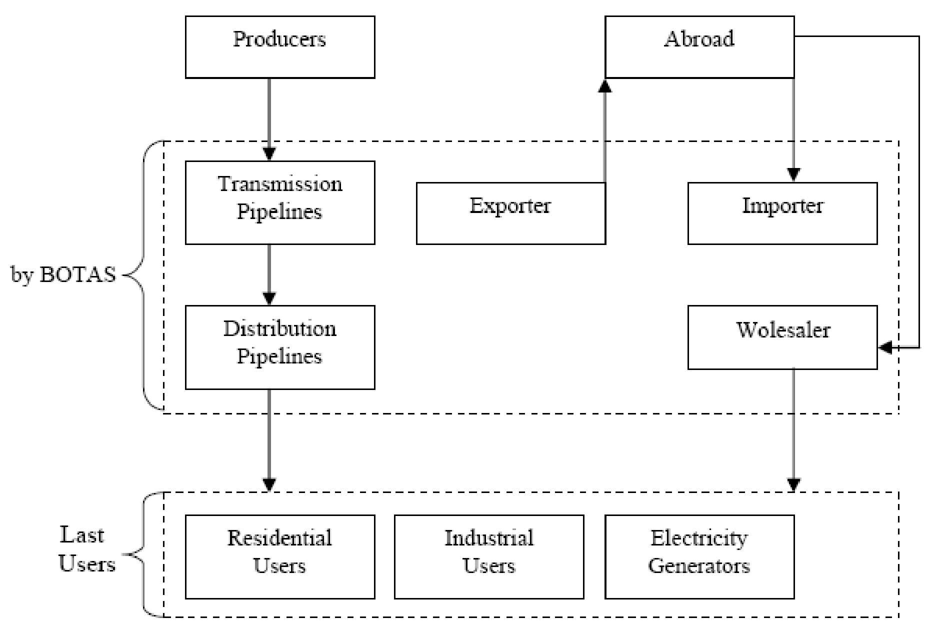
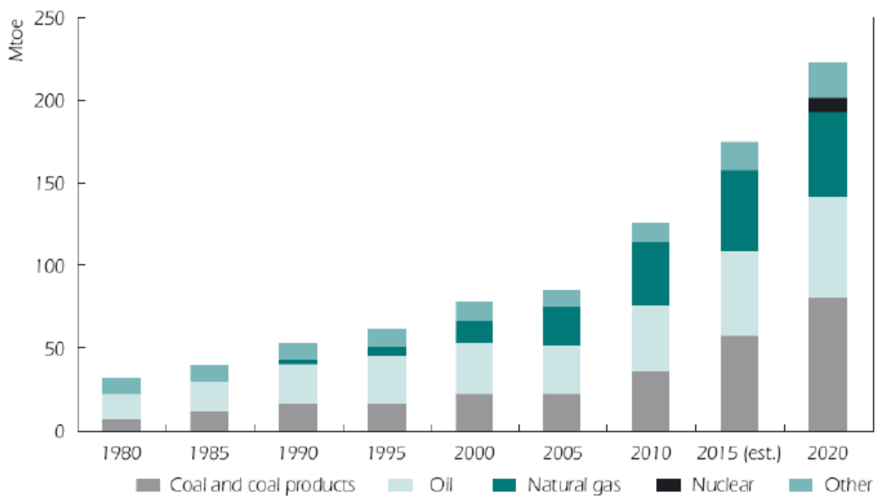


Figure 9. The Industry Structure before the New Law, 2001.

By using these discretions, BOTAS established natural gas pipelines and related facilities, signed long-term natural gas sale and purchase contracts, and additionally purchased natural gas on the spot markets [Mazzanti and Biancardi, 2005]. However, it could not sufficiently expand natural gas facilities to households and establish a stable market structure. For example, it could not establish an underground storage facility in the market. Naturally, BOTAS's monopolistic structure in the market obstructed introducing competition to the market and encouraged the need for a competitive market reform.

Production, Consumption, and Multidirectional Dependency

Turkey's population has increasingly grown over the last 15 years. It has reached to 73 million in 2005. It is estimated that the population will reach nearly 90 million by 2020. As shown in figure 10, total primary energy is also growing rapidly, while growing population. It is expected that anticipated growth in total primary energy will reach to 7 % over this decade, from 86.4 mtoe in 2005 to 126 mtoe in 2010 and 222 mtoe in 2020.

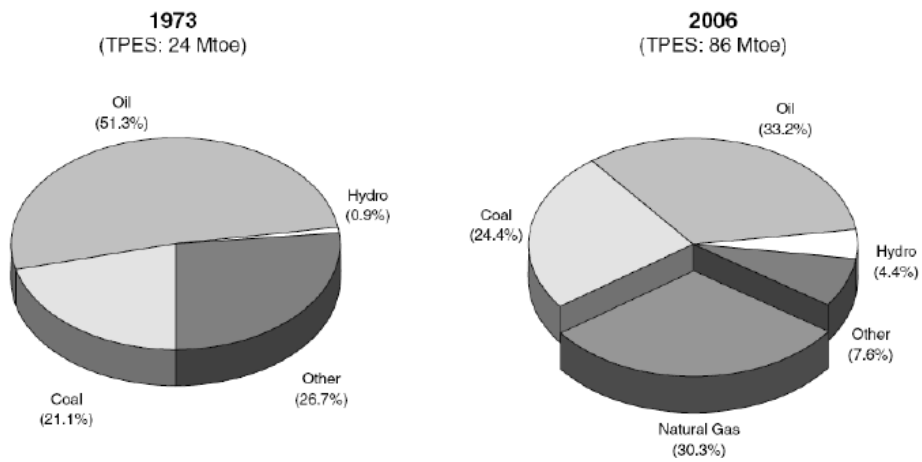


Source: IEA, 2007a: 224.

Figure 10. Turkish Primary Energy Supply.

Especially, as seen in figure 11 gas and coal are predicted to grow rapidly and their shares in the total primary energy supply will reach to 30 % each by 2010. However, the share of natural gas in this energy mix has increased from 5% in 1990 to 25% in 2006. In other words, total gas use in 2005 was 30.9 billion cubes meters (bcm) behind Spain and Korea in the ranks of IEA gas users. Consequently, natural gas begun to play a crucial role in Turkey's economy [IEA, 2007a; 222-223].

The Turkish Petroleum Corporation (TPAO), and after 2001, local and foreign private companies are incumbents to implement natural gas exploration and production in Turkey. Gas production is mainly carried out *de facto* by three companies: TPAO, BP (formerly Arco), and Shell. TPAO also conducts gas exploration and production abroad in behalf of Turkey. TPAO owns 16 of the 22 operational fields currently in Turkey. Most of them are onshore. The Kuzey Marmara field in the Marmara Sea that was firstly produced natural gas in 1997 was Turkey's first offshore field. Natural gas consumption in Turkey began in 1987 and has increased rapidly, particularly since the mid-1990s with economic growth [IEA, 2005a]. As shown in table 5, natural gas consumption in Turkey increased from 3468 million cubic meters (mcm) in 1990 to 31183 mcm in 2006.



Source: IEA, 2007b: 334.

Figure 11. Fuel Shares in Total Primary Energy Supply.

Table 5. Production and Consumption of Natural Gas in Turkey (mcm)

	1990	2003	2004	2005	2006
Indigenous Production	212	560	688	897	905
Imports	3257	20650	21732	26573	30219
Total Consumption	3468	21181	22443	27375	31183

Source: IEA, 2007b; 336.

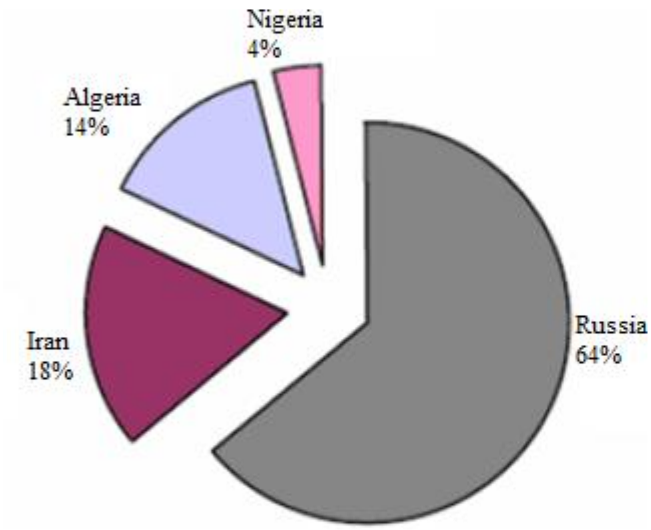
Up to now, the majority of gas production in Turkey has been re-injected into oil fields as part of enhanced oil recovery (EOR) schemes. In spite of increasing consumption, Turkey's natural gas production has been rather low because of the insufficiency of the native gas reserves. At the end of 2003, the estimated recoverable reserves were 800 mcm and it was produced 560 mcm natural gas. In the end, indigenous production could only increase from 212 mcm in 1990 to 905 mcm in 2006 [IEA, 2007b; 8]. Turkey in 2006 could only produce 905 mcm of its total consumption with 31183 mcm. In that case, Turkey can produce only 3% of its gas needs from indigenous sources, so almost all supplies are imported. In other words, Turkey imports 97% of its natural gas consumption.

Turkey's natural gas consumption obviously depends on imports. As in seen in table 6, imported gas had reached from 21732 mcm in 2004 to 30219 mcm in 2006. Natural gas imported from Algeria and Nigeria is by LNG shipment, whereas gas imported from Russia and Iran is carried out by pipeline. Natural gas imported from Russia in 2006 reached to 19316 mcm. Accordingly, as shown in figure 12, gas imported from Russia is about 64% of total. Iran with %18 follows Russia [IEA, 2007a; 223].

Table 6. Natural Gas Imports by Country of Origin (Million cubic meters)

	2004	2005	2006
Russia (pipeline)	14102	17523	19316
Iran (pipeline)	3497	4249	5594
Algeria (LNG)	3118	3786	4130
Nigeria (LNG)	1015	1015	1100
Non-Specified/Other	-	-	79
Total Imports	21732	26573	30219

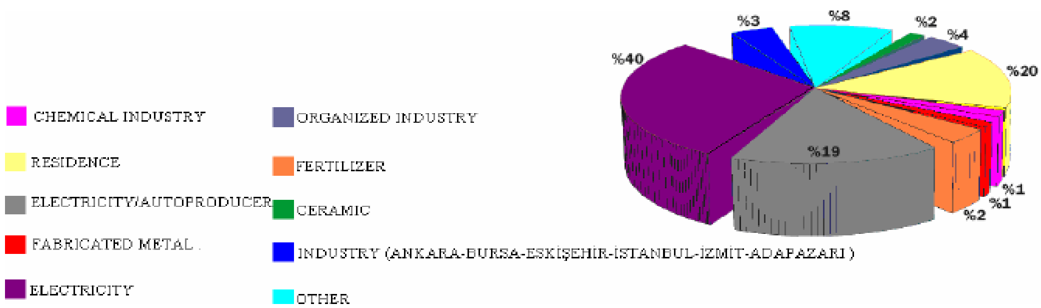
Source: IEA, 2007b; 338-339.



Source: BOTAS, www.botas.gov.tr.

Figure 12. Shares of Importer Country in Natural Gas Imports.

Turkey's another issue in natural gas is the interdependence of natural gas and electricity markets. As shown in figure 13, electricity generation from natural gas in Turkey is nearly about 60%. Such a dependency can trigger a probable crisis as in California electricity crises. Electricity generation in California at the crisis in 1999 depended on natural gas as well. Half of electricity generation had been provided from natural gas. A keen increase in natural gas prices as a factor caused the California electricity crises and the high electricity prices [Joskow and Kahn, 2002]. Such a dependency brings about an unnecessary risk and uncertainty of supply. For that reason, the Turkish electricity market has been exposed to the irregularity in natural gas supply. As experimented in 2006 and 2007, natural gas supply in Turkey that is depended on imports can be cut at any moment and the electricity market can face a probable crisis [Cetin and Oguz, 2007a]. Consequently, the electricity reform in 2001 necessitated a reform in the natural gas market.



Source: BOTAS, www.botas.gov.tr.

Figure 13. Turkey Gas Demand by Sector .

Distribution

Distribution facilities in the pre-reform market structure were owned by municipalities and private companies. As indicated in table 7, there were only 7 distribution companies established in 6 cities [Akcollu, 2006]. However, BOTAS was a monopoly on distribution activities, because of private companies or municipalities were required to purchase natural gas from BOTAS. Although BOTAS's dominant position in distribution segment did not restrict the potential competitive companies, purchase obligation of gas from BOTAS had impeded to establish competition in the market. In this environment, private companies could distribute gas to cities, but not purchase or imports it from another supplier by bypassing BOTAS. Consequently, this situation had obstructed competition in the market for long years [Cetin and Oguz, 2007a].

Table 7. Distribution Companies Established before the 2001 Law

Distribution Region	Company	Date of Operation
Ankara	EGO (Municipality)	1998
Bursa	BURSAGAZ (Calik Group)	1992
Istanbul 1	IGDAS (Municipality)	1992
Istanbul 2	Bahcesehir (Nurol-Mesa-Suzer-TOKI)	1994
Eskisehir	ESGAZ (Kolin Construction Company)	1996
Izmit	IZGAZ (Municipality)	1996
Adapazari	AGDAS (Erdem Holding)	2002

Source: BOTAS, EMRA and IEA, 2005a.

Transmission

BOTAS has enjoyed its monopoly rights on transmission as well since 1987. As a transmission company, BOTAS makes transportation contracts with importers, wholesalers, producers and exporters. It also enters into delivery contracts with producers, free consumers, storage companies, and other transmission companies [Cetin and Oguz, 2007a; 3863].

BOTAS signed eight long-term (from 15 to 30 years) purchase contracts with six gas exporting countries (Russia, Iran, Turkmenistan, Azerbaijan, Algeria, and Nigeria) between 1986 and 2001 [Akcollu, 2006]. While some of them are showed in table 8, detailed information related to these contracts is shortly given below.

Table 8. Turkey's Natural Gas Purchase Projects Signed by BOTAS (2006)

Existing Contracts	Amount (Plato) (Bcm/year)	Sign Date	Year	Operation
Russian Federation (West)	6	14 February 1986	25	Working
Algeria (LNG)	4	14 April 1988	20	Working
Nigeria (LNG)	1.2	9 November 1995	22	Working
Iran	10	8 August 1996	25	Working
Russian Federation (Black Sea)	16	15 December 1997	25	Working
Russian Federation (West)	8	18 February 1998	23	Working

Source: BOTAS, www.botas.gov.tr.

With the estimated rapid increase in natural gas consumption, in 1984 the government of Turkey signed an intergovernmental agreement with the former Soviet Union. According to this agreement, in 1986 BOTAS for the first time signed a natural gas sale and purchase agreement for a 25-year period. Turkey started providing natural gas in 1987. Natural gas imported by this agreement reached to 6 billion cubic meters per year in 1993 [Mazzanti and Biancardi, 2005; 210].

The 842-kilometer Construction of Russian Federation-Turkey Natural Gas Main Transmission Line began on October 26, 1986, and reached to Hamitabat on June 23, 1987. Natural gas imported from this pipeline has been used for power generation at the Trakya Combined Cycle Power Plant in Hamitabat. The pipeline reached to Ankara in August 1988. Residential and commercial users in Ankara started to use in October 1988. In 1996, this pipeline was extended to the western Black Sea region via the Izmit-Karadeniz Eregli line.

The main transmission line was extended to Çan for the purpose of supplying natural gas for Çanakkale Ceramic Factory in Çan via the Bursa-Çan Natural Gas Transmission Line that was completed in 1996. In 2000, this line was expanded to Çanakkale as the Çan-Çanakkale Natural Gas Transmission Line.

In 1998, BOTAS signed a new agreement with Russia to import 8 bcm per year of natural gas from the West line via TURUSGAZ-BOTAS, GAZPROM (Russia), and GAMA (Turkey, civil contractor) joint venture. Another agreement was signed with the Russian Federation on December 15, 1997. With this agreement, it was committed to be imported 16 bcm of gas per year through the so-called *Blue Stream* pipeline beneath the Black Sea. In order to construct Blue Stream pipeline, it was established a joint venture by GAZPROM (Russian state-owned gas company) and ENI (Italy). On December 2002, it began to be imported natural gas from Russia via Blue Stream pipeline.

In August 1996, Turkey signed a 25-year natural gas sale and purchase agreement with the Islamic Republic of Iran as another supplier country. With this agreement, it was aimed the natural gas supply to start at a volume of 3 bcm per year and to reach to 10 bcm per year in 2007. The Eastern Anatolia Natural Gas Main Transmission Line that was planned to be constructed with this agreement was completed at the end of 2001 between Dogubeyazit and Ankara/Seydisehir. Natural gas from Iran through this pipeline began to be imported in December 2001. In April 2002, the Karacabey-Izmir Natural Gas Transmission Line was added to the Eastern Anatolia Natural Gas Main Transmission Line and the line became operational.

In 1999, BOTAS signed a purchase contract of 16 cbm of natural gas per year for 30 years with Turkmenistan. A project on the basis of the contract that was performed by a joint venture includes construction of a pipeline from Turkmenistan to Turkey. This pipeline extends parallel to Baku-Tblisi-Ceyhan crude oil pipeline and adds the Eastern Anatolia Natural Gas Main Transmission Line near Erzurum [Mazzanti and Biancardi, 2005; 210].

5.2. Reasons for the Reform in Natural Gas

By taking account aforementioned the pre-reform structure of the market above, it can be shortly summarized the reasons for the reform of natural gas market.

The Situation of Supply and Demand

An important reason for the reform in the Turkish natural gas market was instability between supply and demand and dependency on imports in natural gas consumption. As mentioned above, since 1987 when natural gas began to be imported to Turkey, natural gas consumption has increased rapidly with demand that is dependent on economic growth. On the other side, indigenous natural gas production has been insufficient during this period. In the end, Turkey's natural gas needs are dependent on imports.

In order to solve the problem of the lack of supply and increased demand, BOTAS signed long-term purchase contracts with gas-importer countries, Russia, Iran, Turkmenistan, Azerbaijan, Nigeria, and Algeria. But, under the market structure with monopolistic-BOTAS, this problem could not been able to solve. Consequently, instability between the lack of supply and increased demand and dependency on imports in natural gas triggered the reform process in the natural gas market.

Storage

Another reason for the reform is the absence of underground facilities for gas storage in Turkey. Natural gas demand in Turkey is seasonally volatile and depends on imports. Supplier countries can put ceilings on imports for economic and political reasons. For example, Ukraine and Iran cut gas exports to Turkey in 2006. In January 2007 and now in January 2008, Iran reduced the supply of natural gas two more times. Iran always defends the cut in supply on the basis of technical problems and a heavy winter. Nonetheless, political reasons also had some role in Iran's behavior. However, because of the contract with Iran sets a limit for annual importation, it does not require a steady flow of gas throughout the year.

To a lesser extent, Ukraine's political troubles with Russia intensified the gas shortage in 2006. During the crisis with Russia, Ukraine consumed domestically some of the gas it is needed to transport to Turkey. This unexpected supply shortage gave signals about the vulnerability of the market structure and raised questions about the sustainability of the current system.

There are two probable alternatives to solve such a problem. These are constructing storage facilities and diversifying sources. Storage would be a good tool for smoothing out variations in prices. It would also help in cases of supply disruptions and minimize risks of dependency. Under the monopolistic structure of BOTAS, both alternatives have not been satisfied. In the end, the storage issue provided a reason for the restructuring of the market.

Vertical Integration

Another important reason for the reform is vertically integrated structure of BOTAS. Source diversity as the increase in the number of suppliers is a crucial part of competition in the natural gas market [Gallick, 1993; 1]. Competition in natural gas requires downstream customers to have legal rights and ability to choose their upstream supplier of gas, without any regional restrictions [Doane and Spulber, 1994; 489]. However, because of the monopolistic structure of the Turkish natural gas market, the last users for natural gas, especially eligible customers and industrial users, could not access to competitive suppliers.

On the other hand, as mentioned before, BOTAS's monopolistic structure also constrained competition in distribution market. Private distribution companies could distribute gas to cities, but not imports it from another supplier by bypassing BOTAS. This monopolistic structure impeded to introduce competition into the market and in the end, encouraged the reform.

Turkey's Advantageous Location in the Region

Turkey is in a strategically advantageous position in terms of its natural gas market. Being in the middle of Europe and energy-rich countries of Central Asia, it can be an energy corridor between these two regions. It can import gas from a number of countries and diversify its sources. This situation may also provide motivation for a competitive gas market.

Likewise, Turkey strives to be the Eurasian Energy Corridor between eastern supply and western demand by reforming the market. Turkey is expected to attract foreign investments in natural gas in coming decades [Kilic, 2006; Tunc et al., 2006]. It is a natural connection point because of its strategic position between European markets and Central Asian and Middle Eastern producing countries, as explained in detail below [Cetin and Oguz, 2007a].

Compliance of the Internal Market to EU Gas Directives

Turkey is a candidate country for full membership in the European Union (EU). To this end, Turkey's regulatory institutional structure has to comply with the EU requirements for accession. Accordingly, the regulatory environment of Turkey's natural gas market needs to comply with directive 2003/55/EC of the European Parliament and of the Council of June 2003. This directive aims to establish common rules for the internal market in natural gas and to increase competition for the member and the probable-member (candidate like Turkey) countries. In order to carry out the compliance with the EU Gas Directives, Turkey reformed its natural gas market.

6. THE 2001 LAW AND INSTITUTIONAL CHANGE

In the end, BOTAS's dominant role on the market, the lack of competition, issues of supply and demand, dependency of electricity generation on natural gas and of natural gas on imports, the absence of storage facilities within the country, Turkey's inability to benefit from its advantageous geopolitics location in the energy-rich region, and compliance necessity of the internal market to the EU's energy *acquis* brought about some issues and the restructuring of the market in 2001.

With the regulatory reform, it is aimed:

- to increase the use of natural gas,
- to expand gas transmission pipelines,
- to construct new gas distribution pipelines for all the cities in the country,
- to introduce and to institutionalize competition to the market,
- to diversify the natural gas sources for the security of supply,
- and to develop transit infrastructures between the Caspian Sea and the Middle
- East and Europe [IEA, 2005a; 99].

With the Natural Gas Market Law[13] (NGML) enacted in May 2001, the objective of harmonizing the Turkish natural gas regulatory environment with the Directive 2003/55/EC has almost been fully achieved. The main components of the Directive are exactly complied with the new Natural Gas Market Law, including independent regulatory body, BOTAS's vertically separation, third party access, market opening, privatization, and competition. In short, the New Law passed in 2001, by harmonizing the local legislation with the EU's *acquis* related to natural gas markets, opened *de jure* the Turkish natural gas market to competition [Akcollu, 2006].

6.1. NGML's Regulatory Components

The legal environment of the Turkish natural gas market was reformed with NGML enacted in 2001. NGML is the main regulatory statute of the natural gas market. The main purpose of the new law is to 'establish a legal framework for developing a fair, transparent and competitive natural gas market by separating market activities and unbundling the BOTAS's monopolistic structure in the market', to reduce state role in the market, and to prepare the ground for the integration to the EU natural gas market by harmonizing regulations. In this context, NGML was an initial stage to introduce competition to the market and to unbundle vertically the market.

As in the case of electricity[14], NGML designates EMRA as the only regulatory authority and describes the legal environment for regulations in the market. Accordingly, all legal entities are required to obtain licenses from EMRA for transmission, export, import, wholesale, distribution and storage activities. Licenses are granted for a minimum 10 and maximum 30 years.

EMRA applies an incentive-based rate of return[15] formulation in licenses and sets single prices for storage, transmission, distribution, wholesale and retail facilities. These licenses also include inflation adjustments for prices. EMRA evaluates tariffs, efficiency, and safety of facilities regularly. Thus, NGML provides the legal ground for supply security and 'fair' rates of return for companies.

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[13] Law no.4646, d. 02.05.2001

[14] See Cetin and Oguz [2007b] for the politics of regulation in the Turkish electricity market.

[15] Incentive-based rate of return differs from the traditional rate of return model. The rate of return model guarantees some level of return on investment. Firms do not have incentives to reduce costs in this model. Incentive based rate of return model encourages the firm to reduce its costs. Firms keep any reductions in costs for the contract duration. Electricity Market Law gives authority to EMRA on cost-price relationships. Fair rate of return refers to an 'acceptable' return over investment. Incentive-based rate of return regulation encourage firms to reconsider their cost during the contract period [Intven and Tetrault, 2000].

NGML unbundles the market and sets up the legal ground for privatization. Privatization began with city distribution and storage facilities in Adapazari, Bursa and Eskisehir regions.[16] Others are expected to follow [IEA, 2005a; 99]. The law requires the vertical disintegration of the natural gas activities of BOTAS after 2009 by separating three state enterprises, responsible for trading, storage, and transmission respectively [Mazzanti and Biancardi, 2005].

The law limits the amount an importer company can buy from abroad to 20% of national consumption during any one year. According to NGML, BOTAS need to sell 10% of its share of gas import contracts to private companies to introduce competition in the distribution segment of the market. The sale will be carried out with a series of annual competitive tenders to sell existing import contracts to new importers for no less than 10 percent of total imports share in each year. Similarly, importers, wholesalers and distributors cannot have market shares more than 20% to ensure that competition will be institutionalized. Distribution companies cannot buy more than half of their gas from a single wholesaler or importer. The law gives discretion to EMRA to change these ratios. National market shares are also limited to the same ratio [Cetin and Oguz, 2007a].

Importers and wholesalers need to inform the EMRA about the source and security of their gas imports for security of supply. Importer entities must contribute to the development and security of the transmission system. In addition, NGML necessitates that importers store 10 percent of their annual import volumes within five years.

In addition, transmission and storage companies, and operators of LNG must offer services their customers under nondiscriminatory conditions, given the availability of capacity and absence of financial risks related to contracts. NGML gives the right to build storage facilities to third parties as well.

Furthermore, by NGML, third parties would construct new pipelines; eligible consumers, which will be determined by EMRA, would choice their own suppliers under the free market conditions; distribution facilities would be performed under a tender; EMRA will determine five different categories for gas prices including connection, transmission, storage, wholesale sales, and retail sales [Mazzanti and Biancardi, 2005].

6.2. EMRA's Regulatory Discretions for the Natural Gas Market

EMRA was initially established as an independent, administratively and financially autonomous electricity regulatory authority, so-called the Electricity Market Regulatory Authority, in 2001 in accordance with Electricity Market Legislation, No.4628, on 03.03.2001. Name of this regulatory board was changed as the Energy Market Regulatory Authority with NGML. The regulatory responsibilities of EMRA were expanded to include the Petroleum Law, No. 5015, enacted in 2003.

Nowadays, the main aim of the EMRA is to ensure a financially viable, stable, and an accountable and transparent regulatory process on energy markets and to take necessary

[16] The choice of distribution as the first step toward full privatization may reflect both economic and political preferences. On the one hand, as in electricity, distribution segment is crucial for the efficient working of other segments. On the other hand, the nature of the distribution segment brings about suspicions about potential public choice issues, even though there is not any empirical data to test this hypothesis.

measures to provide sufficient electricity, natural gas, petroleum and LPG services of good quality to consumers. However, the main responsibility of EMRA concerning the Turkish natural gas market is to set up and implement regulations to ensure the establishment of a competitive natural gas market where all market segments will be open to new entrants. BOTAS's activities have also been regulated or controlled by EMRA until BOTAS's market share in imports decrease to 20% in 2009.

Although EMRA is administratively independent and financially autonomous, while it is administratively related to MENR, it is independent in its authority over the market.[17] Its budget is outside the consolidated state budget and not under the supervision of the Higher Court of Accounts, Sayistay. The major source of its income is the fees it collects from the industry. When EMRA's incomes exceed its expenditures, the remaining part is transferred to the consolidated state budget.

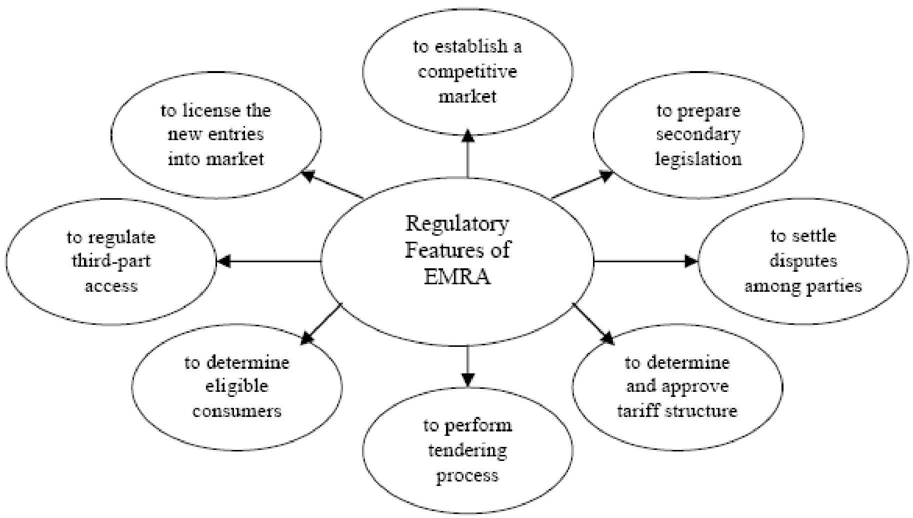

Figure 14. Regulatory Features of the EMRA in the Natural Gas Market.

As shown in figure 14, the regulatory responsibilities of EMRA related to natural gas market are:

- to approve all regulations related to the natural gas market activities, on which the Authority has been authorized as per the provisions of the Natural Gas Market Law, and to ensure the execution thereof,
- to ensure the performance of the duties of the Authority for execution of the rights and obligations arising from the international agreements regarding the natural gas market activities,
- to determine and publish secondary legislation and the opinion and suggestions of the Authority with regard to the plans, policies and applications regarding natural gas market activities,

[17] However, the recent Higher Planning Council Decision on electricity turned over some of the rights and responsibilities of EMRA to the Ministry [Oguz and Ulusoy, 2007].

- to decide on filing applications with any legal or administrative authority for purposes including litigation and enforcement of any penalty or sanction as part of the Board's authority to supervise, carry out preliminary investigations and inquiries concerning the natural gas market operations,
- to enforce regulated third party access, to determine eligible customers over time,
- to take, implement and oversee all kinds of decisions regarding issue of licenses and certificates as provided in the Natural Gas Market Law as well as the compliance with and termination of such licenses and certificates,
- to settle the disputes among legal entities or between legal entities and consumers arising from the implementation of Natural Gas Market Law,
- to organize tendering process for natural gas distribution licenses of the cities,
- to approve the tariffs regarding the activities indicated in the Natural Gas Market Law or to decide on tariff revisions,
- to regulate procedures and principles regarding the formation of tariff and price structures in transmission and distribution facilities where competition is non existent or insufficient [EMRA, 2004; Atiyas and Dutz, 2005].

EMRA regulates and approves transmission, storage and wholesale tariffs, and all retail tariffs, until competition is well established. The secondary legislation has been issued including regulations for licenses, tariffs, internal installations, market certificates, transmission network operation, distribution and consumer services and facilities.

EMRA is responsible for organizing tenders for natural gas distribution licenses in cities. The tender process was carried out in 17 cities in 2003 and in almost 20 cities in 2004 [IEA, 2005a]. As of 2006, EMRA issued 13 transmission, 33 distribution, and 13 wholesale licenses.

EMRA is responsible for solving disputes of access to the transmission and distribution system and approve investment plans by transmission and distribution companies. In 2004, 64 complaints have been received regarding the natural gas market. These include 30 complaints on access demand and issues arising from contracts, 9 on meters, 14 on tariffs, 3 on invoices and 8 on amendments made in the legislation. 53 complaints have been concluded in the same year [EMRA, 2004]. It also has responsibility for certain[18] safety regulations, including construction and services of gas facilities. EMRA is also responsible to monitor that prices reflect costs of investment. Companies calculate rates based on future cost projections. Turkey has preferred uniform-ceiling rates and a 'fair' rate of return. Uniform-ceiling pricing is an attempt to close the difference between household and industrial use, even if it does not eliminate cross-subsidies fully. Gas prices for industrial consumers are above the average in comparison to other IEA member countries. On the other hand, household prices are below the average. In the past ten years, price increases were reflected mostly on industrial consumers rather than residential consumers, as a political choice. EMRA, as in the case of electricity, tries to introduce cost-based pricing into the market [Cetin and Oguz, 2007a].

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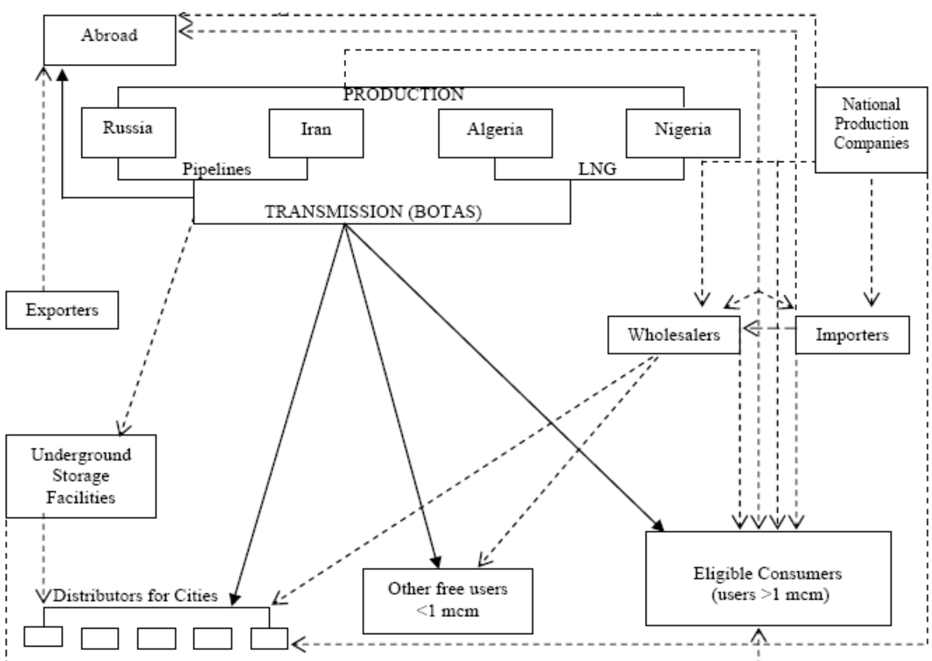
[18] Other government bodies, including the Ministry of Industry and Commerce, have also some regulatory power of social regulations in the industry.

6.3. The New Structure of the Market

The regulatory reform of the 2001 law radically aims to change the market structure in the long term. The main aim is to open the market to competition. To this end, the vertically integrated market structure of the pre-reform will be unbundled vertically by splitting state-owned BOTAS into transmission, trading, and storage segments after 2009. In other words, the structure of state-owned BOTAS will be separated into three different segments as transmission, trading, and storage facilities and BOTAS's monopoly rights on distribution, storage, the sale of natural gas and imports will be annulled by the 2001 law.

Figure 15 depicts the new structure of the industry. However, the figure also reflects differences between *de facto* and *de jure* situations in the market and hence the institutional problems of the industry. Although the 2001 law legally reshapes the industry structure, the transition to this designed structure will be possible after BOTAS's market share falls under %20 in 2009. For that reason, BOTAS has to transfer the discretions on the import facilities and contracts to private sector participations as to 2009. The nature of BOTAS makes transition harder. BOTAS has no incentive to follow the legal procedures and continues to be part of the political game [Cetin and Oguz, 2007a].



→ De facto Structure.
- - - → De jure Structure.
Source: Cetin and Oguz, 2007a: 3862.

Figure 15. The New Structure of the Natural Gas Industry.

Production Developments

According to NGML, producers can sell produced gas to importers, wholesalers, distributors or free consumers by getting wholesaler license. Producers can sell 20 percent of their annual production to free consumers directly. They have to sell the rest through importers, distributors or wholesalers. They can also export the gas with an exporter license.

Although NGML *de jure* unbundles vertically the market activities, production activity of natural gas in Turkey is not deemed as a market activity, because of Petroleum Law, No. 6326. According to Petroleum Law, the General Directorate of Petroleum Affairs must grant exploration and operating licenses. Because of legal and technical difficulties, EMRA does not have authority over exploration activities. Leaving exploration and generation outside the jurisdiction of EMRA might be a problem in establishing a competitive market in natural gas, even though it is too early to see the direction of the market at this stage.

Distribution Market

The older grids in Turkey's big cities that were owned and controlled by the municipalities are well developed. NGML decreed that the state-owned distribution regions should be privatized three years after the enactment of the law or within three years following the clearance of the external debt backed by the Treasury [IEA, 2007a; 225]. The Government initiated[19] a privatization process for the grids in Istanbul (IGDAS), Ankara (EGO), and Izmit (IZGAZ).

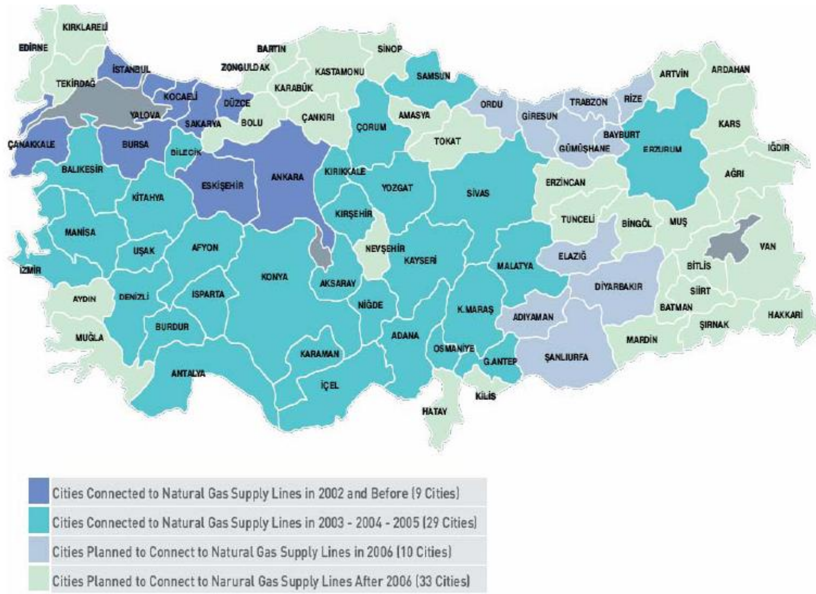
Table 9. Structure of the Distribution Regions

Before the 2001 Law		7
After the 2001 Law	Tenders Concluded	42
	Licenses Given	39
	Industrial and Residential Users Served Natural Gas	13
	Industrial Users Served Natural Gas	13
	Pending License	3
	Planned Tenders	8
Total		57

Source: Akcollu, 2006.

Developments in the distribution market after the 2001 Law is shown in table 9. As of 2006, the tender process was carried out for 42 cities by EMRA. Licenses for 39 of them were given and 3 licenses are also pending. In addition, there are 8 planned tenders. Structure of the distribution market is depicted in the following map. Accordingly, as of 2006, 38 cities are connected to natural gas supply lines. It is planned 43 cities to connect to transmission pipelines for 2006 and afteryears. Figure 15 shows the affiliation conditions of cities in Turkey to natural gas supply lines.

[19] The choice of distribution as the first step toward full privatization may reflect both economic and political preferences. On the one hand, as in electricity, distribution segment is crucial for the efficient working of other segments. On the other hand, the nature of the distribution segment brings about suspicions about



Source: BOTAS, Annual Report, 2005.

Figure 15. Cities Connected to Natural Gas Supply Lines.

Consequently, as mentioned before, BOTAS's monopolistic structure in distribution does not *de jure* restrict other entrants. However, BOTAS's existence is *de facto* an impediment to the establishment of competition in the market, because of private distributors are required to purchase gas from BOTAS. While some private companies distribute gas to cities they cannot bypass BOTAS currently. This situation is expected to change in 2009 by allowing private distributors to go around BOTAS.

Transmission Developments

Third party access to transmission grid is a crucial element of institutionalizing competition in the natural gas market. According to NGML, the transmission company is obliged to connect demanding legal users to the 'most appropriate' grid in one year.[20] EMRA has the dispute resolution authority with respect to transmission issues. The transmission company makes transportation contracts with importers, wholesalers, producers and exporters. It also enters into delivery contracts with producers, free consumers, storage companies, and other transmission companies.

According to the 2001 law, existing, planned and under construction parts of the national transmission grid remain under BOTAS ownership. BOTAS's market share in transmission is an exception to the rule that its market share would be reduced below 20% after 2009. Existing natural gas pipelines and related facilities are given in figure 16. They are as follows [Cetin and Oguz, 2007a].

potential public choice issues, even though there is not any empirical data to test this hypothesis [Cetin and Oguz, 2007b].

20 The phrase of 'most appropriate network' may create legal hurdles in the future. Who will decide which one is the most appropriate network? EMRA has the responsibility and authority disputes about networks. Yet, conflicts of interests may shift parties to legal competition, rather than market competition. What will happen if they think that they are intentionally connected to higher cost networks, as a result of discrimination?

Source: IEA, 2005a.

Figure 16. Turkey’s Natural Gas Infrastructure.

Table 10. Natural Gas Pipelines in Turkey

Pipelines	Length	Diameter	Date of operation
Existing national pipelines			
Main line Malkoclar-Ankara	842 km	36 inches-24 inches (”)	June 1987-August 1988
Pazarcık-Kdz. Eregli	209 km	24”-16”	January 1996
Bursa-Can	208 km	24”-8”	July 1996
Can-Canakkale	107 km	12”	July 2000
Eastern Anatolia main line	1 491 km	48”-40”-16”	December 2001
Karacabey-Izmir	241 km	36”	April 2002
Samsun-Ankara 1	501 km	48”	January 2002
National pipelines under construction			
Southern (Sivas-Mersin)	565 km	40”	
Sivas-Malatya	168 km	40”	
Malatya-Gaziantep	182 km	40”	
Gaziantep-Mersin	215 km	40”	
Konya-Izmir	618 km	40”	
Konya-Isparta	217 km	40”	
Isparta-Nazilli	203 km	40”	
Nazilli-Izmir	198 km	40”	
Planned pipelines			
Eastern Black Sea region	308 km	24”-12”	
Kdz. Ereg˘li-Bartın	141 km	16”-12”	
Georgia border-Erzurum	225 km	48”	
Interconnector Turkey-Greece	200 km	36”	

Source: IEA, 2005a; 102.

The gas transmission network is composed of 6 000 km of high-pressure transmission lines. Table 10 and figure 16 show the existing pipelines as well as those under construction or planned. The total length of the transmission network will reach about 10 000 km, which includes the completion of lines under construction and planned [IEA, 2005a; 102].

Import and Export

Obtaining a license, importers can *de jure* sell natural gas to wholesale market, free consumers, or exporters. The 2001 law stipulates that annual natural gas imported by each import company cannot exceed 20% of the national gas consumption projection of that year. Companies that obtain an import license can perform wholesale activity without a wholesaler license. Export companies can export the gas produced in the country or transported from abroad to international markets by using transmission pipelines and obtaining an exporter license.

Wholesale

Wholesalers must satisfy regulations on storage capacity, transportation conditions and origins of buying. Wholesale companies can sign gas sale contracts with distributors, importers, exporters, and free users on market prices. Wholesale companies must take an import license for gas imports. Wholesale and import companies must store 10% of the imported gas in 5 years later the license date.

Eligible Consumers

Eligible consumers, which consume more than 1 mcm gas annually, have the right to choose their own gas suppliers. At present, the gas market opening rate is 80 percent [EMRA, 2004]. This rate is on average 78 percent for EU countries [Mazzanti and Biancardi, 2005]. In this sense, Turkey meets European Community averages. EMRA has the right to allow the amounts of eligible consumers to increase.

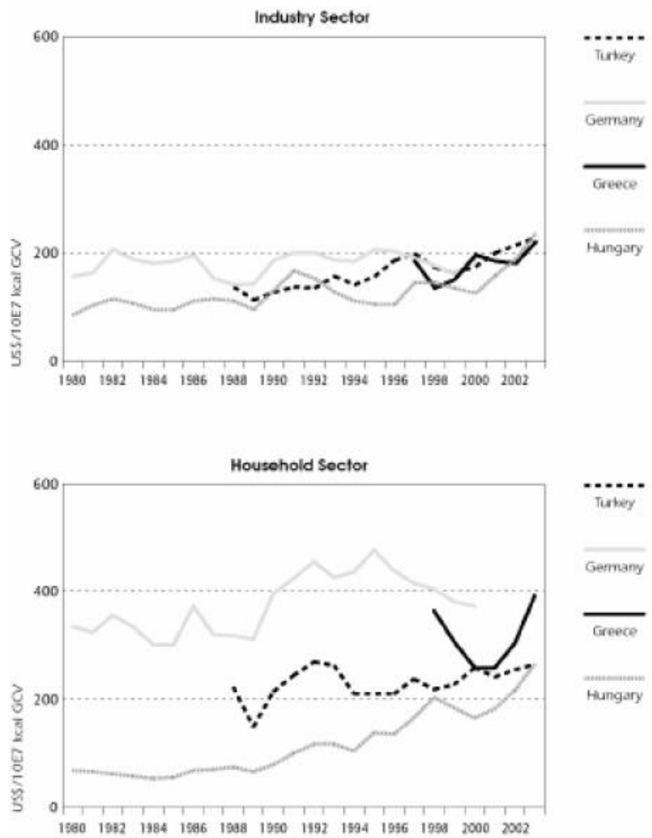
Even though they have the right to purchase natural gas from national and international producers, storage facilities, importers and wholesale companies, current market structure forces them to deal with BOTAS. They can bid for the tenders to be issued by BOTAS. Only after the tenders are realized new suppliers will be allowed to enter the market and consumers will have the opportunity to change their suppliers [EMRA, 2004].

Storage

Private storage facilities can *de jure* take license and sell natural gas to distribution companies and eligible consumers. However, Turkey does not have *de facto* storage facilities. Three projects of underground natural gas storage, Northern Marmara, Degirmenkoy, and Salt Lake, have started recently. The Northern Marmara and Degirmenkoy projects, constructed by TPAO, will be in operation in 2006. The construction of the third one, the Salt Lake project, is in the planning phase.

Prices and Tariffs

According to NGML, gas prices that include the network access tariffs as well are regulated by EMRA. As EMRA applies the price-cap method in price regulation of storage, wholesale and transmission facilities, it determines the unit service and depreciation charges for the supply of natural gas in existing distribution zones. The unit service and depreciation charge for distribution is regulated as a result of the tender by EMRA.



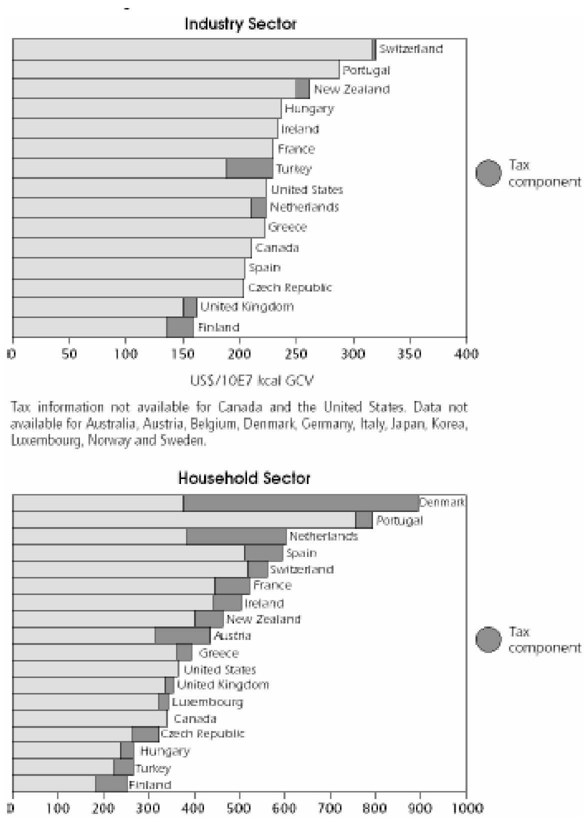
Source: IEA, 2005a; 108.

Figure 17. Natural Gas Prices by User Groups .

At present, the price structure in the Turkish natural gas market is as shown in the following graphs. As seen in figure 17, gas prices for industrial users appear to be in the mid-range in a comparison with other IEA member countries. On the other hand, the prices for household users are in the lower level. The uniform ceiling price causes this price structure between the consumer groups. This structure indicates that there are cross-subsidies from industrial users to household users in natural gas market. In 2006, Turkish gas prices for household are only 18% higher than industry gas prices, while French gas prices for households are 72% higher than the ones for industry. In addition, figure shows that natural gas prices for industrial users have increased since the late 1990s, whereas those for household users have not change. This structure implies that the cross-subsidies in natural gas market have been rapidly increasing [IEA, 2005a; 107].

Gas prices for industrial users closely follow the heavy fuel oil price. End-user prices continue to increase due to current high wholesale prices. In addition to these developments, VAT (value-added tax) is applicable to households and non-commercial usage at a rate of

18%. A fixed excise tax (Fuel Consumption Tax) of 22.9 new Turkish lira per 107 kilocalories GCV (gross calorific value) applies to natural gas for industry or electricity generation. As seen in figure 18, in a comparison with other IEA member countries, tax rates in natural gas prices for industry users are considerable higher than tax rates in the other countries, whereas taxes in prices for households users are relatively lower.



Source: IEA, 2005a; 109.

Figure 18. Tax Shares in Natural Gas Prices in IEA Countries.

7. Issues and Future Perspectives in Natural Gas

Although the Natural Gas Law of 2001 is in force and it is *de jure* established *competition for the market* and *in the market* by being unbundled vertically state-owned BOTAS, BOTAS's monopolistic structure in the market still has been going on. Thus, BOTAS's monopoly power injures the transition process to a competitive market structure by delaying competitive trading in the market. On the other hand, the absence of an independent transmission system and storage operator is another obstacle in the front of a competitive market.

Although eligible consumers have the right to choose their suppliers and the third-party access right to transmission, distribution and storage facilities, they can face difficulties in practice because of cross-subsidies and the monopolistic position of BOTAS in import and trade. Tariffs settled by BOTAS and distribution companies in the distribution and transmission grant monopoly power to these companies in their own areas.

Previous governments signed some of the long-term sale and purchase contracts. According to NGML, BOTAS must transfer some of the contract to new market participants until BOTAS's market share fall to the legally mandated levels and BOTAS is responsible for the contract transfer program.

However, uncertainty related to the details of BOTAS's contract transfers has delayed the transfer process so far. The transfer process is politically motivated and it is suspicious that how BOTAS's attitude will take a form. Delays in BOTAS's contract transfers signal probable issues in the market. For example, importers, who undertake BOTAS' responsibilities through the tendering process, may have disputes with suppliers on price differences. These risks may easily turn into uncertainties about the institutional structure of the market and create artificial entry barriers.

Although EMRA has *de jure* the discretion to regulate prices in the market, gas prices are *de facto* settled by BOTAS due to the contracts. Apparently, the dominant position of BOTAS on existing contracts impedes the independence and the regulatory discretions of EMRA on the market prices and increases transaction costs of the regulatory reform process.

Another issue is the interdependency in natural gas and electricity use. As mentioned before, electricity generation from natural gas in Turkey is nearly about 60%. This situation opens the door the same issues as in the California electricity crisis. In addition, in terms of political structure of the Turkish natural gas market, the dependence creates an 'unnecessary' risk and uncertainty of supply. Moreover, the Turkish electricity market is exposed to the irregularity in natural gas supply. As observed two times in 2006 and 2007, an interruption in gas supply by Iran or another supplier is always possible. In such cases, a problem in natural gas market can cause a crisis in electricity market.

According to NGML, EMRA is the only responsible to decide on new long-term natural gas contracts. However, the Ministry signed a new contract with Egypt and transferred the responsibility of the contract to BOTAS. This situation gave a signal about the dispute between the Government and EMRA on regulatory discretions and NGML.

As another problem, Turkey has not a storage capacity. Although Turkey is a *natural* energy corridor between Europe and Asia, it has not sufficient underground storage capacity that would store more gas than it consumes to realize its aim to be the Eurasia corridor. This deficiency constrains Turkey both in terms of efficiency of its energy policies related to natural gas and in terms of development of competition in the internal natural gas market.

Such probable problems in the market indicate that the Government of Turkey and EMRA should effectively take measures. Otherwise, the regulatory process in the Turkish natural gas market and Turkey's aims to be the Energy Bridge by diversifying supply sources as well can fail at the very beginning of the reform.

In this context, as IEA [2005a] pointed out as well, The Government of Turkey and EMRA should:

1. Follow up decisively the objective of competitive market as mentioned in the 2001 Law and monitor closely the process.
2. Go on to promote the transit natural gas pipeline projects and establish the necessary regulatory framework especially for new pipeline projects as Iraq-Turkey Natural

Gas Pipeline Project, Egypt-Turkey Natural Gas Pipeline Project, and Iran-Turkey Natural Gas Pipeline Project

3. Encourage new projects to diversify supply sources and to establish a competitive structure for new entrants. Accordingly, redefine precisely the roles of EMRA and BOTAS in this regulatory process.
4. Abolish the restrictions on natural gas imported by new entrants from countries where BOTAS is importing.
5. Oversee firmly the market power of exporter countries on imported natural gas.
6. Eliminate cross-subsidies on natural gas prices and re-regulate natural gas prices as cost-based in terms of industrial and households users.
7. Facilitate the third party access (especially eligible consumers) to the transmission, distribution and storage facilities and review tariffs for the access.
8. Expand the gas distribution networks to new cities by taking account into the environmental benefits and to enable imports by new entrants from any supplier, while reducing BOTAS's market share until.
9. Establish an independent gas transmission system and storage operator, in accordance with the vertical separation of BOTAS [IEA, 2005a].

8. CONCLUSION

This chapter tried to analyze the process of institutional change in the Turkish energy markets. Firstly, enacting the Electricity Law of 2001, Turkey has reformed the electricity market. The aim was to introduce competition to competitive segments of the market and to regulate the natural monopoly elements. Afterwards, with the same aim for the natural gas market, NGML was enacted in May 2001. Although both electricity and natural gas markets are *de jure* opened to competition, the legal reform could not yet *de facto* establish competition.

Both the electiricity law and NGML delegated crucial regulatory discretions to EMRA as an independent regulator. However, the reform process has brought about some problems. In the electricity market, timetable relation to competition and privatizations determined by EMRA and the Law has often been interrupted by the government. The reform process has deviated from the beginning aim. Privatizations have not been able to implement on time. Some state-owned assets whose are needed to be privatized according to the Law and EMRA have remained as a monopoly in the market. EMRA's insistence on competitive pricing methods and the nullification of cross-subsidies over the tariffs has been ignored by the political authority. In the end, political pressure surrounded EMRA and this situation has impeded competition in the electricity market.

There are similar problems in the natural gas market as well. The conflicts among EMRA, the political authority and BOTAS, and BOTAS's ongoing monopoly structure have impeded competition in the market so far. In order to institutionalize competition successfully, it is needed to redefine the regulatory discretions of EMRA, BOTAS and the Ministry over the market and to reduce BOTAS's market share in related to market activities.

Multidirectional energy dependency in Turkey has also injured Turkey's energy policies in natural gas. Turkey has not yet been able to ensure the security of supply in natural gas sufficiently to minimize the effects of an external shock. In addition, Turkey has not necessary storage facilities. Thus, in the event of a probable economic or political instability in the region, the dependency on Russia in natural gas can trigger natural gas and electricity crises. Apparently, Turkey needs to diversify the supply sources and to discard the natural gas dependence in electricity generation.

To solve the problems, the government should take measures. It should comply with the Electricity and Natural Gas Laws, and the EU Electricity and Natural Gas Directives. It should be passed from the national tariff to the cost-based regional tariff in pricing of electricity. In particular, privatizations in distribution have to be implemented immediately. The legislature and the judiciary are needed not to intervene in the regulatory discretions of EMRA related the market.

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Chapter 14

GLOBALIZATION, DEVELOPMENT, AND ENVIRONMENTAL POLICIES IN TURKEY

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ABSTRACT

Against the backdrop of economic development's increasing burden on the environment, the chapter argues that the state in Turkey is in many cases not fulfilling its duties towards the environment. This seems rather paradoxical given that Turkey seemingly has all the ingredients associated with the successful development and implementation of environmental policies: a well-developed environmental legislation, an active environmental civil society, and capable public environmental institutions. This inconsistency is investigated by developing an analytical framework that sheds light on the nature and workings of the environmental policy-design and implementation process in Turkey.

INTRODUCTION: SETTING OUT THE PARADOX

This chapter aims to formulate an explanation as to the existence of a paradox, evidenced by the near failure of the state in Turkey to put environmental policies into practice despite the existence of a set of detailed legal regulations and a strong state tradition, by addressing the political economy of the environment problem in an analytical framework. Environmental problems are defined as the pollution of nature on the one hand, and the mismanagement of natural resources on the other. These two concepts, no doubt, often overlap: by depositing waste matter into a lake, we not only pollute the lake, but also cause its fish population—a key dimension of the lake's natural resource—to decrease.

Unlike certain other developing countries, Turkey, with its strong state tradition that is a legacy of the Ottoman Empire, is not a nation that shirks its responsibilities when it comes to formulating legislation on the environment. Still, in almost all fields, there is ample evidence highlighting the fact that the environment is being decimated. What might be the underlying causes of this apparent paradox?

Numerous studies conducted in Turkey have shown that, in the last 50 years, a rapidly growing population, industrialization, urbanization, intensified pesticide, herbicide and fertilizer use, and increasing demand for coastal areas have all come with a high cost to the environment. While air, water and soil pollution is on the rise, water sources keep on decreasing. Turkey has presently joined the ranks of "water-poor" countries. Soil degradation and loss of biodiversity continue unabated. The ratio of protected areas to all other areas is merely one percent. We do not have an inventory of our genetic resources, and about 2 million tons of genetically-modified corn, soy, cotton and canola are believed to be smuggled into Turkey per year. Annually, 500 million tons of fertile land is lost to erosion. Every year, great swathes of forest are totally destroyed: 20,000 to 25,000 acres burn down and 1,250 to 1,750 acres are cleared for fields or homes (Baykan, 2008; see also Markandya, 2003; Adaman & Arsel, 2005, 2008b; European Commission, 2007, 2008).

While the pollution Turkey generates constitutes a threat beyond its borders—to its neighbors and global ecological equilibria (such as the fact that, according to 2004 figures, Turkey is the 23rd largest CO_2 emitter in the world)—the country is also passively exposed to environmental issues generated by its neighbors and the general global circumstances (such as European pollution being carried on the Danube, and contaminating the Black Sea coastline and the Bosphorus and Dardanelles Straits). Consequently, environmental issues cannot be examined only within the context of national borders and national actors. However, the area we hope to highlight in our chapter will be limited to Turkey, and a detailed analysis of other international actors will not be undertaken. (For a brief discussion of Turkey-EU relations, see Adaman & Arsel, 2008b.)

Both politicians and the bureaucracy have made well-documented statements noting that putting environmental concerns aside and achieving high growth rates first, and addressing the environment at a later point in time is the strategy best suited to national interests. To provide a few simple but striking examples: The Southeastern Anatolia Project (GAP) is a world-class project—despite concerns regarding its master plan—yet southern parts of the Harran Plain today face grave ecological devastation because measures against salinization resulting from irrigation were inadequate and taken too late (Adaman & Ozertan, 2007). Advanced irrigation techniques are still not used in the region, and farmers have been improperly informed about irrigation; consequently, thousands of acres of fertile land has now become desert. Similarly, news about how subterranean and surface waters are becoming increasingly polluted by agricultural, domestic or industrial waste, and how numerous wetlands are drying up due to dams built for energy and irrigation purposes have virtually become matters for the courts. The number of lakes drying up, losing water or being polluted is on the rise, and because lakes have dried up, birds have begun to change their migration routes (for ecological problems observed at Lake Burdur, a designated Ramsar site—a status given wetlands of international importance—and a political economy assessment of these issues, see Adaman, Hakyemez & Ozkaynak, 2009). A similar approach is reflected in Turkey's longstanding resistance to signing the Kyoto Protocol on account of "national interests", which finally ended in February 2009. And when the dilemma between industrialization and the environment is on the table, the official discourse chooses to back industry obsessively, rather than investigating sustainable industry options.

The consumption of natural resources, especially in relation to development efforts, is another notable heading under which environmental problems appear. The most striking and relevant example is the devastation of coastal and forested areas, ongoing now for years. Studying these examples closely, it becomes apparent that the development frenzy was equally the result of patronage-based reciprocity, or relations built on bribery, rather than a rational and long-term plan that consciously sacrificed environmental quality at the altar of rapid economic growth.

In addition, as local administrations are not very sensitive to environmental issues (which is partly because the local public rarely makes such demands, at least explicitly), there exist no sewage or waste treatment systems in many provinces, counties or neighborhoods in Turkey (Guney, 2004). The general public's apparent lack of sensitivity to environmental issues may be a reflection of this fact (in public opinion studies in Turkey, only one or two percent rate environmental matters as one of the most vital problems of the country; see, for example, Carkoglu & Kalaycioglu, 2009).

Although this approach to development and industrialization is inherently linked to societal attitudes, it is nonetheless true that significant steps in legislation and regulation were taken in the last three decades. Environmental problems were first addressed in the 1973-78 Five Year Plan, and the undersecretariat attached to the prime ministry founded in 1978 became the Ministry of Environment in 1991. It was merged with the Ministry of Forestry in 2004, chiefly in adherence to EU perspectives. Similarly, Turkey not only attended the 1972 Stockholm, the 1992 Rio and the 2002 Johannesburg Environmental Summits and is party to numerous international conventions, but has taken significant steps in drawing up environmental legislation at the governmental level (Guler & Cobanoglu, 1998; the website of the Ministry of Environment and Forestry: http://www.cevreorman.gov.tr/yasa/index.htm). The 1982 Constitution, which protects environmental rights through a number of articles—and which, ironically, is filled with a number of highly antidemocratic items—can also be considered one of these steps (first and foremost, Article 56, which confers all citizens the right to live in a clean and safe environment: "Everyone has the right to live in a healthy and balanced environment. It is the duty of the state and citizens to develop the environment, protect environmental health, and prevent environmental pollution.") Presently, many ministries in addition to the Ministry of Environment and Forestry (the Ministry of Health, the Ministry of Tourism, the Ministry of Energy and Natural Resources, for instance) have duties and responsibilities concerning environmental issues. Moreover, the authority and responsibility to be enjoyed both by the local administrative branches of the central government (the governor's office, environment directorates, *et cetera*) and local governments are very clearly defined. Furthermore, in conjunction with the continued negotiations with the EU, the transformation and expansion of the country's environmental legislation in line with the "Environmental *Acquis*" is a currently ongoing process (for a recent study aiming to predict how much the harmonization with EU legislation will cost to industry, see Gorgun, Incecik, Atessacan & Erenguc, 2007).

In the end, a paradoxical picture emerges: There is extensive environmental legislation and regulatory mechanisms built on a deep-rooted and powerful tradition of state on the one hand, and increasing environmental devastation on the other. This brings with it a general consensus along the lines that environmental policies are inadequate overall, and good practices only isolated events. In other words, what we have here is poor report card performance that corresponds to neither the comprehensive legislation nor the powerful state tradition in Turkey. Consequently, it should come as no surprise that in the recent *Progress Reports* Turkey is criticized of experiencing problems in the implementation of environmental regulations in its EU accession process (European Commission, 2007, 2008).

Conducting a political economic analysis to understand the root of the problems—and thus, the above mentioned paradox—in the implementation of existing environmental policies would be highly beneficial. In fact, the present study aims to develop a method to this end, which can be applied to a variety of environmental outcomes in contemporary Turkey in order to understand not only why policy implementation fails to deliver desired outcomes but also how this failure comes about. Here we focus only on environmental *policies* and the *implementation* of these policies. For instance, we are not interested *per se* in whether or not people use disposable plastic bags instead of bringing bags from home when they go shopping, or not opt for light bulbs that use less energy but have higher purchasing costs. We focus on whether or not the state developed policies aiming to influence consumer choice in bags or light bulbs, and more importantly, the level of success achieved in implementing these policies.

We believe that to conduct such an analysis, it will be necessary to approach the problem from an analytical perspective. To form an analytical framework, we will first need to construct different players that can be distinguished from one another within the system. The underlying assumption in working toward such an analytical method would be that different players take different stands and have different capabilities in terms of different environmental policies. An example of constructing different players might be as follows: An environmental regulation being enforced in the field of cement manufacture would satisfy residents living in the area where the factory is because air pollution would decrease, but it would be found objectionable by the cement industry since it would probably result in rising costs, and hurt other industries that use cement to the extent that the cement industry was able to reflect the rising costs on other industries. To continue this analysis, some cement factories may even need to shut down because of this regulation, and a certain portion of the people working in this sector would become unemployed. While Turkey's CO_2 emission levels would fall, should meeting domestic demand prove difficult, importing cement from neighboring countries may become necessary. This would cause emission levels in those countries to increase and transportation costs to go up.

Certainly, differentiating among the various players may not always be so easy: players may change roles; any one person/organization may be playing multiple roles; two people within the same group may be affected by the environment differently (due to varying levels of knowledge about the environment or varying environmental values, *et cetera*). To return to the cement factory example, a local resident who is also a partner of the factory will be affected both favorably and unfavorably by the decision. However, we have chosen to simplify a number of things in the name of forming a parsimonious analytical framework. Consequently, we assume that the different categorizations offered below will correspond to distinct ontological units, and acknowledge from the start that the simplification efforts must be carefully kept in mind, as is the case in any analytical approach.

In the following section, stakeholders within the context of environmental policies in Turkey are presented as those who will favorably or unfavorably be impacted by a given policy, or have a say in the nation's political decision-making mechanisms (thus including environmental issues) even if they would not be directly affected by these environmental policies. Next, we discuss the characteristics of these different players and, to a degree, their links to one another. After assessing the players and their qualities, we address different positions and interactions within the context of the environment, from a political economy point of view. Finally, we attempt to take into consideration certain ideas for the future, and assess Turkey's stand regarding environmental problems in the globalized world.

1. Players in the Development and Enforcement of Environmental Policies

In this section, we define and critically discuss the nature of various players that have, or would be expected to have, agency in the political decision-making mechanisms through which environmental legislations and regulations are implemented.

1.1. The State

This is the category that has—in the widest sense—either the authority to make laws and enact regulations and change existing ones, or directly influence those authorized to do so. Parliament and the top levels of central and local governments (cabinet members, high-level bureaucrats, governors, and district administrators) are given priority in this category. Because the topic is environment, the Ministry of Environment and Forestry and other relevant ministries obviously will head these agencies. The Office of the Presidency, the Constitutional Court, the State Planning Organization, the Council of State and other similar institutions should be included as well. Similarly, although local governments seem to be the manifestation of self-governance by the public, they are by and large part of the state mechanism in the sense that they are defined by a legal environmental framework.

To categorize, the *legislative* and *executive* distinctions are less valid in Turkey than they are in other western countries. Furthermore, the military also needs to be mentioned as an institution that goes beyond, and in certain contexts even supersedes, this distinction. We assume that the agencies that make up the institution of state take positions that sometimes overlap, and sometimes differ. And the subgroups of these agencies will also hold positions with regard to the environment, as will be addressed below.

While the role of the *judiciary* is clearly defined in the constitution as validating the nation's laws, old and new, its precise position in the power matrix of the state is less clear. This makes the system particularly prone to the "politicization of judiciary", a weakness that haunts even mature industrial democracies. However, Turkey also demonstrates evidence of what Shambayati (2004) calls "judicialized politics", where the woolly nature of the power of the judiciary can be exploited by the ruling elite (and especially the military brass) to legitimize certain "corrective" decisions. The judiciary exercises formal power over the legislative and executive branches as well as the non-state. It is important to note, however, that it has little oversight over the military.

As a political actor, the *military* is as powerful as it is opaque. While there exists universal agreement that it wields enormous power (arguably the single most powerful actor on the national scene), opinions vary regarding both its intentions and its means of exercising power, since these (unsurprisingly) contravene democratic norms. Its formal and informal influences are felt by all domestic actors, though recent developments suggest that—thanks partly to international pressures—its ability to flex its muscles may now have begun to diminish.

These four separate categories—legislative, executive, judiciary, and military—together comprise the ruling power of the “Turkish state”. (See the large circle in Figure 1.) However, we also argue that the encircled quadripartite governing mechanism has two additional and important dimensions. First, the “will” of the state does not simply emerge from the conflictual relationship among its four components. Rather, a nucleus—the aforementioned “ruling elite”—cuts across all four branches to choreograph the general direction of state power, if not specific moves. The second feature is the clear separation of this four-fold state system from the society it governs. This is not to suggest that state-society relationships are characterized by conflict, for this mode of interaction can still be normal and healthy in a democratic regime. Rather, state-society relationships in Turkey are defined by the large distance between the two, an historical reality that can be traced back first to the Ottoman style of governance from a distance, and second to the military heritage of the modern republic.

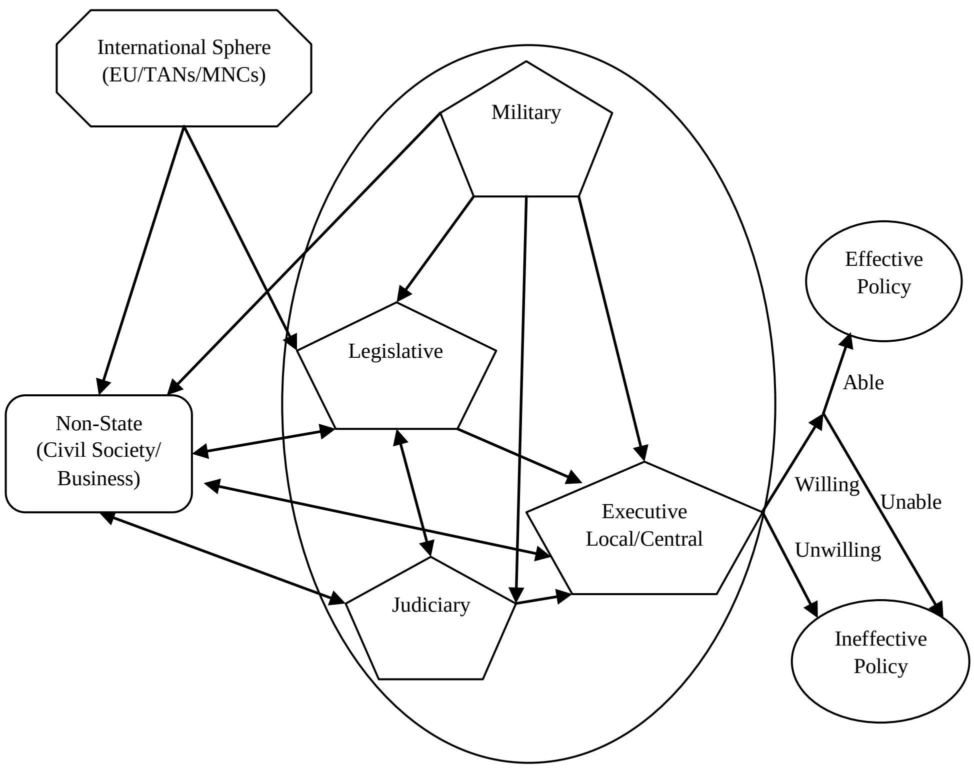

Figure 1. An Analytical Model of the Political and Policy-making.

That Turkey has a strong state tradition is a well known fact: Unlike many developing nations, where the primary challenge has been the formation—often from scratch—of an efficacious modern state apparatus, Turkey’s state structure is built on the Ottoman tradition and is rather deep-rooted (Frey, 1965; Heper, 1991; Gocek, 1996). However, it is also known that this powerful structure takes a somewhat restrictive position when it comes to democratic processes and fundamental rights and freedoms. In addition, there is a general consensus that the paternalistic state structure began to break down especially following the transition to the multi-party system, and the elite that founded the Republic began to dissolve during this process. Consequently, there are numerous theoretical and field studies on how the state institution is inwardly dissolving, while interaction between larger groups of people and the state is mostly being conducted through the use of corrupt networks, such as bribery and patronage (Ahmad, 1993; Heper & Keyman, 1998; Adaman & Carkoglu, 2003; Adaman, Carkoglu & Senatalar, 2001, 2003, 2009; Green, 2005; Keyman, 2005; Keyman & Icduygu, 2005; Transparency International, 2009). This process results not only in the weakening of the social dimension of state function, but also leads to reduced efficiencies in state capability and damages the evenhandedness of the judicial system.

An inquiry into the quality of the state institution will inescapably bring with it very extensive ontological and methodological debates regarding the nature of the state and how it can be examined in social scientific inquiry. Is the state a platform, a political arena, where a number of players battle for power, or an autonomous structure that exists in and of itself? Here, due to space constraints we will not delve into a detailed discussion of the matter, but embark from the point that the state structure in Turkey encompasses both qualities: An elite-dominated structure that views itself above and beyond society (and often—but to a lessening degree—takes the Kemalist movement as its starting point) simultaneously exists with players that work to somehow influence the state mechanism. It is hardly surprising that these two matters come face to face and contradict one another in myriad fields (including the environment).

1.2. Enforcement Agencies

This category refers to those charged both at central and local governments with the duty of enforcing the decisions made at the state level. The relationship between these agencies and the state institutions appears to be hierarchical in structure (where the state gives orders to the enforcement agencies). Although the existing system of governance does have upwardly operating channels, decisions made by the topmost levels are what count.

With the exception of a few distinct and singular practices, enforcement agencies presently often lack a structure that would promote efficient and effective operation. Consequently, since there are no merit-based incentives or other measures to reward higher performance, enforcement agencies can hardly be expected to conduct their work properly (Adaman & Sertel, 1997). Moreover, as was noted earlier, there is widespread public belief, certainly not unfounded, that enforcement agencies are involved in corrupt networks (Adaman, Carkoglu & Senatalar, 2001, 2003; Adaman & Carkoglu, 2003; Green, 2005). As a result, although enforcement agencies are hierarchically attached to the central government, they sometimes do take “initiative”. This is why the extent to which these agencies achieve success in enforcing environmental regulations determined at the state level depends very much on a number of factors that will be addressed below.

Ultimately, the problem of corruption mentioned in relation to governance appears in both the state mechanism and the enforcement agencies. “Buying off” the officials inspecting a factory that generates waste beyond what is designated by regulation, corresponds to corruption at the enforcement agency level: the bribe accepted here (cash or in-kind) will line the pockets of the officials in question. Yet, for instance, if a municipality—and here we mean the institution and not individual actors within the municipality—knowingly provides a construction permit for an environmentally-undesirable construction project, the bribe accepted, which might take the shape of otherwise legal charitable donations toward the operation of the municipality, will not line anyone's pockets but ultimately go toward the provision of other services. But both cases represent a departure from existing legal regulations, where environmental devastation is overlooked due to personal or partisan interests.

1.3. Social Stakeholders

This section refers to non-state actors, who have a clear stand on a specific issue and are organized around it, and are able to influence decision-making bodies through formal or informal channels. Civil society and the business world come to the fore as stakeholders to pay attention to with regards to the environment. In Turkey, labor unions, which are often addressed as another social stakeholder, have no clear position on environmental matters, and are therefore not discussed here.

Civil society representatives that must be examined are surely, first and foremost, NGOs focusing on the environment (TEMA, Cekul, DHKD, WWF of Turkey, Nature Society, Greenpeace of Turkey, *et cetera*) and social movements that have taken a stand on environmental issues (Bergama, Akkuyu, Hasankeyf, *et cetera*). (See, e.g., Kocan & Oncu, 2002; Arsel, 2003, 2005; Coban, 2004; Adem, 2005; Aydin, 2005.) In addition, various civil groups and initiatives can sometimes directly or indirectly become actively involved in environmental issues, even if this is not their main area of work. Civil society representatives that are sensitized to ecological issues appear to differ from one another: A small group values the environment highly, and some of these groups are activists with regard to environmental policies (activism may sometimes correspond to activities in the political arena, but mostly refers to efforts geared toward environmental conservation). Environmental movements and green NGOs, diverse both in quality and quantity, may be considered to belong to this group. Regarding environmental movements, a complex set of preconditions determine the formation, long-term viability and efficacy of these organizations, as was the case in Bergama, including the existence of clearly articulated environmental grievances and other socioeconomic and political concerns that can be "piggybacked" on these, sufficient political space for communal organization and political association, and policy entrepreneurs who are able to catalyze movement creation and network formation (both nationally and trans-nationally).

Meanwhile, the business world exhibits its presence with regard to environmental issues at the central or local government levels, through corporate structures at different platforms, or sometimes via individual efforts (Kalaycioglu & Gonel, 2005). The presence of the business world can at times be advantageous for the environment, and disadvantageous at others. An examination of the business world reveals that except for a small group that generates economic gains from environmentally-friendly production (vendors of goods marked as being produced by environmentally-friendly manufacturing processes, companies organizing nature tours, organic farmers, *et cetera*), stakeholders in business often make choices that are detrimental to the environment because of financial concerns. The underdevelopment of a “Western” style “sustainable consumption” movement, combined with the lack of (effective) regulatory mechanisms, practically eliminates all domestic incentives for businesses to even attempt to be seen as “green”.

In the end, the probable impact of social stakeholders might be putting pressure on state institutions either for or against the environment, and demanding policies that could be costly in terms of the environment in return for political gain. In addition, within the context of corrupt networks, enforcement agencies may very well be asked not to enact or to soften certain environmental regulations. For stakeholders to direct enforcement agencies toward pro-environment action through pressure or other mechanisms seems unrealistic, and even if enforcers were targeted by the activity, the message is usually directed at the state mechanism.

1.4. Players Overseas

This section addresses entities abroad that have a direct or indirect impact on environmental policies in Turkey. International environmental movements (including NGOs) and policies on various platforms (such as the Rio or Johannesburg Summits, or the activities of Greenpeace in a country) can be influential in the formation of environmental policy in that country (Kadirbeyoglu, 2005).

Firms based abroad (TANs and MNCs) similarly can directly or indirectly influence policies in Turkey. One mechanism would be for these corporations to seek support in the shape of political pressure from their “home” governments to be placed on the Turkish state. Recall, for example, the Australian prime minister’s intervention and “request” from the then Turkish Prime Minister Ecevit to “resolve the problem” concerning the complex and slowly-progressing legal dispute surrounding the cyanide-leaching process of gold mining in Bergama (Arsel, 2005). Another mechanism would take the shape of corporations “voting with their feet” by setting up operations in Turkey because of (perceived or real) “ease” with which environmental regulations can be fulfilled or skirted. Some of these corporations may indeed be taking part in a “downward spiral” movement of seeking the least burdensome location to operate within where others might simply be acting in a “practical” manner by adjusting their operations to fit local regulatory demands, which vary greatly, rather than adhering to global standards that seek to ensure sustainable outcomes.

As noted above, as a condition of doing business in Turkey, certain foreign companies demand that established environmental standards be applied. It is obvious that this policy will also have an indirect impact on the quality the environment in Turkey. However, there are two sides to every coin, and this case is no different: It is also true that there are foreign companies that wish to sell to Turkey the factories and power plants that meet low environmental standards and can no longer be used in countries with higher environmental standards (or more effective regulatory mechanisms); store industrial waste in Turkey; or mine in Turkey in accordance with lower environmental standards.

Meanwhile, the EU has become the player that has the most power to influence environmental policies in Turkey within the context of the “Environmental *Acquis*” that is part of the accession process. The *Acquis* covers horizontal legislation, water and air quality, waste management, nature protection, industrial pollution control and risk management, chemicals and genetically-modified organisms (GMOs), noise, and forestry. Assuming that

Turkey still aspires to be an EU member (and negotiations with the EU are ongoing), it is certain that significant steps will have to be taken concerning the environment (Adaman & Arsel, 2008b). One point we would like to briefly touch upon concerns the EU-15 especially; while these countries played an important role in environmental devastation as a result of early industrialization back in the day, they presently conduct some of their economic activities outside the EU, and this enables them to be environmentalists within their own borders but cause environmental degradation in other nations. How this point will be discussed within the context of the environment in Turkey-EU relations would certainly have a major impact on what type of (environmental) "concessions" will be made by Turkey during its process of accession.

The EU's stance on two dimensions is important for Turkey: One, what political stand will the EU take in the future regarding the environment (scenarios foresee the EU embracing a more social, or environmental, or market-oriented stand)? Two, how much of a priority will the environment be for the EU in its relations with Turkey? The cash and in-kind assistance that the EU will provide Turkey for the environment will obviously have great impact on the matter. In addition, the EU has the power to indirectly influence a large portion of the public, stakeholders, and enforcement agencies in the context of environmental issues. Some instances that come to mind include the support the EU provides to NGOs, and ongoing efforts to restructure the bureaucracy. It would not be erroneous to assume that in all cases, influence originating from the EU would have a favorable impact on the environment. Needless to say, sustainability of the EU's environmental impact also depends on Turkey's continued willingness to become an EU member.

As touched upon above, international players other than the EU can be expected to have an impact either favorable or unfavorable to the environment. The growing international movement for environmental conservation, international environmental organizations, and the businesses in support of environmentally-friendly production will have a positive impact on the environment in Turkey. However, as mentioned above in the case of foreign companies hoping to conduct business with low environmental standards, unfavorable effects are also a possibility. But in the end, it would probably not be wrong to say that international players other than the EU will not have a very strong influence on social stakeholders and enforcement agencies.

2. Interaction Networks and the Stands Players Take on the Environment

So, how do the interaction networks between these four categories come about? Interaction among the players, partially discussed in the previous section, is presented in Figure 1. (Note that arrows represent strategies, outcomes, or influences; and instances of two-way interaction may certainly be the case at times.) Taking the state institution as the main axis, it would be best to begin the discussion here. The state will make "pro-environment" and "anti-environment" choices. Obviously, pro- or anti-environment stances will differ according to a reference point; or in other words, a given environmental regulation that has been enacted may be deemed insufficient by some and excessive by others. Here, the reference point will be current environmental quality: policies that advance sustainability are categorized as “pro-environment”, and policies that revert as “anti-environment”. We had said that policies determined at the state level reach enforcement agencies as directives (and the arrows pointing from the state to enforcement agencies correspond to this assumption). However, as will be discussed below, it would be wrong to assume that a pro-environment decision reached by the state mechanism will automatically be enforced.

To examine the processes whereby policies that will directly or indirectly impact the environment are determined, an attempt is made to categorize the reasons that push the state to make a decision. In this categorization effort, while some factors correspond to the qualities of the state, others represent the outcomes that result from the relationship between the state and other stakeholders. We present these factors in no particular order of importance, though without wishing to suggest that they are all equally weighty in determining state behavior. It is possible to identify five distinct dimensions.

The first can be described as the prevalence of “myopia” in decision-making when it comes to environmental issues. In environmental regulations, costs often accumulate in the short run while ecological effects spread out over the long term. For example, if the sewage from a town is being discharged into a lake, it may take a long time for the lake to become polluted, but the cost of the sewage treatment plant must be paid in the short term. While this is inherent in many areas of public policy-making and not merely a Turkish or even a developing-nation problem, environmental issues in Turkey seem to suffer particularly severely from it.

The second issue concerns the existence of the deeply entrenched patronage and bribery practices already introduced above. In cases where a large group bears the costs while a small group enjoys the benefits of an environment project (e.g. when a hotel construction permit is granted on landscape deemed a national park), or where the reverse is true (e.g. when a firm is forced to stop discharging its waste discharged into a lake that services a village), patronage and bribery relations may possibly hinder the state from developing environmental policies—assuming that large groups will find it more difficult to mobilize compared to small groups, and small groups may succeed in influencing the state. Needless to say, local governments are another level where patronage networks are observed—spreading squatter communities, building second homes on the coastline or scenic panoramas, *et cetera*. There is widespread consensus that unplanned urban growth is the result of the actions of municipalities that discard environmental concerns in return for political gain (Keyder, 1997, 2005a, 2005b).

Perhaps as a combination of the previous two issues, the third may be described as limited political gains that can be achieved by resolving (or preventing) environmental problems. Since the outcomes of environmental policies are often not concrete (decreased lead in the air is not observable nor its gains easily quantifiable or immediately observed), there is the possibility that such efforts will bring few “political gains”—in cases like these, the public may be reluctant to get involved with such policies. The underlying assumption here is that in Turkey, the majority of the public is neither well-informed, nor highly concerned about the environment, or, as the post-materialism thesis of Inglehart would have it, not prepared to demand higher quality environmental outcomes. Studies have shown that while the public in Turkey does in general value the environment, and is worried about environmental problems, environmental issues are nonetheless not considered a priority; the level of environmental awareness overall was observed to be not particularly high (Adaman, Goksen & Zenginobuz, 2003; Inglehart, Basanez, Diez-Medrano, Halman & Luijkx, 2004; Eurobarometer, 2006).

As the fourth dimension we observe that, at the level of local governance, conflicts may mar the efficiency of all institutions involved. Because there are externalities and freeloading in matters relating to local governments, agencies may opt for a "drag your feet" policy when it comes to the environment. If more than one municipality is using the same lake, each municipality will expect the others to work for the environment while undertaking almost nothing themselves. Or if the river receiving discharged wastes affects the neighboring municipalities, the ones that pollute the river will not concern themselves much. Examples of such behavior are well widespread as most rivers, lakes and bays are becoming increasingly polluted. Here, in passing, we should also mention that property rights over most natural goods and services are not well-defined, leaving a vacuum at the legislative level.

And lastly, modernization and more importantly an almost religious adherence to modernization politics have shaped much of contemporary Turkey, and the environment is no exception. If growth and the environment are in contradiction, the tendency to choose growth may dominate. Moreover, belief that rapid growth will enable the transition to more environmentally-friendly technologies may determine the agenda. Turkey's appetite for modernization is well-known (Lewis, 2001); it may be argued that this appetite usually masks the social and environmental problems that can accompany rapid modernization. At this point, we would like to highlight the fact that suggestions as to environmentally-friendly modernization processes have yet to come to the fore as noteworthy alternatives at the state level.

The other side of the coin includes matters that explain why the state may tend toward pro-environment policies. Here four major dimensions come to the fore.

First, as discussed above, Turkey is obliged to meet certain conditions for EU accession. In other words, Turkey is required to harmonize its environmental legislation with that of the EU in accordance with the "Environmental *Acquis*". Clearly, any problems in implementation must be seriously addressed during this time as well. As long as the state mechanism takes the EU process seriously, it will have to take pro-environment steps.

Second, it is true that beyond the EU, global environmental politics are relevant to Turkey's environmental performance, although as mentioned above, their impact is much less salient. Nevertheless, in a setting where environmental concerns are growing daily in the international arena, Turkey may not wish to be excluded from these processes. Ongoing negotiations on how best to tackle the issue of human-induced global climate change are perhaps the best test case to observe to what extent Turkey will be willing or able to resist pressures to reduce its greenhouse gas emissions, a threat perceived neither as immediate nor catastrophic by policy-makers and the general public alike.

The third position argues that the position of the general public and specific demands from social stakeholders are of major significance. Strong and well-articulated demands from social stakeholders, especially when the media is incorporated, will likely be met with affirmative responses.

Finally, sustainable development is more than the sum of a number of principles or dictates on what and what not to do. To genuinely pervade policy-making, sustainable development needs to be taken up as a major guiding principle in all aspects of it. Thus, this dimension concerns the full acceptance of sustainable development and its components at the state level. For example, while the State Hydraulic Works was interminably obsessed with building reservoirs or dams on even the smallest rivers (no doubt a reflection of an ideology informed by Turkey's modernization politics) with no concern for ecological impact until recently, it has finally acknowledged the need to embrace the "basin management" approach and begun to take note of its effect on the environment. Such a shift in ideological outlook regarding the definition and resolution of problems is certainly crucial to environmental effectiveness.

The question that needs to be asked at this point is whether the state, or even its constituent layers, can be seen as monolithic. Reducing the structure of the state to subcategories, and examining the sometimes-differing stands they take in relation to the environment, may allow for a much-detailed analysis. While the armed forces do not have a readily apparent stance concerning the environment (on the one hand, the continued expansion of Turkey's network of dams in Southeastern Turkey, with serious environmental impact, can partially be seen as the armed forces' stand that transboundary riparian management and control is essential to national security; on the other hand, the military brass has historically channeled financial resources and significant manpower to regular national campaigns to plant trees across the country), the legislative and executive bodies have been observed to take differing stands on the environment from time to time. For instance, during the Bergama mining process, recall that the legislative body had ruled to ban the operation of the mine, while the executive body decreed that mining could continue. It is notable that the eventual "breakthrough" in the case came from "Danistay" (Council of State), an arm of the state where a certain overlap can be observed between the judiciary and executive.

It is one thing for the state mechanism to make a pro-environment decision; enforcement of that decision is something else. For this is the point where enforcement agencies enter the stage. Given that the role attributed to *enforcement agencies* is to enforce decisions (decisions that may be pro- or anti-environment, as stated above) taken by a higher entity (the state), factors that influence whether or not a pro-environment decision is properly implemented may be assessed and summarized under these four headings:

- Deficient legislation: Unclear matters and loopholes in judicial procedures may make implementation difficult; imprecise definition of responsibilities, charging more than one agency to undertake the same duty, *et cetera*, leads to irregularities in enforcement efforts.
- Capability level: Deficiencies in human capital, equipment, *et cetera*, and organizational capacity, may render the enforcement agencies ineffective.
- Encouragement system: In cases where performance criteria to be applied to those employed are erroneously formulated, and encouragement structures that would ensure the necessary effort is spent do not exist, implementation problems will surely follow—for in such cases it should come as no surprise that the typical "civil servant attitude" will flourish (meaning that civil servants will not perform at a high level, knowing they will get paid regardless).
- Corrupt networks: Personal interests supersede public interests as a result of patronage or bribery relations. This means social stakeholders "collaborate" with enforcement agencies through corrupt networks and prevent the implementation of pro-environment activities, or similarly prevent judicial mechanisms from (fully or properly) conducting the necessary procedures against environmental devastation. At this point and in addition to blatant bribery, we also refer to mutual in-kind assistance, patronage relationships, that is damaging to public interest.

Consequently, if it is the case that enforcement agencies are unwilling to execute the instructions given to them (if undertaking the task requires effort and there is nothing to offer as encouragement in return), or consciously refrain from carrying out the task due to corrupt networks, or if the existing regulations are unclear, then the task will not be undertaken. On the other hand, enforcement agencies may wish to conduct the task as per instructed, but may lack the necessary equipment and thus not achieve as effective results as desired.

This concludes the explanation of the arrows leading from the enforcement agencies in Figure 1. The arrows do not define strategy, but only convey possible situations. Clearly, as mentioned above, it is possible for any player to adopt a *pro-environment* stand on one issue, and an *anti-environment* stand on another. Moreover, in our assessment of relationships, we did not touch upon *counter effects*; for instance, we discussed how social stakeholders impact the state, but we excluded how the state impacts stakeholders from the discussion. In the end, reality is much more complex than what our analysis shows. However, we chose to examine the main directions of impact and the main forces, for simplification purposes.

In this context, the final point to emphasize is the quality of the relationship between stakeholders, and between the state and enforcement agencies. When stakeholders choose a pro-environment stand, they will expend various types of resources to influence the different levels of the state mechanism by using especially the media. Consequently, the stance adopted by the media is crucial. However, if efforts to make an impact are anti-environment in nature, then we would need to consider that if the steps taken for unfair gain are to bear fruit, especially if existing legislation is to be bypassed, then patronage and corrupt relationships will become imperative. This may be valid both in terms of the state as well as the enforcement agencies. Here, too, the stand of the media will be of great importance.

3. CONCLUSION

The framework outlined above is a proposal for an analytical model to understand environmental policy processes in Turkey reflecting a political economy approach. Based on the idea that it would be beneficial to design the analytical analysis by beginning with concrete events and moving backwards, it becomes clear that almost all policy decisions and the implementation mechanism of each decision corresponds to different equilibria and conflicts. Capturing the holistic nature of these processes will offer us a rich roadmap on the formulation of environmental policies in Turkey. Only and only when we have such a roadmap in hand will we have the opportunity to conduct a more detailed analysis of the origins of policy choices and problems in implementation.

To understand the general and the environment-specific structure of Turkish politics, it is necessary to gauge the characteristics, stances and powers of the political players. One reality that must be kept in mind is that in Turkey's political arena, patronage-based networks play a significant part in defining the relationships between the public and the civilians, and the elected and the bureaucracy. This structure is mainly built on "reciprocity" and rooted in settings far from transparency and accountability, relying mostly on Ottoman heritage, and as a result causing grave erosion in the public arena. With regard to the environment, it is clear that neither civil society—still on rather shaky feet—nor EU-based policies are likely to take a robust stand against this case of erosion. Furthermore, it would be beneficial to add that a plan for growth that does not pay much attention to environmental costs has quite a few supporters in Turkey; it would also seem that those advocating a perspective that welcomes all types of foreign capital with open arms, without examining their impact on the environment first, are not a small percentage at all. Making this harsh truth visible will perhaps bring about the opportunity to create change in the opinions of larger groups of people.

To summarize, the environment, perhaps due to its definition, is a good with dominant public features. Pollution and destruction affect us all (some of us more, some of us less) one way or another. If accepting this truth brings with it the adoption of an environmental stance that is longer term and more equitable, leads to the transformation of the public into being transparent and accountable, and helps develop the necessary structures for encouragement, then there still remains hope for the future.

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Chapter 15

ACCESS TO FINANCIAL SERVICES IN TURKEY: INSTITUTIONAL BARRIERS AND OPPORTUNITIES

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ABSTRACT

Despite three-decades of reform, it is astonishing to see that one out of two Turkish adults is still excluded from the financial system. Such exclusion is an incredible waste of capital and talent for any country, given the positive effects financial access has on economic growth and poverty reduction. Not surprisingly, this issue has come to the forefront of the agendas of the World Bank, IMF, UN and development agencies in recent years. The high level of exclusion in Turkey is both a great challenge and opportunity. This article explores the level of (and barriers to) financial access in Turkey and draws some policy lessons for the future.

Keywords: Turkey, financial access, barriers, growth, emerging markets.

INTRODUCTION

Money and finance have been considered a *sideshow* in traditional economics. In classical theory, capital markets are perfectly efficient and all agents posses full information. Hence, there is no essential function served by financial institutions. Likewise, Keynes never attached much weight to the productive role of financial intermediaries in the economy, except to note the disarray that a collapse of the banking system can cause. Apparently, money was *irrelevant* in classical economics and an *enemy* in Keynesian economics.

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However, McKinnon (1973) and Shaw (1973) begged to differ. In their view, there are two kinds of monies, *inside money*, meaning bank deposits supporting private sector loans, and *outside money*, meaning cash outside of the banking system. Economic growth is spurred by creating incentives for people to avoid holding true deadweight assets (outside money such as gold, jewelry and other physical objects that are often prized as inflation hedges) and to instead trust the financial systems and create more inside money. More inside money means more funds are channeled by banks to productive uses, hence more economic growth. Time has proven them right. Finance has been shown to *matter* for countries' economic development. The empirical and theoretical evidence that finance causes growth is so robust that it is available at all levels (country, sector, firms, and households) and supported by various econometric techniques. Furthermore, based on extensive cross country databases, researchers have found a strong and causal relationship between indicators of financial sector development and GDP per capita growth, productivity growth, poverty, firm growth, and entry rates (see Beck and Levine, 2005 for the review of the literature).

Finance is important for several reasons. It promotes growth through raising and pooling funds, thereby allowing more and more risky investments to be undertaken, by allocating resources to their best uses, by monitoring usage of funds, and by providing instruments for risk management. More importantly, finance helps with improving income distribution and poverty reduction (Beck et al., 2004). Clearly, financial development is not only *pro-growth* but also *pro-poor*. More abundant private credit creates a rising tide that lifts all boats but gives a bigger lift to the poorest ones, according to Asli Demirguc-Kunt, a research manager in the World Bank. Hitherto, the empirical literature behind the evidence that finance causes economic growth has used financial sector *depth,* typically measured as the ratio of financial assets (e.g., private credit or liquid liabilities or total deposits) to GDP as the "independent variable". The underlying assumption was that financial depth is a good surrogate for financial development. However, de la Torre et al. (2006) rightly argue that the intricate web of institutional and market interactions at the heart of financial development can hardly be reduced to a single dimension. Financial development, with all of its dimensions, not just financial depth, lubricates and boosts the process of growth. These dimensions include *stability*, *depth,* and *breadth* (access to finance). Of these dimensions, access to finance is a new discovery that has attracted wide attention from the World Bank to the United Nations and from politicians to academicians in a very short time.

Political democracy and market economy are separable concepts, but they tend to converge over the long run. McKinnon and Shaw postulate that private intermediaries operating in a liberalized financial environment (as distinct from government planners) make better use of funds at their disposal. There is much empirical support for their view that financial liberalization leads to financial deepening and fosters a more efficient allocation of investment (Williamson and Mahar, 1998). However, the well known study, "Good-bye financial repression, hello financial crash" (Diaz-Alejandro, 1985), reminds us that the economic stage should be prepared for change before liberalization is put in motion; otherwise the system could become prone to crashes, as demonstrated lately in Chile, Mexico, Russia, and several Eastern and Central European countries. Banks and securities markets cannot function properly unless their institutional foundations are strong. At the very least, we have learned out of experience that sudden financial liberalization can create instabilities when the underlying institutional structure contains serious weaknesses. Thus, the way financial liberalization occurs also matters, particularly for ensuring that financial development rests on sound institutional footings. It seems that what matters the most for growth is not the *form* in which financial services come, but the fact that they are provided in an efficient manner and supported by a proper institutional and competitive environment (Claessens, 2005). In many developing countries, areas where it is obvious that progress can be made in furthering access to financial services are institutional infrastructure improvements. Better legal, information, payment systems, distribution, and other infrastructures are needed in many countries. Governments can play a critical role in creating or strengthening the foundations of a financial system. Inspired by the worldwide trends in the 1980s, Turkey has embarked on a long path to build institutional foundations, open its economy, and liberate its markets. In this article, we will evaluate the current level of financial development and financial access in Turkey as compared to other countries in order to judge the success of financial, institutional, and legal reforms that have been at work for the past three decades in the country.

1. ACCESS TO FINANCE AND INSTITUTIONAL FOUNDATIONS

Access to finance means the absence of price and non-price barriers to the use of financial services. It measures the degree of dispersion of financial services across a country. Thus, *financial breadth* –who has access to financial services– is at least as important as *financial depth* –what is the size of financial services industry– in determining economic growth.[1] Financial inclusion can promote growth, reduce poverty, and alleviate income inequality. Theoretical studies indicate that frictions in financial markets may hinder broad access and can result in income inequality and poverty traps (Banarjee and Newman, 1993). Market imperfections in the form of informational asymmetries, transaction and contract enforcement costs are especially binding on poor or small entrepreneurs who lack collateral, credit histories, and connections. Lack of access reduces the efficiency of resource allocation and has adverse consequences for growth and poverty alleviation (Galor and Zeira, 1993). Schumpeterian argument tells us that financial development causes growth because it fuels the process of "creative destruction". However, it is through broader access to finance that talented newcomers are empowered and freed from the disadvantages that would otherwise stem from their lack of inherited wealth and absence of connections to the network of more privileged incumbents. Access to finance for large parts of the population is thus seen as essential to level the playing field, expand opportunities beyond the rich and connected, and promote democracy and a market economy (Rajan and Zingales, 2003). Above all, access to financial services is considered "public good" by some authorities, the same as safe water, health services, and education (Peachey and Roe, 2004).

Individuals and firms outside the system are untapped resources, thus representing forgone opportunities for an economy. *Outside money* is a waste and drain from the banking system and often times results from trust issues. The use of this type of money may be reduced by increased confidence that the rules, contracts, and personal and business practices are fair and can be trusted. Unless people have some trust in the rule of law and government,

[1] Hanohan (2007) showed that there is a positive but weak relationship between financial depth and breadth measures, indicating that financial depth and access are two distinct dimensions of financial development and play different roles in affecting economic growth.

they will not part with their money and lend it to a ‘stranger’ with productive opportunities. Hence, there is a strong connection between rule of law, confidence in government, willingness to trust nonfamily, and economic well being. In his provocative book, ***Trust***, Fukuyama (1995) examined the importance of interpersonal trust in making societies and economies work. In *low trust societies,* he found that the extended family is the only social unit that inspires trust, and any dealings beyond the family or tribe requires great care. Modern economies are so complex that they cannot function well without known, enforceable rules that protect arm’s length relationships in the marketplace. In environments with weak institutions and lack of trust, contract writing and enforcement is difficult and publicly available information is inadequate. Agency problems tend to be alleviated with mechanisms between private parties that rely heavily on personal relationships, fixed collateral, and group monitoring, which hinders financial and economic development to a large extent. Arm's length financing frees borrowers from the encumbrance of using collateral and personal connections, yet necessitates the prompt and unbiased enforcement of private contracts by a third party (governments and/or courts). Hence, in integrated economies, dealing with strangers is inevitable and requires a commonly accepted rule of law by established governments. Thus, the vast gains from broad participation in financial markets depend on the establishment of strong institutions and enforcement of credible laws (Beim and Calomiris, 2001).

As of 2009, Turkey is the 15’th largest economy in the world and the 6’th largest in Europe (IMF). However, Turkey has bigger aspirations for the future. In 2023, it will celebrate its 100’th anniversary as a republic. In many circles, Turkish politicians boastfully express their wishes that by then they want to see their country among the 10 largest economies. Turkey is currently about a $700 billion dollar strong economy. To play in the giants’ league, the economy should surpass the 1 trillion dollar threshold, requiring the national output to rise about 50% until then. Regardless of whether this ambitious goal is achievable or not, one thing is certain that Turkey needs more labor, capital, technology, land, and entrepreneurs to support such a “great leap forward”. The cardinal obstacle facing Turkey is a shortage of capital. An export oriented economy and FDI bring in some required additional funds. However, this is neither sufficient nor reliable.

Whether money or talent or nature or knowledge, developing economies tend to underutilize *all* their resources. By 2008, the size of the entire Turkish banking industry is around half a billion dollars. This is below the size of a mid-size bank in the EU. The ratio of bank assets to GDP is about 70% in Turkey, whereas it is 900% in Luxemburg, 600-700% in Ireland and the UK, and 200% in Italy and Greece. Lower inside money in Turkish banks means insufficient funds to support the intended growth. This could be a product of the country’s prosperity level or the public’s attitude to financial institutions. Where is the money then? We know that “above ground money” should be either in banks or in securities markets. Turkish bond markets are literally inexistent and the stock market occupies less than 5% of the financial system. Obviously, money did not migrate to markets. One plausible explanation for the miniscule size of the Turkish banking system is that there are substantial drains from the system. Lack of trust in the financial system might have induced people to keep their money under mattresses or in alternative forms of value storage, foreign currencies, gold, or other jewelries. A country with historical goals needs every ‘lira’, every talent, and every positive NPV project, however small. Thus, financial inclusion is an important and critical policy variable for Turkey. Then, some questions become vital. What is the level of financial exclusion in Turkey? Why are many individuals and firms operating underground? What obstacles are they facing in accessing financial services? What could be done to broaden access and 'domesticate' idle resources? It is worthwhile to examine how far three-decade long economic reforms have been successful on these key fronts.

2. THE LEVEL OF BANKING SECTOR OUTREACH IN TURKEY

World Bank publishes overall financial access levels for many countries, as developed by Hanohan (2007), and indicators of financial access and use, as developed by Beck et al. (2006). *Financial access* is measured by the percentage of adults with a financial account (checking, saving, insurance, investment, or loan account) in a bank or a similar formal financial institution in a country. One should note that *financial access* and *financial use* are not the same things. People might have access to financial services but might decide not to use them, either due to socio-cultural factors or high opportunity costs. Beck et al. (2006) used the following indicators for *financial access:* 1) number of bank branches per 1,000km^2 [*geographic branch penetration*]; 2) number of bank branches per 100,000 people [*demographic branch penetration*]; 3) number of bank ATMs per 1,000 km^2 [*geographic ATM penetration*]; 4) number of bank ATMs per 100,000 people [*demographic ATM penetration*]. For *financial use,* they adopted these variables: 1) number of loans per 1,000 people [*loan accounts per capita*], 2) average size of loans to GDP per capita [*loan-income ratio*]; 3) number of deposits per 1,000 people [*deposit accounts per capita*]; average size of deposits to GDP per capita [*deposit-income ratio*]. Geographic penetration variables are proxies for the average distance for a potential client from the nearest physical bank outlet. Demographic penetration indicators are a proxy for the average number of people served by each physical bank outlet. Higher loan and deposit accounts per capita indicate greater use of financial services. However, higher loan or deposit income ratios indicate that banking services are more limited in use, because they are likely only to be affordable to wealthier agents. Utilizing the data collected by the World Bank, Table 1 shows the overall level of financial access and bank outreach in Turkey vis-à-vis world statistics.[2]

Overall financial access level for Turkey is 49%, indicating that about half of the Turkish population does not have any account in a financial institution, somewhat validating the extreme levels of capital flight from the system. Global access average is 41% and median is 32%. Turkey is between 50%-75% quintiles globally in terms of access. To be exact, its ranking among 157 countries is 26. However, this does not mean that there are 25 countries above Turkey. In fact, there are 46 countries ahead of Turkey, as many superior countries have equal access levels. There is universal access in Netherlands (100%). However, in Tanzania and Nicaragua, only 5% of the population has access to financial services. Average access is 90% for the OECD countries and 26% for developing nations. Among the EU countries, Turkey's access level is the lowest, except for Romania. Table 1 also provides the level of financial development (depth) as measured by the ratio of private credit to GDP in 2003. Turkey's financial depth ratio is 17.1%. The average financial development is 57% for the world, 163% for the USA and 159% for Switzerland. In terms of financial development in 2003, Turkey seems to lag behind 75% of the countries. These causal observations imply a close association between financial access, depth, and economic growth. It also reminds Turkey of the distance it needs to travel to catch up with the more advanced countries.

Financial access is closely related to the proximity of bank outlets and affordability of financial services in a country. Turkey has 7.81 bank branches and 16.54 ATMs per 1,000 km^2. Bahrain, Belgium, Malta, Netherlands, and Singapore have more than 120 branches per 1,000 km^2; Korea, Malta, Bahrain, Japan, and Singapore have more than 253 ATMs for the same area. The global averages (medians) are 30.2 (4.9) and 13.0 (10.5), respectively. Turkey's ranking is 44/103 for branch penetration and 38/94 for ATM penetration. As for demographic penetration, 8.5 branches and 18 ATMs serve 100,000 people in Turkey, whereas, 96 branches in Spain, 2,643 ATMs in Singapore serve the same number of people. Global averages (medians) are 13.9 (8.4) and 28.4 (16.7), respectively. The ranking of Turkey for demographic penetration is 48/103 for branches and 39/94 for ATMs. These observations indicate that the level of both geographic and demographic penetration in Turkey is not on par with more advanced economies.

As for the availability of the most widely used financial services (loans and deposits), per 1,000 people, there are 265 loan and 1,114 deposit accounts in Turkey. This indicates that there is more than one deposit account per capita. However, because more than half of the Turkish population is unbanked, the implication is that some individuals and firms have more than one account with banks. Global averages (medians) are 199 (81) and 944 (529), respectively. Turkey's rank is 13/44 for loan accounts and 20/54 for deposit accounts. In terms of loan usage, the champions are Greece (776), Poland (774) and Israel (710), whereas in deposit usage, the leaders are Austria (3,120), Belgium (3,080) and Denmark (2,706). In Albania, there are just 4 loans per 1,000 people. Turkey is above average in terms of both loan and deposit accounts. The top 25% of the countries have 305 loan accounts and 1,500 deposit accounts per 1,000 people. The average size of loans to income is 0.65 and the average size of deposits to income is 0.68 in Turkey. This places her below 75% of the countries. The lower these ratios, the more affordable and accessible these services are. In Bolivia, average size of a typical loan is 28 times greater than the average income, which probably keeps many potential borrowers at bay. However, in Poland, the loan size is only one-third of the average income. In terms of the deposit income ratio, Turkey is in the middle, with 68%. This ratio is 931% for Madagascar, 4% for Iran and 7% for Russia.

[2] The overall access statistics reflect the latest available data in 2007 and banking sector outreach data come from 2003-04.

Table 1. Financial access and banking sector outreach measures in Turkey

Access Variables	Turkey Score	World Mean	Min	25%	50%	75%	Max	# of obs
% Access	49	41	5	20	32	56	100	157
Ratio of private credit to GDP (1999 to 2003)	0.171	0.6	0.0	0.2	0.4	0.9	1.6	92
# of bank branches per 1,000 km^2	7.81	30.2	0.1	1.7	4.9	21.4	636.1	103
# of bank ATMs per 1,000 km^2	16.54	75.8	0.1	1.6	10.5	38.7	2642.6	94
# of bank branches per 100,000 people	8.5	13.9	0.4	3.8	8.4	15.2	95.9	103
# of bank ATMs per 100,000 people	18	28.4	0.1	5.2	16.7	40.7	135.2	94
# of loans per 1,000 people	264.51	198.5	4.4	50.1	80.6	305.4	776.5	44
# of deposits per 1,000 people	1,114.23	943.9	14.5	291.0	528.9	1545.3	3120.0	54
Average size of loans to GDP per capita	0.65	5.6	0.3	2.1	3.7	6.4	27.9	44
Average size of deposits to GDP per capita	0.68	1.6	0.0	0.4	0.7	1.7	9.3	54

Source: World Bank (2008).

3. Barriers to Financial Access in Turkey

Despite the fact that Turkey has come a long way, the financial system is still in its infancy. Turkey is a mediocre country in terms of financial access and development, with half of the population outside the financial system. Market frictions such as transaction costs and asymmetric information necessitate the existence of financial institutions. These frictions may limit the extent to which financial institutions can reach out to clients. Barriers like high minimum deposit balances, minimum loan amounts, and fees can lead to exclusion by making these services unaffordable for large segments of the population. Using back-of-the-envelope calculations on income distribution, Beck et al. (2006) demonstrated that fees to maintain checking accounts effectively prevent more than 30% of the population from using such services in 10 of the 58 countries in their sample (more than 50% in several African countries). The limited breadth and depth of the Turkish financial sector imply that there must be some barriers to bank access and use. In this section, we will examine the likely barriers. World Bank researchers have developed a number of indicators of barriers to financial access and categorized them into three different dimensions: 1) *Physical access* refers to the points of service delivery. 2) *Affordability* means the costs in terms of minimum balances and fees that bank customers need to pay to obtain financial services. 3) *Eligibility* refers to the criteria (in terms of documents or other requirements) that determine who can access financial services and who cannot. Using the survey results collected by the World Bank, we created Table 2, showing the barriers to *deposit services*; Table 3, displaying the barriers to *consumer* and *mortgage loans*; Table 4, exhibiting the barriers to *business* and *SME loans*; and Table 5, summarizing the barriers to *payment services* in Turkey in comparison to other countries. The purpose is to uncover the reasons behind the level of repression in Turkish financial markets and institutions in terms of access.

To open an account, banks in many countries require various documents on top of ID cards such as recommendation letters, wage slips, and proof of domicile. The most severe barriers to open a deposit account in Turkey seem to be bureaucratic (Table 2). The average number of documents demanded is 3.20 for a checking account and 2.40 for a savings account in Turkey, substantially greater than the world averages (2.49x2.13) and medians (2.53x2). In addition, the costs of using these services appear to be above the world average, especially for savings accounts. This may limit the affordability of these services for the wider public. Annual maintenance fees, as a percentage of average income, are 0.30% for a checking account and 0.14 % for a savings account in Turkey. On the other hand, responding Turkish banks do not impose any minimum amount to open or maintain an account, which is good for financial access. Table 3 and 4 display the indicators of physical access, affordability, and eligibility for 4 different types of loans – consumer, mortgage, business, and SME loans. The most important barriers to consumer and mortgage loans in Turkey seem to be affordability constraints. Fees paid by Turkish customers for a housing loan reach 2.16% of the minimum loan amount. This is at least twice the amount paid by the residents of more than 50% of the countries in the world. The minimum amount of a mortgage loan is 165% of the average income in Turkey, which is also much more than the typical resident of the world (144%). As Table 5 shows, Turkish residents are not exposed to excessive fees in terms of making payments. The cost of wiring $250 internationally is 6.34% of the wired amount, which is close to the world median.

Table 4 summarizes the barriers to business and SME loans. It seems that Turkish firms face sizable cost and bureaucratic obstacles in doing business. Fees charged on business and SME loans in Turkey are above the world medians. Days to process loan applications are about 14 days in Turkey, whereas it is 11 days for the median country. World Bank conducts two surveys to measure the barriers to business across the world, World Business Environment Survey (WBES) and Investment Climate Survey (ICS). In these surveys managers are asked about the obstacles they face in their operation and growth, including several questions related to the financial system. According to the WBES results, 36% of all firms around the globe rate financing a major obstacle, 27% moderate, 18% minor, and 19% no obstacle for their growth. Evidently, 81% of the respondent firms see finance as an obstacle (with varying degrees). The World Bank survey on Turkish firms was done in 2008. We construct Figures 1.A to 1.E to summarize the findings. Turkish firm managers claim that the main obstacle they face for growth is access to finance. 26% of all Turkish firms rate access to finance, 18.21% tax rates, 17.52% political instability as the major barriers for their growth potential (Fig 1.A). It is also clear that Turkey faces more severe finance constraints than its income and geographical counterparts in Eastern Europe and Central Asia (Turkey is also among the OECD countries that bear the highest finance obstacles). It is also obvious that *domestic firms* are suffering more from finance hardships than *foreign firms* operating in Turkey (Fig 1.B). Small firms and firms in countries with poor institutions use less external finance, especially less bank finance. Evidently, among the different sized firms, *SMEs* are more constrained in Turkey. While only 10% of large firms report finance as their main obstacle to growth, 16% of small firms rate finance as the main obstacle (Fig 1.C). *Export* *oriented* firms are less restrained financially (Fig 1.D). Most of the firms that consider finance as the major barrier operate in the *service sector* (Fig 1.E). As compared to industrial firms, service firms posses less tangible assets to pledge as collateral to support a loan application. The quality of legal systems, property rights and the presence of mechanisms for reliable information are especially important for small firms (Beck et al., 2005).[3] Our results demonstrate that all kinds of firms are facing important barriers to financial access in Turkey, but finance constraints are more acute for the SMEs. An environment conducive for small firms to grow and/or act bigger is essential for long term growth. With further legal, institutional, and economic reforms, Turkey may take important steps towards her goal of joining the major world economies on the shoulders of small, but vibrant entrepreneurs.

4. What Explains the Variations in Access to Finance?

Explanations of the lack of access fall into two dimensions: financial institutions' specific factors and barriers from the overall institutional environment. Beck et al (2005) in their empirical analysis explored such factors and barriers to explain cross-country variations in access to finance. Their correlation and regression results show that financial access indicators are significantly and positively associated with conventional indicators of economic development (GDP per capita) and financial development (private credit, liquid liabilities, and bank deposits to GDP). They also find that geographic access to banking services is positively correlated with population density. Expectedly, access to financial services is greater in larger economies. These results somewhat reflect *economies of scale* in the provision of financial services. Another noteworthy finding is that where access is wider, firms report lower financing obstacles.

Moreover, even after controlling for country size and density, the authors detected important associations between financial access and other country traits and policy variables. In particular, they find that a better communication and transportation infrastructure is closely associated with greater access. Countries with better developed institutions enjoy greater levels of financial access. Quality of credit information sharing systems is positively associated with measures of access to bank outlets, whereas, restrictions on banks' activities and entry requirements are negatively correlated with access. They also reported that government ownership of financial intermediaries does not necessarily mean greater access and more concentrated banking systems are unexpectedly associated with more usage of financial services. Foreign banks do not directly increase access, nonetheless, their very existence pushes local firms to look downward and reach more customers. Interestingly, the effect of outreach does not systematically vary across firms of different size.

[3] Institutional environment matters more for SMEs than households. Better protection of property rights increases external financing of small firms significantly more than that of large firms, mainly due to more bank and equity finance. It also appears that substitutes to bank finance are imperfect; e.g., small firms do not use disproportionately more leasing or trade finance compared to larger firms (Claessens, 2005).

Table 2. Barriers to deposit services in Turkey

			Physical access	*Affordability*						*Eligibility*	
	# of banks responding	Deposit market share (respondents share)	Locations to open deposit account (out of 3)	Minimum amount to open checking account (%GDPPC)	Minimum amount to open savings account (%GDPPC)	Minimum amount maintained in deman account (%GDPPC)	Minimum amount maintained in savings account (%GDPPC)	Annual fees checking account (% GDPPC)	Annual fees savings account (% GDPPC)	No. of docs. to open checking account (out of 5)	No. of docs to open savings account (out of 5)
Turkey	3	50.14%	2.20	0.00	0.00	0.00	0.00	0.30	0.14	3.20	2.40
World	193	48.25%	2.14	11.09	7.79	3.85	5.65	2.36	0.55	2.49	2.13
Minimum	1	4.63%	1.00	0.00	0.00	0.00	0.00	0.00	0.00	1.00	1.00
5%	1	13.68%	1.50	0.00	0.00	0.00	0.00	0.00	0.00	1.00	1.00
Median	3	44.56%	2.00	0.62	0.88	0.00	0.45	0.30	0.00	2.53	2.00
95%	5	89.08%	3.00	57.17	45.26	14.23	31.36	11.69	3.38	4.15	3.92
Maximum	6	100.00%	3.00	141.84	70.92	123.77	73.83	26.63	7.79	4.57	4.72
# of obs		69	70	70	70	70	69	70	70	70	70

Source: World Bank (2008).

Table 3. Barriers to loan services: consumer and mortgage loans in Turkey

			Physical access	*Affordability*				*Eligibility*	
	Number of banks responding	Loan market share (respondents share) 2004	Locations to submit loan applications (out of 5)	Minimum amount consumer loan (% GDPPC)	Fees consumer loan (% min. loan amount)	Minimum amount mortgage loan (%GDPPC)	Fee mortgage loan (% min. loan amount)	Days to process consumer loan applications	Days to process mortgage loan applications
Turkey	3	38.33%	4.15	11.83	0.95	165.37	2.16	2.94	5.00
World	193	45.19%	3.23	56.79	3.07	428.58	3.70	4.58	12.68
Minimum	1	5.61%	1.77	0.00	0.00	0.00	0.00	0.73	1.00
5%	1	14.43%	2.00	0.03	0.00	0.00	0.01	1.00	1.67
Median	3	43.17%	3.05	13.63	1.08	143.77	1.09	2.94	9.45
95%	5	80.46%	5.00	215.50	6.16	1631.76	9.11	14.10	33.70
Maximum	6	100.00%	5.00	1153.17	109.24	5157.40	109.24	20.71	70.63
# of obs		75	76	75	75	72	73	75	73

Source: World Bank (2008).

Table 4. Barriers to loan services: business and SME loans in Turkey

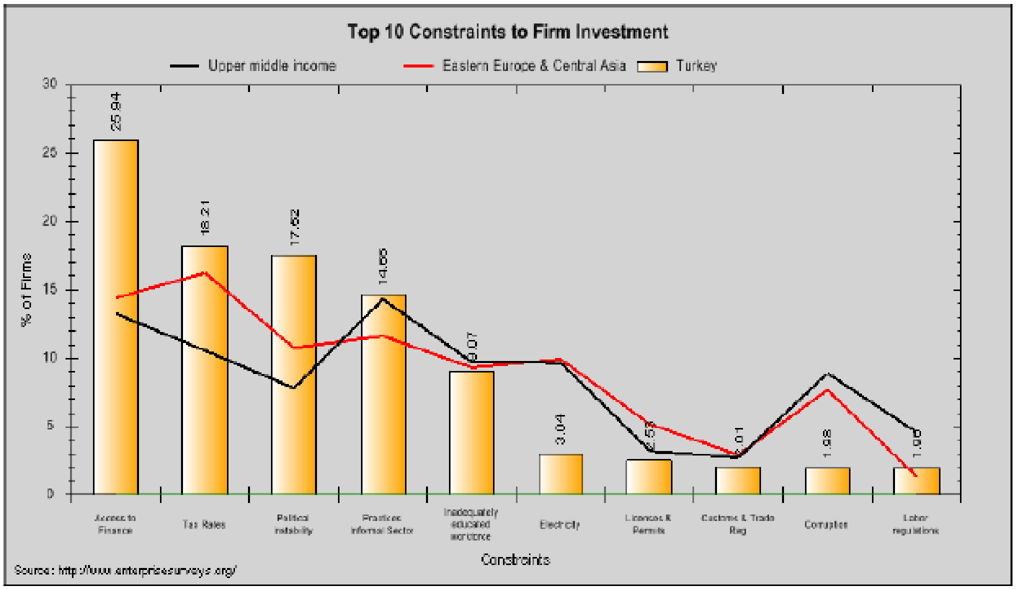
			Physical access	*Affordability*				*Eligibility*	
	Number of banks responding	Loan market share (respondents share out of total system)	Locations to submit loan applications (out of 5)	Minimum amount business loan (% of GDPPC)	Fee business loan (% of min. loan amount)	Minimum amount SME loan (% of GDPPC)	Fees SME loan (% of min. loan amount)	Days to process business loan applications	Days to process SME loan applications
Turkey	3	38.33%	4.15	74.26	1.94	18.57	1.41	13.75	4.61
World	193	45.19%	3.23	2259.06	4.73	337.58	4.67	12.68	11.03
Minimum	1	5.61%	1.77	0.00	0.00	0.00	0.00	1.00	1.00
5%	1	14.43%	2.00	0.00	0.00	0.00	0.00	1.99	1.99
Median	3	43.17%	3.05	55.28	1.26	39.86	1.28	10.64	9.09
95%	5	80.46%	5.00	9845.42	15.54	1876.04	16.13	31.54	31.54
Maximum	6	100.00%	5.00	64216.77	100.35	3141.17	100.35	50.00	43.26
Count		75	76	74	76	74	76	76	76

Source: World Bank (2008).

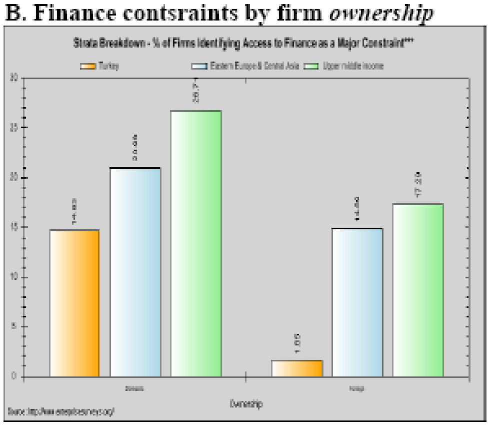
Table 5. Barriers to payment services in Turkey

	Number of banks responding	Deposit market share (respondents share out of total system) 2004	Cost to transfer funds internationally (% of $250)	Amount of fee for using ATM cards (% of $100)
Turkey	3	50.14	6.34	0.00
World	193	48.25	6.63	0.17
Minimum	1	4.63	0.12	0.00
5%	1	13.68	1.01	0.00
Median	3	44.56	6.34	0.00
95%	5	89.08	14.75	0.42
Maximum	6	100.00	20.00	5.70
Count		75	75	75

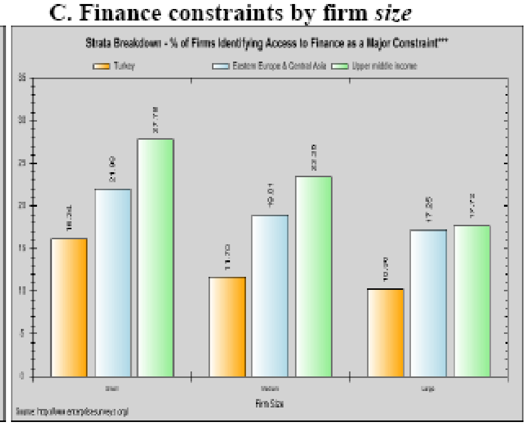
Source: World Bank (2008).



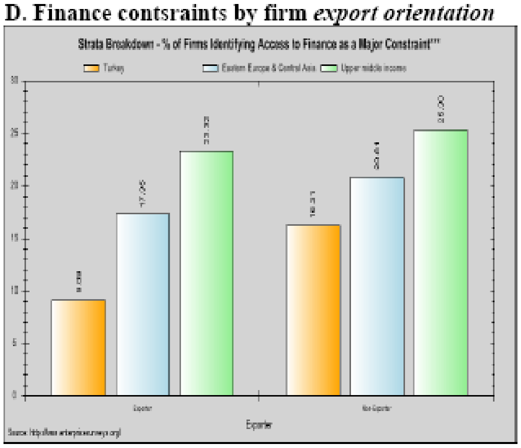
B. Finance contsraints by firm *ownership*



C. Finance constraints by firm *size*



D. Finance contsraints by firm *export orientation*



E. Finance constraints by firms' *sector*

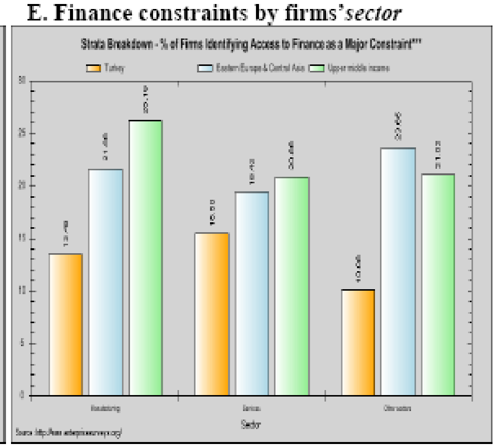


Figure 1. A Top 10 constraints to firm investment in Turkey.

In a follow up paper, Beck et al. (2006) examined the variations in *barriers* to bank access and use around the world. Specifically, they investigate indicators of 'physical access', 'affordability' and 'eligibility' barriers to deposit, loan and payment services. They found that banks in more economically and financially developed economies impose lower barriers. Barriers are negatively correlated with financial outreach and with lower financing obstacles. They concluded that bank size and the existence of physical infrastructure in a country are the most important determinants of barriers. In particular, they reported that larger banks demand lower minimum balances to open a checking account, charge lower checking and savings fees, require fewer documents to open accounts, impose lower minimum loan amounts for SMEs and consumer loans, need fewer days to process loans, and are more likely to accept loan applications through non-traditional delivery channels such as phone or the Internet. This is also another indication of *scale economies* in delivering financial services. Hitherto, empirical and theoretical literature has not attached much weight to the relationship between infrastructure, input costs, and financial depth and breadth. However, their paper's findings suggest that the quality of the physical infrastructure, such as communication and electricity networks, influences banking costs and can explain a significant chunk of cross country variation in barriers to financial access. Furthermore, they presented some institutional evidence that in more competitive, open and transparent economies, and in countries with better contractual and informational frameworks, banks impose fewer barriers. Again, despite the fact that foreign banks themselves seem to charge higher fees than local counterparts, in foreign dominated banking sectors, fees are lower and it is easier to open bank accounts and to apply for loans. Whereas in government dominated systems, bank clients may pay lower fees but face greater restrictions in terms of where to apply for loans and how long it takes to have applications processed. In other words, cheap public financial services come with lower quality. Apparently, these findings yield significant implications for policy reforms to reduce barriers and expand access to financial services.

5. CONCLUDING REMARKS AND POLICY SUGGESTIONS

More than half of the Turkish adult population is unbanked. In other words, the fraction of adults with an account in any financial institution in Turkey is less than 50% (World Bank, 2008). Isik (2009) also reports that there are wide variations and inequalities in access to finance across regions and provinces within Turkey. This implies that access to financial services is still a privilege in Turkey, confined to only wealthier and more connected segments of society. However, in advanced countries, the issue of financial exclusion has been eradicated from the public sphere, like malaria and tuberculosis of the past. The level of financial access is 100% in Netherland, 99% in Sweden, 97% in Germany and 96% in France and Canada. The average inclusion in the OECD countries is over 90%. However, Turkey, which is an accession country to the EU, is lagging behind all the member countries, except for Romania, in terms of access to and use of financial services. Recent theoretical and empirical literature shows that financial development (depth) and financial access (breadth) are not only pro-growth but also pro-poor in both absolute and relative terms. The countries with more developed financial systems both in terms of depth and breadth tend to have higher growth rates, alleviate poverty, and mitigate income inequality faster. If examined from a fine angle, the excluded represent forgone opportunities to expand the economic pie and individual slices for everyone, including the included.

So, what can be done to broaden access to financial services and raise opportunities for all in Turkey? Before answering this vital question and outlining policy prescriptions, one first should ask another vital question. What are the reasons for the financial exclusion? We need to remember that *use* of financial services is distinct from *access* to financial services. Non-users of formal financial services are either voluntarily or involuntarily excluded. Some people may opt out using such services voluntarily although they have no access issues. Voluntarily excluded people may choose not to use financial services for cultural or religious reasons or simply they may refuse to use them due to lack of need or demand. On the other hand, some people are involuntarily excluded; i.e., they wish to use financial services but they cannot access them for various reasons. Some people are screened out by banks because they do not qualify due to high risk or insufficient income. In some extreme cases, people are refused by lenders for no other reason than their ethnic background, gender, religion or age. Sometimes, financial institutions may lack adequate transaction technology or infrastructure to accommodate the people at the fringes, as serving them now may be prohibitively costly and risky. Lastly, some people simply cannot afford financial services due to high minimum balances/fees, or current services may not be tailored to their needs. Thus, policymakers who wish to expand financial access probably may not be able to do much if certain people are rightly excluded due to their high chance of default. However, they can certainly take some actions against discrimination, insufficient informational and contractual infrastructure, and high provisional costs of financial services.

In this study, when we examine barriers to bank access in Turkey as compared to other countries, we find that Turkish residents or firms do not particularly face excessive barriers in terms of physical access (proximity of branches or ATMs, or availability of on-line or phone services etc.). In terms of convenience, Turkey is actually better than more than half of the countries around the world. It seems that Turkish residents can access bank outlets easily, but they prefer not to use them. Then, what excludes one out of two Turks from accessing financial services? For involuntary exclusion in Turkey, four possibilities may exist: affordability, insufficient income and high risk profile of potential clients, discrimination, or weak contractual and informational frameworks. To answer the question, we must trace money in Turkey. Total assets of Turkish banks as of 2008 are around $500 billion dollars. This is about three thirds of the national income. Turkey lags all credible EU countries in depth. Monies of modern societies are either channeled by financial institutions or financial markets. Turkish financial markets do not seem to be the secondary address for the money. One cannot help but ask then, if money is not kept in banks or markets, where is it? It seems that money has fled the financial system; either it is parked in unproductive financial assets such as gold or jewelry, kept under mattresses, or just taken abroad. Then, the subsequent curious question is why money is escaping from the system?

Part of the flight from banks may spring from socio-economic reasons. Religious or cultural concerns may still keep away some groups from the ‘mundane’ financial institutions; despite the fact that the spread of zero-interest financial institutions in Turkey in recent years has notably shrunk this unbanked segment of the society. More can be done on this front by introducing more financial services and products compatible with religious concerns. Islamic jurists could be called into service to mitigate the theological concerns of the pious and help invent new products to domesticate still untapped funds. As for discrimination, there are some concerns in certain circles that rural money is collected and loaned in urban areas like Istanbul, Ankara and Izmir. Moreover, holding banking structure is still a prevalent organizational form in Turkey. Various major banks are under the control and ownership of the giant industrial holdings. Many entrepreneurs are complaining that they are turned down by some banks if they have projects to enter a business line or industry where the parent company of the bank is doing business as well. As for injustices on the basis of religion, gender, age, or ethnicity, it is hard to judge without concrete evidence. We need more investigation. However, the bureaucracy of opening an account or obtaining a loan in Turkey is much more problematic as compared to other countries, since Turkish banks demand more documents from clients and take more time to process loan applications. This red tape could be some, albeit weak, sign of discriminatory tendencies. Legislations in the U.S. like the Community Reinvestment Act, which bars *red-lining* certain regions, and the Equal Credit Opportunities Act, which prohibits discrimination, could be enacted to protect the innocent. Also, employing bank clerks speaking local dialects, or representing some ethnicities could help. Alternatively, the real problem could be a matter of poverty or financial illiteracy, not access, for certain groups. Then, financial or general education policies gain importance.

The large capital drain from the Turkish financial system also signifies the trust issues inflicting the whole society. Cash is still the most prominent payment instrument. Check payments are not common. Thus, people carry big stacks of cash around to settle daily transactions. Furthermore, one half of the Turkish banks have failed in 2000-01. Hence, the severe anorexia of Turkish citizens to deal with banks may be engraved in their psyche after a number of very costly and frequent mass bank failures, resulting mainly from outright fraud of bank owners and managers. The lack of an effective legal and contractual system that will timely resolve conflicts between economic agents may be keeping many Turks at bay. Market frictions like information asymmetries and agency problems can only be overcome by constructing a credible legal system, effective oversight, prudent regulations, transparent government and corporations, reliable accounting and auditing practices, and market discipline. Moreover, inflationary fears of the past could still be in the public subconscious, which might be encouraging the holding of outside money like gold. Then, prudent macroeconomic policies become instrumental. There are also some signs that many banking services are not affordable for an average Turkish citizen. Fees charged on savings accounts, mortgage, business, and SME loans are considerably above world medians. This can be the result of weak competition among Turkish banks. According to many pundits of financial development and access, public efforts in the long run should be geared towards improving the *enabling institutional environment*, where all agents would feel safe to play and deal with strangers. However, for those who are impatient and suffering from reform fatigue, the best medicine in the short run is a *stiff competitive environment*, which encourages self discipline in everyone.

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