

# THE INSTITUTIONAL FOUNDATIONS OF ECONOMIC CHANGE IN TURKEY

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**Abstract:** Turkey has attempted to institutionalize its economic endowment for a long time. In the 1980s, Turkey initiated to experience transition to *the economic institutions of capitalism* and put liberalization to the forefront in setting economic policies. In the 1990s, it suffered from the loose political structure. In this process, while the legal and bureaucratic processes resisted economic change, the political processes led to a rent seeking society. The paper focuses on the interaction between institutional endowment and economic change in Turkey. In doing so, it aims to understand the role of political institutions over economic change in Turkey.

**Keywords:** Economic Change, Reform, Institutions, Credibility, Turkey.

**JEL Classification Codes:** D02, P11.

## *Introduction*

The analysis of institutional change has generated a considerable amount of literature. 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 particular, new institutional economics has put at the forefront the role of institutions over economic change. A change in the institutional structure brings about altering incentives and is 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, 2005). 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 process of change or transition depend upon the institutional setting. The institutional setting is shaped by political institutions (Menard and Shirley, 2005). By following Levy and Spiller (1994), political institutions can be considered as the legislative, the executive, and the judiciary. For that reason, in this paper, institutions approach over

the economy presented and developed by new institutional economics is employed to analyze the institutional structure of interaction between state and markets in Turkey.

Turkey has attempted to institutionalize economic change over the last three 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 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. An influential resistance from the traditional institutional structure has constrained the success of economic change and hence the reform effort came to Turkey with its costs. The reforms have been nullified in particular by the legal and bureaucratic institutional structure. It is possible to say that the ongoing reform efforts have partly succeeded, but not led to institutionalize economic change.

To begin with, the paper 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 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 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 regulatory-institutional process 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 independent regulatory agencies (IRAs). In this sense, the paper includes an analysis of the change in the executive as the second player of institutional structure.

We analyze the judiciary as the third institution reshaping the process. 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 institutional environment have at least relatively a dynamic structure compatible with the nature of economic change, the judiciary as the third institutional actor has presented a stationary position incompatible with the change.

### *The Political Foundations of the Change*

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.

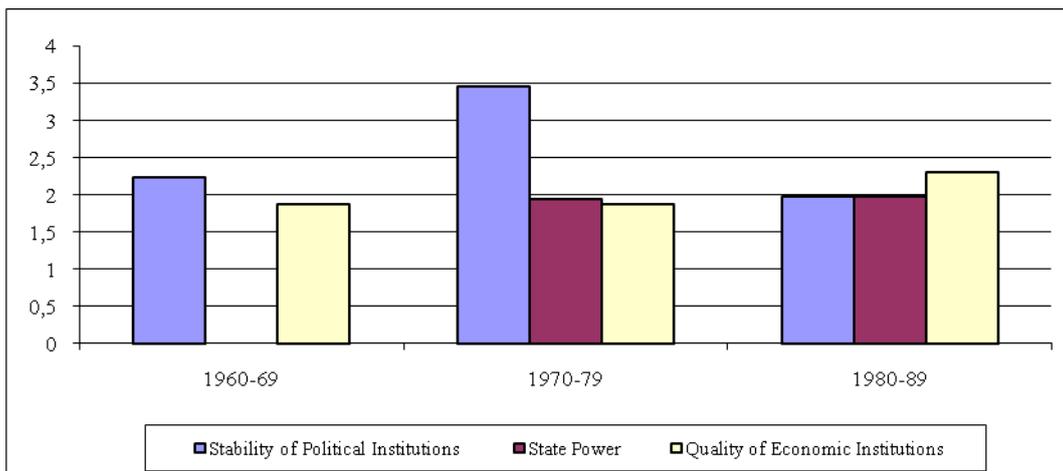
The main features of the legislature in terms of the process of economic change in Turkey can be explained characteristically and periodically. These features include some distinctive components. Characteristically, a prominent feature of the legislative politics in Turkey is the tradition of distributive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

### *The Distinctive Attributes 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 generated 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, while the stability of political institutions deteriorated and the state power on the markets increased, the quality of economic institutions partly improved (Borner et al., 2004). 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.

Fig. 1. The progress of the political and economic institutional structure in Turkey

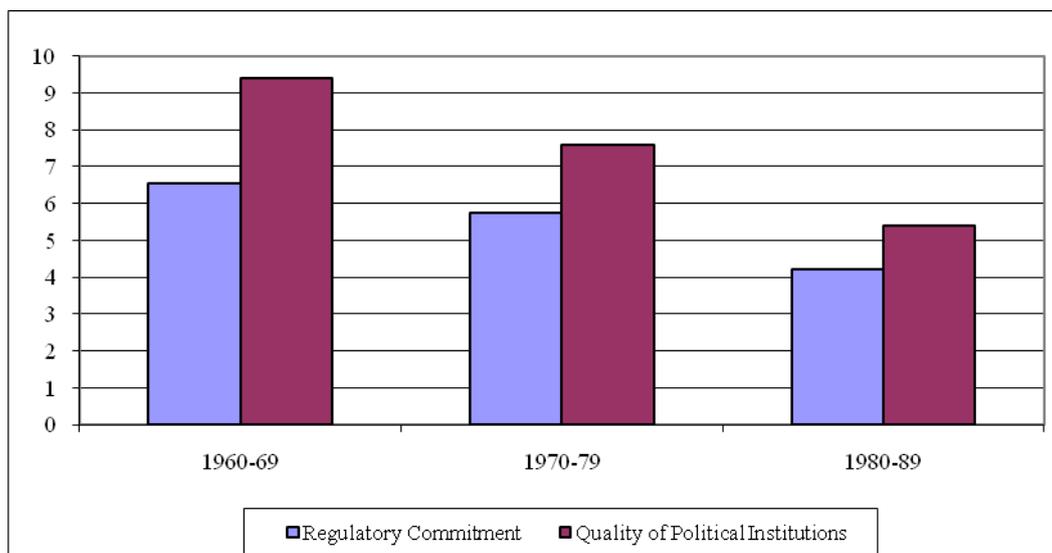


\*There is no State Power data concerning the 1960-69 term.

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

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 regulatory 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 (Borner et al., 2004).

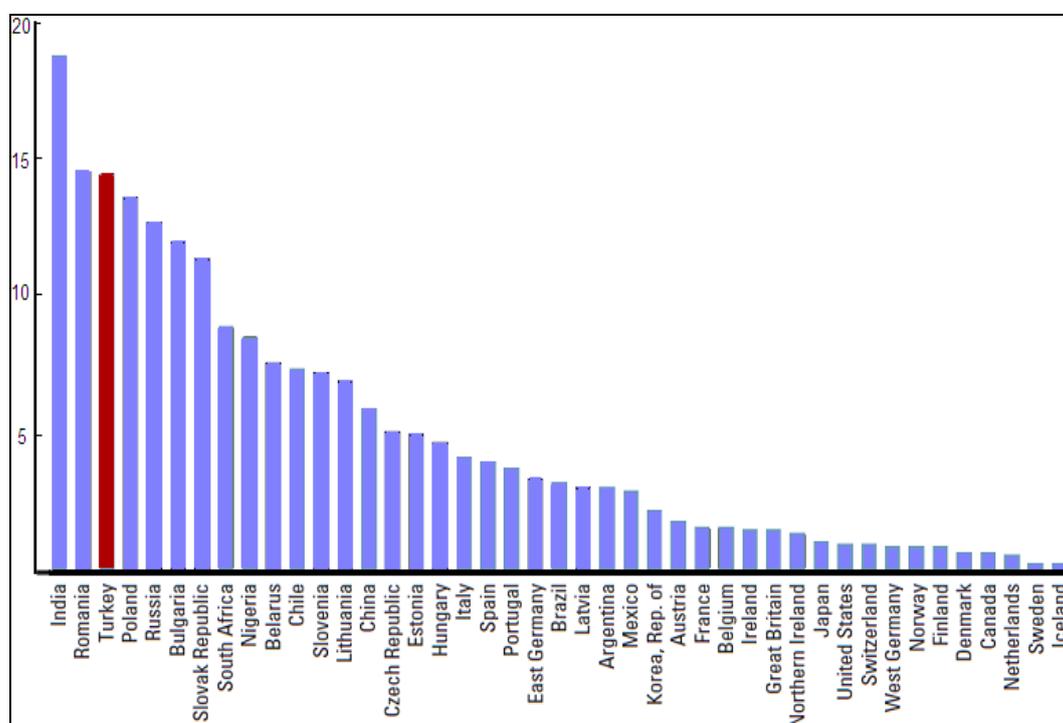
Fig. 2. The interaction between regulatory commitment and political institutional structure



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

As another feature, 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<sup>1</sup> 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 countries 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.

Fig. 3. Understanding of the state and the economy



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

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 context, the center-periphery relations shape the institutional structure. This tradition also continues to influence and reshape the Turkish

<sup>1</sup> 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.

politics today (Heper, 2000). Consequently, a regulatory policy in Turkey could lead to the rent-seeking processes (TUSIAD, 2002, 71).

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. Understanding of 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. 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 in terms of understanding the political institutional structure. Since the Constitution of 1982, a 10% electoral threshold has been applied throughout the country (Bacik, 2004, 823). 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<sup>2</sup>. Afterwards, the European Court of Human Rights in arbitration decided this threshold, not as contrary to the Human Rights, but as a high rate<sup>3</sup>. 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.

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<sup>2</sup> See the Constitutional Court decision no. E. 1995/54, K. 1995/59, Kt.18.11.1995

<sup>3</sup> Grand Chamber, no. 10226/03.

### *Politics without Policy*

*Politics without policy* is another aftermath of the electoral system in Turkey. Turkey's political environment has long been defined by coalition governments. The instability of coalitions made bargaining and strategic behavior an important component of 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 regulatory procedures. 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 the government. Allocating regulated industries among coalition parties harms the regulatory process 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 regulation and contributed to the economic crisis in 2001 (TUSIAD, 2001).

The economic crisis of 2001 is another important example of conflicting views on the economy among the coalition parties. 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).

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.

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).

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<sup>4</sup>. 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 (Cetin, 2008; Cetin and Oguz, 2007a).

Consequently, the nature of the electoral system was some degree responsible for the buildup 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

<sup>4</sup> For a detailed discussion of the political game in the electricity market, see Cetin and Oguz (2007a).

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<sup>5</sup>. Inflation rates had been steadily high up to the early 2000s and FDI inflows had been lower than in the 2000s.

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	n.a	432	907	120	537	187	1283	8222	8096	3665
Revenues										

Source: Onis and Bayram, 2009.

Privatizations turned into a policy game and became political interest groups 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 seen 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 (Arıcanlı and Rodrik, 1990, 1350). In the end, political preferences replaced efficiency considerations and regulatory reform has stalled for a long time.

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).

<sup>5</sup> According to the Maastricht criteria, the PSBR / GNP ratio should be lower than 3 %.

Table 3. Foreign direct investment (net inflows, as a percentage of GDP)

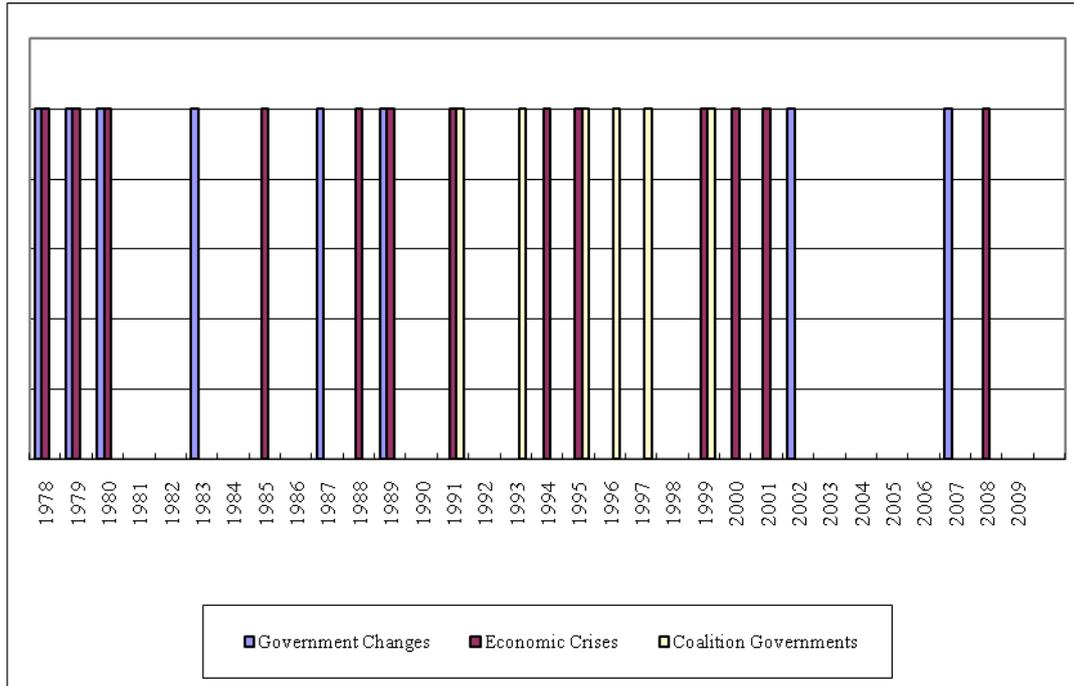
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Turkey	0.49	0.34	0.43	0.45	0.34	0.29	0.29	0.07	0.06
Hungary	3.93	6.00	2.61	10.02	5.04	3.79	3.31	3.59	2.49
Poland	0.79	1.98	1.86	2.85	3.09	3.37	3.82	4.67	5.92
Czech Rep.	na	1.58	1.85	4.86	2.22	2.38	6.27	11.31	8.69
Korea	-0.14	-0.22	-0.41	-0.36	-0.45	-0.34	0.21	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

Source: OECD, 2002b, 134.

In the end, Turkey faced three biggest economic crises (1994, 2000, and 2001) during this period. As depicted in Figure 4, it is possible to see that 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 one 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 expired. The current government has launched stronger efforts at institutional reforms than have been endeavored so far. Consequently, the present government has performed a notable economic performance at least as compared to the previous coalition governments<sup>6</sup>.

Figure 4. Government changes and economic crises in Turkey

<sup>6</sup> See, for a deeper economic analysis of the post-2002 term, Onis and Bayram (2008).



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/hukümetler/hukümetler.htm>.

### *Fundamentals of the Change in the Executive Structure*

According to the center-periphery relations in Turkey, politicians determine economic processes in the center and resources are distributed to the periphery by means of bureaucrats. In this setting, public funds 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).

### *The Place of Independent Regulatory Agencies in the Turkish Administrative 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. 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. Currently, 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.

On the other hand, 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 Capital Markets Board (CMB) and 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<sup>7</sup>.

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 Energy Market Regulatory Authority (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 within the legal structure. While provisions regarding transparency and accountability requirements of Sugar Authority (SA), Tobacco and Tobacco Products Market Regulation Authority (TTPMRA), Telecommunications Authority (TA), and EMRA to the media and/or the public does not contain clear obligations, the specific laws related to CMB, BRSA, CA, and Public Procurement Authority (PPA) lay down more

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<sup>7</sup> 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.

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.

### *The Legitimacy of Independent Regulators*

To begin with, there is the lack of constitutional protection and a legal ambiguity concerning the place of IRAs in the legal 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 these institutions. 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. 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 TA, CMB, and PPA, are audited by Sayistay (the Supreme Court of

Accounts), another group of IRAs, consisting of EMRA, SA, and TTPMRA, is audited SSB<sup>8</sup> (the Supreme Supervision Board of the Prime Ministry). The establishing laws of TA, EMRA, SA, and TTPMRA do not contain that financial accounts of these agencies are overseen by SSB and Sayistay, respectively (Sosay and Zenginobuz, 2006).

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 for regulation of 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 the Turkish Constitution<sup>9</sup>, only centralization and decentralization are possible in Turkey. 1982 Constitution does not allow any other organization type.

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

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<sup>8</sup> SSB is essentially established to supervise the financial accounts and the activities of the state-owned enterprises in Turkey.

<sup>9</sup> 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."

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<sup>10</sup>. 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.

### *The Judicial Foundations of the Change*

An independent judicial review is necessary economic change to comply 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 regulatory processes 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.

### *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<sup>11</sup>. Interpreting the

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<sup>10</sup> O.G. 4 August 2006.

<sup>11</sup> 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.

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 10<sup>th</sup> Administrative Court<sup>12</sup>. 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<sup>13</sup>. 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 be 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 accepted that the constitutional amendment in 1999 opened the door for the franchise

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<sup>12</sup> See decision of June 3, 2004.

<sup>13</sup> 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).

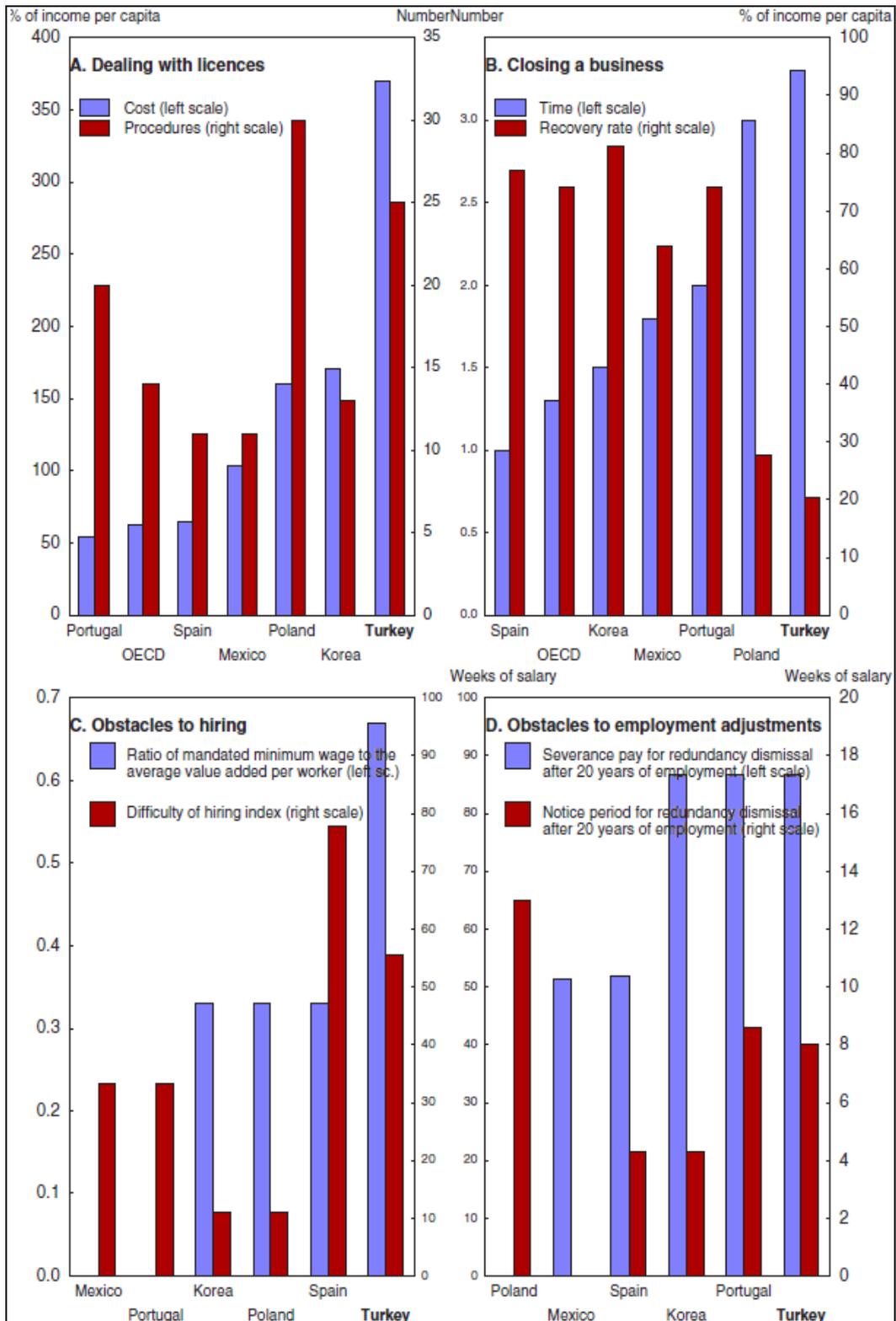
contracts to international arbitration and thus to privatizations (Ulusoy and Oguz, 2007). Consequently, privatization revenues in the post-2000 term have increased (see Table 2).

### *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).

Fig. 5. Product and labour market regulations

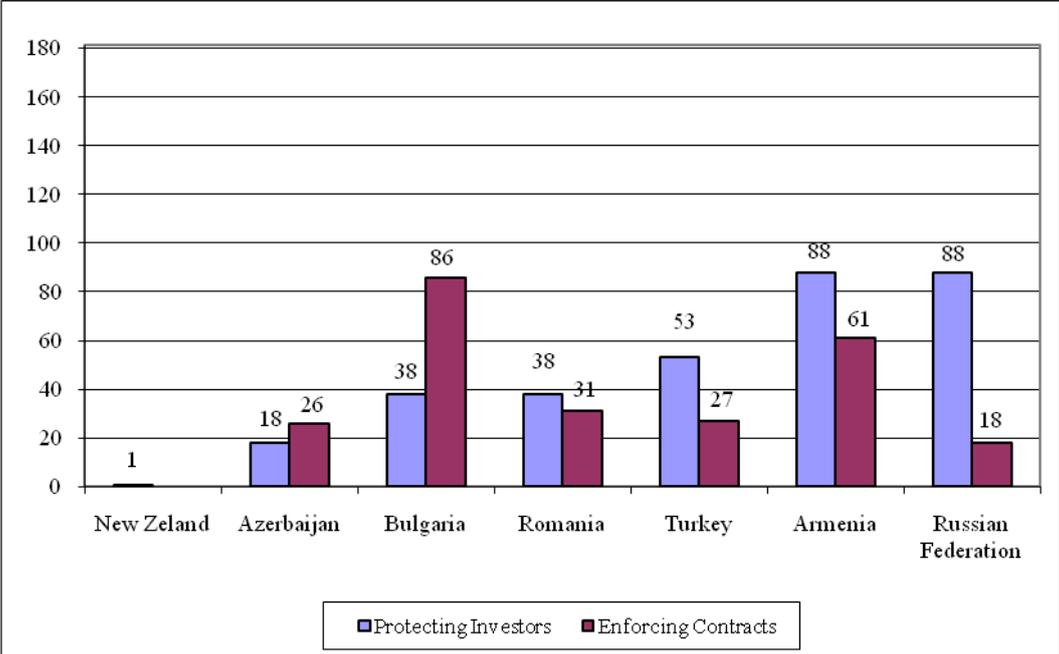


Source: OECD, 2008, 34.

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 requires 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.

Fig. 6. Protecting investors and enforcing contracts-global rank



Source: DB, 2009.

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 requires 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.

### ***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 the principal, in one sense, the judiciary and the executive are the agent. As the legislature as a principal determines policies, the executive as the 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.

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. Although IRAs in Turkey are established, there have been the political interventions to IRAs and not a constitution-based protection for them. 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 has increased political transaction costs of transition to IRAs in Turkey.

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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