

## Economic Institutions and Institutional Change in Turkey during the Neoliberal Era

İzak Atiyas\*  
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### Abstract

In the last three decades, the Turkish economy has become much more open and market-oriented. This paper provides an account of the changes in the underlying economic institutions that have accompanied this transformation. In particular, it assesses whether or not new economic institutions have emerged that constrain the discretionary powers of the executive in the area of economic policy and whether institutional change has resulted in a more rule-based and transparent policy framework. The story that broadly emerges is that the first two decades of the neoliberal era were predominantly a period of increased discretion at the expense of rules. By contrast, after the crisis of 2000-2001 one witnesses a substantial delegation of decision-making power to relatively independent agencies, and the establishment of rules that constrain the discretion of the executive. But this transformation is not uniform across sectors, and there are divergences between the *de jure* rules and their *de facto* implementation. Moreover, there are also examples that do not fit the general trend, especially in the case of the construction industry. Finally, recent signs suggest that the government may be having second thoughts about the “excessive” independence of regulatory and policy making bodies.

**Keywords:** Economic institutions, institutional change, independent regulatory agencies, delegation, rules vs. discretion, transparency.

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\* Sabancı University; [izak@sabanciuniv.edu](mailto:izak@sabanciuniv.edu). I am grateful for comments received from the participants in the Conference on “Turkey's Experience with Neoliberal Policies since 1980” held at London School of Economics, October 27-28 2011, from Hasan Ersel, Murat Üçer, Şerif Sayın and two anonymous referees at NPT. All remaining errors are mine.

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Institutions are rules that govern social interactions.<sup>1</sup> These may be self-enforcing norms of behavior or explicit rules enforced by third parties, such as laws and regulations enforced by the state. A very useful distinction is typically drawn up between *de facto* and *de jure* institutions, in which the gap between the two may result from an insufficient enforcement capacity, or from a distribution of political power that is at odds with the intentions of the forces that instituted the formal rules in the first place.

*De jure* economic institutions most often result from deliberate interventions by those who hold the authority and power to establish or change the rules of the game. The rules of the game may entail laws and regulations or arrangements that confer rule/decision-making authority on particular bodies, perhaps accompanied by procedures for decision-making. In such cases, institutional change entails the design and enforcement of new rules so as to change the incentive structure faced by current and future economic actors. However, in what follows, it may often be the case that the *de facto* rules of the game are different from the *de jure* rules. Hence, while a law may invest an agency with rule-making authority, and perhaps also a set of procedures to develop competition in a particular industry, in reality the agency may, through action (or inaction), delay the development of competition. For example, while formal rules may envisage agencies' political independence from ministries, in practice there may be various channels of influence that a ministry can use to shape agency decisions. Moreover, decisions by rule making bodies may have unintended consequences because of uncertainty, unforeseen contingencies, lack of technical capacity or sheer mistakes

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<sup>1</sup> The definition provided by North (1990) is seminal and seems to be widely accepted: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction."

(Sönmez, 2011). Thus, any analysis of institutional change has to pay particular attention not only to formal rules, but also to how those rules are shaped and implemented in reality.

In the last three decades (henceforth called the neoliberal era), Turkey has been transformed from a closed economy subject to widespread state intervention into an economy which is much more integrated into the global economy and in which the market mechanism plays a more prominent role in the allocation of resources. This paper attempts to provide an account of the changes in the underlying economic institutions that accompanied or even gave rise to this transformation. In so doing, it focuses on one important and controversial dimension of institutions and institutional change; that is, *rules versus discretion*. The key questions posed by this paper therefore relate to the following: first, the extent to which the Turkish transformation been accompanied by new institutions that constrain the discretionary powers of the executive in the area of economic policy; second, whether economic policy is applied in a transparent and non-discriminatory way, or rather allows the executive to act in a selective and clientelistic manner — for example, to transfer public resources to particular firms or groups in exchange for political support; and finally, whether or not institutional change has resulted in a more rule-based policy framework.

Within these broader questions, the paper will pay particular attention to two specific themes. The first relates to institutions of monetary and fiscal policy. Fiscal policy is a primary determinant of macroeconomic stability, and it is generally believed that fiscal policy is closely determined by the nature of fiscal institutions (von Hagen, 2006). In the area of monetary policy, the institutional feature emphasized in the literature is the independence of the central bank. This is a significant dimension of the rules vs. discretion debate as the degree to which the central bank is independent determines, for example, the ease with which governments can rely on it to finance budget deficits, with obvious negative implications for macroeconomic stability. The second theme

concentrates on a specific form of institutional change; namely, the delegation of decision making power to independent regulatory agencies. A large number of regulatory agencies have been established in the last decade, and this paper interrogates the extent to which this trend represents a convergence towards a “regulatory state”; a model that is believed to describe the governance structure of high-income capitalist democracies (Majone, 1996)<sup>2</sup>

The story that broadly emerges from the case of Turkey is that the first two decades of the neoliberal era by and large were a period of increased discretion at the expense of rules. By contrast, in the decade after the crisis of 2000-2001 one witnesses a substantial amount of institutional change, entailing delegation of decision-making power to relatively independent agencies, and the establishment of rules that constrain the discretion of the executive. Overall, this transition has increased the level of transparency in the policy-making process. But this transformation is not uniform across sectors, and there are divergences in both the *de jure* rules and their *de facto* implementation. Moreover, there are also examples that do not fit the general trend, especially in the case of the construction industry, where a key public player has emerged with enormous discretionary power and massive economic resources that can be deployed in a non-transparent manner.

Transition to a more rule-based form of economic governance and delegation of discretionary power to agencies not directly controlled by governments are political acts. Acemoğlu and Robinson (2008) warn that “...one should not try to understand or manipulate economic institutions without thinking about the political forces that created or sustain them” (p. 10). This warning is relevant to Turkey, particularly as the crisis of

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<sup>2</sup> Clearly, these themes cover only a subset of economic institutions that affect the performance of an economy. For example, the list leaves out the judiciary, other institutions of contract enforcement, and other areas of economic policy, such as those that relate to inequality and poverty or the provision of public services like health and education. In all of these areas, whether or not rules are applied in an equal, objective and non-discriminatory manner would be an important ingredient of any general evaluation of the nature of institutional change. While such an evaluation is very important, it is beyond the scope of this paper.

2000-2001, the increased degree of leverage of the World Bank and the IMF immediately afterwards, and Turkey's engagement with the European Union (EU) have all played important roles in the political decisions behind this transition. In other words, it is not yet clear whether the new institutions reflect a new political equilibrium, or whether the political forces that have shaped the economic institutions of the past still prevail; a situation that may result in further changes in economic institutions or even reversion to more discretionary patterns of policy making. As discussed below, recent indications suggest that the government may be having second thoughts about handing out decision making powers to relatively independent entities.

The paper is organized as follows: The next section discusses the nature of economic institutions in the first two decades of the neo-liberal era. This is followed by an overview of the changes in the institutional landscape after the crisis of 2000-2001. The last section concludes.

### **The 1980s and 1990s**

The 1980s witnessed fundamental changes in Turkey's economic policy framework. With the late Turgut Özal as Prime Minister, within a matter of a few years Turkey changed from a closed and controlled economy to one where markets played the major role in allocating resources. Barriers to international trade and finance were reduced or altogether removed, domestic markets were liberalized, prices and interest rates were freed, and a host of restrictions on the banking system were eliminated.

Parallel to these changes, there was a significant degree of centralization of policy making authority, and an increased appeal to discretionary instruments. Hence, while on the one hand the scope of state intervention was reduced through liberalization, decision making within the government became more centralized. Özal faced resistance from the traditional economic bureaucracy and the status quo, who were still in favor of

state controls over economic activity and were therefore against market-oriented reforms. The way Özal tried to deal with such resistance was to sidestep normal procedures and centralize policy making authority. For example, in one important move, an Undersecretariat of Treasury and Foreign Trade was established under the Prime Ministry (Heper, 1990). The Treasury was to be responsible for public debt and cash management, leaving the Ministry of Finance with the basic task of revenue collection and merely procedural management of the public budget. Another important instrument was the extensive use of extra budgetary funds (EBFs), which allowed the executive to circumvent parliamentary oversight and allocate public funds for preferred projects. By the early 1990s, the expenditures of the funds had reached about one-third of total expenditures in the consolidated budget (Atiyas, 1996).

Özal also saw privatization as an important vehicle for establishing a market-oriented economy. Attempts to privatize state assets were undertaken through half-baked laws and often through decrees with the force of law.<sup>3</sup> This approach, continued by governments through the mid-1990s, attempted to give substantial discretion to the executive — or to specific agencies controlled by it — over the due procedures and methodologies to be followed in the privatization process. In effect, these policies would have allowed the government to pursue privatizations in unaccountable and non-transparent ways. In the end, however, most of these efforts were met with annulments by the Constitutional Court; in most cases on the grounds that the laws or decree-laws effectively transferred legislative authority to the executive. In other words, the Constitutional Court demanded that the details of the procedures to be followed during privatizations, the options available regarding privatization methods and the methodologies for asset evaluation be explicitly stated in law, and not left to the discretion of the executive. The constitutional court also worried about foreign ownership of strategic assets and, in the case of the privatization of natural monopolies,

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<sup>3</sup> On the Turkish experience with privatization, see Atiyas (2009), Ercan and Öniş (2001), Öniş (2011).

of inadequate safeguards and a lack of regulatory frameworks to contain monopolistic behavior. Finally, a more comprehensive privatization law was enacted in 1994, going through further changes in the late 1990s, to clarify tender and valuation methods. By the end of 1990s, a legal basis for a workable privatization policy had been established; and one which was more or less consistent with the constitutional interpretations of the Constitutional Court.

The regulation of the banking system also proved problematic throughout the 1980s and 1990s. A banking law was enacted in 1985 that made the Treasury and the Central Bank responsible for the supervision and the regulation of banks. This created a major conflict of interest since the banking system was the main holder of government debt, creating disincentives for these public institutions to intervene when the finances of the banks deteriorated. Rules governing connected lending and equity holding in affiliates were also deficient and poorly enforced (Denizer, Gültekin and Gültekin 2000, p. 11).

Moreover, in the regulatory process, too much discretionary power was assigned to the political stratum: critical decisions regarding banks in financial difficulty were left to the minister responsible for the economy and the Council of Ministers, who subsequently “refrained from taking unpleasant decisions” (Ersel 2000, p. 7). The excessive amount of political discretion further weakened banking regulation, and an orderly exit of insolvent banks could not therefore be implemented (Denizer, Gültekin and Gültekin, p. 13; OCED 2002).

The liberalization of the capital account was carried out in a similarly lax regulatory environment, without the endorsement of the Central Bank, and despite warnings that liberalizing international finance under conditions of macroeconomic instability was ill-advised (Ersel, 1996). The banking sector thus expanded rapidly without a supervisory and regulatory framework that would ensure that risk-taking activities would be adequately monitored and excessive risk taking curtailed. This was particularly relevant given the availability of arbitrage opportunities provided by borrowing in foreign

currency and investing these funds in domestic assets, especially government securities with high real rates of interest (Alper and Öniş 2004). Deficiencies in the regulatory infrastructure not only encouraged excessive risk-taking among banks, but also permitted several cases of gross corruption in which banks' assets were siphoned off by bank managers and owners (Denizer, Gültekin and Gültekin, 2000; Atiyas and Emil, 2005). To summarize, in the area of banking regulation, there was insufficient insulation from the political process, rules were deficient and those that did exist were incorrectly implemented.

The general lack of interest in developing the basic regulatory-legal infrastructure of the market economy was apparent in other areas of economic policy as well. Throughout the 1990s there were attempts to pursue privatizations and private participation in the telecommunication and electricity sectors, though without first establishing a proper regulatory framework to contain the exercise of monopolistic power or ensure the development of a competitive environment. With regards to the energy sector, governments tried to attract private capital through various contractual schemes entailing monopoly rights and government take or pay guarantees.<sup>4</sup> However, several contracts were awarded without any competitive tender procedure at all. Furthermore, many of these contracts were subsequently investigated by the High Court of Accounts and denounced for high costs, possible irregularities and incompatibility with competitive markets (Atiyas, 2005). The contingent fiscal liabilities such contracts generated also caused concerns.

In the area of fiscal policy during the 1990s, there was a steady erosion of budgetary institutions that ensured control over public financial resources and the transparency and unity of fiscal expenditures. The political science literature on Turkey has often emphasized the importance of populism and patronage in political competition from the

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<sup>4</sup> These schemes were given different names: "Build, Operate, Transfer", "Build, Operate, Own" and "Transfer of Operating Rights".

start of multi-party democracy in the 1950s (for example Heper and Keyman, 1998). In terms of fiscal policy, this means that the use of public resources to nurture political support has been a central political strategy. This has put pressure on public finances and created a strong tendency towards public deficits. This tendency was contained throughout the Özal period, though this was primarily due to a lack of effective political competition, thanks to the ban imposed by the military government on the leaders of the political parties in existence before the 1980 coup. Once this ban was lifted in 1987, a marked deterioration in public finances followed (Atiyas 1994). Budget deficits widened, and were primarily financed by public borrowing, leading to significant crowding-out because of high real interest rates.

Towards the end of the 1990s, budget “unity” broke down completely. Reflecting the discretionary excesses in the fiscal area, there were various off-budget expenditures, especially through state-owned banks in the form of support for agriculture and small enterprises. The real magnitude of these quasi-fiscal expenditures and their implied burden on the budget and public debt were neither shown at the time in official statistics, nor disclosed to the public.<sup>5</sup> As mentioned above, a large amount of this public debt was held by the banking system. By 2000, the banking system had accumulated significant foreign exchange and interest rate risks which could not be contained by the government due to the deficiencies in the regulatory framework. Excessive risks in the

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<sup>5</sup> A major portion of these off-budget expenditures were the so-called duty losses — claims by state banks on the Treasury in exchange for subsidies provided to agriculture and small enterprises. Normally, these claims would be eliminated by giving public banks so-called non-cash government securities, but, towards the end of 1990s, a large stock of unpaid duty losses accumulated. The relevant data for these quasi fiscal expenditures was collected by the IMF and published in IMF reports, but it never appeared in official fiscal statistics of Turkey. Of course, the presence of these off-budget expenditures meant that true budget deficits were underestimated in official budget statistics. See Atiyas et. al. (1999) and van Rijckeghem (2003).

banking system, driven by high public deficits as well as hidden public debt in state banks, eventually triggered the crises of 2000-2001 (Özatay and Sak, 2003).<sup>6</sup>

Two initiatives during this period deserve separate attention. The first was the establishment of the Capital Markets Board (CMB) in 1982 to develop and regulate securities markets in Turkey. The CMB was the first independent regulatory authority (RA), and, as discussed by Atiyas and Ersel (1994), it was evident that, since it entailed delegation of significant rule-making authority away from the government and ministries, it represented a counter-example to the centralization of policy making authority that characterized most of the 1980s and 1990s. One possible explanation for this move is the rapid and uncontrolled growth of non-bank financial institutions from 1980-81, which subsequently resulted in the “bankers’ crisis” of 1982, and led to a loss of popular confidence in the non-bank financial system. CMB was seen as necessary to restore the confidence without which capital markets could not develop. The development of capital markets was seen in turn as a necessary component of the economic transformation the country was going through in the post-1980 period.

The second initiative was the enactment of a competition law in 1994 and the establishment of the Competition Authority in 1997. These moves can be explained by Turkey’s commitments under the Customs Union with the EU in 1996. Indeed, in the aftermath of the 2000-2001 crisis, the response to crisis, the path towards EU accession and pressures from international agencies such as the IMF and the World Bank all played major roles in the evolution of Turkish economic institutions.<sup>7</sup>

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<sup>6</sup> One could say that the emergence of corruption in the financial sector and the disintegration of fiscal institutions were expressions of a more general institutional decay in the country. This was reflected both in the emergence of putatively illegal, para-military gangs committing murders on behalf of the state, and in the Susurluk scandal, which revealed the close relationship between the state and organized crime. See, for example, Özgönül and Sağlar (2001).

<sup>7</sup> For a discussion of factors explaining the development of regulatory agencies in Turkey, see Özel and Atiyas (2011).

## **The 2000-2001 Crisis and its Aftermath**

The program that was launched after the crisis of 2000-2001 entailed a number of institutional measures that addressed some of the problems described above. In a way, the program adopted the “second generation reforms” proposed by international organizations such as the IMF and the World Bank, but by and large the reforms also coincided with those that Turkey had to pursue as a country in the process of accession to the European Union. Many of these reforms were part of the recovery program launched in May 2001. The design and the execution of the program were initiated by a team led by Kemal Derviş, who was at the time a Vice President at the World Bank, and was called in as Treasury Minister to lead the implementation of the post-crisis economic program.

In a CEPS paper by a group of authors that included Derviş (Airaudo et. al. 2004), the environment prior to the crisis was described as:

a rent-seeking political economic system, with governments promising to distribute more resources than they were able to raise, and with the private sector spending much time and resources trying to capture rents; resources which could have been spent on real production and the development of markets and technology. (p. 21)

The paper went on to describe the recovery program in the following terms:

The objective of these reforms has been to build the legal and institutional infrastructure of a modern competitive market economy, where transparency reduces the scope for rent-seeking and corruption and where entrepreneurial spirit can be devoted to production, rather than securing privileged access to monopoly positions or state contracts. The reforms also aimed at creating a leaner and more efficient state, while strengthening the regulatory capacity of state institutions and the quality of the social safety net. (pp. 21-22)

Most of these reforms were subsequently adopted or continued with little change by the Justice and Development Party (AKP) government that came to power after the elections of November 2002.

## Monetary and Fiscal Policy

One important step undertaken in the reform program was the introduction of the *de jure* independence of the central bank, through an amendment to law in 2001. The Central Bank was given the primary task of maintaining price stability and was left free to choose its own instruments. Furthermore, the amendments prohibited the Bank from granting advances and extending credit to the Treasury or other public entities. The Central Bank has experienced significant institutional development in the last decade. It has started to publish regular reports on inflation and financial stability and has undertaken other measures that have increased the transparency of its operations. After ensuring that proper preconditions were in place, it eventually moved to Inflation Targeting in 2006. During this period, inflation dropped dramatically to single digits, from crisis peaks of 70-75%. The success of this monetary policy was also aided significantly by a supportive fiscal policy stance in the form of significant non-interest surpluses in the overall budget.<sup>8</sup>

Another important area of reform was fiscal policy, and initial attempts at reform were undertaken by the Derviş team. For example, as early as 2001, public banks were banned from incurring any duty losses unless they were budgeted in advance. However, it is also clear that successive AKP governments after 2002 saw fiscal control and macroeconomic stability as major political objectives. The Public Financing and Debt Management Law adopted in 2002 subjected all central government borrowing and guarantees to strict rules and imposed reporting requirements on all debts and guarantees. The Public Financial Management and Control Law (PFMCL) was passed in December 2003 and, with some minor exceptions, it extended the coverage of the budget and financial accounts to include all sectors of the government, in line with international standards. Relative to the 1980s and 1990s, these measures meant that expenditures outside the budget were better curtailed. It also meant that the transparency of public expenditures

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<sup>8</sup> For a detailed discussion, see Ersel and Özatay (2008).

increased, and that the government could exercise tighter control over public expenditure.

The PFCML went even further. It introduced a 3-year budgeting/planning framework, and envisaged a transition to performance budgeting whereby line ministries would publish strategic plans including performance targets.<sup>9</sup> Their budgets were henceforth to be based on performance plans and explicit performance targets. The key idea here was that performance budgeting would provide better incentives and increase the operational efficiency of spending ministries, or, put differently, increase the efficiency of fiscal expenditures. To date, even though public entities have started to publish strategic plans, other important ingredients for the transition to performance budgeting have not yet been developed (OECD 2008).

There is general agreement that the outcomes of fiscal policy have been successful; in particular, with respect to the goal of achieving primary surpluses in the general government budget and a reduction of public debt (Ersel, 2009). However, it is not easy to determine to what extent this was the result of an institutional change, or simply the consequence of political determination by the AKP governments. In any case, if one were to summarize institutional changes in finance, one could say that the new institutions increased governmental control over public expenditures and reduced discretion to the extent that non-transparent off-budget expenditures were restricted. Yet, at the same time, reforms aiming to increase overall efficiency in public administration and accountability in public expenditure have not been followed through.<sup>10</sup>

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<sup>9</sup> An essential feature of multi-year budgeting frameworks is that they provide spending ceilings for ministries. However, these ceilings have not been met in practice, and significant deviations have occurred.

<sup>10</sup> Although an evaluation of the nature of the fiscal adjustment is beyond the scope of this paper, the absence of public sector reform may also cast doubts on the quality of the fiscal adjustment achieved in the post-crisis era (Ersel, 2009). Fiscal adjustment has mainly occurred on the revenue side, thanks to economic growth, high privatization revenues and more enforcement in tax collection. This has

Recently, the Turkish government has resisted pressure by the IMF to consolidate fiscal institutions in two important directions. First, the IMF's insistence that the government's tax collection activities be organized by an independent revenue agency has been rejected. In fact, this was reportedly one of the reasons that Turkey did not renew a stand-by arrangement with the IMF at the peak of the global crisis. Second, plans to adopt more stringent fiscal regulation surfaced in 2009-10, but were subsequently shelved. Specifically, a Draft Law on Fiscal Rule was accepted by the relevant parliamentary commission, but was later withdrawn, apparently because of objections from the line ministries. More generally, the implementation of the new fiscal system has also been problematic, and observers have identified a significant number of slippages (Dedeoğlu 2010).<sup>11</sup>

### **Privatization<sup>12</sup>**

Privatization is another area in which Turkey has undertaken a significant break from the past. By the end of the 1990s, the legal infrastructure for privatization was almost complete. In effect, the executive had been forced to reduce the degree of administrative discretion and establish more transparent and accountable procedures for privatization. In addition, by 2001 legal regulatory frameworks had also been established for the deregulation and privatization of industries hitherto dominated by public monopolies; namely telecommunications and energy. While privatization revenues generated before 2000 had been below \$9 billion, more than \$30 billion was raised between 2001-2010 (Öniş 2010). Among the privatized assets were large enterprises in industries such as petrochemicals, petroleum refinery, telecommunications, electricity distribution, banking, and alcohol and tobacco products.

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allowed a more than 50 percent increase in overall expenditure in real terms between 2005-2011 (OECD 2012, p. 22). This revenue increase has been accomplished without any serious tax reform, and the share of indirect taxes in tax revenues continues to be very high.

<sup>11</sup> The Draft Law on Fiscal Rule contained articles that were designed to address some of these problems.

<sup>12</sup> This section draws on Atiyas (2009).

Overall, privatizations in Turkey have been revenue-driven. The problem with revenue-driven privatizations is that the governments tend to overlook competition problems, or indeed may permit enterprises to be privatized with monopoly rents in order to maximize privatization revenues. The Competition Authority has been involved in the privatization process, and has been able to influence some privatization transactions, ensuring measures have been taken to reduce the competition problems that may arise once assets are turned over to private ownership. For example, during the privatization of Türk Telekom, the Competition Authority required that the provision of internet services be organized as a separate legal entity, and that the cable TV infrastructure be separated from Türk Telekom. However, international experience suggests that, in industries characterized by natural monopoly segments, such interventions by the Competition Authority have limited influence on market outcomes. The evolution of market structure ultimately depends on the existence and effective implementation of a regulatory framework that protects competition, ensures access to network facilities by new entrants and prevents exclusionary and discriminatory behavior by incumbents.

However, as discussed below, the competition-enhancing aspects of institutional change in industries characterized by competition problems have been weak in Turkey.

### **Regulatory Reform**

The purported objective of privatization is to reduce or eliminate the inefficiencies associated with government ownership, political influence and lack of competition. It is well known, however, that whether privatization achieves these objectives or not depends critically on whether the legal and institutional environment addresses market failures. More generally, a well-functioning market economy requires a legal and institutional infrastructure that addresses a host of market failures such as externalities, asymmetric information, and inadequate competition.

In most high-income countries — and certainly in the European Union — these regulatory tasks are separated from any operational activities organized under ministries (such as those associated with public enterprises providing public services), and have mostly been transferred to relatively independent regulatory authorities (RAs). Several justifications have been given for this institutional innovation, which has also been diffused to emerging markets in the past three decades. The main logic is one of delegation: by delegating the authority to design and enforce regulations to a relatively independent authority, it is argued, the executive solves a credibility problem. In particular, the delegation of regulatory authority is expected to insulate the regulatory process from political influence — that is, from the possibility that regulatory decisions are affected by clientelistic objectives or by calculations of short-term political gains — and that they will instead be shaped by the objectives of developing competition and encouraging innovation and new investment. In turn, the belief that regulatory decisions will be protected from political influence and guided by well understood principles of efficiency and equity, and that the rules of the game will not be manipulated in a discretionary manner, is expected to encourage the private sector to invest in these industries.

Hence, RAs are given financial autonomy (their budgets often rely on earmarked revenues), and their decisions cannot be overturned by the ministries, but are subject to well-defined appeal mechanisms, often through judicial review.<sup>13</sup> In addition, while the executive may play a role in appointments to the decision making bodies of the agencies, these appointments cannot be recalled unless there is some evidence of impropriety. Undoubtedly, should the model work as intended, it would entail significant transfer of decision-making power from the politicians to administrative agencies over which politicians have less control. The desirability of this type of delegation has been

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<sup>13</sup> In the case of Turkey, this review is often undertaken by the Council of State (Danıştay).

contested by some on grounds of causing ‘democratic deficits’.<sup>14</sup> The response to these concerns is that policy itself is still undertaken at the political level, and any excesses by the RAs can always be corrected by changes to the constituting laws (Majone 1996).

Turkey has seemingly adopted this regulatory model. The Capital Markets Board had already been established in the 1980s. Following the crisis of 2000-2001, the economic recovery program included measures to establish a “truly independent” regulator for the banking system, to implement liberalization and privatization in the telecommunications and electricity industries, and to establish RAs in these sectors.

The Banking Regulation and Supervision Agency (BRSA) was established in 1999 as part of an anti-inflationary program that was punctuated by the crisis. However, as mentioned below, the BRSA did not become operational until August 2000, some 8 months after the onset of the anti-inflation program. Even though this was a period when banks had strong incentives for excessive risk-taking due to the arbitrage opportunities mentioned above, the BRSA was significantly delayed in its oversight of the banking system because appointments could not be made due to political haggling. This delay significantly increased the cost of restructuring the banking system after the crisis.

Subsequently, the powers of the BRSA were strengthened as part of the post-crisis recovery program. Generally, it is regarded as one of the strongest RAs, with sufficient regulatory tools to ensure capitalization and the stability of the banking system. In fact, the resilience of the banking system in Turkey during the recent global crisis is often attributed to the high quality of supervision and regulation executed by the BRSA. At the same time, though, there is also some evidence that, while the BRSA has been successful in ensuring financial stability, it has been less concerned with consumer protection and competition. For example, banks have been accused of very high charges in the rapidly expanding credit card market (Bakır and Öniş 2010).

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<sup>14</sup> Democratic deficit is said to arise when unelected officials, not directly accountable to voters, are given substantial policy making authority.

In the telecommunications industry — at the risk of oversimplifying — the story is one of substantial influence by the incumbent fixed line operator. The purported objective of reform in the telecommunications industry was to develop competition. The Telecommunications Authority (now the Information and Communications Technologies Authority, or ICTA) was established in 2001, and Türk Telekom was privatized in 2005. Privatization has resulted in a significant increase in productivity for Türk Telekom: employment was reduced by almost 50 percent after privatization, reflecting the extent of politicization and over-employment under state ownership. However, the company maintains dominance in the broadband internet services market (87 percent market share) as well as in the telephony service markets (85 percent market share). Until very recently, Türk Telekom was protected from competition by high interconnection rates, delays in the licensing of new entrants, and delays in the introduction of services that would allow new entrants greater command over the range of services that could be provided over the fixed line network.

To most observers, these outcomes reflect Türk Telekom's influence on the Ministry of Transport and, by consequence, on the RA. While the telecommunications laws contained standard measures that have ensured ICTA's *de jure* independence, the RA's *de facto* independence was significantly curtailed (Atiyas and Doğan 2010). By contrast, the ICTA's stance in the mobile industry has been much more pro-competition; reflected in interconnection charges that are among the lowest in Europe. This is perhaps explained by the fact that Türk Telekom's subsidiary is a new entrant in the mobile telecommunications markets (*ibid.*). Thus, at the very least, Türk Telekom has had no reason to resist a more pro-competition stance in the mobile markets. The interesting point here is that, if the ICTA's more aggressive pursuit of competition in the mobile industry can indeed be explained by political economic factors, this stance was carried out through the established rules of the game (i.e., lower interconnection rates) rather

than by more coarse and discretionary interventions. This suggests that perhaps the new rules did have some bite after all.

The international — and especially European — experience suggests that deregulation in the electricity industry is also susceptible to anticompetitive and exclusionary behavior by vertically integrated, incumbent enterprises. In Turkey, the story in the electricity industry is rather different. The restructuring process started with the adoption of the Electricity Market Law in 2001, which envisaged the unbundling of distribution, transmission and generation assets, the establishment of non-discriminatory access to the transmission and distribution networks and the formation of the Energy Market Regulatory Authority (EMRA); the RA responsible for electricity, natural gas and oil industries.

Turkey thus adopted a highly competitive and decentralized model for restructuring its electricity industry, inspired by the New Electricity Trading Arrangements (NETA) of the UK. The restructuring process has been driven by privatization. Privatizations themselves have been structured so as to generate maximum possible revenues for the government. As a result, competition and consumer welfare have taken a secondary role, since there is a danger that high prices paid during privatizations will eventually reflect themselves in higher consumer prices.

A universal problem with restructuring in the electricity industry has to do with the fact that competitive electricity markets are much more complex than markets in other industries. There are strong externalities, and problems arising in one segment of the market can quickly afflict other segments. The existence of reserve capacity is crucial, but reserve capacity itself has public good characteristics, and may not be forthcoming in a completely liberalized market system. Resolving these problems may require the design and creation of specific markets (e.g., capacity markets) that are unlikely to emerge by themselves and require specific public engagement and intervention. In all countries that have deregulated their electricity industries, being consistent in market

design and ensuring that market rules both encourage investment and deliver product innovation and low prices for consumers have turned out to be formidable tasks.

Indeed, in the case of Turkey, inconsistency between government pricing policies and market design resulted in a dearth of private investment until 2006; a problem which was only resolved when the government finally launched a ‘balancing market’ that started to act as a wholesale spot market.<sup>15</sup> Even now, the evolution of the market has diverged significantly from the model initially envisaged in the Energy Market Law; while the prescribed model was one of bilateral contracts supported by a balancing mechanism, in the current market structure, truly private bilateral contracts constitute only a small fraction of electricity consumed. In addition, 11 years after the launch of the restructuring program, truly competitive power producers make up only 25 percent of the capacity in generation (Atiyas et. al, 2012).

Turkey has recently concluded an agreement with the Russian Federation to build a nuclear station at Akkuyu in the Mersin Province.<sup>16</sup> It is well known that building and operating nuclear power stations entail a multitude of risks. There is a sizable literature discussing whether nuclear plants are financially viable without any government subsidies and what type of financing models can generate an effective distribution of these risks. The Akkuyu agreement is interesting, in that most of the financial risks are shifted to the supplier company, with minimum support from the Turkish government. The problem is the strong likelihood that, under this kind of a risk-sharing arrangement, the company will have strong incentives to cut costs through, among other things, watering down safety and security measures. The implication is that the risk-sharing

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<sup>15</sup> Private providers faced stiff competition from retail prices, which were regulated and repressed by the government for apparently political reasons. This meant that private generators, whose costs had increased due to rising natural gas prices, were not able to sell their electricity without making losses, even though demand was increasing rapidly and there was clearly positive demand for their capacity. The establishment of a wholesale market allowed the emergence of prices that reflected the interplay between supply and demand, and allowed private generators to sell electricity without making losses. For a detailed analysis, see Atiyas, Çetin and Gülen (2012), Chapter 2.

<sup>16</sup> This discussion of the Akkuyu model draws on Atiyas (2011).

mechanism adopted in the Akkuyu model puts additional burdens on Turkey's regulatory apparatus, which is especially weak in the area of nuclear plants. It seems that the policy makers have not taken sufficient notice of what the risk sharing properties of the agreements imply.

In general, these developments in the electricity markets reveal an important gap in the making of good public policy which cannot simply be filled by greater reliance on market forces. This gap is aggravated by lack of cohesion, coordination and consistency between the Energy Ministry and the EMRA. The problem will likely be compounded when the privatization of distribution and generation assets is completed. Public policy and regulation will need to be much more effective then, having to face formidable actors in pursuit of high prices and profits. This would be a radically different situation from the one we have now, especially if we recall that half of the current supply of electricity is generated by a state owned company, which is politically motivated to keep electricity prices low.<sup>17</sup> It should thus be clear that the creation of an EU-style regulatory framework does not obviate the necessity for a comprehensive and consistent overall energy policy.

However, these shortcomings should not overshadow an important achievement of the new rules: since 2008, a significant amount of new private generation capacity has been added to the system. This has been accomplished on a competitive basis, without resort to any special contractual arrangements that would hinder competition and confer special benefits on private investors in the form of purchase guarantees, as was typical in the 1990s.<sup>18</sup> Moreover, even though the government has used its power to influence the determination of regulated retail prices, the establishment of a wholesale market — in which prices are determined without any intervention by the government or the

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<sup>17</sup> It is well known that problems of unilateral exercise of monopoly power are much more severe in wholesale electricity markets, relative to other industries. This has led many countries to seek additional measures beyond competition law to deal with problems of market power and institute special mechanisms for monitoring and control. Such measures have not yet been discussed in Turkey.

<sup>18</sup> Atiyas, Çetin and Gülen (2012).

regulatory agency — acts as a restraint on the government’s ability to use its discretionary power to influence market outcomes for clientelistic objectives. Yet it remains to be seen whether this model will prove sustainable in the face of a rapid increase in energy demand in the future.

Another important component of regulatory reform of industries such as telecommunications and electricity in the EU is to ensure universal service; that is, to ensure that poor households have access to public services at reasonable tariffs. However, in Turkey, the distributional objectives of regulatory reform have been largely overlooked. A universal service law for the telecommunications industry exists, but is not implemented properly. In energy, there are no safeguards to prevent energy poverty. In fact, it is expected that the development of the market mechanism is likely to increase the cost of energy for poor households.

Nevertheless, it should be emphasized that, relative to other public administrative bodies, RAs function in a more transparent manner. Draft regulations are often put on agency web sites for public consultation. The decisions of the governing boards of the RAs are routinely published in an official gazette as well as on RA websites. Again, there are differences between agencies in these respects, and there are many additional steps that could be taken to further increase transparency. For example, comments received during public consultations are not published. An important measure that would enhance transparency and accountability would be to require the governing boards of the RAs to provide reasons and justifications for their decisions. Only a small number of RAs are required to do so.

### **Competition Law and Policy**

One area where the delegation model has worked relatively well is in competition policy. Competition law in Turkey is inspired by the European Union model. Overall, the Competition Authority is recognized to be a professionally competent and relatively

independent agency, not only by domestic stakeholders, but by international peers as well.<sup>19</sup> The decisions of the Competition Board are required to be publicly available and published with justifications. This increases the transparency and accountability of the agency, and may also have created an added source of discipline, improving its performance. It may also have been easier for the board to maintain its independence as it functions across many industries, and does not deal with a specific enterprise or groups of enterprises; a situation that might have facilitated influence or capture.<sup>20</sup> These successes, though, do not mean that there are no shortcomings: there are instances of favoritism towards state owned enterprises, inconsistencies in decisions between cases or over time, insufficient or sometimes deficient economic analysis, excessive formalism, and the like. Nevertheless, such shortcomings do not change the basic fact that overall the authority's decisions are seen to be free of systematic bias and to meet a respectable level of quality.

### **Discretion in the Extreme: the housing market and the case of TOKI**

All of the instances examined above have entailed the transfer of some rule making authority to a relatively autonomous entity, as well as a reduction in the discretionary powers of the government in favor of more rule-oriented approaches. However, the case of the Housing Development Administration (TOKI) represents an opposite trend. TOKI is unique in many respects. It is directly attached to the Prime Ministry. It builds public housing jointly with private contractors on public land, to which it has free access. It has been given powers to develop plans on lands over which it has control. It can develop urban regeneration projects in cooperation with local government and has the authority to evaluate and price the land that is to be purchased.<sup>21</sup> TOKI is also given a free hand in its financial transactions, and is exempt from the procurement rules which usually apply

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<sup>19</sup> See the peer review by the OECD (2005).

<sup>20</sup> One should point out that most observers single out another important factor that may help explain the degree of professionalism of the CA: the high quality of the bureaucrats who were initially appointed as line managers and who have shaped the emerging culture of the agency.

<sup>21</sup> See Balaban (2012) and Gülhan (2011).

to public entities (specified in the Public Procurement Act). While this exemption was originally limited to procurement for public housing projects, in 2011 it was extended to all construction undertaken by TOKI. TOKI was originally under the scope of the PFMCL, but was exempted in 2005, and is thus no longer bound by budgetary rules either. According to Balaban, the vast discretionary authority given to TOKI is part of a wider set of legal arrangements which are:

intended to guarantee a fast-track planning process for sectoral investments like housing and tourism investments by transferring the authority concerning urban planning from local authorities to sectoral ministries or administrations at the national level. (2012, 30-31)

The OECD (2010) reports that the value of TOKI's assets have reached about 2 percent of GDP, yet adequate financial information about the activities of TOKI is impossible to find because it does not publish its income statements or balance sheets (Yükseler, 2009). Furthermore, it is audited by the High Audit Board (Yüksek Denetleme Kurulu), which is attached to the Prime Ministry, implying that the financial transactions and activities of TOKI are not being audited by an independent body.<sup>22</sup> In effect, then, TOKI is both a policy maker, a regulator and a service provider; a situation that is contrary to the basic philosophy which has led to the development of RAs in the last three decades. In effect, TOKI has been given tremendous power to appropriate and redistribute urban land rent. Moreover, it can do this in a non-transparent manner.

### **Second Thoughts?**

The literature on Turkey has emphasized that RAs have fitted uneasily into the country's overly centralized governance structure, and have been viewed with suspicion by both politicians and the bureaucracy.<sup>23</sup> Recently there have been signs that the AKP government may be having second thoughts about the "excessive" independence of

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<sup>22</sup> Most RAs are audited by the High Court of Accounts (Sayıştay), which carries out audits on behalf of the parliament. TOKI was removed from Sayıştay's audit in 2005.

<sup>23</sup> For a recent review, see Özel (2012).

regulatory and policy making bodies. In August 2011, the government passed a new law, which authorized line ministries to “inspect” the activities of the agencies associated with them. This clause has been interpreted by the media and many independent observers as another way of weakening the financial and administrative independence of RAs. This may however be an exaggeration because the clause does not give ministries the authority to change or overturn RAs' decisions, or to intervene in their management. However, it does give ministries the authority to intimidate or exert moral suasion on the agencies by subjecting them to inspections — though one would expect that such inspections would need to concentrate primarily on procedural and not substantial issues. At the same time, the desire for the capacity to influence the RAs may reflect the government’s general uneasiness with the act of delegation, and should be interpreted as a threat to the RAs not to deviate too far from the preferences expressed at the political level.

More evidence of the government’s second thoughts comes from the area of financial stability or macro-prudential regulation. In the aftermath of the crisis of 2008-2009, the government was in search of a mechanism to monitor and respond to the risk of macro-financial instability.<sup>24</sup> Instead of a model that would ensure some degree of political independence, the government chose to establish a Financial Stability Committee, chaired by the minister responsible for the Treasury. As emphasized by Ersel (2012), this is a solution that puts government in complete control of the decision making process, in contrast to solutions found in the US and Europe, which entail independence from it.<sup>25</sup>

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<sup>24</sup> A macro-financial risk may arise, for example, if there is excessive credit growth in the banking system. This is generally seen as an area that lies outside of the traditional scope of central banks, which typically focus on price stability, as well as of the banking regulators, which typically focus on risks at the level of individual banks.

<sup>25</sup> In another rather striking example, an AKP parliamentarian was quoted as complaining about multiple authorities in the energy industry, and suggesting that EMRA should be “connected” to the Ministry of Energy (Dunya Daily, January 24, 2012). For additional indications of this tendency towards “de-delegation,” see Özel (2012).

## Conclusion

In Turkey over the last three decades, markets and private actors have acquired a much larger say in the allocation of resources. This paper has argued that the economic institutions underlying this transition have evolved through two main stages. Until the crisis of 2000-2001, economic policy making was centralized and the discretionary powers of the government increased. Furthermore, the governments of this period did not see establishing a legal and regulatory infrastructure to address the market failures of a capitalist economy as a priority. In the post-crisis period, there has been a move towards a more rule-based form of governance. Many of the new rules of the game that reduce the discretionary powers of the government were established in the immediate aftermath of the crisis. The AKP governments that came to power after 2002 have stuck to these new rules, and even added new ones in some areas (especially fiscal policy). Yet this trend has not been uniform across markets and policy areas, and in some instances there have been significant divergences between *de jure* and *de facto* institutions. In the construction industry, the trend has been in the opposite direction. The Housing Development Administration attached to the Prime Ministry has been given wide decision-making powers, enormous resources and discretion to spend them in a non-transparent manner.

It is clear that Turkey has been successful in maintaining fiscal discipline in the post-crisis period, especially relative to the late 1980s and 1990s. It can also be said that there have been a number of important institutional changes that were designed to improve fiscal control. It is unclear, however, whether the success on the fiscal front was due to these institutional changes, or was simply a consequence of political preferences or will. This question can be restated in the following way: are the effected institutional changes robust enough to constrain future governments, or even an all powerful AKP government that showed less preference for fiscal restraint? If political competition increases in the future, or if checks-and-balances weaken in the system, would these

changes prevent future governments from using public resources to create a competitive advantage in the struggle for political power? My expectation is that the institutional changes implemented so far would not have sufficient bite. The current regime contains critical gaps, and has not yet been fully and consistently implemented.

Fiscal control requires coordination between a multitude of players, and if pressure from political competition increases, centrifugal forces may become quite strong. The Draft Law on Fiscal Rule mentioned above was one attempt to fill some of the gaps in the current structure, but so far the government has seemed unenthusiastic about carrying it through, which may indicate a desire to retain discretion, especially in the spending ministries. Hence, in fiscal policy, political dynamics and preferences will likely continue to shape policy choices and outcomes, and the impact of institutional constraints will thus remain weak.

In Competition Law, a well-designed *de jure* system has been reinforced by years of more or less well managed implementation, and a culture of professionalism has emerged. The CA is already immersed in an international network of professional peers, and the domestic legal community is also quite sophisticated. The fact that the decisions of the Competition Authority are subject to judicial review also helps to insulate competition law enforcement from political or private sector influence.

Regarding the new institutions in the area of network industries, the assessment is mixed. In the telecommunications sector, the independence of the RA was impaired from the very beginning, and the market outcomes testify to the fact that the regulatory framework has not been effectively implemented. In electricity, the quality and intensity of policy design and regulatory intervention has been insufficient to match the complexities of the restructuring process underway. On the other hand, the new rules appear to have achieved some degree of success in attracting new generation capacity on a competitive basis.

Overall, then, this overview of institutional change in Turkey provides a mixed picture: even though there has been significant movement in the direction of a “regulatory state” — a model used to describe economic institutions observed in most high-income capitalist democracies — this movement is by no means uniform, and the process is far from complete. Recent indications also suggest that the government may be having second thoughts, reminding us of Acemoğlu and Robinson’s warnings about the political determinants of economic institutions. As indicated in the introduction, the changes in economic institutions occurring over the last decade were predominantly a result of economic crisis on the one hand, and international influences on the other. It remains to be seen, therefore, whether these changes will survive the complex political dynamics of the country.

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