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Replace Discretion with Rules: How Policy Reform Can Boost Economic Performance

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In a nutshell

- *Before the 2000s economic policy making in Turkey was based on discretion and patronage rather than rules.*
- *This put a significant amount of stress on public finances, resulting in macroeconomic instability.*
- *In the wake of the 2000/01 financial crisis, the government created independent regulators for banking, telecoms, energy and public procurement, and made the Central Bank independent.*
- *To support its candidacy for the European Union it embarked on economic reforms broadly based on EU legislation.*
- *It was mainly due to the new regulatory environment that the financial industry survived the global financial crisis of 2008-2009 relatively unaffected.*
- *Between 2002-2007, Turkey experienced one of the highest sustained growth rates in per capita income in her history.*
- *Recently the government has weakened regulators' independence and introduced new schemes with greater discretionary powers.*
- *As a result economic growth is less likely to be driven by open competition and will rely on discretionary instruments to generate investment.*
- *The Turkish experience suggests that a reform-minded government that adopts institutional reform to increase policy credibility and enhance competition may be rewarded with increased economic performance.*

About the author

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A reform-minded government that adopts institutional reform to increase policy credibility and enhance the degree of competition may be rewarded with increased economic performance. The experience of Turkey in the 2000s suggests that anti-corruption and economic reform programs that promote more rule-based policy making and reduce the discretionary powers of the government may make significant positive contributions to economic growth.

From discretion to a more rule-based policy environment

In the past, the Turkish policy making has been mostly characterized by high levels of discretion, deals rather than rules, and patronage and clientelism in politics — all putting significant stress on public finances and resulting in macroeconomic instability. Indeed, it was the excesses of the 1990s and widespread corruption, especially in industries such as banking and energy, that led to the deep financial crisis of 2000/2001. By contrast, especially in the first half of the first decade of 2000s, Turkey experienced major institutional reforms that at least nominally reduced the government's discretion, delegated policy making authority to independent bodies, and introduced more rule-based policy making processes in major — but not all — segments of the economy. Turkey's EU candidacy provided an institutional anchor and guided these institutional reforms.

The reforms mainly affected what can be usefully called "middle level institutions", to distinguish them from deep political institutions. They regulate policy making processes and constrain government discretion, especially by delegating a significant amount of decision making authority to relatively independent administrative bodies such as competition agencies, the central bank, or regulatory agencies. They often have formal legal foundations, such as in the case of competition law. These types of rule-enhancing discretion-reducing institutions are often results of explicit reforms undertaken by governments and have clear constituting laws so the formal aspect is very important. However, their informal characteristics are extremely important as well.

Contours of institutional change

Governments often use trade, investment or industrial policies to distribute rents towards favored businesses. In the case of Turkey, these options had been limited since the mid-1990s because of a Customs Union (CU) with the European Union on the one hand, and membership of the World Trade Organization, on the other. Both of these, but especially the CU, limited Turkey's ability to implement selective support policies. Indeed, most of industrial policy instruments that Turkey used in the last two decades have been "horizontal" in nature, geared towards areas such as regional development and research and development. What these meant was that in tradeable sectors the scope for favoritism was limited.

There were a number of factors that were conducive to additional institutional reform in the 2000s. The first was the deep economic crisis of 2000-2001. As is typically the case, the crisis increased the bargaining power of both international organizations such as the IMF and the World Bank, and also reform-minded people in the bureaucracy. This created an opportunity to implement major institutional reforms within a time span of one to two years. The reforms included establishing independent regulatory authorities in banking, telecommunications, energy, and public procurement. In a major step, the Central Bank was given independence. Transparency and control of the public budget was significantly increased and the ability of the government to use off-budget expenditures (for example through government-owned banks) was significantly reduced.

The second important factor was the EU. While the Customs Union was already in place, Turkey became a candidate country in 1999. EU regulations provided templates for institutional reforms in many areas and most of the laws enacted in the 1999-2002 period were inspired by EU legislation. Importantly, the competition law had already been enacted in 1994 as a condition of the Customs Union.

The third crucial factor was the coming to power of the Justice and Development Party (AKP) in 2002. AKP came to power on a platform of anticorruption and political and economic reform. At that time it had a very strong pro-EU attitude, which reflected a significant shift away from the discourse of traditional political Islam movement out of which it grew. The AKP embraced most (though not all) reforms. Being a conservative party, they were careful about fiscal policy and did not allow demands for wealth redistribution to result in the deterioration of the budget.

Reform focused on privatizations, banks, telecoms and energy

This EU orientation meant that EU-style institutional reforms, imposed as part of the World Bank and the IMF program, were broadly embraced by the AKP government. In terms of competition, what emerged was an interesting institutional set-up with a central role for competition policy. For industries not characterized by naturally monopolistic segments, quite active competition policy was used to fights cartels and abuse of monopoly power. This policy was recognized by international peers for a high level of competence and professionalism. Competition policy also affected the process of privatization and the evolution of competition in imperfectly competitive industries, such as gas, electricity, telecoms and ports. In those industries, the Competition Board took an active part in reviewing privatization bids, to ensure that privatization transactions would not create dominant positions or enhance existing market power. As a result of intervention by the Competition Board, a number of privatization transactions have been cancelled or modified. In telecommunications and electricity, the Competition Board tried to ensure that privatization would be carried out with structural competitive measures, such as horizontal or vertical separation of certain activities.

Excessive risk taking and corruption in the banking industry played a critical role in the financial crisis of 2000-2001. The banking industry went through a fundamental restructuring under the tight control of the newly founded Banking Regulation and Supervision Agency (BSRA) and a new banking law that introduced EU standards for transparency, capital adequacy, reporting requirements, etc. There is general agreement that it was mainly due to the new regulatory environment that the financial industry survived the global financial crisis of 2008-2009 relatively unaffected.

Developments in the mobile telephony industry also suggest the effect of the EU anchor. It is generally accepted that the regulatory authority for telecoms in Turkey has not been very successful in developing competition in fixed line telephony or broadband internet. This reflects the fact that the regulator is timid in its actions against the telecoms incumbent operator, a situation possibly reflecting regulatory capture. However, the regulator's stance in mobile telephony is much more aggressively competitive. The reason is political economy: Turk Telekom, the incumbent fixed line operator has a mobile subsidiary which is a new entrant in the mobile market. Thus, for the regulatory authority taking a competitive stance in the mobile market (to give just one example, mobile termination rates in Turkey have been among the lowest in Europe) was the only way to regulate Turk Telekom, without resorting to more drastic and predatory means that would have challenged Turkcell's property rights.

The electricity industry also provides an interesting example. In the 1990s there were numerous efforts to engage the private sector in electricity generation and distribution through contracts (so-called "build operate transfer", "build-operate" and "transfer of operating rights" contracts) that provided widespread exclusivity and monopoly rights, as well as various forms of government price and purchase guarantees. Within electricity generation, some such investment contracts were approved without any competitive tender mechanism. Some of these were later heavily criticized by the press for very high prices paid by the state and some were investigated by the high court of accounts (Sayıstay). In electricity distribution, the government attempted to transfer operating rights to private companies granting them monopoly rights over consumers in their regions; most were cancelled by the Council of State (Danıstay), which is the high appeals court in administrative law. Irrespective of the details of specific projects, it was clear the government's approach to engaging private capital allowed for significant discretion and mechanisms whereby rents could be transferred to favored firms. By contrast, in the 2000s the industry went through a restructuring process under a new and pro-competitive legal framework inspired by EU directives. Towards the end of the decade the industry attracted annually 3,000-4,000 Megawatts of new private capacity in generation on a competitive basis and without any guarantees.

Moreover, the generally rule-based and inclusive stance of the government both encouraged the entry and growth of its own constituency — the "devout bourgeoisie" (often associated with the so-called "Anatolian Tigers") — and at the same time secured at least the acceptance and sometimes support of sections of the old industrial elite.

But obstacles to competition still remain

One should not get the impression that even in electricity and telecommunications the development of competition did not face any significant problems. Even though the regulatory agencies have formal independence, in practice they are subject to substantial influence by the ministries they are associated with. Hence in telecommunications, Turk Telekom has been almost openly protected from competition, a tendency that has resulted in significant delays in broadband internet uptake. In electricity, the government influences the determination of regulated retail electricity prices, an area that nominally is under the authority of the regulator. The new institutional structure has limited the government's discretion and perhaps made it more predictable but has not eliminated it. Still, compared to the 1980s and 1990s the overall policy making process became much more rule-based.

Not all segments of the economy were subject to more rule-based governance. Two areas especially stood out as loci of rent creation and allocation towards favored firms. One was construction where the Housing Development Administration (TOKI), which is directly attached to the Prime Ministry, has been given control over public land and tremendous discretionary authority to develop joint projects with the private sector including for public housing and urban regeneration projects. TOKI is given a free hand in its financial transactions, and is exempt from the procurement rules which usually apply to public entities (specified in the Public Procurement Act). It is also not bound by the rules of public budget.

The other area where the government can use discretionary authority to systematically create and allocate rents is public procurement. Even though Turkey passed an EU-inspired public procurement law in the early 2000s the law has been amended frequently to increase government agencies' ability to use non-competitive procedures in awarding procurement contracts. There is much evidence that many of these contracts have been awarded to politically connected firms.

The government has also used politically connected or favored firms to establish control in the media industry. Connected business groups have been encouraged (or even forced) to buy newspapers and TV channels which increasingly have become outlets of government propaganda.

Politics trumps economic institutions

The political environment started to change radically in the last few years. For various reasons the prospect of EU membership weakened and lost its allure. The government turned increasingly authoritarian and intolerant of dissent. The high degree of cooperation between the AKP and the Gulen movement, a tight conservative network organized within business as well as the police and the judiciary, was replaced by open hostility when police apparently associated with the movement instigated corruption investigations against AKP ministers.

Change in the political environment took its toll on institutions of economic policy. Independence of the regulatory authorities and the Central Bank became increasingly challenged. In 2011 the government passed a decree-law that stated that regulatory agencies would be "inspected" by the associated ministries, in effect giving the government an instrument which can be used to harass regulatory agencies. In one revealing incident, President Erdogan openly called upon the BSRA to intervene in a bank associated with the Gulen movement, which the agency eventually did. More generally, state authority started to be used against businesses that fell out of favor with the government (or the President) or worse, that were regarded as part of the Gulen network. The Central Bank came under intense pressure to keep interest rates low. With regard to investment incentives, the government introduced new schemes that give it more discretionary power. It appears that the more the government moves away from rule-based policy making and resorts to discretion, the less it will be able to rely on the competitive process to generate growth, further increasing the government's incentives to rely on discretionary instruments to generate investment.

Conclusion

Turkey went through a period when the scope of rule-based governance increased in major segments of the economy and systematic rent creation and allocation to favored firms was limited to particular industries. This was the result of reduced bargaining powers of a government due to the financial crisis, and the fact that Justice and Development Party (AKP) embraced reforms and found them consistent with their then prevailing political objectives such as EU membership. It is difficult to measure the impact of these institutional changes on economic performance. Nevertheless one can note that between 2002-2007, Turkey experienced one of the highest sustained growth rates in per capita income in her history. Macroeconomic stability was achieved relatively quickly and inflation reduced to single digits, a substantial achievement given Turkey's inflation history. The reforms created an environment more conducive to reap the benefits of competition and creative destruction.

The major lesson is that if a reform-minded government were to adopt pro-competition institutional reform, for example, to increase policy credibility and enhance the degree of competition, there is a good chance that reforms will prove effective. Typically this involves delegation of considerable policy making authority to relatively independent agencies insulated from short-term politics. Once created, formal measures of independence will protect rule-based policy making from political encroachment, but not indefinitely. Ultimately it is the nature of the political institutions that determine the nature of economic institutions. In the golden years of the early 2000s in Turkey, the evolution of economic institutions largely reflected a political orientation that apparently was interested in EU accession. Currently the evolution seems to be closely influenced by the more authoritarian and survival instincts of the government.

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