

**INSTITUTIONAL STRUCTURE,
GOVERNMENT POLICY & ECONOMIC
PERFORMANCE IN TURKEY**

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Institutional Structure, Government Policy, and Economic Performance in Turkey

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Abstract

This paper studies the interaction of political institutions, government policies, and the economic performance in a developing country. The focus is on Turkey's economic history and the "paradox of Turkish liberalism". Except during the periods of war and post-war recovery, the fastest long-lasting growth episodes (1929-39 and 1961-77) have occurred under inward-looking, public-sector-oriented economic policies, while the episodes of slower and unstable growth (1951-60 and 1981-1991) have been associated with liberal, market-oriented policies typically considered more efficient by economists. It is argued that the main factor underpinning this outcome is the evolution of political institutions that increased the government's commitment to its policies during the high-growth periods. During the other two periods, the potential efficiency of policies introduced by the government was seriously undermined by lack of commitment. Commitment was achieved in the first high-growth period by constraining political competition under a single-party rule, and in the second one by diffusing power, creating many veto filters on policy change, and introducing a comprehensive planning system. Although successful for well over a decade, neither mechanism was sustainable in the long run. Lack of long-run stability under these regimes and weakness of commitment under the other two acted as an engine of institutional change in Turkey. The results imply that striking a balance between commitment and flexibility in policymaking tends to be a more difficult problem in countries with a weak private sector and may act as an important factor behind institutional dynamics.

ملخص

تدرس هذه الورقة التفاعل بين المؤسسات السياسية، وسياسات الحكومة، والأداء الاقتصادي في الدول النامية، مع التركيز على تاريخ تركيا الاقتصادي و"تناقض الليبرالية التركية". وإذا استثنينا فترات الحروب وفترات انتعاش ما بعد الحروب، فإن أسرع فترات النمو طويل الأمد (١٩٢٩-١٩٣٩ و ١٩٦١-١٩٧٧) حدثت في ظل سياسات متجهة نحو الداخل ونحو القطاع العام بصفة خاصة، في حين ارتبطت فترات النمو البطيء أو غير المستقر (١٩٥١-١٩٦٠ و ١٩٨١-١٩٩١) بسياسات ليبرالية، متجهة نحو السوق، والتي يعتبرها الاقتصاديون عادةً أكثر فاعلية. ونذهب هنا إلى أن العامل الأساسي المحدد لهذه النتيجة هو تطور المؤسسات السياسية التي رفعت من التزام الحكومة بسياساتها خلال فترات النمو المرتفع. أما خلال الفترتين الأخريين، فقد كان لعدم التزام الحكومة أثراً خطيراً في الفاعلية المحتملة للسياسات المتبعة. وتحقق الالتزام خلال فترة النمو المرتفع الأولى عن طريق تقييد التنافس السياسي في ظل حكم حزب واحد، وخلال الفترة الثانية عن طريق عدم تمركز السلطة، وخلق العديد من مراحل إبداء الرأي حول تغيير السياسات، وادخال نظام تخطيط شامل. وبالرغم من نجاح هاتين الآليتين على مدى عقد وأكثر، فإن الإبقاء على أي منهما لم يكن ممكناً في المدى الطويل. وقد كان كل من عدم استمرارية هذين النظامين على المدى الطويل وضعف الالتزام في ظل النظامين الآخرين بمثابة قاطرة للتغيير المؤسسي في تركيا. وتوضح النتائج أن خلق توازن بين الالتزام ومرونة صنع السياسات يعد مشكلة عسيرة في الدول ذات القطاع الخاص الضعيف، وأن هذا التوازن من شأنه أن يكون عاملاً هاماً وراء الديناميكيات المؤسسية.

1. INTRODUCTION

This paper studies the interaction of political institutions, government policies, and economic performance in a developing country. The focus is on Turkey's economic history. The discussion is organized by seeking an explanation for "the paradox of Turkish liberalism:"¹ Except during periods of war and post-war recovery, the fastest long-lasting growth episodes (1929-39 and 1961-77) have occurred under inward-looking, public-sector-oriented economic policies, while the episodes of slower and unstable growth (1951-60 and 1981-1991) have been associated with liberal, market-oriented policies, typically considered more efficient by economists. We argue that the main factor underpinning this outcome is the evolution of political institutions that increased the government's commitment to its policies during the high-growth periods. During the other two periods, the potential efficiency of policies introduced by the government was seriously undermined by an inability to commit, especially in the face of electoral cycles. Commitment was achieved in the first high-growth period by strongly curbing political competition under a single-party rule, and in the second one by diffusing power, creating many veto filters on policy change, and introducing a comprehensive planning system. Both of these institutional setups were conducive to robust economic performance in the medium run, but could not be sustained in the long run. The 1929-39 episode was aborted due to the events surrounding World War II and the growing demand for democratization. The 1961-77 experience came to an end because the combination of institutions and policies had rendered the system too rigid to respond to major shifts in the economy's parameters. Lack of long-run sustainability under these regimes and weakness of economic performance under the other two acted as the engine of institutional change in Turkey.

Sustained long-run growth requires commitment to policies that reward investment and productivity, but allow those rewards to respond to changing supply and demand conditions. While there is a variety of institutional mechanisms that provide commitment across societies and over time, successful countries generally seem to have been able to combine such mechanisms with policies that extensively rely on the private sector.² However, when the experience of a modern private sector in the country is limited and extensive involvement of foreign investors is not an option, such a combination may be slow to materialize because it takes time for the

¹ This terminology is borrowed from Bugra (1994: 120). She dubs the failure the pro-market and pro-business governments of the 1950s and 1980s to stimulate private investment as "the paradox of Turkish liberalism."

² This is, for example, what Korea and Chile have done. In both countries, under authoritarian rule the political leadership had a long-term horizon and could develop a "self-enforcing implicit contract" with the private sector. This served as a flexible commitment mechanism. After transition to more democratic rule, each country has instituted some form of institutional commitment. Korea established a dominant ruling party that can take a long-term view in its policy making. In Chile, the outgoing authoritarian rulers established widespread share ownership in the economy to create popular support for a market economy and designed the institutions of the upcoming democracy in ways to ensure that power would remain highly decentralized. The two institutions, which reinforced each other and generated a form of flexible policy commitment, were partly intended to prevent the emergence of concentrated political or economic powers that might have challenged the military privileged position. For a more detailed discussion on these international comparisons, see Campos and Esfahani (1995).

private sector to build its assets, entrepreneurial skills, and institutions. As in other underdeveloped countries, this was the case in Turkey at the time of its birth and the experiments with alternative institutions and policies partly reflect the country's attempts to find substitutes while the private sector develops. Some of these formations worked better than others, but none was a long-term solution. Understanding the causes of the rise and decline of such formations can help improve the design of institutions and policies in other countries in comparable situations. Similar lessons can be also be found in the experiences of other countries. The Turkish case is interesting because it contains a number of different institutional formations that have run their course in the same country.

The idea that the weakness of constraints on policy change may give rise to a "time-inconsistency" problem on the part of the government and adversely affect economic performance is an old one (Kydland and Prescott, 1977). Also, the fact that electoral cycles exacerbate the problem is well understood (Alesina, 1994). In fact, both ideas are important themes in recent studies of economic policy in Turkey (e.g., Atiyas, 1994; Bugra, 1994; Önis and Webb, 1994; and Waterbury, 1993). What is new in this paper is the analysis of institutional mechanisms that help mitigate the problem, the limitations of such mechanisms when the private sector is weak, and the institutional changes induced by such limitations. The literature on the political economy of policy reform has paid attention to these issues, but mostly in the context of factors that delay policy reform.³ This paper is concerned with the determinants of policy success and failure in a broader context which sheds further light on the causes of delay in reform as well as their dynamic links with institutional change and economic performance. For the Turkish case, the paper offers a unified explanation for the past trends in economic policies and outcomes, with important implications for the possible future path of the economy as the country's institutional structure evolves.

The analytical approach of this paper is a new institutionalist one akin to the framework outlined by North (1990).⁴ We posit that economic policies act as contracts between the government and economic agents to address perceived market imperfections or redistribution demands. Thus, policies can reach higher efficiency and lead to better economic performance when the government faces less contracting problems. That is, if it can commit to the incentives that it offers and collect information about the conditions of investment and production at low cost. The capabilities to commit and to collect information, in turn, depend on the society's institutions (i.e., formal and informal rules that structure human interactions). Hence, although economic performance depends on policy, its roots must be tracked to institutions. The institutional setup itself is subject to change as a result of movements in system parameters and performance. Dynamic shifts in resource scarcities, tastes, and technology induce changes in economic organizations in general, and economic policy in particular. Since policy and organizational change are constrained by institutions, parameter and performance variations can

³ For recent surveys of this literature, see Alesina (1994) and the introduction to Haggard and Webb (1994).

⁴ For a survey of methodology and a collection of empirical works in new institutional economics see Alston et al. (1996).

reveal the limitations of the existing institutions and encourage social and political entrepreneurs to seek institutional change. Because this process of change depends on the existing institutions, organizations, and beliefs within the society, the outcome may solve some immediate problems but may not necessarily result in institutions that allow efficient policies and organizations to take shape.

Analysis of policy efficiency obviously requires some measure of dynamic economic efficiency. Since direct measures of economic efficiency are not available, we use per capita GDP growth rate, investment-GDP ratio, and the rate of total factor productivity (TFP) growth as proxies.⁵ These variables are closely related to economic efficiency in less developed countries because capital, skills, and technology are scarce in these countries and, therefore, a low investment rate or a slow growth indicates that the country is not attracting and employing economic resources efficiently.

The next section develops the analytical framework of the paper and summarizes the arguments. Sections 3 through 8 analyze the main historical episodes in the Turkish economy and relate economic performance to institutional characteristics. Section 9 contains some concluding remarks.

2. THE FRAMEWORK OF ANALYSIS

To make the analysis manageable, it is convenient to partition the participants in an economy into three main groups: (1) the political elite, who comprise the individuals with skills and connections necessary to run the government; (2) the economic elite, i.e., entrepreneurs with the skills, resources, and connections necessary to identify investment opportunities and direct significant productive enterprises; (3) the non-elite, including peasants, workers, and the middle class, who may be professionally skilled, but do not control major resources or networks. Each group may consist of subgroups with special interests. The economic elite and the non-elite receive payoffs based on the returns to their assets and redistributions effected by the government. The politicians' payoff depends on the resources and the support they receive from the other groups to maintain a position of power. The government's role is to make rules and take actions that help resolve coordination and redistribution problems among the participants in the economy. The efficiency of economic policies depends on the politicians' access to information, their incentive to formulate long-term policies, and their ability to enforce policies adopted by the government. These in turn depend on rules and mechanisms that facilitate transmission of information and constrain the actions of the participants, including those in control of the government. Such rules and mechanisms may be based on formal institutions or informal relationships between politicians and other groups.⁶

⁵ In this paper, TFP growth is measured as the residual GDP growth unaccounted for by the increases in the stock of capital and the number of workers. More refined measures of TFP growth are not available.

⁶ Formal policy constraints are based on explicit (usually written) rules that vest certain veto powers in individuals or groups in control of designated positions. Informal constraints are "implicit contracts" between the government leaders and various interest groups, which are maintained by the value of cooperation.

To direct the economy, the political elite choose a level of intervention ranging from extensive reliance on private transactions to widespread control of production and exchange. The advantage of a private economy is decentralized decision making and efficient information processing, except when there is a serious market failure. But, due to interest group demands, politicians have an incentive to intervene and redistribute. As a result, successful operation of a private economy depends on confidence among private agents that government interventions remain limited and predictable. Government-controlled markets and enterprises do not demand the same level of trust, but they require centralized information processing and decision-making. This may not cause much resource waste when the government bureaucracy is effective and its control is limited to a few enterprises and markets or when the economy is primitive and does not entail a great deal of specialized exchanges. But, efficiency loss can be significant when controls proliferate and the economy is complex.⁷ In particular, the informational burdens of the large bureaucracy needed to run a centralized system forces the government to use rigid, across-the-board operation rules (e.g., with respect to prices, procurement, wages, and personnel management) rather than allowing decisions respond to specific circumstances.

The incentives of politicians in charge of the government to formulate and implement efficient policies depends largely on their time horizon in office, their relationships with other groups, and institutional constraints on their behavior. The ruling subgroup of politicians (e.g., political party or clique) has an incentive to focus on policies with short-term payoffs if it expects to lose power in the near future through legal or illegal means and has little chance of returning to power or remaining influential in the government. Such a focus may not necessarily be due to opportunism and lack of integrity among politicians. They tend to act in this way if they expect others who succeed them to reverse the policies initiated at present. However, the ruling politicians may be persuaded to launch long-term policies and go along with pre-existing ones if the institutional structure makes policy change costly; e.g., when policy change requires costly coalition building across different interest groups (Shepsle, 1991). Thus, when the probability of regime turnover is high, the economy is likely to suffer if institutional constraints on policy change are weak.⁸ When institutions restrict policy discretion, the economy may perform well, especially if the initial policies support the development of a flexible economy. This is in fact the way successful democracies maintain policy stability while keeping the political leadership positions contestable.

The incentive of politicians to consider more efficient, long-term policies improves when they expect to rule for a long time or have a good chance of remaining influential and regaining power in the near future. This is the case when a single party dominates the politics of the country and political competition for the control of the government is restricted. The long-term horizon of the ruling elite in such a situation does not automatically translate into efficient policies because

⁷ Former centrally planned economies are prime examples of such inefficiency.

⁸ By turnover in the government, in this paper, we mean replacement of a political *team* controlling the government by another one with different orientation and ties to individual interest groups.

political leaders may not be competent managers of the economy or may not trust that other groups respond to policy incentives appropriately. For example, when private investors are suspicious that a dictator may expropriate them, policy incentives can hardly induce investment in the country and the dictator may not offer incentives for private sector development in the first place. Also, the absence of a significant private sector and lack of understanding or experience with the operation modes of a private economy may lead to extensive government intervention and reliance on public enterprises.

Political institutions are themselves subject to change depending on the performance of the conditions and performance of the economic and political systems. Demand for institutional change increases among interest groups when an alternative institutional setup offers prospects of better economic performance or more effective resolution of interest group conflicts. But, transforming institutions is costly because it requires a great deal of coordination among interest groups, by consent or by force. As a result, the likelihood of institutional change increases when the demand grows high because of poor performance of the economy or systematic failure of conflict resolution mechanisms. When change does occur, the new institutions are likely to address the failures of the previous institutional setup subject to the constraints imposed by the relative power of various interest groups, their beliefs and "mental images," and the economy's resources (Alston et al., forthcoming). For example, when institutional change occurs in a situation where opportunistic use of policy discretion has seriously impeded saving and investment, the new institutions are likely to impose stronger constraints on the government's actions (North and Weingast, 1989). This may be combined with restricting government intervention in the economy if those who are influential in the design of the new system believe that the private sector can operate the economy efficiently and find the outcome in their interest. On the other hand, constraints on policy may be combined with extensive government controls over assets and markets if the designers lack confidence in the capability of the private sector or view restricting intervention detrimental to their interests.

In our analysis of institutions and economic performance in Turkey, we focus on various episodes of institutional change. For each episode, we take as given the initial political and economic conditions as well as the social and cultural parameters that determine the informal relationships within and among various groups. We argue that these conditions were conducive to the formation of observed institutional structures and policies, which entailed the economy's actual performance as their likely outcome.⁹

3. INITIAL CONDITIONS

Modern Turkey emerged after World War I out of the ruins of the Ottoman Empire. Ottoman power had been on the decline for three centuries. The Empire had faced changes in its position in the world economic and political system, but its highly bureaucratic system of governance had been slow to respond (Keyder, 1987). While the Ottomans were fighting increasingly costly

⁹ The main macroeconomic data for the periods discussed in the paper are summarized in Table 1.

internal and external wars, their sources of revenue were stagnant or shrinking. Until the early 19th century, heavy reliance of the rulers on the bureaucracy and the army had prevented the rise of any source of political or economic power outside the central government (Frey, 1975; Mardin, 1980). At the same time, bureaucratic control over economic resources and activities had left little incentive for investment and economic expansion (Mardin, 1980). During the 19th century, the Ottoman elite made a number of attempts to solve the Empire's political and economic problems and halt its decline. However, the solutions they sought were essentially bureaucratic reforms, most of which proved to be failures. Meanwhile, the Ottomans had become vulnerable to European pressure and, as part of the reform programs, the government established very liberal foreign trade and investment regimes, with special privileges granted to foreigners. British and French capital took key positions in the economy, including the control of the Ottoman Bank, which acted as the central bank and issued currency (Keyder, 1987: 64).

Although the liberal trade and investment measures did not help the finances of the central government, they gave rise to an expansion of agricultural production, a greater security of private property, and involvement of foreigners in domestic commerce, banking, and infrastructure. These developments particularly benefited Levantine minorities (mainly Armenians, Greeks, and Jews which comprised about 20% of the population) and some Ottoman notables who resided along the seaports of the eastern Mediterranean and Aegean Seas and had links to businesses in Europe (Bugra, 1994: 36-37). In the rest of the Empire also local notables gained greater independence, but those areas did not experience much economic development (Mardin, 1980). In Anatolia and Istanbul, the heartland of the Empire and the geographic location of modern Turkey, this process exacerbated the ethnic division of labor between Levantine minorities and the Turkish majority. While the elite of minority groups prospered in trade and commercial agriculture, the Turkish elite either became large landowners and tax farmers or joined the Empire's main pillars of power---the bureaucracy, the army, and the religious hierarchy.

In 1908-1909, a group of army officers and bureaucrats, known as the Young Turks, deposed the ruling Ottoman Sultan and transformed the Empire into a multi-ethnic and multi-party constitutional monarchy. The Ottoman government under the Young Turks took a more developmentalist stance. Private investment was encouraged through an 11% tariff on all imports except production equipment and machinery (Hansen, 1992: 301). The government also began to actively invest in industry. Although the Young Turks followed the Ottoman tradition of reliance on the bureaucracy, they were aware of the past bureaucratic reform failures and sought to build a local capitalist class (Mardin, 1980). Some army officers, ex-bureaucrats, and individuals closely related to the Young Turks took advantage of the incentives provided by the government and started new businesses, often in partnership with the state (Bugra, 1994: 40-41). These developments were aborted by the advent of World War I, in which the Ottoman government was dragged in on the side of the Central Powers.

The ascent of the Young Turks in 1908 reflected the disappointment of the elite with the Empire's Ottoman-Islamic traditions and the spread of a belief in institutional Westernization as a means of saving the Empire. However, once in power, Young Turks could not keep their promises of equality among all ethnic groups and increasingly turned to Turkish nationalism. As

a result, separatist movements in various corners of the Empire found fertile grounds and were readily exploited by Western powers to disintegrate the system. This process accelerated with the start of World War I and, before long, even Anatolia was being partitioned by victorious Western powers. In response, a group of high ranking army officers and bureaucrats who had their roots in the Young Turks movement joined forces with Anatolian landowning local notables and formed a Turkish nationalist front to save the heartland of the empire as their homeland (Turan, 1984). This front, which came to be known as the Republican People's Party (RPP), established Turkey as a new nation after successfully fighting a war against Greece that had invaded parts of Anatolia with backing from Western powers.

World War I and the Graeco-Turkish War had four important consequences for the future of Turkey. First, the resentment developed over the previous century against the involvement of foreigners in the country was accentuated. This seriously inhibited the potential participation of foreign investor in the development of the economy for many decades. More importantly, in the process of these wars and their aftermath, the Armenian and Greek minorities who sympathized with the Western powers and invading Greek forces were largely expelled and purged from the country.¹⁰ Since these minorities controlled most of the commercial activities in Anatolia, their departure left a great vacuum in the economy. This vacuum was partially filled by the Turkish population expelled from the Balkans in a process mirroring that in Anatolia. However, the loss of commercial skills and networks was substantial. In addition, the two wars destroyed a great deal of the country's infrastructure and productive assets.

Second, to end the Graeco-Turkish War, the RPP signed a treaty with the Western Powers in Lausanne in 1923. In this treaty, the newly established government of Turkey gained recognition from Western powers in exchange for guarantees of protection for a variety of Western interests in the country until 1929. In particular, the Turkish economy was to remain open to foreign trade and investment and, moreover, the concessions and monopolies granted to foreigners by the Ottoman government had to be maintained. The treaty constrained the economic policy options of the Turkish government for some time, but assured the participation of foreign capital in the Turkish economy during the 1920s. This helped partially replace the capital and networks lost due to the departure of minorities.

Third, the political and economic weakness of the landowners and the exigencies of the war gave the military and bureaucratic leaders of the RPP a natural advantage over their coalition partners. As a result, those leaders came to form the political elite of the country and dominate the government. Even among the elite, the power structure took a military-bureaucratic form, with an army general, Mustafa Kemal (Atatürk), assuming undisputed leadership (Frey, 1975). The landowners only managed to secure the protection of their local interests. This protection was institutionalized in Turkey's 1924 constitution by vesting all powers in a parliament, the Grand National Assembly, where the members of the nationalist coalition could be represented.

¹⁰ The share of Levantine minorities in Turkey's population declined from about 20% before World War I to only about 2% in 1927 (Hansen, 1992: 295).

However, the electoral system was designed multi-tiered and indirect so that only the members of the military and bureaucracy and the local elite approved by the RPP leaders could join the Assembly (Ahmad, 1976: 3).¹¹ Since the Assembly chose the executive officers, the RPP leaders in effect concentrated all government powers in their own hands. The only check on their power was the provision that the Assembly could not be dismissed. Only the Assembly could call for early elections before the end of its four year term. After each elections, the Assembly would elect a president to serve a concurrent term as the head of the government. The president would then appoint a chief executive officer, the prime minister, who would form a cabinet and stand responsible to the Assembly. Until the introduction of competitive politics in the late 1940s, the presidency was the most powerful office in this system.

Aside from the events surrounding the Graeco-Turkish War, a key characteristic of the Turkish society played an important role in the formation of an authoritarian state in the early decades of the republic. The dominance of bureaucracy in the Ottoman Empire gave the state a patrimonial role in society (Heper, 1985). This implied that the political elite considered themselves above the society and distinct, and maintained entry into their ranks restricted through a variety of formal and informal rule. These restrictions were justified largely by the belief that "national interests," as defined by the existing political elite, could be jeopardized by open political competition in an "uneducated" society (Frey, 1975). This cultural feature facilitated erection of strong limits on the negotiation and bargaining of interest groups with the leadership and helped power become highly concentrated.

Thus, by 1924, Turkey's political elite had established a constitutional government with an authoritarian character in which their main (junior) partners were the landowning local notables of the country. At the time, Turkey lacked a domestic economic elite experienced in industry and services to develop those sectors. In view of the historical relations between the Ottoman Empire and Western powers, the political elite were also reluctant to depend on foreign capital, even though foreigners had invested in Turkey and continued to maintain their interests. Naturally, the political elite had to largely rely on the bureaucracy to develop the economy and to deliver the goods justifying their rule. The hope was that at a later date an enterprising private sector would emerge and take over the task (Turan, 1984).

4. POLICY STABILITY UNDER SINGLE-PARTY RULE, 1923-1939

The events in Turkey during the first two decades of the Republic present examples of the potential flexibility and effectiveness of economic policy under typical conditions in an underdeveloped economy when the institutional setup concentrates power but there is continuity in the government. The events also show that in this situation, given the lack of commitment mechanisms, many policy inefficiencies are related to the weaknesses of the private sector and

¹¹ The constitution did not require that Assembly members to belong to (i.e., be born or live in) the districts they represented. The Assembly candidates were typically determined by the RPP leadership from among party activists and bureaucrats (Frey, 1975).

strains in its relationship with the political elite. Finally, they show the limits to the benefits of leadership continuity when conditions change sharply and there are no institutional constraints on policy.

Immediately after establishing the Republic, RPP leaders focused their attention on consolidating their power by dismantling all remnants of Ottoman institutions, especially those serving as power bases for the religious establishment. Through the control of the Grand National Assembly and the electoral process, they also undermined any actual or potential opposition to the RPP rule. In the course of these activities, the political elite strengthened the bureaucracy, fused it with the RPP, and turned it into their main base of power. Bureaucratic control was imposed on many aspects of life in Turkey, and interest group representation was effectively curtailed. Interest group associations were either outlawed (e.g., labor unions) or were required by law to become extensions of the bureaucracy where ministries appointed the top officials (e.g., chambers of commerce).¹² The political system took a dictatorial form in which Atatürk and a few of his associates exercised a great deal of power through the RPP and the bureaucracy. Atatürk was elected as the first president of the Republic and remained in that position until his death in 1938. At that point Atatürk's position was passed on to his old-time first lieutenant, İsmet İnönü, who led the RPP until 1972 and served as the president of the Republic until 1950.

Although the political elite maintained their alliance with the local notables, they could not rely on the notables as an economic elite to develop the industrial and service sectors of the economy. Thus, they began to invest and develop the economy with the help of the bureaucracy, while supporting the private sector and planning to ultimately hand over business management to the economic elite that was expected to emerge from the process. The commitment to the development of a private enterprise economy was reflected in the principles adopted by a National Economic Congress organized in 1923, which brought together the representatives of merchants, industrialists, farmers, and workers (Bugra, 1994: 98). It was also evident in the establishment of the Is Bank in 1924 to encourage private investment in a variety of industrial and commercial activities. The Is Bank was initiated as a private corporation in which the government participated and many among the political elite, including Atatürk, took a personal interest (Hershlag, 1968: 126). Even state-owned financial institutions such as the Bank for Industry and Mines which were in charge of managing the existing public enterprises, participated in a variety of privately-owned firms (Hershlag, 1968: 91). The vision behind these policies was that a high industrial concentration and close ties between big, modern firms and the state were crucial characteristics of successful Western economies and needed to be reincarnated in Turkey (Bugra, 1991). Such an approach seems to have fitted Turkey's institutional conditions quite well. The country had inherited a problem of insecure property rights from the Ottoman Empire, and the Republican regime could not effectively solve it while it remained authoritarian.

The economic recovery from the war destruction was rather quick and the Lausanne treaty helped foreign businesses fill part of the void created by the exodus of economically prosperous

¹² For an account these developments see Bianchi (1984).

minorities. Between 1924 and 1929, on average, real GDP per capita grew at about 5% per year by investing only 12.3% of the GDP (Hansen, 1992: Tables 9-2 and 9-3). Thus, while the volume of investment was relatively low, efficiency in the use of invested capital and TFP growth must have been substantial. The main source of this growth was agriculture, which in the 1920s produced about half of the GDP and grew at the rate of 8.2 %. Agriculture greatly benefited from free trade, foreign involvement, and a variety of government support programs, particularly public investment in the sector's finance institutions and infrastructure.¹³ Industry did not receive much incentives or public investment in this period and its growth rate was not as spectacular (6.1% per year). The government could have bypassed the Lausanne treaty and protected specific domestic industries by instituting state monopolies over them, but it chose not to do so (Keyder, 1987: 96). These policies seem to have been quite reasonable given the conditions because at the time Turkish agriculture had a great deal of untapped resources, especially abundant land, and needed the attention of the government (Hansen, 1992: 331). Ottoman bureaucratic rule had largely failed to resolve agriculture's institutional and infrastructure problems. The RPP government could easily enhance economic efficiency by addressing some of those problems, in part thanks to its alliance with the landowners.

When the Lausanne treaty expired in 1929, the government passed a law that provided a framework for regulation of foreign trade. It also took over the monopolies and infrastructure enterprises controlled by foreigners and hired domestic private firms to administer them. The end of the treaty also coincided with the onset of the Great Depression and a sharp drop in Turkey's terms of trade. Initially, the economy suffered a balance of payments problem and a considerable decline. But, the government soon allowed the domestic currency to depreciate and began to restrict imports and encourage domestic industrial production. The response to these import-substitution industrialization (ISI) policies was favorable: Between 1929 and 1932, manufacturing output expanded by more than 15% per year and even the hard-hit agriculture grew by about 5% per year. Although the rate of investment in the economy as a whole fell to about 8.5% of GDP, the growth rate of GDP per capita was approximately 3.7%, a highly respectable rate considering the external conditions of the economy at the time (Hansen 1992: 321 and Table 9-2). Again, TFP growth must have been quite high (Hansen 1992: 331).

Despite the performance record of the economy after 1929, the political elite had little confidence in the private sector to take full charge of the country's economic development (Hansen, 1992: 322). This was partly due to the historical scarcity of entrepreneurial skills in the country and partly the result of the Great Depression, which critically damaged all market economies including the Turkish one. Also, the anticipated changes in the trade regime after the expiration of the Lausanne Treaty in 1929 induced rampant speculative activities and fueled the accusation that Turkish businessmen were corrupt and profiteer rather than enterprising and productive (Bugra, 1994: 101). At the same time, Turkey's political leaders could not ignore the concomitant

¹³ Government investment in financing agricultural development had started under Ottoman rule. But, the state-owned Agricultural Bank established in 1889 had developed at a slow pace before 1924. The Republican government substantially strengthened this bank and expanded its activities (Hershlag, 1968: 48).

success of the industrialization drive in the Soviet Union, even though they were averse to instigate class-based ideologies (Hershlag, 1968: 63). This confluence of events led the leaders to the conclusion that the state should act as a pioneer in industrial development. This approach, labeled as *étatisme*, involved an active ISI policy to direct the private sector and to support the public sector in addition to an investment program in public enterprises wherever private investment was considered inadequate (Hershlag, 1968: 73).

The wave of increased state control over the economy started in 1930, partly in response to the speculative activities of 1929, by the passage of the Law for the Protection of Turkish Currency and the creation of a Central Bank that assumed the functions of issuing currency and controlling transactions in foreign currency. The Law was particularly indicative of the government's intention to gain extensive control. The text mandated the government to keep the currency stable without specifying limits to the type of measures that could be used for this purpose. Instead, it "incorporated the type of sanctions to be imposed against those who act in a way to hamper currency stability" (Bugra, 1994: 101). Another milestone in the government's involvement in the economy was the 1933 establishment of the Sümerbank which replaced the Bank for Industry and Mines and became the leading institution in the management and development of industrial public enterprises. Later on, in 1935, Etibank was also founded with similar responsibilities in the mining sector. Meanwhile, the government drew up a five-year plan in 1934 to coordinate all public investment activities.

Under the etatist policy, investment as a share of GDP increased to about 10% during 1936-1938.¹⁴ This was below the 12.3% investment rate reached in the pre-etatist period of the late 1920s. Yet, the per-capita GDP growth rate rose to over 5% again. Thus, the economy's overall TFP must have continued to grow at a fast pace, though the volume of investment was evidently too low. The inadequacy of capital formation was entirely due to the virtual stagnation of private investment. Public investment continued to grow rapidly and increased its share of the total from 26% in the late 1920s to about 45% throughout the 1930s.¹⁵ That this shift did not cause a decline in TFP growth is indicative of the possibility for a government to operate a limited number of public enterprise without much efficiency loss. However, it also reflects the fact that, the industry-oriented rhetoric of *étatisme* notwithstanding, the government did not lose sight of agriculture's continued long-term potential. Indeed, agriculture remained the focus of government attention and the main driving force in the economy:

Throughout the whole interwar period, . . . , public investment primarily supported agriculture. Even in the last years of interwar *étatisme*, the government allocated only about 25 percent of public investment to industry against 50 percent to agriculture and railroads. In terms of actual investment, industry was never the primary concern of the government (Hansen, 1992: 329).

¹⁴ The data in this paragraph are all based on Hansen (1992: Tables 9-2 and 9-3).

¹⁵ Public enterprises established in the 1930s were highly capital intensive compared to the existing industrial ventures and may have displaced private investment (Hershlag, 1968: 106).

RPP leaders' attention to agriculture and their success in developing the sector is in stark contrast with the failure of the Ottoman government in this area. An important difference in the two situations is the much stronger alliance between the political elite and the landowners under the Republican government. Also, compared to the Young Turks period, the leadership had a stronger hold on power and took a longer view in its policy making. Indeed, the overall economic policy making under *étatisme* marked high scores. The government was sensitive to the concerns of the producers and, in particular, emphasized policy stability. Monetary and budgetary policies were conservative and, despite rapid increase in government expenditures, inflationary financing was avoided (Hansen, 1992: 330). Even the distortions and rent-seeking inefficiencies of protectionism were minimized during the 1930s by instituting a uniform across-the-board tariff (Bugra, 1991).

With the advent of World War II, the Turkish government decided to remain neutral between warring states. Given the international conditions at the time, the political elite found it necessary to prepare the country to defend its neutrality. Thus, Turkey began to rapidly expand and equip its army. To finance this mobilization, the government imposed burdensome price controls and taxes on the private sector, many of which fell on agriculture. Agricultural and overall economic growth rate turned negative.¹⁶ The only flourishing part of the economy was trade and finance, especially in areas that circumvented government controls.

As the war went on, the government decided to act more freely in generating tax revenues. In particular, in 1942 it instituted a wealth levy that could be arbitrarily imposed on individuals (Keyder, 1987: 113). Although, as one might have expected, the bulk of this levy fell on non-Muslim merchants, wealthy Turks also had to live with the threat of arbitrary expropriation and, indeed, carried about a third of the burden. Such policies left a deep resentment in the private sector against the political leadership. The fact that the policies were established through law did not matter because the government had a great deal of discretion in writing the laws. Businessmen as well as landowners viewed the policies as "unjust" acts even though the leaders had been pressed by the exigencies of the war. These violations of the leadership's "implicit contracts" with the private sector were an important factor in the ultimate transformation of the political system into a more competitive one after World War II.

5. POLICY UNCERTAINTY UNDER MULTI-PARTY RULE, 1946-1960

Turkey's basic institutions did not change after World War II, except for a split in the RPP and the emergence of an opposition party. The political and economic developments between 1946 and 1960 are witness to the significance of the potential turnover problem that this change brought about while political power remained highly concentrated. Efficiency of economic policy sharply declined and led to a crisis that was ultimately resolved by a major institutional change.

¹⁶ It is estimated that during 1939-1945 agricultural, industrial, and total GDP declined at the annual rates of 6.0%, 7.0%, and 5.4%, respectively. The public sector value added declined at the rate of 6.4%. However, the economy in this period has not been studied in much detail and these estimates may be biased downward. See Hansen (1992: 335).

At the end of World War II, Turkey was quick to align itself with the winners, especially the West that needed Turkey's cooperation in containing the Soviet Union. The promises of receiving foreign aid through the Marshall Plan and the prospects of trade and foreign investment were too great to be missed. Since private sector orientation seemed to reinforce these promises and prospects, the government reemphasized private sector development. However, the strained relationship between most interest groups and the RPP leadership at the end of the war provided an opportunity for a group of high ranking RPP members to split away and establish a new party, the Democrat Party (DP), seeking a new alliance with the private sector and hoping to rule by themselves. The remaining RPP members generally saw the DP—which was headed by Celâl Bayar, a former prime minister and the founder of the Is Bank, and Adnan Menderes, a charismatic Assembly representative—as a potentially loyal opposition and allowed its formation to appease the disenfranchised population.¹⁷ At the same time, the RPP reformed its programs and policies and brought them close to what the opposition was offering. Indeed, by the late 1940s, there was no practical difference between the programs of the RPP and the DP (Ahmad, 1977: ch. I). Moreover, with a rapid post-war recovery during 1946-1950, the RPP leaders were confident that they would be able to continue their rule despite the private sector support for the Democrats. The lingering political repression prevented the leaders from appreciating the depth of the popular resentment. Many in RPP even held the view that the population must be thankful to the ruling party for its past accomplishments and its current democratization and liberalization. However, much to the surprise of RPP leaders, in the elections held in 1950 the DP won 90% of the popular vote and an overwhelming majority in the parliament. Bayar was elected president and he, in turn, appointed Menderes as the prime minister.

To maintain their new position, the DP leaders faced three major problems. First, the RPP had deep roots in the bureaucracy and the army and could easily undermine DP rule.¹⁸ Second, the private sector on which they hoped to rely was still quite diffuse and weak. Third, the large coalition that the DP had built was vulnerable to internal dissent. To respond to these problems, the DP leaders first moved to bring the army and the bureaucracy under their control by changing the entire upper echelons of the two hierarchies (Ahmad, 1977: 36 ff.). Later they raked through the bureaucracy and the judiciary by legislating laws that empowered the government to retire any state employee over sixty or with 25 years of service and to dismiss civil servants judged to be incompetent or politically involved (Ahmad, 1977: 53; Bugra, 1994: 158). At the same time, the DP started a series of political skirmishes with the RPP and especially focused its attacks on the party's leader, İnönü. In addition, the government began to investigate the RPP's finances and,

¹⁷ There was a radical faction within the RPP that opposed political liberalization. But they did not prevail in the party. Besides, even that faction was hopeful that if liberalization did not work well, the opposition parties could be dissolved and the mono-party system restored. This had indeed happened twice before, in 1925 and 1930. For accounts and analysis of the events that led to the emergence a multi-party system in Turkey see Ahmad (1977), Chapter I, and Turan (1984).

¹⁸ Immediately after the elections there were rumors that the RPP might try to restore its power by force. However, the RPP leaders adhered to the rules they had set up and only mounted a political challenge to the DP rule.

after passing appropriate legislation, stripped the party of much of its property (Ahmad, 1977: 44).

To deal with their second problem, the DP leaders accelerated a process of trade liberalization already initiated by the RPP and proposed a program of privatization. Moreover, credit supply through state banks was eased tremendously to finance private sector activities (Hansen, 1992: 344). The government also sought foreign assistance by joining the NATO pact and allowing American military bases in Turkey. These policies were expected to strengthen the private sector and improve economic conditions, thus buying the support of business leaders, landowners, and other participants in the private sector.

Successful private sector development could have contributed to the resolution of the DP leaders' third problem. However, that would have been a long-term benefit and could not have helped in the short horizon of electoral cycles. A more certain solution was to use the extra-ordinary powers of the executive office to repress the internal and external opposition to party leaders and, more importantly, to create extensive patronage networks. The allocation of preferential credit, government contracts, and jobs in the public sector and the administration became important means of patronage, rewarding those who supported the DP and harassing those who opposed it (Heper, 1991b: 15). Later on, foreign exchange rationing also turned into another major source. The high degree of discretion used in these allocations gave rise to a "love-hate" relationship between the government and the private sector, which Bugra (1994) has extensively documented. The accusations and rumors of abuse of government power and resources was a daily subject of discussion in the newspapers throughout the 1950s.

Economic policies of the 1950s had a short-horizon character that was in clear contrast with that of RPP policies during the 1930s. Trade liberalization was combined by a fixed exchange rate, a large agricultural price subsidy, and an enormous domestic credit expansion. This combination did not pose a serious problem in 1950-1952 because at the time Turkey enjoyed an unusually favorable terms of trade due to the commodity boom during the Korean War. But, once the boom ended, the policy was clearly unsustainable. The DP leaders, however, chose to deplete the foreign reserves of the Central Bank and increased foreign borrowing to continue the flow of imports and maintain the interests of their supporters in the private sector. At the same time, the government started to quickly invest in infrastructure, which created enormous government contracts, and in a series of sugar and cement plants, which came to be called "election factories." "The Democrats—and the same would probably have been equally true of the Republicans—began to give priority to economic projects that would also have a favorable political impact and guarantee votes in the next elections" (Ahmad, 1977: 128). These measures did in fact win another parliamentary majority for the DP in 1954. However, by then the subsidization and credit expansion policies had given rise to accelerating inflation. This further eroded the real exchange rate and increased the demand for imports.

The government's response to inflation was extensive price controls, especially the prices of public enterprises, including infrastructure services. But, the deficit of these enterprises became another source of credit expansion. The problem of foreign exchange shortage was addressed by

rationing, which allowed the government to direct the flow of imports toward politically-determined targets. This was an effective tool of political control because in the free market foreign exchange commanded a very high premium over the official rate. By 1956, Turkey had entered a period of economic distress and political instability. This was largely a product of the domestic policy rather than exogenous shocks. Although the Turkish economy experienced a decline in its external terms of trade after 1953, these terms were at historically high levels and remained well above the terms of trade during 1925-1949 (Hansen, 1992: Figure 6-2).

In 1957, the Democrats called for an early election with little time for the opposition to prepare. Although they again won a majority in the parliament, their share of the popular vote had declined to 47%. More importantly, the RPP questioned the legality and honesty of the elections and opposition activity intensified. The DP representatives in the Assembly passed legislation that significantly curtailed freedom of speech in public and in the Assembly itself. Rumors of a military conspiracy spread and the newspapers reported the arrest of nine officers. "Menderes was in a state of panic" (Ahmad, 1977: 57).

In 1958, Turkey was in an economic crisis. Economic activity was declining, inflation was on the rise, and foreign creditors refused to finance the countries trade deficit. To resolve the balance of payments crisis, in mid-1958 the government accepted an IMF-sponsored stabilization program. A currency exchange tax of 221% was imposed on all imports and capital transactions, which in effect devalued the Turkish lira. But, on the export side there was little shift in the exchange rate. The program also included removal of price controls, imposition of ceilings on credit and budget deficit, and trade liberalization (Hansen, 1992: 347). However, by 1959 the government had effectively abandoned the program and again inflation and current account were on the rise (Hershlag, 1968: 147). Turkey was headed toward another crisis, but Menderes and his fellow DP leaders could not restore confidence in the government and the economy. Finally, on May 27, 1960, a group of junior military officers with the help of two senior officers as figureheads toppled the DP government with an almost bloodless coup.¹⁹

The record of Turkey's economic growth during the 1950s was a relatively weak one. Although per capita GDP increased by an average rate of about 2%, most of the growth happened in the first half of the 1950s. The main source of growth in that period was agriculture. A great deal of foreign assistance and the credit extended to the private sector during 1950-1956 went to investment in tractors, which helped extend cultivated area and increase agricultural production at 8-9% rates. When foreign exchange became short after 1956, the number of tractors peaked and the process came to an abrupt halt. The decline in the external terms of trade did not have much impact on the slowdown of agricultural growth because the internal terms of trade were insulated through a government subsidization scheme and were allowed to grow steadily throughout the 1950s. The significance of tractors for the agricultural growth is also reflected in the fact that in

¹⁹ Many leaders of the DP ended up in jail and Menderes and his finance and foreign ministers were later executed. The executions were quite puzzling and, perhaps, were carried out just to signal that there would be no return to the old politics and, especially, to the Democrat rule (Ahmad, 1977: 171).

this period there was little improvement in crop yields and probably no growth in the agricultural TFP (Hansen, 1992: 343).

The weakness of TFP growth in the Turkish economy as a whole during the 1950s can be inferred from the investment and growth data. In this period, the share of investment in GDP was about 15%, which was 50% higher than the corresponding figure for the 1930s. However, per capita GDP growth rate during the 1950s was less than one half of the 1930s' record. The increased rate of investment itself may seem to be an achievement. But, this was not the consequence of strengthened incentives for investment in Turkey. Rather, it was made possible largely as a result of the superpower rivalry in the post-World War II international environment, which brought Turkey a windfall of foreign assistance and concessional loans. The emergence of the turnover potential in leadership under a system of concentrated power seems to have had a significant negative impact on economic performance and efficiency.

The lack of confidence in the stability of government policies was also reflected in the sectoral pattern of private investment. During the 1950s, agricultural machinery and residential construction dominated private investment (Hansen, 1992: 344). Neither domestic nor foreign investors, who were being courted to bring in their capital and help mitigate Turkey's foreign exchange shortage, showed much interest in long-term investments in industry (Ahmad, 1977: 128-132). Indeed, this was one of the main reasons why the privatization attempt of the early 1950s completely failed (Hershlag, 1968: 140). Businessmen were not willing to pay much for public enterprises when easy policy change could dramatically change the fortunes of privatized firms:

Some business representatives suggested unrealistically privileged conditions of transfer, making the purchasing of the shares of state enterprises almost less risky but more profitable than the purchasing of government bonds. Even under such conditions, there were, as Prime Minister Menderes stated in 1954, too many profitable investment opportunities in the country for the private sector to show any interest in taking over the industrial establishments under state ownership (Bugra, 1994: 123).

Lack of experience and sufficient financial capability were perhaps other factors that prevented the domestic entrepreneurs from actively investing in industry. However, government policy was supposed to overcome those problems and help develop the private sector. The government was unable to follow effective policies of that type because it could not establish the required long-term commitments.

The 1950s could have been much more successful years for the Turkish economy. The economy enjoyed favorable external terms-of-trade for most of the period and received substantial foreign aid and loans. Nevertheless, foreign exchange shortage became a chronic problem and the economy performed poorly, especially compared to the 1930s when the external conditions were not nearly as favorable. As the comparison with the experience of the 1960s further confirms (see below), the turnover in a government with concentrated power was the most likely culprit.

Of course, the experience of the 1950s may have also been the result of factors other than the institutional characteristics of the country at that time; e.g., the personality of the leaders. But, comparisons with other periods generally tend to underline the significance of institutional characteristics in determining economic policy and performance. In particular, although the personalities of the leaders certainly matter, it is interesting to note that the economic policies of the DP were not very different from those of the RPP during 1946-1950 (Hansen, 1992: 340). Agriculture was given priority by keeping its terms of trade favorable, by providing it with cheap credit, and by increasing public investment in its infrastructure and inputs. The DP administration also accelerated a land reform program initiated by the RPP to distribute state-owned pastures to farmers. In industry, the public sector maintained its share. Finally, trade liberalization and attempts to attract foreign aid were both underway well before 1950.

6. POLICY STABILITY UNDER UNSTABLE GOVERNMENTS, 1961-1980

Political instability was a hall mark of the two decades that followed the 1960 coup d'etat. But the first seventeen years of that period were one the most successful periods in Turkey's economic history, only matched by the experience of the 1930s. The key to the reconciliation of these two facts is the institutional constraints that the 1960 junta imposed on the political system. Indeed, these constraints themselves may have been partly responsible for the political instability when the government proved unable to deal with the system's rigidities. The institutional setup worked well when the parameters of the system were stable, but had difficulty in dealing with large changes in its exogenous conditions and ended up in a major political and economic crisis.

The leaders of the 1960 coup had little agreement over what to do with the government they had taken over. In the power struggle that ensued, the senior officers managed to gain an upper hand and to prevent a radicalization of the government (Ahmad, 1977: 159-172). The military leaders who dominated found it necessary to run the country with the help of civilian politicians. They also considered themselves as part of the elite of the country and were strong believers in Westernization. Therefore, from the beginning they promised quick return to democratic civilian rule as soon as some fundamental institutional reforms were in place to prevent the reemergence of the pre-1960 type of crises.

The junta, in consultation with a group of university professors, diagnosed the main sources of Turkey's political and economic problems as excessive concentration of power and policy uncertainty. To diffuse power, in a new constitution ratified in July 1961 they sought to further democratize the country's politics by instituting a system of proportional representation in the parliament. This institutional change was strengthened by granting freedom of association in a broad sense and allowing a variety of interest groups to participate in the political process. In addition, the constitution created a Senate as an upper chamber of the parliament, which helped represent specific institutions in the legislature. In particular, twenty-three members of the junta were appointed as Life Senators (Ahmad, 1977: 186). The Senate also served as the vehicle of continuity in the parliament: only one-third of the Senate's regular members were subject to reelection every two years. Moreover, a Constitutional Court was created that could review the

constitutionality of the legislation and impeach any official in the government. The causes of power diffusion and continuity were served furthermore by reducing the power of the president's office, while extending the term to seven years. The president was to be elected from among the members of the two chambers with a two-thirds majority. Finally, the military formed a committee, the High Command, that retained vigil over politicians' activities.

To deal with policy uncertainty, a number of administrative checks and balances were introduced while encouraging planning. The epitome of this approach was the establishment of the State Planning Organization (SPO) on September 30, 1960. The primary responsibility of the SPO was the formulation and implementation of a series of five-year plans within the context of 15-year strategic plans. The plans were meant to be comprehensive. Hence, Article 129 of the 1961 constitution stated that:

Economic, social, and cultural development is based on a plan. Development is carried out according to this plan. The organization and functions of the State Planning Organization, the principles to be observed in the preparation and execution, and application and revision of the plan, and the measures designed to prevent changes tending to impair the unity of the plan, shall be regulated by special legislation.

That special legislation was the Law concerning the Enforcement and Preservation of the Integrity of the Long-Term Plan, approved on October, 16, 1962, which allowed the SPO to monitor, among other things, the allocation of credit, foreign exchange, and public investment and expenditure (Hershlag, 1968: 188). The SPO could use its supervisory role to reallocate foreign exchange and credit and, as a punishment, withhold them from enterprises that did not follow the plan. This gave the SPO and its plans an influential position in all economic and social policy making (Önis and Riedel, 1993: 99). The five-year plans, once approved, imposed constraints on the government for five years which made policy change quite difficult. Moreover, since each plan was to be drafted when the previous one was under implementation, there was a continuity in the objectives and even specific means of consecutive plans.

Changes in both political and administrative institutions had a mutually-reinforcing effect in committing the government for a long time to a given set of initial policies.²⁰ Under the new institutional setup, any major policy change required at least the approval of the two chambers of the parliament, the president, the Constitutional Court, and the military High Command. In addition, proportional representation implied that politicians would have little incentive to unite and maintain solidarity under large parties. As a result, the legislature would be fragmented and, to initiate policy change, political leaders would have to engage in extensive coalition building even within their own parties. Thus, while the new political institutions allowed a wider

²⁰ This served the purposes of the military Commanders well because they could initiate certain policies and then turn the government to civilian politicians. The policies would be implemented without the Commanders themselves directly managing the government.

representation and enhanced democratization, they imposed major constraints on policy change as well. The administrative framework also encouraged continuation of the existing policies at both stages of design and implementation.

Under the new institutional setup, the initial policy design had paramount importance because it could shape the course of the economy for a long time. Moreover, the success and failure of the policy would influence the fate of the institutional setup itself. In the policy debates and deliberations that took place over the First Five-Year Plan, the participants—military Commanders, technocrats, civilian politicians, landowners, and business leaders—showed an overwhelming concern to guarantee minimum distributive shares for various socio-economic groups to create a sense of "fairness" and buy widespread political support and credibility for the plans as well as for the system as a whole (Ahmad, 1977: 270-275). They were also concerned about the stability of the economic system and searched for ways to minimize the impact of internal and external shocks. As a result, the economic policies incorporated in the First Five-Year Plan (1963-67), which continued in the Second Plan (1968-72), had four important components:

1. The plan specified detailed wage and price guidelines, sectoral investment allocations, and fiscal activities in various areas.
2. The plan followed a principle of "equal treatment" of the public and private sectors: roughly half of the planned investment had to be carried out by the government (Hershlag, 1968: 189).
3. The plan had a clear ISI bias: it focused on domestic markets, took exports as exogenous, and sought to minimize import requirements (Önis and Riedel, 1993: 100).
4. The plan restricted inflationary financing of the budget deficit (Hansen: 1992: 422).

The first two components helped freeze the relative economic positions of various interest groups, reflecting their balance of power in the early 1960s. Maintaining a large public sector was essential for this purpose because it was an important tool of guaranteeing minimum real incomes for the workers and customers of public enterprises. Leaving the task largely to the private sector was viewed as risky because, with the weaknesses of the private entrepreneurship especially in the industrial sector, policy designers had no way of assuring that sufficient private investment would occur in desired sectors. Incorporating public investment in the plan could guarantee a pattern of minimum investments to strengthen the belief that the plan would not fail. This effect together with the subsidized inputs public enterprises offered to the private sector were expected to induce private investment take place according to the plan.²¹ The last two main components of the plans were further instruments for ensuring the stability of the system. Keeping the economy stable and insulated seemed to fit the needs of the system well because, with the rigidities introduced by the first two components and the costs of policy change, internal economic instability and external shocks could derail the whole scheme. In fact, this view

²¹ Conway (1990) finds that during this period in Turkey public investment crowded in private investment, at least in the short run.

of import restrictions and state-led development was widespread at the time both inside and outside Turkey.²² The Turkish elite could have easily drawn such conclusions from the experience of the 1950s when the destabilization of the economy was preceded by trade liberalization, declining terms of trade, inflationary deficit financing, and *ad hoc* market controls.

The first elections after the promulgation of the new constitution were held in October 1961. The electoral rules and the freedom of association had given rise to a proliferation of political parties and interest group organizations. The DP was banned from reconstituting itself. But, the Democrats established a number of new parties, the strongest of which turned out to be the Justice Party (JP). As with their predecessor, the neo-Democrat parties were supported by the private sector at large, but each one tended to represent more specific interests. The neo-Democrats did relatively well in the elections, although no party obtained a majority and the RPP ended up with the highest number of seats in the Assembly. Under pressure from the Commanders, all parties agreed to respect the previous decisions of the junta and also to elect General Cemal Gürsel, the leader of the junta, as president. Then, President Gürsel asked the RPP leader İnönü to form a government. In the following three years, İnönü entered into three different coalitions with the neo-Democrats. The main contentious issue in these coalitions was the nature of the policies to be followed in the plans. The RPP leaned toward more radical reforms, while the neo-Democrat parties were dominated by conservatives (Ahmad, 1977: ch. VIII). The outcome of these controversies were the plan characteristics outlined above.

In 1965, President Gürsel set the RPP aside and allowed an independent politician supported by the JP to form the cabinet. The JP won a majority in the 1965 elections. By then, Süleyman Demirel, the leader of the JP, had established connections with the bureaucracy and the army, assuring them of cooperation and respect for the institutions and policies established under the 1960 junta. Demirel was allowed to become prime minister and even continue in 1970 when the JP lost its majority and suffered a split within the party. In 1966, President Gürsel resigned due to poor health and was replaced with General Cevdet Sunay, the Chief of the General Staff. The second half of the 1960s was a period of relative stability in the government, but there were strong cleavages within the JP that Demirel kept under control only until 1970.

By most measures, the policies implemented under the five-year plans were highly "distortionary" (Krueger, 1974). The stability in the government was no greater than in the 1950s, especially before 1966 and after 1969. Yet, the performance of the economy during the First and Second Plans was quite strong. Turnover in the cabinet did not seem to have much negative impact on policy stability and economic growth. Indeed, confidence in the continuity of policies seemed to outweigh the distortions caused by those policies. The economy initially stagnated during 1960-62 when institutional and policy uncertainties were being resolved and the country was experiencing an adverse terms-of-trade shock. But then the GDP per capita began to

²²Hansen (1992: 363-365) quotes the OECD *Economic Surveys* for Turkey during the 1960s indicating support for ISI in Turkey.

steadily grow at rates over 4% per year, close to the target of the plan.²³ At least one quarter to one third of this growth was due to improvements in TFP.²⁴

Industry led the process with a growth rate of over 10% per year and an annual TFP growth of about 2.4%. Agriculture grew less spectacularly, but it did much better than it had in the second half of the 1950s. In particular, crop yields increased by an average of about 2.7% per year. Average investment share in GDP rose to about 18.5%, of which less than 8% was financed by external borrowing and the rest, 92%, largely originated in the domestic savings. The private sector played the part assigned to it by the plans and contributed more than 50% of this investment. Also, at least until 1970, government deficit remained low and monetary growth occurred largely through credit extension to the private sector. As a result, during the 1960s inflation remained remarkably steady at about 5%. The nominal exchange rate was held constant until 1970, but for quite some time its slow real appreciation did not cause any serious balance of payments problem. Finally, the internal terms of trade between agriculture and industry remained essentially unchanged. Throughout this period, external conditions were relatively stable.

Toward the end of the 1960s, political leaders faced two major problems under the new institutional setup. One problem was the rise of labor and middle class political activism and militancy. Over time, economic growth, especially in the 1960s, had expanded the ranks of these groups. But, their role in the country's politics was small and their share in the economy had remained low (Aksoy, 1980). In the late 1960s, these groups became more active and, given the rights granted by the 1961 constitution, began to organize. In particular, unionism among workers grew fast and in 1967 an independent nation-wide labor organization, the Confederation of Revolutionary Workers' Unions, was formed.²⁵ The activism of such organizations coincided with large migrations of Turkish workers to West Germany and helped reverse the trend in real wages and labor share. However, the system had a great deal of inertia and progress was slow. This, together with the on-going breakdown of the traditional culture in Turkey and the worldwide spread of militant leftist politics, led to increasing civil unrest, student militancy, and violence.²⁶ Since the diffuse nature of power prevented the government from acting decisively, the elite began to consider a constitutional amendment to strengthen the government. But, the amendment required the consent of small parties, which opposed the measure because it implied a curb on their power.

²³ The data presented in this paragraph are based on Önis and Riedel (1993), Tables 5.1 and 6.13, and Hansen (1992), Tables 6-6, 6-7, 9-6, 11-1, and 11-6. These sources, as well as Wälstedt (1980), Chapter 3, provide detailed analyses of economic performance during the 1960s and 1970s.

²⁴ Hansen (1992: 356) estimates the rate of TFP growth during 1958-1975 at 1.1% per year. However, TFP growth during 1972-75 was strongly negative (Hansen, 1992: Table 11-1) and is likely to have been so during 1958-62.

²⁵ Labor unions were outlawed in the early years of the Republic. The ban was lifted after World War II, but until 1967 the main labor organization was an officially controlled confederation, TÜRK-İS (Mumcuoglu, 1980).

²⁶ For an insightful analysis of the causes of social unrest in Turkey see Mardin (1978).

Another growing problem during the late 1960s was the deterioration of the current account. The memory of the 1958 foreign exchange crisis and its aftermath was still fresh in the politicians' minds and they did not want to allow that episode to be repeated (Ahmad, 1977: 198). But, changing the exchange rate would affect the delicate equilibrium of the system and trigger a wave of renegotiations of the relative positions. The uncertainty associated with such a realignment was large and could endanger the entire institutional setup. This was indeed what happened when, after much debate, support for a devaluation grew and, finally, in August 1970 the Turkish lira was devalued by 66%. Following this adjustment, the Assembly was quick to approve large salary increases for civil servants. However, the same could not be easily done for many other groups. Workers, peasants, and private businesses all demanded compensation for the devaluation. To ease the tension, the government kept the prices of public sector products low. Public enterprises soon developed large deficits and the government's attempt to subsidize them fueled inflation (Önis and Riedel, 1993: 23). Imbalances among different wages and prices that followed could only exacerbate the growing political conflicts among various interest groups.

Observing the rising tensions and the government's inability to deal with the situation, military commanders found it necessary to take a more active role. In March 1971, they asked Demirel to step down. Soon martial law was imposed on Turkey's major cities and a cabinet of technocrats was appointed. This cabinet, and a similar one that replaced it in 1972, managed to amend the constitution, pass laws, and set up special courts that allowed the government to curb civil unrest and political activism, especially on the part of the labor organizations and leftist groups (Ahmad, 1977: 310). These measures sharply reduced real wages and, together with the devaluation, helped maintain the pace of investment and economic growth. The impact on the balance of payments was particularly favorable: Between 1970 and 1973, the dollar value of exports jumped by 125% and the remittances from Turkish workers in West Germany quadrupled. For the first time since World War II, the current account balance turned strongly positive. By 1973, the conditions were sufficiently promising to warrant a return to parliamentary rule.

The restriction on the activities of the leftist political parties and groups, greatly benefited the RPP (Ahmad, 1977: 312). The RPP had moved left of center during the mid-1960s to strengthen itself against the neo-Democrat parties. It now could act as the only viable channel for legal leftist activity. However, this was by no means sufficient to secure a parliamentary majority for the RPP. The main consequence of this change was that it enabled the RPP to become the nucleus of parliamentary coalitions and help break up coalitions built around the JP. This made the years between 1973 and 1980 the most unstable period in the history of Turkish government. From 1974 to 1980, five elections were held, but no party achieved a parliamentary majority and the government changed hands between the RPP, the JP, and a caretaker coalition seven times (Önis and Riedel, 1993: Table 14.3).

Despite the instability in the government, economic growth accelerated after 1973 and made the Third Five-Year Plan (1973-77) quite successful in terms of investment and growth. Real GDP per capita grew at close to 5% per year and investment rose to 21.7% of the GDP. The private sector was again an active participant in this process and especially tried to increase its presence

in industry, even though the real wages recovered from their slump of the early 1970s and industry's domestic terms of trade vis-à-vis agriculture remained unfavorable.²⁷ The constraints imposed on the government by the institutional setup continued to keep policies generally stable despite the high turnover in the cabinet.

The general characteristics of the Third Plan were in many respects similar to those of the first two. It continued to implement ISI policies and allowed the exchange rate to continuously become overvalued. However, partly as a result of the events following the 1970 devaluation, fiscal discipline and foreign borrowing restraints of the Third Plan were weaker than those of its predecessors. Also, the circumstances surrounding the Third Plan were different in at least four other respects. First, Turkey suffered a major terms of trade shock following the oil price hikes of 1973-1974. This event also negatively affected the job opportunities for Turkish workers in Europe and led to a reduction of remittance revenues. Second, in 1974 there was a coup in Cyprus, to which Turkey responded by invading the Turkish-speaking region of the island. This caused a ban in the United States on the sale of arms and a reduction in economic assistance to Turkey. Third, the recycling of petrodollars in international capital markets tremendously increased the supply of foreign loans. For Turkey, these loans could lessen the impact of the terms of trade shock and remittance and aid reduction. Fourth, industrialization had advanced and the marginal return of ISI projects had declined. Under these circumstances a major overhaul of economic policy, especially with respect to the relative prices of tradables and public sector products, was in order. But, under the existing institutional setup, the task was monumental. With the option to borrow externally, the system failed to respond to the need for reform and postponed its day of reckoning (Saracoglu, 1994).

During the Third Plan the deficit of public enterprises and the government substantially increased. The output prices of these enterprises were being raised very slowly, while their input costs and wage bills were growing no slower than the rate of inflation (about 20% per year). As long as external financing was forthcoming, the deficit growth did not lead to much acceleration in the rate of inflation. However, when foreign lending came to a halt at the end of the Plan, a sharp rise in inflation was inevitable. By 1979, the rate of inflation reached 60%. Another consequence of the rigidity in public sector prices was a decline in the performance of public enterprises. The quality of public sector products declined and their inefficiencies mounted (Keyder, 1987: 168-171; Kjellström, 1990). By the 1970s, the public sector was too large and diversified to lend itself to flexible management by the government. The exhaustion of the ISI possibilities reinforced this effect and reduced the efficiency of investment in both public and private sector enterprises. The result of all this was that during 1973-1976, the TFP growth in manufacturing declined by 1.2% per year (Hansen, 1992: Table 11.1).

²⁷ Given the crisis of the system toward the end of 1970s, it may be puzzling why private investors did not foresee the demise and continued to invest in the mid-1970s. However, until 1977 it was not clear that the system could not cope with its problems. Before then, the government continued to offer strong incentives for investment and external conditions could become favorable again.

In the early 1970s the system had managed to respond to some imbalances and, with the help of the military establishment, avoid a serious crisis. But, those imbalances were not nearly as great as the ones that emerged during the mid-1970s. In the second half of the 1970s foreign debt, especially of short-term nature, accumulated at a rapid rate. By the end of 1977, Turkey was unable to service its foreign debt and in March 1978 signed a stand-by agreement with the IMF. Yet, no reform materialized and the IMF blocked its loan. The country plunged into a serious political and economic crisis. Between 1977 and 1980, private investment plummeted by 50% and the average real wage rate by 45% (Önis and Riedel, 1993).

To understand how the institutional mechanisms actually worked and prevented a badly needed policy change to take effect, it is instructive to briefly examine the process of formation and implementation of a reform plan that was finally adopted in January 1980. In October 1979, an RPP-led coalition suffered a setback in parliamentary by-elections and resigned. The JP then formed a coalition with a smaller party and came to power. The JP leaders were determined to develop a major liberalization program, but to protect it from early sabotage gave no hint of their intentions during the election campaign and kept the program secret before it was ready to be adopted. The program was prepared by a newly formed team of technocrats under the leadership of Turgut Özal, who had previously served in the SPO but had left the government to join a private corporation and had used private sector associations to voice his views in favor of economic liberalization. As Krueger and Turan (1983) document in detail, the team worked with extreme secrecy, extracting information from the bureaucracy in ways that did not arouse suspicion. They even kept the cabinet, including the ministers whose domain of responsibility included the measures of the program, in the dark. Meanwhile, the consent of the president was obtained to sign the decree once approved by the cabinet. On the other hand, Özal briefed the military Commanders to buy their support for an urgent program to control inflation and increase exports.

Although the reform program comprised a range of measures to stabilize and liberalize the economy, the initial measures taken were those that could be immediately decided within the cabinet. These consisted of (1) a devaluation, (2) some foreign trade and payments liberalization and export incentives, (3) decontrolling of public enterprise prices, and (4) an administrative reorganization plan to assign the implementation of the reform package to new agencies directly responsible to the prime minister. A number of other measures that could be treated in the same manner, such as adjustments in interest rates and agricultural prices, were postponed. Other parts of the program, such as a tax reform badly needed for stabilization purposes, had to be ratified by the parliament and required more time.

On January 24, 1980, Prime Minister Demirel forced the package of initial reform measures through the cabinet. Shortly before the meeting the Commanders had given a hint that they were ready to intervene, and the politicians understood that they would be out of office if economic problems are not addressed. The ministers were essentially told that the package was the last change and they should go along with it in that same meeting or resign (Krueger and Turan, 1993). Soon the program was announced to the public and implementation began. It was expected that these initial measures would trigger an irreversible process in which other complementary parts

of the program would follow. However, before long the more significant obstacles to change began to impose themselves. Political opposition began to mount and adjustment in other prices and policies started. Other stages of the program were also stalled. Even some of the measures taken later within the cabinet, such as the adjustment in the buying price of wheat, failed to follow the spirit of the program (Krueger and Turan, 1993). Other parts of the reform requiring legislation were in worse shape: the parliamentary debates did not sustain any hope that their ratification was imminent. Meanwhile, inflation accelerated to 110%, the economic crisis deepened, and political turmoil and violence escalated.

In September 1980 the army intervened and took control of the government to restore order, overhaul the political system, and implement the reform program. Two years later, Özal who had been retained to continue his program commented:²⁸

If the intervention of September 12 had not been conducted, we would not have been able to obtain the results of the economic program. Anarchy was on the rise and the tax laws did not go through the National Assembly. We should be thankful that a tax reform has been conducted

7. ECONOMIC LIBERALISM AND POLICY UNCERTAINTY, 1981-1991

Since 1980 Turkey has experienced a major shift in its economic policy orientation. ISI has been abandoned in favor of export promotion and more liberal policies. The role of the government as a major producer of goods and services has also diminished, except in the infrastructure sectors. Yet, economic performance during the first decade following the reforms was much weaker than under first three Five-Year Plans. The problem seems to be a return to a high concentration of government power combined with electoral turnover concerns. The institutional changes that gave rise to this situation were rooted in the elite's diagnosis of the reasons behind the inability of the government under the 1960-1980 institutional setup to respond to shifts in the economy's conditions. The outcome may have been partly unintended because power concentration was a transient feature of the new institutional setup designed to help the system to break away from the past policies and the vicious circle during the late 1970s. Although the feature helped more market-oriented policies be implemented in the early 1980s, it had the opposite effect during the later years and left the government with highly inefficient set of policies at a time when power concentration substantially declined and policy reform became considerably more difficult.

The turn to economic liberalism and emphasis on private sector production was in clear contrast with the orientation of policies during the 1960s and 1970s. This was partly due to the political leaders' realization of the limits of ISI and public sector production. Also, the winds of ideological change around the world had left their marks in Turkey. However, the recognition of the importance of markets and private entrepreneurship was not new to the Turkish elite. At least during the 1920s and 1950s they had followed liberal economic policies, with disappointing

²⁸ Quoted in Krueger and Turan (1993: 363).

results in the latter period. What encouraged them to return to those policies in 1980 was a crisis for which government controls over markets and productive enterprises could be held responsible.²⁹ The public sector had grown large and the economy had become complex. Managing the controls had become increasingly costly, especially in the face of changing circumstances. At the same time, a diversified and experienced private sector had emerged in the country that could manage the tasks of investment and production in a decentralized manner. The private sector had also formed a number of associations independent of the government-controlled chambers of commerce that offered forums for effective communication of business problems and informed debates over policy alternatives. Most prominent among these associations was the 200-member Turkish Industrialists' and Businessmen's Association (TÜSIAD), which by the late 1970s was actively publicizing its views and gaining the attention of the politicians (Arat, 1991).³⁰

The 1980 coup was led by General Kenan Evren, the Chief of the General Staff. The junta established martial law, dissolved the Assembly, and took control of all government functions. Activities of all political parties were banned, media censorship was imposed, and many interest group associations, such as independent labor unions, were outlawed. The Commanders promised a return to democracy once the situation stabilized and the fundamental flaws of the political system were corrected. While the needed political reforms were being contemplated, the Commanders allowed Özal to continue his reform program.

The key features of the post-1961 political system that the Commanders held responsible for lack of appropriate policy response to the crises of the 1970s was the diffuse nature of government power and institutional constraints on policy making.³¹ Accordingly, the new constitution ratified in 1982 and its accompanying institutional changes increased the power of the prime minister and permitted greater flexibility in policy making. The most important institutional changes in this respect were: (1) A minimum 10% of the popular vote was required for a party to be eligible to participate in the parliament. This ended the extreme fragmentation of the parliament and supported the formation of larger parties and majority governments. (2) The Senate was eliminated to reduce veto filters on legislation. (3) The prime minister was allowed to dismiss a minister without the entire cabinet having to resign. (4) The government was given greater opportunities to issue decree-laws. (5) Severe restrictions were imposed on the movements of parliamentary deputies from one party to another by allowing the majority in the Assembly to take away membership and limit the right to future candidacy of any deputy who resigned from a party (Evin, 1994; Heper, 1994). Another factor that increased the prime minister's power was a series of constitutional restrictions on the activities of political parties

²⁹ For a theoretical argument and a cross-country empirical investigation of the determinants of market-oriented reforms in developing countries which supports these claims see Campos and Esfahani (forthcoming).

³⁰ TÜSIAD largely represents the dozen or so major conglomerates that have come to dominate the private sector.

³¹ For an analysis of the background and provisions of the constitutional reforms in the early 1980s, see Tachau (1984: Chapter 3).

and interest group associations.³² These restrictions were potent because their terms were rather general and gave the government substantial leeway. A case in point is the government's ability to ban any association deemed to have acted outside its "specialized" area. Labor unions could not support political parties or make political demands and business associations could not publicly discuss government policies in ways that had political overtones (Sakallioglu, 1991; Arat, 1991). The term of the Assembly was increased to five years to lengthen the horizon of the government.

Although the above features increased the freedom of the executive to act relative to the 1961-1980 situation, by themselves they could not concentrate power to the extent of pre-1960 system. This was particularly the case because there was some increase in the powers of the president as well to enable the office holder to act as a balancing force and to break the stalemates in the legislature and call for early elections if the government goes without a confirmed cabinet for more than 45 days. However, there was another factor that had substantial impact on the prime minister's discretion during the 1980s and brought the parallel closer. The 1982 constitution placed a ten-year ban on political activity by some 700 politicians who led the political parties of the 1970s. This left the field largely open for Özal to form the Motherland Party (MP) and run on his record of economic management in the early 1980s. With other political parties in disarray, the 10% minimum popular vote requirement gave the MP a comfortable majority in the parliament throughout the 1980s.

The economic consequences of the reform program under the military government (1981-1983) were mainly stabilization and restructuring. The government emphasized real depreciation, export incentives, tight monetary policy, tax increase, deregulation of interest rates, ceiling on wage increases, and relaxation of controls on the public sector (Saracoglu, 1994). Import liberalization was more gradual. Inflation declined to the 30-35% range and per capita GDP growth rose moderately to 1.8%.³³ Despite a terms of trade shock, the value of exports doubled in two years and the balance of payments stabilized. The decline in the deficit of public enterprises allowed the government to step up its investment, especially in infrastructure, by about 1% of the GDP. But, the share of private investment in GDP remained essentially unchanged from its low level in late 1970s despite the fact that the real wage rates were rapidly declining (Önis and Riedel, 1993: Figures 10.3 and 14.1).

The skepticism of the private sector was not baseless. There was uncertainty about the consequences of return to civilian rule and even about the policies of the military government itself. The Commanders were interested in maintaining their influence after transition to civilian rule and, once the constitution was ratified, became more responsive to the electorate, although

³² Many leftist parties and organizations and Kurdish separatist movements have always been outlawed by a perennial provision of the Turkish constitutions that no party or organization could profess ideologies that would divide the nation; e.g., by encouraging class conflict or separatism.

³³ The macroeconomic data presented in the rest of this section are based on the World Bank's *World Tables, 1993*, unless noted otherwise.

with a short-term view of their policies. An important event that illustrates these concerns is the so-called *Banker's crisis* in 1982. Financial liberalization of 1980 had allowed an unregulated network of brokerage houses (called *Banker*) to grow. In the summer of 1982, when these institutions controlled about one-fourth of money in circulation, the largest banker failed and triggered a run on the system. While Özal felt that the government should not do anything about the crisis, the Commanders were persuaded to intervene (Krueger and Turan, 1983: 366). As a result, Özal resigned and was replaced by a bureaucrat closer to the concerns of the military leaders. In the following year, the reform lost momentum and inflation began to rise.

The first general elections under the 1982 constitution was held in November 1983 with only three parties permitted to offer candidates: a party supported by the military, another one representing social democrats, and the MP. Özal's success in the implementation of the reform program and his distance from the military after the Banker's crisis made him a clear choice for most of the electorate. The MP managed to win 45.1% of the popular vote and a large majority in the National Assembly. Özal became the prime minister. General Evren had earlier been elected president as part of the referendum on the constitution.

Once in office, Özal began to use his control over both the executive and the legislature to create instruments that allowed him to direct economic policy freely. This included establishing agencies and funds that could be used to bypass the bureaucracy as well as the Assembly. The key agency created in this manner for economic policy making was the Undersecretariat for Treasury and Foreign Trade, which took over the most important functions of the Ministry of Finance and the SPO. In addition, the government significantly expanded the use of "contract personnel" who did not have job security and could be appointed at all levels of the bureaucracy without the entry and promotion requirements of the regular staff (Waterbury, 1993: 258). Another major move was the establishment of extra-budgetary funds (EBFs) that could be spent without prior parliamentary approval. These funds and the sources on which they could set levies had to be legislated, but the levies and expenditures of the funds were decided by the cabinet (Önis, 1991). EBFs had existed before in Turkey, but on a limited scale. In 1981, they accounted for 1.3% of GNP. However, after 1983 EBFs proliferated quickly and came to control 11% of GNP and more than half of all government revenue in 1990 (Önis and Webb, 1994: 152). These developments permitted Özal to grow autocratic, "increasingly bypassing the cabinet, the Parliament, and the MP and consulted mostly with his team of young technocrats, his brothers and close relatives, and few trusted aids" (Sayari, 1992).

By the mid-1980s pressure was mounting to lift the ban on the excluded politicians. Özal campaigned against the constitutional amendment, but since he had gained his office in a restricted election and his legitimacy was in question, a referendum was scheduled for 1987. When the poll lifted the ban, Özal called for new elections in short order. While the opposition was still disorganized and fragmented, the MP took over two-thirds of the seats in the Assembly with only 36.3% of the popular vote. Support for the MP in these elections was also aided by increases in public works projects, cheap credit for the private sector, and subsidies paid to public enterprises to keep their prices down. In fact, the central bank credit to the government grew by 60% in 1987 compared to 40% in both 1986 and 1988 (Önis and Webb, 1994: 170). As

a result, inflation which had declined to the 30-40% range in the mid-1980s accelerated to almost 80% in 1988 despite deflationary measures taken after the elections.

During 1984-1989, Turkey benefited from a steady improvement in its terms of trade. Average per-capita GDP growth rate increased to about 3% and the share of investment in GDP reached 22.8%, as compared to 21.8% during 1981-1983. A comparison of these figures with those in the 1930s and 1960s suggests that TFP growth may not have been very high in the 1980s. Also, the increase in investment was almost entirely due to the expansion in public investment, largely financed by foreign borrowing. However, the private sector orientation of government policies meant that public investment was channeled mainly toward infrastructure projects rather than industrial enterprises as in the past.³⁴ Private investment was highly concentrated in housing, which was being subsidized through an EBF under the office of the prime minister. Exports also continued to be heavily subsidized, yet little private investment was attracted to the exporting sectors (Conway, 1990).³⁵ The subsidies helped exports grow, but this was achieved through diversion from domestic markets, which raised domestic prices and contributed to inflation. On the import side, liberalizations in the first half of 1980s were partially reversed due to the proliferation of EBFs that heavily depended on import taxes for their budgets and were used for rewarding or punishing domestic producers (Celasun, 1994: 468).

Increasing macroeconomic imbalances, partial reversal of trade liberalization, and hesitation of the private sector to invest under a pro-business government are reminiscent of the events in the 1950s. In fact, in the 1980s businessmen complained about the same problems in their relation with the government that they had in the 1950s (Bugra, 1994). If one overlooks the combined role of electoral cycles and power concentration, this appears as a puzzle. Özal's government had much clearer credentials of private-sector orientation than the DP government and dealt with a far more experienced and better-endowed private sector. Özal had championed a liberalization program and many of those surrounding him, including the members of his cabinet, had links and past experiences in the private sector. Özal himself had been a member of TÜSIAD, had served as an executive officer at a private conglomerate, and had ties to the private sector (Arat, 1991). Thus, economic policies were expected to be supportive of the private sector and to boost growth through massive private investment. Indeed, business leaders welcomed Özal's ascendancy to power and the government did offer incentives for the private sector (Arat, 1991). Nevertheless, private investors did not have sufficient confidence to commit their assets at a larger scale to the development of the Turkish economy.

³⁴ The importance of the private sector as a target of economic policy can be observed in the facts that at the same time that public expenditure was rising, the salaries of government employees and expenditures on items such as education and health were allowed to sharply decline in real terms. The shares these expenditure in GNP came down from 3.3 and 1.1% in 1980 to 2.4 and 0.6% in 1985, respectively (OECD, 1987: 54).

³⁵ Export incentives included tax rebates, duty-free imports, and credit subsidies. Tax rebates alone were quite substantial and at their peak in 1983 reached 22.3% of eligible exports and 14.2% of total exports (Önis, 1992).

The problem of Özal's government was that it had too much discretion to resist the temptation of offering patronage to keep many individuals in the business community supportive.³⁶ Yet, the private sector as a whole saw serious flaws in the policies and questioned their rationale and sustainability. "Even though individual entrepreneurs benefited from the system through personal ties, conditions favorable to private entrepreneurs [as a whole] could not be created" (Arat, 1991). Many business groups that had supported the 1980 coup and the MP were alienated by the late 1980s as a result of "arbitrary" policies and the government's unresponsiveness to their demands (Bugra, 1994; Kalaycioglu, 1991). Even the beneficiaries could not be sure that the policies would continue and avoided committing their assets to the lines of production being promoted. Özal was not oblivious to the policy problems, but could not commit the government to a more long-term approach.

Turkey's privatization policy in the 1980s is also indicative of the government's preoccupation with short-run concerns at the cost of long-term efficiency. Privatization of a large part of the public sector was part of the 1980 reform program. The MP professed to be committed to the policy, but did not accomplish much while it was in power. As Kjellström (1990) suggests, the MP was interested in privatization not so much as a necessary step to improve productivity, but mainly as a means of generating current revenues for the government (see the Appendix). Policy uncertainty implied that for most public enterprises the offered prices could not be very high and the sale was not worthwhile. Widespread distribution of shares could have generated support for more favorable policies toward privatized units. But, that required selling a large part of the assets at a low price, which would defeat the government's purpose.

Dissatisfaction with the MP's economic policies and the inflation and external debt it had created in the late 1980s manifested itself in a major setback for the MP in the local elections of 1989. After the elections, the government intensified its stabilization efforts. However, at that time the National Assembly elected Özal as president and he resigned as the MP leader. The MP, which had been a loose coalition around Özal soon displayed its cleavages and could not regain its unity. Two MP prime ministers served during 1990 and 1991 and finally early general elections had to be called. In these elections the MP did very poorly and captured only one fourth of the Assembly seats. Instead, Demirel's True Path Party (TPP), a reincarnation of the JP, won 40% of the seats and formed a coalition government with a center-left party.

The 1989 stabilization policy entailed the repeal of export subsidies and retrenchments in public investment and expenditure, which brought economic growth and exports expansion to a halt. The economy briefly recovered in 1990 following a spurt in government expenditure. However, despite continued improvement in the external terms of trade, growth could not be sustained because of the large external debt and continuing high inflation. In 1991, the economy experienced another recession.

³⁶ For discussions on this issue, see Bugra (1994), Heper (1991c), Kalaycioglu (1991), and Sayari (1992).

8. MORE RECENT DEVELOPMENTS

In the early 1990s, the 1980 restrictions on political activity lost its impact on Turkey's political economy. The system's checks and balances strengthened and made policy change more difficult, although not nearly as much as in the pre-1980 system. In recent years, no party has obtained parliamentary majority and changing policies has required substantial coalition building. The reduced power of the executive also has reflected itself in the 1993 reincorporation of most EBFs in the regular government budget (Atiyas, 1994). This has been a mixed blessing because while the government has gained more commitment power, its ability to modify the inefficient and unsustainable policies it inherited from the experience of the 1980s has diminished. The task of putting macroeconomic, trade, and public enterprise reforms back on track has been monumental.

Although progress toward reform has been slow, there have been positive achievements. In 1994 the government started a major stabilization and liberalization effort and passed a massive privatization plan through by the National Assembly. These are more solid gains because reversing policies under the current political setup is far more difficult than under the situation in the 1980s. Indeed, private investors seem to have developed greater confidence in the current situation and have expanded their share of total investment from 42% in the 1980s to over 54%. However, as a result of the stabilization plan the moderate recovery experienced by the Turkish economy in 1992-93 has turned into a deep recession 1994 from which recovery has been slow. Nevertheless, the reforms may bear fruit if the system survives the current political and economic crisis. Given that the Turkish economy is now far more open and market based than in the 1960s and 1970s, it may greatly benefit from a combination of commitment and flexibility.

A factor that makes the situation more hopeful is the prospects of Turkey's gradual integration into the European Union. This factor gives the government a strong incentive to pursue market-oriented reforms and makes reversal of such policies quite costly. Turkey expects to gain greatly from expanded relations with European economies and the requirements of integration act as guiding posts and discipline measures. This factor has been present for some time, but it has grown stronger in recent years as the stumbling blocks towards the formation of a customs union are being removed.³⁷

8. CONCLUSION

The experience of Turkey and many other countries shows that robust economic performance requires institutions that commit the government to a long-term course of action. There are two types of political institutions that help mitigate the problem of confidence in the government.

³⁷ The application for full membership was actually filed in 1987 after the relations with the European Community had been frozen for nine years. But the Community's initial response made it clear that it "did not view Turkey as being ready to enter as a full member in the near future" (Steinbach, 1994). Since then, the prospects of a settlement in Cyprus have improved, which should reduce Greece's opposition to Turkey's membership. A number of measures have also been ratified in Turkey that satisfy the Union's demand, although some key issues remain unresolved—e.g., the question of human rights in Turkey, especially is the case of Kurdish population.

First, a setup whereby the same political party or group dominates the government and restricts competition such that it can expect to remain in power for the foreseeable future. In this case the reputation of the government for honoring its promises acts as a collateral for the commitment. Second, a setup in which power is diffuse and no individual or group can significantly influence government policies without the consent of many other interests. The first setup can offer flexibility in policymaking, but can fail badly when short-term exigencies overwhelm the long-run perspective of the regime or when, in the process of selecting the leadership, individuals with inappropriate skills rise to the top. The second setup reduces the role of individuals in policy making and in that sense can offer stronger commitment possibilities, but flexibility would be reduced. This disadvantage is less important when policies focus on the general rules of exchange rather than the details. In particular, if the government is committed to support private markets, rigidities in policymaking can be compensated by the flexibility of the economy, while commitment to extensive controls on markets can be quite costly, especially over longer terms when the circumstances change.

The dilemma of many low-income countries is that their markets are too underdeveloped and the assets and skills of their private sectors are too limited to make commitment to private markets an attractive option when the government can achieve higher growth rates or secure stronger economic and political support for itself by extensive bureaucratic intervention. Indeed, the economy may be seen as too vulnerable to shocks if it is left to a weak private sector and, as a result, commitment to maintaining private markets may not be credible. Thus, striking a balance between commitment and flexibility in policymaking tends to be a more difficult problem in these countries. This can induce a dynamics in the institutional setup whereby the system moves between low and high commitment phases. The high commitment phases offer opportunities for growth, but end with a crisis when the leadership loses its reputation under the first type of institutional setup or policies fail to respond to changing circumstances under the second type. The resolution of such crises entails removal of the commitments. But low commitment phases fail to generate stable growth and induce a demand for stronger commitment. More stable institutions can emerge when the private sector is strong and offers the political leaders a reliable option relative to what they can gain through extensive bureaucratic operations in the economy. Knowledge of these dynamics and the underlying problems can be useful for the design of institutions when the opportunity arises.

APPENDIX: PRIVATIZATION POLICY SINCE 1980

This appendix outlines the causes of failure in Turkey's privatization policy since 1980. The policy was an important part of the 1980 reform program, but was not taken up seriously until 1986 and even then was pursued in a haphazard manner.

Privatizing a substantial part of Turkey's extensive public sector was not expected to be an easy task. In particular, it was natural to expect political opposition to policy in an economy that had grown around the public sector for five decades. But, Özal's government was in a strong position and, in fact, in 1984 the cabinet obtained authorization to decide on privatization of public enterprises without prior approval by the Assembly (Kjellström, 1990). Moreover, when the issue was expressed as distribution of shares to public enterprise workers, small savers, and the people in general, there was considerably less resistance in the polity. For this reason, early in the process, the government declared this method of privatization as the only permissible one. Also, the privatization law passed in 1986 assigned the task to the Mass Housing and Public Participation Administration (MHPPA), an extra-budgetary fund developed to manage revenue-sharing certificates for infrastructure projects and help subsidize private investment in housing. In the mid-1980s, the MHPPA had succeeded in selling fix-term revenue sharing certificates to finance the Bosphorus Bridge and the Keban Dam and the idea of selling public enterprise shares were seen as similar.

Given the MP's large majority in the National Assembly, legislative resistance to privatization was quite weak. The privatization law essentially turned the policy into an administrative matter in which the prime minister had control over the entire process and retained a substantial part of the revenues for his discretionary expenditures. In particular, the law specified that an inter-ministerial committee chaired by the prime minister was responsible for identifying public enterprises that were candidates for sale. Such enterprises would be transferred as corporations to the MHPPA, which would act as a holding company and decide on the procedures for sale. The MHPPA was allowed to retain 30% of the proceeds for its own use.

If the government's concern was building support for the privatization program and increasing the efficiency of the economy, it would have probably started with a number of relatively large companies with stable conditions, would have created institutional mechanisms for the new owners to install and monitor a management of their own, and would have underpriced the shares sold to small investors. Instead, the first test case offered to the public in February 1988 was Teletas, a relatively small telecommunications equipment company. The MHPPA sold the company's shares in small lots through branches of commercial banks, but the control of the management remained in the government's hands (Ilkin, 1994). Although the shares were fully subscribed and subsequently traded on the Istanbul Stock Exchange, a great deal of uncertainty remained about the conditions of the firm. Shortly after the sales, the state-owned Post, Telephone and Telegraph Agency, the major customer of Teletas, announced a significant cutback in its investment program. This, together with a declining trend in the Turkish stock market, eroded half of Teletas's share value in a few months (Kjellström, 1990: 28). Subsequently, the government bought back some of the shares to prop up the price, which partially reversed the

process. But, the experience eroded the public's confidence in this method of privatization and the government decided to abandon the idea of widespread ownership for a while.

The MHPPA soon shifted to the strategy of direct sales (Ilkin, 1994). In October 1988, the agency concluded a deal with Coca Cola company of the United States to sell the Ansa bottling company. This case went rather smoothly and did not stir up controversy because Ansa was a formerly bankrupt private firm that the government had been forced to take over. The government was encouraged that this method may be more effective than widespread domestic ownership and stepped up the direct sales to foreign investors. However, before long the opposition parties went to the administrative court and obtained a restraining order. It turned out that in a rush to sell the companies, the government had not canceled its initial decision on sales methods. Although eventually the government corrected the problem and made direct sales possible with another decree, this avenue of raising revenue proved problematic as well because the credibility of the government was in doubt and few further sales were made.

In 1990, the MHPPA returned to widespread share sales through a commercial bank and Istanbul Stock Exchange, while pursuing direct sales whenever possible as well. However, this time the focus shifted to selling minority shares in public enterprises. The MHPPA also decided to support the price of shares it sold for some time after the sale. As a result, the process went more smoothly, but the volume of sales remained small and the impact on enterprise efficiency is uncertain. The justification for the government's hesitation to sell shares at a larger scale was that Turkey's capital market is shallow and cannot absorb large volumes (Waterbury, 1993: 152; Ilkin, 1994). But, this should not be a major concern if the goals of the reform are broader than financing the budget deficit. The reforms in the Czech Republic provide a clear example. The Turkish government, on the other hand, has displayed the dominance of its narrower concerns by its tendency to overprice the shares: For most partially privatized companies share prices have not kept up with the Istanbul Stock Exchange index since the date of issue.

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Table 1
Economic Performance in Turkey*

Period	Growth of GDP per-capita	Gross Investment-GDP Ratio	Share of Private Sector in Total Investment	Inflation
1924-29	5.0	12.3	74.0	1.2
1930-33	3.7	8.5	56.5	-14.0
1933-38	5.0	10.0	54.0	0.6
1939-45	-9.0	9.5	60.0	25.0
1946-50	11.0	9.5	n.a.	-0.6
1951-60	2.0	15.0	54.0	10.9
1961-72	4.0	18.5	51.4	7.0
1973-77	5.0	21.7	51.6	20.0
1978-80	-1.4	19.9	45.2	69.2
1981-83	1.8	20.9	44.5	33.0
1984-89	3.0	22.8	42.1	51.0
1990-92	2.8	21.4	54.2	63.0

* The data given in this table are approximate figures for the dates shown. All figures are in percentage terms.

n.a. Not Available.

Sources: Hansen (1991), Önis and Riedel (1993), World Tables (1993).

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