The Ups and Downs of Turkish Growth, 2002-2015:
Political Dynamics, the European Union and the Institutional Slide*

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Abstract

We document a change in the character and quality of Turkish economic growth with a turning point around 2007 and link this change to the reversal in the nature of economic institutions, which eat underwent a series of growth-enhancing reforms following Turkey's financial crisis in 2001, but then started moving in the opposite direction in the second half of 2000s. This institutional reversal, we argue, is itself a consequence of a turnaround in political factors. The first phase coincided with a deepening in Turkish democracy under the prodding and the guidance of the European Union, and witnessed the waning of the military's influence and the broadening of effective political participation. As Turkey-European Union relations collapsed and internal political dynamics removed the checks against the domination of the governing party, in power since 2002, these political dynamics went into reverse and paved the way for the institutional slide that is largely responsible for the lower-paced and lower-quality growth Turkey has been experiencing since about 2007.

Keywords: economic growth, emerging markets, institutions, institutional reversal, low-quality growth, Turkey.

JEL Classification: E65, O52.

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Though EU-Turkey relations are multifaceted, in this essay we focus on one specific aspect: the role of the EU in the improved institutional structure of Turkey during the early 2000s and the rapid growth that this engendered, and its subsequent more ominous contribution to the unraveling of these political and economic improvements.

There is a seldom-addressed macroeconomic puzzle of Turkish growth. Following its severe financial crisis in 2001, Turkey enjoyed five years of rapid economic growth, driven in large part by structural changes, productivity growth and a broadening base of economic activity both geographically and socially. This process stopped and reversed itself, however, even as the foreign and the Turkish media were touting a new Turkish model immune to the "stop-go cycles" so characteristic of its economy in the 20th century.

From about 2007 onwards, economic growth slowed significantly, as government spending became the mainstay of the economy, and productivity growth almost fully stagnated. Underpinning the sea change was likely the reversal of the productivity-enhancing structural changes that had played a pivotal role in the previous five years.

Although one could label this just another example of the stop-go cycles, our essay starts by noting that it has an arguably different character. Rather than the typical stop-go cycle whereby the growth phase is itself unsustainable and heralds the inexorable contraction phase, because it is playing out in a *given weak institutional environment,* we argue that we are witnessing a first phase of growth underpinned by institutional changes and reforms, and a second phase driven by a reversal in the same institutions.

Why did Turkey undergo unusually rapid institutional improvements starting in 2001? Our answer emphasizes a confluence of factors, partly external and partly internal. First, the 2001 crisis forced Turkey's lethargic and conservative political system to accept a slew of fairly radical structural reforms imposed by the International Monetary Fund (IMF) and the World Bank, which not only brought under control the persistently high inflation but also imposed discipline on the budgetary process, shifted decision-making and regulatory authority towards autonomous agencies in an effort to cultivate rule-based policy-making, and introduced transparency in the notoriously corrupt government procurement procedures.

Second, these economic reforms, after their introduction by a care-taking government, were overseen by the popularly elected AK party (the Justice and Development Party) that, for all practical purposes, ended the tutelage of the Turkish military over politics, which had characterized the Republic's entire history.

Third, and most relevant for this essay, both the economic reforms and the political changes undergirding them received a substantial boost from the general warming of EU-Turkey relations and the blossoming hopes in Turkey that accession to the EU was a real possibility — only if economic and political reforms continued.

We are of course aware that it is impossible to conclude with any certainty whether a five-year growth spell reflects the flourishing of an economy under new economic institutions and reforms, or the first phase of yet another stop-go cycle. Nevertheless, not only were the changes in economic institutions we have just described potentially far-reaching, but several pieces of evidence we describe below bolster the case that, absent the institutional about-face, economic growth in Turkey could have continued without morphing into the low-quality growth observed in the post-2007 period.

Why then did these institutional changes that spurred high-quality growth in the first half of 2000s come to an end thereafter, also bringing down both the rate and quality of economic growth in Turkey? Once again, several factors played a role. First, the reforms initiated by the IMF and the World Bank gradually came to be reversed, with Turkey’s recently-institutionalized rule-based policy framework increasingly shifting back toward discretion. The procurement law tells the story most sharply: more and more industries and items were declared exempt from the law by the ruling AK party, removing this fairly substantial barrier against corruption.

Second and even more importantly, the AK party government that had earlier supported the economic opening, made an about-face once it became sufficiently powerful. Gradually the *de jure* and the *de facto* control of the ruling cadre of the AK party intensified, amplifying corruption and arbitrary, unpredictable decision-making.

Finally, the collapse of EU-accession talks played an arguably oversized role, both removing a powerful anchor tying the AK party to the reform process and undermining the support that had built up for institutional change within a fairly broad segment of Turkish population. The turnaround in economic and political reforms were reflected very closely in the macroeconomic picture, impacting the pace and nature of economic growth from about 2007 onwards.

This causal story from a variety of internal and external factors, including centrally the EU, to institutional changes and from institutional changes to macroeconomic outcomes, is far from widely accepted. Though parts of it have been emphasized in other writings,[1] we are not aware of other works that have formulated it in this fashion. We do not pretend that our arguments conclusively establish these causal links, nor do we expect that this story will convince those skeptical of the critical role of institutional factors in the macro economy or the experts viewing this episode of Turkish macroeconomic history just as another example of unsustainable stop-go cycles of a structurally unhealthy, emerging economy.[2] We do nevertheless hope that this perspective will invite further work on this fascinating and rather unusual episode of Turkish history and on the role of various external and internal factors in triggering rapid institutional reform in emerging economies suffering from a myriad of institutional ills.

The speculative nature of our story notwithstanding, we would like to emphasize the potential lessons it contains. First, it is a hopeful story on the ability of emerging economies with weak institutions to reform rapidly and enjoy the fruits thereof. This hopeful reading is counterbalanced, however, by two considerations: first, this process of rapid institutional change was triggered by Turkey's deep financial crisis in 2001, which left few other choices to the political elites, and second, it didn't last. All the same, it does suggest that other countries, and Turkey in particular, have an option to restart structural change and productivity growth if they can overcome their admittedly gargantuan political problems.

Second, it does suggest that, the current stalemate notwithstanding, EU can again play a transformative role in Turkish institutional and economic developments at some point in the near future if its priorities change once more towards enlargement or if another formula for closer engagement with Turkey can be found. We also argue in closing that this type of re-engagement would be not only hugely beneficial for Turkey but also for Europe.

[1] See, for instance, World Bank (2014).
[2] For a recent statement of this view, see Rodrik (2015).

The rest of this essay is organized as follows. In the next section, we provide a more detailed description of the ups and downs of the Turkish economy since 2002 from a macro perspective. The following section provides the institutional background for Turkey in the early 2000s and how this changed first in a positive direction and then slid towards a worse institutional equilibrium. This section also provides a brief overview of the EU-Turkey relations and how these played an essential role in both the positive and negative institutional dynamics of the last decade. The last section concludes with a further discussion of the future of EU-Turkey relations.

Section I — The Ups and Downs of the Turkish Economy Since 2002

In this section, we contrast the 2002-2006 period — the five years that followed Turkey's devastating financial crisis of 2001 — with the subsequent macro developments in the Turkish economy. Our key point is that this was a period of solid, inclusive, and reasonably high-quality growth from which, there is much to learn.

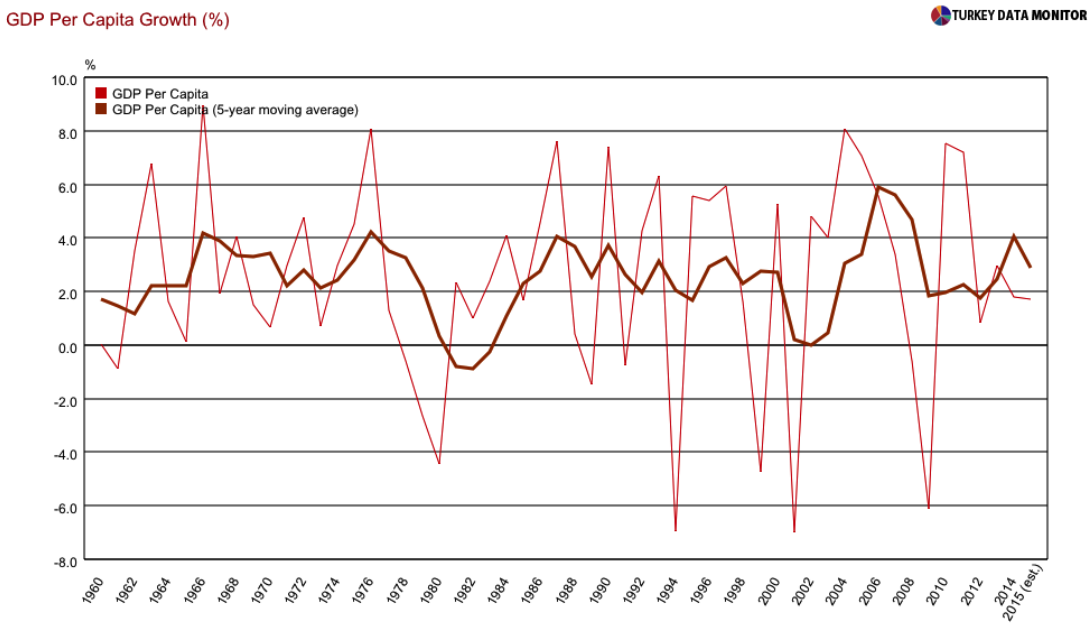
Basic statistics tell the story rather well. Figure 1 shows that the Turkish economy grew at almost 6% per capita (per annum), its fastest per capita growth since the 1960s. Turkey's growth performance during this period was notable not only because it was above the rates experienced by most peers, barring some exceptional cases like China and India,[3] but also because it came with relatively high productivity growth.[4] In sharp contrast to the earlier periods of paltry total factor productivity (TFP) growth, about half of the growth in per capita GDP during this period stemmed from TFP growth, which increased by about 3% per annum between 2002 and 2006.[5]

[3] See, for instance, Table 1 in Kutlay (2015) or the broader discussion in Akat and Yazgan (2012).

[4] In addition, using a "synthetic Turkey" approach, Meyersson (2015) finds that Turkey's GDP per capita increased at a faster rate after the AK Party came to power than before.

[5] See, for instance, Ungor (2014). In their analysis of decadal TFP trends, Atiyas and Bakis (2014) find that 2002-2011 not only outperforms all other decades in terms of TFP growth, but it also does very well in international comparisons, with Turkey ranking seventh among 98 countries. While much of this TFP growth was driven by the "structural" shift in employment from agriculture to industry and service sectors, this shift has probably reflected broader improvements in the economy and the institutional environment, as we will turn to below.

Figure 1



Source: TURKSTAT; Development Ministry; Turkey Data Monitor.

Figure 2

Source: TURKSTAT; Turkey Data Monitor.

Figure 2 further shows that during this five-year interval, private investment rebounded sharply from a post-crisis low of 12% of GDP, to around 22%. The rebound was driven largely by investment in machinery and equipment; construction investment also picked up, but by no means dominated investment during this period. Contrary to a common misperception, manufacturing sector also did reasonably well during this period. Thanks to very strong productivity growth at around 7% per annum, the share of manufacturing in GDP in constant prices increased from around 22% in 2001 to almost 24% in 2007.[6]

These developments reflected a host of structural changes. Inflation, which had averaged around 80% in the 1990s, swiftly fell to single digits, while public sector debt also declined sharply from a post-2001 crisis peak of 75% of GDP to about 35%. These improvements helped to pave the way for the private-sector led boom that would follow.

Importantly for our story, there was also a major broadening of the economic base in two senses. Economic growth through most of the Republic's history had been driven by growth in the major industrial cities in the Western part of the country and spearheaded by large conglomerates in these same cities. This began to change during the first half of the 2000s, resulting in a convergence of living standards between the more advanced West and the so-called "Anatolian Tiger" cities (e.g., Konya, Kayseri, Gaziantep). This was in turn driven by firm-level productivity catch-up, thanks to investments in physical and social infrastructure as well as improvements in the quality of public services in the inland regions.[7]

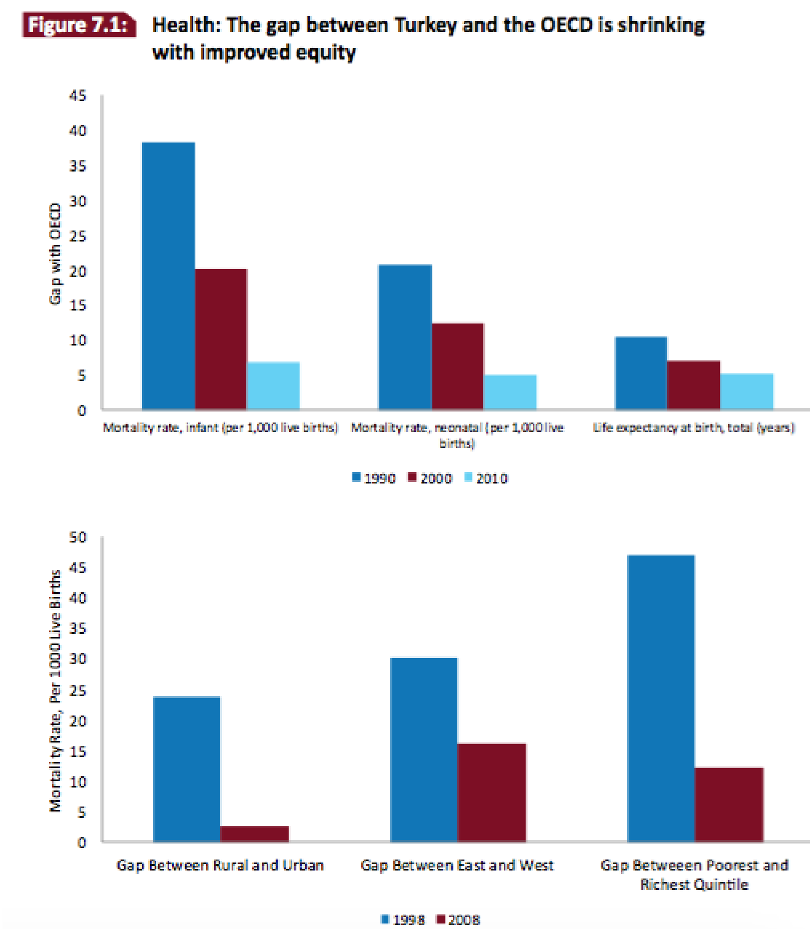
The second dimension of the broadening of the economic base may be even more important. The extreme levels of inequality of income and inequality in access to public services started declining, with some signs of "shared" prosperity previously unseen in Turkey. As comprehensively detailed in a recent World Bank report, examples of this transformation are many, but they all point to the same conclusion: poverty rates declined, the middle class expanded, and

[6] In current prices (nominal terms) the share of manufacturing declined from 19% to 17% during the same period, as service deflator outpaced manufacturing deflator. But importantly, as noted, real growth in the manufacturing sector kept up with broader growth in GDP. Rodrik (2009) notes that in addition the composition of investment moved toward tradables (i.e., manufacturing) during this period.

[7] Chapter 4 of World Bank (2014) documents the regional as well as firm-level convergence story comprehensively. See also Hakura (2013), which includes a brief and useful discussion on the Anatolian Tigers.

income inequality contracted.[8] For example, the headline Gini coefficient measuring income inequality dropped from a very high 42% in 2003 to about 38% in 2008.[9] This contraction in inequality was in part driven by labor income growth at the bottom of the distribution, resulting from both wage growth and employment expansion.[10]

Figure 3



Source: World Bank (2014)

Many public services underpinning the future productivity of the Turkish workforce, such as education, health and infrastructure, have expanded and become more equally distributed. There was also a sharp improvement in basic

[8] See Annex I as well as Chapter 7 in World Bank (2014). See also Raiser (2014) for a brief discussion on the "inclusive" nature of Turkish growth, based on the World Bank study.

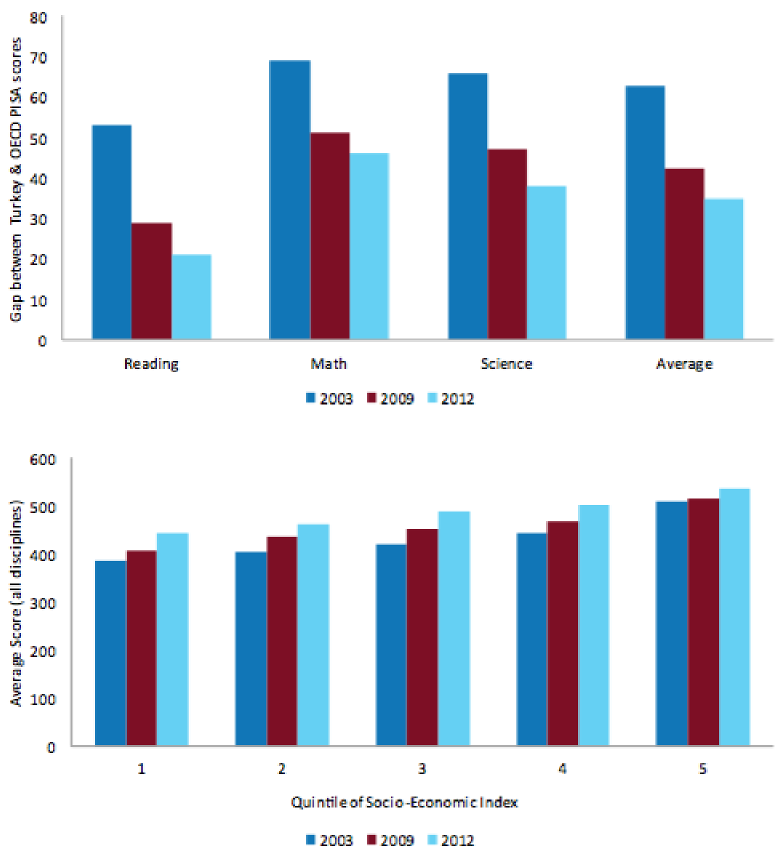
[9] See World Bank Development Indicators.

[10] World Bank staff observes that Turkey's experience in this sense is more akin to East Asia and Eastern Europe than Latin America.

social services, narrowing the gap between Turkey and the rest of the OECD. This was achieved through a combination of reforms in public service delivery, significant increases in budget allocations, and changing priorities towards service delivery in less-advantaged areas. Figure 3 shows a rapid catch-up of infant mortality and life expectancy with OECD averages, with particularly striking gains in rural areas and among poorer households. The gains in education are no less noteworthy. Figure 4 shows Turkey recording the largest improvements within the OECD in the quality of education as measured by OECD's Program for International Student Assessment (PISA) scores, with gains once again disproportionately concentrated among poorer households and in rural areas.[11]

Figure 4

Figure 7.2: **Education: Remarkable improvement in learning, particularly among low performers**

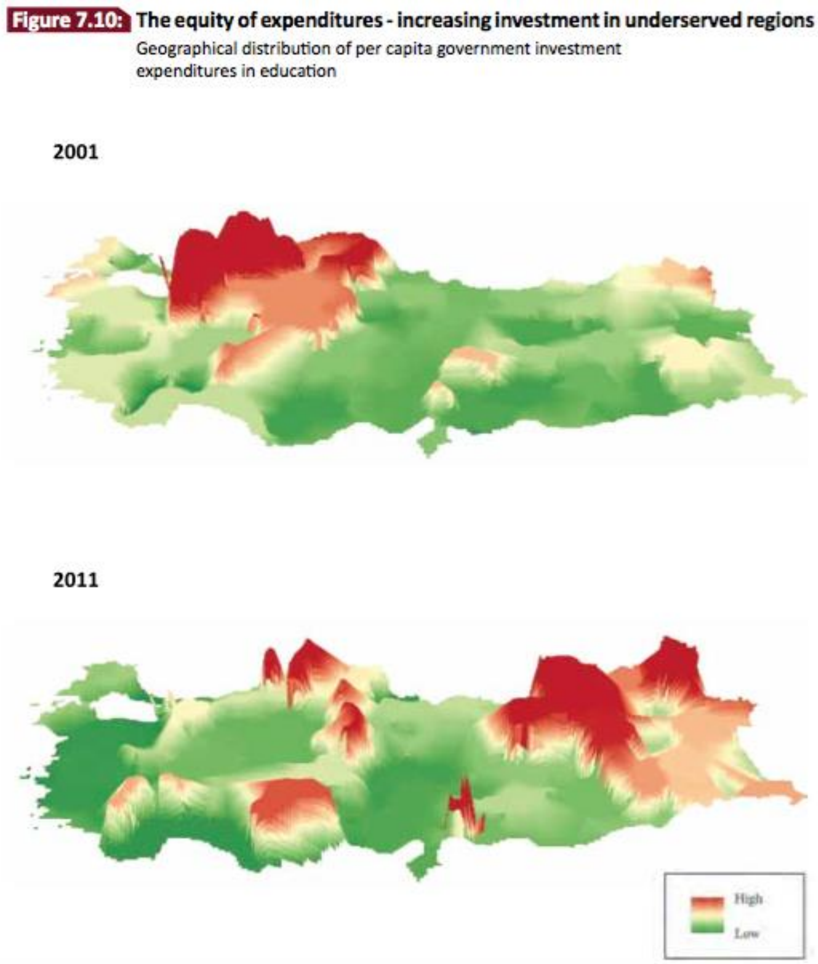


Source: World Bank (2014)

[11] The World Economic Forum's Competitiveness Index also shows significant improvements in Turkey's infrastructure quality, at least after its first year of availability, 2006.

The budget allocations that have centrally contributed to these trends have been made possible by the greater fiscal space that lower interest expenditures created. This has enabled the share of health expenditures in total government expenditure to increase by about 6 percentage points from 11% in 2002 to 17% in 2007 and that of education, from about 10% to almost 14%.[12]

Figure 5



Source: World Bank (2014)

Equally important were the changing priorities in public service spending and delivery, which largely reflected the AK party's political objectives and payback to its base, comprising the less advantaged segments of the population living either in provincial towns or poorer neighborhoods of the major cities. Figure 5, for example, shows a striking reallocation of education spending away from the more prosperous areas in the major cities towards rural areas in the East.

[12] Our estimates, based on Ministry of Development data.

All of this did not go unnoticed by the population and particularly by AK party's base. As reported by Gurkaynak and Sayek-Boke (2012), in a poll conducted in 2008, approximately 85% of the respondents that had voted for AK Party said they did so "because of the economy," largely accounting for the ongoing support for the AK party from these less advantaged, more rural and conservative demographics.

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Many aspects of this story began to change sharply around 2007. Notable is the fact that this reversal in the character of macroeconomic growth predated the global economic crisis. As Figure 1 shows, average per capita income growth decelerated to little over 3% from 2007 through 2014, markedly lower than the above-mentioned 6% growth during 2002-06. The figure also makes it clear that the loss in momentum started earlier than the deepening of the global economic crisis in late 2008; the economy grew by a less impressive 4.7% in 2007, with the slowdown continuing throughout 2008, even before the global crisis hit. Corroborating this timing, Figure 2 shows a deceleration in private investment around 2007 which, except during the short-lived post-2009 rebound, has been at levels lower than those reached in 2006-2007.

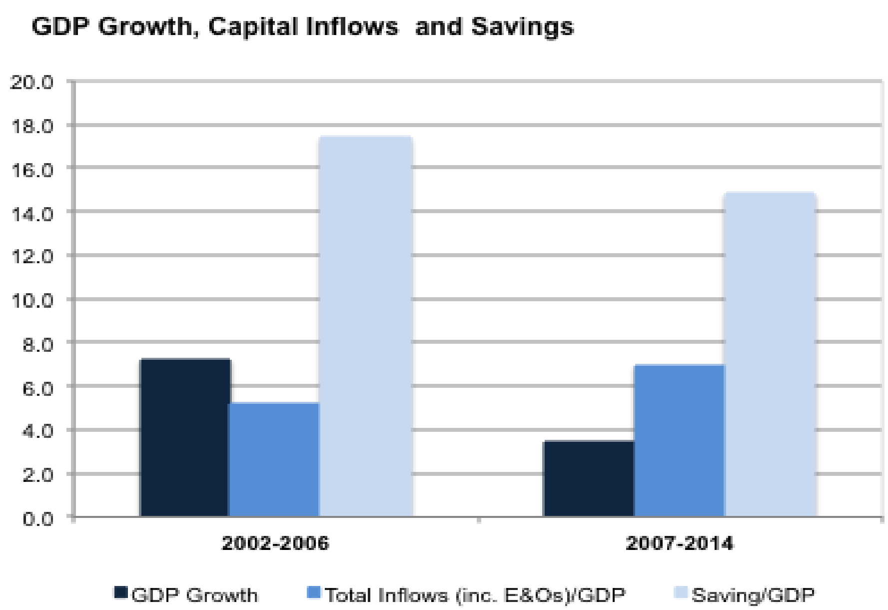
In this sense, the global economic crisis may have helped mask the growing weaknesses in Turkey's growth dynamics. After a sharp contraction in 2009 (by about 5%), growth rebounded during 2010-11 to an unsustainable near-9% per annum pace, fanned by massive monetary and fiscal stimulus. The Central Bank's policy rate was reduced by over 10 percentage points, with the real interest rate declining to zero-to-negative territory from the pre-crisis 7%-8% levels. Fiscal stimulus was also substantive, increasing government spending relative to GDP from 13% around 2006 to near 16%, almost completely eroding Turkey's hitherto impressive public sector primary surplus.[13] As a consequence, the contribution of government spending to GDP growth rose from about 10% in 2002-2006 to 25% in the later period.[14]

Though monetary and fiscal stimulus did bring growth back briefly during 2010-11, growth in the post-2007 period as a whole has been markedly low-quality.

[13] The government spending over GDP figures are computed from on national income accounts data.
[14] This contribution is calculated as the change in government consumption and investment spending as percent of change in GDP.

Productivity growth has almost fully stalled, while TFP growth has also come down from its highs during 2002-2006, and by some estimates, is hovering in negative territory.[15] Manufacturing productivity, growing at about 1% per annum since 2007, has been lackluster as well. There has also been no repeat of the broadening of the economic base witnessed in the early 2000s. The Gini coefficient of inequality, for example, has edged up to 40% in 2011 from 38% in 2008.

Figure 6



Source: TURKSTAT, CBRT, Turkey Data Monitor and the authors' calculations.

Perhaps one of the most important manifestations of this low-quality growth has been the changing nature of the current account-growth relationship. While high growth was accompanied by a relatively moderate current account deficit, mostly financing the rebound in domestic investment in the 2002-06 period (as depicted in Figure 2 above), Figure 6 indicates that the post-2007 pattern is quite different in nature: it combines lower growth with higher current account deficits and a sharply lower saving rate -- and no higher investment rate as shown in Figure 2 -- suggesting that the higher inflows have been largely financing higher

[15] See Conference Board Total Economy Database.

consumption.[16] The way the current account deficit has been financed during these two periods also bolsters this interpretation, with fairly long-term financing and foreign direct investment in the first period, and shorter-term flows in the second.[17]

Section II – Turkey's Institutional Backdrop and the EU Relations

Though causality is much harder to establish, it is noteworthy that Turkey's high growth episode overlapped with a period of major institutional and political changes. During this brief period of five years, Turkey's broader institutional setting has taken a conspicuous break from the past, moving from extreme discretion towards a rule-based environment, accompanied by major structural reforms. The deepening of Turkish democracy at the time appeared potentially epochal. The relations with the EU also experienced a hopeful turn with the decision to start the accession negotiations on October 2005.

In what follows, we provide the broad contours of the ebb and flow of Turkish economic institutions, then turning to political factors and the political institutional dynamics undergirding the economic changes.

The consensus view among Turkey experts is that there has been a significant break in the 2000s in terms of "delegation of the decision-making power to relatively independent agencies, and the establishment of rules that constrain the discretion of the executive" (Atiyas, 2012). [18] This institutional shift from unchecked discretion of the 1990s to a more rule-based framework has had significant effect on the implementation of monetary and fiscal policies, the regulatory environment and privatization practices.

The key reform on the monetary policy front was undoubtedly the greater independence granted to the Central Bank, implemented as early as 2001. The

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16 See Akcay and Ucer (2008) for a discussion of these dynamics.

17 Though some of the foreign direct investment in the early phase was linked to privatization, much of it was driven by mergers and acquisitions in the private sector.

18 Prominent examples of these independent, autonomous agencies that were established in the early 2000s include Public Procurement Authority (established in 2002), Banking Regulatory and Supervision Agency (established in 1999 but commenced operations in late 2000); Energy Market Regulatory Authority (established in 2001), the Telecommunications Authority (established in 2000 and recently renamed to ICTA), and Tobacco, Tobacco Products and Alcoholic Beverages Market Regulation Authority (established in 2002). The Competition Authority (established in 1994 and commenced operations in 1997) and the Capital Markets Board (established in 1981) were affected by these changes as well.

new law defined the sole objective of the Central Bank as achieving and maintaining price stability in a context of first implicit and then formal inflation targeting, and prohibited direct lending to the government.

On the fiscal front, institutional overhaul was substantial as well. The important steps here were the passing of two crucial laws —the Public Finance and Debt Management (PFDM) Law of 2002 and the Public Financial Management and Control Law (PFMCL) of 2003 — targeted at breaking with the destructive fiscal legacy of the 1990s with runaway off-budgetary expenditures, non-transparent borrowing practices, and lack of fiscal accountability. The objective of the PFDM was to bring all central government borrowing and guarantees under strict rules, and to impose reporting requirements on all debts and guarantees. The PFMCL, on the other hand, set the main framework of the fiscal management system, by establishing "principles and merits, multi-year budgeting, budget scope, budget execution, performance management and strategic planning, internal control, accounting, monitoring and reporting."[19]

Finally, a Procurement Law, enacted under pressure and guidance of the World Bank in 2002, sought to ensure effectiveness, transparency and competitiveness in the public procurement system. The Law replaced the notoriously politicized and corrupted State Procurement Law, which had been in place since the 1980s.

The changes on the regulatory front were similar and also relied on the establishment of a number of independent autonomous agencies (sometimes dubbed the "European Model") in order to strengthen rule-based decision-making and insulate the regulators from political influence.

The bottom line is that thanks to the enactment of these comprehensive and best-practice laws, governmental control over public expenditures was enhanced and Turkey's out-of-control off-budget expenditures (including so-called "duty losses") were greatly restricted.[20]

The early 2000s also witnessed improvements in Turkey's broader institutional environment as can be gauged from the World Bank governance and doing

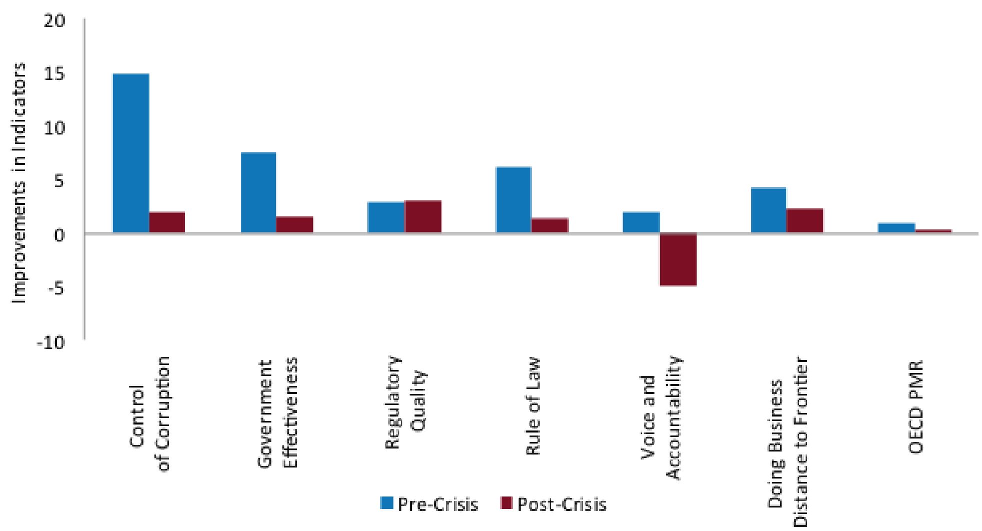
[19] See Kaya and Yilar (2011) for details, which also provide a comprehensive assessment of the evolution of Turkey's fiscal structure over the past two decades.

[20] Nonetheless, these reforms were highly incomplete, and potential reforms aimed at increasing overall efficiency in public administration and accountability in public expenditure were shelved (Atiyas, 2012), and many inconsistencies and loopholes remained in fiscal transparency and reporting (OECD, 2014).

business indicators depicted in Figure 7, where Turkey shows solid progress in all key areas.

Figure 7

Figure 8.8: Institutional reforms have slowed since the mid-2000s



Source: WGI, Doing Business, OECD
Note: Pre-crisis refers to 2001-2007 for WGI, 2004-2007 for Doing Business, and 2003-2008 for Product Market Regulation (PMR); post crisis refers to 2008-2012 for WGI and Doing Business, and 2008-2013 for PMR.
Doing Business indicators are calculated based on the 2014 release. From the 2015 release onwards, a change has been introduced in the methodology and "distance to the frontier" measures for 2015 are not comparable across time.

Source: World Bank (2014)

The corruption perception index compiled by Transparency International, depicted in Figure 8, tells a similar story: there are tangible signs of lower corruption starting from 2003 (corresponding to higher values of the index), and Turkey's rank improves from around high 70s among 175 countries in 2003 to low 50s in the late 2000s.[21]

Then things began to change for the worse at around the time of the global crisis, with the pace of deterioration accelerating during AK Party's third term that began in June 2011. This has taken the form of a virtual stalling of the structural reform efforts as well as a marked weakening in the institutional environment.

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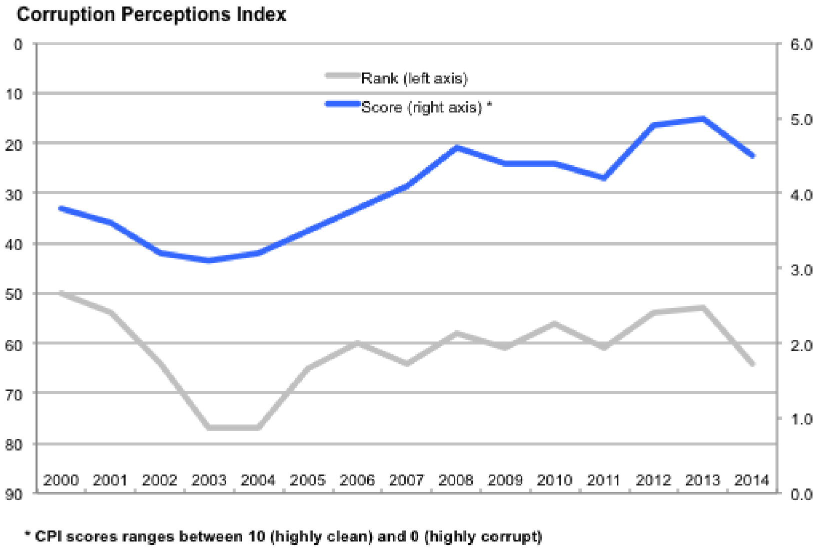
[21] We interpret the fact that there is continued, albeit slight, improvement in Turkey's score and rank in the late 2000s as a consequence of the backward-looking nature of this corruption perception index.

Figure 8



Source: Transparency International Corruption Index, authors 'calculations.

The gutting of the aforementioned procurement law is indicative of the *de facto* and *de jure* changes in economic institutions during this period. In some sense, AK Party was never at ease with the new law, seeing it from the very beginning as a major constraint on its grandiose investment projects (such as "15,000 kilometers of double-lane highways") and the funneling of state resources toward its own constituencies. As the party gained confidence and control, the procurement law began to be altered dramatically via various mechanisms, including a continuously expanding set of "exceptions", changes in the tender rules (open vs. restricted), various advantages for domestic bidders, and the introduction of rather high minimum monetary limits, below which procurement of goods and services would be exempted from the law.[22]

As documented by Gurakar and Gunduz (2015) in their very comprehensive account, both the number and the value-share of public procurement contracts

[22] EU's 2014 Accession Report complained about both the state of the procurement law and its implementation, writing: "Turkey's public procurement legislation remains not in line with the acquis in a number of aspects. This includes numerous derogations and exemptions from the scope of the law. Both the classical and utilities sectors are formally subject to the same law and procedures, thus making the legislation for the utilities sector more restrictive than envisaged by the EU Utilities Directive. ... There have been various allegations of political influence on public tenders."

that were left outside the transparent public procurement practices increased substantially during the period from 2005 onwards, reaching 44% in 2011.[23]

One giant entity that was fully left outside the purview of the procurement law, alongside public-private partnerships and defense spending, was the State Housing Development Administration, TOKI, which is directly attached to the Prime Minister's Office. As reported in Atiyas (2012), although TOKI's exemptions were originally limited to procurement for public housing projects, in 2011 these were extended to all construction undertaken by TOKI. Given that TOKI is now also exempted from PFMCL or any other budgetary rules, this meant that the organization has wielded tremendous power over and a completely free hand in the redistribution of urban land throughout the country.

Perhaps unsurprisingly in the light of these changes, Figure 8 shows declines both in the corruption perception index and Turkey's rank, with the latter sliding 11 notches to 64 in 2014 (again out of 175 countries). It is probably also not a coincidence that land and construction deals were at the very heart of the Turkey's largest corruption scandal, which broke out in December 2013, and the then-Minister of Environment and Urban Planning was one of the four ministers implicated in the scandal.[24]

Setbacks can also be seen in crucial reform proposals that fully stalled. Two proposals that had been floated during the IMF program negotiations, which were held throughout 2009 during the apex of the global crisis, were first resisted and then shelved for good by the AK party leadership. One of these was about creating an independent tax authority, which was greatly needed not only to insulate tax collection activities from political influence but also to alter Turkey's tax structure, which heavily relies on indirect consumption taxes, towards direct taxes. The other proposal was about adopting a "Fiscal Rule", which would consolidate Turkey's fiscal adjustment and contain the deterioration experienced during the crisis. Though early on promoted by Ali Babacan, the Deputy Prime

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[23] They report that "the number of contracts awarded via open auctions fell from 100,820 in 2005 to 77,151 in 2011, the number of contracts covered by exclusions rose from 41,157 to 59,680. The share of the latter in total number of public procurement contracts rose from 29% to 44%. Similarly, contracts covered by exclusions and direct buying quadrupled from TL10.3 billion per annum in 2005 to 39.1 billion in 2011. In terms of value-share in total public procurement, this indicated an increase from 34 percent in 2005 to 44 percent in 2011."

[24] For a timeline of the investigation and government's response, see Muller (2014).

Minister and the Treasury Minister in charge of economic coordination, this also never got off the ground.

Arguably more ominous was the aggressive attacks by the government on autonomous agencies. As explained in Ozel (2015), after some *de facto* meddling in the affairs of these agencies (e.g., in the form of influencing the election of board members or the hiring and firing of staff), the government took the formal steps by signing two decrees to law in 2011 that paved the way for more explicit intrusion from respective ministries. Of these, one (Decree No.649) explicitly stated that the respective minister would have "the authority to inspect all transactions and activities of the related, attached and affiliated agencies" (which included the autonomous regulatory agencies), thus giving the ministers and their staff the ability to restrict the independence of these agencies. At around that time, the idea of independent regulatory institutions has been dealt another blow, with Mr. Babacan, the main reform advocate within the government, stating that "it was time for some independent agencies to re-delegate their authority" (Ozel, 2015).[25]

Meanwhile, the Central Bank, already eager to accommodate the excessively low interest rate policies pushed by the then-Prime Minister Recep Tayyib Erdogan, came even under heavier pressure for not reducing interest rates quickly enough to support growth. The whole episode was damaging not just because of its implications for macroeconomic policy, but because it demonstrated the unwillingness of the government to be restrained even by the most pliable organizations.

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We have argued that the turnaround in Turkey's economic performance is a reflection of the turnaround in economic policies and institutions, including the stalling or reversals in the process of much-needed structural reforms. But this

[25] Another episode that showed AK party's growing intolerance toward independent scrutiny was witnessed around Turkey's Court of Audits (TCA). After adopting a best-practice law with some 5-year delay in 2010, the government attempted to curb the Court's powers and the Parliament's access to proper financial reporting by way of passing new legislation in 2012. After a repeal of the Law by the Constitutional Court, the government pressed ahead with another draft law, which could, as stated in EU's Progress Report of 2013, "…result in a distortion of the TCA's mandate and its ability to carry out independent and effective audit". The Law is now on hold, having been withdrawn because of objections from both within and outside the Parliament.

only provides a proximate answer to the deeper question of why economic policies and institutions improved in the first phase and then went into a reversal. We argue that both the initial improvements in economic institutions and their subsequence slide are related to political factors.[26]

To put it simply, during its first five years of rule the AK party became, partly unwittingly and perhaps even unwillingly, an instrument of deep-rooted political reform. This period witnessed the broadening of the political base as the military tutelage in Turkish politics, probably the most important factor holding back Turkish democracy and civil society, ended. A confluence of factors came together to make the early 2000s a propitious time for such a fundamental transformation in Turkish politics. Four deserve to be emphasized in particular.

First, as already noted, the AK party came to power after a basic structure of economic reforms had been put in place following the 2001 financial crisis. This, and the inexperience of their top echelon, limited what they could do.

Second, the AK party came to power as a representative of an increasingly disenfranchised (or at least feeling disenfranchised) segment of Turkish society: provincial, conservative businessmen; urban poor (who were often recent migrants); and rural population except Kurds and Alevis (who were always viewed suspiciously by the almost entirely Sunni AK party leadership). These social groups, which were less Western, more religious and more conservative, were never welcomed by the rulers of Turkey in the 20th century, the so-called "Kemalist elites" (named after their ideological commitment to the principles of the Republic's founder, Mustafa Kemal Ataturk; often defined to include the military, the bureaucracy and big, urban-based conglomerates; and argued to be represented by the state's party, the Republican People's Party). This is not to deny that the conservative ideology of these groups has all too often influenced school curricula or formed the foundational rhetoric of several military regimes, most notably the one catapulted to power by the 1980 coup.

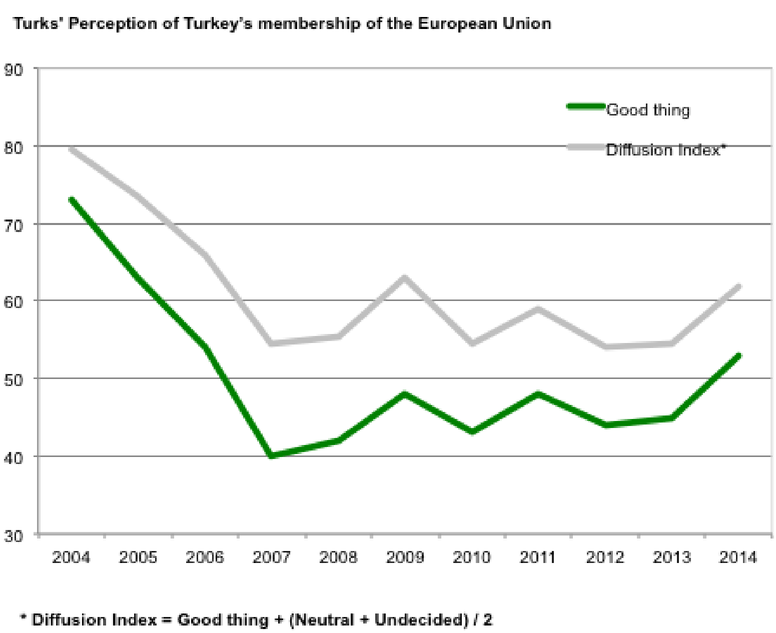
But both traditionally, and specifically during the 1990s, these groups both felt increasingly excluded and were at one end of a culture war, with seemingly stronger forces on the other side — a culture war summarized, even if bombastically, by Prime Minister Recep Tayyip Erdogan's famous statement: "In

[26] This emphasis on the role of political institutions in shaping economic policies and institutions builds on Acemoglu and Robinson (2012).

this country there is a segregation of Black Turks and White Turks. Your brother Tayyip belongs to the Black Turks."[27] The AK party's rise to power thus came to be seen as the enfranchisement of this previously-excluded group. During their early rule, they had to defend democracy (which they interpreted as respecting the electoral results rather than succumbing to a military intervention against them) as a survival strategy.

Third, the AK party came to power in 2002 with a limited mandate, receiving only 34% of the national vote. They had little choice but rule *inclusively*, especially given the suspicious and almost hostile attitude of the military towards it from the get-go.

Figure 9



Source: Authors' calculations based on GMF Transatlantic Trends

Fourth, the AK party came on the scene when EU-Turkey relations were undergoing perhaps their most constructive period and presented itself as a staunch supporter of EU accession. To be sure, the process leading up to the

[27] While the exact timing of this statement is a matter of debate, it first rose to prominence when quoted in a New York Times interview with the newly-elected Erdogan by Deborah Sontag in May 2003.

accession negotiations, launched on October 2005, was anything but smooth. Yet, the process started reasonably earnestly and with significant momentum in 2006, and had the strong backing of the Turkish public, as illustrated by Figure 9.[28]

The view at the time was that Turkish accession to EU could proceed relatively rapidly, as summarized by a high-profile report:

> "Our starting assumption is that it is likely that accession negotiations would start during 2005, but that they would last for quite some time, with membership materialising only around 2012-15. We therefore take a long-term perspective and explore particular areas in which the EU and Turkey could cooperate during the long interim negotiating period." (The European Transformation of Turkey, Dervis et al (2004))

The EU accession process had at least two sorts of effects on Turkish institutions. First, on the political side the EU shouldered a role similar to the one that the IMF and the World Bank played on the economic side in the aftermath of the 2001 financial crisis, providing both pressure for reform and a template for best-practice legislation in the areas of civil and political rights, civilian-military relations and judicial reform. As part of the engagement process with the EU, a number of far-reaching and difficult reforms were thus set in motion, even if many of these were finally enacted in the late 2000s. A non-exhaustive list includes improved property rights for non-Muslim religious foundations; the lifting of draconian penalties against speech construed as criticizing Turkish identity; the introduction of the ability of civilian courts to try military personnel and the banning the trials of civilians and military courts; laws protecting children; improved trade union rights, including permission for workers to become members of more than one union simultaneously; permission for public service workers to sign collective labor agreements, removing previous bans on political and solidarity strikes; and permission for individuals to apply to the Constitutional Court in cases where their freedoms of fundamental rights are violated.[29]

[28] As detailed in Morelli (2013), while the EU Council agreed to a "Negotiating Framework" and opened the negotiations, language of the Framework was kept deliberately loose (meaning no guarantee of eventual membership was extended). Cyprus was a thorny issue from day one, exacerbated by Turkey's refusal to extend Customs Union to Greek Cyprus. This has subsequently led to EU Council blocking 8 chapters. See the annex table for a time line of EU-Turkey relations since 2005.

[29] See Hale (2011).

In addition, the lifting of bans against Kurdish protests and legislation allowing state-run Turkish radio and television to broadcast in Turkish; the ending of the emergency rule over the last two of the 13-Kurdish-majority provinces; the introduction of broad civilian supervision over defense expenditures; and the removal of National Security Council presence in the oversight of cinema, video, musical works and radio and television as well as a shift in the government's willingness to generally respects rulings by the European Court of Human Rights were also steps long-advocated by the EU and are generally interpreted as being a direct result of EU-Turkey engagement.[30]

Second, as already noted, the prospect of EU accession acted as an anchor and a carrot to the ruling party — there were major economic gains from closer ties with Europe. It wasn't just the economic benefits of EU accession that motivated the AK party, however. Since the AK leaders viewed themselves under constant threat from the military, closer ties to EU appeared as an attractive bulwark against a military coup. For Turks were increasingly keen on becoming part of Europe, the cards were stacked against any moves that would alienate Turkey's European partners.

All of these factors would disappear or change their character by the middle of the 2000s. The effect of the economic institutional framework put in place after the 2001 crisis ceased to have much of a determining role as the AK party elites and mayors found ways of circumventing the regulations and laws or changing them, as we recounted in the case of the procurement law, to benefit themselves or their party.

The 2002 election brought the beginnings of the end of the two major center-right parties, with their votes going almost in block to the AK party in the next 2007 elections, making it a much more formidable force in electoral politics. By 2011, the AK party commanded almost 50 percent of the vote.

More importantly, the balance between the AK party (and its base) and the Kemalist forces changed significantly. Because these events are important both for understanding how the center of gravity of Turkish politics shifted, and how the AK party came to define itself and understand its power, it is useful to recount them in some detail.

[30] See Kirisci (2011) and Gursoy (2011).

The backdrop is the political history of Turkey in the 20th century, which was dominated by the military and state bureaucracy. The one-party rule Ataturk imposed came to an end in the first semi-democratic elections of 1950,[31] which brought the Democratic Party, fashioning itself as a representative of the same provincial business interests and conservative cultural values that the AK party later came to speak for. In 1960, the military moved against the Democratic Party and proceeded to hang its leader, Adnan Menderes. The military then engineered two more coups, in 1971 and 1980, and also brought down another Islamist party in 1997 with the threat of a coup (and subsequent action by the Constitutional Court closed the party). The generals were already unhappy about both the AK party's rise to power and their increasingly marginalized role in the 2000s, when the AK party nominated its number two, Abdullah Gul, for the presidency. The military, and their civilian allies, were alarmed by the fact that Gul's wife wore a headscarf, and would represent Turkey in international forums and inhabit Ataturk's presidential palace.

This, combined with their general unease about the political direction of the country, made the military top brass move to threaten another coup with a web memorandum in April 2007, following the confirmation that Gul would be the next president of Turkey. Ominously, the Constitutional Court started proceedings to close the AK party for anti-secular activities. But the situation was different in 2007 than in 1960 or 1997. The AK party had already organized deeper social networks within modern Turkish society, and had taken control of large parts of the bureaucracy and the increasingly heavily militarized police, while the status of the military within Turkish society was at an all-time low. The military's threat this time came to nothing.[32]

This episode not only sidelined perhaps the most powerful opponent of the AK party, the Kemalist generals, but also further radicalized the AK leadership. According to some insider accounts, leading AK figures are reported to have packed their bags during the events of April 2007, fully expecting the military to come to power and put them in jail. Their David and Goliath reading of Turkish

[31] The first multi-party election in 1946 was not only called early by the ruling Republican People's Party before the opposition could organize itself, but was also marred by widespread vote-rigging (Zurcher (2004)).

[32] This dynamic was greatly assisted by a symbiotic alliance between the ruling AK party and the so-called "Gulen Movement" (named after the self-exiled preacher Fetullah Gulen in the Unites States), which soured in the course of various power struggles and then acrimoniously broke up over Turkey's historic corruption investigations in December 2013.

history — where the victimized “Black Turks” are stamped out by the conspiracy of Kemalist “White Turks” – was both confirmed and embellished. They may have concluded that they had to destroy not only the anti-AK party military elites, but also tear down the institutional structures that they saw as supporting these hostile groups. It is therefore natural to see the roots of the sham Ergenekon and Sledgehammer trials that the AK party and their allies organized against journalists, former mid-ranking soldiers and generals in their increasingly urgent need to weaken and remove their enemies.[33]

And finally, the EU’s anchor for Turkish institutional reforms and leverage over Turkish politicians came to an abrupt end at around 2010 as the accession process almost completely stalled. Several factors played a role in this. The first stumbling block was Cyprus. The collapse of the UN-sponsored talks on a comprehensive settlement and Turkey's unwillingness to extend the Customs Union to Cyprus brought relations to a standstill and caused the suspension of eight ongoing chapters in 2006. Second, the government, and to a degree certain segments of the population, were also resistant to many of the legal and human rights reforms. Third, there was a backlash against Turkey in some of the key European countries, most notably in France’s referendum and the rise of Nicholas Sarkozy, with an explicitly anti-Turkish accession platform. Finally, these developments also started changing support for EU within the Turkish population. As disillusionment set in, support for EU took a tumble, falling from above 70% in 2004 to a low of 40% in 2007 as detailed in Figure 9.

As enthusiasm and support for EU accession among Turks waned, and as the AK party turned East (a process that had many causes), Turkish institutions became increasingly unanchored, further damaging Turkey-EU relations. Recent remarks by Jean-Claude Juncker, President of the European Commission, summarize what has become a common stance among many European policymakers and bureaucrats:

> “...under my Presidency of the Commission ... no further enlargement will take place over the next five years. As regards Turkey, the country is clearly far away from EU membership. A government that blocks twitter is certainly not ready for accession." (The Official Website of the EC President, *My Foreign Policy Objectives*, April 2014)

[33] On the Ergenekon trials, see Jenkins (2011). On the Sledgehammer case, see Rodrik (2014).

Though these comments emphasize the Turkish bans on social media, they are a reaction to a culmination of increasingly authoritarian policies and institutional changes adopted by the AK party as a result of the turnaround in all of these factors that were previously pushing it to adopt pro-democratic, pro-civil society reforms. EU's 2014 Accession Report, for example, was alarmed by the government and the judiciary's response to the December 2013 corruption scandal, concluding:

> "The response of the government following allegations of corruption in December 2013 has given rise to serious concerns regarding the independence of the judiciary and separation of powers. The widespread reassignments and dismissals of police officers, judges and prosecutors, despite the government's claim that these were not linked to the anti-corruption case, have impacted on the effective functioning of the relevant institutions, and raise questions as to the way procedures were used to formalise these."

The implications of all of these trends for the Turkish political institutions and freedoms are striking. The World Justice Project, a comprehensive snapshot index of a country's legal environment, ranked Turkey 80th among 100 countries (down from 59th previously). In press freedoms, Turkey was labeled "not free" by the Freedom House, and was ranked 149th place among 180 countries by another independent watchdog, Reporters Without Borders. Figure 7 above further indicates that Turkey's progress in terms of broader governance and reform indices has come to a complete halt.

It is of course natural to ask why Turkish political institutions and civil society organizations failed to defend the advances and the freedoms gained in early 2000s. The most likely answer is that these institutions were not as strong as one might have hoped and civil society organizations did not wake up to the slide until it was too late. The weakness of the institutions that were supposed to guard society against the usurpation of power probably lie in the fact that the judiciary and state bureaucracy in Turkey have never been independent, and their allegiance, which firmly lay with the military before 2000, shifted quickly to the AK party, which exploited its power to make appointments and promotions.

The AK party also came to have a heavy, almost stifling influence on print media and TV — not unlike the influence of the Kemalist elites in earlier periods — as indicated by the above-mentioned deterioration in Turkey's standing in press freedoms. It also took time both for civil society organizations, which were just finding their voice during this period, and foreign media to recognize how the political balance was shifting in Turkey, partly because they were still celebrating the eclipse of the military.

Section III – Concluding Remarks and the Way Forward

We have advanced in this brief essay several key arguments:

The Turkish economy's most recent ups and downs, with a turning point around 2007, are not an exemplar of the typical stop-go cycle experienced by many emerging economies (including Turkey itself in the past), but the consequence of a first phase of structural reforms and unprecedented (by Turkish standards) improvements in economic institutions, and then a total about-face in a second phase during which all of these improvements were reversed.

The roots of the ups and downs of economic institutions is to be found in the political dynamics of Turkey, which created a propitious environment for a major political opening in 2002, with the governing AK party as its unwitting agent but then enabled the AK party to become too powerful for the always-weak checks and balances presented by Turkish civil society, judicial institutions and parliamentary opposition.

Though several other factors, including the waning effect of World Bank/IMF reforms and the ending of the fight between the AK party leaders and the military decisively in favor of the former, set in motion the slide in Turkish political and economic institutions, EU-Turkey relations arguably played the critical role. Even though both the reforms adopted in the process of EU accession and the anchoring role of the relations with the EU facilitated the difficult economic and political reforms of the first phase, as relations with the EU soured subsequently, these dynamics played in reverse.

In concluding, we draw several lessons for the future of the Turkish institutions, Turkey-EU relations and more broadly.

The most important lesson, which applies both to Turkey and other emerging economies in our view, is that even starting with weak institutions and political imbalances, rapid and high-quality growth appears feasible if the political opening for deep structural reforms and improvements in economic institutions can be found. We are fully aware that such a political opening is far from trivial, and in the Turkish case it may have been made feasible only because the bastions of the old order, the military and other parts of the Kemalist elites, were particularly weakened, many of the traditional politicians were blemished because of incompetence and widespread corruption during the 1990s, and a deep financial crisis left no choice to a caretaker government and its successor, the AK party, but to work with the IMF and the World Bank. All the same, the rapidity with which these reforms bore fruit is a surprise to many commentators who view them as either ineffective or only slow-acting.[34]

Second, this episode also underscores the closely linked nature of political and economic reforms. In our account, what enabled the structural and economic reforms of the first phase were the favorable political winds of change that strengthened democracy and representation in Turkey. But these political factors went in sharp reverse in the second phase, and as a result, so did economic institutions. The slide of political institutions reflected the unrestrained domination of the AK party, enabled partly because of the inherent weakness of Turkish civil society and judicial institutions, and partly because the AK party elites were able to come to establish their unrivaled control over the judiciary and media via appointments and intimidation.

Finally, we believe there are also important lessons from this episode for the future of EU-Turkey relations. Though these appear to have hit bottom at the moment, there are plenty of grounds for future engagement. To start with, closer trade ties that were initiated by the Customs Union are ongoing, and "upgrading" these ties, which seem inevitable given the developments in the global economy over the past two decades, could be one such vehicle.[35] More importantly perhaps, once the current European economic crisis and the mounting refugee crisis are brought under control in the next several years, EU's priorities may shift once again towards enlargement. Even without a full-scale turnaround of this sort, European leadership might find different formulas for closer engagement with Turkey.[36] An important reason for such engagement for the EU is highlighted

[34] Though they are consistent with other findings, such as Acemoglu, Naidu, Restrepo and Robinson (2014) showing fairly rapid improvements in economic growth following democratization.
[35] See Ulgen (2012), Pierini and Ulgen (2014) and Kirisci and Ekim (2015).
[36] For a concise and effective articulation of this point see Ahtisaari et. al. (2015).

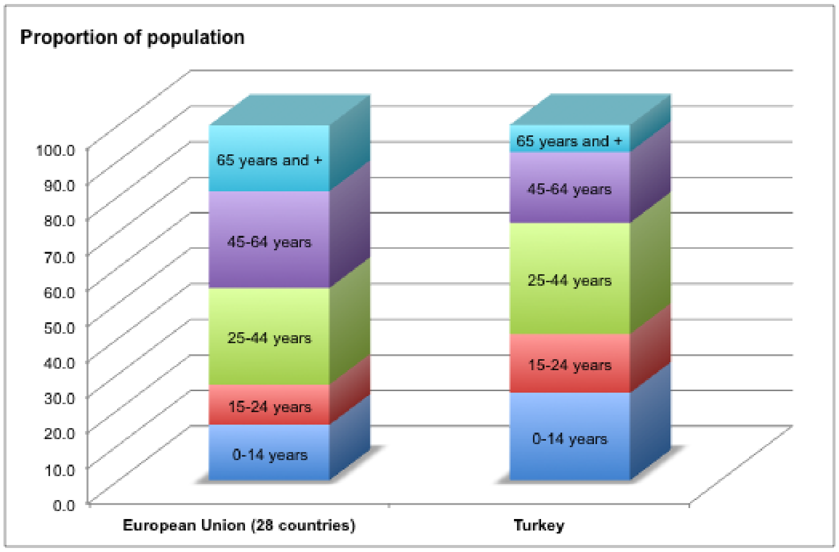
by our account: under the right type of engagement, the EU might have significant power over Turkish institutions, capable of moving them in the direction of deeper and stronger democracy under the EU's pressure and anchor. Although this power most likely requires a willing, or at the very least pliable, partner at the helm on the Turkish side, internal political dynamics may yet nudge Turkish leaders towards such a position in the not-too-distant future. Our essay also suggests that such re-engagement can generate sizable economic gains for Turkey.

But the gains are not all one-sided. This institutional power is an argument for EU engagement precisely because the EU can reap two types of major gains from closer relations with Turkey and improvements in Turkish institutions. The first one, though almost trite because of the frequent emphasis put on it in many debates, is still important: Turkey can play a stabilizing role in the Middle East (especially contrasting with its current complicating role in the Syrian crisis).[37] With European nations, large and small, increasingly drawn into conflicts in the broader region and feeling its aftershocks, there is arguably a greater need for a holistic engagement with the Middle East and North Africa, a strategy for which a democratic Turkey, engaged with the EU, could be an invaluable asset, not only as a partner in foreign policy but also as an exemplar of a successful Muslim democracy for the rest of the region.[38]

The second pertains to demographic benefits to the EU from Turkish membership, though the short-term economic costs, and perhaps the medium-term social costs of Turkish membership are not to be downplayed. As Figure 10 shows, Turkey has a much younger population than Europe. As Europe keeps getting older, the gains from integrating Turkey's younger population into the European economy could be substantial — both for the labor market and for the sustainability of the ever-evolving set of social welfare programs that are so important for Europe's population — even if the demographic window of opportunity presented by possible Turkish accession will inevitably get narrower over time.

[37] For an assessment of Turkey's Syria policy, see Hope (2013). Stein (2015) looks at the more recent developments.
[38] Ahtisaari et. al. (2015).

Figure 10



Source: Authors' calculations based on Eurostat

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Annex - Timeline of Turkey-EU Relations: 2005-Present

	Chapters	Other Developments
2005		Council adopts negotiating framework, and negotiations are formally opened.
2006	Chapter on Science & Research (25) opened and provisionally closed	Due to the Cyprus conflict, EU decided that negotiations on 8 chapters cannot be opened and no chapters can be provisionally closed. These were: Free Movement of Goods (1), Right of Establishment & Freedom To Provide Services (3), Financial Services (9), Agriculture & Rural Development (11), Fisheries (13), Transport Policy (14), Customs Union (29), External Relations (30)
2007	Five chapters are opened. Enterprise & Industrial Policy (20), Consumer & Health Protection (28), Trans-European Networks (21), statistics (18) and Financial Control (32) are opened	France declared it will not allow opening of negotiations on 5 chapters because these chapters are directly related to the membership. These were: Agriculture and Rural Development (11), Economic and Monetary Policy (17), Regional Policy and Coordination of Structural Instruments (22), Financial and Budgetary Provisions (33), Institutions (34)
2008	Four chapters are opened. Free Movement of Capital (4), Company Law (6), Intellectual Property Law (7) and Information Society & Media (10) are opened	Council adopts a revised Accession Partnership framework for Turkey.
2009	Two chapters on Taxation (16), Environment and Climate Change (27) are opened	Cyprus unilaterally declares that it would block the opening of 6 chapters: Freedom of Movement for Workers (2), Energy (15), Judiciary and Fundamental Rights (23), Justice, Freedom and Security (24), Education and Culture (26), Foreign, Security and Defense Policy (31)
2010	Chapter on Food Safety, Veterinary & Phytosanitary Policy (12) was opened	
2011	No Activity	
2012		Positive Agenda launched, intended to bring fresh dynamics into the EU-Turkey relations.
2013	Chapter on Regional Policy & Coordination of Structural Instruments (22) is opened	France lifted its blockage on Chapter 22, Regional Policy & Coordination of Structural Instruments

Sources: http://www.mfa.gov.tr/relations-between-turkey-and-the-european-union.en.mfa; http://ec.europa.eu/enlargement/countries/detailed-country-information/turkey/index_en.htm;