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Transition to the Regulatory State in Turkey: Lessons from Energy

Tamer Çetin and Feridun Yılmaz

Abstract: Turkey has recently reshaped its own institutional structure by establishing Independent Regulatory Agencies (IRAs). However, the political authority has not desired to delegate the political property rights to IRAs. Although IRAs is *de jure* established, the political conflicts occurring during the evolution of the traditional-patrimonial state to the regulatory state *de facto* impede IRAs to institutionalize. This paper observes recent policy changes during the transition and lessons from the energy regulation in Turkey. So, the paper reveals whether the change in the regulatory institutional structure of Turkey is an effective policy in terms of transition to *the institutions of capitalism*.

Keywords: regulation, regulatory state, Turkish energy industry

JEL Classification Codes: L5, L51, L52, L94, L95

Over the last 20 years, there is a consensus in the literature that regulation has acquired unique ground in European countries. Since the 1980s, liberalization and privatization have not led to *laissez-faire* capitalism.¹ Because of the failure of privatization policies, the operation of markets has been accompanied by more regulatory rules. Furthermore, government regulation of the markets has been used as a tool for the allocation of resources. This movement has been called the rise of the regulatory state (Jordana and Levi-Faur 2005; Gilardi 2008). The most important feature of the regulatory state is delegation of the regulatory policy-making power to non-majoritarian institutions. However, independent regulatory agencies (IRAs) represent the best examples of the delegation. Regulatory institutions are thought of as part of the “economic institutions of capitalism” (Newbery 1999). In that case, the rise of the regulatory state in a country brings about institutional reform and the establishment of IRAs (Majone 2001b).

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IRAs have exploded since the end of the 1980s and have become a pervasive institutional model in all European countries (Gilardi 2008, 2), in Turkey they appeared toward the end of the 1990s and have dispersed to all sectors in the 2000s. Although the constitutional and bureaucratic structure of Turkey was not ready for the transition, with the pressure from international organizations such as IMF (International Monetary Fund), OECD (Organization for Economic Cooperation and Development), EU (European Union) and the World Bank, the transition was initiated (Sosay and Zenginobuz 2006; Çetin and Oguz 2007a; Sezen 2007).²

The transition suffered from the political environment of the time. In particular, energy markets include feasible cases for this issue. First we focus on the transition term and then look at cases from energy markets.

Transition to a Regulatory State in Turkey

The distinctive feature of the transition term was coalition governments. In the political sphere, Turkey lived with coalition governments throughout the 1990s until 2002. The last coalition government took the first crucial steps with its structural reforms in 2001. The transition program prioritized competition and efficiency in the economy and introduced the institutions of market economy. However, the same government faced many corruption issues. The close ties between the political elites and leading holding companies opened doors to widespread rent seeking and corruption. In the absence of a regulatory institution in the banking industry, excessively politicized public banks emerged as major instruments of rent distribution in the political process.

Because of the duty losses of these banks in 2000 and 2001, Turkey had to counter a financial crises, large costs to the economy and a necessity for fundamental change in the banking and other industries (Alper and Onis 2002; TUSIAD 2003).³ Not only the banking industry, but also other tightly regulated industries and state monopolies were main targets of rent-extracting and rent-seeking activities.

Turkey's political environment has long been defined by coalition governments. The instability of coalitions made bargaining and strategic behavior an important component of political life. The 1990s were particularly unsteady. There were eleven short-lived governments, seven of them were coalitions. Turkey faced three big economic crises (1994, 2000, and 2001) during this period. There is a positive correlation between economic crises and political instability (Kibritcioglu 2001).

Governance by coalitions harms the stability of any regulatory policy. The costs of decision-making are relatively higher in coalition governments because of widespread principal-agent problems (Martin and Vanberg 2004). Interest groups use this system competently to extract rents, as the cost of rent-seeking decreases. There are two dominant channels for the capture. First, campaign financing and other ways of pecuniary gains influence political decision making. Second, these groups may provide only beneficial information to politicians to persuade them (Figueiredo and Figueiredo 2002, 161-162).

Coalition governments also increase transaction costs of regulatory procedures. Coalitions are usually short-lived. So, interest groups spend more resources to get and

protect their interests (Olson 1999). Coalition parties may have conflicting policies toward some industries. The divergence among parties weakens the power of the government.

Allocating regulated industries among coalition parties harms the regulatory process too. To give an example, two prominent regulatory institutions, the Banking Regulatory and Supervisory Authority (BRSA) and the Competition Authority (CA), were established under the bargaining of coalition parties. The government could not appoint their board members for a long time after their law passed in the parliament because of political haggling. Conflicting views of coalition parties delayed the institutionalization of regulation and contributed to the economic crisis in 2001 (TUSIAD 2001).

The economic crisis of 2001 is an important example of conflicting views on the economy among the coalition parties. On the one hand, the governing parties tried to implement market-based institutions; on the other hand, they had no intention of letting go of their rent resources. The banking industry, because of rent seeking of political elites, was not adequately regulated. An ineffective regulatory framework was one of the reasons for problems in the banking sector that helped trigger the 2001 crisis, causing vast welfare losses (OECD 2002, 9).

Lessons from the Energy Industry

The previous coalition government had initiated the privatization of many state owned enterprises (SOE). The AKP (Adalet ve Kalkinma Partisi-Justice and Development Party) government took over this framework and promised to improve the previous government's performance over selling many SOEs in 2002. While the government has succeeded in some privatizations such as TurkTelekom (the State Telecommunications Monopoly) and Tupras (Turkish Petroleum Refineries Company); electricity has been a failure. The lack of a consistent regulatory policy in the energy industry between the government and regulator also aggravated the disappointment.

In this section we will look at four cases where AKP had conflicting attitudes in terms of economic policies. Moreover, all these examples show the preference for political expediency. Energy policy is one of the major areas where AKP's expressed aims before elections and behavior after elections deviate. Following World Bank and IMF guidance, regulatory reform had begun in 2001. AKP defended a liberal market in energy in its election programs. However, after a very successful election in 2007, it decided to hold EMRA (Energy Market Regulatory Authority) in its grip.

The Ministry of Energy and Natural Resources (MENR), with the signs from the industry about the excess demand crisis in the future, became more active in the generation segment of the market. One reason is that privatization efforts did not go well so far. Secondly, EMRA seems to be unsuccessful in managing the market efficiently. While, the secondary legislation and regulations are in place, in reality, the industry has not progressed as initially expected. The government, against the global trends, wants to push a more state-oriented energy market and restrain the power of

EMRA. Apparently, it is inconsistent to argue for a more liberal market structure on the one hand, and to become more dominant over the market on the other. Many opportunities for a better energy market are missed in this political game.

Electricity Strategy Paper

The recent regulatory reform in the electricity market began in 2001, with a new electricity market law (EML).⁴ Privatizations were an important step of the reform. EML required generation and distribution companies to be privatized within two years. The law gave the authority to the Privatization Administration. In 2004, the new government decided to change the path of the regulatory reform despite EML and the independent regulator. In 2004, the government published a strategy paper to express the new policy. The new strategy paper, without any legal enforcement changed the course of privatizations.

This document brings the issue of regulatory commitment to the forefront. Political expediency remained the prominent goal of the government. As the literature on regulatory commitment shows (Levy and Spiller 1996; Spiller and Tommasi 2003), transaction costs rise as regulatory commitment of the political authority weakens.

The strategy paper reflects the government's political preferences over electricity markets. As a strong government, AKP preferred to control electricity markets. For example, EML describes TETAS (Türkiye Elektrik Ticaret ve Taahhüt Şirketi), the state electric trade company, as a transitory monopoly. This company pursues general electricity policy and enters into purchase and sale contracts with producers and consumers. According to the law, TETAS has to be a transitory monopoly. Yet, the strategy paper makes it permanent in order to continue the government control over the market.

The government put EML's articles on distribution and generation aside without annulling them. The strategy paper gives priority to privatizations in distribution. It required the distribution privatizations to be completed before the end of 2006. However, it was postponed one more time and uncertainty dominates privatizations at the moment. These delays create extra transaction costs for the regulatory process.

Dispute Over Regional Pricing

Another conflict between the government and the regulator occurred on the issue of regional pricing. Cost considerations require regional pricing in Turkey because of illegal and inefficient use of electricity. Government subsidizes electricity in regions where costs are relatively high. This is related to widespread illegal use in Southeastern Turkey. EMRA attempted to introduce regional pricing in 2003. Politicians from this region strongly resisted regional pricing. The government preferred political consistency and supported the existing national pricing. While EMRA has the sole authority on pricing issues, it gave up under political pressure.

There are significant political benefits of following national pricing. First, one-price system subsidizes the illegal use, by reflecting its costs to other consumers. As shown in Table 1, the current government has a large voter-base in this region. The government's action is politically expedient, even though it encourages illegal use and adds to economic inefficiency. It also supports cross-subsidization of households, which have more votes, by charging higher prices to industrial consumers.⁵

Second, the agricultural sector largely depends on electricity. AKP was unwilling to delegate its power on pricing to an independent regulator. From time to time, all governments cross out farmers' electricity debts. Governments also supply other types of subsidies such as discounted gas to farmers. Thus, they do not want to reduce their political tools to manipulate the electorate.

As a result, other regions in Turkey continue to subsidize illegal use in the Southeastern region. As seen in Table 1, the illegal use rate is as much as 75% in some parts of this region. In this connection, government aims to transfer \$2.5 billion to these regions as subsidized electricity until 2011 via the new price equalization mechanism. In the new system, the profits of western distribution companies will be transferred to the Eastern and Southeastern distribution companies. In ten cities where illegal use is highest, AKP had the highest votes in nine, in the last election. On the other hand, in western cities with the lowest illegal use rate, AKP could not take first place in elections, with the exception of three. This reveals the political preference to overlook illegal use and see it as a cross-subsidy tool. A major consequence of this policy shift is to make the state company (TETAS) permanent in the distribution, wholesale and retail segments of the industry. TETAS will be the pool to distribute sources across distribution regions.

The Natural Gas Side of the Story

Another case of government-regulator tension occurred in natural gas. Natural Gas Market Law (NGML) left the authority in the natural gas market to EMRA. According to the law, the state monopoly in natural gas, BOTAS (Boru Hatlari ile Petrol Tasima Anonim Sirketi), was required to reduce its share in the market to 10% by 2009. It required that no importer or wholesaler in the market would have more than 20% of the market. It also gave the authority to enter into natural gas purchase agreements to EMRA. However, the incumbent government decided to control the market. MENR entered into a natural gas purchase agreement with Egypt because of political considerations. Government sees the contract with Egypt as an important step toward resource diversity and natural gas transfer to Europe. EMRA declared that there is not a scarcity of natural gas. It sees the contract unnecessary. The legal status of the contract is controversial. EMRA cannot annul the contract nor can it ignore it.

Government's move to enter into purchase contracts on its own weakens the independence and authority of EMRA in the market. MENR made BOTAS the authority over the contract with Egypt, which contradicts the current law. According to NGML, even if EMRA and MENR reach an agreement, BOTAS cannot be part of the contract.

Table 1. Illegal-Inefficient Use Rates in Some Regions (2005)

Regions	Cities	Illegal-Inefficient use rate	AKP' votes (%)
East and Southeastern Anatolia (The highest 10 cross-subsidized cities)	Mardin	75.8	15.43*(1)
	Van	66.2	25.86*(1)
	Hakkari	65.6	6.81 (4)
	Batman	65.6	20.62*(1)
	Diyarbakir	65.2	15.96*(1)
	Sanliurfa	60.2	22.90 (1)
	Sirnak	59.9	14.02*(1)
	Bitlis	55.1	17.67*(1)
	Mus	53.3	16.90*(1)
	Agri	50.9	17.70*(1)
Other cities (Cross-subsidizing cities)	Mersin (Akdeniz)	19.9	18.07 (3)
	Istanbul (Marmara)	13.3	37.20 (1)
	Kocaeli (Marmara)	12.5	42.85 (1)
	Mugla (Ege)	11.3	13.17 (3)
	Tekirdag (Marmara)	10.4	17.01 (2)
	Edirne (Marmara)	9.8	8.73 (5)
	Antalya (Akdeniz)	9.5	21.16 (2)
	Kırklareli (Marmara)	9.0	12.54 (4)
	Bilecik (Marmara)	7.0	24.88 (1)
Izmir (Ege)	6.8	17.17 (3)	

* In these cities, DEHAP (a regional nationalist-separatist party) took first place but it could not reach the needed national minimum votes, so it could not enter parliament. AKP took second place in the elections, yet it gained first place in terms of parliamentary seats.

Sources: www.tedas.gov.tr and www.belgenet.com.

Note: Figures in parentheses show AKP's place in terms of votes.

Political expediency played a crucial role in this issue as well. NGML limits the market share of any importer or wholesaler to 20% of the domestic market. This also applies to BOTAS, which cannot make new purchase contracts until its share of imports falls to the required level. The earliest possible date for BOTAS' share to fall to the legally required level was 2009.

In short, as in the case of electricity, the government does not want to leave energy policy to a regulatory agency and this reduces the role of EMRA in the natural gas market to a bureaucratic arm of the government (Çetin and Oguz 2007b).

Politicians' Inability or Aversion to Change the Constitution

The process of institutionalizing and legitimizing IRAs is not yet completed in Turkey (Sezen 2007). IRAs were introduced to Turkey's economy as *ad hoc* remedies after economic crises, without much discussion of their constitutional place.⁶ The Constitution does not mention those institutions. Governments have preferred not to back these institutions with constitutional protection so far. The vagueness of the legal structure creates many issues around the legitimacy and place of IRAs in the bureaucratic structure.

The constitutional ambiguity has two sources for IRAs: constitutional legitimacy and judiciary's resistance to privatizations. Both issues continue to exist because governments do not attempt to change the constitution and pursue regulatory reform through indirect methods.

Privatization efforts are exemplary in this connection. Build-Operate-Transfer (BOT)⁷ contracts were consistently annulled by the Constitutional Court in recent years. The Court reasoned on the basis of public interest and required these contracts to stay within public law rather than private law (Çetin and Oguz 2007a). While the court is widely criticized for its reasoning, the more basic issue of changing the constitution did not come to the forefront.

The incumbent government has a majority and could change the constitution. However, it considers that this would damage its political capital. More importantly, the constitutional court's view is harmonious with AKP's policies on regulatory institutions.

The legal hurdles around privatizations influence the energy industry as well. The legal status of energy markets in Turkey is still controversial. The conflict of interest between the government and judiciary slows down the process. For example, after the 1999 constitutional amendment on international arbitration, Danistay has decided that it is the first court on BOT contracts because of the public status of these contracts.⁸ This allows Danistay's supervision over EMRA on contractual transactions.

A more important problem originates from the structure of the judicial system. Danistay, the higher court of administrative issues, has the power to restrict the power of EMRA in the market. As in many other countries, a separate court is necessary. Danistay is not well prepared to deal with regulatory issues. More importantly, the appellation process may easily be part of a strategic game. This process only raises political transaction costs in the industry.

Another problem with the appellation process is the nature of Danistay's decisions. When Danistay makes a decision on a matter, EMRA should consider that decision in the future. In terms of Turkish administrative law, this means that Danistay may, and will, restrict the power of EMRA on the market. Now, foreign investors have the right to go to an International Tribunal, following a change in the Turkish Constitution in 1999. It is expected that the access to the International Tribunal would encourage foreign investments to the Turkish electricity market. The independence of EMRA needs a constitutional protection to restrict what Danistay can do. A specialty court would be a better alternative for the appellation process for all IRAs.

The law does not define the exact responsibility and accountability of the EMRA. There is a need for a criterion to evaluate the performance of EMRA in terms of maximizing social welfare. It is extensively discussed that EMRA should be under strict governmental control in terms of its incomes and expenditures (Çetin and Oguz 2007b). However, debates on this issue bypass the issue of costs and benefits of regulatory decisions. The lack of this kind of cost and benefit analysis limits the responsibility and accountability of EMRA to a great extent.

Conclusion

Turkey recently has reshaped its institutional structure. However, the political and legal environment was not ready for the transition. The pressure for the transition was heavily from the international organizations, but not internal powers. The governments have intended to change the traditional structure, but have not made an effort to align the institutional and legal structure with the guidelines of the international organizations.

As discussed in the paper, although IRAs in Turkey was *de jure* established, their legitimacies are *de facto* not yet committed by the governments. The governments have not desired to solve the constitutional and legal ambiguity regarding IRAs. On the other hand, the current government's political pragmatism over energy policies has increased political transaction costs of the transition to IRAs in Turkey. The political conflicts between the government and EMRA and the delay of the privatizations have impeded to ensure a credible commitment for the private-sector investors in the market. However, following the process, the IMF now attracts more attention to regulatory reforms and to the importance of strong institutions and good governance (Önis and Senses 2005). Consequently, Turkey is a failure in the experience of transition to the institutions of capitalism.

Notes

1. Chang (1997, 714) labeled the 1980s as "the age of deregulation." Privatization and macroeconomic stabilization are the primary policy measures that were implemented by many countries in the 1980s. However, "[a]t the level of the overall economy, the impact of deregulation seems much less positive. Despite some sectoral success stories, the two leading countries in deregulation, namely the US and the UK, have not succeeded in markedly improving their economic performances after their

- deregulation drives.” (Chang 1997, 715). Trebing (2004) also sheds light on the implications of deregulation from the institutional perspective.
2. The transition process neglects that “politics itself is an institutionally structured process” (Chang 2002, 556) and regulatory attempts should be conceptualized as “an evolutionary process that must change in order to be responsive to evolving industry structures” (Trebing 2004, 2).
 3. The banking crisis is estimated to cost around \$40 billion to the economy (Pazarbasioglu 2005, 163). This sum is quite large in comparison to the Turkish GDP.
 4. See Çetin and Oguz (2007a) for discussions of the recent reform. “Traditionally, most electric and gas utilities have been privately owned but regulated by government in the United States and Canada, while service has been provided by publicly owned monopolies in Europe” (Trebing 2008, 469). As a European country, service has been provided by publicly owned monopolies in Turkey too.
 5. Another example is the Turkish Radio and Television Institution’s (TRT) share in electricity bills. AKP promised to stop this subsidy too. Yet, after the elections, it decided to reduce its share only. TRT is a state broadcasting institution. No politician wants to cut their own easy and free access to national media via TRT.
 6. Telecommunications Authority, EMRA, Sugar Authority, Tobacco, Tobacco Product and Alcoholic Beverages Market Regulatory Authority, and Public Procurement Authority were established after the 2001/2002 crises. The Radio and Television Supreme Council was established after the 1994 crisis. The appointment of the board members of the Competition Authority (established in 1994) and the Turkish Banking Regulatory and Supervision Authority (established in 1998) was delayed until 1997 and 2000, respectively.
 7. BOT is a type of contract of provision of electric power. It includes long-term purchasing requirements. Producers return the plant to the state at the end of contract period.
 8. Danistay 10. Chamber, Decision no. 347, (2002). While the constitutional amendment severely restricts the power of Danistay over electricity contracts, Danistay’s decision overlooks the 1999 amendment.

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