Politics, Society, Labour Markets and Patterns of Distribution During Transition; the paths of retransformation in the post-liberalization era in Turkey

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First Draft, March 2002. Written for the Seminar on Labour Markets, Work and Welfare During the Transition and Integration Processes 2002.

JEL Classification Numbers: E62, F34, H50, H63

Key Words: Economic liberalization, Labour Markets, Politics, Distribution, Authoritarianism and Decision Making.

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Abstract

The risks and benefits of unregulated financial liberalization as a complement of trade liberalization during transition has been one of the highly debated issues in the current economic analysis. In the first part of the current article, we will focus on the long-term effects of big-bang type approach in transition on society, labour markets and accumulation processes while at the same time analyzing the political impacts of top-down decision making on welfare and democratization of the country. In the second part, we will analyze the political economy of Turkey in the 1980s and 1990s to illustrate the importance of the underlying institutional infrastructure, at the time of transition, and the accompanying economic and political actors involved in it on the economic outcomes attained in the end. Turkey appeared as the first country, in 1980s, to test the validity of shock-therapy approach in transition. The ambitious program of deregulating the country's financial markets together with the ongoing processes of liberalizing commodity markets and integrating with global capital markets was expected to bring about fiscal and monetary stability, enhance business confidence to invest in productive sectors and generate new employment opportunities, stimulate stable growth and reduce the inflation rate while preventing rent seeking behaviour in both public and private spheres. However, in contrast to these expectations, the new hegemony of capital markets has gone hand in hand with deteriorating macroeconomic performance, deteriorating public deficit, increasing unemployment, corruption and rent seeking behaviour, worsening income distribution and further isolation of the state bureaucracy from society along side with increasing authoritarianism and crony capitalism. The article tries to reveal the underlying reasons behind this divergence of the neo-liberal economic program from the expected results and argues that timing and sequencing mistakes in implementation of economic reforms and their technocratic character (with negative effects on the institution building capacity of the country) played an important role in the depressing results achieved in the end. The development paths of rent seeking coalitions between business community and state bureaucracy is also given special emphasis while discussing the factors that have led to the failure of the economic programs Turkey tried to undertake.

Introduction

The impacts of domestic and external financial and trade liberalization together with deregulation and downsizing of the state have been one of the highly debated issues in the contemporary economic analysis especially over the course of last two decades. In this respect, although, starting from early 1980s, there has been a growing consensus among the majority of economists, international financial institutions and most policy makers on the favorable impacts of this neo-liberal economic program, especially after the non-stop crisis era of 1990s, the negative and destructive effects of uncontrolled economic liberalization started to be given more attention by the groups mentioned above, at least in the developing countries.[1]

The advocates of economic liberalization programs during transition processes start their argument from the intrinsic efficiencies, fairness and self-regulating capacity of markets. These three aspects of "free markets" are assumed to generate economic outcomes far superior to those, which might be generated by even the best-intentioned and technically sophisticated state-led controls and interventions. It is strongly believed by the members of the aforo-mentioned group that the liberalization and opening-up of capital controls will inevitably result in an optimal allocation of capital and resources in the world scale.[2] In addition to economic outcomes, the liberalization of markets is also expected to bring about democratization and liberalization of political life in the course of transition (Nonneman, 1996a; Sachs et al., 1997, Kleinberg et al., 2000).

As a natural outcome of this faith in the miraculous outcomes of the liberalization of markets, the economic programs implemented in transition economies are built upon a common theoretical framework and embody a number of standard policy instruments (Calvo et al, 1996; Rodrik, 1996; Bird, 1998). However, the countries going through this liberalization process differ widely in their capacity to implement the general-standard framework tailored upon them, and therefore in the degree of success achieved in the end (Onis, 1992:4).

The current article proceeds from the above premise and tries to discuss the fact that historically determined institutional characteristics, and the political environment of the country (Turkey in our case) are of crucial importance in determining both the nature of the transition process and the following economic performance achieved in the end. In this respect, we will argue that the organization of the state structure and the rent distribution among the actors involved in it and the accompanying institutional framework constituted the key elements determining the path which was followed during and after the post-1980 neoliberal policies in Turkey. These structural conditions will help us to illuminate why we have observed radically different responses among countries in transition to the economic liberalization programs that they have tried to adopt within the last the last two decades.

In our search for an answer to the above questions, the Turkish experience since the 1980s provides us with an interesting case study with its being the first country where the standard neo-liberal economic reform program was tested. Turkish case also provides strong evidence on the relative merits of different economic transformation strategies, namely gradualism versus shock therapy. Lastly, the case study of Turkey provides us with an interesting picture of the relationship between the state, business, society and the international economic system from the outset during the course of economic reforms.[3]

We argue that there are major institutional and political constraints on the ability of state elites to carry out top-down economic transition from a centrally planned to a market oriented economic system in most developing countries, particularly in countries that are simultaneously undergoing a process of democratic consolidation or in which the institutions of parliamentary democracy are reasonably well established. The main reason for this is the fact that given the constraints of parliamentary democracy, the need to construct an electoral coalition emerges as a prerequisite for the success of a policy aimed at state divestiture. The governments in power during the process of transition has to take into account that fact that powerful groups in society would emerge as losers from this process and therefore can undermine the government's existing electoral coalition (that was initially formed in favour of the transitional reforms).

General Assessment of Reforms in Transition Processes

The transition to a market economy involves certain basic elements that are common in all cases (Collins et al., 1991:11). The standard neo-liberal framework for economic liberalization and transition processes can be summarized as follows;

Table 1. Elements of Transition to a Market Economy

Elements of Transition
Macroeconomic stabilization
Sustainable monetary and fiscal policies
Competitive exchange rate
Price reform
Domestic price liberalization
Trade liberalization
Currency convertibility for current account transactions
Structural and institutional reforms
Hard budget constraints for firms
Reform of the legal system and protection of property rights
Privatization and support for private sector development
Reform of the banking system and financial intermediaries
Expansion of capital markets
Development of welfare state functions and social safety net

However, despite the general agreement on the points depicted in the above diagram as the major steps in transition from a centrally planned economy to a market economy, there is disagreement on the appropriate sequencing and the appropriate speed with which these reforms should be implemented.

There is a common consensus on the macro economic stability as a precondition for reform. The reason is the fact that without such stability, it is extremely difficult for prices to act as market signals and for government to conduct the needed institutional reforms (Collins et al., 1991). The most important step in macroeconomic stabilization is fiscal consolidation, which requires the elimination of the underlying fiscal and quasi-fiscal deficits that are the main cause of the high inflation in those economies. Deficit reduction, on the other hand, means appropriate policy changes on both expenditures and taxes. Tax reform (which involves a move from a tax system based on the state enterprise to a system based on value added taxes-VAT-and individual income taxes) and fiscal consolidation (which involves sharp cuts in price subsidies, reduction in wages and public investment) are, therefore, the prerequisites for the success of economic reforms (Sachs, 1997:244).

The fiscal deficit as a percentage of GDP (d) can be financed by monetization of the Central Bank -CB(m), or by foreign borrowing (f) or by domestic bond financing (b), d=m+f+b. In this respect, privatization is, often, considered as the fourth determinant of this equation. Considering the limitations and risks of CB monetization[4], and the relatively limited size of domestic capital markets which hinder the option of bond financing, and the restricted size of foreign borrowing, privatization of State Economic Enterprises (SEEs) appears as the most convenient way of fund raising for public deficit during the transition process[5].

However, it should be noted that public enterprises in many transition economies have evolved into a major source of employment, welfare provision and political patronage. The endemic problems of overemployment or labour surplus in the public sector, which appeared so irrational from an economic point of view, represented a rational response on the part of the governments which lack the basic welfare state provisions such as unemployment benefit but instead compensate them through public enterprise employments. The provision of subsidized inputs and services by the public enterprise sector constituted yet another major form of social and economic support.

Therefore, key social groups-including managers and employees of public enterprises, members of the bureaucracy, and the wider segments of the population who benefited from subsidized inputs and services-can be identified as the principal losers from the privatization process. Consequently, any government committed to the implementation of privatization program would need to secure a new electoral coalition that would replace the one consisting of groups that benefited from the presence of a large public enterprise sector. Both the pace and magnitude of privatization hinge critically on the ability of the policy makers to construct a new pro-privatization coalition (Onis, 1991).

Furthermore, the empirical cross country studies show that immature privatization process leads to increasing market concentration and monopoly structures and rent seeking behaviour in the course of development in transition economies. (Kirkpatrick et al., 1988). Nevertheless, the option of selling these SEEs to small investors, thereby of avoiding concentration, is not feasible for the capital markets in those countries, at the time of transition, remains quite underdeveloped. The option of selling to foreign investors, therefore, appears as the only viable option. Foreign investors may participate in a privatization program either by direct purchase of equity or via debt-equity swaps. Debt-equity swaps constitute a mechanism for repayment of external debt given the underlying constraints on the ability to expand exports or compress imports and the alternative sources of external finance. Although privatization via the sale of public assets to foreign investors represents the most realistic option available at present, it is at the same time the least attractive option from a coalition-building standpoint. Foreign investors are likely to show an interest only in the most efficient and profitable companies in the public enterprise sector. As a result, the participation of foreign investors is likely to generate serious political opposition; involving an alliance of labour and domestic business which would naturally be capitalized on by the opposition parties.

Does the Sequence Matter?

Despite the implicit assumption that privatization is a precondition for a successful transition to a market guided economy, the Turkish experience contradicts this assumption and suggests that the opposite may be closer to the truth: namely, that an attempt in the early stages to privatize SEEs may slow down the transition rather than accelerate it. Why?

As discussed briefly above, other than the fact that SEEs are a major source of government revenue from the taxation of profits, the state enterprises are also providers of social services. They provide pensions for their retired workers, housing for their employees, guaranteed employment for the urban work force in the absence of unemployment insurance and even child care and holiday facilities. Some state enterprises also are responsible for the operation of health and educational facilities (Griffin, 1996:164)

Hence, privatization of SEEs would lead to not only a change in property relations but a complete restructuring of employment policy and the introduction of state financed unemployment compensation, a reform of the system for allocating housing and the creation of a housing market, and the design and implementation of a state funded pension scheme for the elderly.

In addition, many of the state enterprises are regional or national monopolies with high profit potentials (such as telecommunication companies). Hence privatization would have to be accompanied by a well conceived and implemented competition policy, including a liberal import policy, in order to prevent the newly privatized firms from exercising market power and engaging in uncompetitive behaviour.

Privatization, furthermore, in contrast to the expectations, would weaken macroeconomic stability by simultaneously reducing government revenues and creating pressures for increased government expenditure on social services and unemployment compensation, which eventually slows down growth. If industrial enterprises are relieved of the responsibility for providing pensions, guaranteed employment and other social services, the state will have to step in and provide these services itself. Therefore, even if only from a fiscal point of view, privatization should be postponed until reforms of the social services and taxation have been completed.

Another problem is with the valuing state enterprises prior to privatization. If SEEs are given away or sold at bargain prices, the government will relinquish an opportunity to obtain revenue from the sale of assets and, depending on how the privatized assets are distributed away among the entire population, probably will create inequalities in the distribution of wealth and income. SEEs should be sold at their full market value to avoid corruption, market concentration, and unequal distribution of income.

The arguments for delaying privatization are even stronger in countries, which have adopted a strategy of "shock therapy" and experienced a sharp fall in output and incomes. An attempt to dispose of state assets through sale, in such countries, is almost certain to lead to disappointment. If buyers are restricted to citizens of the country, the sale price is likely to be depressed because of lack of purchasing power; if foreign investors are allowed to bid for the assets, valuations are likely to be higher, but the most profitable enterprises are likely to end up being owned by multinational companies which, as a result, generates serious political opposition by the groups that are hurt by the privatization process.

Besides, there is always a danger that if the reforms are implemented before institutionalizing the legal and regulatory framework, after the transition process the ownership of assets will become heavily concentrated and the market guided economy that emerges at the end will be characterized by a polarization of wealth.

Therefore, both to avoid or at least ease the opposition to reforms during transition process and to reduce the social cost of transformation, some form of short-term safety nets can play an important political as well as social welfare role by helping to protect large numbers of unemployed from major declines in standards of living (Graham, 1997:325).

Political context and interest groups

In many transition economies, societies are simultaneously going through two massive transformation processes, namely; the political shift from authoritarianism to democracy and the economic shift from central planning to market economy (Nissinen, 1999). Hence, during the implementation of reforms, communication with the public, pertaining to the political costs of reform, plays a critical role in making economic reform feasible and sustainable, and reform for social welfare systems acceptable (Graham, 1997:325).

In contrast, lack of public understanding of reform process often leads to heightened public anxiety about its social costs and to short-sighted political behaviour. Furthermore, in societies which had emphasized egalitarian values and supported an extensive state role in the provision of social welfare through SEEs, these trends (displacing large numbers of highly specialized workers and significantly increasing poverty and unemployment) are politically explosive and hence have brought short-term safety net issues to the core of public debate. In addition to short-term safety net issues, these nations must reform their basic social welfare and social insurance systems to establish a social consensus around the new economic and political reform program (Graham, 1997:343). Therefore, the sequencing of new economic reforms is of significant importance for the continuation of public support in favour of the reform programs. In this respect, postponement of privatization process, (other than the fiscal reasons that has been discussed in the previous section), until the institutional reforms are implemented and labour market reforms-such as unemployment benefits, and social security reforms- are conducted seems to be the most viable option during transition period.

Consequently, the central question confronting the economies in transition is to what extent the introduction of democratic regimes prior to economic reform is an obstacle to the latter when transition measures hurt majority of the population at least in the short term. Will these societies accept the social costs of transition or will support for reform erode during the course of action? It is well known that concerns over accountability makes politicians worried about the social costs of economic transition whilst the reform requires decisions which will be extremely unpopular with the electorate, at least in the short run. Under democratic conditions, where the discontent can find political expression at the polls, even the most promising reform strategies may be abandoned (Nissinen, 1999). The Turkish transition experience, the details of which will be discussed in the next section, provides ample evidence for the argument over the incompatibility of the logic of democratic politics with shock-therapy reforms under austerity programs. It should be remembered that the society will be willing to make sacrifices for long term benefits appears valid to only a limited degree and in most cases rests on the degree to which sacrifices are shared equally.

In retrospect, from purely an economic view, it is clear that authoritarian regimes are strictly advantaged in undertaking macroeconomic stabilization and liberalization programs with the guidelines of shock therapy and austerity measures because of their ability to ignore or repress oppositions from the losers of the reform measures. However, considering that these countries are also trying to go through a transformation in their political systems from a top-down organized autocratic state structure towards a democratic, individual oriented one, the nature of implementation of these reforms is of crucial importance for building confidence in democratic institutions and sustainability of reform programs. Despite the fact that there is the need for a strong government to avoid the danger of populism (because of strong opposition to cuts in subsidies and calls for wage increases) in the early stages of economic reform, it is also inevitable that, as pressures mount, democratic governments begin to vacillate between mutually inconsistent political styles, namely between the technocratic political style inherent in shock-therapy type economic reforms and the participatory style to maintain consensus. The technocratic style of launching austerity measures, leads to erosion of already fragile confidence in democratic institutions in such countries, and prevents development of a strong civil society (Nonneman, 1996b; Nissinen, 1999).

Turkey in Transition-the historical heritage

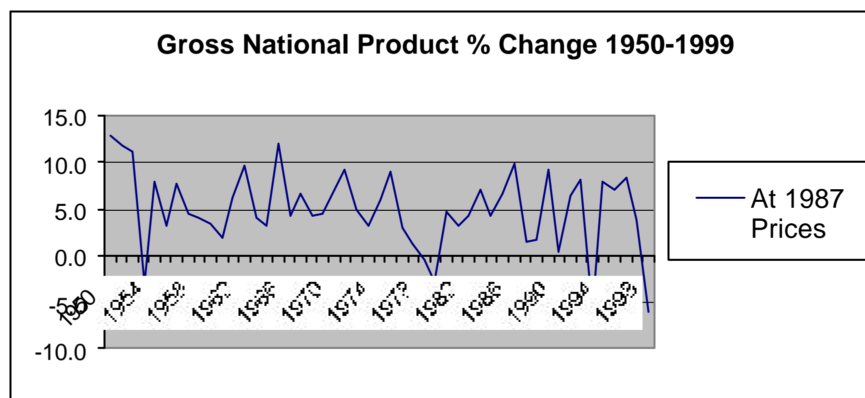
The year 1980 constitutes a corner stone in the modern economic history of Turkey. Following a major balance of payment crisis in the late 1970s, Turkey emerged as "the test case for the newly implemented World Bank (WB)-International Monetary Fund (IMF) joint programme involving cross conditionality"(Schick, 1987:333-365; Rodrik et al., 1990; Onis, 1998:192) The crisis also brought about the ending of the already-exhausted import substitution regime in the country. The program designed by these twin institutions aimed at stabilizing and liberalizing the closed, centrally planned inward-oriented economic structure in Turkey and at shifting it to an outward-oriented free market based path of development.

Several scholars have already discussed the underlying reasons behind the selection of Turkey as the test case for this (later to be well known) standard structural adjustment package (Rodrik, 1990, Rodrik et al., 1990; Atiyas, 1995;Yeldan, 2001: 25-56). The main outlines of these arguments can be summarized as follows; firstly, the timing of the crisis was important for the crisis in Turkey took place in late 1970s, just before the Latin American debt crisis. The second factor is related with Turkey's strategic role as an integral part of the NATO alliance in a two-polar world. Thirdly, these twin institutions needed a test case to prove to other developing countries in transition the correctness of the highly debated neo-liberal economic policies and the accompanying benefits of the free market model.

As a part of this program, Turkey received five successive structural adjustment loans (SALs) from the World Bank (WB) in the period 1980-84. In addition to financial resources made directly available, the programme was also influential in providing a significant flow of resources from other official creditors, mainly from the governments of the OECD countries. Considering the size of the financial assistance generated to other countries under similar adjustment programs, the amount provided to Turkey appears to be significantly greater than the rest during early 1980s.

Having already provided a considerable amount of financial resources, the WB and IMF were willingly committed to the success of the Turkish experiment and wished to project it as "a model of success" to the rest of the transition economies to be followed.

Figure 1: Percentage Change in Gross National Product



Source: State Planning Organization (SPO), Main Economic Indicators, June 2001; Central Bank of Republic of Turkey (CBRT)
(*)GNP figures for 1950-1967 period are based on the growth rates of 1968=100 GNP series.

The Turkish economy, starting from late 1950s to late 1970s, was characterized by an import-substitution regime. Although the growth rates during the 1960s were significant comparing to those attained in the course of post 1980 era (figure 1), under planned economy, the import regime acquired quite a restrictive character in time while the quantitative controls on trade gained momentum and overvalued exchange rates[6] became the main features of the system (Baskaya, 1986:161-181).

Increasing dependence on imports, deteriorating current account balance, negative interest rates, political insolvency and increasing fragmentation in the society among marginal political groups were the broad headlines of the last stage of the above system in late 1970s. One of the interesting features of the era is the fact that during ISI years, accumulation process highly depended on policy and politics rather than markets.[7] Entrepreneurs became increasingly depended on the state and bureaucracy and on the subsidies (through direct and indirect ways) provided by the latter rather than exploiting the opportunities created by the market itself. This political and economic environment created vast opportunities for wide-range rent seeking behaviour among the business community as the business people competed for the special set of incentives (in the form of cheap credit availability,

cheap foreign exchange through state banks, permission for import of certain intermediate and final goods, etc.) provided by the state (Boratav, 1993; Onis 1993; Balkan et al, 1998).

Strict controls and restrictions on prices, exchange and interest rates, import and export transactions (in the form of import licenses and foreign exchange regulations) were some of the accompanying features of the above system. Foreign exchange and bank credit were subject to severe rationing and there existed fierce competition among the business people for the above provisions since access to these resources guaranteed exceptionally high profits in the highly protected domestic market. The system, as a result, encouraged and generated serious moral hazard problems and rent seeking behaviour on a systematic basis in both public and private spheres.

The ISI experience in Turkey, hence, inevitably gave rise to a narrow distributional coalition[8] between the state bureaucracy, and the business community.

While the severe balance of payment crisis that hit the country in late 1970s brought the system to a halt and made its continuation impossible under existing conditions, a change in the rules of the game became almost inevitable. Under the directions of IMF and WB, Turkey tried to undertake a profound switch in the philosophy of state structure mainly concerning its role in economic affairs. The new economic (and political) policy aimed at reducing the size of the public sector involvement in the real sector through its operations of SEEs as well as at reducing the degree of intervention in the organization of the market activities.

Under this broad program, in the course of the 1980s,Turkey has become the first country to adopt shock therapy in its economic transition. Liberalization of the foreign trade regime, removal of exchange rate controls, adoption of special policies with generous incentives to attract foreign direct investment, liberalization of market interest rates to encourage private savings, privatization of SEEs, and shifting to income transfers through public spending instead of price mechanisms via subsidized pricing of SEEs were some of the components of the new economic program implemented under the guidance of IMF and World Bank (Onis, 1998:183-196).

In the final stage of this program, the August of 1989 witnessed a complete transition to an extremely liberal capital accounts regime "even by the standards of advanced economies with highly developed financial markets."[9]

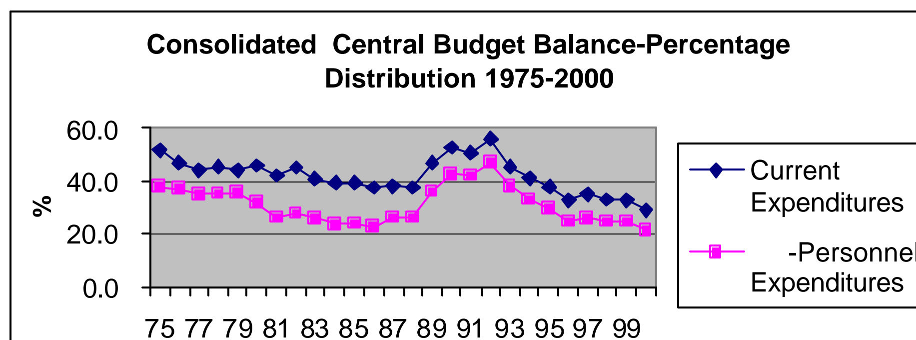
On the other hand, when we turn to the political side of the picture, the whole process of structural transition from a centrally planned inward oriented regime to the outward oriented free market model was accomplished under military rule that "officially" continued from September 1980 till late 1983 but effectively lasted till first free elections-after the coup d'etat-in 1987. This enabled the policy makers implement the new economic reforms without facing any opposition from the society, at least until the return to *full* democracy in 1987.

Figure 1 displays the cyclical character of the Turkish economy where sharp fluctuations in growth rates and alternating crisis eras were of an integral part of its development path even before

1980. However, although the year 1980 constitute the starting point for the Turkish neo-liberal experience, August 1989-which mark the shift to full capital account liberalization-appears as the Achilles' Heel in its trajectory. Since then, Turkey has been exposed to the instabilities and accompanying problems and risks of financial liberalization and deregulation which proved themselves with three major crisis in the post 1990 era which made a sharp contrast to the initial risk-free phase of the reforms in the early 1980s.

The reasons of the sudden recovery of the economy and the accompanying high growth rates in the early 1980s can partly be explained by the absence of distributional pressures during the first phase of the liberalization program (Boratav, 1990:199-224; Onis, 1992:12-23). The military government during the years between 1980-1983 imposed strict restrictions over trade union rights and labour's bargaining power. Yet, even after the re-transition to democracy in November 1983 considerable restrictions over labour's bargaining power continued to be held-while at the same time holding the ban over the parties established before the 1980 takeover. Repressed real wages of labour and civil servants and the following considerable decline in the purchasing power of these groups were the accompanying features of the transition. Moreover, it can further be argued that the initial fast recovery of the economy and the boom cycle was enabled partly by the huge income transfers from the labour (including the civil servants) to a small industrialist group in the country[10]. The return to the multi-party democracy took place with the elections in 1987 and from then on (till 1994) we observed an attempt by the losers of the new model-namely the workers, public servants, and the agricultural workers-caused by the structural adjustment program to reorganize themselves and to recover the losses they had incurred over the past years (Boratav et al, 1996:373-380; Onis, 1998:495-508). In other words, populism returned to Turkish politics right after the first free elections, yet did not last long and austerity measures were once again implemented following a major economic crisis in 1994.

Figure 2:



Source: SPO, Main Economic Indicators June 2001; Undersereteriat of Treasury and Foreign Trade (UTFT) Main Economic Indicators; CBRT.
(*) The year of 1982 covers 10 months

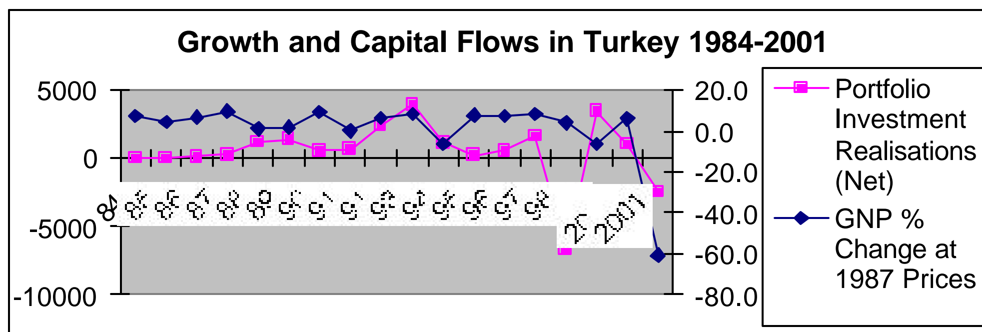
As can be seen from figure 2, the share of current expenditures (most of which consist of personnel expenditures) in the consolidated budget decreased from almost 52%in 1975 to 37% in 1988. Yet, the years between 1987-1993 witnessed a rapid recovery period for the losers of the system demonstrating itself with the sharp increase in the share of the current expenditures up to 56% by 1992.

Hence, a distinguishing feature of Turkey during late 1980s and early 90s was the reemergence of a distributional conflict between the losers and the winners of the new economic paradigm in the society. However, as we will discuss in the following sections, the conflict did not last long and once again was solved against the wage earners in the face of another serious crisis in the post reform era in 1994. Following the 1994 crisis, the share of current expenditures in the consolidated budget expenditures declined to around 21.4% by the year 2000 from its peak of 56% in 1992.

The elements of the post 1987 cycle are clearly demonstrated by the sudden increase in the share of public expenditures in GNP form 16% in 1986 to 24% in 1993. Within the public expenditures, especially the rise in current expenditures was striking which reflects the size of the public sector wage booms in the period of 1989-91. Another striking element in this period was the record rise in PSBR/GNP ratio (12% of GNP in 1993), especially just before the crisis in 1994.

Nevertheless, this kind of populist cycles has never been a novel phenomenon in the Turkish trajectory (Keyder, 1987:293-307; Onis, 1998:495-512). The pre-liberalization period witnessed several upward-downward swings generated mainly by this kind of populist public expansions. However, the distinguishing factor in the post 1989 era has been the implementation of full capital account liberalization whereby the pace of fiscal expansionism became heavily dependent on the continuation of the highly volatile and reversible short term international capital flows. In this respect, figure 3 is helpful in showing the close correlation (with a time lag) between growth rates attained and the short-term capital movements poured into the country.

Figure 3:



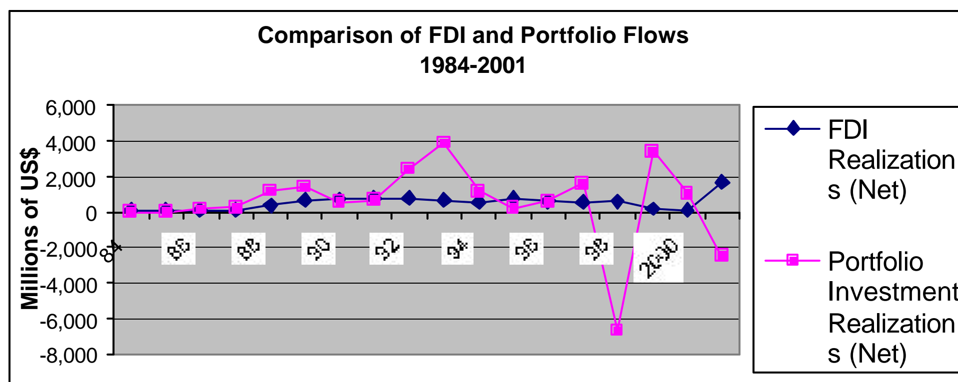
Source: SPO, Main Economic Indicators 1950-1997; CBRT

(*)The data for 2001 covers the period up to 8th month.

It is argued by several scholars that "capital flows towards developing countries arise from structural conditions which are unlikely to change dramatically in a short period of time"(Strange, 1986; Knight, 1998:1185-1200; Boratav, 2000:1032-1037). In this respect, without having the necessary regulatory framework in the economy, large current account deficits are expected to accompany *premature* implementation of the neo-liberal policies. Furthermore, the sustainability of large trade and public deficits has also become possible by the availability of short-term capital flows, which is highly volatile by nature.

Turkish experience provided ample evidence for the proposition that the regulatory framework and the institutional infrastructure are indeed of special importance for the success of liberalization package and thereby creates an important obstacle against the *big-bang* approach in transition. In an environment characterized by under-developed capital markets, economic and political instability and uncertainty that is accompanied and stimulated by a highly unstable and fragmented party system, Turkey faced quite a distorted capital account structure. In spite of the implementation of quite a liberal FDI structure and several incentives (i.e. in the form of land provisions, tax exemptions, etc.), the inflows of Foreign Direct Investment (FDI) remained at marginal levels while large budget deficits made the country more and more dependent on short term capital flows. The ratio of FDI to overall capital inflows have been relatively low comparing to the levels attained by other emerging markets (see figure 4) (Yenturk, 1996:151-169).

Figure 4:



Source: SPO Main Economic Indicators June 2001; CBRT.

In this respect, Turkey's post 1980 neo-liberal era has suffered serious problems and the distorted capital account structure is not the only one among them.

In retrospect, there is a growing controversy among the economists familiar with the Turkish experience on the underlying reasons behind the dramatic gap between the expected gains from market led outward oriented growth path and the depressing results that have been achieved so far (Cizre-Sakallioglu et al., 2000:483-487). The point of departure is whether this "disappointing performance"

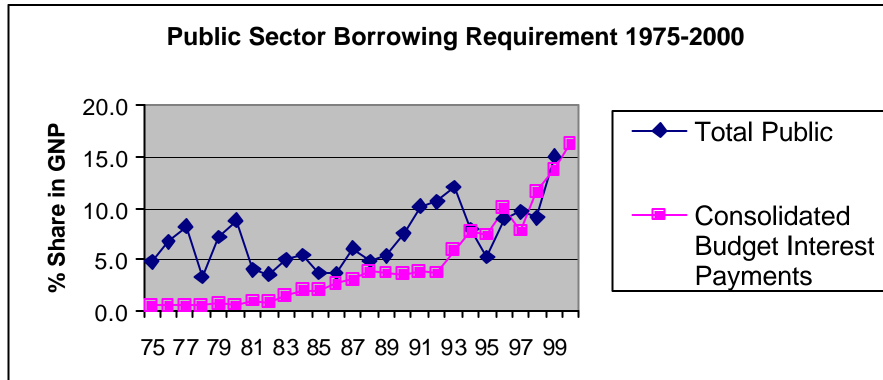
is because of the domestic policy failures and the accompanying deviations from the structural adjustment programs or simply because of " the inherent difficulties with the neoliberal adjustment model, or at least in the Turkish setting (Boratav at al., 1996:391) or is it a problem generated by *timing and sequencing mistakes* during the implementation of the policy objectives (McKinnon, 1982; Frankel, 1997). The last two arguments originate from the premise that the developing countries share common structural problems in their institutional settings and the policies that are designed to liberalize the economy may also produce "frictions, inequalities, uncertainties, discontinuities and an unbalanced-distorted economic structure at the outset"(Cizre-Sakallioglu et al., 2000:482).

Especially in transition economies like Turkey where there is a comprehensive shift in the role of state and functioning of the markets, lack of democratic accountability, and lack of transparency in economic affairs of the state further contributes to the already fragile nature of the institutional structure in the country. (Onis, 1994)

The financial liberalization reform, as discussed in the previous section, was expected to generate a more efficient and developed financial system, which could direct the national savings into private investments at a lower cost. The political background (that of being implemented under military rule) of the policy shift led to a strong commitment to the non-reversibility of the course of the reform (Onis, 1993:39-48, Onis, 1994:128-184; Cizre-Sakallioglu et al., 2000:494-497).[11] Yet, the reforms were not accompanied by any change in the financial behaviour of the corporations and did not lead to a cheapening of investment costs (Akyuz, 1990). The real rate of interest jumped up to three digit levels in the course of 1990s, while domestic asset markets became increasingly volatile and unstable as a result of sudden changes in speculative capital flows. The weak and fragile nature of the Turkish economy, in the end, contributed to the rise of three serious crisis in 1994, 2000, and 2001 each of which was followed by a complete collapse of the economy and could (partly) be stabilized only after the IMF intervention and the accompanying "rescue packages".

The collapse of public disposable income-reasons of which will be discussed in the following section-inevitably led to public sector over borrowing syndrome. The state has become a powerless actor lost in a vicious cycle generated by the widening public debt. The interest payments on public debt (most of which is in the form of short term liabilities) could only be financed through new borrowing again from short-term sources. The continuous flow of short-term funds, on the other hand, could only be made possible by offering higher and higher interest rates, which again led to worsening of the interest burden on the budget. In the face of this growing debt trap which resulted from timing and sequencing mistakes and fiscal policy mismanagements (and rent seeking behaviour), the capital account liberalization of 1989 provided the successive governments with a deadly tool, mainly to finance their expenditures through short term capital inflows (Atiyas, 1995; Ersel, 1996; Tukel, 1997:27).

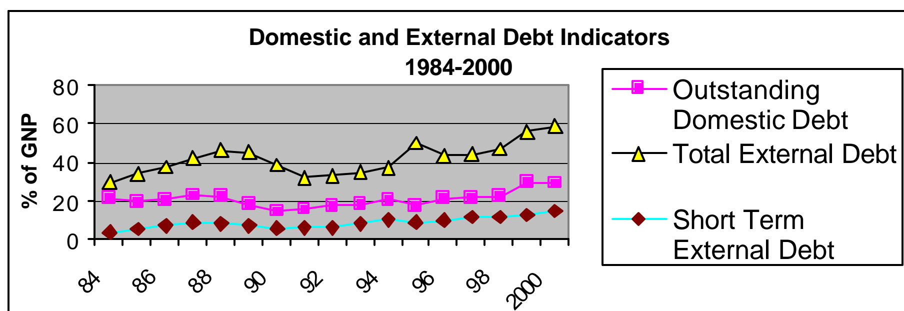
Figure 5:



Source: SPO Economic and Social Indicators; CBRT
(*)The latest data for PSBR/GNP is for the year 1999

As the foreign debt reached its limits in the course of 1980s, the public sector turned to the option of domestic borrowing (Figure 6). With its small and limited capital market and existing oligopolistic structure in it, this policy change resulted in very high interest rates on government bonds and treasury bills while enabled the financial sector to strengthen its hegemony over the real sector of the economy (Yeldan, 2000:144-155). The natural outcome of these developments was nothing but a death trap for the public sector economics. The need for high interest rates (to attract additional funds and cheap foreign currency-in the form of overvalued TL) to avoid the threat of capital flight and to ensure a continuous flow of short term resources to finance the growing public expenditures lead to further increases in real interest rates. High public borrowing requirement together with overvalued TL and deteriorating current account balance further triggered the instability in exchange and interest rates (Boratav at al, 99:21). The size of the debt trap can be seen from the figures 4 and 5. The share of total public sector borrowing requirement reached 16% while the share of interest payments in consolidated budget increased to 17% of GNP by year 2000. In the search for the underlying reasons of this sudden rise in the PSBR and the interest burden on the budget, the year of 1989 once more appears as the critical turning point in the Turkish trajectory.

Figure 6:



Source: SPO, Main Economic Indicators June 2001, CBRT.
(*)External Debt data covers the period till 1997 January-June Period
(*)Domestic Debt data covers the period till June 2001

Throughout this period, the banking sector and other financial institutions have become the leading forces behind the capital manipulating the economy (Akyuz, 1990; Tukel, 1997; Yeldan, 2000). Figure 6, on the other hand, displays another important aspect of the Turkish experience in the post-liberalization era, mainly, the character of the rent distribution in the economy. As can be seen in figure 6, the share of domestic debt in GNP increased by almost 60% from around 18,2 in 1989 to 28,9 in 2000. For the same period, on the other hand, the external debt to GNP ratio increased by only 30%. However, this relative decline in foreign debt with respect to domestic debt mainly resulted from the substitution of foreign with domestic resources. In other words, as the ability of the Turkish government to have access to long-term borrowing sources reached its limits-because of the widening official debt to international lending agencies, the government chose the option of financing its debt liabilities and the growing public deficit through short term speculative financial flows (in a kind of Ponzi-financing) and short term borrowing by selling of treasury bills whose maturity were less than one year in most cases. Despite the relative decrease in the external debt, the share of short-term external debt to GNP ratio increased by almost 103% since 1989. Hence the increase in domestic debt in the aftermath of the financial deregulation was also accompanied by a sharp rise in the short term borrowing of the state.

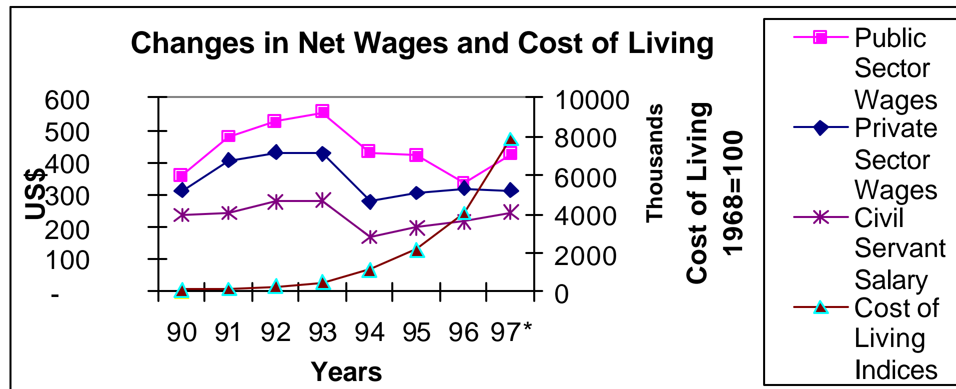
The International Linkages

The international side of the picture, on the other hand, is no less important. As the country proceeded towards complete deregulation of financial sector, it has become subject to the manipulations of the international asset holders. The judgment of global markets and the creditworthiness of the country became two interrelated determining factor in the continuation of the capital inflows needed by the public sector in the country (Calvo, 1996; Balkan, 1998; Stiglitz, 2000).

A side effect of this distorted picture was the growing dependence on short-term policy making in economic and political decisions because of the "veto effect" of the global finance whose primary concern is not long-term development but short-term financial gain. The fatal consequence of uncontrolled financial deregulation in the Turkish context is first realized in the fourth quarter of 1994 when the domestic currency appreciation reached unprecedented levels and the subsequent current account deficit (4% of GDP in 1993) became no longer sustainable. The crisis was triggered by two major causes, namely, the unsuccessful attempt of the policy makers to control the interest rates-which were quite high because of the reasons already discussed-and thereby to reduce the interest burden on the public finance, as well as the exchange rate in the high inflation environment of Turkey (Ozatay, 1994). The end result of these policy attempts was a sharp decline in the foreign exchange reserves of the central bank (in the first 3 months of 1994, the Central Bank reserves diminished by 50% amounting to US$2,8 billion) which led to a speculative attack on Turkish Lira (TL) (TL was devalued on April 5th following the speculative attack yet during the first three days after the devaluation, TL lost almost 70% of its previous value). The attack ended up with a large devaluation of TL and with another rescue packet by IMF.

The IMF program of 1994 had many in common with the standard IMF packages. A combination of expenditure shifting and reducing policies were accompanied by a sharp contraction of output and employment, which proved itself with a negative growth rate of –6.1 in 1994. As a result of the devaluation, exports recovered slightly with an increase by 17%, while the import boom was reversed with a decline of 21% comparing to their 1993 values and led to rapid improvement of the current account balance from – 4% in 1993 to +2% of GDP in 1994. Although the economy went through a fast and smooth recovery period as a result of the stabilization program, the long-term costs of these policies were much greater than expected. The contraction of output and employment, real decline in wages, increasing unemployment, deteriorating political environment and further fragmentation of the society were among the costs of the recovery measures. Nevertheless, the country, after recovering from the crisis, again returned to its old path of financing its rising expenditures by short term capital flows.

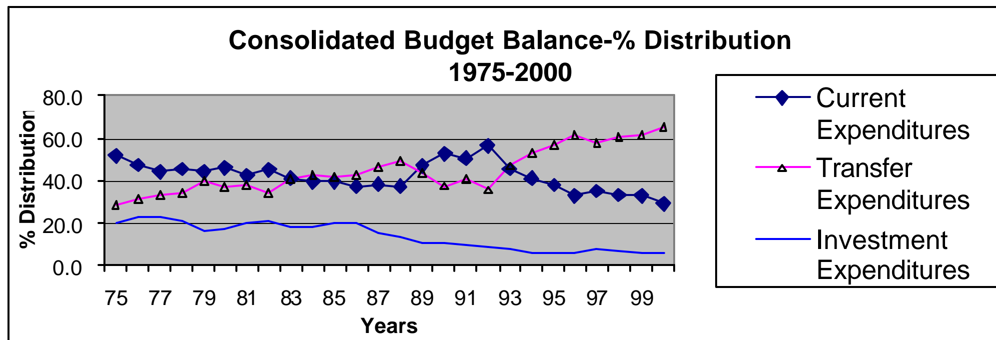
Figure 7:



(*) Estimated values
(**) Cost of living indices are represented by the right axis of the graph.
(***) For the calculation of net wages in US dollar, we used the central Bank's dollar buying rate at the end of each period
Source: SPO Economic and Social Indicators 1950-1997, State Institute of Statistics (SIS) Households, Labour Force and Income Distribution Surveys (various years), CBRT.

Part of the rapid recovery after the 1994 crisis was enabled by labour market flexibility and the subsequent redistribution of income from wage earners (as was the case in the course of 1980s as well) (Cizre Sakallioglu, 1991; Onis, 1996:4-12; Senses, 1994). As can be seen in Figure 7, following the crisis in 1994, the net wages of both public and private workers and civil servants dropped by around 22% in real terms in one year while the cost of living sky rocketed by almost 98% comparing to the previous year[12]. To put it in another way, in the year following the crisis, the living standards of people dropped by a net total of 120%. There are also certain measures implemented by the government in the aftermath of the crisis-under the guidance of IMF-which speeded up the recovery process. Yet, despite the fact that these policies worked for the time being, they also led to the development of further crisis in the year 2000 and 2001. Short term measures resulted from myopia on the part of the politicians and the nature of the IMF programs-that does not consider long-term development perspectives but short term solvency-created negative repercussion effects whose results were to be felt only after a time lag. In this respect, there are two developments that were pregnant to future crisis. Firstly, the policy of keeping interest rates high to encourage short term capital inflows have resulted in a rapid built up of domestic debt with deteriorating burden on the budget in the form of high interest payments (Rodrik, 1990; Ersel, 1996; Yenturk, 1997). Secondly, the IMF guided changes in the banking sector regulations, especially the introduction of full state insurance for deposit accounts created serious moral hazard problems and rent seeking behaviour (Kumcu, 1997; Yeldan, 2000, OECD, 2001:18)[13]. In other words, it can be argued that, the source of the two latest crises in December 2000 and February 2001 were originated (or at least triggered up) from this myopic decision in 1994.

Figure 8:



Source: SPO Main Economic Indicators (various Years), CBRT.

In the aftermath of the recovery period from the crisis, fiscal disequilibrium continued to deteriorate while the share of transfer expenditures in it reached unprecedented levels due to increasing interest payments on domestic debt. The growing interest burden in the consolidated budget has been tried to be covered through investment cuts with negative effects on growth rates and through reducing current expenditures most of which were personnel expenditures (Figures 7 and 8) (Ozmucur, 1996; Oyan, 1997; Onis, 2000).

As the only solution to close the gap between the public revenues and expenditures, the state followed the path of reducing its investment with negative effects on the long-term growth perspectives of the country while closing the financing gap with increasing the tax burden on the wage earners and speeding up the privatization process.

Lack of transparency, on the other hand, appears to be one of the continuing illnesses of the Turkish economy. (Oyan, 1997; Boratav, 1998)

The epidemic of non-transparency and non-accountability in the Turkish public sphere reveals itself in various forms such as deteriorating performance of the banking sector and the financial system. As the crisis in the public debt grew further, the outside pressure by the international financial institutions for a tighter control over the quasi-fiscal activities of the state banks in developing budget transparency and accountability also gained momentum (OECD, 2001:17-18). The use of state banks for political rent distribution in the form of distributing cheap credits on non-economic grounds manifested itself in the accounts of huge "duty losses" of these banks. The subsidized lending operations performed by the state banks on the behalf of the government generated record level of duty losses, which reached 8.2% of GNP in 1999, and was one of the main reasons leading to the deterioration of the consolidated budget deficit (OECD, 2001).[14] On the other hand, the state banks still appear to be keeping the upper hand in the banking sector with their control of 40% of the total assets in the sector. The total of bad debts generated by these banks, on the other hand, amounted to some $20 billion, which is nearly 20% of GDP in the country (IMF letter, April 30, 2001).

1999 Stabilization Program: Unrealized Dreams

At the end of 1999, under the guidance of IMF, Turkey embarked upon an ambitious stabilization program aimed at reducing the inflation to single digit levels by 2002 (OECD, 2001). The program was designed around the use of monetary and exchange rate policies so that to provide a nominal anchor for reducing the inflationary expectations[15], sounder public finance aimed at eliminating the main source of inflationary pressures, and continuation of structural reforms that started in early 1980s to liberalize the economy. But a severe banking crisis took place in late November 2000, accompanied by a massive capital outflow and followed by another severe financial crisis in early February that led to the collapse of the IMF program. The two crisis originated from three basic reasons, namely, the vulnerability of the banking sector and lack of required regulations and supervision in it; fragile nature of foreign confidence and international capital flows, and widening current account deficit (as a result of overvalued TL driven by the IMF designed fixed exchange rate policy).

The trigger of the crisis in late November was the emergence of financial problems in some mid-sized banks, which had positioned themselves aggressively for continuing declines in interest rates via longer-term investments, which were highly leveraged by short-term funds. The widening current account deficit together with delays in realization of the scheduled structural adjustment program targets resulted in increasing interest rates starting form September and speeded up after mid November 2000. The above-mentioned banks had no other option but to sell their large amount of government bond holdings to remain liquid in the face of the increasing cost of the funds. The central Bank, which could –under normal conditions- have easily avoided the crisis by providing liquidity to the market, was constrained from stepping into ease these liquidity problems because of its monetary policy targets promised to IMF as a part of the program. Around 20 November, as rumors about the illiquid banks spread, first-tier banks cut their credit to the inter-bank market and international participants exited the overnight market. This development speeded up market pressures and led to further deterioration of the portfolio losses of the exposed banks. These events, as a result, brought about a serious liquidity problem in the market pushing the overnight interest rates up to 2000% while generating an excess dollar demand and pressure on central bank exchange reserves. Only after that, central bank intervened to the market and injected huge amount of liquidity to the system. The capital outflow and devaluation fears (within two weeks over $7 billion of Turkey's original $24 billion of foreign currency reserves had flown out of the country) which further worsened the speculative attack (due to the expectations that the government was no longer able to realize the provisions of the 1999 IMF program with the pegged exchange rate) could be slowed down by a large IMF loan package of in total $10 billion including $7.5 billion from the supplementary reserve facility, in addition to $5

billion from the World Bank. The final result was the takeover of the country's sixth largest private bank, Demirbank, which had been the major source of the liquidity problems in the beginning of the crisis by the independent banking and supervision agency of the state.

Nevertheless, only after two moths following the crisis in December, Turkey was shaken once more in February by another major crisis. In fact, this time it was Turkey's politicians, not its financial bureaucrats, who triggered up the latest *kriz*, or crisis. On February 19th, Bulent Ecevit, the prime minister, stormed out of a meeting with Ahmet Necdet Sezer, the president. Mr. Sezer had apparently chided Mr. Ecevit for his half-hearted pursuit of corrupt politicians. The markets, not missing the opportunity, took the news badly, fearing that infighting might distract or even topple the government, and hence bring Turkey's much-needed economic and political overhaul to an untimely end. Jittery investors started pulling billions out of the country, seriously denting the central bank's reserves of foreign exchange. In the end, the government had no choice but to abandon the lira's "crawling peg", under which the currency was to be allowed to slide down by about 15% this year against a currency basket comprising the dollar and the euro. The move led to an immediate slide of more than 30% against the dollar together with 18% decline the stock market on February 21 alone. Interest rates have soared to several thousand percent (as high as 7000%) in the inter-bank market. However, although what reportedly scared away investors was a publicized argument between President Ahmet Necdet Sezer and Prime Minister Bulent Ecevit, whom the president had accused of being too lenient toward corrupt politicians, that was merely the beginning of the crisis, not its underlying cause. A fragile economy and faltering banking system, growing public deficit, increasing dependence on short-term capital flows and a distorted capital account structure, endemic corruption and a shaky coalition government with weak political leadership have been the real underlying causes of the last crisis which has been the country's 17th failed IMF program within past 54 years. The very fragility of Turkey's economic reforms and the boom-let they had created, sending market indexes up from 5,000 to nearly 20,000 points in 1999 and early 2000 came to a halt with the last crisis but not to an end for the inherent structural problems still remain to govern the economy. Another important reason for the last crisis appears to be the lack of transparency and the very corruption in both public and private spheres.[16]

Together with the last crisis, the total number of private banks taken over by the state reached a total of 12.

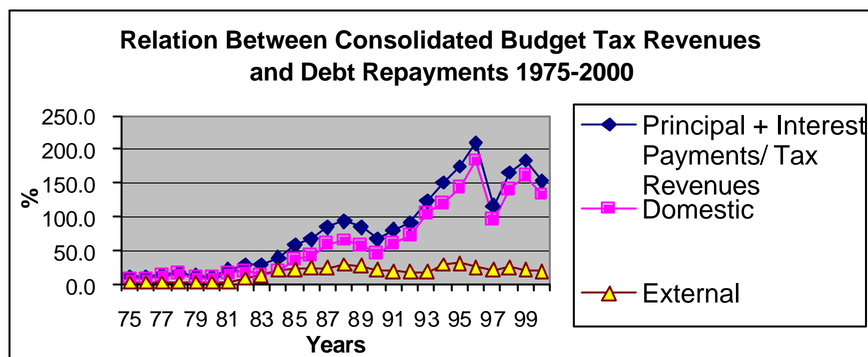
As was the full state guarantee provision on bank deposits (imposed as a part of the IMF rescue program after 1994 crisis) the triggering effect on wide-range corruption and moral hazard problems in private banks, this time, after the December 6 crisis, treasury announced that it would provide a full guarantee on deposits and credits of Turkish banks. The guarantee covers all domestic banks including foreign branches of them. Although this provision was designed to give the private banks a breathing space in the midst of the crisis, as was the case in 1994, it is highly likely to create

further problems and lead to future crisis in the banking sector in the unregulated crony market environment of Turkey.

The challenge for banking reform is no less than prior to the crisis as was unlimited Turkish lira deposit insurance (introduced after 1994 crisis) a major source of banking sector moral hazard.

As a part of the reform program, the government promised to eliminate its extra-budgetary resources and give full state insurance on bank accounts, yet the financing of this comprehensive program arises as a question mark. As part of the solution, as was in the previous IMF programs, wage earners will have to bear the burden of adjustment through wage cuts and indirect taxation measures.[17]

Figure 9:

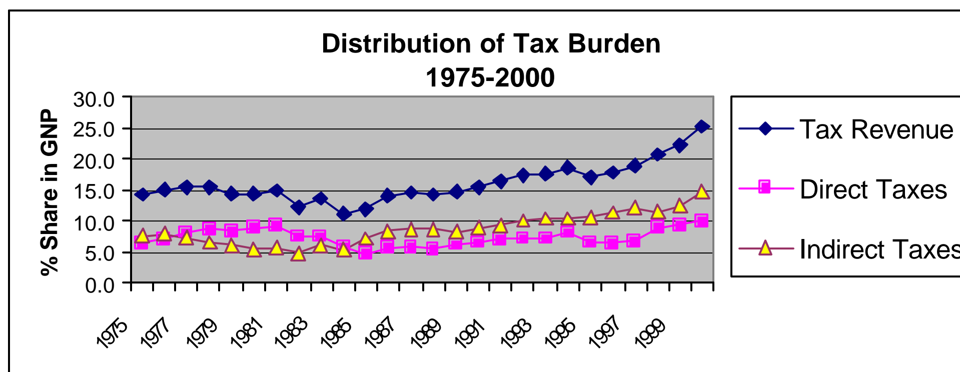


Source: SPO Main economic Indicators (various years), UTFT, Main Economic Indicators.

The inability-or unwillingness- of policy makers to implement an efficient and fair tax scheme has contributed to the macro-economic disequilibrium of public finance of the country (Figure 9) (Akyuz, 1990; Rodrik, 1990; Atiyas, 1995; Ozmucur, 1996; OECD, 2001:17; Yeldan, 2001:121-125). The share of principal and interest payments to total tax revenues increased from around 12% in 1980 to a record number of 182% of which 160% was on domestic debt in 1999 (figure 9). Furthermore, the interest payments on government debt to tax revenues ratio increased to 77% by 2000. In other words, sixty cents of each dollar citizens paid as tax was to be spent on interest payments. The major development in this area took place in the 80s as a part of the new economic program. The introduction of VAT (Value Added Tax) contributed to already regressive nature of the system. "In retrospect, Turkey's tax system has been characterized by two major problems: (i) the negative incapacity to tax effectively which is related in inadequate overall tax revenues, in particular judged by the OECD standards, and (ii) the highly unequal distribution of the tax burden with low income groups bearing a disproportionate share of"(Senatalar et al, 1991; Yeldan, 1992; Onder et al, 1993). Another striking fact about the post liberalization era after the 80s has been the relative decline in the burden of taxation on capital (Cizre-Sakallioglu et al., 2001; Yeldan, 2001). Along with these developments, as can be seen in figure 10, the share of indirect taxes has risen drastically comparing to direct taxes following the shift to neo-liberal economic policies after 1980. As a consequence of these

complementary policies which supported each other and helped to generate a kind of vicious cycle in the public finance of Turkey, the corporate business and the banking sector have benefited from the deteriorating public deficit by making considerable sums of profit (see figure 9) out of the growing borrowing requirement of the state mainly through lending at very high interest rates.

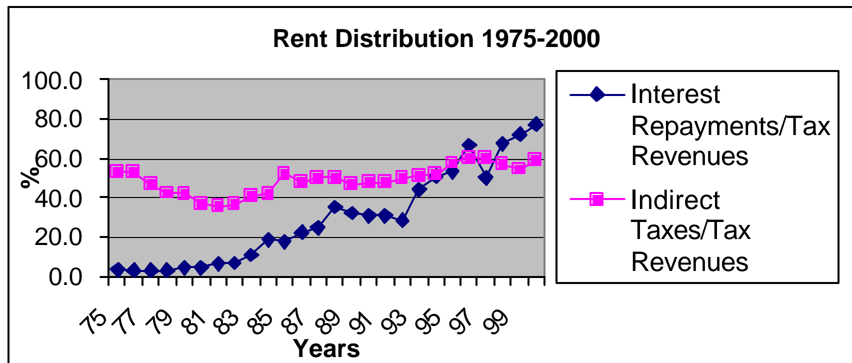
Figure 10:



Source: SPO Main Economic Indicators, CBRT

Furthermore, the inability of the successive governments to produce an effective method to incorporate the informal sector to the system further strengthened the wide spread tax erosion. The existence of large informal sector (which roughly accounts for almost 45-50% of all market activities in the country) contributed detrimentally to the efforts for establishing an efficient tax base with negative repercussion effects on the labour market. The workers in the informal sector are unregistered and work at below market rates without access to any means of social security. [18]. The existence of generous tax exemption clauses also displayed the unwillingness of the state to tax the financial sector and the incomes derived from rent in general. A close inspection of the relationship between the consolidated budget tax revenues and the distribution of the debt repayments, as shown in figures 9 and 10, displays the nature of the direction of the rent distribution in the country and the consequences of immature economic reform programs during the course of transition in 1980s. Starting from early 1980s, the ratio of interest payments to tax revenues skyrocketed (from 4.2% in 1980 to 77.1% in 2000) showing the direct redistribution of income from the taxpayers towards the corporate capital. Another fact supporting this view is the increasing share of the indirect taxes in the total tax revenues. As can be observed in figure 11, the share of indirect tax revenues to total revenues increased from around 37% in 1980 to around 60% in 2000. The low and middle-income groups who provide most of the indirect tax revenues[19], therefore, have become the scapegoat of the new economic system that benefited the higher income groups by lowering the tax burden on them and by generating a recycle of the tax revenues towards them in the form of debt repayments.

Figure:11



Source: SPO Main Economic Indicators, CBRT.

The underlying grounds for this kind of indirect subsidy system provided to the private sector is not unique to Turkey and indeed has been observed in many other transition economies as well (Keyder, 1987; Brett, 1988; Bugra, 1994; Nonneman, 1996c; Bugra, 1997; Belka, 2001).

Therefore, despite the emergent need of the public sector for greater and stable sources of income rather than short-term and volatile capital flows and continuous borrowing, the state is unwilling to tax the corporate capital while not hesitating in taxing the low and middle income groups in a disproportionate way comparing to these groups contribution to the national income.[20]

The Winners and Losers: the effects of transition on labour markets and society

The capital account liberalization in 1989 and the following expansion in international capital mobility have not given rise to the expected consequences in the Turkish economy. As the FDI remained at marginal sums, new investment and employment creation is not stimulated by international investors. On the other hand, starting from early 1980s and especially after early 1990s, we observe a dramatic decline in the purchasing power of the masses and increasing unemployment (see table 1& figure 7).[21]

The main contribution of Turkey's *miraculous* economic reforms in the 80s has turned out to be aggravating a widening public sector debt and making the government main source of inflation in the country. In the period of 1990-96, public disposable income declined by 45% in real terms (which is an expected outcome of austerity measures and the immature privatization process, as discussed in the previous sections).

The introduction of new financial instruments into the system enabled the successive governments to finance their borrowing requirements from domestic sources by issuing government bonds and treasury bills thereby bypassing many of the legal regulations and protocols constraining their fiscal operations.

Another reason for the shift from international to domestic borrowing was the growing foreign debt burden due mainly to the accumulation of official debt borrowed from international financial institutions. The PSBR climbed to more than 15% of GNP by 1999from around 3% in 1987(figure 5).

The fragile nature of the domestic asset markets with a relatively undeveloped capital market (which is dominated by a few major players) gave rise to very high interest rates. "The real rate of return offered on government debt instruments exceeded comparable market rates on demand deposits by a margin of almost 20%"(Yeldan, 2000:6) Interest payments as a ratio of public revenue, on the other hand, increased to 77% by the year 2000 (figure 11).

In our view, Turkey is rapidly approaching a dangerous debt trap, in which rising interest payments consume the government revenues to such an extent that total debt continues to grow even when the government is not overspending. High public debt is a major concern simply because the cost of servicing it amounts to a significant portion of government spending, perpetuating the deterioration in fiscal imbalances. With the crisis in progress, the problem has essentially evolved into a self-sustaining vicious circle, running from debt stock, to higher interest rates, to interest payments, to budget deficits and once again to higher debt stock. To service public debt, the central government channeled 77% of tax revenues - about 16.4% of GDP- to interest payments in 2000, up from a mere 17.6% of tax revenues in 1985. Furthermore it is estimated that, the cost of interest payments is likely to reach 94% of tax revenues this year.

The state played a twin role during the ISI era before 1980 reforms, namely the role as a producer through its operations of the SEEs and the regulatory role as its involvement with the administration of several accounts like foreign exchange rates and setting of key prices in industry and energy. In the post-reform era, however, the state is complied to give up its productive role while continued to play its regulatory role in income distribution through fiscal operations in the market. In the Turkish example, the state's use of fiscal operations appears to be a kind of income transfer mechanism from the wage earners and peasantry to emerging domestic business groups.

The state's instrumental role in this income transfer mechanism is evident in the figures comparing taxes on capital incomes. A comparison of the interest payments by the state and its tax earnings from corporate capital income reveals the nature of the relationship between state corporate business and the use of fiscal debt management in this dual relationship. " The contribution of corporate incomes to aggregate tax revenues lies well below the income captured through interest earnings on the domestic debt, which means that capital incomes in Turkey are effectively untaxed, and the current mode of domestic debt management works as a direct income transfer to the holders of capital income" (Cizre-Sakallioglu et al., 2000:490). When we go back to 1988, the interest payments on domestic debt to GNP ratio was around 2.4% while the corporate tax to GNP ratio was 1.8%. In this respect, the taxation of corporate capital and the interest payments transferred to them were in a rough balance. Yet, when we come to 1998, just after a ten-year-period, the share of interest payments

on domestic debt in GNP rose to around 14% while the corporate tax to GNP ratio remained almost the same at around 2% of GNP. Another way of seeing the character of this transfer mechanism is to look at the distribution of domestic debt among buyers. Between the years 1987-1999, on average, 84% of treasury bills and government bonds sold by public are hold by private banks, therefore, the banking sector (which are owned by the corporate sector) appears to be the main beneficiary of the growing debt trap on the public budget. The banks in Turkey are owned by major conglomerates that use them to shore up their firms and finance dubious investment projects while at the same time enjoying the government deposit insurance which enables them to continue this transfer of resources without incurring any risk on their part. The moral hazard problem that resulted from the state guarantee on all bank deposits, hence, were the primary source of the bail out of 12 private banks by the state within the last 2 years.

Furthermore, there has been no serious attempt to eliminate the informal sector, on the assumption of providing flexibility to labour market, which accounts for almost 50% of the market to generate a more equal distribution of the tax burden in the society.[22]

Although the main target of these tax deduction and amnesty policies were to encourage individuals to declare their unregistered-underground asset holdings and also to enhance economic activity by lowering the investment cost for the private sector through tax cuts, there is no sound improvement in the government revenue as a result of these policies. On the contrary, the fiscal deficits are expected to deteriorate after these generous tax reform programs.[23]

Table 1-Distribution of Income Across Households

	% Share in Aggregate Disposable Income	
Household Percentiles	**1987**	**1994**
Lowest 20%	5.23	4.86
21%-40%	9.61	8.62
41%-60%	14.07	12.60
61%-80%	21.16	19.02
Highest 20%	49.93	54.88
Memo:		
Lowest 10%	1.94	1.84
Highest 10%	34.02	40.51
Lowest 5%	0.70	0.69
Highest 5%	23.01	30.34
Gini Coefficient	0.44	0.49

Source: SIS, Household, Labour Force and Income Distribution Surveys (various Years).

Diminishing real wages, increasing oligopolistic structures in the market (as a result of unregulated privatization process), expansion of the informal (unrecorded) economy, together with the widening distributional conflicts in the society display their consequences through the opening up of

the already large income gap among different income groups. According to a recent report, the richest 18,000 families in Istanbul, who constitute only 1% of the city's population, receive $6 billion of the $20 billion generated in the city (Sonmez, 1998). The disparity in income distribution is not limited with the big cities. While the highest 20% of the population have managed to receive almost 55% of total disposable income over the last two decades, the remaining 80% have had to afford their living with the other 45% (table 1). Furthermore, the gap widened over the last decade especially after the implementation of full capital account liberalization in 1989 (Kasnakoglu, 1997:58). The share of lowest 5% of population in national income dropped from 0.7% to 0.69 between 1987-1994, while for the same period the ratio for the highest 5% have risen to 30.34% from around 23%. In other words, when we arrived at 1994, the highest 5% was earning 44 times more than the lowest 5% of the population.

The difference between the highest and lowest 1% of income groups has reached to 236 times while the regional disparities has also widened. While Marmara region collects 40% of the total income generated in the country, Southeastern part receives only 4% (Sonmez, 1998). Another important indicator of the deteriorated in come distribution is the change in the Gini coefficient during the past decade which increased from 0.44 in 1987 to 0.49 in 1994.

In addition, the last two crises have increased the already high unemployment level by an addition of about 700,000 new ones (Radikal, 8/05/2001) and widened the income gap further. Among all these depressing results, the privatization programs of SEEs have further accelerated the pauperization of the lower and middle-income groups in the country while creating a distorted market structure with high concentration ratios. As discussed in the first part of the paper, the underlying factor for this is the fact that public enterprises are given a set of tasks in developing countries. Under the presence of high-income inequality and redistributional pressures in the society, SEEs are expected to fulfill contradicting objectives in such an environment. The inevitable conflict between efficiency and profit maximizing targets as a rule of the market and social objectives in the form of providing employment and under priced services become unsustainable during and after neo-liberal structural adjustment programs (Onis, 1991; Senses, 1996).

The point IMF and other international financial institutions ignore to see is the fact that SEEs provide a kind of social safety net, for the masses impoverished under the economic liberalization programs, that is missing in such developing countries as Turkey. The inability of the state to establish a system that guarantees the basic needs of the poor and unemployed during downswings is further worsened by the IMF programs for which privatization is generally the first step in downsizing the state control and participation in the economy.

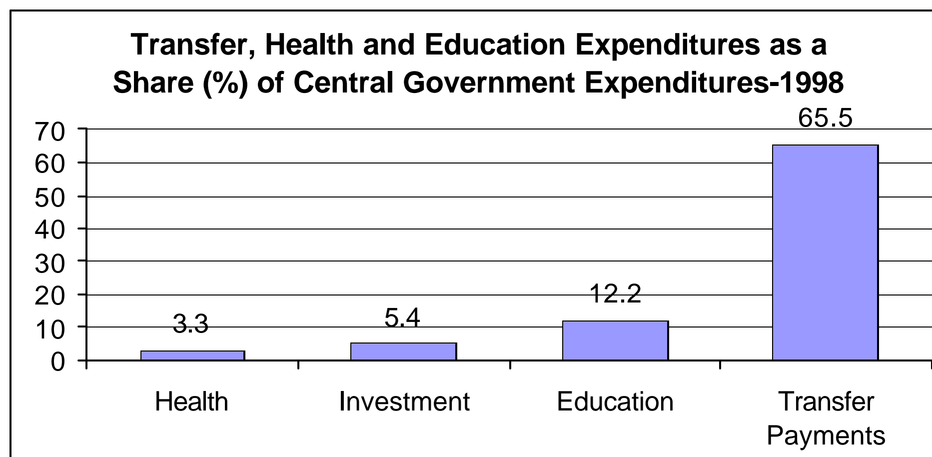
Furthermore, because of widening fiscal deficit, privatization programs in Turkey have turned out to be perceived as a way of fund raising for the budget rather than efficiency gain targets. This also

contributed to the loosing of the cement keeping the society together. Contrasting life styles, increasing and polarization of the poor brought with itself the danger of social explosion as well.[24]

The economic collapse has further provoked the already loosened social fabric in the country. The economic and political divisions among several groups in the form of urban-rural, secular-islamist, and Turkish-Kurdish brought about serious concerns among political leaders.[25]

In contrast, the government has chosen the option of reducing its spending on the most important components of its budget like education, health and public investment. In 1998, the relative shares of health, investment and education expenses from the central budget were 3.3%, 5.4%, and 12.2% respectively while the share of transfer expenditures (the most important component of which is the interest payments) was 65.5% alone. This distribution of budget revenues is in a sharp contrast with OECD figures, in which an average of 75% of all tax revenues are used to finance public expenditures on health and education (Oyan, 1997).

Figure 12:



Source: World Bank; United Nations; SPO, Main Economic Indicators.

In this picture, the place occupied by the society in the determination of the country's economic programs is relatively minor. The inability of the society to control the state apparatus goes together with the perception in people's minds that corruption and bribery has become a fact of state affairs during the transition process.[26]

Hence, the Turkish market economy experience has turned out to be a strange combination of autocratic etatism and crony capitalism in which economic, political and social rents are shared away among domestic and international businesses, subcontractors the state bureaucracy (Cizre-Sakallioglu, 2000:496).

Mixed Results

Lack of transparency and accountability in Turkish politics and economy together with its authoritarian top-down economic policy making (as a result of technocratic structure of the economic reform programs implemented) have produced strange results as the country became more and more dependent on international financial organizations for the continuation of financial flows. Each time the country called for IMF help, a team of high-level technocrats with close ties with the international community became responsible for preparing and implementing the new program (Kirkpatrick, 1991). For instance, the key figure in the process of policy formation in 1980 was Turgut Ozal, a former head of the state planning organization who spent a formative period at the World Bank in the mid-1970s. He was the main negotiator with the international donor organizations during late 1970s and became the architect of the January 1980 program that mark the beginning of the new liberal economic era.[27] Likewise, after the serious balance of payment crisis in 1971 the military government invited one of the researchers of the World Bank, A. Karaosmanoglu, who was a Turkish citizen, to rebuild the economy and implement economic policy reforms, but later on, populism and internal political struggles overcome the efforts for restructuring of the economy. The last crisis, ironically, gave rise to a similar development in the mixed political-economic arena of Turkey. Kemal Dervis, former vice president of WB was invited[28] to rebuild the country's ruined economy after the two consecutive crises in late November and early February. From the beginning, the 52-year old world bank economist appeared to be the fourth partner of country's three-party coalition government with special powers given from the outset. As was read in the Financial Times' columns, "when the IMF approves a fresh boil-out for Turkey…, it will be betting its money on Kemal Dervis, the new economy minister". His connections with the international financial community and independence from political manipulations and populist policy making are two qualities that are expected to bring an end to the economic turmoil and chaos in the country.

Although "the Turkish experience provides strong support to the proposition that the character and unity of the technocratic elite with clear ties to international lending agencies is a key factor in determining the success of an adjustment program", it also supports the proposition that in countries with lack of democratic institutions and transparency in state affairs, top-down policy building further strengthens the already autocratic and repressive state governance. Lack of transparency together with a social structure characterized by extreme polarization of incomes and life styles further limits the possibility for a social pact that is needed to build a consensus around economic reform programs (Onis, 1997:37; Kowalik, 2001).

The existence of widespread corruption also contributes to lack of trust in society for any new economic program aimed at stabilizing the economy.[29] A side effect of the ongoing economic crisis in

the country, therefore, has been the insulation of the state from social pressures further away. The isolation of decision makers (in economic and political affairs) from the rest of the society also strengthened the resistance of these groups to any criticism against their subsequent conducts and helped to deepen the fragmentations among different groups in the society.

The broad view discussed above brings us to conclusion challenging the generally accepted neo-liberal view of the reciprocal relationship between economics and politics which base on the premise that these two are and must be independent of one another. In contrast to the arguments put forward by the mainstream economists, Turkish experience demonstrates a clear-cut lesson that "politics matters in the era of financial liberalization." The volatile nature of capital flows largely depend on the good news from the markets and these good news gain special importance especially in countries where there is lack of institutional infrastructure to ensure continuity in political and economic policies.[30]

Conclusion

The Turkish experience in the 1980s and 1990s provides an important case study to other transition economies for the demonstration of close relationship between the economic programs a country applies and the political and economic infrastructure surrounding those programs.

We tried to argue that Turkey's switch to neo-liberal economic policies in the early 1980s did not bring about the expected results partly because of its lack of the required infrastructure for the economic reforms at the time it was trying to apply and partly because of its timing and sequencing mistakes during transition. To the surprise of many but not all, the end result has turned out to be a strange combination of market economy and crony capitalism.

As demonstrated in the last Asian crisis, Turkish case also provides new evidence to the fact that "weak financial institutions may make a [developing country] particularly vulnerable to large and sudden changes in short-term flows."(Stiglitz, 2000) especially in the face of unregulated and immature capital account liberalization.[31]

The Turkish trajectory in the post-liberalization era, on the other hand, displayed some interesting results in terms of the existence and the continuation of the rent-seeking coalitions formed during the centrally planned era prior to the liberalization wave of the 1980s. The distribution of rent (created in the formal and informal parts of the economy) between the business and state bureaucracy, in this respect, appears to be the distinguishing elements of Turkish capitalism. The attempts to downsize and reduce the state control and regulation in the economy have yielded (un)expected results in terms of state-business-society relationship.

The widening public debt, and the deteriorating income distribution in the country have gone hand in hand with increasing isolation of the state from society. Suppression of the democratic rights

(in part in order to enable easy implementation of austerity measures), division and polarization of the society among several political and ideological fractions, and the untransparent functioning of the state apparatus together with the destructive effects of the uncontrolled trade and financial liberalization programs have put the country away from the expected results of the neo-liberal reform package of the 1980s.

Furthermore, Turkish example provides strong support to the need for a selective gradualism approach during the transition process. Immature liberalization of markets (both current and capital) and downsizing of state (through privatization and deregulation) creates serious distortions in the economy in terms of long-term growth objectives of the country. However, the reason we used "selective gradualism approach" as the correct path instead of just a gradualism approach is the fact that there is also a strong need, during transition, to undertake some reforms in a quick "shock therapy" fashion. The emphasis here is especially in areas concerning institutional framework, and rules and regulations needed for a smooth functioning of the market economy. In this respect, a radical shift towards independence of SEEs and state owned banks, in order to avoid clientalism and rent seeking behaviour, prior to privatization is an important step in the early stages of reform programs.

In addition, the policy makers should be able to come up with clear cut answers to the following questions that; "who pays for the new system and for whom does it serve? Can it count on continuing support in the society?" It should be taken into account that people always judge systems in terms of capacity their expectations and needs. The policy makers need to persuade the society to accept short-term costs of transition and guarantee that they will share in future benefits. The ability of labour institutions, particularly unions, to promote market reforms and convince workers and other wage earners to accept transitional costs while protecting them from the excesses of market economy has a profound effect on the success of the transition process. Lack of this general consensus in society and failure of the policy makers to realize the promised achievements in a short period of time have created a system with serious market distortions and social conflicts, conflicts which were softened initially because of undemocratic political environment (military government) that allowed the policy makers to implement shock therapy measures in a relatively short span of time. Hence, the clear-cut answer from the Turkish experience to the question that "Does the sequence matter in transition?" is, looking back, it appears that it does.

We further argue that the dichotomy of retreating states and expanding societies is rather superficial and misleading. In fact, what we observe in the aftermath of liberalization and privatization experiments in several contexts is not a retreat of the state but emergence of a strong need for reconstruction of the state (with increasing emphasis on its regulatory roles). Although globalization has weakened the economic power of the state, it has not made the state impotent. Government policy in developing countries still has a major role in creating more and better employment and income earning opportunities, reducing poverty and improving the distribution of income and wealth. What is

needed is not a smaller state but a different state, which places greater emphasis on human development and creating appropriate institutions and en efficient set of incentives for a well functioning market system (Griffin, 1996:127).

In this respect, we have argued that the political sustainability of neoliberalism, at least in the Turkish context, in the 21st century is largely determined by the performance of the political and economic order both in the domestic and the international sphere at the same time.

End Notes

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[1] For a detailed discussion of the financial deregulation and trade liberalization programs and their effects on the developing countries' growth paths, see World Bank, 1997; Knight, 1998;Gabriele et al, 2000; Stiglitz, 2000; Eichengreen, 2000.

[2] As an exa mple of this view, see Dornbush, 1992; Citrin et al., 2000.

[3] For an in depth analysis of the relationship between politics and the economic liberalization package of the 1980s, see e.g. Boratav, 1993; Onis, 1998; Cizre-Sakallioglu et al, 2000.

[4] $\Delta H/P= f(\Pi, h)$ (11) where Π is the inflation rate ($\Delta P/P$) and h is real monetary base (H/P). We further know that ?f/?h>0; and ?f/?Π>0 up to a certain level but after that ?f/?Π <0 hence there is an upper limit on the amount that the government can force the private sector to save through seignorage generation.

We can find the seignorage revenue as follows;

$\Delta(H/P)= [\Delta H*P- \Delta P*H]/P^2$ where $\Delta(H/P)$ gives us the change in real monetary base.

$\Rightarrow \Delta (H/P)= \Delta H/P- \Delta P/P*H/P$

$\Rightarrow \Delta H/P= \Delta(H/P)+ (\Delta P/P*H/P)$ (12)

The left hand side of the equation (12) represents the seignorage revenue, and the first component of the right hand side is simply the change in real monetary base and the second component is the inflation tax that is calculated by the inflation rate ($\Delta P/P$) times the real monetary base (H/P). Hence, seignorage revenue is equal to the change in real monetary base plus the inflation tax.

Here again for simplicity we assume that the change in real monetary base ($\Delta(H/P)$) is negligible and therefore we ignore the changes in real monetary base. Hence we end up with having seignorage revenue as equal to the inflation tax.

[5] We can use the three-gap analysis, which was originally developed by Chenery et al. (1962&1966), McKinnon (1964) and Bacha (1984), in explaining these bottlenecks in growth perspectives of a developing economy. These are, the so-called investment-saving gap, I= Sp*+ (T-Cg)+ (CAPIN+F); foreign exchange gap $I=1/\mu$ (E*+CAPIN+F); and the fiscal gap $I=(1+\gamma)[f(\Pi, h)+(T-Cg)+(CAPIN+F)]$ where μ represents the share of the imported intermediary investment goods (machinery, equipment, etc.) in the total imports, Y: GDP, I: Investment, Ip: Private investment, Ig: Public investment, M: Imports, X:Exports, CAPIN: Capital Inflows, F: Net factor services from abroad, C: Total consumption, Cg: Government consumption, Cp: Private consumption, S:Total Savings, Sp: Private savings, Yd: Private disposable income, T: Net tax revenue.

In this model, income is assumed to be at its potential (steady state) level, F is exogenously determined and all foreign debt is taken by the government, and the consumption is given as fixed rather than being a function of income.

[6] The main target of these policies was to support the domestic industrialists by providing cheap intermediate inputs imported through subsidized exchange rates.

[7] For a detailed analysis of this relationship between the state and the business class, see Keyder, 1987; Bugra, 1994.

[8] The development paths of this narrow distributional coalition have been analyzed by several scholars, see e.g. Keyder, 1987; Celesun, 1989; Onis, 1992; Boratav, 1993.

[9] "Turkey is one of the seven countries in the OECD to have the least number of restrictions on capital account transactions." (Kumcu, 1997:31).

[10] For a discussion of the over invoicing, tax rebates and virtual exports that led to a direct income transfer to the business community see, e.g. Rodrik, 1988.

[11] Also the increasing dependence on the international capital flows from both private and official sources-to finance the widening public deficit resulted in loss of control over the economic policies followed by the country.

[12] For a detailed analysis of the post-1980 economic reforms and their effects on the income distribution, see e.g. Celesun, 1989, Ozmucur, 1992, Yeldan, 2000.

[13] For a general view on the disruptive effects of the international capital flows on domestic markets and the moral hazard problem associated with the state guarantee on private sector debt and bank deposits, see e.g. Edwards, 1998; Felstein, 1999; Rasich, 2000; Eichengreen, 2000; OECD, 2001.

[14] ie., one of the state banks, Ziraat Bank itself has $12 billion uncollected assets vis-à-vis the Treasury.

[15] The exchange rate framework was designed to have the following features:

- A pre-announced exchange rate path with respect to the existing basket will be introduced before the IMF Executive Board meeting (a prior action). The exchange rate path will be announced for the period January 1, 2000-December 31, 2000. During this period, the depreciation rate will be 20 percent, equal to the target for WPI inflation. Within each month, the daily exchange rate adjustment shall remain constant. After the introduction of the new exchange rate system, the depreciation rate for the rest of December 1999 will be the same as in the first part of the month.
- At the end of each quarter, the exchange rate schedule will be extended by three additional months, without changing the part of the exchange rate path already announced. The devaluation rate for the additional three months may differ from the announced rate in the preceding period with a view to furthering the disinflation process.
- There will be no band around the exchange rate path for the first 18 months following the introduction of this regime. A gradual shift toward a more flexible exchange rate regime will begin on July 1, 2001 when a symmetric, progressively widening band about the central exchange rate path will be introduced. This band will widen at a rate of 15 percentage points per annum, measured from edge to edge. The total width of the band will thus reach 7½ percent by end-December 2001, 15 percent by end-June 2002, and 22½ percent by end-December 2002. For a detailed description of the program outlines see; http://www.imf.org/external/np/loi/1999/120999.pdf

[16]In this respect, Turkey is not unique among other developing countries. As Samuel P. Huntington explains in his 1968 classic, "Political Order in Changing Societies," high levels of corruption are endemic to societies undergoing the stress of rapid modernization. Corruption greases the wheels of creaky, unresponsive bureaucracies, creates informal networks of power so that things get done when they otherwise wouldn't, and allows people to purchase power in third world systems that they would otherwise violently revolt against.

[17] The government, in its letter of intent to IMF dated June 26, 2001, clearly displayed the path to be followed in its economic program and the groups who will carry the burden. It is stated that; "Wage negotiations for public sector workers were concluded in late May. We estimate that the two-year agreement will lower the ratio of average net salaries of public sector workers and civil servants from 2.6 in 2000 to 2.2 in the first contract year before raising it to 2.3 in the second contract year.

Regarding policy efforts, in May we raised VAT rates as planned, and increased the minimum contribution base relevant for social security payments by 40%, while increasing the contribution ceiling from four to five times the minimum contribution. We also raised petroleum consumption taxes by over 20% in May and by 16% in June, more than originally planned."

[18] For an analysis on the size of the informal sector, see e.g. Celesun, 1989; Derdiyok, 1993. Also, for a detailed discussion on the effects of the distorted labour market structure on employment and wages, see Bulutay, 1995; Senses, 1996; Yeldan, 2000.

[19] For an in depth analysis of the repressive nature of the Turkish tax system see e.g. Senatalar et al, 1991; Ozmucur, 1992; Onder et al, 1993.

[20] Kazgan (1990) provides a historical overview of the underling reasons behind the distorted income distribution in the country.

[21] The cost of the last two crises has been an increase in the country's already high unemployment figures by 42% comparing to the previous year, which means almost 700,000 new jobless people. (Milliyet 04/08/2001).

[22] For a detailed analysis of the development paths of the informal sector and its effects on the labour market, see e.g. Senses, 1996; Ozmucur, 1992; Derdiyok, 1993.

[23] Despite the last general tax amnesties, only 35% of total 4.5 billion accrued tax liability could be collected (Radikal 17/07/2001).

[24] This depressing picture is not unique to Turkey and has been observed in many other developing countries that go through "big-bang" type approach in their transition. For instance, even in the case of Polish experience that is often presented as a success story, we observe the same pattern of development; "Poland has the highest rate of unemployment and less than 25% of the registered unemployed receive benefits…Poland also leads the way with regard to the depth and breadth of poverty. In 1990s, the number of people living in poverty more than doubled. Mass unemployment and widespread poverty are accompanied by an exceptionally large and uneven differentiation of earnings and incomes. The crisis in the welfare state and the erosion of social security is also more acute in Poland than in the other Central European states. The result of the transformation was to create a social sytem pregnant with social conflict…"(Kowalik, 2001:34-39).

[25] The president A.N.Sezer, for instance, vetoed the legislation proposal to reduce subsidies for tobacco farmers to avoid deepening the already too much suffering among agricultural workers. On the other hand, the military dominated National Security Council-which is an institution established after the 1980 military coup and where

the threats to national security issues are the primary topic-discussed the potential for social uprisings and unrest in public in its closed meeting (Radikal, 26/07/2001).

[26] Ex-president of the Central Bank of Turkey, for instance, has been accused of making illegal gains by using his position in exchanging his TL60 billion holdings to dollar on the very last day just before the devaluation in February. While his case is now being processed by the court, it is found out that he is not the only one benefited from the last devaluation. Ex-president of the biggest state bank-Ziraat bank, also exchanged his TL102 billion to dollar two days before the devaluation (Radikal, 8/1/01; Ozgur Politika, 16/4/01; Ozgur Politika, 23/4/01). It is currently a highly debated issue in the country that the central bank is being asked-by public- to announce the names of the buyers of the $5billion sale just prior to the devaluation.

[27] He was later to be first prime minister and then the president of the country.

[28] It is claimed that the idea of choosing K. Dervis as the minister of economy came from S. Fisher, president of IMF, to gain the international community's trust and support.

[29] Countless parliamentary investigation committees have been set up in the 90s to investigate ongoing abuses in the public sphere. However, these committees which themselves had no sanctioning power, faded away as a result of political negotiations among groups involved in the abuses and were to be investigated.

[30] The Asian experience in 1997 supported the above claim that even the countries with sound macro-economic performance and low public debt are also subject to speculative debt in the presence of lack of the required regulatory institutional bodies.

[31] " …one might compare capital account liberalization to putting a race car engine into an old car and setting off without checking the tires or training the driver. Perhaps with appropriate tires and training, the car might perform better, but without such equipment and training, it is almost inevitable that an accident will occur. One might actually have done far better with the older, more reliable engine: performance would have been slower, but there would have been less potential for an accident, similarly, the international economic architecture must be designed to "work" not just in the presence of perfect economic management, but with the kind of fallible governments and public officials that in fact occur in democratic societies." One more thing needs to be added to this statement which is the fact that the governments, in most of the developing countries, are not an independent unit from the capitalist class and play an important role in directing the rent distribution from the working class to the capitalists" (Stiglitz, 2000).

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