

# The Turkish Experience with Regulatory Reform and the Role of Independent Regulatory Authorities

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*In recent years, Turkey has introduced fundamental changes into the nature and scope of government intervention in several important sectors. In telecommunications, steps are being taken in electricity and gas to end state monopolies and introduce competition, to allow private enterprises entry, and vertically separate and eventually privatize some of the key public assets. Such steps are accompanied by a major redistribution of discretionary authority to design and enforce rules and regulations away from ministries towards newly established independent regulatory authorities (IRAs). This paper reviews some of the salient features of IRAs and issues they raise in the Turkish context.*

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## ***Regulatory reform in Turkey***

The term regulatory reform refers to fundamental changes in the nature and scope of government intervention in several key sectors of the economy. In some cases, these changes aim at introducing competition to industries that have traditionally operated through vertically integrated (often state-owned) monopolies. Regulatory reform also refers to institutional changes, whereby significant discretionary authority is transferred from central governmental agencies towards Independent Regulatory Authorities (IRAs).

In the last two years, Turkey has undertaken a number of important steps in the area of regulatory reform.<sup>1</sup> In telecommunications, electricity and gas fronts, new laws have been enacted to end (or will end) state monopolies and introduce competition, allow private enterprises entry, and vertically separate - to eventually privatize - some key public assets. In addition, these laws have established two new IRAs, namely the Telecommunications Authority (TA) and the Energy Market Regulatory Authority (EMRA). Competition policy is a crucial component of regulatory reform. In Turkey, the Competition Board (CB) has been active since 1997, and has been responsible for the enforcement of the Turkish competition law (itself modeled after key competition articles of the EU Treaty). In the financial sector, steps have been undertaken to reduce political influence over state banks. Regulatory powers have been transferred from the Central Bank and the Treasury to a new powerful authority, the Banking Regulatory and Supervisory Agency (BRSA).

These changes have not been smooth. Many steps have met significant resistance. The implementation of Turkish competition legislation was delayed for

two years because political authorities did not appoint board members for CB. In telecommunications, a major power struggle broke out between the TA and the Ministry of Transport over which institution should have the authority to issue telecommunications licenses following the setting up of the TA. After some serious arm wrestling (including some by the IMF), that power was eventually transferred to the TA. Significant new investment was delayed as a result of the scuffle.

In some cases changes were preceded with years of inaction or incoherent policy. Quick solutions had been found in the past to circumvent constitutional barriers to private participation in the electricity sector. These took the form of concessionary contracts with long term price and purchase guarantees, which were likely to both create significant contingent liabilities for the Treasury, and lead to a conflict with the spirit of the liberalized, competitive energy markets that the new regime envisaged. Currently, the fiscal crisis has led the government to annul majority of the plans to transfer substantial operating rights to private undertakings, even though some were close to completion. This may have adverse influence on the climate for private investment in the near future, reflecting another cost of inadequate solutions to the problems of the sector. In effect, the absence of a former coherent policy framework will make EMRA's task significantly more difficult.

The predicament of the financial sector is even more interesting. The BRSA was established in the midst of the stabilization program that was expected to create significant risks for the banking system. It was also clear to many that the existing regulatory framework was inadequate to deal with these risks. It took nine months to appoint board members to the BRSA, and still a few more months had to pass before the agency could become operational. By the time the BRSA was operational, the

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<sup>1</sup> For a recent review of regulatory reform in Turkey see OECD (forthcoming).

banking system was already under significant interest and foreign exchange risks that created fragility in the system and helped trigger the financial crises Turkey faced in 2000 and 2001. If the agency had been established earlier, it might have taken actions that would have reduced incentives to bear excessive risks during the stabilization program. The BRSA was envisaged to be independent and its founding legislation protected members of its Board from political influence. The government decided to appoint new board members following the crisis, and did so by simply passing a new law! The new members of the Board may have enhanced the credibility and effectiveness of the agency, yet at the cost of a serious damage to statutory independence.

Regulatory reform in Turkey was not a product of a carefully planned, well-reviewed, consensual and coherent vision about future course of policy making. The reforms themselves were in harmony with international trends and globally accepted institutional responses to significant policy problems.

### ***Why IRAs?***

The argument that there is need for extensive government intervention in these sectors is well established in economic theory. Segments of electricity, gas and telecommunications industries are characterized by significant economies of scale and scope, as well as network externalities, limiting the extent to which competition can be generated by new entry. This results in monopolistic or oligopolistic structures in bottleneck segments. On the other hand, entry in potentially competitive segments can only occur if entrants have access to bottleneck facilities at reasonable prices. This creates incentives for operators owning bottleneck facilities to engage in anti-competitive behavior. Additionally, technological change expands the number of

segments where competition can potentially be introduced. Regulation is therefore required, among other things, to manage the interaction between bottleneck and potentially competitive segments of industries. Hence, even when countries engage in extensive liberalization, significant government intervention remains, albeit in different forms.

The banking system also suffers from significant problems of informational asymmetries and externalities. Problems in a small number of banks can quickly expand into systemic failures. Moreover, the nature of the banking business is such that there may be incentives for excessive risk taking. Hence, regulation and supervision is needed both to monitor the financial health of banks and to provide incentives for prudent behavior.

The question is why government intervention in these sectors in the past two decades in most industrial countries, has been exercised through IRAs, as opposed to, say, departments in ministries of the central government. The literature (*e.g. Thatcher and Stone Sweet 2002*) identifies a number of functional reasons, including:

- resolving commitment problems (that is, generate confidence whereby regulations, once designed, will be enforced effectively and will not be reversed for political or other reasons);
- overcoming information problems in fields that require technical expertise and enhance the efficiency of rule making.

The commitment problem is especially important in sectors such as telecommunications and electricity where investments are lumpy and to a large extent, sunk (or costly to liquidate). If new capacity and new services in these sectors are

largely to be created by private investment, absence of commitment capacity, that is the lack of investor confidence that rules will remain stable over time, will result in serious under-investment. Insulating the process of rule making and enforcement from short term political dynamics has been seen as a necessary condition for the attainment of stability in the regulatory environment.

Analysis of the actual historical development of IRAs in most European countries reveals that additional factors have also played a role. Historical legacies and adoption by countries of institutional responses deemed successful in earlier experiences (especially in the USA, and later in the UK), have also been important. Indeed, notwithstanding efforts by transnational institutions (especially those of the EU) to harmonize regulatory rules and institutions, significant cross-country differences remain in a number of dimensions, including distribution of rule making authority between governments or ministries and IRAs, and the degree of IRA independence with respect to budget and personnel decisions (*e.g. Majone 1996, Thatcher 2002*).

### ***The peculiarities of the Turkish experience***

Notwithstanding cross-country differences, IRAs have become the accepted form of institutional response to policy challenges of sectors such as telecommunications, electricity and banking. There are a number of interrelated peculiarities that distinguish the Turkish experience from those of most industrial countries.

First, there is strong perception that “outside pressure”, especially by the IMF (and the World Bank) has played a crucial role in recent cases of regulatory reform.

While the role of recent agreements with the IMF is undeniable, the “outside pressure” perspective possibly underestimates the considerable amount of preparation and work undertaken by various parts of the bureaucracy, both by its own initiative and as part of the work in preparation for membership to the EU. The theme of “IMF pressure” has also been skillfully employed and possibly exaggerated by the reform-oriented bureaucracy to put pressure on various governments to adopt reforms. While that strategy has clearly paid off thus far, it has also helped reform opponents question their legitimacy.

Secondly, regulatory reform, and especially the establishment of IRAs carry a special significance in the context of Turkish political heritage. The Turkish political system has been increasingly driven by concerns of patronage, influence and control rather than the design and implementation of good public policy (for example, Kalaycıoğlu 2001; also OECD forthcoming). As a result, most ministerial and bureaucratic appointments were made not on the basis of merit but on the basis of political affinity and reciprocity. The situation was exacerbated by political instability and by the fact that the 1990s witnessed a large number of short lived coalition governments. During the process of government formation, influence over and control of agencies that could be instrumental in patronage and clientelism became the overriding concern of coalition partners. The importance of coherent public policy became secondary. Policy making agencies, in turn, became more concerned about protecting their staff and spheres of influence, relative to improving public policy.

To many concerned with public policy issues, establishment of IRAs was seen as a quick and an effective solution to problems of populism and patronage. While it is still too early to judge whether the IRAs have been more merit oriented than the

majority of the traditional bureaucracy, casual observation as well as an early assessment by the OECD (forthcoming), definitely seems to suggest this to be the case.

Finally, Turkey's EU perspective played a fundamental role in providing well recognized benchmarks as to how to resolve public policy issues in these important sectors. In fact, given the peculiarities of the political system, it can safely be said that the EU perspective (and the regulatory solutions which this perspective encompasses) was more effective in providing an overall vision and coordination among disparate reform efforts, relative to, say, meetings of the council of ministers, which under a normally functioning parliamentary government is *the* vehicle for inter-ministerial coordination.

### ***IRAs and problems of governance***

Given the variability in the degree of independence displayed by IRAs in Europe, for example, it can be said that Turkish IRAs are quite independent in an *ex-post* sense. For example, in both France and Germany, the central government retains significant control over merger decisions. Such ex-post discretion by the central government is not possible in the Turkish context (*CA decisions can be appealed at the Council of State*).<sup>2</sup> While many IRAs in Europe rely on the central government budget, the TA and the CB in Turkey rely on special fees and taxes levied on enterprises. Hence in an ex-post sense, Turkish IRAs display a strong commitment capacity.

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<sup>2</sup> On the other hand, the Turkish CA has less effective investigative powers than its German counterparts.



That is not to mean, however, that Turkish IRAs are independent of political influence *ex-ante*. Appointments of board members are still predominantly influence oriented and are subject to major political negotiations. Many appointments are delayed because coalition partners or different concerned ministries find it difficult to agree on names.

The real problem is that, given the broader governance problems inflicting the Turkish political and administrative system, it is extremely difficult to design the institutional infrastructure for public policy. The immediate reaction of many who are tired of patronage and populism in Turkey, is to grant IRAs as much independence as possible. However, there has been insufficient thinking about how to secure the accountability of IRAs, or how to make sure that they use their powers for public interest. It seems that the presumption has been that once IRAs are populated by decent technicians, additional mechanisms of accountability will not be necessary. In the short run, and given the current political and administrative environment, this “technocratic” solution sounds reasonable (and also quite risky: just consider the possibility of an all powerful independent agency with a completely “co-opted” leadership which is accountable to no one). Over time, however, there will have to be some serious thinking about what additional mechanisms can be established to enhance the accountability of IRAs (*Majone 1999*).

Making IRAs transparent, forcing them to disclose the reasons for their decisions, and having them engage in consultations before major regulatory decisions, would definitely help make IRAs more accountable. In fact, as has apparently been the case in Europe (*Thatcher 2002 and Majone 1999*), it can easily be said that IRAs in Turkey have been more transparent than traditional bureaucratic agencies. The

presence of international, especially EU, norms on many areas where IRAs will be active, also provides yardsticks against which IRA performance can be judged.

The real danger here is that EU or other international norms can be taken as foolproof and this is not necessarily the case. Many opponents of regulatory reform in Turkey would be delighted to learn that Germany does not have an independent electricity regulator (and that it is not very fond of the idea of liberalization in the electricity sector). The point behind bringing out the German example is that the availability of norms should not preclude a lively domestic discussion and innovation. In fact, norms themselves are not uncontroversial. To provide just another example, Turkey, in telecommunications, will soon be adopting important EU regulations, but perhaps without a chance to seriously consider whether such adoption (most likely with little modification) is appropriate when network expansion is still a major social policy concern. Similar examples can be given from other sectors.

Regulatory reform in Turkey is on the one hand extremely late, and on the other, proceeding perhaps a bit too fast and with insufficient discussion about the variety of options available. This is true both with regard to institutional structure and substantial policy issues. This is not to say that the process should be slowed down. Rather, it is perhaps a call to non-governmental entities, especially the academia, to become more active in generating a public debate.

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