OECD Reviews of Regulatory Reform

TURKEY

CRUCIAL SUPPORT FOR ECONOMIC RECOVERY

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Turkey

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2002

OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Une aide capitale pour la reprise économique

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Foreword

The OECD Review of Regulatory Reform in Turkey *is one of a series of country reports carried out under the OECD's Regulatory Reform Programme, in response to the 1997 mandate by OECD Ministers.*

Since then, the OECD has assessed regulatory policies in 16 member countries. The reviews aim at assisting governments to improve regulatory quality – that is, to reform regulations to foster competition, innovation, economic growth and important social objectives. It draws on two important instruments: the 1995 Recommendation of the Council of the OECD on Improving the Quality of Government Regulation *and the 1997* OECD Report on Regulatory Reform.

The country reviews follow a multi-disciplinary approach and focus on the government's capacity to manage regulatory reform, on competition policy and enforcement, on market openness, and on the regulatory framework of specific sectors against the backdrop of the medium-term macroeconomic situation.

Taken as a whole, the reviews demonstrate that a well-structured and implemented programme of regulatory reform can make a significant contribution to better economic performance and enhanced social welfare. Economic growth, job creation, innovation, investment and new industries are boosted by effective regulatory reform, which also helps to bring lower prices and more choices for consumers. Comprehensive regulatory reforms produce results more quickly than piece-meal approaches; and they help countries to adjust more quickly and easily to changing circumstances and external shocks. At the same time, a balanced reform programme must take into account the social concerns. Adjustments in some sectors have been painful, but experience shows that the costs can be reduced if reform is accompanied by support measures, including active labour market policies.

While reducing and reforming regulations are key elements of a broad programme of regulatory reform, experience also shows that in a more competitive and efficient market, new regulations and institutions may be necessary to ensure compatibility of public and private objectives, especially in the areas of health, environment and consumer protection. Sustained and consistent political leadership is another essential element of successful reform, and a transparent and informed public dialogue on the benefits and costs of reform is necessary for building and maintaining broad public support.

The policy options presented in the reviews may pose challenges for each country. However, the in-depth nature of the reviews and the efforts made to consult with a wide range of stakeholders reflect the emphasis placed by the OECD on ensuring that the policy options presented are relevant and attainable within the specific context and policy priorities of the country.

Each review consists of two parts. Part I presents an overall assessment, set within the macroeconomic context, of regulatory achievements and challenges across a broad range of policy areas: the quality of the public sector, competition policy, market openness and key sectors such as telecommunications and energy. Part II summarises the detailed and comprehensive background reviews prepared for each of these policy areas, and concludes with policy options for consideration which seek to identify areas for further work and policy development in the countries under review. The background reviews for Turkey have been posted on the OECD Web site: www.oecd.org/regreform/backgroundreports

Acknowledgements. *The horizontal Programme on Regulatory Reform is headed by the Deputy Secretary-General Richard Hecklinger. The country reviews are co-ordinated by the Public Management Service. The Review of Turkey reflects contributions from the Government of Turkey and many other sources. Major contributions were made by the Working Party on Regulatory Management and Reform of the Public Management Committee, the Competition Law and Policy Committee and its Working Party, the Working Party of the Trade Committee, the Working Party on Telecommunication and Information Services Policies of the Information, Computer and Communication Policy Committee; representatives of member governments, and members of the Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC), as well as other groups.*

In the OECD Secretariat, the following experts contributed substantially to the review of Turkey: Odile Sallard, Rolf Alter, Cesar Córdova-Novion, Caroline Varley, Alexandra Bibbee, Izak Atiyas, Peter Ladegaard, Sophie Bismut, Anthony Kleitz, Michael Wise, David Parker, Patricia Heriard-Dubreuil, Bernard J. Phillips, Takashi Yamada, Dimitri Ypsilanti. Document preparation: Jennifer Stein.

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* The background material used to prepare this report is available at: *www.oecd.org/regreform/backgroundreports*

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Executive Summary

Work is underway to develop a stable, effective and durable market economy.

The roots of Turkey's current reforms can be traced back to the 1980s. A state-directed and inwardly focused model of economic development served Turkey well before then, but was no longer adapted to Turkey's needs, and reforms to open up the economy were started. The most impressive development was in trade liberalisation. By 2000, exports accounted for 40% of GDP. The Customs Union with the EU, which became effective in January 1996, was another major step forward. But the crisis of 2000/2001, based on unsustainable fiscal and external imbalances, highlighted how far Turkey still had to go.

A comprehensive new reform programme has been set up.

The latest reforms appear to mark a much stronger break with the past. The government's "Program of Transition to a Strong Economy" addresses reform of the financial sector, public finance reform, and a new monetary policy geared to a flexible exchange rate regime, which is ultimately based on price stability (now formally the main objective of the Central Bank). The break with the past is most evident with monetary policy, which is no longer subordinate to fiscal policy, itself the subject of far-reaching reforms. The government has also launched stronger efforts at structural, institutional and regulatory reform than have been attempted so far. The transformation to a market economy driven by competition and a much larger role for an efficient private sector is accelerating.

But the Turkish economy remains in a critical state and the transition to a market economy is not yet complete.

The economy has suffered from macroeconomic instability and chronic inflation for three decades. Earlier reforms failed to establish an effective market economy and to deliver durable solutions to fiscal problems, which reflect deeply rooted weaknesses in underlying governance. Instead, an unworkable mix of state intervention and unregulated private sector activity evolved. Turkey's problems have created major uncertainties in the economic environment, reduced investment and growth, and have caused regular crises, with large losses in national income. Reforms and restructuring are now moving the economy towards greater reliance on markets and competition. But privatisation appears to have slowed, though the 2002 privatisation program has set ambitious targets. The state enterprise sector remains very large. Productivity is very low in the public sector compared with the private sector, and staffing needs to be reduced. The government stills interferes extensively in price setting.

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The cost of delayed regulatory reform has been high.

Regulatory reform has been slow to emerge on the list of priorities for action over the last few years (with some important exceptions, such as the establishment of a clear competition policy). Yet delays and failures in regulatory reform so far have incurred some particularly heavy costs. An ineffective regulatory framework was responsible for problems in the banking sector that helped trigger the 2001 crisis, causing huge welfare losses. The development of the electricity sector has been constrained by the absence, until recently, of an adequate regulatory policy. The management of public finances has been matched by extreme waste in public expenditure.

However the momentum for regulatory reform has increased.

Relative to the majority of OECD countries, Turkey has so far moved slowly in reforming its governance and regulatory framework. But the momentum for such reform has now accelerated. The 1999 earthquakes demonstrated that ineffective governance (for example the failure to enforce building regulations) carried unacceptably high welfare costs. The crisis of 2000/2001 brought to light a number of important regulatory and institutional weaknesses which had not been addressed, and increased general awareness of the urgency of regulatory reform. It has become clear that comprehensive reforms are urgently needed to address regulatory institutions and practices that are outdated, incoherent, ineffectively managed, and undermined by lack of trust in government, wide-spread non-compliance and in some cases corruption. It is also now generally recognised that tight monetary and fiscal policies cannot be implemented so long as severe governance weaknesses persist.

The aim of accession to the EU has helped to create a positive reform climate.

In 1999 the European Council recognised Turkey as a candidate for accession. Joining the EU has become one of Turkey's highest political priorities, and is a major force in shaping regulatory reform to promote high quality regulation, so that it can meet the accession criteria. Incorporation of the EU "*acquis communautaire*" is helping to shape the reform agenda, and provides a benchmark against which the reform process can be evaluated.

Banking sector regulation, fiscal management and monetary policy are being overhauled.

The banking sector has been restructured and reregulated. Regulatory reform of the private banking system was complemented by measures to enhance transparency and reduce governmental discretion over the quasi-fiscal operations of public banks. In addition, an independent Governing Board has been appointed for public banks. The next step is operational restructuring to prepare for privatisation. The framework for the management of public finance is being strengthened. The government has set three main objectives: strengthening aggregate fiscal management, building capacity for policy decisions, and improving operational performance. These reforms need to be vigorously pursued and in some respects, taken further. There is a need to strengthen external auditing arrangements. Local government expenditure should be brought within the definition of the public sector for accounting purposes.

The key principles of quality regulation are now being addressed.

Some important elements of an appropriate regulatory management system are in place, and can be built on. Fighting corruption is an integral part of the agenda and the focus of several dedicated projects. In October 2001 Turkey implemented a range of constitutional amendments primarily addressing liberal rights issues, and relations between citizens and the state. Transparency has been improved through concrete initiatives related to the EU accession process. There are also new measures to improve budgetary transparency. These recent developments to promote better governance and regulation are most encouraging.

In particular, progress is underway to reform the public administration.

There is a crisis of public confidence in the institutions of government. The public sector must improve its efficiency, transparency and accountability. As well as the reforms to improve transparency and initiatives to fight corruption, reforms to depoliticise public sector recruitment and place it on a merit basis (rather than patronage or influence) are underway. These reforms must be vigorously pursued.

Progress is also underway to improve the effectiveness of regulatory agencies.

Turkey has increasingly favoured the "independent regulator" model as part of a strategy to separate ownership, policy development and day-to-day regulatory overview in liberalised sectors. It is a little early to assess performance of the most recent regulators, but the principles on which they are based are generally sound, and show a strong commitment by the government to establish independent and effective regulatory bodies. That said there have been problems in the appointment of regulatory agency board members. There should be continued attention to safeguarding the independence of the sectoral regulators.

A clear and reasonably effective competition policy has been developed.

This was an important and early achievement in Turkey's reform path. The process of reducing the state's direct involvement in the economy was accompanied by the development of an explicit competition policy. Turkey's Competition Act was adopted in 1994, based on the competition provisions of the EU, and the Competition Authority was appointed in 1997. The competition laws and enforcement structures, the Competition Authority and its decision-making Competition Board, are well-considered and supported by adequate resources. However these institutions have not yet had to weather a serious political storm.

Important sectoral reforms are being taken forward.

As in many other countries, the network industries in Turkey have been dominated by vertically integrated public monopolies. Rapid technological change, a deep fiscal crisis, which has reduced the state's capacity to undertake necessary investments, degradation in the quality of services provided, the politicisation of public enterprises, and pressure from international institutions have finally prompted the government to initiate fundamental reform in key network industries, notably energy and telecommunications, that make a major contribution to the economy. Energy sector reform is especially vital, to avoid a situation in which energy supply shortages hamper economic growth. Turkey also stands to benefit from its geopolitical location as a pivotal transit route for international oil and gas trade (the Eurasian energy corridor). Turkey's most recent sectoral reform plans are encouraging: they generally follow OECD good practice benchmarks.

But local government remains inefficient, undermining general efforts to raise regulatory quality.

The most recent OECD Economic Survey of Turkey analysed the legal structure and framework of local government and concluded that it impeded the efficiency and effectiveness of local authorities, as well as undermining the overall administrative structure. Six main problems were identified: inappropriate distribution of functions between central government and local authorities, insufficient financial resources, insufficient organisation and personnel, unnecessary practices of trusteeship by central administration, lack of transparency and participation, and over-dependence on central government.

The fragmentary approach of the past must be avoided, with a strong centrally-driven reform strategy.

There is still a marked absence of any government-wide regulatory reform strategy. Unlike most OECD countries, there is no single government unit in Turkey responsible for co-ordinating regulatory reform or regulatory quality across government. This means that the speed of regulatory reform and the quality of regulation are uneven. The absence of Regulatory Impact Analysis (RIA) is a particular weakness in Turkey's current regulatory quality control procedures. A minister designated to oversee regulatory policy and report publicly and regularly on progress, supported by a central technical unit, should be considered.

Transparency and effective consultation must be quickly nurtured into existence.

Despite growing awareness of the need to enhance transparency, consultation in Turkey is currently neither systematic nor formalised. A more comprehensive approach to consultation is needed. Several initiatives have already been taken, suggesting that the importance of consultative mechanisms is now better appreciated.

Communication is vital to sustain public support for reform.

The goals and advantages of regulatory reform need to be communicated. Communication is also necessary to dispel the widespread belief that reform has been imposed by outsiders. The public should not therefore be neglected in the government's communication strategy.

Implementation and enforcement are just as important as the design of the new regulatory framework.

Turkey suffers major implementation and enforcement problems, particularly at the local level. The welcome focus that has started to be applied to this issue must be sustained.

Competition policy should be further integrated into the general policy framework.

Turkey is still in a state of transition, and competition policy is not yet fully integrated into general policy. The lack of public awareness about competition policy and institutions is indicative of the uncertain status of competition in Turkish public policy and debate. The Competition Authority should develop a stronger and more consistently applied advocacy role over the competitive effects of new policies: it is encouraging that all ministries must now take account of the Competition Board's opinion on relevant issues.

Foreign investment needs to be encouraged: it can make a major contribution to Turkey's development.

Increased Foreign Direct Investment (FDI) could play an important role in the development of a strong Turkish economy. Macroeconomic and political instability has limited the attractiveness of Turkey as a place to invest. Weaknesses in the regulatory environment are also an impediment, as indicated by a number of investor surveys. Administrative procedures are often lengthy and unpredictable, raising the costs and risks associated with investments.

In conclusion, regulatory reform is crucial but its context remains difficult, and it needs strong political leadership.

The context remains one of severe economic crisis, societal transition, and inadequate governance. But the need for reform is incontestable, and there is a growing understanding of what is required. The major reforms currently underway are encouraging, even if it is too early to judge long term success. The government must be alert to the risk that macroeconomic stabilisation measures do not crowd out the regulatory reform programme, which is just as important to restore and develop the economy. Progress will require continued strong political leadership. Remaining resistance to reform needs to be overcome, and ownership of reform established throughout the political and administrative structures.

PART I

Regulatory Reform in Turkey

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PART I

Chapter 1

Performance and Appraisal

Abstract. *Among the OECD countries, Turkey figures as a comparative latecomer to regulatory reform. Yet, there is a crucial need for it. Over the last three decades, the Turkish economy has suffered from macroeconomic instability and chronic inflation, with implications for both investment and growth. Governance and regulatory structures remained weak and contributed also to the 2001 economic crisis. Nonetheless, this review notes the highly encouraging efforts currently being undertaken to reform key economic sectors, the public administration and regulatory frameworks. These developments appear to mark a fundamental break with the past. Important elements, such as a clear competition policy, are already in place. Fighting corruption, among other measures, is high on the policy agenda, and constitutional amendments are reshaping the relationship between citizens and the state. The "depoliticisation" of the public sector and its renewal on a merit basis is underway. Future success will depend crucially on the continuing implementation of the programme. In particular, sustained political commitment is required well beyond the recovery from the recent crisis.*

Introduction

Work is underway to develop a stable, effective and durable market economy

The roots of Turkey's current reforms can be traced back to the 1980s. A state-directed and inwardly focused model of economic development served Turkey well in an earlier phase of its evolution, but was unsustainable and no longer adapted to Turkey's needs. The first reform agenda took important steps toward the development of a market economy: it opened the economy to international trade, opened up the capital account and increased the role of prices in the allocation of resources. But over time, it became evident that the agenda had to be much broader. It also needed to address deep-rooted fiscal problems, structural reforms including privatisation, and public sector institutional reforms. The aim of reducing the role of the state in the economy also requires the development of a new framework of regulation adapted to oversight rather than control of the country's economic resources. These issues are being addressed, in the wake of the 2000/2001 crisis, and appear to mark a more fundamental break relative to the reforms of the past. The transformation to a market economy driven by competition and a much larger role for an efficient private sector is accelerating.

But the Turkish economy remains in a critical state

The economy has suffered from macroeconomic instability and chronic inflation over the last three decades. The reforms of the last two decades failed to deliver durable solutions to fiscal problems, which reflect deeply rooted weaknesses in underlying governance. Turkey's problems have created major uncertainties in the economic environment, reduced investment and growth, and have caused regular crises, with large losses in national income. As a result, Turkey has not been able to close its per capita income gap with the rest of the OECD and the EU. With the highest population growth rate in the OECD and nearly a third of its population under 15 years old, a stronger future economic performance is not only desirable but essential. Boosting performance will help meet social welfare goals for the whole population. But it will require a sustained and long-term commitment.

The momentum for regulatory reform has increased, and must be sustained

Regulatory reform is crucial to the development of a well – functioning market economy. It can be expected to promote economic efficiency by removing barriers to competition and innovation. This increases competitiveness, productivity and long term growth, and frees up public resources for social expenditure (on health, education, and the environment for example).

Relative to the majority of OECD countries, Turkey has so far moved slowly in reforming its governance and regulatory framework. But the momentum for reform has now accelerated. The 1999 earthquakes demonstrated that ineffective governance (for example the failure to enforce building regulations) carried unacceptably high welfare costs. The deep financial and economic crises of 2000/2001 brought to light a number of important regulatory and institutional weaknesses which had not been addressed, and increased general awareness of the urgency of regulatory reform. Turkey's unsustainable fiscal and external imbalances have led to a new deal with the IMF, reached in January 2002, which involves further fiscal adjustment, a reduction in inflation in the context of a floating exchange rate policy, and a continuation of bank restructuring. The Central Bank is eventually to move to formal inflation targeting. These economic reforms need the support of effective governance and regulation.

The EU accession process is also important. Incorporation of the EU "*acquis communautaire*" (the adoption and implementation of the entire body of current EU legislation) is helping to shape the reform agenda, and provides a benchmark against which the reform process can be evaluated. This EU-based legislation must also be properly implemented and enforced, which requires effective administrative structures and legal systems, with trained and professional staff.

The pressure for regulatory reform must be nurtured within Turkey itself, so that it can be sustained in the years to come. The government now seems determined to pursue a comprehensive reform agenda, and a consensus appears to be in the making. There is an important and growing constituency for reform, including at the highest levels of government. But strong political and administrative resistance also remains. Reform involves a major redistribution of decision – making authority including the devolution of authority from ministries to independent regulatory agencies, and a necessary reduction of discretionary power. It is often difficult for those involved to give up this authority. Different ideological views also still remain about the best economic framework for promoting long term welfare.

The cost of delayed regulatory reform has been high

Regulatory reform has been slow to emerge on the list of priorities for action over the last few years (with some important exceptions, such as the establishment of a clear competition policy). Yet delays and failures in regulatory reform so far have incurred some particularly heavy costs. There is a close link between Turkey's macroeconomic performance and its weak governance and regulatory structures. An ineffective regulatory framework was responsible for problems in the banking sector that helped trigger the 2000/2001 financial crisis, causing huge welfare losses. The development of the electricity sector, which is closely tied to economic growth, has experienced major difficulties in the transition from state dominance to greater involvement by the private sector due to the absence, until recently, of an adequate regulatory policy. Weaknesses in attracting foreign investment can be linked to investor concerns over the regulatory environment as well as macroeconomic instability. The management of public finances has been marked by extreme waste in public expenditure, a lack of citizen orientation in the provision of public services, and a lack of transparency and accountability.

But the key principles of quality regulation are now being addressed

The success of regulatory reform will depend on the extent to which the government sustains political ownership of a comprehensive reform programme, and develops a clear overall strategy. Many in the government now appreciate that the *ad hoc* crisis driven reforms of the past are not enough. Reforms that tackle all the weaknesses of the current framework of governance are now an urgent matter. Political ownership needs to be backed up by an effective policy of communication, both within the government and with the general public and affected parties.

Some important elements of an appropriate regulatory management system are in place, and can be built on. Fighting corruption is an integral part of the agenda. In October 2001 Turkey implemented a range of constitutional amendments primarily addressing civil rights issues, and relations between citizens and the state. Transparency has been improved through concrete initiatives related to the EU accession process. Important reforms have been made to depoliticise public sector recruitment and place it on a merit basis. There are also new measures to improve budgetary transparency. These recent developments to promote better governance and regulation are most encouraging.

The macroeconomic context for regulatory reform

To understand some of the reasons for Turkey's economic position today, it is necessary to start with the policies that shaped the economy for fifty years before the changes to open up the economy in the 1980s. It is also useful to review the tradition of distributive politics, which has permeated Turkey's public institutions. Understanding these issues provides a basis for assessing the reforms which are needed to secure a strong future economy and ability to meet public policy goals.

Turkey started out with a statist approach to economic management

Turkey's economic policy framework from the 1930s until the reforms of the1980s may be characterised as import substitution industrialisation (ISI), a development model that was also used by other countries. It rested on an ideological vision called statism which assigned a leading role to the public sector in the economic development of the country. ISI promoted several key principles.

First, it was a regime that discouraged international trade and promoted a closed economy. The country was protected from imports through tariff and non-tariff barriers, and strict foreign exchange controls. There was a strong anti-export bias in the trade and exchange rate regime.

Second, public enterprises were made important tools of the development strategy. They were established in a wide range of sectors (including mining, manufacturing, energy, transport, communications and banking). They were expected to develop productive capacity in key industrial sectors, and to help reduce regional inequalities in income and employment. Some also acted as vehicles of agricultural policy and played an active role in the allocation of agricultural subsidies. Others were established in highly capital-intensive intermediate goods sectors: the price of their products was kept below inflation and costs so as to provide subsidised inputs to the private sector.

Third, monetary policy was subordinated to fiscal policy. The Central Bank was legally independent of the government, but in practice it accommodated the resource demands of the government and public enterprises and financed their deficits. It also acted as a semi-development bank and provided credit to the private sector. Money growth was higher than income growth (Table 1). The government and public enterprises took an increasing share of central bank credits. The banking system was heavily regulated: but this was

Table 1. **Selected macroeconomic indicators 1960-79**

	GNP growth (%)[1]	GNP per capita (USD)[2]	Investment (% in GDP)[2]	Current account (USD million)[2]	GNP deflator (% change)[1]	Growth of money supply (%)[1]	Central Bank Credit (% of total)[2]		
							Private sector	Budget	Public enterprise
1961-65	5.0	542[3]	17.0	–78	4.7	12.2	36.1	34.1	29.8
1966-70	6.8	519	22.2	–171	6.7	16.5	44.5	29.9	25.6
1971-75	7.7	1 205	21.5	–1 648	20.1	27.4	40.4	25.3	34.2
1976	7.7	1 338	24.6	–2 029	16.4	27.9	37.8	19.7	42.6
1977	3.9	1 488	25.9	–3 140	16.1	39.0	33.2	23.8	42.9
1978	3.5	1 604	22.6	–1 265	48.0	37.3	32.4	23.4	44.2
1979	1.3	1 760	21.0	–1 413	67.7	49.4	32.1	24.0	43.9

1. Average annual growth rate.
2. End of period.
3. 1968.

Source: Hale, 1982, Table 9.5; Kepenek, 1982, Table VII.2; SPO, 1997, Tables 1.4, 2.3, 3.10.

regulation to meet government needs (financial repression), rather than prudential regulation (which was inadequate and not effectively implemented). Thus interest rates were set by the government (as inflation accelerated in the 1970s, real interest rates became negative).

Import substitution did encourage significant capital accumulation and growth in GDP (between 1950 and 1977 the average growth rate was around 6%). The private sector, not surprisingly, flourished in the protective environment and from fiscal and financial subsidies, subsidised inputs from the state owned enterprises, and government contracts. The overvalued exchange rate and import regime encouraged the acquisition of imported capital goods and production for the domestic market. But these developments took place in an unsustainable context: a closed, highly protected economy, characterised by oligopolistic industrial structures, with very low levels of domestic or international competition.

There was also significant structural change. The share of agriculture in GDP declined from around 45% in 1950 to 25% in 1975. The share of industry increased from 12% to 22% in the same period.

Output grew, but capital accumulation, not productivity growth, was responsible for this. The contribution of Total Factor Productivity (TFP) to growth was actually negative (Table 2 below).

Table 2. **Growth accounting in private manufacturing (average percentage growth)**

	1970-76	1976-80	1980-88	1988-96
Value added	7.13	–7.64	9.77	9.33
Labour	24.24	13.26	11.83	2.95
Capital	180.26	45.66	24.01	65.91
TFP	–104.5	–158.92	64.16	31.14

Source: Filiztekin (2001).

The ISI regime could not last, based as it was on an overvalued exchange rate underpinned by exchange controls. Foreign debt and exchange problems developed. Foreign financing dried up in 1977 and a crisis erupted. At first, the government tried to resolve the crisis by administrative measures (including further exchange controls). A reform package was finally instituted in 1980. But a deepening political crisis led the way to a military take-over a few months later.

Significant reforms were implemented in the 1980s, starting Turkey on the path to a market economy

Significant reforms were introduced in the 1980s to re-establish macroeconomic stability. The changes started in 1980 with a major reform programme to open the economy to competition. The programme reduced subsidies and price controls (for example controls over the prices of state enterprise products were removed), liberalised the foreign exchange regime, deregulated interest rates and liberalised trade in encouraging a more sustainable private sector development and promotion of exports.

Restrictions on imports were progressively eliminated. Quota restrictions were virtually eliminated by 1985. The average real rate of import protection was reduced from 71% to 38% between 1983 and 1991. Exports were promoted by a policy of sustained real depreciation of the exchange rate and various tax rebates, credit subsidies and foreign exchange allocations that allowed for duty-free imports of intermediate goods and raw materials. The average effective rate of export subsidy amounted to around 20-23% in 1983, and was reduced to about 16% by 1986.[1]

Domestic financial markets were liberalised by lowering entry restrictions to the banking system, and by progressively eliminating controls on deposit interest rates. Citizens were allowed to hold foreign exchange deposits from 1984. In 1989, the capital account was liberalised and full convertibility of the lira introduced.

The initial response of the economy was favourable. Real GNP growth increased from –1% in 1980 to an average of 4-5% over the rest of the 1980s.

Trade liberalisation was, and remains, particularly successful

The most impressive development was in exports, with the export/GNP ratio jumping to 10-12% by the end of the 1980s. The composition of exports changed, with the share of manufactured goods in total exports increasing from about one quarter in 1980 to over 60% by the end of the 1980s.

A second major step after the liberalisation of the 1980s was the Customs Union with the EU, which became effective in January 1996. Following the agreement, Turkey eliminated tariffs on manufactured imports from the EU, adopted the EU common external tariff for manufactured products, and adopted its preferential trade regime (signing bilateral trade agreements with Central and Eastern European countries, the Baltic States, and Israel). As a result tariff barriers have significantly decreased, with the average MFN tariff declining from 26.7% in 1993 to 5% in 2001. However agricultural products have remained outside the scope of the Customs Union, and Turkey maintains high tariff rates on many agricultural products.

By 2000, exports and imports accounted for 40% of Turkish GDP, up from 9% in 1979 and 25% in 1993. The share of manufacturing in exports has increased to reach over 80%

in 2000. Trade with OECD countries, in particular European countries, has intensified since the late 1980s. In 2000, EU countries accounted for 54% of Turkish exports and 53% of imports.

But the reforms of the 1980s were not enough: an unworkable mix of state intervention and unregulated private activity was created

But the 1980s reforms did not lay the complete groundwork for a market economy. Turkey was now an open economy but the state continued to play a dominant role in key aspects of economic life. This approach could not be sustained either.

The central problem that arose was high public sector deficits. Turkey's fiscal policy and a distorted banking sector sowed the seeds of later crises. The opening of the capital account became a vehicle for financing public deficits via excessive bank borrowing abroad, which eventually led to the 1990s and early 2000s crises, as the banking system was deregulated without prudential reregulation. Even with debt-financed deficits, inflation was a problem as the Central Bank funded the debt via the banks, and also accommodated high inflation with its real exchange rate targeting policy. The distorted banking sector kept the financial system small and immature, incapable of sustaining the funding of the public sector deficit on its own, so that funding was dependent on foreign capital.

The 1980s reforms also paid little attention to the fact that the governance of a well-functioning market economy required well-functioning institutions, and an efficient and accountable system of government.

A deeply rooted tradition of distributive politics lay in the way of further reform

The management of demands on the state from different sections of society has been a crucial problem for Turkey in its efforts to move forward. It has deep roots in the country's economic and political development of the last few decades. The ISI regime – a regime that put the state at the centre of economic development – encouraged a populist political culture, which drew strength from Turkey's past. A central element of the traditional political culture in Turkey has been the idea of a "father state", an institution that guarantees the livelihood of a broad stratum of the population. Demands for redistribution and economic protection have therefore been seen as legitimate forms of political engagement.[2] This attitude has not only affected performance in the last two decades, but continues to influence today's economic, political and institutional relationships. Some of the issues raised below continue to raise problems today.

The focus of promoting public policy goals was lost

In practice, distributive politics meant that the state's intervention in the economy gradually lost its connection with well-defined and objectively pursued economic or social goals. Instead it was used to garner political support from different constituencies. Implicit and explicit transfers to a wide range of interest groups including farmers, public employees, industrialists, students and small enterprises were made. The means to this end included price and exchange controls, the allocation of subsidised credit, and regular amnesties granted to new city dwellers occupying government owned land (with disastrous consequences in the earthquakes of 1999).

Discretionary and arbitrary decision-making flourished

Discretionary and arbitrary decision-making flourished in this context. State enterprises were originally foreseen as instruments of sectoral and regional development. They soon became subject to political intervention, and were extensively used for non-developmental and non-commercial objectives.[3] Their managerial autonomy was restricted, prices were manipulated according to electoral cycles, and over-employment became widespread. In the 1980s, there was widespread arbitrariness in the design and allocation of export subsidies.[4] Unfortunately, the reforms of the 1980s further weakened rules in favour of discretion. To facilitate the financing of government priorities, governments resorted to the establishment of extra-budgetary funds, rather than reform and modernise the public financial management system.[5]

A tendency to favour shortcuts over institutional reform was also evident in governments' approach to public administration. Rather than reform public administration, governments centralised public decision-making.

Patronage replaced merit in public appointments, weakening public institutions

The legacy of this approach was that influence, control and patronage became more important than merit and the promotion of effective public policy. The process of government formation included negotiations over who would acquire control of key ministries and agencies, including public banks (the source of subsidies and employment), and key bodies responsible for macroeconomic and sectoral policy, such as the Treasury and the State Planning Organisation.

Budgetary institutions became especially weak, contributing to fiscal problems rather than containing them

Good budget management helps to ensure that allocation and redistribution objectives are achieved in a sustainable way. Effective institutions, rules and procedures are needed to contain pressures and prevent them from causing macroeconomic instability. Such a budgetary framework should minimise fiscal discretion and fragmentation, promote control by central government agencies responsible for fiscal policy, and promote transparency and accountability. Turkey failed to develop such a framework, with disastrous consequences.

The government could no longer keep track of expenditure

Rather than limiting the pressures of distributive politics on public resources, budgetary institutions evolved to accommodate them, not least through the development of a range of discretionary instruments for the allocation of public funds. The regular budget process ended up covering only a part of total government expenditure. This weakened aggregate fiscal discipline, and reduced controllability, accountability and transparency. The government became unable to track even the magnitude of off-budget expenditure. Thus, official statistics were not able to incorporate both public sector borrowing requirements and total liabilities of the public sector (Box 1).

Agricultural subsidies have been a particular fiscal burden, their scope and magnitude varying according to political pressures. Credit subsidies for agriculture and small and medium enterprises increased the fragility of the banking system prior to the 2000/2001

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crisis. Contingent liabilities (predominantly from the international borrowings of local governments, but also from long-term contracts for power generation) have also not been well monitored.

Nor could it easily prioritise: there was no evaluation

A second weakness of the budget system was that it did not provide information helpful to prioritisation. Budget preparation often took the form of incremental budgeting, in which the appropriations of previous years were increased incrementally, without evaluation. Prioritisation requires some evaluation of the impact of programmes. No such evaluations have been carried out. In particular, there has been no rigorous assessment of sectoral subsidy and transfer programmes. For example, a goal of agricultural policy is to protect poor farmers, but the policy's success has not been evaluated (a recent study concluded that agricultural policies were likely to have contributed to income inequality in the rural sector.

This also meant that budget cuts were inefficient: they generally started with public investment, and additional cuts were undertaken across the board, without any effort to target the less important programmes. This shows up in the excessive accumulation of investment projects relative to financing capacity, resulting in a significant amount of wasted resources on incomplete projects (Box 2). Public procurement was inefficient and corrupt.

Box 1. **Duty losses in public banks**

An important type of discretionary quasi-fiscal expenditures was subsidies for the agricultural sector and for small and medium enterprises (SMEs), provided through public banks. The costs of these subsidies were recorded as claims of public banks against the Treasury. Normally duty losses were eliminated by giving public banks so-called non-cash government securities, but towards the end of 1990s a large stock of unpaid duty losses accumulated. Duty losses were capitalised at very high interest rates. These high rates, in turn, were justified because the public banks carried out additional "duties" against which they did not have the legal authority to claim duty losses. Annual interest payments by the treasury against these claims were also sometimes done through non-cash government securities, which were also off-budget. As a result, official statistics underestimated both the extent of public sector deficits (by not recording the flows of subsidies or interest payments against accumulated duty losses) and the level of public debt (arising from non-securitised stock of duty losses). Between 1996-1999, public deficits arising from the annual flow of unpaid duty losses were 3.1, 3.0, 4.6 and 8.2% of GNP (OECD, 2001, Table 11). Interestingly, the flow and stock of duty losses were documented in reports by international organisations (*e.g.* IMF, 1998; IMF, 2000), but they were not explicitly recognised in the governments' Annual Programs.

Source: OECD (2000); Atiyas *et al.* (1999).

Budget control methods were outdated and external audits inadequate

The budget system relied on outdated methods of control. *Ex ante* controls on expenditure were excessively rigid, leaving little or no flexibility for managers to conduct their tasks or provide services efficiently. Partly to escape *ex ante* controls, many agencies established their own revolving funds, the revenues of which were not recorded in the budget. By contrast, *ex post* evaluation of performance was weak, and the system provided no incentives for agencies to improve their performance. External audit of public expenditures was inadequate.[6] And audits focus only on compliance, not on the efficiency and effectiveness of expenditure.

Persistently high public deficits characterised the 1990s and brought other problems in their wake

The weakness of budgetary institutions and procedures had a very direct and negative effect on the macroeconomic performance of the 1990s. The pressures of distributive politics and the inability of the political and administrative system to manage them were evident in the high public sector deficits that characterised the decade. As soon as political competition intensified, the public sector borrowing requirement (PSBR) rose. It went from about 5% of GNP in 1987 to 12% in 1993. With a temporary improvement in 1994-95, the PSBR continued to increase until 1999.

By the mid-1990s, Turkey was caught in a vicious cycle of debt dynamics. Governments' inability to resolve fundamental issues behind the fiscal problems sharply increased risk premiums and real interest rates for government debt. An increasingly large part of government expenditure went on interest payments for existing debt. The use of discretionary off-budget instruments increased in the second half of the 1990s.

Box 2. **Inefficiencies in investment budgeting**

An important problem in public investment projects in Turkey is *over-programming*, that is, initiating an excessive number of investment projects relative to financial resource availability. One indicator of ineffective screening is the time-to-completion of ongoing projects. According to a recent report by the World Bank, in 1994, it could be estimated that then-current portfolio of projects could be completed in 6 years. Over 1995-1999, 3 455 new projects were initiated. By the end of this period, the public investment program consisted of 5 321 projects with an estimated cost of USD 150 billion and an unfinished balance of 105 billion. SPO has estimated that the current portfolio would take 20 *years* to complete. One problem is that many project get started because of political pressure even though fiscal resources for its completion is not available. Another problem is that as projects are delayed, the estimates of costs of projects are revised upwards. According to the World Bank report, the contracting mechanism actually provides incentives for delays and increases in costs. Both problems cause significant amounts of waste. Currently SPO is in the process of screening and reducing the stock of projects.

Source: World Bank (2001b).

Fundamental fiscal reforms should have been made at this stage, but were not, which led to serious repercussions

Both the composition of the PSBR, and the presence of large off-budget items, meant that the fiscal problem could not be solved by simple retrenchment (squeezing public sector salaries and cutting public investment). The only way out was to address the underlying issues: institutional and structural reforms to straighten out and strengthen fiscal management and contain distributive pressures. But this did not happen. As noted below this had a number of serious consequences.

The quality of the civil service suffered

A particular vicious circle was set in motion, which further weakened the civil service. Personnel takes an important share of public expenditure. Fiscal adjustments have therefore often entailed salary caps. But public sector salaries are already very low, and this prevents the public sector from attracting qualified staff Overstaffing also made it difficult to bring in new personnel. Job security in the civil service was guaranteed. Fundamental civil service reform was the solution, but this eluded the government.

The banking sector was badly distorted by the failure to reform, and increasingly exposed

As noted, the high borrowing requirements of the public sector combined with capital account liberalisation and inadequate prudential regulation had already distorted the banking system and this continued. The banking sector grew rapidly the 1990s (total assets of private banks grew from 21% of GNP in 1991 to 39% in 2000). But its main focus remained government securities. Banks borrowed internationally at low interest rates and invested in government securities at high interest rates. Though there were limits on banks' "open positions", inadequate prudential regulation allowed banks to circumvent these by using off-shore accounts. The banking system became increasingly vulnerable. Another serious effect of the distortion was the limited flow of funds to the private sector. With most of its attention focused on the public sector, the contribution of the banking system to private investment formation was low. What lending took place was often to related parties (most banks were part of large industrial holdings while bank licensing was heavily politicised).

Monetary policy was also distorted by the need to manage high public deficits

The high public deficits shaped monetary policy, which continued (as in the past) to be subordinated to fiscal policy. The main concern of the Central Bank in the 1990s was increasingly to maintain stability in financial and foreign exchange markets, rather than to reduce inflation. Given the constraints of an open capital account, fiscal deficits and high inflation, the Bank followed a "real exchange rule" whereby the real exchange rate was kept roughly constant, and tried to minimise the burden of high interest rates on the financial system by providing liquidity in the event of sudden liquidity crunches. Liquidity was provided through reserve accumulation, and open market operations were used sparingly as necessary. This policy could be pursued as long as capital inflows were positive and the banking system was willing to roll over domestic debt.

An important accord between the Central Bank and the Treasury in 1999 was intended to eliminate direct monetisation of the deficit, but had little practical effect.

A heavy price was paid: chronic inflation

There were also dramatic consequences in terms of high and persistent inflation. While the switch to debt-financing of deficits weakened the link between deficits and inflation, chronic inflation could not be eliminated without a sustainable resolution of the fiscal problem. By the end of the 1990s, it was clear that the debt dynamics were unsustainable. An attempt at stabilisation in 1998 was cut short by the emerging market crisis that followed the Russian default in 1998. In 1999 a relatively stable coalition government was formed. That created an opportunity to launch another reform programme.

Further reforms in 1999 tried, but failed again, to stabilise the economy

In 1999 Turkey launched an ambitious programme of exchange-rate based macroeconomic stabilisation supported by the World Bank and a stand-by agreement with the IMF. The goal was to bring down inflation from over 65% in 1999 to 12% by the end of 2001. A "crawling peg" exchange rate policy was adopted which linked the exchange rate to inflation targets. Monetary policy was now exclusively based on capital flows and the consequent adjustment of interest rates to maintain equilibrium in financial markets. Fiscal targets were tightened. Structural reforms in agriculture, social security, fiscal management, and the banking system were also planned, as well as a privatisation programme to help achieve fiscal targets.

But the plan went astray. Delays in reaching inflation targets led to a real appreciation of the currency. This together with a rapid decline in interest rates created a consumption and import boom, resulting in a higher than expected increase in the current account deficit. The programme had envisaged a current account deficit of about 1.5-2% of GNP in 2000. In fact, by the end of 2001 it was 4.9%. The privatisation programme was delayed. International investors became nervous and capital flowed out of the country. A banking crisis erupted in November 2000 and was followed by a collapse of the exchange rate regime in February 2001.

The failure to regulate the banking system effectively played a key role in the failure of the programme. With the launch of the programme, the banks responded to new profit opportunities and increased their exposure to foreign exchange, interest rate and liquidity risk. But they did not have the systems to deal with these risks. In the nine months after the start of the programme, the banks' open position was estimated to have increased by USD 10 billion.[7]

In addition, public banks faced serious short-term liquidity problems due to the off-budget debt (duty losses) that had built up and the failure to resolve the problems of the banks taken over by the SDIF which were running heavy losses throughout 2000. With no restructuring plan in sight, and with the Central Bank now prevented from acting as lender of last resort under its strict monetary rule, they resorted to the volatile overnight markets to solve liquidity problems. This further increased fragility in the financial system and bid up interest rates.

The regulatory framework existed in principle, with the newly formed Banking Regulation and Supervision Agency (BRSA). But key supervision and restructuring measures were seriously delayed, because of delays in appointments to the BRSA board, and other staffing problems. By the time the BRSA was operational, at end-August it was too late.

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The crisis of 2000/2001 has at last promoted a more broadly based reform programme

This latest crisis has forced a fundamental change of strategy in respect of key issues, compared with the reforms that had taken place since the 1980s. The government has put together a new programme ("Program of Transition to a Strong Economy"). This addresses reform of the financial sector, public finance reform, and a new monetary policy geared to a flexible exchange rate regime which is ultimately based on price stability. It is in this last respect that the break with the past is most evident: monetary policy is no longer subordinate to fiscal policy, which is itself the subject of far-reaching reforms. The government has also launched stronger efforts at structural, institutional and regulatory reform than have been attempted so far.

Banking sector regulation, fiscal management and monetary policy are being overhauled

The banking sector has been restructured and reregulated

The Banks Act, adopted in 1999, had already established the BRSA as an independent authority responsible for the supervision and regulation of the banking sector. The formation of the BRSA, delays notwithstanding, was a great improvement in the regulation of the banking system and brought Turkey closer to international (especially EU) norms (see Box 3). Regulation until then had been carried out by the Treasury. Major decisions, such as requiring banks to strengthen their capital or forcing them into liquidation, required the Treasury minister's approval, creating a potential for inaction as such decisions could be politically unpopular.[8]

But an immediate concern was to address the deterioration of bank balance sheets and the mounting problem of non-performing loans in the wake of the crisis. A target was set for all private banks to achieve a capital adequacy ratio of at least 8% by the end of 2001. But it became quickly apparent that private capital injections were going to be insufficient to strengthen the capital base of the banking system. To meet capital requirements, banks were going to have to downsize and further reduce lending to the private sector. In addition, the ratio of non-performing loans accelerated in the second half of 2001. Under a new initiative, it has been decided to provide public capital support to solvent banks, following a rigorous evaluation of bank portfolios. Efforts are also under way to develop a systemic approach for the resolution of distressed loans on a voluntary basis through out-of-court arrangements between banks and major corporate debtors.

The public banks, which as noted, faced severe liquidity and solvency problems, were also given attention. They and the SDIF banks were recapitalised by the Treasury. This had the effect of doubling the domestic debt in 2001, but against a background of far greater transparency than had existed before.

Regulatory reform of the private banking system was complemented by measures to enhance transparency and reduce governmental discretion over the quasi-fiscal operations of public banks. In an important step, a Cabinet decree cancelled all regulations and laws that cause duty losses on public banks. Subsidies from public banks now have to be financed by prior appropriations through the budget. In addition, an independent Governing Board has been appointed for public banks. The next step is operational restructuring to prepare for privatisation. Resolution of the bad SDIF banks though sales, liquidations and mergers is another important component of ongoing bank reform. There has been a significant reduction in bank branches and staff of both the public and SDIF banks.

The reforms have had a positive impact on market outcomes. The removal of the public banks from overnight markets has eased liquidity pressures in the system and contributed to the decline in interest rates. However, restructuring in the private banking system is still in progress. Credit is still scarce and the problem of non-performing loans needs to be resolved to free financial resources for the private sector. Resolution of the bad SDIF banks is another important component of ongoing bank reform. Currently, the problem of non performing loans is being addressed within the context of a voluntary approach (the so-called "Istanbul Approach") to enable restructuring of the corporate debts to the financial sector. In late May, a Framework Agreement was signed by the financial institutions and on June 4, the agreement was approved by the BRSA. Regarding the SDIF banks among the 19 intervened banks since 1999, 15 have been resolved, 2 are in the process of being sold, one

Box 3. **Banking system regulation**

Capital Adequacy: The Banks Act authorised the BRSA to determine capital adequacy ratios. The BRSA, in turn, issued a regulation on the measurement and assessment of capital adequacy of banks in February 2001, requiring banks to maintain a minimum of 8% of capital adequacy standard ratio, both on an unconsolidated and consolidated (that is, together with financial subsidiaries) basis. The BRSA has pledged that banks will be required to reach that minimum ratio by December 2001. The regulation also stipulates that capital adequacy ratios will incorporate various forms of market risk on a solo basis by January 2002 and consolidated basis by June 2002. Given the growing problem of non-performing loans, however, private bank portfolios have been rigorously re-evaluated in early 2002, to be followed by equity injections by shareholders and subordinated debt investments by the SDIF in viable banks.

Loan Loss Provisioning: The tax deductibility of loan loss provisions has been clarified and extended. A regulation by the BRSA (June 2001) has specified rules to be followed for provisioning: Loans and receivables are classified under 5 groups according to collectability, and different provisioning ratios have been specified for each group.

Connected lending and exposure limits: Exposure limits have been set taking into account both direct and indirect lending and risk groups have been defined. Connected lending is treated separately from equity exposure in non-financial entities. New limits consistent with EU regulations have been imposed on non-financial equity exposure. Banks are required to be in full compliance with these new limits by 2009.

Internal audit and risk management: A BRSA regulation (February 2001) provides guidelines to banks on implementing internal audit and risk management systems and requires banks to establish such systems by January 2002.

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is kept as a bridge bank and the resolution process of another bank is been halted by courts. However, restructuring in the private banking system is still in progress.

But the challenges are also longer term, not least in terms of increasing the volume of private investment in the economy. The domination of government securities means that banks have not yet developed the skills necessary to evaluate a wide range of private sector investment projects. Credit rationing is extensive and a large majority of firms currently have to rely on internally generated resources to finance their investments.

The framework for the management of public finance is being strengthened

The government has gone a long way to address fundamental weaknesses in this area. It has set three main objectives: strengthening aggregate fiscal management, building capacity for policy decisions, and improving operational performance.

Under the first objective the aim is to expand the scope of the budget so as to provide information on the entire public sector. The accounting law will be revised to cover all government agencies, with full implementation of accrual accounting in 2003. Implementing a medium term expenditure framework is also planned. Finally, the budget will be accompanied by a two-year macro-fiscal framework.

Under the second objective, line ministries will be invited to initiate policy reviews and prepare statements of objectives that will be considered during the preparation of the budget. Ministry capacities to do this will be enhanced. The Cabinet will decide on policy priorities, and ensure appropriate funding for high priority policy areas.

Under the third objective, agencies will be given more flexibility in budget implementation, in return for a commitment to improve performance. A set of 3-6 agencies has been selected as pilots. A crucial step here is to reduce *ex ante* controls by the Ministry of Finance, and devolve internal control functions to ministries, once new internal control standards have been set. Once agencies establish their own internal control mechanisms, the budget will appropriate funds to these agencies in "block" form, taking performance criteria as basis, allowing them more discretion in the use of funds. Meanwhile the Ministry of Finance's capacity will be developed to monitor agency outputs and evaluate the effective use of resources.

These reforms need to be vigorously pursued, and in some respects, taken further. There is a need to strengthen external auditing arrangements. Reform of local government is critical. This has been stalled in Parliament for years. But it is the level at which many regulations are implemented, and where corruption and incompetence particularly rooted. Local government expenditure should be brought within the definition of the public sector for accounting purposes.

A new law makes price stability the main objective of the Central Bank

Law 4651 (April 2001) introduced several amendments to the Central Bank Law (CBL). In line with the norms of the Economic and Monetary Union of the EU, the law stipulates that the primary objective of the Central Bank is to achieve and maintain price stability. The Bank is expected to support the growth and employment policies of the government only if they do not contradict the objective of price stability. The amended CBL prohibits the Bank from granting credit to the Treasury and the public sector as a whole. It also bans the Bank from buying the Treasury's debt instruments from the primary markets.

The amended CBL authorises the Bank to independently identify and control monetary policy instruments. The Bank is instructed to determine inflation targets with the government. The Bank then determines monetary policy that is consistent with that target. The Bank alone is authorised and responsible for the application of monetary policy. These provisions are regarded as granting the Bank instrumental independence.

To enhance the transparency and accountability of the Bank, the Law requires an external audit of its accounts. In addition, the Bank must provide reports to the Council of Ministers on its activities and on monetary policy (in April and October of every year). It is also required to brief the Planning and Budget Commission of the Turkish Grand National Assembly. In addition, it must prepare periodic reports on monetary policy targets and applications and make them publicly available. If policy targets are missed, the Bank is required to report to the government (in writing) the reasons for this, and the measures to be taken. This report is to be made public.

The new law makes significant progress in establishing the independence of the Bank as well as making it more accountable. However, as also stated in the 2001 Regular Report on Turkey's Progress Towards Accession, further measures are needed to align the Central Bank law with the acquis. The Central Bank law is incompatible with the acquis as far as the determination of the inflation target is concerned, since this is decided upon in agreement with the Government. Moreover, its actual independence is still constrained by the current macroeconomic environment and concerns about the sustainability of the public debt. Conditions for true independence may only mature once significant progress is achieved in fiscal adjustment and reform.

This may take some time. Net public sector debt increased from 57% at the end of 2000 to 92% a year later (as noted, because of the capitalisation of public bank losses). Dealing with this will require a sequence of annual primary surpluses. However there is one critical difference compared with the past: previously hidden public sector liabilities are (at last) transparent and recognised.

The Bank has committed itself not to intervene to the foreign exchange market except to smooth transitory and excess volatility in the foreign exchange market. It will be conducting a reserve money programme, and is expected to move to formal inflation targeting once "preconditions" are met. This will require a long-term commitment to resolve the fiscal and public debt problem, a well capitalised banking system and a general high level of confidence about economic management and reform capacity of the government. Inflation targeting will also require a technical infrastructure (for example high quality macro-modelling).

But institutional and tax reforms also need to be taken forward

Success will also critically depend on addressing the institutional weaknesses that have underlined the fiscal problems of the last two decades. The adoption of the new Public Procurement Law in January 2002 is an important step. Tax reform is also envisaged, including a reorganisation of tax administration. Although the implementation of the personal tax identification number has improved the effectiveness of tax collection, evasion of taxes continues to be widespread in the industrial and business sector. Tax reform is essential to bring Turkey's informal economy (estimated at 50% of the total economy) into the formal economy, which will widen the tax base and lower the tax rate, boosting growth. Civil service reforms to increase efficiency and to avoid misuse of the resources reduce waste in the public sector are also critical.

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Foreign investment needs to be encouraged: it can make a major contribution to Turkey's development

The experience of central European countries over the past decade demonstrates that foreign investment (FDI) can make a significant contribution to economic restructuring and modernisation. Foreign investors bring capital, technology, expertise and management know-how, raising productivity and increasing innovation. Increased FDI could play an especially important role in the development of a strong Turkish economy. Turkey has been over-dependent on capital inflows that were channelled (via the banking system) to the financing of government debt, leaving the country vulnerable to shifts in investor sentiment, and hence crisis-prone. FDI provides a much sounder basis for helping long-term growth and stability because it is tied directly to investment and growth, within a longer timeframe.

But progress in economic and political stability is crucial. FDI into Turkey has remained low despite a world-wide surge in the 1990s. It increased somewhat in the 1980s, following the liberalisation implemented at the beginning of the decade, but growth stopped in the 1990s, with inflows averaging less than 0.5% of GDP.

Inflows of FDI in the service sector have remained at low levels, with limited foreign involvement in the banking or utility sectors. FDI is more significant in the manufacturing sector, particularly among large firms. Foreign companies account for 37% of total exports and 20% of employment among the 500 largest firms in Turkey.

This performance is disappointing in relation to Turkey's potential. Geographically, its strategic location between Europe, the Middle East and Asia makes it an economic gateway for the region (in particular given the Customs Union with the EU). The country also offers a potentially large domestic market, abundant skilled labour, high-quality suppliers and a dynamic entrepreneurial sector.

Turkey has had generally liberal foreign investment legislation since the 1950s, and a major obstacle to foreign investment was removed with the establishment of full currency convertibility in 1989. However, macroeconomic instability, with sporadic growth and high inflation, has limited the attractiveness of Turkey as a place to invest. Political instability, leading to frequent unexpected policy changes and slow implementation of structural reforms, has also been a factor. Weaknesses in the regulatory environment are also an impediment, as indicated by a number of investor surveys. Administrative procedures are often lengthy and unpredictable, raising the costs and risks associated with investments. Restrictions concerning foreign investment in various sectors are still in place and the current authorisation system for investment is not in conformity with the relevant EU acquis. Turkey has recently issued a decree establishing Committees to work on the reduction of such administrative barriers, and a draft law on Foreign Direct Investment is being signed by the Council of Ministers and will be submitted to Parliament soon.

The transition to a market economy is not yet completed, and the state must withdraw further

Last but not least, Turkey must complete the transition from a state-led economy to an innovative and entrepreneurial economy, driven by the market and civil society. Reforms and restructuring are moving the economy towards greater reliance on markets signals and competition. But privatisation appears to have slowed or stalled in 2001 due to domestic and global economic crisis. Total proceedings from the 2001 privatisation program have been 120 million US Dollars. However, 2002-2003 privatisation program has set ambitious targets in the framework of the ongoing economic recovery program. The state enterprise sector remains very large. For example, state banking still accounts for one third of the whole banking sector though there have been attempts to restructure the state banks. Productivity is very low in the public sector compared with the private sector and staffing needs to be reduced. The government stills interferes extensively in price setting.

The strengths and successes of regulatory reform

There is growing awareness of the importance of reform, and support for it

The depth of the current economic crisis and the prospect of EU accession create a highly favourable climate for regulatory reform in Turkey. Economic crisis has exposed substantial weaknesses in the Turkish public administration. It has become clear that comprehensive reforms are urgently needed to address regulatory institutions and practices that are outdated, incoherent, ineffectively managed, and undermined by lack of trust in government, wide-spread non-compliance and in some cases corruption. It is also now generally recognised that tight monetary and fiscal policies cannot be implemented so long as severe governance weaknesses persist.

In short, there is growing political will to confront the grave governance issues that have contributed to the crisis. Major initiatives have already been launched. Prospects at this stage appear to be encouraging. Some important elements of an effective regulatory management system are already in place, and lessons from positive reform measures are emerging. For example, basic mechanisms are already in place for consultation within government. These could be developed to involve more stakeholders and incorporate quality checks. The apparent success of the programme to manage public sector recruitment on a merit basis demonstrates that – provided there is continued strong political support – results can be achieved, despite strong opposition.

Progress is underway to reform the public administration

Alongside the recent economic reforms, significant progress has been made in laying the groundwork for reform of the public administration. Turkey's first challenge is to build up an effective, accountable and merit-based public administration, without which further development of an effective regulatory management system has no chance of long term success. A skilled, well-trained, impartial and respected civil service is the necessary starting point. Administrative capacities also have to be strengthened to ensure an effective implementation and enforcement of the EU acquis.

It is therefore very encouraging that recent reforms to improve public administration capacities have been made, and that additional reforms are under way. They include improving transparency through constitutional reforms, initiatives to fight corruption, reforms to depoliticise public sector recruitment and place it on a merit basis (rather than patronage or influence) and new measures to improve budgetary transparency and the performance of the administration.

Until 1999, recruitment of new civil servants was based on examinations held by the recruiting agency or ministry. Evaluation of examination results was not considered sufficiently clear and objective, sometimes leading to favouritism in recruitment. This "flexibility" in employment criteria, combined with very weak central budgetary mechanisms to control the staffing arrangements of agencies and departments, provided ample opportunities for abusive practices in public sector employment, fostering clientelism.

In 1999 a set of new recruitment rules and criteria for the public sector were introduced to improve central government's ability to monitor and control the level of new employment throughout government, and to introduce homogenous test and evaluation criteria for the employment of civil servants (Box 4).

Central government agencies are, without exception, covered by these new recruitment mechanisms. This is quite an achievement, because powerful ministries often succeed in lobbying for "necessary" flexibility. The explanation for this apparent success can be put down, not least, to strong and continued support from the very top of the Turkish government. This underlines the crucial importance of high level support for regulatory reforms.

A clearer regulatory management system and principles are emerging

Some important elements of an appropriate regulatory management system are already in place, and can be built on to strengthen and expand regulatory reform capacities. It is true that Turkey's current regulatory capacities compared with the OECD principles (Box 5) show there is some way to go.

Box 4. **New public service recruitment initiatives**

The new recruitment rules and criteria have two purposes: First, to improve central government's possibilities to monitor and control the number of new employment throughout government. Second, to introduce homogenous test and evaluation criteria for employment of civil servants. This recruitment, personnel allocation and monitoring system works as follows:

1. Candidates take a general exam prepared by the Central Exam Unit (OSYM), an independent body attached to the Higher Education Council. Exams are intended to be held biannually (but since 1999 only one has taken place).
2. Individual agencies and departments send requests for new staff to the State Personnel Department (staff request organised according to centralised skills categories).
3. Based on the requests and in some cases additional information gathering and negotiation with the Personnel Department, the State Personnel Department allocates new staff slots to the applicant agencies and ministries.
4. The State Personnel Department publishes all vacancies.
5. Candidates with the relevant exam apply for the vacancies to the State Personnel Department, who allocates candidates to vacancies according to an electronic system matching candidates' skills and exam scores with the requested skills profile.

But Turkey's recent record of new laws and regulations to promote a more effective regulatory management system is nonetheless impressive, given the difficult starting point (Table 3).

Examples of the efforts that are now being made include a stronger and critical focus applied to governance structures and practices. Fighting corruption is an integral part of many programmes as well as the focus of several dedicated projects. An anti-corruption steering committee made up of senior civil servants from key ministries was set up in July 2001, with the aim of preparing a comprehensive plan to fight corruption (building on a 2000 law that had already facilitated the prosecution of civil servants on charges of corruption). In 2001 Turkey signed three conventions of the Council of Europe on money laundering and the fight against corruption. On February 2002, the Council of Ministers adopted a strategy for increasing transparency and combating rent-seeking activities. In particular, it established a Steering Group for Public Sector Reform to implement a transparency and good governance plan. 2001 also saw the implementation of a range of constitutional amendments aimed at liberal rights issues and relations between citizens and the state (for example facilitating citizens' access to the judicial system).

The aim of accession to the EU has generated a set of important reform initiatives

Turkey has had an Association Agreement with the EU since 1964, and entered a customs union in 1996. In 1999 the European Council recognised Turkey as a candidate for

Box 5. **Good practices for improving the capacities of national administration to assure high quality regulation**

The OECD Report on Regulatory Reform, welcomed by Ministers in May 1997, includes a co-ordinated set of strategies for improving regulatory quality, many of which were based on the 1995 Recommendation of the OECD Council on Improving the Quality of Government Regulation. These form the basis of the analysis undertaken in this report, and are reproduced below:

A. BUILDING A REGULATORY MANAGEMENT SYSTEM

1. Adopt regulatory reform policy at the highest political levels
2. Establish explicit standards for regulatory quality and principles of regulatory decision-making
3. Build regulatory management capacities

B. IMPROVING THE QUALITY OF NEW REGULATIONS

1. Regulatory Impact Analysis
2. Systematic public consultation procedures with affected interests
3. Using alternatives to regulation
4. Improving regulatory co-ordination

C. UPGRADING THE QUALITY OF EXISTING REGULATIONS

(in addition to the strategies listed above)

1. Reviewing and updating existing regulations
2. Reducing red tape and government formalities

Table 3. **Selected reform legislation relating to regulatory reform in Turkey**

Law 2872/1983	Environment impact assessment mandatory for major water infrastructure projects
Law 3628/1990	Disclosure of personal assets of persons holding senior positions in state owned enterprises
Law 4054/1994	Foundation of the Competition Authority
Circular 14821/1998	Obligation for regulators to obtain the opinion of the Competition Authority in regulations affecting issues under the Competition Board's responsibilities
Law 4457/1999	Foundation of the Turkish Accreditation Institution
Law 4491/1999	Foundation of the Banking Regulation and Supervision Agency
By-law, 1999	Objective criteria for the appointment and promotion of public personnel
Cabinet decree, 1999/12770	Specification of the maximum number of public personnel in public organisations
Law 4502/2000	Foundation of the Telecommunications Authority
Law 4587/2000	Foundation of the General Secretary of European Union Relations
By-law, 2000	Basic principles and definitions of public sector staff categories
Law 4628-4646/2001	Partial liberalisation of and competition on the electricity markets. Foundation of the Energy Market Regulatory Board
Law 4634/2001	Partial liberalisation of and competition on the Turkish sugar market
Law 4640/2001	Improving transparency and efficiency of public expenditure management
Law 4647/2001	Partial liberalisation of and competition on the Turkish civil aviation market
Law 4641/2001	Re-establishment (by law) of the Economic and Social Council
Law 4673/2001	Permission to the Government to the sell more than 51% of Turkish Telecom Corporation
Laws 4629/2001 and 4684/2001	Closure of budgetary and extra-budgetary funds in order to improve budgetary transparency
Law 4709/2001	Amendments of 33 articles of the Constitution, two thereof with a view to improve access and transparency of the judicial system
Law 4733/2002	Foundation of The Tobacco, Tobacco Products and Alcoholic Beverages Market Regulation Board
Law 4734/2002	Foundation of Public Procurement Authority
Law 4749/2002	Law on Public Debt Management

Source: OECD.

accession. Joining the EU has become one of Turkey's highest political priorities, and is a major force in shaping regulatory reform to promote high quality regulation, so that it can meet the accession criteria. Important initiatives in regulatory and other reforms have been launched in this context (Box 6).

Progress is underway to improve the effectiveness of regulatory agencies

As in many OECD countries, the establishment of new independent sectoral regulators, and the remodelling of existing ones has been a key element of Turkey's recent structural and regulatory reforms. Turkey has increasingly favoured the "independent regulator" model as part of a strategy to separate ownership, policy development and day-to-day regulatory overview in liberalised sectors. Such agencies are particularly important in Turkey's environment, to ensure impartial and effective regulation isolated from political influence.

Turkey's sectoral regulators are established by specific legislation which defines their remit, objectives and powers. They are generally accountable to Parliament. They produce annual reports (though these do not have to be made public – this should be strongly considered). They are generally independent from the government budget and are funded from licence fees, permits and levies. It is a little early to assess performance of the most recent regulators, but the principles on which they are based are generally sound, and show a strong commitment by the government to establish independent and effective regulatory bodies (Table 4). That said (and as noted later) there have been problems in the appointment of regulatory agency board members; there should be continued attention to safeguarding the independence of the sectoral regulators.

In the network industries, high quality regulation requires agencies which are well equipped with expert human capital. Honesty and independence from political influence are paramount, but skills and expertise are also important. Entrance exams for most of

Box 6. **Main initiatives and commitments of the National Programme for the Adoption of the Acquis**

- The development of a draft law on public procurement, ensuring more transparency and competition.
- Commitment to establish an independent legal or administrative institution to consider complaints and to settle disputes in public procurement.
- Establishment of 12 specialised courts to provide expertise in the settlement of disputes on intellectual and industrial property rights. A Specialised Court for Intellectual and Industrial Property Rights has been established in the province of Istanbul.
- Commitment to establish (or strengthen) a range of supervisory or independent authorities and boards such as the Turkish Accreditation Authority (TÜRKAK), a Regulating Marketing Board on Tobacco, Tobacco Products and Alcoholic Beverages, Market Regulation Board, the State Aid Monitoring Authority *(to be established)*, the Telecommunication Regulatory Authority, the Banking Surveillance and Regulatory Authority and the Energy Market Regulatory Authority.
- Commitment to establish adequate administrative infrastructures to support reporting requirements under the Common Agricultural Policy and other heavy reporting areas such as fishery and statistics. As a first step, studies on the current infrastructure will be undertaken.
- Commitment to revise and simplify the complex structure of the current legislation on state aid, support to enterprises in complying with EU policies, and development of supporting technological infrastructure for enterprises.
- Acceleration of work on administrative reform in the field of justice and home affairs and strengthening of co-ordination between competent ministries and other public institutions.
- Strengthening the Economic and Social Council.

Table 4. **Turkey's major regulatory institutions**

Board/regulator	Laws/year	Sectors	Task	Powers	Selection of the executive board	Resources/funding
Competition board	Law 4054/1994 (operative 1997)	All	Supervise and prevent agreements, decisions and practices which prevent, restrict or distort competition within the markets for goods and services. Control of mergers and acquisitions	Administrative, supervision, rule-making	Government selection. (The Council of Ministers appoints the members of the Board from among the two candidates that will be nominated for each vacant post by several institutions either from inside or outside these institutions)	General fees, government budget, fines publication revenues No. of staff: 315
Banking regulation and supervision agency	Law 4389/1999 (operative in 2000)	Banking	General competence on enforcement of the New Banking Law. Enhancing efficiency, confidence and transparency of the Banking Sector and ensuring efficient functioning of the credit system. The Agency is obliged and authorised to prevent any actions which could jeopardise rights of depositors and a regular and secure operation of banks	Supervision, rule-making	Government selection (The Council of Ministers appoints the members of the Board)	General fees paid by companies in the banking sector No. of staff: 323
Telecommunication board	Law 4502/2000	Telecommunications	The Telecommunications Authority *i)* sets the administrative, financial and technical regulations pertaining to telecommunication; *ii)* performs follow-up function for these regulations; *iii)* issues technical standards and test equipment in accordance with these standards; *iv)* implements administrative and financial measures to those who break the rules and regulations	Administrative, supervision, rule-making	Government selection (The Council of Ministers appoints the members of the Board)	Contribution to the administrative testing fees, revenue from sales of publications, consultancy fees, fines and government budget No. of staff: 422
Energy market regulatory board	Law 4628 and 4646/2001	Electric energy and natural gas	Ensuring the formation of electric energy and natural gas markets which are financially robust, transparent and operate in accordance with provisions of private law in a competitive market environment. Achieving a stable supply of adequate, good quality, cheap and environment-friendly electric energy, and ensuring autonomous regulation and supervision of these markets	Administrative, supervision, rule-making	Government selection (The Council of Ministers appoints the members of the Board)	Licence fees, transmission tariffs, administrative fines, publication revenues No. of staff: 426

Table 4. **Turkey's major regulatory institutions** *(cont.)*

Board/regulator	Laws/year	Sectors	Task	Powers	Selection of the executive board	Resources/funding
Capital markets board	Law 2499/1982	Capital markets	Regulates and supervises the capital markets and protects the rights and benefits of investors	Administrative, supervision, rule-making, adjudication	Government selection (The Council of Ministers appoints the members of the Board)	Fees based on the registered amount of securities, and on the income of the Exchanges No. of staff: 390
Radio and television Supreme Council	Law 3984/1994	Radio and TV broad-casting	Competence on regulation of radio and television broadcasting	Administrative, supervision, rule-making	Parliament selection (The supreme Council is composed of 9 members, 5 of them is selected from candidates of majority parties, 4 from candidates of opposition parties)	Revenue from advertising, broadcasting permit and licence fees, Government budget No. of staff: 337
Sugar board	Law 4634/2001	Sugar, starch based sweete-ners	General competence on enforcement of the new Sugar Law and other related regulations. Supervision of enforcement	Administrative, supervision, rule-making	Government selection (The Council of Ministers)	Levies (on the sale of sugar)
The tobacco, tobacco products and alcoholic beverages market regulation board	Law 4733/2002 (not yet operative)	Tobacco, tobacco products and alcoholic beverages	General competence on enforcement of the new Law and other related regulations. Supervision of enforcement, co-operation with national and international organisations	Administrative supervision, rule-making	Government selection (The Council of Ministers)	Levies (on the sale of tobacco, tobacco products and alcoholic beverages), licences fees, administrative fines
Public procurement board	Law 4734/2002 (not yet operative)	All public sector	Examines the complaint about all public procurements; Prepares all regulations related with public procurement; Co-ordinates public procurements	Administrative supervision, rule-making	Government selection (The Council of Ministers)	Contracts fees, revenues from publication and government budget

Source: OECD.

these agencies have been prepared or certified by the Central Exam Unit of the Higher Education Council (associated to the State Personnel Department). Other simple measures could also be taken to ensure high quality appointments and to increase trust in these new institutions. Staff salaries must also be high enough to attract qualified personnel.

A clear and reasonably effective competition policy has been developed

This was an important and early achievement in Turkey's reform path. The process of reducing the state's direct involvement in the economy was accompanied by the development of an explicit competition policy. It was understood that in a private enterprise economy, protecting the public interest requires effective laws and institutions dedicated to the promotion of market competition. The expansion of ties with the EU (the customs union agreement includes competition policy conditions) was another factor, and the alignment with the EU acquis continues to be an important driver of anti-trust policies.

The law on protection of Competition (Competition Act) was adopted in 1994, and (due to political delays) the Competition Authority was appointed in 1997. The Act is based on the competition provisions of the EU treaty. The Competition Authority, which is politically and financially independent, can act against agreements that restrain competition and abuses of a dominant position. The competition laws and enforcement structures, the Competition Authority and its decision-making Competition Board, are well-considered and supported by adequate resources. However, its enforcement powers tend to be weak: a long judicial appeals process and high inflation combine to make penalties almost meaningless. Also, these institutions have not yet had to weather a serious political storm, though.

Turkey's experience with competition policy has been generally positive. Turkey's conception of competition policy supports a broad programme of pro-competitive reform. The Competition Board's ambition, to be at the centre of a broad reform programme, does not quite match its present circumstances, but it is not necessarily unrealistic in the long run. The Competition Authority is linked into the privatisation process, and efforts are under way to create frameworks of collaboration with the newly established regulatory authorities in the network industries.

Important sectoral reforms are being taken forward

As in many other countries, the network industries in Turkey have been dominated by vertically integrated public monopolies. Rapid technological change, a deep fiscal crisis, which has reduced the state's capacity to undertake necessary investments, degradation in the quality of services provided, the politicisation of public enterprises, and pressure from international institutions have finally prompted the government to initiate fundamental reform in key network industries, notably energy and telecommunications, that make a major contribution to the economy. Energy sector reform in electricity and gas is especially vital, to ensure the financial stability of the sector. Turkey also stands to benefit from its geopolitical location as a pivotal transit route for international oil and gas trade (the Eurasian energy corridor). Turkey's most recent sectoral reform plans are encouraging: they generally follow OECD good practice benchmarks.

The electricity sector

Significant steps have been made recently towards a fundamental restructuring of the *electricity sector*. The 2001 Electricity Market Law sets the framework for privatisation and competition in generation, distribution and wholesale and retail supply. The state is to withdraw to a regulatory role, to be exercised by an independent Energy Market Regulatory Authority (EMRA) and will retain ownership of transmission (a natural monopoly). The basic approach is sound, in line with EU law, and consistent with good practice elsewhere in the OECD. Enactment of secondary legislation will clarify crucial issues (such as access to network and regime for constructing new capacity) that were not completely defined in the Electricity Market Law.

The circumstances in which reform is taking place will make it a challenging process. Limited spare capacity and rapidly expanding demand, assuming macroeconomic growth resumes, are not ideal conditions in which to undertake major change, but waiting is not a viable option. Past arrangements to promote new capacity have unfortunately created problems for the smooth implementation of today's more soundly based reforms. Long term power purchase contracts – Build Operate Transfer (BOT), Build Operate Own (BOO), and Transfer of Operating Right (TOOR) power generation schemes with long term price and purchase guarantees – now constitute significant potential stranded costs and contingent liabilities for the government. These contracts will block a large part of the market from competition for a significant period. The government has run into difficulty with most plans to transfer power plant and distribution/retail company operating rights to the private sector, and this may adversely affect the future climate for private investment.

Withdrawing from the old regime will not be easybut the new regime envisages the start of a competitive market in electricity in September 2002, perhaps with an additional five year phased transition period to resolve the problems of the old system. This is a challenging schedule, but if the government succeeds the long-term gains will be substantial. Success will depend on the quality of the new regulatory regime and effective arrangements to deal with the long-term contracts. Given that the present price structure entails significant cross subsidies, and given the financial problems faced by the current generation and transmission and distribution companies, prices for many consumers may have to increase in the medium term.

Creating competitive electricity markets is difficult – they do not evolve naturally, and need careful regulation (see for instance the Polish experience in Box 7). Success will require careful design and early decisions on the structure of the market. Privatisation will be crucial for the establishment of competition in generation, and should be guided by the objective of creating a market that is structurally competitive (rather than generating revenues). The initial market opening set by the Law amounts to 20% of demand, with further opening to be decided by the EMRA. Close collaboration between EMRA and the Competition Authority will be crucial in dealing with problems of competition and market power that will almost inevitably arise.

The gas sector

Reform in the *gas sector* is encouraged by Turkey's geographic location. Turkey is striving to make good use of its location as a transit country linking the oil and gas rich Caspian with the Mediterranean and the demand centres of western Europe. Reform aims to exploit this advantage, with a phased divestiture of import contracts by the state owned monopoly

Box 7. **Electricity reform in Poland**

Poland launched its electricity sector reforms in the early 1990s. Reform started with the separation of electricity from coal issues, the removal of regulatory functions to the (now) Ministry of the Economy, the creation of generation and distribution companies, and the reorientation of international grid connections from Eastern to Western Europe. Grid management and system operation were vested in the Polish Power Grid Company (PSE) which became the "single buyer" for the sector. Large price increases followed. In order to update old, inefficient and heavily polluting plant, a substantial investment programme followed, financed largely by commercial, long-term bank finance secured on the revenue stream provided under long term power purchase agreements (PPAs) between PSE (as single buyer) and the generation companies.

But despite of the fact that a fairly comprehensive legal basis for a competitive market has been created, including the establishment of an energy regulator and a power exchange, there is very little *de facto* competition yet. PSE's role as transmission operator and as the main trader disadvantages other players and the presence of PPAs which have "locked in" most electricity sales leaves little room for competitive trading and an effectively functioning market.

The long-term contracts between the generators and PSE are a major block on the development of a competitive market. "Locked-in" electricity sales account for some 95% of the market, against a potential 43% of competitive sales that could be possible with the legal market opening so far. To raise the electricity volume traded in the free market, particularly the spot market, the government has developed a novel policy to deal with this "lock-in" problem: the "Compensation Payments Scheme" (SOK), under which generators may sell electricity on the open market and receive compensation for any revenue shortfall relative to what they would have got under the PPAs. It is a necessarily complex system and it remains to be seen whether the incentives are adequate for generators to opt into the system. In the pilot phase three long-term contracts were prepared for SOK implementation, but were suspended due to the legal-tax problems. Relevant modifications are expected. One important issue is that SOK is optional: it has to respect the privacy of the PPA contracts. If the SOK fails, then the only prospects for competition are from imported electricity or through re-negotiation of the long-term PPAs. To substitute SOK, the Ministry of Economy is also considering other options such as the possibility to implement a special fund based on charges imposed on end-users. This could perhaps follow the form used in the US where transitional charges were imposed on consumers to recover sunk costs.

Source: OECD (2002), *Regulatory Reform in Poland: From Transition to New Regulatory Challenges*, Paris.

importer, BOTAS. This is a commendable and highly competitive approach, designed not just to allow but to promote competition. It will help Turkey with its own gas supply, and could also avoid further environmental strain on the maritime routes through the Bosporus. The law envisages a significant degree of ownership separation, both horizontal and vertical. Secondary legislation already under preparation will implement specific measures in order to deal with important issues such as third party access, unbundling, universal service obligations and storage. Hence, the outcome of reform will depend significantly on secondary legislation and effective implementation. Moreover, the beneficial effect of greater competition on lower prices will probably take time given past policies of the government relying on take-or-pay contracts. But if the divestiture of BOTAS gas contracts is successful, Turkey has a strong chance of establishing a competitive gas market. One possible constraint on competition is that gas storage facilities (to which suppliers need non-discriminatory access) are not due to be liberalised from BOTAS for another eleven years.

The telecommunications sector

Regulatory reform is more advanced in the *telecommunications sector*. The sector has grown substantially. Market forces have been allowed to play an increasing role. But fixed line penetration (28.3 per 100 people in 2001), is still far below the OECD average (52.8).

Limited competition in mobile telephone services started in 1994. But there was significant delay before further reform was promoted. A major step took place in 2000, with the establishment of the Telecommunications Authority (TA) as the independent regulator, and new rules for the privatisation of the incumbent operator, Turk Telekom. Monopoly rights in fixed line services and infrastructure will expire and full liberalisation will be established at the end of 2003 (or if and when the government's share in Turk Telekom, is reduced to below 50% through privatisation). Meanwhile the TA is organising the necessary secondary legislation, based on EU law.

The introduction of competition in the mobile market has already benefited consumers through lower prices and new services. But unusually high taxes (55-60% on GSM mobile), some of which were introduced after the earthquake disaster of 1999, are bound to be negative for growth. Fixed line tariffs have also been coming down, along with some tariff rebalancing in the expectation of full liberalisation. Speeding the liberalisation process can be expected to result in even more benefits.

The basic principles of the current regulatory regime are sound, but improvements are possible. The licensing regime could be streamlined. The TA is severely restricted in its staff recruitment. It can only recruit from the civil service, and should be allowed to recruit freely. This is crucial to ensure that it can cope effectively with the large number of (often complicated) new regulations that need to be put in place. Strengthening the administrative capacity of the TA is also a key priority to bring Turkey's telecommunication regulatory framework in line with the EU acquis.

Moreover, OECD countries have placed high priority on Internet, especially broadband development, as a means of increasing growth and productivity. A key requirement in this area has been to ensure competition and minimum regulation in order to allow new applications to grow. There is concern in Turkey that proposed legislation which may subject Internet content to the new broadcasting law could have the effect on slowing Internet growth and have negative economic implications. Such action would also be contrary to steps aimed at opening other markets to competition and streamlining regulations.

The road freight sector

The *road freight sector* in Turkey is highly fragmented between the international sector and the domestic sector. The international sector is subject to regulations based on EU norms. The 2001 Regular Report on Turkey's Progress Towards EU Accession states that Turkey is well advanced in taking over and implementing the EC road transport acquis in the technical field. The same regulations are not yet applied to the domestic sector. The draft Highway Transport Law established is designed to remove this duality and proposes significant structural change in the domestic sector. The government plans to consolidate the industry by creating a smaller number of co-operatives: firms could choose to join a co-operative, or meet the new regulatory requirements themselves. Care should be taken to ensure a sufficient number of co-operatives to sustain an adequate level of competition.

The challenges confronting regulatory reform

The context for regulatory reform remains difficult, and needs strong political leadership

The context for regulatory reform in Turkey is challenging: it remains one of severe economic crisis, societal transition and inadequate governance. Progress will require a coherent overall strategy and vision of reform. It will also require continued strong political leadership as well as co-ordination. Clear ownership of reform has to be established not just at the highest political level but with commitment from all the relevant ministries.

The reform of the civil service which has been set in motion must be vigorously pursued

Strong political leadership will continue to be needed to promote fundamental and sustainable change in the civil service. Perseverance with the reforms which have been started to re-establish a merit based civil service is key.

There is a crisis of public confidence in the institutions of government. This task is made more challenging by the dynamics of coalition politics and the laws on political parties. Problems that persist are the close links between top levels of the public administration and the political parties, hierarchical structures that concentrate decision-making at the highest levels, and corruption and occasional defiance of the rule of law by parts of the public sector itself. The public sector must improve its efficiency, transparency and accountability.

The effectiveness of the regulatory agencies has suffered from political problems

Important appointments to the regulatory agencies have been delayed by protracted negotiations between coalition partners. Implementation of the 1994 Competition Law was delayed for two years because governments did not appoint the board members of the Competition Authority. Appointment of the board members of the new banking regulator (set up by a June 1998 Law) was delayed until March 2000, and the new board was dismissed after the February 2001 crisis by a change in the law. This delay proved extremely costly when weaknesses in the banking system proved to be one of the main factors that led to the 2000/2001 crisis. But this could be an issue of the past: appointments to the board of the energy regulator were smoothly implemented without delay.

Local government remains inefficient, undermining general efforts to raise regulatory quality

The most recent OECD Economic Survey of Turkey analysed the legal structure and framework of local government and concluded that it impeded the efficiency and effectiveness of local authorities, as well as undermining the overall administrative structure. Six main problems were identified: inappropriate distribution of functions between central government and local authorities, insufficient financial resources, insufficient organisation and personnel, unnecessary practices of trusteeship by central administration, lack of transparency and participation, and over-dependence on central government.

The division of power between ministries' local representatives, the provincial administrations and the municipalities is not clear. There are concerns both at central and local government level about regulatory and administrative overlaps and inconsistent inspection and enforcement practices. In particular the lack of co-ordination between individual ministries imposes unnecessary burdens on businesses and reduces the overall efficiency of inspection and enforcement.

Local government also suffers from internal management problems. Patronage has distorted recruitment processes in the past, while low wages and inadequate performance incentives reduce efficiency and productivity. Accountability needs strengthening if further powers are to be devolved.

Competition policy should be further integrated into the general policy framework

In keeping with the fact that Turkey is still in a state of transition, competition policy is not yet fully integrated into general policy. Many features of state-led development remain, such as state-owned commercial enterprises with special or monopoly privileges, for which reforms have been announced, but implementation is slowed by crisis. The lack of public awareness about competition policy and the new institutions is indicative of the uncertain status of competition in Turkish public policy and debate.

The reach of competition policy has some constraints. The heritage of state monopolies distorts competition in a number of sectors, such as mining, salt, tobacco, and alcoholic beverages. There is no general framework to deal with competition issues related to public monopolies that have exclusive rights and duties to provide public services. Turkey has interpreted its competition law to exempt a state owned entity if its prices are controlled by a ministry. Some private professional associations and service providers are authorised by law to fix prices. These legal impediments to competition should be removed. Sectoral laws regulating network industries take different approaches to the relationship with the competition law and enforcement, sometimes preserving special rules.

The Competition Authority should develop a stronger and more consistently applied advocacy role over the competitive effects of new policies and regulations. Consultation with the Competition Authority over draft laws and regulations needs to be systematic. It is encouraging therefore that since 2000 all ministries must take account of the Competition Board's opinion about draft laws, regulations, and communiqués on issues under the Competition Board's responsibilities.

The fragmentary approach of the past to regulatory reform must be avoided: a strong government-wide, centrally-driven strategy is needed

Regulatory reform must avoid the fragmentary approach adopted in the past. There is a marked absence of any government-wide regulatory reform strategy. Unlike most OECD countries, there is no single government unit in Turkey responsible for co-ordinating regulatory reform or regulatory quality across government.

This means that the speed of regulatory reform and the quality of regulation is uneven. Much of the co-ordination that does take place is provided by the IMF-supported programmes, and the process of adoption of the *acquis communitaire* of the EU. This is not an adequate foundation for the longer term: the country needs its own regulatory reform motor. Co-ordination needs to be institutionalised within government on a more sustainable basis. One way to achieve such co-ordination is to designate a minister to design and implement regulatory policy, and require that minister to publicly and annually report on achievements and challenges. A central technical oversight office could support the minister's work (Box 8).

Box 8. **Central oversight units**

Country experiences show that a well-organised and monitored process, driven by "engines of reform" with clear accountability for results, is important for the success of the regulatory quality policy. There are several reasons for this. Maintaining consistency and systematic approaches across the entire administration is necessary if reform is to be broad-based and credible. It is often difficult for regulators to reform themselves or integrate new quality disciplines, given countervailing pressures.

Promoting reform requires the allocation of specific responsibilities and powers to agencies at the centre of government to monitor, oversee and promote progress across the whole of the public administration. OECD countries agree that the primary responsibility for quality regulation and reform must be at the level of the ministry or independent regulator. That is where the expertise lies, and where policies are formulated. Yet most governments have established central regulatory co-ordination and management capacities, (*i.e.* regulatory oversight bodies) supported by ministers with whole of government responsibilities for regulatory policy.

Considerable experience across the OECD has shown that central oversight units are most effective if they have the following characteristics:

- independence from regulators (*i.e.* they are not closely tied to specific regulatory missions);
- operation in accordance with a clear regulatory policy, endorsed at the political level;
- horizontal operation (*i.e.* they cut across government);
- expert staffing (*i.e.* they have the information and capacity to exercise independent judgement); and
- linked to existing centres of administrative and budgetary authority (centres of government, finance ministries).

One centrally driven procedure that could be expected to make a big difference to regulatory quality in the long run is the use of Regulatory Impact Analysis (RIA, see Box 9). This is an excellent way of ensuring that regulations are of the highest quality, as it combines good habits of consultation with a rigorous assessment of the impact of prospective rules. It involves making a clear and balanced assessment of the costs and benefits of a new rule (a challenging process, which if it is to be done well requires investment in training and new practices). The absence of RIA is a major weakness in Turkey's current regulatory quality control procedures.

In the short run much attention should be focussed on reviewing existing regulations and on reducing administrative burdens, particularly those of business. A substantial amount of new laws and regulations has been produced since a comprehensive review undertaken in the 1980s. Much evidence suggests that regulations in Turkey are out-dated, slowing innovation and causing unnecessary rigidities. Excessive burdens have particularly been observed in the licensing of businesses where approvals are granted by multiple ministries, municipalities, prefectures as well as some regulatory agencies.

Crises have most often been the spur for major review programmes, as governments have sought to supplement traditional macroeconomic tools with supply side reforms. Experience from other OECD countries suggest that de-regulation – as a first step in developing a high-quality regulatory system – has been important in boosting sectoral efficiency and innovation and enhance economy-wide flexibility and potential growth.

Transparency and effective consultation must be quickly nurtured into existence

Despite growing awareness of the need to enhance transparency, consultation in Turkey is currently neither systematic nor formalised. This reduces the quality of regulation by increasing the likelihood of regulatory capture, raising the likelihood of regulatory mistakes due to inadequate information, reducing the credibility and legitimacy

Box 9. **Getting maximum benefit from RIA: best practices**

1. Maximise political commitment to RIA.
2. Allocate responsibilities for RIA programme elements carefully.
3. Train the regulators.
4. Use a consistent but flexible analytical method.
5. Develop and implement data collection strategies.
6. Target RIA efforts.
7. Integrate RIA with the policy-making process, beginning as early as possible.
8. Communicate the results.
9. Involve the public extensively.
10. Apply RIA to existing as well as new regulation.

Source: OECD (1997), *Regulatory Impact Analysis: Best Practice in OECD Countries*, Paris.

of regulation and making regulation less predictable, due to increased last minute lobbying and compromise. Lack of consultation opportunities also means that stakeholders focus their lobbying on final decisions of the cabinet and parliament. This undermines the legislative process and comes too late to be effective in terms the emerging legislation.

A more comprehensive approach to consultation is needed. This will help to avoid mistakes and improve regulatory quality, and will enhance the legitimacy and enforceability of regulations. Several initiatives have already been taken, suggesting that the importance of consultative mechanisms is now better appreciated. The approach to the resolution of financial distress has been designed with the active participation of bank representatives and other interested parties. Several agencies now routinely put draft regulations on the Web, asking for comments. Some, like the Telecommunications Authority, also hold meetings where comments are discussed. These mechanisms and others need to be applied consistently and comprehensively across the whole spectrum of regulatory activities.

Experience with the Competition Authority and with the Telecommunications Authority suggests that independent agencies will be more transparent in their operations and decisions compared to the rest of the administration. But even they still lack an overall strategy. Making draft regulations publicly available and soliciting comments is an important step, but transparency would be substantially enhanced if regulators were also required to assess the impacts of their proposed regulations.

Communication is vital to sustain public support for reform

Communication is crucial to mobilise support for reform. The goals and advantages of regulatory reform need to be communicated. Communication is also necessary to dispel the widespread belief that reform has been imposed by outsiders. Opponents of reform use this to de-legitimise reform and mobilise resistance against it. For some proponents of reform, external pressure has been an expedient argument to force the government into action. Ultimately, what matters for the success of reform is domestic consensus and political ownership.

The most important determinant of the scope and pace of further reform is arguably the attitude of the general public. A high priority to motivate support for reform is to deliver visible benefits to businesses and consumers and by doing so building a constituency for reform. The public should not therefore be neglected in the government's communication strategy. It is currently poorly informed. Press comment is often the main source of information and can give a distorted and negative view of developments. For example it has been asserted that the regulatory agencies are new instruments of patronage. At the same time, there are legitimate worries about an "inflation" of regulatory agencies. It is important that the government sets the record straight: explaining the purpose of the agencies, the steps taken to ensure that they act professionally, and the difficult but important tasks that they have in managing sectors (such as banking or electricity) which involve complex problems of prudential oversight or natural monopoly.

Implementation and enforcement are just as important as the design of the new regulatory framework

The success of regulatory reform depends not just on effective well – designed objectives, institutions and procedures, but also on implementation and enforcement. Poor compliance threatens effectiveness and also the regulator's credibility. This includes the pace and sequencing of reform, including the effective management of transition. Turkey suffers major implementation and enforcement problems, particularly at the local level. The welcome focus that has started to be applied to this issue must be sustained.

Conclusion

Relative to the rest of the OECD, Turkey is a latecomer to regulatory reform. But it is now well placed to take it forward: the need for it is incontestable. The earthquakes of 1999 brought out the human, social and economic costs of weak and ineffective regulatory governance. The crises of November 2000 and February 2001 have reinforced awareness of the fact that higher economic growth and social welfare cannot be achieved without better and more effective governance and regulation, starting with stronger and more capable institutions. In short there is a need for a major overhaul of the role of the state in economic and social life.

It is now accepted by a growing number of people in Turkey that it is no longer possible for the state to continue to finance a patronage based governance system. The time is past when a significant part of the population could benefit from a system of arbitrary transfers, subsidies and protection. In fact, this was only possible because those benefits were financed by transferring resources from the future. The spiralling fiscal deficits and successive crises have made this approach unsustainable. The mechanism underlying distributive politics, which did much at an earlier stage to help develop the country, have broken down in an open economy framework.

There is also a growing understanding of what is needed to establish a new model of effective governance. It means a radical shift from more traditional modes of governance: including transparency, accountability, impartiality, communication and effective enforcement.

Faced with severe economic crisis, the government is now undertaking major reforms to eliminate structural weaknesses, improve the market orientation of the economy and open it to international competition. Work is also underway to create a regulatory framework that supports this restructuring. The public administration is undergoing reform. It is too early to judge long-term success, but the reforms are deeply encouraging and go in the right direction. To ensure that direction and momentum are not lost, a strong central unit with political support to oversee the developing regulatory framework would be very helpful.

The most recent reforms have – as in the past – understandably focused on restoring the economic situation as priority (though the monetary and fiscal reforms, if properly carried through, mark a sharp break with the past). This time, however, regulatory and governance reforms should not slip into second place. The government must remain alert to the risk that urgent short-term action aimed at stabilising the economy may crowd out the pursuit of important regulatory and governance initiatives. These may take longer to put in place and to have effect, but are essential to long-term stability and success. The momentum to improve governance and regulation must be sustained and developed. They are indispensable complements to other measures to restore and develop the economy.

Notes

1. Baysan and Blitzer, 1990.
2. Onis and Webb, 1994.
3. Celasun and Arslan, 2001.
4. Bugra, 1994, p. 150.
5. Sak, 2000.
6. In line with the economic programme agreed with the IMF, all off-budget expenditures were recently eliminated, except four.
7. Lehman Brothers, 2001; Uygur, 2001.
8. Ersel, 2001.

*PART II**

Regulatory Policies and Outcomes

* The background material used to prepare this report is available at: *www.oecd.org/regreform/backgroundreports*

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PART II

Chapter 2

Regulatory Governance*

* For more information see: "Background report on Government Capacity to Assure High Quality Regulation" at *www.oecd.org/regreform/backgroundreports*

Regulatory reform in a national context

The regulatory reform agenda is developing in Turkey in response to both domestic and international factors. Internationally, the key element is Turkey's drive towards European Union membership, which will require a major overhaul of regulatory regimes and practices. As well, economic crises have lead major international organisations like the World Bank and IMF to argue strongly for the need for reforms to Turkish regulatory governance. Domestically, economic crisis has accelerated needed reforms and brought an unprecedented sense of urgency. Regulatory reform is increasingly seen as an essential element of the policy responses needed to restore economic stability and growth.

Important economic reforms were launched in 2000, 2001 and early 2002, while progress has also been made in reforming the government and public administration. There is a growing realization that Turkey must modernize its public institutions and regulatory framework to support private sector growth, deliver better services and improve its prospects for EU entry.

The regulatory reform programme will, however, confront strong opposition and must avoid the fragmentary approach often adopted in the past. Turkey must, in particular, address four interconnected challenges listed below.

Firstly, Turkey must restore confidence in the institutions of government, addressing the current crisis of public confidence. This task is made more challenging by the dynamics of coalition politics and the laws on political parties. Particular problems are the close links between the top levels of the public administration and the political parties, hierarchical structures that concentrate decision-making at the highest levels and corruption and occasional defiance of the rule of law by parts of the public sector itself.

Secondly, Turkey must complete the transition from a static, state-led and rule-bound economy to an innovative and entrepreneurial economy, driven by the market and civil society. The advantages of market mechanisms are not yet fully appreciated by many officials.

Thirdly, the public sector must improve its efficiency, transparency and accountability. This means implementing administrative practices based on results and market-orientation, rewarding performance and providing sanctions for poor performance.

Fourth, Turkey must build an integrated and consistent framework for regulatory management. Today's regulatory management system is weak and mostly centred on legalistic controls, and the institutions responsible for these functions are dominated by extensive political oversight and intervention.

In sum, the absence in Turkey of a government-wide regulatory reform strategy, regulatory impact assessment, a public notice and comment process and policies favouring the use of regulatory alternatives contrasts with OECD recommendations and the practices adopted by many OECD countries (see Box 10). The context of regulatory reform in Turkey is one of severe economic crisis, societal transition and insufficient governance structures.

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Promising reforms are being launched, but have to date lagged economic and social reforms. This has created a significant gap between regulatory requirements and capacities and has strained relations between regulators and the regulated.

Major recent reforms to improve public administration capacities include: improving transparency through constitutional reforms, initiatives to fight corruption, reforming the tax system, reforms to depoliticise public sector recruitment and improve its merit basis and new measures to improve budgetary transparency and the performance of the administration. Little can yet be said about the impact of many of these reforms, as they are still at an early stage. Their speed and scope differs across policy areas, but it is clear that the need to fulfil agreements with external bodies – notably the IMF, World Bank and European Union – has been a major driver.

For example, in 2001, Turkey adopted a *National Programme for the Adoption of the Acquis*, setting priorities and commitments for aligning Turkey's regulatory structure to the EU *acquis communautaire*. This included commitments to: adopt a new public procurement law to enhance competition in this area; establish specialised courts to deal with intellectual and industrial property issues; strengthen independent regulators and other supervisory bodies, overhaul legislation on state aid and strengthen the legal basis of the Social and Economic Council. The May 2001 economic transition programme called *Strengthening the Turkish Economy* can also be seen as linked to international commitments. Important steps to date include the passage of laws to restructure the financial sector, enhance budgetary transparency and the transparency and efficiency of public expenditure management. The

Box 10. **Good practices for improving the capacities of national administration to assure high quality regulation**

The OECD Report on Regulatory Reform, welcomed by Ministers in May 1997, includes a co-ordinated set of strategies for improving regulatory quality, many of which were based on the 1995 Recommendation of the OECD Council on Improving the Quality of Government Regulation. These form the basis of the analysis undertaken in this report, and are reproduced below:

A. BUILDING A REGULATORY MANAGEMENT SYSTEM

1. Adopt regulatory reform policy at the highest political levels
2. Establish explicit standards for regulatory quality and principles of regulatory decision-making
3. Build regulatory management capacities

B. IMPROVING THE QUALITY OF NEW REGULATIONS

1. Regulatory Impact Analysis
2. Systematic public consultation procedures with affected interests
3. Using alternatives to regulation
4. Improving regulatory co-ordination

C. UPGRADING THE QUALITY OF EXISTING REGULATIONS

(in addition to the strategies listed above)

1. Reviewing and updating existing regulations
2. Reducing red tape and government formalities

October 2001 constitutional amendments, which primarily address liberal rights issues, were also explicitly intended to bring the Turkish Constitution more closely into in line with the Copenhagen political accession criteria of the EU.

Fighting corruption is integral to many programmes and is the focus of several specific projects. In particular, an Anti-Corruption Steering Committee, composed of senior civil servants from key ministries, was set up by in July 2001. It has the responsibility to present to the Prime Minister by September 2002 a comprehensive plan to fight corruption in Turkey.

In 1999 a set of centralised *civil servant recruitment tests* were introduced to enhance consistency and provide better control of recruitment. They have assisted in controlling public sector expenditure and have been supplemented by efforts to introduce performance management and auditing in the public sector, commencing in 2001 with the adoption of a number of training initiatives in key institutions.

Drivers of regulatory reform

Regulatory reform policies and principles

The 1997 *OECD Report on Regulatory Reform* recommends that countries "adopt at the political level broad programmes of regulatory reform that establish clear objectives and frameworks for implementation". The 1995 *Recommendation of the OECD Council on Improving the Quality of Government Regulation* contains a set of best practice principles for reform policies (see Box 11).

While the reforms noted above are important steps toward achieving good regulatory practices, Turkey does not yet have an explicit policy on regulatory quality. The absence of a government-wide policy promoting regulatory quality has fragmented reform efforts and impeded overall progress.

Nevertheless, some procedural requirements are in place. Principles issued by the Prime Ministry require proponent ministries to consult with "relevant" institutions and agencies prior to submitting draft regulation, and the parliament's Standing Orders require all bills to be presented with a "justification", or explanatory memorandum. These requirements do not contain quality assurance objectives or criteria and so cannot be considered as consistent with the above-mentioned "good practices". However, they do provide a potential foundation for the adoption of such principles and practices in the regulatory process.

Mechanisms to promote regulatory reform within the public administration

Appropriate reform mechanisms, including government bodies with explicit responsibility and authority for managing and tracking reform are essential to drive reform. Experience across the OECD shows that central oversight units are most effective if they are independent from regulators, endorsed at the political level, operate in accordance with a clear regulatory policy, operate horizontally (*i.e.* across government), are staffed by experts able to exercise independent judgements and are linked to existing centres of administrative and budgetary authority.

Unlike most OECD countries, there is no single government unit in Turkey responsible for co-ordinating regulatory reform or regulatory quality across government. Moreover, there are no laws on how to prepare laws or other regulations. External quality controls during the preparation of laws are limited to the use of *ad hoc* expert preparatory commissions in some cases (particularly for major changes to civil laws) and the requirement on ministries to follow the intra-governmental consultation requirements stated in "*The Principles on Preparation of Laws, Decrees Having Force of Law, Regulations and Draft By-Laws*" ("the Principles"). The Principles require the opinions of specific ministries to be considered if the regulation will have effects within their portfolios. However, they do not prescribe any specific quality assurance measures, while external consultation is discretionary.

These controls are supplemented by procedural requirements at Cabinet and parliamentary levels. First, parliamentary standing orders require that bills be submitted together with a "justification", giving the background and purpose of the draft law and a justification for each article. By tradition, the justification is attached to the draft laws sent for consultation within government and externally. Second, all members of the **Council of Ministers** must sign draft legislation before it is forwarded to Parliament. Third, four units within the **Prime Ministry** participate in regulatory management. These are:

- **The General Directorate of Laws and Decrees (GDLD)** has a general co-ordination function and scrutinises draft laws, decree-laws, tüzüks and by-laws for constitutionality, consistency with existing legislation, legal quality and compliance

Box 11. **Principles of good regulation**

The experience of OECD member countries shows that quality standards and an effective regulatory management institution are interdependent. Specifying objective quality standards for regulation clarifies what is expected of regulators and links quality standards with regulatory objectives. But quality standards and principles alone are not enough to improve regulatory habits and provide adequate incentives for producing high quality regulation. Central oversight of regulatory management, through an expert government-wide institution, can provide a source of expertise and advice, monitor progress and ensure consistent approaches to reform tasks.

A concrete and market-oriented set of quality standards should be based on the OECD principles accepted by ministers in 1997, which read:

Establish principles of "good regulation" to guide reform, drawing on the 1995 *OECD Recommendation on Improving the Quality of Government Regulation*. Good regulation should: *i)* be needed to serve clearly identified policy goals and effective in achieving those goals; *ii)* have a sound legal basis; *iii)* produce benefits that justify costs, considering the distribution of effects across society; *iv)* minimise costs and market distortions; *v)* promote innovation through market incentives and goal-based approaches; *vi)* be clear, simple, and practical for users; *vii)* be consistent with other regulations and policies; and *viii)* be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.

Source: OECD *Report to Ministers on Regulatory Reform*, 1997.

with the intra-governmental consultation requirements of the Principles. GDLD also mediates conflicts between ministries and may itself prepare bills on cross-cutting issues, in co-ordination with relevant ministries and institutions.

- **The General Directorate of Legislation Development and Publication** reviews the legal quality of those regulations that do *not* require Council of Ministers approval to become valid.
- **The State Planning Organisation** prepares Turkey's five-year development plans and is thus consulted on draft laws affecting economic and social policies, measures and annual programmes.
- **The Secretariat General for EU Affairs** examines whether draft laws and regulations conform with the National Programme for Adoption of the Acquis.

Four other ministries and arm's length bodies may be consulted before draft laws are sent to the Council of Ministers by the GDLD. In each case, the GDLD is responsible for dealing with areas of disagreement:

- **The Ministry of Justice** reviews laws for constitutionality, consistency with existing laws and legal quality.
- **The Ministry of Finance** is consulted on draft laws affecting budgetary and fiscal policy.
- **The State Personnel Department** is consulted on draft laws and regulations about public personnel regime and organisational matters.
- **The Competition Board** is systematically consulted on the competition aspects of draft laws.
- In addition, **the Conseil d'État** is constitutionally authorised to examine draft Tüzüks. The GDLD must obtain the opinion of the Conseil d'État before the Tüzüks are sent to the Council of Ministers.

For draft laws, the **Parliament**, particularly through its **16** standing sub-commissions, completes the regulatory management system. All Bills are forwarded to a sub-commission, which may invite experts, NGOs and ministers to assist in its assessments. The Committee's recommendations are sent to the General Assembly suggesting approval, amendment or rejection of the Bill. Many bills are withdrawn or fundamentally changed as a result, often due to major problems with the consultation procedures.

As Table 5 shows, the Turkish management system is characterised by extensive and overlapping legal controls, with six specialised units sharing responsibility for drafting and checking legal texts. However, similarly rigorous controls on substantive quality are notably lacking.

Co-ordination between levels of government

The 1997 OECD Report advises governments to "encourage reform at all levels of government". High quality regulation at one level can be undermined by poor regulatory policies and practices at other levels. Conversely, co-ordination can vastly expand the benefits of reform.

Turkey is a unitary republic with a highly centralised government structure, despite some decentralisation over the last 15 years. However, there are three levels of sub-national administration: 81 Special Provincial Administrations, 3 228 municipalities and 32 120 village administrations.

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Table 5. **Quality controls of new laws and regulations**

	Prepare draft	Legal quality control	Accordance with competition law principles	Budgetary impact assessments	Consultation with affected ministries and agencies	Consultation with business and civil society	Arbitration between conflicting ministerial interests
Proponent ministry	X			(X)[5]	X	(X)	X
Ministry of Finance				(X)[5]			
Ministry of Justice		X[1]					
The Competition Board			X				
Prime Ministry* (GD of Leg. Development and Publication)		X[2]			X[2]		X[2]
Prime Ministry (GD of Laws and Decrees)	X	X[3]			X	X[6]	X
Council of State		X[4]					

X Not mandatory, exercised *ad hoc.*
1. Examines draft laws and decrees having force of law.
2. Examines only by-laws not promulgated by the council of ministers as defined in Law 3011.
3. Examines draft laws, law decrees, tüzüks, cabinet decrees and by-laws for decision by the Council of Ministers.
4. Tüzüks needs to be examined by the Council of State. On request from the Council of Ministers, the Council of State also gives its opinion on other draft types of legislation. Such opinions are not binding on the government's implementation of the legislation.
5. No standardised format or guideline for the preparation of budget impact assessments exist.
6. Only exercised rarely.

Source: OECD.

Central authorities directly provide many essential urban services. However, municipalities have broad general powers relating to the health, well-being and welfare of their inhabitants as well as specific powers relating to both service provision and regulatory functions, including the regulation of construction, environmental matters, local transport and some business licensing. Despite this, local government has always been closely controlled by central government.

There are no institutional mechanisms for policy co-ordination between levels of government on regulation, although informal mechanisms exist, both between central and local government and among local authorities. These include *ad hoc* committees or panels, conferences and meetings.

Turkey entered a customs union with the EU in 1996 and was formally recognised as a candidate state in 1999. The prospect of EU entry is a major force in shaping regulatory reform in Turkey.

Turkey's national programme for the adaptation of the *Acquis* has provided a wide ranging agenda for political and economic reform. Like other candidate countries, Turkey benefits from institutionalised co-operation with the EU to stimulate and support its reforms. Relations between the EU and Turkey are organised in the EC-Turkey Association Council and its eight sub-committees, each relating to a specific ministry's portfolio. The General Secretariat for EU Affairs was established by law in June 2000 to ensure effective internal co-ordination in the process of adopting the EU acquis.

The Secretariat General for EU Affairs uses the informal EU guidelines on "Main administrative structures required for implementing the *Acquis*" as a benchmark for scrutinising whether the current administrative structures are sufficient to implement the various chapters of the *Acquis*. In sum, the mechanisms for co-ordination between Turkey and EU institutions are extensive and well-developed.

Administrative capacities for making high quality regulation

Administrative transparency and predictability

A transparent regulatory system is essential to establish a stable and accessible regulatory environment that promotes competition, trade, and investment, and helps ensure against undue influences by special interests. Transparency involves a wide range of practices, including standardised processes for regulation-making; consultation with interested parties; plain language drafting; publication, codification, and other ways of making rules easy to find and understand; and implementation and appeal processes that are predictable and consistent. Despite growing awareness of the need to enhance transparency in Turkey, long-standing practices hinder openness and public participation in regulatory development. On the whole, Turkey lags other OECD countries in terms of regulatory transparency.

Administrative procedure laws set out transparent and consistent processes for making and implementing regulation and are fundamental to confidence in the rulemaking process and to stakeholder participation. The rulemaking process is less structured in Turkey than in many OECD countries. Turkey does not have a specific law or comprehensive guidance document setting out rule-making requirements. The most important legal requirement is a by-law issued by the Council of Ministers, which essentially requires a measure of intra-governmental consultation. The Government has made several attempts to pass an Administrative Procedure Act in recent years, but has not to date succeeded in obtaining Parliamentary approval.

Public consultation allows citizens and businesses input to regulatory decisions and is central to the creation of high quality regulation. Consultation in Turkey is neither systematic nor formalised. No mandatory requirements or general guidelines on how to consult exist. Informal consultation processes, which vary with the views of the ministry or the minister in charge, are often used.

The lack of a systematic and transparent public consultation mechanism reduces the quality of Turkish regulation by increasing the likelihood of regulatory capture, raising the

Box 12. **The European *acquis communautaire***

The *Acquis communautaire* comprises the entire body of legislation of the European Communities. It totals more than 80 000 pages, including the founding Treaty of Rome, as revised, Regulations and Directives passed by the Council of Ministers, most of which concern the single market and judgements of the European Court of Justice.

Countries wishing to join the European Union must adopt and implement the entire *Acquis*, though there is some flexibility as to timing. In addition to transposing the body of EU legislation into their own national law, they must ensure that it is properly implemented and enforced. This may mean that administrative structures need to be set up or modernised, legal systems need to be reformed, and civil servants and members of the judiciary need to be trained.

likelihood of regulatory mistakes due to inadequate information, reducing the credibility and legitimacy of regulation and making regulation less predictable, due to increased last minute lobbying and compromise. Lack of consultation opportunities also results in stakeholders focusing their lobbying on the final decisions of the cabinet and parliament. This tends to undermine the legislative process, with draft bills sent back and forth between the Council of Ministers and Parliament, frequently changing significantly or being removed from the Parliamentary agenda altogether.

An important recent change is the 1995 establishment of the tripartite Economic and Social Council (ECOSOC) as a standing advisory committee to represent interest groups and promote consensus in policy-making. ECOSOC seems to represent a step forward in Turkish consultative approaches and is generally supported by participant groups. However, unlike most equivalent bodies in OECD countries, ECOSOC includes a very substantial government representation (15 of 36 members), a feature that is likely to reduce its effectiveness as a consultative body with civil society and business.

Forward regulatory planning is a means of raising awareness of proposed new regulation and thus improving effective consultation. It usually includes the publication of the government's overall legislative agenda. Turkey uses a range of mechanisms to provide forward notice of its legislative plans, including five-year plans and annual programmes that set out broad economic and social goals and specify the main instruments to reach them. However, the annual programmes do not clarify specific government priorities for legislation put before Parliament and the government does not publish its plans for specific legislative initiatives. Regular publication of such a list would improve consultation opportunities.

Assessment. Turkey lags other OECD countries in its consultation performance. This weakens the accountability of ministries and reduces their ability to assess the likely impacts of new regulations. The adoption of a government-wide policy on consultation is fundamental to improving regulatory quality in Turkey. It should include standardised procedures and requirements, ensuring consultation is open to all parties, starts early in the legislative development process, is supported by early publication of draft legislation and, ideally, is integrated with RIA processes.

Effective Communication of the existence and content of regulations is another dimension of transparency. Communication is also essential to achieving compliance. Turkey's processes for providing access to information about regulations are broadly consistent with best practices in OECD countries. The full text of new regulations, by-laws and communiqués is published in the Official Gazette, as are the decisions of independent regulators. The General Directorate of Legislation Development and Publication prepares and updates bound volumes codified according to subject. An electronic version of the codified register is accessible via the Internet. Most ministries and independent regulators also make regulations and decisions relevant to their portfolio available electronically.

However, *de facto* transparency can be reduced when a regulatory framework is constantly revised and amended. Turkey seems to be confronting such a situation, as suggested by the existence of a sizeable consulting industry to assist people in dealing with bureaucratic and regulatory requirements. An additional communication issue is Turkey's very limited success to date in communicating the need for regulatory reform and the benefits of such reform. These represent substantial areas for further action.

Assuring high levels of *Compliance and enforcement* is essential if law is to achieve its intended objectives. Poor compliance threatens regulatory effectiveness and ultimately government credibility. Compliance and enforcement issues can embrace processes and practices as well as institutional structures.

Turkey suffers major enforcement problems, particularly at local level. Local government sensitivity to the economic and employment consequences of business licenses and permits has lead to inadequate enforcement. Enforcement is often based on a negotiated "tolerable solution", rather than the letter of the law. Such practices can substantially undercut the credibility of the law. The major compliance problems existing in Turkey are closely linked to the lack of consultation identified above. Low involvement of stakeholders in the preparatory process means that the *feasibility* of compliance and enforcement is often inadequately considered in designing new laws. At the same time, awareness of the rules, "ownership" and acceptance of them suffer due to lack of consultation.

A lack of co-ordination between ministries also reduces the general effectiveness of the regulatory framework, while the current division of enforcement responsibilities between municipalities and central government agencies is not clear. There is no system or widespread practice of co-ordinating inspection and enforcement across ministries and agencies, leading to inconsistencies and overlap.

Public redress and the judicial system

Mechanisms to redress regulatory abuse must also be in place, as a democratic safeguard in a rule-based society, and as a regulatory feedback mechanism. The first stage for seeking redress is to complain directly to the administration. Turkey's *Administrative Jurisdiction Procedure Act* gives uniform rights of appeal to citizens, stipulating the manner and time within which administrative authorities must respond to an applicant and requiring administrative decisions. No response within 60 days automatically means that the request is rejected.

The second stage for seeking redress is to launch a court review. The Constitution provides a general protection, stating that "all acts and actions of the administration shall be subject to judicial review". It was recently amended to extend similar rights to foreign nationals resident in Turkey. As in many OECD countries, the administration of justice in Turkey is slow, with 29 376 cases pending with local administrative courts as of 1999. For the regional administrative courts and the Conseil d'État the numbers were 781 and 63 861 pending cases and an average of 16 and 348 days for court decisions.

Another common institution for redress is the ombudsman. Turkey does not have an ombudsman, although a draft bill to establish an ombudsman is currently before Parliament. The Parliamentary Petition Commission performs some similar functions, but does not have formal judicial or executive power.

Choice of policy instruments: regulation and alternatives

A core administrative capacity for good regulation is the ability to choose the most efficient and effective policy tool, whether regulatory or non-regulatory. In the OECD area the use of tools other than traditional regulation is expanding as experimentation occurs, learning is diffused, and understanding of the markets increases. Support for innovation and policy learning is a fundamental role for reform authorities if the benefits of informed policy choice are to be attained in practice.

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Increasingly, regulatory guidelines in OECD countries require consideration of whether or not traditional regulation is likely to be the most effective policy instrument. By 2000, 18 out of 28 OECD countries had adopted such requirements. Turkey currently does not require regulators to consider alternative policy instruments before adopting new regulations, and alternatives to regulation are rarely used. Turkey has made little progress in this area.

In many countries the environment is a pioneer in the use of many regulatory alternatives. Turkey has recently experienced some innovation in this area, which may provide the basis for experimentation in other sectors (see Box 13).

Assessment. Turkey has, to date, made very limited progress in encouraging the use of regulatory alternatives. The adoption of a systematic approach to this issue would substantially favour policy innovation, reduce compliance costs and enhance effectiveness. However, this requires strong capacities at the centre of government, to provide information, guidance and training and to communicate government commitment to the use of alternatives.

Box 13. **Regulatory alternatives used in Turkey**

Financial incentives. Since 1994/5 imported R&D, materials and equipment used to improve environmental performance have been fully exempted from customs duties, while grants and tax rebates are also available in respect of domestic expenditures in this area. A discounted tariff, 17% less than the normal industrial rate, applies to electricity generated from waste treatment plants.

Integration of environmental concerns in fiscal policies. Although there are taxes on goods and services that affect the environment, such as the gasoline consumption tax, marine vessel fees, or electricity and coal consumption taxes, they are generally revenue raising instruments and do not specifically aim to alter consumer behaviour. However, part of the revenues from taxes on motor vehicle sales and aeroplane tickets is earmarked for environmental purposes. The Ministry of Finance has recently begun imposing high tax rates on highly polluting vehicles. Energy consumption beyond 150 kW in residential houses attracts extra energy consumption fees of almost 50%.

Voluntary agreements. A number of voluntary agreements have been signed between the Ministry of Environment and industries (the yeast, sugar and paper industries in 1995, the leather industry in 1997) to install waste water treatment plants. Other voluntary agreements have been made between the cement industry and the Government to reduce particulate emissions, as well as between the automobile industry and the Government whereby all cars assembled in Turkey will be equipped with catalytic converters by 2001.

Source: OECD (1999); The Turkish Government.

Understanding regulatory effects: the use of Regulatory Impact Analysis

The 1995 OECD *Recommendation on Improving the Quality of Government Regulation* emphasised the role of RIA in systematically ensuring that the most efficient and effective policy options were chosen. The 1997 *OECD Report to Ministers on Regulatory Reform* recommended that governments integrate RIA into the development, review, and reform of regulations.

Turkey has no formal requirements to undertake regulatory impact assessment.This is a major weakness in its quality control procedures. Policy officials do not base decisions on an explicit assessment of the costs and benefits of proposed government actions. The justification currently attached to draft laws includes almost no quantitative assessment of the likely effects of the regulation.

As Turkey has yet to adopt a formal RIA programme, and implementing RIA is a long term process, the following discussion is presented as a "roadmap" that the Turkish government may wish to consider as a feasible approach to implementing RIA disciplines and moving toward OECD best practices. It follows OECD best practice recommendations, with specific reference to the Turkish context.

Maximise political commitment to RIA. The use of RIA should be endorsed at the highest levels of government. Given the Turkish legal culture, the implementation of RIA should probably be ratified by law. The scope of RIA should encompass both primary and subordinate regulation. Transparent monitoring mechanisms (such as annual reports to parliament) are also required.

Allocate responsibilities for RIA programme elements carefully. To ensure "ownership" by regulators, while also establishing quality control and consistency, responsibilities for RIA should be shared between regulators and a central quality control unit. RIA should be prepared by the ministries proposing new regulations, but subjected to an independent and objective assessment. An expert regulatory reform authority, located at the centre of government, is needed to assess RIA and promote and enforce adequate standards of analysis.

Train the regulators. Regulators must have the skills to prepare high quality assessments, including an understanding of the role of impact assessment in assuring regulatory quality and an understanding of methodological requirements and data collection strategies. The Turkish RIA programme should consider from the outset a prolonged investment in training, guidance and a central help desk.

Use a consistent but flexible analytical method. A RIA programme in Turkey should be based first on a clear qualitative assessment, then as soon as possible move to incorporate quantitative assessment methodologies to assure consistency and objectivity. A practical starting point would be to concentrate on business compliance costs. The long term goal should be to move to full benefit-cost analysis.

Target RIA efforts. The preparation of an adequate RIA is a resource intensive task. Experience also shows that central oversight units can be swamped by a large numbers of RIA. It is thus vital that Turkey targets RIA efforts toward proposals that are expected to have the largest impact on society.

Develop and implement data collection strategies. The usefulness of a RIA depends on data quality. Data issues are consistently problematic and the development of strategies and guidance for ministries is essential if a successful programme of quantitative RIA is to be developed.

Integrate RIA with the policy making process, beginning as early as possible. Integrating RIA with the policy making process will, over time, ensure that the disciplines of weighing costs and benefits, identifying and considering alternatives and choosing policy in accordance with its ability to meet objectives become a routine part of policy development.

Involve the public extensively. The public, especially those affected by regulations, can constitute cost-effective sources of the data needed for high quality RIA, while consultation can provide checks on the feasibility of proposals, possible alternatives, and the degree of acceptance of the proposal by affected parties. A potentially powerful means for Turkey to formalise public consultation and improve rapidly the quality of RIAs would be to require the publication of a RIA through a "notice and comment" mechanism.

Building administrative skills through training and merit-based recruitment

A skilled and well-trained civil service is a prerequisite for developing high-quality regulations and regulatory policies. In Turkey, widespread clientalism and patronage in the recruitment of new civil servants has for many years undermined the achievement of this goal. This led to low efficiency in many parts of the public sector and reduced confidence in the impartiality of decisions by public authorities.

The Turkish government shows a strong awareness of the need to address these issues. It took a major step in this direction in 1999, amending the by-law regulating public sector employment to improve the objectivity and consistency of the standards applied by ministries and allow greater monitoring and control by the centre of government. Fundamental elements included:

1. Candidates take a general exam prepared by the Central Exam Unit (OSYM), an independent body attached to the Higher Education Council.
2. Individual agencies and departments send requests for new staff to the State Personnel Department.
3. The State Personnel Department allocates new staff slots to the applicant agencies and ministries.
4. The State Personnel Department publishes all vacancies.
5. Candidates apply for the vacancies to the State Personnel Department, which allocates candidates to vacancies according to an electronic system matching candidates' skills and exam scores with the requested skills profile.

A wide range of public sector agencies remain outside the scope of the by-law, including the armed forces, university lecturers, judges and public prosecutors. In addition, some public sector agencies and independent regulators have been exempted from the by-law. These bodies have – as required in their founding laws – set up *specific* tests relevant to their special skill requirements. However, these tests are also prepared or certified by the OSYM.

Despite these exemptions and limitations, the implementation of the by-law seems largely successful: notably, no central government agencies are exempt from its operations. It is likely that this success – perhaps surprising given that a by-law is a relatively weak requirement in the Turkish legal culture – is largely the result of the strong and continued support for it at the highest political levels. This underlines the importance of such support in achieving effective regulatory reforms.

Building regulatory agencies

As in many OECD countries, the establishment of new independent sectoral regulators, and the remodelling of existing ones has been a key element of Turkey's recent structural reforms. Turkey has increasingly favoured the "independent regulator" model as part of a strategy to separate ownership, policy development and day-to-day regulatory overview in liberalised sectors. These steps are particularly important in Turkey, given the importance of impartial and effective regulatory institutions, isolated from political influence, to the perceived attractiveness of markets to foreign investors. The renewed impetus for these structural reforms also reflects the need to adjust the inadequate governance structures established following the privatisation of public monopolies in the 1980s. Agreements with the IMF and the drive toward EU accession have also been factors.

Turkey's sectoral regulators are established via specific legislation, which defines their jurisdictions, specifies regulatory objectives and grants them independent decision-making powers, implemented in practice through statutory appointment procedures, administrative, human resources and budgetary autonomy. In general independent regulators are accountable to Parliament. Annual reports are produced, although they are not required to be made public. Auditing arrangements often include *ad hoc* expert commissions, with the audit report and the annual reports being submitted to the Council of Ministers. Decision-making bodies of the authorities are usually appointed by the Council from a list of candidates submitted by stakeholders. The governing laws stipulate qualification requirements, including experience and professional credentials. Members are governed by the civil service law and cannot be dismissed before for reasons other than those explicitly stipulated by the laws. These include standard criteria of an offence in performing their duties or breaking the conflict of interest rules. However, some parties have questioned whether these provisions are sufficient in practice to prevent political influence over the appointment and decisions of these bodies.

To increase transparency regarding appointments, a procedural measure could be introduced requiring candidates to be evaluated in public hearings based on their skills and experience, with the participation of relevant civic and private organisations. As a general administrative practice, the biographies of all prospective and actual members of the boards of all regulatory authorities should be made available on the agencies' Web sites.

Independence also requires an adequate resource base. The regulatory institutions are primarily independent from the government budget, being funded on the basis of fees for licences/permits, fines and levies. In addition to the above mentioned exemptions from the recruitment by-law, recruitment flexibility is provided by the ability to employ staff on the basis of "contracts", which allow for higher remuneration levels, usually linked to the salaries in the regulated sector.

Authorities can produce subordinate legislation, subject to a check by the General Directorate of Legislation Development and Publication on the regulation's constitutionality and accordance with other laws. While no other standardised procedures or requirements exist for this rule-making, many independent regulators are considered more open and consultative in this regard than central government, perhaps due to the absence of traditions constraining the use of new methods. The rights of businesses and citizens to appeal decisions of independent regulators are identical to those regulating government regulations.

General Assessment. It is too early to assess the performance of the newly established regulatory agencies. However, two areas of concern are the risk that a proliferation of sectoral regulators may increase institutional rigidity and fragmentation (for instance regarding the tobacco and sugar industries), and the concerns that have been expressed regarding the effective level of independence from the government of many of the regulators. A critical approach must be taken to the decision as to whether a new sectoral regulator is required and how potential overlaps will be avoided. Once established, the regulators must vigorously apply their governing statutes to ensure that confidence in their independence is created and maintained. A critical part of this work involves sufficient educational and promotional efforts to mobilise strong support constituencies and ensure that intended beneficiaries – supported by activists and the media – also play a monitoring and oversight role. However, it is important to note that the regulatory framework established for the new sectoral regulators shows a strong commitment by the government to establish truly independent and effective regulatory bodies.

Dynamic change: keeping regulations up-to-date

Revisions of existing regulations, laws and subordinate regulation

Regulations that are efficient today may become inefficient tomorrow, due to social, economic, or technological change. Thus, systematic review and reform of existing regulations is a fundamental element in achieving a high quality regulatory structure. Turkey has undertaken a number of large scale reviews of existing regulations in recent years, with substantial results. Experience from other OECD countries suggest that de-regulation – as a first step in developing a high-quality regulatory system – has been important in boosting sectoral efficiency and innovation and enhance economy-wide flexibility and potential growth.

From 1985-1988 Turkey reviewed and codified all laws and regulations then in force, with more than 11 000 laws being reviewed individually and classified by subject matter. 1 664 laws and regulations were abolished and the rest were compiled and published as a collection. Today, EU accession drives the review of existing regulations. Revisions of existing regulations are reported in the annual EU reports on progress towards accession. (For these reports the European Commission makes use of the implementation reports prepared by the Turkish Secretariat General for EU Affairs.) While there are no mandatory periodic reviews (other than those stemming from EU accession requirements), sunsetting is used in some areas. For example, time limits were set for the activities of Regional Disaster Co-ordination Governorship and of the Southeast Anatolia Development Administration.

In sum, experience from other OECD countries suggests that Turkey may benefit from another review of its existing regulations. A substantial amount of new laws and regulations has been produced since the 1980s review, and there is much evidence suggesting that many regulations in Turkey are out-dated, slowing innovation and causing unnecessary rigidities. Review strategies should be carefully planned and focussed, with a clear set of principles guiding review programmes, including particularly competition principles. Standardised evaluation techniques and decision criteria should complement these principles.

Reducing administrative burdens

A key area for reform of existing requirements in Turkey is that of business licensing. Compared to other countries, procedures for setting up a company are lengthy. There are 19 steps for a foreign company to establish in Turkey, while local companies face similar levels of complexity, including the need to produce up to 65 separate documents and apply to as many as 13 different institutions.

Excessive licensing requirements can add substantially to business costs and discourage new ventures or expansion of existing businesses. Administrative burdens are a leading competitive disadvantage of the Turkish business environment and a key constraint on foreign direct investment. A whole service industry in Ankara has evolved as a result: a recent study showed that over 65% of investors use specialized consultants to deal more effectively with bureaucracy.

The Turkish government has implemented several programmes to deal with this issue over many years, but significant results from these efforts are not visible. Much effort has been expended in improving access to information about regulatory requirements (for example, current efforts to establish electronic "one stop shops") and facilitating the internal transactions within the public sector. However, efforts to address fundamental regulatory design and co-ordination issues have been lacking until recently.

A positive sign is the recent Council of Ministers Decree for Improvement of Investment Climate. Nine technical committees were set up to implement the recommendations of the FIAS/World Bank report on reducing administrative barriers to investment. These committees are co-ordinated by the Investment Climate Improvement Co-ordination Council headed by the Under-secretary of the Prime Minister. The Council will report on the studies carried out by the technical committees to the Council of Ministers on a quarterly basis.

Assessment. The Turkish government's burden reduction activities have been disproportionately directed toward *information access*, rather than reducing substantive requirements. The licensing system imposes excessive burdens, while lack of transparency combined with bureaucratic discretion in implementation creates incentives for corruption and non-compliance. The effectiveness of the programme to implement the FIAS recommendations is a crucial medium-term test in this area.

Conclusion

The depth of the current economic crisis combines with the prospect of EU accession to create a highly favourable climate for reform in Turkey. There is growing awareness of the importance of reform and growing political will to confront the grave governance issues that have contributed to the current crisis. Major initiatives have already been launched, but success depends on building stronger reform constituencies and on strengthening governance capacities to manage and implement regulatory reform.

Economic crisis has exposed substantial weaknesses in Turkish public administration. Comprehensive reforms are urgently needed to address regulatory institutions and practices that are outdated, incoherent, ineffectively managed, and undermined by lack of trust in government, wide-spread non-compliance and in some cases corruption. The implementation and enforcement capacities of the public sector lag far behind policy decisions.

Some important elements of an appropriate regulatory management system are already in place, and policy learning is underway. An important challenge is to build on this base.

Policy options for consideration

The policy options below represent a balanced and far-reaching reform agenda intended to produce an effective transparent, accountable, and user-friendly regulatory environment. The strategies recommended are based on good practices in other OECD countries. If implemented, they will change significantly the style and culture of Turkey's public administration, and its relations with society at large. However, implementation will require considerable time and sustained commitment by reformers.

These recommendations do not deal with the issues of the capacity of the judiciary and the reform of the electoral and party laws, which are crucial foundations for an overall structure of interlocking institutions that together establish the incentives and pressures for high-quality regulation. It is particularly important in Turkey to provide an effective judicial infrastructure for dispute settlement, since the role of arbiter of the rules of the game must expand as direct economic intervention by the government is reduced.

1. Adopt at the political level a broad policy on regulatory reform that establishes clear objectives, accountability principles, and frameworks for implementation.

The regulatory reform policy should be based on explicit principles of good regulation such as those in the 1997 OECD *Report to Ministers*. In particular, the principle that regulatory costs should be justified by benefits should be adopted. It would provide a basis for performance assessments and improve accountability. The policy must be strongly supported at the highest political levels.

2. Establish a ministerial position to champion regulatory reform at Cabinet level and to co-ordinate regulatory reform across government.

A cabinet member should be designated to promote and implement regulatory reform and should report publicly on its results. Consideration should also be given to supporting the minister via a ministerial committee similar to that employed in the Netherlands in implementing the influential MDW programme.

3. Establish a technical oversight unit to help the minister monitor regulatory reform progresses.

This unit would provide the necessary support to the ministerial committee and take a broader role in regulatory quality assurance by providing assessments, based on RIA principles, of all proposed regulation to be discussed in the Council. Its mission, powers and legal status in the regulatory process should be formalised to reduce opposition. It would need authority to advocate and design thematic and sectoral programmes of reforms and develop performance targets, timelines, and evaluation requirements.

4. Clarify and streamline the legal scrutiny currently undertaken.

Currently an overlap exists between the legal scrutiny exercised by a number of different bodies. Duplication of the legal scrutiny functions should be avoided and measures should be taken to ensure an efficient allocation of resources in legal scrutiny of draft laws and regulations.

5. Improve the quality of new regulations by implementing across the administration a step-by-step programme for regulatory impact assessment, based on OECD best practice recommendations, for all new and revised regulations.

Lack of information on impacts of regulatory proposals means that Turkey's laws are vulnerable to the influence of special interests and lack transparency. Turkey should adopt a RIA programme, based on OECD best practice principles, with quality control by the oversight unit recommended above. Comprehensive training should be provided to develop capacities for impact assessment. The Council of Ministers should refuse to discuss proposals not accompanied by a RIA, and subordinate regulations should not be signed by the responsible minister without a RIA reviewed by the independent body. RIA resources should be targeted on the most important regulations.

Adopting benefit-cost analysis must be the long-term goal of the RIA programme. However, immediate constructive steps, consistent with current administrative skills, could involve incorporating in the justification reports received by Parliament the ten quality dimensions of the 1995 OECD checklist. The checklist could also be made mandatory for subordinate legislation, decree laws and (tüzüks).

6. Improve transparency by establishing legal requirements for notice and comment-procedures for all ministries, agencies and independent regulators during the development and revision of regulations.

Current informal public consultation practices reduce regulatory quality and leave Turkish regulators vulnerable to the influence of organised interest groups. A mandatory public consultation requirement, based on objective criteria, would substantially improve quality and transparency. An effective mechanism would be to adopt "notice and comment" requirements for all regulations. Notice and comment processes are based on clear rights to access and response, are systematic and non-discretionary and are open to all. Requiring that all regulatory projects be published together with the RIA (see previous recommendation) could also strengthen the system.

7. Promote the systematic consideration of regulatory alternatives for new regulatory proposals, including subordinate legislation, so that the use of alternatives flows beyond the area of environmental protection to all regulatory controls.

A significant omission from the current regulatory quality programme is the failure to promote the use of regulatory alternatives. Explicitly requiring the consideration of alternatives would encourage the use of these instruments where gains in policy effectiveness are available. Requiring the RIA to document this consideration would provide an appropriate quality control tool.

8. Initiate a comprehensive review of existing regulations to ensure that regulations continue to meet their intended objectives efficiently and effectively.

A substantial amount of new laws and regulations has been produced since the 1980s review of the regulatory stock. Much evidence suggests that many regulations in Turkey are out-dated, slowing innovation and causing unnecessary rigidities. Experiences from other OECD countries suggest that prioritising reviews of existing regulations as an initial regulatory quality policy may be a particularly beneficial strategy. Review strategies should be carefully planned and focussed, with a clear set of principles guiding review

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programmes, including particularly competition principles. Standardised evaluation techniques and decision criteria should complement these principles.

9. Continue efforts to reduce administrative burdens by establishing a central registry of administrative procedures and business licences and permits.

Administrative burdens, in particular business licences and permits, are among the most important barriers to Turkish entrepreneurs. Rapid and resolute abolition of this type of regulation can bring swift economic gains and build a constituency among SMEs for further reform. To obtain such results rapidly, a mandatory registry of all forms should first be organised, with positive legal security.

10. Increase significantly the attention given to compliance and enforcement of regulations.

Improvements in enforcement and compliance are interlinked and are among the most important challenges to Turkey's regulatory management system. Reform must involve improvement to ministries' enforcement capacities as well as consideration of opportunities for *ex ante* consideration of compliance and enforcement issues as is done in the Netherlands.

Managing regulatory reform

The success of regulatory reform programmes depends not only on their policy content, but also on the implementation strategies followed, including the pace, sequencing or reform, accompanying policies, and transitional arrangements. Turkey's recent regulatory reforms have focused on restoring the economic situation, while reforms to the public sector and governance capacities have lagged. There is a risk that urgent short-term actions tied to the need for fiscal adjustments may crowd out important systemic initiatives that are essential to longer-term success.

The most important determinant of the scope and pace of further reform is the attitude of the general public. The Turkish experience suggests communication strategies should accompany the policy reforms suggested above. A high priority to motivate support for reform is to deliver visible benefits to businesses and consumers and by doing so building a constituency for reform.

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PART II

Chapter 3

Competition Policy*

* For more information see: "Background report on Competition Policy in Regulatory Reform" at *www.oecd.org/regreform/backgroundreports*

Competition law and policy in Turkey

Competition policy institutions are in place and active, but competition policy is not yet fully integrated into the general policy framework for regulation. Many features of state-led development remain. Reforms have been announced, but implementation is slowed by crisis. The lack of public awareness about competition policy and the new institutions is indicative of the uncertain status of competition in Turkish public policy and debate. Turkey's conception of competition policy supports a broad program of pro-competitive reform. The competition laws and enforcement structures, the Competition Authority and its decision-making Competition Board, are well-considered and supported by adequate resources. But the institutions have not yet had to weather a serious political storm. The Competition Board's ambition, to be at the centre of a broad reform programme, does not quite match its present circumstances, but it is not necessarily unrealistic in the long run.

Competition policy became a priority in the 1990s

Adoption of an explicit competition policy was an element in Turkey's project to restructure and reform its economy over the last 10 years. State-led development in the 20th century had depended on monopoly and control. This old programme created many problems that the recent reforms have been trying to correct. Efforts to shift toward a more liberalised market economy have been underway for about 20 years. Despite substantial moves toward liberalisation, many areas of the economy remain under government control or ownership, and the state's share of manufacturing remains high: 25% measured by value added, 12% by employment (EC, 2001). Tobacco and alcoholic beverages (and at one time, sugar and tea) have been state-owned monopolies, with prices fixed all the way to the retail level.

The possibility that a formal competition policy would be needed was recognised at the beginning of the long-term reform process. Both internal and external forces supported the development of competition legislation. The competition law was being developed while Turkey was negotiating a customs union with the EU, and the competition law that was adopted at the end of 1994 takes the EU treaty as its substantive basis. But the institutional structure came slowly. The Competition Act has been in force for nearly 7 years, but the Competition Board has been applying it only since the end of 1997.

The Board has staked an ambitious claim for the scope of competition policy: Competition laws do not, in fact, detail all the competition policy of a state. Apart from competition laws, competition policy is a broad concept including subsidies, domestic and foreign trade, state monopoly and public buying policies. Turkey's competition policy as creating and maintaining a healthy and competitive domestic environment, is designed to build a powerful Turkish economy with high competitive power abroad. Such a policy can only be successful by directing all the instruments of the state towards the same target. The conductor of this mechanism will be the Competition Authority.

Overall economic plans have emphasised reliance on markets and competition. Events have overtaken plans, but market reforms are still a high priority. Crises have demanded attention and resources, particularly concerning macroeconomic stability and banking. Many crisis-response measures reduce state control and improve market functioning, in part to prepare the way for privatisation. The demands of responding to crisis have not distracted from the generally pro-competitive intention of reform, but rather have intensified it.

Turkey's substantive competition law has generally followed the outline of EU law

Turkey decided that the EU model was appropriate, in part because Turkey's relationship with the European Union is an important vehicle for integration into the world economy. The Competition Act's prohibition against anti-competitive agreements is slightly broader than the EU model. Turkey's law adds an interesting innovation to deal with tacit collusion, a "concerted practice presumption" that is designed for oligopolistic markets in which proving overt, subjective agreement is often difficult. Recognising that this rule is novel, the Authority is using it cautiously to see how it works.

Commonly encountered cartel situations drew enforcement attention as soon as the law became effective. Left to their own choices, firms in many industries had chosen to avoid the contest or independent action that the Competition Act seeks to promote. Persistent problems require repeated attention. The Authority and the Board have already revisited some sectors, such as cement and baking, to find and address commonly recurring restrictions.

Further reforms will parallel changes in the EU. Along with the EU system of substantive law, Turkey took on the practical problems of applying it through the method of prohibition and exemption. One result is an excess of applications for exemption or negative clearance, as businesses want to be sure their agreements are not challenged. The draft of an exemption system like the European Commission's new block exemption regulation was under consideration by the Board in June 2001.

Some problems will require legislative solutions

The constitution and other laws support the use of industry or trade associations to prevent competition in some sectors. These associations have a quasi-public status and statutory responsibilities for self-regulation that may include the power to fix prices. This legal support for their conduct prevents the Board from using the Competition Act to stop price-fixing by providers of many professional and other services. As services become a more important part of the economy, the laws that authorise these associations should be revised to remove the authority to fix prices or to limit entry on grounds other than competence, to ensure that these sectors operate competitively.

Concepts about dominance and abuse follow the EU model. The prohibition of abuse of dominance has been applied in telecoms to discrimination against internet service providers. In most respects, though, Turkey is dealing with dominance and abuse in traditional infrastructure monopolies through specific sectoral laws. Some of these laws set thresholds, some of them based on market share, evidently to prevent the creation of dominant positions after reform and restructuring. These sectoral laws also contain rules about pricing and network access to control abuse by dominant incumbents. These rules will probably displace the Competition Act as a practical matter, although the sectoral reform laws do not create formal or explicit exclusions and thus the Board retains jurisdiction and power in these industries. The Board's potential role in restructuring traditional network monopolies is limited by the absence in Turkey's law of provisions equivalent to Art. 86 of the EU treaty setting out some competition-based principles to apply to state monopolies and firms with special and exclusive rights.

Merger control has been applied sensitively, to support creation of efficient-scale firms while resisting creation of post-privatisation monopolies. Privatisation transactions are subject to an analogous review process. The Board has rejected at least one privatisation-related acquisition because it would have created a dominant position in the nitrogen fertiliser industry (IGSAS). Because a major goal of government economic policy is to maintain and develop effective competition, mergers have generally been permitted, in order to establish efficient-scale operations that can compete with imports. The obligation to notify a merger (or privatisation) may be determined by market share as well as by overall turnover. Basing the formal notification obligation on what is often a contested judgement of market definition and market share imposes costs without providing much benefit. Unless there is a significant problem in Turkey with high-market-share mergers among relatively small firms, it would be better to drop the market share test and rely on the aggregate turnover standard, which governs nearly all the time anyway.

A body is needed to monitor anti-competitive state aids

Currently, there is no body charged with responsibility for controlling anti-competitive state aids. The Authority is in an independent position, not subject to oversight by a ministry with programmatic responsibility, and thus may be well placed to perform this monitoring and supervision. The Authority believes that the inevitable political pressures can probably be managed. The issue is still under discussion.

The new institutions are independent and ambitious

The institutions with formal responsibility for competition policy are the Competition Authority and Competition Board. The Authority is a legally separate entity from the government. Administrative and financial autonomy are decreed by statute. The Authority is in effect self-funded. The Competition Board exercises the Competition Act's decision-making powers. The Chairman of the Board is also the President of the Authority and acts as its chief executive. The complex process of appointing Board members balances expertise with political responsiveness Appointments are made by the government, from individuals nominated by several designated institutions. Problems raised by the "representative" character of some members may be diluted by the indirect appointment process and by the preponderance of members that have no links to interest groups. Only 1 of the 11 members is nominated by the business groups that are actually subject to the law.

The procedures and methods that the Board and the Authority have introduced into Turkish administrative practice could be models for reform practice by other regulators. Law enforcement processes centre on adversary hearings. The Board's procedures for applying the law were a novelty in Turkey's administrative practice, which did not historically envisage the participation of the parties in the decision-making process. Investigation powers are broad. Deadlines govern every stage of the process. Transparency is a priority, but disseminating information remains a challenge. Practitioners find that the Board's decisions, when they appear, are well-reasoned. A program of regular lectures and seminars about competition policy issues is open to the public and well attended. Despite the Authority's efforts, the public at large, and even the business sector, are not yet well informed about competition policy developments. Among those who are paying attention the Authority has a reputation for quality administration.

Substantive sanctions appear adequate: one recent case resulted in a fine of over EUR 5 million. But administrative sanctions to ensure compliance with rules and procedures are weak, as inflation has diluted their effect. One firm subject to a "dawn raid" elected to pay the daily fines and continued to resist access (although it relented after holding out for a few days). Appeals are delaying effective implementation. As the law is clarified by decisions on these appeals from the Board's first actions, and as businesses and the courts become more familiar with the Competition Act's requirements and the Board's practice, delays due to appeals may decline.

Resource levels show serious commitment to competition policy. The number of staff is commensurate with the scope of the Authority's responsibilities and the scale of the Turkish economy. For comparison: the Authority's personnel complement is about 50% greater than that of the competition agencies in Italy, Poland, and Mexico, and it is about 75% of that of the competition agencies in Korea and Canada.

Regulations and public monopolies limit the scope of competition policy

The Competition Act appears to apply broadly, but in fact authorisation by public bodies and agencies limits the reach of competition policy significantly. There are very few explicit exclusions from the law, but many regulatory programmes displace or undermine competitive markets. Some are remnants of the tradition of state control, and some respond to current crises. Regulatory authorisation, if specific enough, may confer an exclusion.

Narrow interpretations of general terms have resulted in an exclusion for many public entities. Even public entities that are engaged in business may be excluded from the Competition Act prohibitions because of the interpretation of the term "undertaking". A public firm that might be subject to ministerial direction might not be considered an "undertaking" subject to the competition law. The Board fined BELKO, an undertaking with a legal monopoly over heating coal in Ankara, for abuse of dominance; the action led the Ankara Municipality to terminate the monopoly right.

No general rules set standards to control public monopoly. Turkey's competition law has no rule equivalent to Art. 86 of the EU treaty, to govern the permissible operations of monopolies providing public services. Indeed, there are general provisions about operations of public enterprises that tend to exacerbate competition problems, by giving them advantages over their competitors in access to funds. And local government bodies may enjoy some degree of exemption from competition policy.

In order to strengthen further its competition policy control on government decisions that suppress rivalry throughout the economy, Turkey may wish to consider introducing legal prohibitions against anti-competitive acts by other governmental bodies. Such prohibitions, successfully used by a number of transition economies from Eastern Europe and the CIS which still have a substantial amount of regulatory barriers to competition at both central and local government levels of government, provide additional legal instruments for an area that in other countries falls under the purview of advocacy activities.

Special sectoral rules sometimes limit competition, and sometimes promote it

In the financial sector, some rules limit the reach of competition policy. Bank mergers are exempt from Competition Act review, in the current emergency conditions. Interest rates could be controlled, but in fact they are not. Regulatory intervention in banking affects competition in other sectors. Credit has been allocated by regulations or by decisions of the council of ministers. Public-capital banks must make low-interest loans to identified sectors, farmers, and artisans. Reforms are planned to prevent this practice, which distorts competition in the markets where credit preferences are targeted.

The law to re-regulate the tobacco industry, enacted in January, 2002, sets up a 7-member Tobacco Products and Alcoholic Beverages Regulatory Board with responsibility for regulating pricing, distribution and sale. Tobacco is to be purchased through contract or auction. Production of tobacco products requires approval from the Board. Large undertakings (with the annual capacity to produce at least 2 billion cigarettes and 15 000 tons of other tobacco products per brand) may freely import, price, distribute, and sell that brand. For smaller importers, the price and marketing principles are to be determined by the Council of Ministers.

Mineral products have long been state monopolies; some may be privatised. Salt production was a TEKEL monopoly. Only since 1998 have other firms been permitted to produce salt, and then only from new locations or from sites that TEKEL has abandoned, and with the permission of the government. Other mineral products that have been state monopolies include boron, trona, asphaltite, uranium, and thorium. In petroleum, TPAO, the Turkish Petroleum Corporation, has an advantage over its competitors in access to licences, though not a monopoly.

In agriculture, official intervention and support displace supply and demand. Historically, government price supports stabilised this sector, which is particularly important in Turkey. Though the support programme did not technically prevent application of the competition law, the non-competitive markets that resulted implied a *de facto* exemption. The new agricultural policy is trying to shift toward market economy rules, and a new law on the sugar market takes some steps toward market reform.

In pharmaceuticals, Ministry of Health regulations control competition. These regulations appear to be generally consistent with common practices in EU countries.

Self-regulatory bodies of professionals and other providers of services are recognised in the Constitution as quasi-public entities. The laws authorising these associations typically also authorise them to set their members' prices, and that authorisation makes it difficult to challenge these pricing agreements under the Competition Law. Some association restraints may be subject to the Competition Act, though. The Authority has tried to call attention to the competition problems that these rules raise, and the Board has taken some law enforcement action where possible. Shortly after it began work, the Board investigated price fixing among electrical engineers, who stopped the practice when the investigation started. More recently, the Authority has looked at the by-laws of the chamber of city planners and the association of chambers of architects and engineers. The associations argued that provisions setting minimum prices protected the public interest, but the Competition Authority disagreed and concluded that the practice infringed competition.

The telecoms law overlaps the Competition Act in some respects. Both laws apply; there is no exemption from the Competition Act. The telecoms and competition agencies are working to develop a protocol for co-ordinating their actions. Monopoly rights of the incumbent, Türk Telecom, are to end when its public ownership falls below 50% or at the end of 2003, whichever comes first. The telecoms and competition agencies are working to co-ordinate their actions. The two agencies have developed a practice of consultation, on particular cases and general regulations. The agencies agreed on the analysis and outcome in a case involving abuse of dominance over Internet service providers, and the telecoms regulator is consulting the Competition Authority about tariff setting principles.

Plans for reforming the electricity and gas sectors preserve a role for the Board. The sectoral reform laws do not create exclusions from the Board's jurisdiction, and they incorporate some competition principles, such as prohibition of discrimination by natural monopolies and elimination of geographic restrictions on retail sales of electricity. But unlike the telecoms law, these sectoral laws do not call for input from the Board in the development of regulations affecting competition in these sectors.

In passenger transport (bus and taxi services), several levels of authority control aspects of entry, operation, and pricing, depending on the geographic scope of operations. The Authority has investigated complaints about abuse of dominance by terminal operators and price fixing by bus firms. Meanwhile, the state rail monopoly is faltering. Domestic ocean-going trade is regulated to control competition, but international maritime trade is open to competitive entry, and the national shipping firm, Sea Transport Inc., has been privatised. The legal monopoly was ended in February 2002, but in practice piloting and towing remain local monopolies.

Regulation and operation of airlines have been combined as government functions. The Civil Aviation Act of 1983 permitted competitive entry, but most of the entrants foundered. Would-be entrants faced crippling conditions. The ministry no longer applies these conditions, though, and in April 2001, the rules about the minimum number of planes for a firm entering scheduled service were changed to make entry easier.

The postal monopoly may enjoy unfair competitive advantages. In the absence of a provision similar to Art. 86 of the EU treaty, the anti-competitive effects of cross-subsidies in this sector cannot be investigated under the Competition Act.

Special rules imposed by the broadcast regulator try to limit control of different media outlets. The motivation for rules such as these is as much to preserve viewpoint diversity and to disperse influence over opinion, as it is to protect economic competition. Meanwhile the Board has undertaken several cases involving ownership and distribution relationships in publishing and media.

Advocacy about the competitive effects of policies and proposals has been limited

Because competition policy is novel in Turkey, the Authority has concentrated on public education to call attention to the law and its principles. The Board and the Authority are nevertheless concerned about anti-competitive regulations. They are undertaking a comprehensive review of the laws on the books, in order to identify possible conflicts with the Competition Act. The results will be assembled into a report for submission to the government. The Board is evidently the only body with the power to make such a report without being invited to do so. The Board's institutional autonomy may be a handicap in the policy process, though. The office of the Prime Minister has encouraged other parts of the government to consult with the Board. But consultation pursuant to this admonition has been uneven. The Board has often not been asked for an opinion, or its opinion was sought only at a very late stage.

Conclusion

The process of reducing the state's direct involvement in the economy has been accompanied by the development of an explicit policy about competition. Turkish policy makers understand that in a private enterprise economy, protecting the public interest requires viable institutions dedicated to supporting market competition. That concern motivated development of the law on competition in the early 1990s. Another motivation was the expansion of ties with the EU, evidenced by the customs union agreement of 1995, which includes competition policy conditions. Turkey now has a comprehensive competition law and a credible institution to apply it. But even though the law has been in place for 7 years, public awareness of what competition policy really means is limited.

Box 14. **"Advocacy" in the privatisation process**

Consultation about competition impacts in privatisation appears to be working well. The Board may be involved at two stages, first in designing a privatisation plan for an industry or asset, and then in applying the general merger review authority to the proposed transaction. The Board's *Communiqué* about the privatisation process sets thresholds, so that consultation is required only for transactions that are more likely to present competition issues: those where the entity being privatised holds a market share over 20%, or has turnover above TRL 20 trillion, or has a legal monopoly or other competitive advantage. And the Board must be consulted if the acquiring party has a market share over 25% or turnover above TRL 25 trillion, whether or not any of the conditions about the privatised entity are met.

The general law providing for the Privatisation Authority calls for that body to consult with the Board. A general law provides for privatisation procedures; in addition, the privatisations of Turk Telekon and the banking sector are governed by particular legislation. The Board's views are to be obtained before the tender so the Board can advise about whether to eliminate firms that should not participate. The decision to privatise an asset and the approval of a bidder are made by the Privatisation High Council, a political body. But even after that decision, the Board may still have an opportunity in the merger review process to correct competition problems.

Some examples:

- The Authority helped develop the conditions for selling 20% of Turk Telecom, pointing out that the GSM holders should not bid, and if their affiliates won, divestiture might be needed.
- In the fertiliser case, the Board intervened at the end of the process to prevent the privatisation from leading to a monopoly.
- In petroleum distribution, the Authority said that the distributors' association should not be permitted to bid for the state firm.
- The two-stage review protocol is being incorporated in the privatisation legislation for the electricity and gas sectors.

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Reform plans call for more competition in traditionally monopolised infrastructure sectors. Implementation of those plans will depend on action by sectoral regulators and the outcome of the privatisation process. As in most OECD member countries, the role of the competition agency in infrastructure reform is largely to advise about the design and implementation of reform, and to enforce the law against abuse of dominance aimed at new entrants.

But the state's involvement in the economy remains strong. In sectors that the state has long dominated, reforms and restructuring are moving toward greater reliance on markets and competition. Events and conditions of the recent economic crisis have compelled many of these changes, some of which are being encouraged by international institutions like the World Bank and the IMF. But market conditions and inertia have slowed or stalled important privatisation projects. In some sectors, proposed reforms only go half-way, by providing for new regulatory bodies rather than simply dismantling the monopolies and thus eliminating the need for economic regulation. Political sensitivity and linkages to other policy concerns no doubt counsel caution. Thus, the effort to reduce controls in the tobacco industry was delayed because of concern about the fact that the reforms would also have reduced subsidies to producers. The evident need for outside support to make these changes happen indicates the difficulty of establishing market competition principles in the face of Turkey's regulatory and political traditions. The general direction of policy is toward greater reliance on markets and competition, but legislation is coming faster than action.

In competition law enforcement the process is more advanced, as concrete actions are being taken to apply well-established basic legislation. The Authority and the Board have been doing this for more than 3 years. Several important action had been taken even before these institutions were in operation. Enforcement priorities are well considered and actions show increasing confidence and imagination. The Board's position with respect to the government and the composition of its membership show a sensible balance of independence and responsiveness. The Board and the Authority are off to a good start. It remains to be seen how well they will weather a substantial politically-charged controversy, though. And the Board's first decisions still have not been finally decided on appeal; in the meantime, big fines remain unpaid.

Competition advocacy has been sporadic. The Authority may have been concentrating at first on applying the Competition Act, including educating business and the public about its provisions and requirements. A solid record of competition law enforcement can make advocacy about competition in other policy areas more credible. And there have been important steps. The Board's role in the important task of privatisation appears well-conceived. The Authority is engaged in a valuable project to canvass the existing body of legislation to identify and report on anti-competitive provisions that should be reformed or removed. But in general, its involvement in policymaking and sectoral reform is inconsistent, despite the instruction from the Prime Minister's office that other agencies consult with it about proposals that could affect competition. In some cases, crisis and time pressure make more thorough consultation difficult. But other parties may also try to bypass the Competition Board in order to avoid its likely policy advice. It is curious that the telecoms legislation calls for consultation between the Board and the sectoral regulator, but the energy legislation does not. Does this represent an oversight in the preparation of the energy law? The Competition Board has an expansive conception of its responsibilities, and it clearly wants to be a leader in pro-competitive reform. It is not yet clear how many will follow. But it is clear that the benefits to the country from enhanced competition advocacy would be substantial.

Policy options for consideration

The following steps are recommended for consideration to strengthen the scope, effectiveness, and enforcement of competition policy, by eliminating gaps in coverage, enforcing competition law vigorously, and providing competition policy institutions with the authority and capacity to advocate reform and to participate effectively in the transition to competition in deregulating, restructuring industries. They are listed beginning with the most important–and the most difficult.

1. Finish eliminating state monopolies and anti-competitive protections.

Despite the efforts to reform over the last several years, several state monopolies remain in place, in sectors that could be competitive. For some, such as tobacco and sugar, the plans for reform call for establishing new bodies to regulate their prices and control abusive behaviour. It would be better simply to eliminate the monopolies and to prevent abuse by applying the general competition law. Special sectoral regulation is not costless. Care must be taken to ensure that sectoral regulatory boards represent the interests of consumers and the public, rather than the industries themselves. Even then, regulation is unlikely to achieve the level of efficiency and innovation expected from market competition. And for some other sectors, such as salt and petroleum, state firms enjoy actual or implied advantages over non-state competitors, in access to licenses or drilling rights, for example. Those advantages should be removed, to eliminate inefficient competitive distortions and discriminations. Market conditions may have made it more difficult to privatise these firms and thus eliminate the motivation to protect them. But pending successful privatisation, and in preparation for it, any special advantages in access to resources or to regulators should be eliminated.

2. Assign formal responsibility for controlling anti-competitive state aids.

The benefits of reducing direct state involvement in the economy could be compromised by a proliferation of indirect distortions and preferences that also distort competition. The need for centralised control of anti-competitive state aids is widely recognised. Turkey has already undertaken an obligation to control these subsidies in the context of its customs union agreement with the EU. A general principle that applies to effects in Turkey, as well as to effects on trade with EU countries, would be a valuable addition to Turkey's substantive competition law. No single office in Turkey is responsible for this task. Increasingly, EU countries are incorporating this principle into domestic law and giving this responsibility to competition authorities, paralleling the assignment of responsibilities at the EC. The EC has proposed that the Authority and the Board perform this task in Turkey.

To strengthen its control over government decisions that suppress rivalry, including restrictions on enterprise entry and operation as well as non-competitive procurement practices, Turkey may wish to consider introducing legal prohibitions against anti-competitive acts by other governmental bodies as an additional instrument of competition policy enforcement.

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3. *Develop a competition policy control on monopolies providing public services.*

Another item from the EU "toolkit" that Turkey has not yet adopted is a general principle to govern the treatment of public monopolies. The EU approach, based on Art. 86 of the EU treaty, provides some basis for limiting the anti-competitive effect of grants of special and exclusive rights or duties to perform services in the public interest. Turkey might consider adding that tool to its domestic law. In addition, Turkey might consider revisiting the interpretation of the technical jurisdictional definition of "undertaking", to eliminate the protection now accorded to public firms subject to ministerial control. Narrow interpretation has limited the application of the Competition Act to state-related entities in important cases. In EU practice, the interpretation and application of this undefined term has led to broader application than Turkey recognises.

4. *Limit self-regulation to pro-competitive tasks.*

Some trade and professional associations with quasi-public status and statutory responsibilities for self-regulation can use those powers to fix prices and limit competition. This is one of the most significant formal exclusions from the competition law. Self-regulation to protect consumers against misrepresentation and injury is possible without eliminating competition. Any self-regulation needs to be monitored so that what purports to assure quality is not just a device to prevent competitive entry. Provisions of the authorising legislation, and perhaps of the constitution itself, should be revised to eliminate those aspects that authorise professional and other service associations to fix prices and to limit entry on grounds other than competence, so the Competition Board can take law enforcement action against abuses.

5. *Strengthen advocacy and the role of competition policy in regulatory analysis.*

Other parts of the government are to consult with the Competition Board about proposals that could affect competition. That direction, in a communiqué from the Prime Ministry's office, is not followed consistently. It appears to be treated more as guidance than as a formal requirement. The requirement for consultation should be mandatory, and it should be integrated into the process of policy review. On its own, the Board has undertaken a comprehensive review of the laws on the books and plans to submit a report to the government about provisions of law that are inconsistent with the Competition Act. The Board believes it is the only body with the power to make such a report without being invited to do so. It is equally important to be alert to the risks that new legislation or regulation will also impair competition unnecessarily. As Turkey adopts a stronger institutional structure for regulatory management, competition policy must be made part of it. It may be appropriate for the Authority to be assigned responsibility for the technical oversight of regulatory reform, in order to review both proposed and existing important regulations based on RIA and competition principles. In the meantime, the Authority and the Board should devote more resources to studies and public reports about competition issues in Turkish markets, building on increasing enforcement experience and pointing out the need for legislative change. Advocacy can be an important vehicle for educating the public about the need for pro-competitive reform and about the importance and value of competition policy, thereby giving information and voice to beneficiaries of pro-competition policies throughout civil society.

6. Ensure consultation with sectoral regulators.

As infrastructure (and other) monopolies are restructured, competition agencies and sectoral regulators need to be in continual communication to ensure policy consistency. Turkey's sectoral regulators are just being established. Co-ordination with the telecoms regulator is provided in the sectoral law, and the two agencies are both trying to make it work. So far, the energy law does not call explicitly for the same level of consultation with the regulator established for electricity and gas. Although the agencies could co-ordinate the consideration of common issues even without legislative direction, statutory authority would eliminate any uncertainty about either agency's power, so that the Competition Board and the Competition Authority could participate as appropriate in the process of restructuring and developing the regulatory system for those sectors.

7. Simplify the merger notification standards and streamline the decision process.

The always-ambiguous "market share" test for notification should be removed. Basing the obligation on a judgement about market definition and market share imposes unnecessary costs and risks. Problems of high-market-share mergers among relatively small firms, if any, could be handled after-the-fact. That would save firms the costs of pre-notification, although it would admittedly make enforcement more complex in those cases. But the savings in costs to firms are likely to be higher than the increase costs of enforcement in what would surely be a tiny number of cases. The aggregate turnover standard determines notification in nearly all cases already. Another potential problem in the merger process is the time that could be required for decision in a contested case. Mergers are usually time-sensitive, and if a consummation of a merger must await a decision that is 12-18 months away, parties may abandon it. For that reason, many jurisdictions set deadlines or special procedures to ensure prompt final decisions in merger cases. To be sure, virtually all transactions that are notified in Turkey are now processed and approved within the 30 day deadline, and the full process of investigating and deciding a claim of infringement has not been applied to a merger transaction yet. But if a merger is challenged as an infringement, then even if firms are allowed to merge pending the Board's final decision they might not implement some potentially valuable strategies, if there is a significant risk that their transaction will have to be undone or significantly modified. Thus provision of a faster track for final decisions about merger infringements could provide valuable certainty. There is some risk that tight deadlines for mergers could crowd other matters off the docket, but the Board's merger workload has not been disproportionate, so that risk is probably low.

8. Restore competition policy oversight of banking sector mergers.

Once the emergency situation in the financial sector is under control, the exclusion for bank mergers should be repealed. Competition problems in the banking sector may spill over into other sectors, as problems of access to funds may discourage entry or encourage discrimination. To be sure, it will be necessary to devise institutional means of considering prudential and systemic regulatory issues along with competition issues, where those are relevant.

9. Strengthen administrative sanctions to aid investigations.

Sanctions to ensure compliance with the administrative process should be strong and credible, so the Authority can get the information it needs to make sound judgements at reasonable cost. The financial sanctions for this purpose appear to have lost the battle with the inflation rate. Sanctions for substantive violations are adjusted annually for inflation. A similar system, and perhaps a higher basic level, should be applied to administrative sanctions as well.

10. Leverage and expand the Authority's reach through international co-operation.

The Authority should consider forming stronger, more formal relationships for co-operation with other competition agencies. Increases in foreign investment and the expansion of the scope of foreign trade will increase the need for co-ordination and for obtaining information and evidence from abroad. This may be a particularly important practical problem for Turkey, which is not part of a supra-national structure with competition policy competence, such as the EU.

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PART II

Chapter 4

Market Openness*

* For more information see: "Background report on Enhancing Market Openness through Regulatory Reform" at *www.oecd.org/regreform/backgroundreports*

Structural reforms in Turkey

For the past two decades, Turkey has moved toward increased reliance on market forces and exposure to international competition. In the early 1980s the government replaced its import substitution strategy with a market-oriented economic policy, while trade liberalisation was given new impetus in the mid 1990s with the signature of the customs union with the European Union (EU), which has strengthened Turkey's economic ties with Europe. Governments have, however, failed to achieve macroeconomic stabilisation. For two decades, fiscal imbalances have fuelled high inflation and undermined growth. At the end of 1999, the government launched a reform programme, supported by the World Bank and the International Monetary Fund (IMF), to stabilise the economy. The programme collapsed with the financial crisis in November 2000 and February 2001, which lead to severe recession.

These developments have highlighted the difficulty of implementing tight monetary and fiscal policies while severe structural weaknesses persist, and given new impetus to structural reforms. The government's economic programme has thus included structural policies to improve the economic environment. The objective is to enhance economic efficiency by reducing the pervasive role of government in the economy, enhancing policy making transparency and strengthening the regulatory framework. The programme focuses on the banking sector, fiscal transparency (including new public procurement legislation), privatisation and general increase in private sector involvement in the economy.

In 2000, exports and imports accounted for 40% of Turkish GDP, up from 9% in 1979 and 25% in 1993. The share of manufacturing in exports has increased to reach over 80% in 2000, from 68% in 1990. Trade with OECD countries, in particular European countries, has intensified since the late 1980s. In 2000, EU countries accounted for 54% of Turkish exports and 53% of imports. For two decades the trade balance has always shown a deficit, but the size of the deficit has fluctuated widely with volatile domestic growth rates, in particular due to strong fluctuations of imports.

Trade liberalisation commenced in 1980 with a major reform programme to open the economy to competition. Since the 1930s, the state had pursued an inward-looking policy, based on state-run companies, with extensive protection against foreign competition. The 1980 programme reduced subsidies and price controls, liberalised the foreign exchange regime, deregulated interest rates and liberalised trade in order to encourage private sector development and promote export growth. Full convertibility of the lira was achieved in 1989.

A second major step in trade policy was the Customs Union with the European Union, commencing in January 1996. Following the agreement, Turkey eliminated tariffs on manufactured imports from the EU, adopted the EU common external tariff for manufactured products, and adopted the EU's preferential trade regime. Thus, Turkey signed bilateral trade agreements with central and eastern European countries, the

Baltic States, and Israel. The EU decision to accept the candidacy of Turkey for membership (taken in 1999) has given new impetus to structural reforms. The goal of accession requires Turkey to adopt the "*acquis communautaire*", entailing far-reaching structural and legislative reform.

Following these international, regional and bilateral agreements, tariff barriers have significantly decreased, with the average MFN tariff declining from 26.7% in 1993 to 5% in 2001. Agricultural products have however remained outside the scope of the customs union, and Turkey maintains high tariff rates on many agricultural products.

Foreign direct investment (FDI) has remained at a low level in Turkey despite the world-wide surge in FDI in the 1990s. FDI increased somewhat in the 1980s, following the liberalisation implemented at the beginning of the decade, but growth in FDI stopped in the 1990s, with inflows averaging less than 1% of GDP. At the same time, central European countries experienced much higher inflows.[1]

60% of total FDI has gone to the services sector. However, inflows of FDI in the services sector have remained at low levels, with limited foreign involvement in the banking or utility sectors. FDI is more significant in the manufacturing sector, particularly among large firms. Foreign companies account for 37% of total exports and 20% of employment among the 500 largest firms in Turkey.

This FDI performance is disappointing in relation to Turkey's apparent potential. Geographically, its strategic location between Europe, the Middle East and Asia could enable it to work as an economic gateway for the region, in particular given the customs union with the EU. The country also offers a potentially large domestic market and boasts abundant skilled labour and high-quality suppliers.

Turkey has had generally liberal foreign investment legislation since the 1950s, while a major obstacle to foreign investment was removed with the establishment of full currency convertibility in 1989. However, macroeconomic instability, with sporadic growth and high inflation, have limited the attractiveness of Turkey as a place to invest. Political instability, leading to frequent unexpected policy changes and slow implementation of structural reforms, has also been a factor. Weaknesses in the regulatory environment are an impediment, as indicated by a number of investor surveys. Administrative procedures are often lengthy and unpredictable, raising the costs and risks associated with investments.

The application of the six efficient regulation principles for market openness

The *OECD Report on Regulatory Reform* of 1997[2] described six "efficient regulation principles" that should be built into domestic regulations and administrative practices to ensure they do not unnecessarily reduce the openness of the market to international competition. This chapter assesses whether and how domestic regulations and administrative procedures give effect to the principles.

The six efficient regulation principles for market openness are the following:

- **Non-discrimination.** This refers to equality of competitive opportunities between like products and services, irrespective of the country of origin.
- **Transparency.** Foreign investors, seeking access to a market, must have adequate information on existing and new regulations to support effective decision-making.

- **Avoidance of unnecessary trade restrictiveness.** Governments should use regulations that are not more trade restrictive than necessary to fulfil the objectives of the regulations.
- **Use of international standards.** When appropriate and feasible, domestic regulations should be based on internationally harmonised measures in order to minimise the costs to business and government of **compliance** with multiple regulatory standards.
- **Recognition of equivalence.** When international standards are not used, the negative effects of cross-country disparities in regulation and of duplicative conformity assessment requirements can be **reduced** by recognising the equivalence of measures taken by another country, such as the results of conformity assessment performed in other countries.
- **Application of competition principles.** Market **access** can be reduced by regulatory action condoning anti-competitive conduct or by failure to correct anti-competitive private actions.

Non-discrimination

Application of non-discrimination principles in making and implementing regulations aims at equalising competitive opportunities between like products and services irrespective of the country of origin and thus at maximising efficient competition. Turkey subscribes to MFN and national treatment principles through its membership of the WTO. With Turkish ratification of the agreement establishing the WTO, the commitment to non-discrimination contained in these texts has become part of the legal system, overriding inconsistent domestic regulation.

Foreign investment law ensures equal treatment for domestic and foreign investors. The principle was stated in the law that established the general legal framework for foreign investment in 1954. The foreign capital framework decree of 1995 considers all firms and branch offices established according to the Turkish Commercial Code as Turkish firms and branch offices. Available incentives for investment, such as customs duty exemptions or investment allowances, apply to foreign and domestic investors alike.

Foreign investors are however subject to specific requirements in establishing a company. They are subject to a USD 50 000 minimum capital requirement per investor. In addition, they must obtain a Certificate of Permission from the General Directorate of Foreign Investment (GDFI) of the Treasury and must only carry out activities listed in the certificate. Any change in activities or increase in capital requires permission. The main objective of this certificate is to collect FDI data and check that the capital requirement is met. Some procedures were, however, simplified in 1995, in particular the required approval by the Council of Ministers of investments above USD 150 million has been abolished. In the first half of 2002, the government prepared a draft law on foreign investment, in which it opted for the full elimination of the GDFI certificate and the minimum capital requirement applying to foreign investors. The draft law is to be submitted to the Parliament.

Sectors of the economy open to private domestic investors are also open to foreign participation, with the participation ratio of foreign capital being limited in only specific (mostly service industry) sectors. Foreign participation is limited to 20% in radio and television broadcasting, and to 49% in air transportation, maritime transportation, ports and fish-processing. In addition, foreign investors need permission from the government to establish in financial services, mining and petroleum sectors. The presence of foreigners in the services market as self-employed persons is also largely restricted.

Box 15. **Turkey's preferential agreements**

In addition to Turkey's participation in a customs union with the EU, it is party to the following trade agreements:

EFTA

A free-trade agreement has been in effect between Turkey and the countries of the European Free Trade Association since 1992. EFTA countries abolished all customs duties on imports of industrial goods from Turkey, while Turkey grants imports of industrial products from EFTA countries the same tariff treatment as imports from the EU.

BSEC

The Declaration on Black Sea Economic co-operation (BSEC), signed on 25 June 1992 by Turkey and 10 other countries of the region, established multilateral economic co-operation, such as exchange of statistical data and economic information in various fields. BSEC does not currently provide for preferential trade agreements.

GSP

The Customs Union with the EU provides for the application by Turkey of EU preferences under the General System of Preferences (GSP), which Turkey is expected to adopt by the beginning of 2002.

Bilateral agreements

Since 1997, Turkey has signed free trade bilateral agreements with Israel, Romania, Lithuania, Hungary, the Czech Republic and the Slovak Republic, Estonia, Bulgaria, Poland, Slovenia, Latvia and Macedonia. These agreements provide for a phased reduction of tariffs on industrial goods, with complete elimination by 2001 or 2002. All agreements include provisions on right of establishment and supply of services, internal taxation, structural adjustment, dumping, state monopolies, rules of origin, competition rules, state aid, balance-of-payment measures, intellectual property protection, and government procurement.

In addition, Turkey has granted Bosnia-Herzegovina the EU's unilateral preferences since end June 1999. Negotiations are underway with the Faroe Islands and Croatia. Turkey has also engaged negotiations with Mediterranean countries with a view to participating in the proposed Euro-Mediterranean Free Trade Area launched at Barcelona. Free-trade agreements have been discussed with Egypt, Morocco, Tunisia and the Palestinian Authority since 1998. Draft agreements have been sent to Malta, Jordan, Mexico and South Africa and Turkish trade authorities have sent a draft agreement to Algeria.

As ***preferential trade agreements*** give more favourable treatment to specified countries, they necessarily depart from the MFN principle. These agreements must be transparent to third countries if their discriminatory effects are to be minimised. Substantive issues such as standards and conformity assessment can also lead to discriminatory treatment if the matters included would be difficult for third parties to meet.

The most important preferential agreement signed by Turkey is the Customs Union with the EU, which has resulted in the elimination of duties and quantitative restrictions on industrial products and included a common commercial policy. The main channel for information on Turkey's PTAs is notification to the WTO. Within this context, recourse is available for third countries that consider they are prejudiced by these agreements. While involving different treatment between trading partners, the application of PTAs in Turkey has coincided with increased trade liberalisation. Application of the EU Customs Union has resulted in substantial decrease in the protection rate on industrial products from third countries and driven changes towards increased transparency in a number of areas.

Overview

In general, Turkey has a liberal investment regime in which foreign investors receive national treatment. Formal discriminatory elements mainly concern services. Their effects can be significant given the growing economic importance of services. As well, while the laws themselves respect the non-discrimination principle, surveys of foreign investors show a perception that large firms, frequently foreign-owned, are subject to tighter treatment in the implementation of Turkey's numerous, complex, but insufficiently enforced laws and regulations, thus raising their relative costs of compliance.

Transparency

The process of creating, implementing, or amending regulations should be transparent and open to all market participants. Transparency requires an open decision-making process, with opportunities for public comment, and mechanisms to ensure comments are considered. It also means availability of information as to market rules, enabling investors to make efficient decisions. It is also a safeguard of equal competitive opportunities, enhancing the security and predictability of the market. Transparency can be achieved through a variety of means, including systematic publication of proposed rules prior to entry into force and use of information technologies. A transparent regulatory system requires that regulations are implemented predictably, with adequate access to appeal procedures.

Information dissemination

Information on new regulations is primarily provided through publication in the Official Gazette, which is available electronically. Publication prior to entry into force is mandatory for laws, statutory decrees and decisions taken by independent regulatory authorities. There is no general legal rule providing for a mandatory minimum period of time between publication and entry into force. Absent specific provisions in the law, entry into force takes place 45 days after publication.

Public authorities increasingly use the Internet to disseminate information and make laws available, while laws and regulations are also displayed on the parliamentary Web site free of charge. There is, however no central registry, of laws and by-laws. The scope of available regulatory information varies among ministries and agencies. In most cases, English language information on regulation is limited.

As part of a policy to attract investors, many countries have established investment promotion agencies, which typically advertise the country as a place to invest, provide potential investors with information on the domestic regulatory and institutional framework for investment, help them identify opportunities and potential suppliers, and support firms in following the various administrative procedures. In Turkey, there is no such agency. The General Directorate of Foreign Investment provides some information on investment legislation, but does not act as an intermediary with other governmental bodies.

Public consultation

As noted in Chapter 2, there is no general requirement to consult with stakeholders as part of the law-making process. In recent years, however, some authorities have sought the opinions of stakeholders, for example by organising conferences and workshops. However, the scope of consultation is left to each ministry, which establishes its own networks and standards. In principle, consultation is open to all parties, but its informal nature often leads "outsiders" to have limited access.

In general, the quality and predictability of regulations is reduced by a lack of participation of the regulated in the law-making process. Business organisations complain that they are rarely consulted and that little consideration is given to their comments, while legal changes often occur by surprise. Some more formal consultation processes such as the Economic and Social Council (ECOSOC) have recently been created (see Chapter 2). This is helping to open up the rule making process in Turkey. However, it appears that interest in promoting transparency is limited with regard to businesses, and in particular foreign businesses. Overall, public consultation remains a new concept in Turkey and further development in this direction entails a change in mindset, both in the administration and the private sector, to move away from mutual distrust towards the co-operation needed to create an improved regulatory environment.

Implementation of regulations and access to appeal procedures

Poor implementation of laws is one of the main problems of the Turkish regulatory framework. Investors complain about delays in decision-making, incoherent application of laws and limited enforcement. Obtaining decisions in areas such as import procedures, business registrations or applications for business licenses can take months and sometimes years, while mutually contradictory decisions are not unknown. As a result, the implementation of rules is seen as an additional source of investment risk.

The problem partly stems from a poor regulatory structure. It also reflects the absence of clear decision-making criteria and deadlines, and discontinuities in the administration following government changes. A combination of complex rules, discretionary power and low salaries also results in perceptions of frequent bribery and corruption, for example in customs matters and development applications. The government has engaged in a programme to address this issue.

The deficiencies in the implementation of rules are exacerbated by the lack of effective and timely means of appeal. The Administrative Jurisdiction Procedure Act has substantial inadequacies, while court system is overloaded with administrative cases and subject to long delays. More generally, deficiencies in the judicial system mean investors can meet serious difficulties in enforcing their rights. An improvement has been made with the introduction of international arbitration for concession contracts between the Turkish government and private entities, which has removed a significant deterrent to foreign investment in some areas.

Transparency in technical regulations

Transparency in the field of standards and technical regulations is essential to firms facing diverging national regulations, as it reduces uncertainty and thus facilitates access to markets. Turkish standards are developed by the Turkish Standards Institution (TSE), while the responsibility for issuing technical regulations lies with various ministerial departments. Turkey provides information on draft standards and technical regulations through notifications to the WTO Secretariat and WTO members in accordance with the WTO Agreement on Technical Barriers to Trade (TBT).

Participation in the standards making process is open to all parties, including foreign parties. The TSE publishes an annual work programme for standardisation and draft standards prepared are sent to stakeholders (*i.e.* industries, universities, public administrations and consumer associations etc.) for comments. Relevant ministerial authorities prepare technical regulations, which can rely on Turkish standards, and consultation follows the usual process for regulation-making. Technical regulations are published in the Official Journal. Transparency will be reinforced by the EU accession process, as Turkey will be required to adopt EU rules relating to the provision of information in the field of technical regulations. EU directives provide for notification of all draft technical regulation and standards that are not a transposition of EU rules and for a standstill period during which member States can examine the effects of the proposed regulation and standard on market access.

Transparency in public procurement

A new procurement law was adopted by the Parliament in January 2002. Its objective is to establish a more transparent and competitive tendering system complying with international standards, including EU requirements and existing bilateral free-trade agreements. Key changes to existing arrangements are:

- Adoption of standard definitions of procurement procedures and use of thresholds for the choice of procedure, as per EU directives.
- Broad application of the requirements to all types of procurement, including state economic enterprises.
- Establishment of an independent Public Procurement Authority to prepare implementation decrees, collect statistics, receive complaints and organise training programmes.
- Increase in time limits for open tenders to 40 days (52 days if announced internationally).
- Extension of the publicity requirement to all procedures. This includes the requirement to publish criteria for selecting tenders and the result of the tender.
- Establishment of a dispute settlement procedure with the Office for public procurement responsible for receiving complaints.

The government is planning to amend the Public Procurement Law. The amendments will include: *i)* bringing the real value of the thresholds toward those in line with international best practices; and *ii)* extending the minimum time period for procurement applicable for cases below the thresholds.

The law maintains some limits on the participation of foreign firms in public procurement, notably allowing their exclusion from small tenders. The law also provides domestic suppliers a 15% price advantage. In addition, the submission period for replying is limited and could impact negatively on international bidders' capacity to participate. However, the changes proposed would bring Turkish law broadly into line with international standards in terms of transparency. This will address current widespread suspicions over possible corruption. The key issue will be to ensure the adequate implementation of the law. The creation of a public procurement authority could help by providing a central point for inquiries, training and monitoring, in particular through setting up a data collection system.

Overview

Improving transparency in decision-making is a major objective of Turkish reforms. The new law on public procurement is a major step towards the adoption of international standards of transparency. However the overall transparency of the decision making process remains low relative to practices observed in most OECD countries. Much remains to be done to ensure that full, accurate and timely information, as well as real opportunities for comment, are given to all market participants during regulation-making.

Avoiding unnecessary trade restrictiveness

Policy makers should adopt regulations that are not more trade restrictive than necessary to fulfil their objective. This principle is included in several WTO agreements and thus applies in Turkey. However, its implementation requires that the process of rule-making integrates an international dimension. Assessing the impact of planned regulations on trade and investment, through *ex ante* analysis and consultation with trade experts and traders allows potential issues to be identified and alternative solutions found to prevent the creation of barriers to trade. Reducing the burdens created by administrative procedures can also facilitate market access, while maintaining the objective of the underlying regulations.

Assessing the impact of regulations on trade and investment

The rule making-process in Turkey does not include specific instruments for assessing the impact of planned regulations (see Chapter 2). However, some mechanisms exist through which impacts on trade and investment may be reviewed. A government communiqué of 2000 creates an obligation to consult the Competition Authority on competition issues arising from draft laws and regulations. In the context of inter-ministerial consultation, the General Directorate of Laws and Decrees of the Prime Minister's Office, checks the compatibility of draft regulations with WTO commitments and EU rules, and can request the redrafting of a text that would violate international obligations. Its role however mainly consists in mediating between ministries and bridging conflicting interests, rather than carrying out assessments of the impact of the regulation. The international dimension of planned regulations is thus mostly considered through legal considerations, and limited attention is given to assessing economic effects and searching for more efficient alternatives. As a result, regulations frequently tend to have restrictive effects on business operations, which are disproportionate to the aim of the regulation and induce non-compliance.

Reducing administrative burdens

Various business surveys have highlighted the major difficulties faced by foreign firms with regard to administrative procedures and hence the potential of these burdens for trade restrictiveness. In the 2001 survey conducted by the Foreign Investment Agency Service (FIAS) 92% of investors ranked complexity and non-transparency in regulatory policies as serious constraints on business operations. The general view given by the FIAS survey is confirmed by the 2000 survey of the World Economic Forum, which ranked Turkey at place 49 out of 59 countries with regard to time spent with bureaucracy.

The establishment of a company in Turkey involves at least 19 steps, and while most requirements are equally applicable to foreign and domestic firms, foreign firms are likely to be less well placed to deal with the bureaucratic demands. Moreover, the delays involved constitute a significant disincentive to investment. Reducing administrative burdens has been an objective of successive governments, with some programmes dating back to the 1960s. These actions have to date produced few tangible results for businesses, although a more comprehensive approach has been recently adopted, with the assistance of the World Bank (see Chapter 2). In the fall 2001, technical committees were set up to work on administrative streamlining. With regard to firm establishment procedures, the ongoing work has aimed at reducing the number of steps to six, and possibly two.

In addition, administrative actions tend to privilege pre-controls and inspection over effective enforcement of laws. Firms can be subject to numerous inspections while at the same time laws are insufficiently enforced in many areas. With regard to intellectual property rights, the amendment to the 1995 Law, which was adopted in May 2001, has addressed this issue by strengthening enforcement capacities through reinforced sanctions and establishment of separate courts. In addition, the government has prepared a draft law to strengthen the Turkish Patent Institute.

Trade facilitation: the case of customs procedures

A broad overhaul of the Turkish customs system has been undertaken since the mid-1990s to achieve compliance with the EU customs union agreement's requirement that Turkey align its customs system with EU legislation. Basic amendments were implemented by decree in 1995, and in 2000, a comprehensive new customs law was adopted, which implements EU customs provisions in a wide range of areas.

The harmonisation work is part of an ambitious reform programme launched in 1993. The reform extends to simplifying and harmonising documents, procedures and control techniques with those recommended by the World Customs Organisation (WCO),[3] introducing full computerisation to all major customs offices and streamlining the organisational structure of the customs. For example, since 1999, simplified procedures for the release of goods at the border have been available, including use of "blue channel" clearances, where declarations submitted by approved firms (*i.e.* those with good past performance) are given automatic clearance by the customs and control is performed through post-auditing of the firms' records. As of November 2001, 14% of declarations were going through this channel.

Computerisation of customs formalities has also progressed, with the automated system BILGE, based on the French automated customs system, being introduced in 1998. At the end of 2000, 75% of all customs formalities were carried out through BILGE. It permits brokers and traders to submit declarations using electronic data interchange from the customs office or from their own office. The reform program also includes reorganisation of the customs administrative structure to improve administrative efficiency.

The reform programme has significantly reduced goods clearance times. In September 2001, 73% of declarations were processed within 24 hours. The use of the simplified procedures was expected to be quasi-universal by the end of 2001. The automation not only simplifies processing, it also limits the discretion of customs officials. Recently, these actions have been complemented by the publication of a code of ethics for custom procedures.

However investors still report problems, including demands for bribes, excessive paperwork, and lengthy delays. While clearance occurs within 24 hours in most cases, it can take up to a month in others, mostly due to complex testing and certification procedures, and lack of co-ordination and common strategy between different administrations involved at the customs. Progress in modernising customs formalities will not produce tangible results for traders unless all formalities related to imports and exports, including tax and standards-related inspections, are streamlined and made more efficient.

Use of international standards and recognition of other countries' measures

The application of different standards and technical regulations for like products in different countries presents manufacturers and exporters with significant and sometimes prohibitive costs. Hence, greater reliance on internationally harmonised standards as the basis of domestic product regulations, can facilitate trade flows. Where harmonisation of regulations is not considered feasible, recognition of the equivalence of other countries' regulatory measures may achieve many of the same benefits.

Major reforms have been undertaken in this area as a result of Turkish adherence to the WTO TBT Agreement and from EU requirements. EU accession arrangements include co-operation in the fields of quality, standardisation, certification, metrology and calibration. Decisions of the relevant co-ordination bodies have set specific deadlines and progressively broadened the scope of harmonisation arrangements.

The reforms imply radical change in product regulation as, to date, the Turkish system has relied on the application of mandatory standards. The new Law on the Preparation and Implementation of Technical Regulations (the "Framework Law" of July 2001) establishes the legal infrastructure necessary to transpose the EU's system of regulatory practices which defines only the essential requirements for product safety and which leaves the manufacturer the choice of how to attain this goal, whether through the application of standards or his own methods. The Law covers the full range of administrative issues surrounding conformity assessment, consistent with the EU New Approach and Global Approach to standardisation and certification.

The Turkish standards organisation (TSE) has been a member of the International Standardisation Organisation (ISO) since 1954 while, in the field of certification, TSE uses internationally recognised ISO/IEC Guides. Harmonisation of Turkish and international standards has gained momentum due to the customs union with the EU and 93% of

Turkish standards are now based on European and international standards, while over 90% of EU standards have been adopted as Turkish standards. Harmonisation work with EU rules has also started in the area of technical regulations. Out of 400 identified regulations that need to be aligned with EU rules, some 150 have been transposed.

With regard to conformity assessment, TSE takes account of international standards and conformity certificates issued in other countries. TSE is also a signatory to several EU schemes that enable mutual recognition of test results and conformity certificates. Again, the customs union with the EU has been the main source of progress in this area. Products which bear EU certificate marks are now directly granted a conformity certificate by TSE and the Ministry of Health. However this arrangement does not extend to other countries. Moreover, in practice some problems have persisted due to technical file examinations before the actual import stage to ensure that "CE-mark" has been correctly applied, which stems from the lack of a well-structured market surveillance mechanism.

Recognition of equivalence

In 1999, Turkey reformed the institutional framework for accreditation, a necessary step for building the confidence of market participants in the Turkish certification system and reaping the benefits of mutual recognition agreements. Accreditation is used to assess and audit laboratories, certification and inspection bodies and provides confidence as to the competence of conformity assessment bodies – an essential condition for mutual recognition schemes. International co-operation on accreditation is also an important contributor to this process. The 1999 Law on the organisation and functions of the Turkish Accreditation Council (TURKAK) established a specific government body responsible for accreditation for the first time. TURKAK commenced operations in 2001.

Overall, the adoption of the framework law on technical regulations represents a move toward a more flexible and market-oriented system of technical regulation. Since 1999, significant progress has been made to adapt the legislative framework with the adoption of laws on technical regulations, consumer protection and accreditation. As Turkey incorporates New Approach directives into its domestic legislation, the number of products that are regulated by mandatory standards will decrease and conformity assessment will be simplified. Effective reduction in technical barriers to trade will thus depend on progress in the transposition of directives. It will also require sustained efforts in implementation as officials need to adapt and change systems, in particular with regard to testing and conformity assessment, and the development of adequate market surveillance.

Competition

The existence of effective legal procedures and institutions for hearing and deciding complaints about regulatory or private actions that impair market access and effective competition are key issues from an international market openness perspective. This issue is considered below, while Chapter 3 deals with broader issues of the application of competition principles in the context of regulatory reform.

Turkey's Competition Law was passed in 1994 and is substantially based on EU Competition Law. It covers all actions of undertakings affecting competition in Turkish markets, regardless of where they are taken. An independent Competition Authority, responsible for the implementation and enforcement, began operations in 1997. Firms wishing to complain about anti-competitive agreements or abuse of dominance must take

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their case to the Competition Authority. The law applies equally to domestic and foreign firms, and there are no rules that restrict the rights of foreign firms in regard of competition rules. The Authority may also act on its own initiative against anti-competitive practices. Its decisions may be appealed in the Conseil d'État.

Conclusion

Faced with severe economic crisis, Turkish authorities have undertaken major reforms to eliminate structural weaknesses, improve the market orientation of the economy and open it to international competition. These reforms have built substantially on progress made through other reforms adopted since the early 1980s. Reduced tariff barriers, convertibility of the currency, the customs union with the EU and the launch of a privatisation programme have represented major steps towards increased openness. Work is also underway to create a regulatory framework that supports this restructuring.

The reforms with greatest direct relevance for trade and investment policy include product regulation, intellectual property rights, international arbitration and customs procedures. Increasing transparency is also important and is reflected particularly in the ongoing reform of public procurement. The government has also taken steps to tackle deficiencies in the business environment, with the assistance of the World Bank Group. The customs union with the EU and Turkey's recognition as a membership candidate have supported efforts to adopt international standards and introduce mutual recognition in product regulation.

These reforms reflect a progressive move away from state control over the economy to a market-based economy, in which the government plays a role of guarantor of the framework conditions. As reform strengthens market principles, the conditions for trading and investing in Turkey will improve. However, much remains to be done. In general, the efficient regulation principles for market openness are still insufficiently embedded in the decision making process and regulatory framework, creating uncertainties and inefficiencies that undermine investment and trade. In addition, progress has been impeded by serious deficiencies in reform implementation. Finally, a general climate of mistrust between the private sector and the public sector remains.

The experience of central European countries over the past decade demonstrates that foreign investment can significantly contribute to economic restructuring and modernisation. Foreign investors have brought capital, technology, expertise and management know-how, raising productivity and increasing innovation. Increased foreign direct investment could play a critical role in Turkey's development in future years. Moreover, the underlying factors for attracting FDI are also those necessary for achieving international competitiveness. Progress in assuring economic and political stability is crucial.

The EU accession process can act as an incentive to reforms, but this cannot produce results without a strong commitment to reforms at the national level. Reforms in Turkey can be stimulated by candidacy to the EU, but the approach to reform cannot be limited to meeting EU rules. The development of a market-oriented regulatory framework requires a comprehensive approach to reforms.

Policy options for consideration

1. Improve the transparency of the regulatory framework and widen the opportunities for concerned constituencies to provide input to the rulemaking process.

Proposed regulation should be available to stakeholders for information and formal channels should exist to receive feedback. Consultation should be timely so as to allow meaningful interaction between stakeholders and regulators. Sufficient time needs to be provided for comments. More attention should be paid to the clarity and quality of regulations, to reduce the risk of differences in interpretations and to ensure consistent enforcement. Specific attention should also be paid to ensuring transparency at the international level.

2. Continue and accelerate initiatives undertaken to streamline administrative procedures affecting business and eliminate unnecessary restrictions to business operations and trade flows.

Priority must be given to ensuring that recent initiatives to identify unduly burdensome administrative procedures lead to the effective streamlining of these procedures, including matters related to regulatory implementation. The tax system, requirements for setting up businesses and requirements concerning conformity assessment in particular call for action. Development of future regulation must also take this issue into account.

3. Develop a consistent practice for assessing the impact of proposed regulations on business and on trade and investment.

The introduction of regulatory impact analysis, as recommended in Chapter 2, is an important means of ensuring that impacts on trade and investment are considered systematically, and the RIA system design should address this issue explicitly, particularly via use of the six principles discussed in this chapter.

4. Promote transparency in public procurement.

The new regulation on public procurement represents a major step towards increased transparency. Its implementation must be supported through training of officials, provision of information to businesses and monitoring to ensure its requirements are effectively put into practice.

5. Enhance efforts in the adoption of international standards and use of mutual recognition.

Progress in this area needs to be pursued through continued attention to testing and conformity assessment requirements, including ensuring repeal of unnecessary regulation once EU directives are introduced.

6. Promote efficiency of customs procedures.

Efforts undertaken in the area of customs procedures need to be pursued through increased co-ordination with other agencies, in particular with tax authorities and conformity assessment bodies.

Notes

1. It should be noted, though, that the official definition of FDI is narrow and does not cover some inflows accepted as FDI by other OECD countries.
2. OECD (1997), "International Market Openness and Regulatory Reform", in The OECD *Report on Regulatory Reform, Volume II: Thematic Studies*, Paris.
3. The objective of the "International Convention on the Simplification and Harmonisation of Customs Procedures" (the so-called "Kyoto Convention") that entered into force in 1974 was to simplify and harmonise customs procedures across countries. In June 1999, the Council of the WCO adopted a revised text to adapt the convention to the development of international trade. The new procedures will increase transparency and harmonisation of customs procedures by using new information technology and modern clearance techniques based on risk analysis. The revised convention is now open for signatures. It shall enter into force three months after forty contracting parties will have signed the amendment protocol without reservation. As of end-June 2000, ten members of the WCO had signed it. Turkey foresees to sign it, following signature by the European Union.

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PART II

Chapter 5

Electricity, Gas and Road Freight Transport Sectors*

* For more information see: "Background report on Regulatory Reform on Electricity, Gas and Road Freight Transport Sectors" at *www.oecd.org/regreform/backgroundreports*

ELECTRICITY

Introduction

The starting point for electricity reform is difficult

The electricity sector in Turkey has been a key element in the "state led development" of the economy. For the time being it remains dominated by state owned entities. Their current financial condition is extremely weak. Without reform, the sector is headed for financial collapse. Widespread theft and non-payment for electricity has weakened cash inflow and earlier moves to promote private participation in needed generation investment generally resulted in expensive electricity being purchased by the state enterprises.

Finally, and necessarily, fundamental reform has been launched with the passage of a new Electricity Market Law and creation of a new Energy Market Regulatory Authority which is working towards the commencement of a competitive electricity market according to EU norms by September 2002. The state will withdraw to a regulatory role (undertaken by an independent regulator) and also retain an active role in the natural monopoly activity of transmission and system operation/balancing. Consequently, in the potential competitive segments of generation and distribution/retail, real privatisation is on the agenda following the attempts for private participation under BOT and TOOR arrangements, which resulted in insufficient outcomes.

The exit from the old system has been very difficult. Also, the supply-demand balance in Turkey has been quite tight and the experience in other countries underlines the risks of electricity reform in tight markets. Some breathing space has resulted from the downturn in demand due to the economic crisis and by commissioning of new power plants under construction. All other countries have liberalised their electricity sectors in circumstances of excess supply that make reform technically and politically easier. This starting point heightens the need for a rapid and successful implementation of planned reforms that, in the end, offer the only prospect for moving the industry onto a financially sustainable basis. Key to this is the creation of a viable distribution segment. Time is short as Turkey is likely to need substantial new private sector generation investment from around 2006. If the reforms as designed are well implemented, over time price discovery will generate investment signals that stimulate new capacity and there will be financially strong actual or potential market participants that can or will respond to investment signals before the emergence of supply shortages.

The electricity sector is undergoing substantial restructuring

From 1993 to October 2001 the electricity sector in Turkey was dominated by two state-owned companies – the Turkish Electricity Generation and Transmission Company (TEAS) and the Turkish Electricity Distribution Company (TEDAS).[1] TEAS was separated into three separate companies covering generation, trading and transmission activities on October 1, 2001 by a decree one of the early steps in the present liberalisation plan. The companies, Türkiye Elektrik Iletim A.S. (TEIAS – transmission), Elektrik Üretim A.S. (EÜAS – generation) and Türkiye Elektrik Ticaret ve Taahhüt A.S. (TETAS – trading) are now legally in operation.

Installed generation capacity has grown quickly over the past two decades with trend growth of around 8% per annum to reach 27.3 GW in 2000. Hydro power accounts for a large share of installed capacity in Turkey (41% in 2000), but a smaller share of output (24.7% in 2000).[2] Drought has been a problem in Turkey over the last three years and has limited hydro output. Fossil fuels account for most of the remainder of capacity (58% in 2000) and are used more intensively than hydro plants (thermal plants generated 75% of total output). As for many other countries, gas has played an increasing role and coal and oil have declined over time (gas 37%, coal 31% and oil 7.5% of output in 2000). Broadly, these trends in fuel mix are expected to continue: gas intensity and imported hard coal increases and the share of hydro and lignite falls and, as a result, import dependence is expected to rise. Private participation in the sector has been relatively limited with a number of episodes of difficulty. Private generators, which either own plant or have operation rights of plant owned by TEAS, account for 10.7% of capacity and auto producers (industrial companies which self generate and sell surplus electricity) account for around 11% of capacity.

The transmission grid in Turkey was owned[3] and operated by TEAS prior to separation into the new transmission company. Load is concentrated with the major population centres in the west of the country while until recently generation capacity was relatively concentrated in the east, reflecting the emphasis on hydro generation that is concentrated in mountainous regions, particularly the south east. As a result there were some transmission constraints due to the large cross-country power flows, and transmission losses are slightly above international norms. New thermal generation in the west of the country has shifted these constraints.

Turkey is a small net importer of electricity, mainly through an international connection to Bulgaria – this accounts for around 3% of domestic consumption. Further large-scale interconnectors to neighbouring countries are under construction or are planned in accordance with longer term plans to run the Turkish transmission system synchronously with international grids, particularly UCTE, which would permit larger scale imports.

TEDAS is the major distribution entity, with its operations split into 33 separate areas, too many to constitute financially viable distribution companies.[4] A major problem in the distribution sector is losses and theft of electricity and free provision of street lighting. These cause significant financial weakness in TEDAS – it must pay for this electricity from TEAS but receives no corresponding payment from its customers. In turn, TEDAS's financial weakness and consequential late payments to TEAS contributed to financial weakness in TEAS. Total electricity losses (generation – final customer paid consumption) totalled 19.4% of generation in 2000 which is a substantial increase from system losses of around 15% in the mid-1990s and around 10% higher than OECD norms.

It is vital that the financial performance of the distribution sector be improved. Reform, including consolidation into a smaller number of financially viable distribution companies and privatisation, is an essential part of the solution to this problem – it is not feasible to expect that deep seated management problems at the local level could be addressed without the strong influence a profit motive. Also relevant, is the fact that liberalisation will expose distribution activities to a further layer of complexity and risk in their operations – not only will they have to better manage their retail business but they will also have the challenge of having to contract and manage their source of electricity in a competitive wholesale market.

Earlier "privatisation" attempts were largely unsuccessful

For some time the Government has had the objective of increasing private participation in the sector so as to reduce the fiscal load on the Government – indeed the first law setting up a framework for private participation came into effect in 1984. There have been many changes to the applicable legal framework since that time, including amendments to the Constitution in 1999 that clarified the status of private investment in this sector and permitted direct privatisation. Overall, there have been significant problems with private participation under so called BOT and TOOR[5] arrangements, which involved the State retaining or ultimately attaining ownership of the relevant generation or distribution assets. BOT generation projects accounted for only around 11% of generation in 2001 and usually involve high cost electricity purchase agreements that have exposed TEAS to significant losses and contingent liabilities. Many other projects have not come to fruition. Few TOOR projects have been completed. A core design deficiency in these arrangements is that while they shifted the up-front capital burden of new or improved generation or distribution investment to the private sector, they did not fundamentally shift risk away from the State. This risk was ultimately borne by the Budget, including under explicit Treasury guarantees for State liabilities under long-term exclusive power purchase contracts with a cost-plus tariff structure. The fiscal crisis associated with the economic crisis brought to the fore that these risks could no longer be born by the budget.

In difficult circumstances, the government announced in October 2001, that previously decided transfer of operating rights of generation and distribution electricity infrastructure could only proceed without Treasury guarantees and with new conditions in order to implement the new market model. Similarly a limited number of BOT generation projects were to benefit from Treasury guarantees of State liabilities under power purchase contracts only if the projects are commissioned by the end of 2002. However, the Constitutional Court in April 2002 annulled the provisional articles of the Electricity Market Law that set deadlines for the execution of the BOT and TOOR projects. Consequently, the Government is now seeking an appropriate solution for these projects and the final outcome remains to be settled. Prospective investors that have incurred substantial preparatory investments in these virtually complete "privatisation" schemes may seek compensation from the government for costs and lost profits. The final outcome of this process also remains to be settled.

This very difficult transition from the old regime is unfortunately likely to have an adverse effect on the willingness of new investors to commit to new investment under the reformed market. As a general observation, Turkey has not been well served by institutional instability in this sector, nor in other sectors, and this has real consequences for perceptions of risk and, ultimately, costs of economic activity. That said the episode needs to be assessed within the broader context of the economic crisis and the constraints this applied to the freedom of government action. Clearly, this underlines the need for the

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new reformed arrangements to achieve a state of regulatory certainty and predictability. On the positive side it can be said that with the legal blockages to direct privatisation now removed, it will be possible for the government to pursue a programme that is not bound by the same constraints and complexities inherent in the earlier policy "work arounds" used to achieve indirect private participation. Important in this context will be the ability for the government to make a "clean break" and desirably avoid the need to resort to Treasury guarantees to provide adequate certainty to the transactions in question.

The other mechanisms for private participation in generation have been Build-Own-Operate (BOO) and auto-generation projects. BOO projects still involve exclusive power purchases contracts with the central State entities and have become the main mechanism for private participation, taking over from BOT. Substantial capacity (5.9 GW) will begin to be put in place onwards up to 2004. The main difference from the BOT model is that the resulting plant under BOO remains in the ownership of the investor at the end of its contracted life which, compared with BOT, provides a lower level of political risk for the owner and additional exit options. However, the success of the BOO arrangements should not be over emphasised – the BOO arrangements do not fundamentally alter the entrenched position of the State enterprises nor substantially shift commercial risk from them (or ultimately the budget). Moreover, the prices under the BOO electricity sales arrangements are front-loaded for early recoupment of the investors' capital[6] at a time when the state institutions are financially weak.

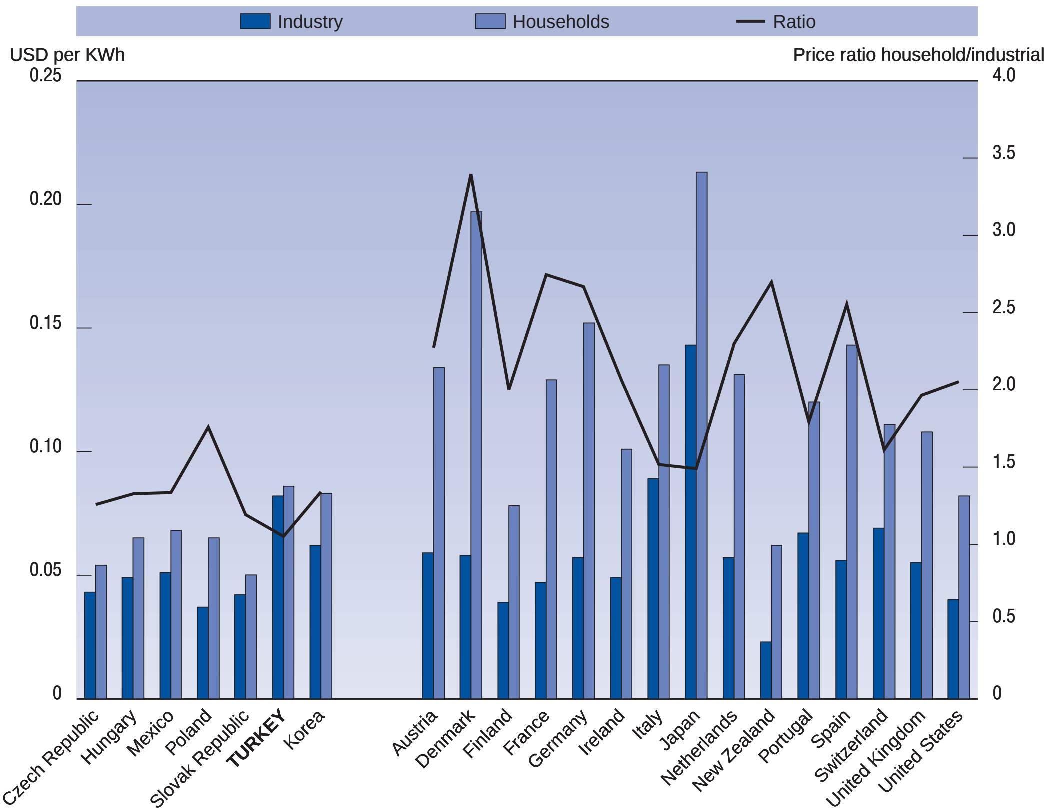
Auto-production is where major electricity users[7] generate their own electricity and sell excess generation to TEDAS at negotiated prices.[8] Many auto-producer plants have been commissioned with a combined capacity of 3 GW at the end 2000. A further 300 MW of capacity is under construction.

Electricity tariffs require significant re-balancing

Prior to the implementation of the new Electricity Market Law, TEDAS proposes final distribution/retail tariffs and these are approved by the MENR. Tariffs are maintained at uniform levels throughout the country – apart from "official" east-west differences which provided embedded preferences for developing areas. Under the new Electricity Market Law it is proposed to shift this to an explicit cash subsidy under a mechanism that is under the control of the council of Ministers. TEDAS tariffs have approximately doubled over the course of 2001 in Turkish lira terms. This compares with inflation of 88.6% and thus represents a significant increase in real prices that is needed to restore financial balance to TEDAS operations.

Industrial prices in Turkey are comparable to household prices, unlike the position in more liberalised markets where industrial prices are often around half that for households. Lower industrial prices reflect the lower unit cost of delivery of large amounts of electricity to industrial customers. Consequently, the present tariff structure involves a significant cross subsidy from industry to the household sector. The degree of this cross subsidy is large compared with most other countries – see Figure 1. This degree of cross subsidy will not survive a more competitive environment – large eligible customers will face a large incentive to opt into the competitive market so as to avoid paying a cross subsidy to captive customers. The emergence of competition, tariff re-balancing and the mechanism used to unwind stranded (as discussed below) costs are all interrelated. Re-balancing of tariffs will be essential to avoid distortions in the competitive environment.

Figure 1. **Electricity prices in Turkey and selected OECD countries**



Source: IEA, *Energy Prices and Taxes – Quarterly Statistics,* Third Quarter 2001, Part II, Tables D19 and D20.

Financial performance of the state enterprises is weak and underlines the need for reform

The financial position of the abolished TEAS/TEDAS (and as a consequence to some degree BOTAS – see discussion of the gas sector) is poor. The accounts of TEAS reveal a deteriorating situation with losses reaching USD 656 million in 2000. This is partly due to high cost BOT (and prospectively BOO) contracts that involve purchase costs to TEAS in excess of subsequent sales prices to TEDAS. TEAS is squeezed between its increasing exposure to private sector participation in the sector (a "privatisation" which has not in fact shifted the commercial risk away from TEAS) and the various constraints on its charges to TEDAS and, in turn, TEDAS's final tariffs. More generation capacity is required and given the fiscal position a substantial part of that will have to be private investment. The prospects are therefore, for the financial performance of TEAS to deteriorate further without significant change.

Secondly, while TEDAS has a gross margin of over 3 cents between its average electricity purchase and sales price, it has been able to pay TEAS for electricity only with significant delays. Part of the reason for the weakness of TEDAS is the non-payment due to theft or late payment by its own customers. As a consequence TEAS has a serious debt and cash flow problem with delayed payments to BOTAS for natural gas and to BOT/BOO contractors for generated electricity. This situation is part of the explanation of the reluctance of foreign investors to be involved in the sector without the benefit of Treasury guarantees. Ultimately, the losses of the system are substantially born by the budget – this contrasts with the desired situation where the very substantial capital invested in the sector should yield a reasonable return to the budget.

Electricity prices for many consumers might rise in the short and medium term, and excess electricity loss and theft problems need to be addressed, if the industry is to reach a stage of financial stability that can support the needed investment to ensure supply security. A well-designed reform in the electricity sector improves economic performance and lowers costs. So, smaller price rises will be necessary to achieve sustainability *than would be required absent the reforms*.

The new regulatory structure is a bold advance

Creating competitive electricity markets is difficult. The regulatory framework for such markets needs to be built – they do not evolve naturally. This includes inter-related decisions on the legal framework and structure of the sector, institutional design, market design, transmission pricing, addressing stranded costs and provision for universal service. An important early step in this process in Turkey was the passage of a new law. The regulatory framework for and the structure of the electricity sector are in the process of significant change, aimed at liberalisation and progressive withdrawal of the state from potentially competitive segments, specifically generation and distribution/retail.

The new Electricity Market Law came into effect in March 2001, with the objective of developing a transparent and competitive electricity market, achieving stability of supply, and ensuring good quality, cheap and environmentally friendly electricity. What is most important under the proposed arrangements is the central role of competition in ordering the market. The law provides for a framework for the establishment of institutions and addresses structural regulation issues as follows:

- A new independent Energy Market Regulatory Authority (EMRA) is established, governed by the Energy Market Regulatory Board, which takes over regulatory functions from the MENR. Standard regulatory functions include licensing, tariff setting, market monitoring, and access dispute settlement.
- Participants in defined market segments (generation, transmission, distribution, wholesale (trading) and retail) are required to be licensed by the EMRA and separate accounts must be maintained for each licensed activity and location. Specific rights and obligations arise from licence conditions.
- Requires bilateral contracting between market participants and thus implies a residual balancing mechanism to operate the transmission system – a compulsory pool type wholesale market is excluded.
- Opens competition from March 2003 for consumers directly connected to the transmission system or with annual consumption of more than 9GWh (~20% of the market in 1999). The scope of competition can be broadened over time by the EMRA. No timeframe is specified for 100% opening.
- Provides for non-discriminatory regulated third party access to the grid and distribution system.
- Provides for the preparation by public industry participants and approval and enforcement by the EMRA of specific regulatory codes for transmission, distribution, retail and the short term balancing market.

- Provides for eventual direct privatisation of the sector, with the exception of the transmission ownership and operation functions. Foreign investors cannot take a controlling interest in generation, transmission and distribution sectors of the market.

The framework established in the Electricity Market Law broadly accords with trends in OECD countries and is intended to harmonise the Turkish framework with the EU Electricity and Gas Directives as part of the accession process. The details of licensing procedures, market operation and rules, tariff mechanisms, vesting arrangements, privatisation plans and mechanisms to deal with stranded costs are left to subsequent secondary legislation or later decisions.

The Energy Market Regulatory Authority and Board have been established

The new Energy Market Regulatory Authority (EMRA) was established in November with the appointment of seven board members by the Council of Ministers. Board members have terms of six years and may be re-elected. Board members can only be removed by a decision of the Council of Ministers in specified instances of misbehavior or incapacity. There are quite significant governance restrictions on activities and interests of Board members which limit their financial interest in the sector and subsequent employment in the sector. The EMRA is accountable to the Ministry in the form of an annual report on its activities and market development issues. There is no formal requirement that these reports be made public but the EMRA is apparently willing to issue a report on its web site (excluding any confidential information).

The detailed requirements for the operation of the EMRA will be set out in secondary legislation, which is still to be issued but is expected to be available for public consultation by end-May 2002. The EMRA will have a lot to achieve at the initial stages of the establishment of the market. Foremost among these goals, and in addition to the simple fulfillment of its prescribed functions, is to establish its credibility as an effective regulatory institution. A very broad range of factors will bear on the credibility of the EMRA – it must not only fulfill its functions but be seen to do this in a clear, objective and unbiased, stable and predictable way according to the law. Important in this respect is the way the EMRA communicates with the market.

The EMRA is required to consult under the law the licensed entities operating in the market prior to issuing regulations. The law does not specify details of the manner of consultation, notice, length or outcome but public consultation is expected to start by early June 2002. Chapter 2 of this study on government capacities for making quality regulation highlights a number of significant areas for improvement in government consultation processes.

Lawsuits against decisions of the board, relating to fines and other regulatory decisions are appealable to the Danistay through either merits appeal or appeal on a question of law. Courts often are not well suited to regulate or to review regulatory decisions, because of the technical nature of the issues in contention and the need for speedy resolution of outstanding issues. Many countries establish a specialist regulatory appeal body that includes expertise in regulatory issues for this reason.

Salary flexibility is important for the EMRA. Regulation of electricity markets is a complex matter and regulators in OECD countries often struggle with the challenge of attracting and retaining adequately skilled staff. It is important for the ongoing credibility

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within government that the staff of the regulator are seen to be "worth" their pay – this requires strict merit selection and performance management of staff.

EMRA approval is required for certain share transfers of licensed firms but this does not displace the authority of the Competition Board to authorise mergers which raise competition issues. The Competition Authority retains its functions of preventing abuse of market power in energy markets.

With the establishment of the EMRA, the role of the MENR will be focussed on the establishment and enforcement of general energy policies, privatisation proposals, determining import and export policies and the promotion of supply security through any subsidies and incentives.

"Regulatory Governance" may need to be strengthened

Rules for the standards, procedures and principles for the connection to and use of transmission and distribution networks, customer service and the Balancing and Settlement Regulation (which establishes the detailed procedures and principles related to real time balancing and financial reconciliation of the system) are prepared by the related public industry participants and approved by EMRA. This is a standard arrangement. Some care is needed here if the EMRA can't initiate change and can only approve change coming up from industry as industry participants can be expected to resist socially desirable change that may be against their own financial interests. It is essential that the reform programme build in mechanisms to implement a transition to the liberalised market to address the emergence of problems in a timely manner, to make changes to market rules and codes and where necessary adopt mitigation measures to address market failures until underlying causes can be corrected.

Vertical and Horizontal Separation is a strong feature of the reform

TEAS was separated on paper into three separate companies covering generation (EUAS), trading (TETAS) and transmission (TEIAS) in October 2001, with assets remaining to be transferred. TEIAS will be the transmission System Operator (SO) and also be the Market Operator (MO) running the settlements system.[9] EÜAS can build new power stations in accordance with EMRA approved projections and taking into account private investments – this could operate as a fail safe mechanism to ensure supply security if the needed private investment fails to materialise for one reason or another. EÜAS will be the dominant generator until its constituent generation assets are privatised. TETAS takes over all energy sale and purchase agreement of TEDAS and TEAS. This includes all energy purchase and sales agreements entered into under BOT, BOO and TOOR contracts and, also export and import contracts. The law requires that for a period of up to 5 years after the preparatory period (*i.e.* up to September 2007) as determined by EMRA, EÜAS shall sell all the electricity it has generated to TETAS.[10] Consequently, TETAS will be the dominant wholesaler in the market.

The joint dominance and tying of EÜAS and TETAS is intended to allow the recovery of stranded costs from BOT, BOO and TOOR contracts – this important structural element of the reform programme is discussed further below. The dominance of EÜAS and TETAS will require regulation of their conduct by the EMRA, including in the wholesale and balancing markets.

In addition to the requirement for separate licences and accounts for generation, transmission and wholesale distribution and retail activities there are a number of structural requirements in the Law that mandate stricter separation. For example, a transmission company may not engage in any other market activity, private generation companies are limited to a maximum of 20% of total installed capacity in the previous year and distribution companies can self generate a maximum of 20% of consumption in their region, as measured in the previous year. Also private wholesalers cannot hold market share of more than 10% of prior year consumption. These structural measures will foster competition in the initial phases of the reform and, consequently, will reduce the regulatory load compared with what might have occurred under continued vertical integration. Over the longer term these requirements could be reviewed to determine if they are restricting desirable market adjustment.

Prior to the privatisation of the generation and distribution/retail assets there will continue to be significant ownership integration at the state level. Consequently, there is the possibility of a perceived conflict of interest at the state level against the interests of new entrants into the generation market who will be in competition with both the government generation and trading company with respect to the supply to eligible customers. The authorities will need to be attentive to avoid the potential for this conflict to discourage entry.

There would be continued integration between distribution and retail activities of the distribution companies. New wholesale and retail entrants and out of area supply by distribution companies will be the channels by which competition will reach down to final eligible consumers. This will require access to distribution wires by the new entrants. In this respect Turkey is relying on accounting separation of the wires and retail businesses of distributors. This is a minimum requirement – further separation might be contemplated at a later point. The UK has recently adopted a requirement of corporate separation between customer services (retail) and infrastructure (distribution) and has found that some firms are specialising in one or other of these segments, *i.e.* beyond some point the industry may naturally tend to ownership separation. The structure in Turkey is expected to evolve over time in this regard.

Structural Competition in Generation and Stranded Costs are a key issue in the early stage of the new market

In Turkey the dominant role of existing government generation and trading firms will initially continue while the market is liberalised. Consequently, competition in generation would be slow to emerge as the only supply not committed to TETAS would come from additional imports, de novo private generation investment and auto-producers.[11] Competition would only emerge as generation assets are privatized, as the dominance of TETAS was eroded by new entry, and as hydro was released back to the market as the run-off of expensive BOTs is met over time. Avoiding misuse of market power will be a central requirement to avoid substantial price increases – initially this will require significant regulation of the dominant firms, including where they are participating in liberalised sections of the markets, such as generation and trading.

The structure envisaged in the new law has been designed to provide for the recovery of stranded costs and this involves a number of complex tradeoffs. Specifically, less competitive arrangements might make for easier recovery of stranded costs or higher

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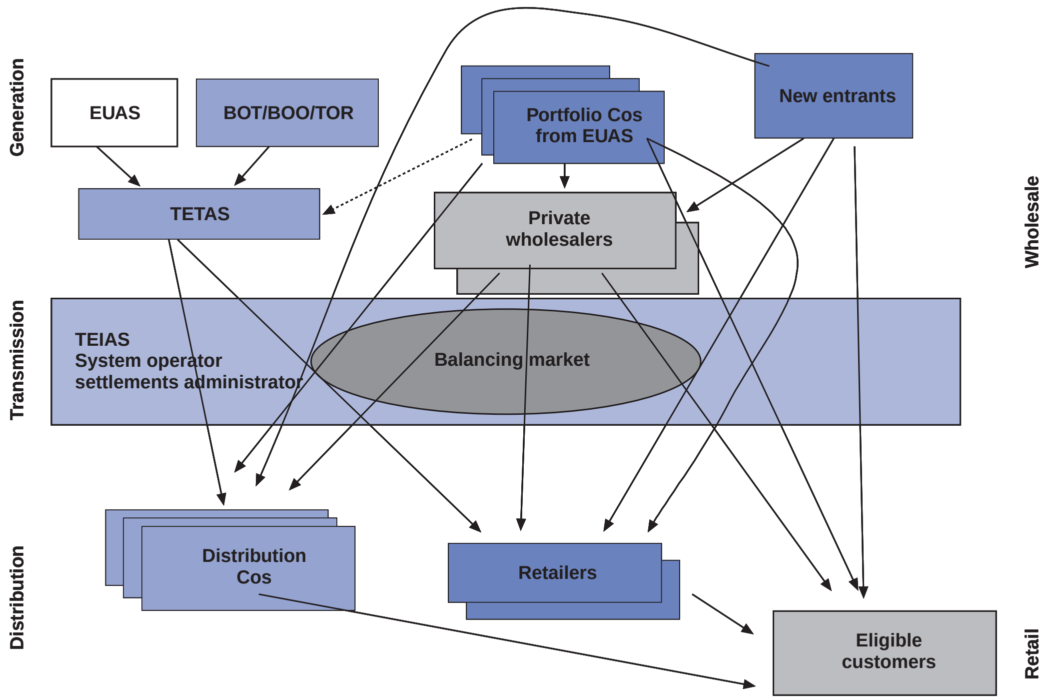
privatisation revenues for the government but the loss of the benefits of competition in these cases should not be accepted lightly. Stranded costs arise from investment under the previous regulatory regime (BOT, BOO and TOOR) that would not be recovered in a competitive environment. Conceptually, stranded costs can be dealt with in a variety of ways: a government subsidy; a charge on consumers; or bundling with "stranded benefits". The latter approach is that adopted by Turkey – it has some advantages and also disadvantages. Prices will not rise to the same extent as if consumers had to directly bear the burden of these costs.[12] And, such bundling is technically more simple than recovery by more normal surcharge methods. Finally, in Turkey it is not simply a matter of recovering the stranded costs and then allowing the BOO/BOT/TOOR generation to be competitively bid into the market. To the contrary, those contracts which have been, or are implemented, have to be enforced to the end including through the period after five years from now when prices will be less than a price which recovers economic depreciation – otherwise there would be an arbitrary transfer of wealth to the private generators.[13] Consequently, annual stranded costs decline over time and there is a possibility of hydro capacity being progressively released to privatisation and thus participation in the competitive market. The disadvantage of the proposed scheme is that it locks existing generation capacity into the continuing government enterprises, *i.e.* there will be free eligible consumers but no free suppliers. Competition is substantially forestalled until recovery of stranded costs.

Following further policy development the Turkish government is now contemplating a less restrictive structural approach which has the potential to foster the emergence of competition within a five year timeframe. This would involve transferring to EÜAS only so much of the low cost hydro capacity as would be necessary when electricity is on-sold to TETAS to offset the stranded costs of the BOT, BOO and TOOR contracts. The remainder of the hydro generation (if any) and the thermal generation assets[14] of TEAS would be transferred to a number of separate generation companies which could be a source of earlier competition. This would permit generation competition from these companies on an earlier time scale as initial vesting contracts unwind.[15] This new perspective is much to be preferred to that formally embodied in the law and could be considered a reasonable balance between the competing aims of recovering the stranded costs in a simple way and the desire to increase competition. There should be no barrier to privatisation of these assets that are not tied to the recovery of stranded costs. It would result in a structure for the industry that is illustrated in Figure 2.

Privatisation to promote competition is desirable

It is clear that the underlying design intent of the Turkish reform is pro-competitive, subject to the recovery of stranded costs. This design intent should be followed through as early as possible with privatisation decisions so that the structure of the industry is pro-competitive.[16] This includes horizontal separation of dominant government owned generation companies to create competing generation companies. Restructuring should take into account the location of generators. Distant generators may not be effective competitors to supply a load centre when transmission congestion arises. Distant generators also may face greater risk of transmission interruptions or significant line load losses that erode their competitive significance. As a rule of thumb restructuring should aim to divide ownership such that for almost all demand conditions, there are at least five companies with generation that will be at the margin that will actively compete to set prices.

Figure 2. **Contemplated market structure**



Source: OECD.

It is a bad reform mistake, which is still made in some countries, to privatise companies with market power to increase the privatisation proceeds. The increase in sale proceeds will represent a poor "deal" for the country:

- Market prices will be subsequently higher and the excess price over a competitive price and this rent will be capitalised into the privatisation proceeds, thus yielding an initially higher return to the government. However, the capitalised amount will be discounted at a private discount rate, which is likely to be greater than the social discount rate – so the private sector will pay less for the rent than it is worth to the government. The capitalised rent will also be discounted by a further factor that will reflect regulatory uncertainty.
- The higher electricity price is equivalent to a special tax on electricity and, *a priori,* is not likely to be efficient.
- The higher electricity price will reduce economic growth and dynamically reduce government general tax receipts.

Attention to issues of scale is also needed in privatisation decisions – there is no point in fragmenting an industry far beyond the degree of horizontal separation that is needed for the emergence of competition.

When the generation companies (desirably five or more) are created out of EÜAS each company should have a portfolio of generation that includes some plant that will be the marginal plant to supply each load packet. By ensuring multiple bids at the margin this will reduce the potential for market power in core markets to be used to manipulate bids and raise price.

Privatising distribution/retail first – subject to the constraint of any distribution TOORs – is a sensible approach as it offers the opportunity to improve the financial soundness of this sector, including through consolidating the presently "too small" distribution areas run by TEDAS, which would then become the foundation for improved financial performance upstream. The creation of financially viable distribution companies allows private generators to structure bankable projects without any government guarantee.

Privatisation of assets can be by 100% outright sale or sequenced sale, including with contracts that govern issues such as new investment and social performance as conditions for subsequently acquiring a majority stake. The choice between these models depends importantly on the specific country context. Where capital markets are undeveloped and regulatory frameworks are incomplete or new it may be best to adopt a sequenced sale approach. This can assist the government to achieve a higher sales price as it provides more scope for a well based assessment to be made of the potential efficiencies that can be achieved before the government disposes of its entire interest. Also sequenced sales carry an implicit regulatory commitment from the government to not damage the company by subsequent arbitrary regulatory decisions since the government maintains an interest it will not wish to damage. On the other hand, 100% sales may be called for to address fiscal needs. Also, 100% sales would be preferable if the political environment is such that on-going and distracting political influence would occur in partially government owned companies. Golden shares which permit arbitrary intervention in corporate governance will be counter productive. Vigilance by the Competition Authority should be sufficient to prevent re-aggregation of assets motivated by a desire to increase market power.

Transmission ownership, system operation and the power markets

Turkey has opted for a bilateral contracting model, which means that dispatch and wholesale market operation are not integrated into the same organisation – generators and wholesalers contract directly rather than through a centralised compulsory wholesale pool. Compulsory pool markets, which establish a single Pool marginal price, have advantages and disadvantages. The advantage is that market operation and system balancing require intensive co-ordination[17] and integrating these functions into a single entity has some advantages of simplicity. The disadvantage is that compulsory pools are likely to be more susceptible to anti-competitive strategic behaviour by generators. A classic strategy in such markets is to withhold marginal generation capacity or otherwise manipulate market rules and raise the Pool price. Bilateral voluntary markets are probably less susceptible to manipulation and temporal market power of generators, which could be a problem in Turkey if a tight supply situation was to re-emerge. There is a trend away from compulsory Pool models for this reason. That said, it will be important that Turkey gives adequate attention to what might be called the "surrounding legal and technical infrastructure" to ensure that the enforcement of contracts and the operation of settlement systems or court arbitration of contract disputes is robust enough to make multiple markets feasible.

Under the bilateral model, the system operator must manage balancing of the transmission system while accounting for the bilateral decisions of generators and their customers. This is done through a balancing market where the system operator buys and sells electricity (dispatches or stands down generation at the margin) to ensure that net generation matches actual demand at each point in time. The design rules of this core market are critical for the emergence of wholesale competition. Even if the core market is small (say 5% of demand), arbitrage to the general market can be adverse if the core market is affected by market power. It will therefore be particularly important to regulate the behaviour of TETAS in this market and consideration could be given to demand side participation[18] in the balancing market as soon as feasible as this can significantly limit the effect of generator market power.

A further issue is the incentives embedded in the Settlement System for generators and customers to generate and use electricity closely in accordance with their contracted positions. It is likely that Turkey will initially adopt a single price system for settlement of imbalances that will use an average of prices from the purchases and sales contracts entered into by the system operator to balance the system – this is a reasonable policy choice at the outset as it avoids significant complexity. One possible half-way house between the simplicity of a single price system (which has poor self balancing incentives) and the complexity of, say, a two price model (which has strong self balancing incentives) would be for settlement prices to include an *ad hoc* charge which increased the price paid to the system by those short and reduced the price received by those with excess electricity. The size of the charge, say 5%, is essentially arbitrary and would be a policy variable that could be set to determine the degree of incentive for self balancing that was desired. Such a charge would also mean that the settlements/system operator would accrue a stream of revenue that could be used to offset some general operation costs.

The system operator should face incentive regulation to operate energy balancing and ancillary services functions in an efficient way. Direct pass through of such costs into transmission pricing is likely to yield poor performance and higher prices for consumers.

The market operator should include an effective market monitoring/surveillance function to detect misuse of market power and manipulative bidding strategies. The output of market monitoring should feed into early corrective policy decisions and mitigation strategies if necessary. This may involve further changes to market rules and, in the extreme, to bid or price control measures. Care must be exercised in any mitigation measures that these do not prevent the resolution of underlying problems or longer-term adjustment and functioning of the market.

Despite its small share in total cost, regulation of transmission is extremely important for an electricity market as this can have significant incentive effects for the location of new generation capacity and the evolution of wholesale markets. This is an extremely complex area and it would be reasonable for Turkey to adopt a highly simplified transmission-pricing scheme at the outset. Policy development in this area cannot be ignored however. This is because the capital value of generation assets is affected by the transmission pricing arrangements. Since generation is to be progressively privatised it would assist the privatisation process (and increase sales revenue to the extent that certainty was reduced) if additional information were available about prospective developments in transmission pricing arrangements.

Conclusion

The enactment of the new Electricity Market Law and the establishment of the EMRA are significant steps forward in the reform of the electricity sector. The framework for competition established by the law and the structure and functions of the regulator accord with OECD good practice benchmarks. Importantly, after a transition period the structure of the sector has the potential to be inherently pro-competitive. A number of remaining policy choices will affect the actual emergence of competition during this transition period, including the recovery of stranded costs and privatisation methods. And, substantial preparatory work remains to be done prior to the commencement of the market, on the details of the market operation and the various elements of secondary regulation and operational codes. Turkey has made a solid start in this reform – it needed to given multiple problems inherent in the pre-reform industry and the problems of exiting from the old arrangements for private sector participation. With careful implementation of the reform there are now good prospects for the industry to move on from what was an unsustainable position. Indeed, it is to be hoped that, in time, this reform will be seen as one element in a fundamental shift in the overall regulatory governance of Turkey that contributed positively to the structural robustness of the economy and helped Turkey to escape from the cycle of economic crises.

Policy options for consideration

1. Energy Market Regulatory Authority and Board

The new Energy Market Regulatory Authority has been established, but some details of its operation remain to be settled, including in secondary legislation. A number of issues were addressed in the discussion of the EMRA, including its governance and staffing, methods of communication and regulation making, its role in oversight of self regulatory functions of the major industry players, and its relations with other institutions. Specifically:

- The independence of regulators has two dimensions – independence from day to day political influence and independence from the commercial interests of the sector. Political independence is at the heart of the new Law. Turkey has opted for significant governance restrictions on activities and commercial interests of Board members that are strict by international standards, particularly in respect of the requirement for non-involvement in the industry for two years after ceasing appointment with the EMRA. This is, nevertheless, appropriate in Turkey where in the case of some other institutions there has sometimes been a blurring of commercial and policy interests. This requirement does mean that it will be difficult to get people from business who really know the industry appointed to the EMRA. In order to avoid problems that might arise from a lack of "connectedness" to the industry, it would be desirable for the EMRA to establish as a matter of practice a strictly advisory private sector consultation committee composed of a balanced membership from the various industry bodies active in the sector. This would have a strictly advisory role upon request from the EMRA Board and would strictly *not* supplant more general requirements to consult the private sector on regulatory requirements.
- The EMRA is accountable to the Ministry in the form of an annual report – it is not clear on the face of the law whether this annual report will be publicly available. Another annual report on the development of the market must be prepared by the EMRA and provided to the Ministry. The absence of a requirement for publication of these reports should be rectified in secondary legislation.
- The detailed requirements for the operation of the EMRA will be set out in secondary legislation, which is still to be issued. The EMRA will have a lot to achieve at the initial stages of the establishment of the market. Foremost among these goals, and in addition to the simple fulfillment of its prescribed functions, is to establish its credibility as an

effective regulatory institution. A very broad range of factors will bear on the credibility of the EMRA – it must not only fulfill its functions but be seen to do this in a clear, objective and unbiased, stable and predictable way according to the law. Important in this respect is the way the EMRA communicates with the market. It would be desirable if the EMRA was to prepare and publish a yearly regulatory plan in which it set out what issues it expected to address over the year ahead and when – this would include forthcoming tariffication decisions, assessments of the competitive state of the market, reviews of licence conditions, etc. A key here is to avoid regulatory surprises that could give the appearance of *ad hoc* decision making and raise perceptions of regulatory risk. In parallel with the annual plan the EMRA should adopt a charter of regulatory practice that commits to operation on the basis of good practice in the fields of communication and consultation; consistency and predictability of decision making; internal effectiveness and efficiency; and accountability and overall transparency. This charter should itself be consulted with the private sector before it is finalised as a basis for action by the EMRA.

- The EMRA is required to consult under the law the licensed entities operating in the market prior to preparing regulations. Chapter 2 of this study on government capacities for making quality regulation highlights a number of significant areas for improvement in government consultation processes. These views apply equally to the energy sector. It would be desirable for EMRA to self adopt RIA like processes and determine a protocol for requirement for consultation on regulation making as discussed generally in Chapter 2.
- The right of appeal against regulatory decisions is important to ensure that a regulator does its job properly. Under the Electricity Market Law, lawsuits against decisions of the board, relating to fines and other regulatory decisions are appealable to the Danistay. Courts often are not well suited to regulate or to review regulatory decisions, because of the technical nature of the issues in contention and the need for speedy resolution of outstanding issues. Many countries establish a specialist regulatory appeal body that includes expertise in regulatory issues for this reason. The challenge in setting up such arrangements is to avoid shifting the standard point of decision making from the regulatory to the appeal body and to avoid the use of the appeal body in strategic games that can increase delay in final decisions. The Danistay is unlikely to be well suited to the **appellate** role in this sector. The appeal structure should be improved by the creation of a specialist appeal body with suitable expertise.
- Staff of the EMRA are civil servants, but are not subject to the same restrictions on salary. Regulation of electricity markets is a complex matter and regulators in OECD countries often struggle with the challenge of attracting and retaining adequately skilled staff. These skills are valued in the market, particularly within the regulated sector, and it is important for the quality of regulation of the sector and consequently economic performance that the regulator has adequate internal staff. It is important for the ongoing credibility within government that the staff of the regulator are seen to be "worth" their pay – this requires strict merit selection and performance management of staff. The EMRA should seek to recruit a high level of expertise, including internationally if necessary, and pay close attention to establish merit based personnel systems to ensure that they are and are seen to be free of influences that have sapped the efficiency of some other parts of the government service.
- There is a requirement for co-operation between the EMRA and the Competition Authority as regulation and competition issues closely interact in this sector. For example, licence

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conditions in generator licences or the licence of TETAS will place constraints on the behavior of licensees that could also be addressed by the generic constraints against monopolistic behavior under the competition law. Consequently, in *particular cases* an issue might arise that could be addressed by the EMRA as a contravention of a licence condition or by the Competition Authority as an abuse of market power. Interface issues of this type can be addressed in a protocol of co-operation between the two bodies. There is also a deeper interface issue relating to *questions of policy* as to whether it is preferable to deal with a matter by a regulatory instrument or through competition law. Questions of this type might arise in future when the issue of whether it is appropriate to remove tariff controls for some customers – this will depend essentially on whether the market is judged to be competitive enough to rely solely on competition law to prevent any market abuses. The Competition Authority has a role to play in informing such decisions. In some countries there is a legal requirement on regulators to consult the competition authority about policy decisions relating to the removal of or reapplication of tariffs. This is not the case under the new Electricity Market Law, so it is desirable that any protocol between the EMRA and the Competition Authority also address the Competition Authority's role in such decisions.

- The Electricity Market Law provides for an element of the regulatory governance of the sector to be performed by sectoral participants. Rules for the standards, procedures and principles for the connection to and use of transmission and distribution networks, customer service rules and for system balancing and settlement are prepared by major industry participants and approved by EMRA. This is a standard arrangement. All electricity market reforms have experienced some problems and unanticipated consequences. It is essential that the reform program build in mechanisms to implement a transition to the liberalised market to address the emergence of problems in a timely manner. Nevertheless such regulatory failure can be in the interests of some industry participants and if these participants are in a position to block change due to their position in the governance structures of the industry problems can persist. Careful attention needs to be paid to this governance structure. If the EMRA has a power to approve but not initiate or over-ride rule changes where necessary in adverse circumstances, then reforms which are evidently desirable taking the interest of the market as a whole into account can be held hostage by the interests of market participants. Such an over-ride power is desirable and indeed necessary at the start of a marketisation process.

2. Market Structure, Competition, Stranded Costs and Privatisation

Turkey has opted for a significant degree of vertical separation between the different segments of this industry. This is inherently pro-competitive and will reduce the regulatory load compared with what might have occurred under continued vertical integration. Nevertheless, actual competition will be restrained through a bundling of low cost hydro with high cost BOT, BOO and TOOR generation through a transition period to permit recovery of stranded costs – after recovery of these costs the state generation assets can be progressively privatised. The degree to which competition will be restrained in this way has not been finally settled and several issues of fine balance are involved. Consequently, significant regulatory issues and policy decisions remain:

- Prior to the privatisation of the generation assets there will continue to be ownership integration at the state level with transmission. Consequently, there is the possibility of a conflict of interest at the state level against the interests of new entrants into the generation market who will be in competition with both the government generation and trading company with respect to the supply to eligible customers. To avoid this potential conflict being seen as an actual conflict by new investors, the state will have to ensure that governance arrangements of the various institutions do not overlap and the EMRA will have to be punctilious in enforcing the non-discrimination requirement for access to the transmission system.

- The government trading company will remain as the dominant player in the wholesale market for the time being. Consequently, the EMRA will have to strictly regulate the behavior of the government trading company in the wholesale and balancing electricity market. The Competition Authority will also have to be closely attentive to prevent predatory conduct in the emerging competitive segments of the market that could deter new entry by generators and traders.
- A key reform challenge is to mitigate and accurately measure stranded costs and to provide for their recovery in a way that is "fair" and does not impede efficient entry or the emergence of competition. The estimation of stranded costs is inherently difficult, often involving estimations of capital values that ultimately depend on future, and therefore unknown, market prices. Under the proposed approach of bundling stranded benefits to offset the stranded costs, the need to carefully estimate the size of the stranded costs is reduced, *i.e.* the **bundling** can continue *until* the stranded costs that actually emerge are recovered, but such bundling does act to forestall the emergence of competition. It is, therefore, to be strongly welcomed that the government is considering the minimum viable degree of bundling and the maximum possible degree of competition. At a minimum state thermal generation should be available to the competitive market. Beyond this, it would be highly desirable if possible *not* to include all hydro assets within EÜAS if this is not necessary to offset the stranded costs in TETAS. A delicate balancing act is required here. While early release of hydro capacity to the market will be pro-competitive, equally it could allow by-pass of the remaining stranded costs if the pricing of such hydro capacity which emerges from the privatisation process is "incorrect". Careful attention will need to be given to this matter.
- It is clear that the underlying design intent of the Turkish reform is pro-competitive, subject to the recovery of stranded costs. This design intent should be followed through as early as possible with privatisation decisions so that the structure of the industry is pro-competitive.[19] Privatisation should aim to divide ownership such that, within each transmission-constrained area and for almost all demand conditions, there are at least five companies with generation that will be at the margin in most demand situations that will actively compete to set prices. It is a bad reform mistake which is still made in some countries to privatise companies with market power to increase the privatisation proceeds. The increase in sale proceeds will represent a poor "deal" for the country.
- Privatising distribution first is a sensible approach as it offers the opportunity to improve the financial soundness of this sector, which would then become the foundation for improved performance upstream. Distribution companies should be consolidated to a more efficient scale.
- Tariff rebalancing is urgent, given that competition for eligible consumers opens from March 2003 and the present tariff structure which implies cross – subsidies from industrial to household customers is not likely to be sustainable under competition. At

the same time, it will be important to include limitations on tariff regulations to protect the interests of captive consumers, so that licensees do not support eligible consumers by cross-subsidies from captive consumers, for instance by preventing them from allocating all their high-priced power purchase contracts to captive consumers. The tariffing arrangements would be considerably complicated if some distribution TOOR agreements are allowed to move forward with a cost plus tariff guaranteed by the Treasury while the remaining distribution companies operate with incentive-based tariff formulae.

3. Transmission ownership, system operation and the power markets

The bilateral contracting model adopted by Turkey is less susceptible to market power problems than the alternative of a compulsory wholesale pool. This is clearly desirable in Turkey's case because problems of market power will be significant, at least during the transition phase and if the supply situation were to retighten it could have the effect of magnifying any market distortions. The need to regulate the behaviour of the government generating company and government trading company for this reason has already been noted. There are a number of additional issues relating to market design that will need to be settled prior to the commencement of the competitive market. These include:

- It will be important that Turkey gives adequate attention to what might be called the "surrounding legal and technical infrastructure" to ensure that the enforcement of contracts and the operation of settlement systems or court arbitration of contract disputes is robust enough to make multiple markets feasible.
- It is understood that Turkey is likely to start its balancing market without demand side participation. This is a reasonable starting point since demand side participation involves an extra degree of complexity, but the authorities should consider allowing demand side participation at the earliest feasible opportunity since it could help to reduce the market power of generators in the balancing market.
- The balancing market will yield the prices at which generators and customers who are out of balance with their contracted position must settle with the system. It is likely that Turkey will initially adopt a single price system for settlement of imbalances that will use an average of prices from the purchases and sales contracts entered into by the system operator to balance the system – this is a reasonable policy choice at the outset as it avoids significant complexity. At an early stage, the EMRA might consider improving the relatively poor self balancing incentives of such single price models. A possible approach is discussed in the chapter.
- The system and market operators should face incentive regulation to operate energy balancing and ancillary services functions in an efficient way. Direct pass through of such costs into transmission pricing is likely to yield poor performance and higher prices for consumers.
- The market operator should include an effective market monitoring/surveillance function to detect misuse of market power and manipulative bidding strategies. The output of market monitoring should feed into early corrective policy decisions and mitigation strategies if necessary. This may involve further changes to market rules and, in the extreme, to bid or price control measures. Care must be exercised in any mitigation measures that these do not prevent the resolution of underlying problems or longer-term adjustment and functioning of the market.

- The approach to transmission pricing also remains to be settled. Initially it is reasonable to adopt simple approaches. Policy development in this area cannot be ignored however. Improved transmission pricing can help to reduce transmission losses in the short and long term. Also, the capital value of generation assets is affected by the transmission pricing arrangements. Since generation is to be progressively privatised it would assist the privatisation process (and increase sales revenue to the extent that uncertainty was reduced) if something was known about prospective developments in transmission pricing arrangements. The annual regulatory plan recommended above for the EMRA would be a suitable means to communicate this information to the market.

GAS

Introduction

Reform in the gas sector is less complicated and, in Turkey, less advanced than in the electricity sector. Nevertheless, Turkey has moved down the path of reform with the implementation of the new Gas Market Law. The Law envisages restructuring of the state enterprise into separate functional companies (transmission, distribution, trading and storage) along now familiar lines. Where Turkey proposes to go further than many other countries is in requiring the present dominant state enterprise to substantially divest itself of its gas supply contracts over the period to 2009. This is a relatively long transition period but it is a highly pro-competitive step compared with reform efforts in many other countries. Turkey is to be congratulated for taking this step, though there do remain formidable challenges to actually implementing it. Turkey also has the relative luxury of location which, in so far as gas is concerned, should allow it to access competitive sources of upstream gas supply – this has strongly positive implications for competition in the domestic sector. To this end, Turkey is diversifying its sources of gas through the construction of new pipelines and, prospectively, this could offer an alternative path for gas from the Middle East and Central–Asia into the major West European markets – a so called Eurasia Energy Corridor.

Description of the sector

The gas sector in Turkey is not as developed as the electricity sector but there are a number of common features. Chief among these is that the sector has been dominated by a government owned entity – Turkish Pipeline Corporation (BOTAS) which owns pipeline infrastructure for oil and gas transmission, LNG terminals, and gas distribution – and that substantial reform is now in prospect that will liberalise and partially privatise the sector. The reform has some close parallels with that in electricity, including a common regulator and a new law that established bilateral trading as the fundamental market model.

BOTAS has monopoly rights for gas import/export and wholesale trading.[20] Gas import sources are Russia, Algeria (LNG), Nigeria (LNG), and, from late 2001, Iran. Before the Iranian connection, the only pipeline import route was for Russian gas through Bulgaria since 1987. The domestic gas sector infrastructure is less well developed than the electricity sector, with distribution infrastructure undergoing rapid development in many areas and new transmission infrastructure being developed to add capacity and diversify supply sources – in 2000 Russia supplied around ⅔ of Turkey's gas requirements. A country-wide network for domestic transmission is expected to become operational in 2003/4. Together with new distribution investments (which will increase gas availability from 5 to 60 cities), this will mark a significant step in the development of Turkey's gas infrastructure.

In 2000, domestic consumption was 14.6 billion m^3, around 16% of Total Primary Energy Supply, with imports accounting for 96% of consumption. The sectoral breakdown of demand in 2000 is: power generation 67%, industry 13% and residential 19%. Demand growth has been rapid, at around 17% per annum between 1990 and 1999. BOTAS projects demand to rise to 58 bcm in 2010 and 88 bcm by 2020. This represents an average growth rate of more than 15% per annum for the first decade (reflecting the take up of gas from extension of the gas network in the first half of the decade) and around 4.2% per annum in the second decade. BOTAS expects that existing import contracts will be sufficient to meet demand growth until 2010, after which new sources will be required. Some commentators suggest that there will be a significant surplus of gas in the second half of the coming decade. The extent of any surplus will depend importantly on the degree of new build in the thermal electricity sector, and also on the take up of gas from the new domestic transmission and distribution systems.

Turkey presently has no major domestic gas storage facilities. This complicates the management of the gas system as it means that the system has little storage flexibility other than through variations in system pressure (called linepack) to take gas in volumes significantly different from actual usage. Storage capacity also assists security of supply and helps to meet seasonal demand and price fluctuations. Several underground storage facilities are being developed.

Gas prices for major customers remain indexed to oil prices and for retail customers are capped under MENR direction to an upper limit of 30% above the BOTAS supply price, since January 2002. These supply prices are set under the long term contracts and are confidential.

The financial performance of BOTAS in 2000 was a profit of about USD 120 million, significantly less than the profit of slightly over USD 400 million in 1998 and just under USD 500 million in 1999. One reason for the poor performance is late payment for gas by TEAS and electricity BOT companies, which is in turn related to the poor performance of the electricity sector as described in the previous section. A second reason is the fall in demand occasioned by the 2000-01 economic crisis, and the take or pay obligations of BOTAS. Consequently, it is reported that BOTAS has delayed some payments under its gas purchase contracts.

Profound regulatory reform is now underway but will take a long time to be completed

The objective of reform in the gas sector closely accords with those in electricity, *i.e.* to establish a financially sound, stable and transparent natural gas market, based on competitive rules with independent regulation to achieve effective, continuous, environment-friendly and economic natural gas delivery, involving the progressive withdrawal of the state and introduction of competition. Regulatory arrangements are substantially parallel to those for electricity under the Energy Markets Regulatory Authority.

The new Natural Gas Market Law came into effect in May 2001 and the law provides for a framework for the establishment of institutions and addresses structural regulation issues as follows:

- Requires separate licences for the import, transmission, distribution, storage, marketing, trade and export of natural gas, which set the rights and obligations of market participants. Separate accounts are required for each licensed activity and each separate facility.

- Ends the legal monopoly of BOTAS and from 2002 requires a phased reduction in the market share of BOTAS through the divestment of gas import contracts equal to at least 10% of the market per year to private import companies to a point where by 2009 BOTAS has no more than 20% of the domestic consumption market. These transfers are to be conducted on the basis of a tender. No importer or wholesaler can procure more than 20% of annual gas consumption forecasts.
- After 2009 separates BOTAS into three companies specialising in trading (import and sales), transmission and storage activities. In the interim, accounting separation will be required.
- Identifies eligible consumers with annual consumption of more than 1 million cubic meters, gas fired electricity generators or co-generators, and companies producing natural gas in Turkey who will be free to select their own gas supplier (estimated 80% of the market) 18 months after May 2001. The EMRA has a power to broaden the class of eligible consumers over time, with the intention that all consumers would become free. Sales by importers or wholesalers to free customers or to distribution companies are at negotiated prices.
- Provides for non-discriminatory third party access to the transmission and distribution systems, subject to available capacity and also to the absence of serious financial and economic damage for existing (take-or-pay) contracts. In the event of refusal of access the EMRA shall verify the basis of that refusal.
- The EMRA can settle disputes about access/connection to the transmission and distribution system and must approve investment plans by transmission and distribution companies. The EMRA also has responsibility for certain safety elements of the gas sector, including with respect to construction and service of gas facilities. The EMRA will set tariffs for connection, transmission and storage and also retail tariffs.
- Requires that distribution companies purchase no more than 50% of their gas requirements from a single importer or wholesaler, subject to an over-riding decision by the EMRA taking account of the emergence of competition in the market. Distribution companies are under an obligation to purchase gas from the cheapest source as a basis for an energy-cost basis tariff.
- Imposes certain restrictions on vertical ownership relationships and the degree of horizontal ownership overlaps.
- Provides for progressive privatisation of city distribution systems (subject to prior repayment of Treasury guaranteed debt) by municipalities and privatisation of the storage company and other companies within two years after the structural separation of BOTAS. The existing transmission system is seen as a strategic asset and will remain in public ownership.
- Preserves the operation of the Competition Law in the gas sector.

It remains to be seen whether the required divestiture by BOTAS of gas import contracts will be successful, but as a policy position it is a highly pro-competitive move. Certainly, it is to some extent arbitrary, but the divestiture will be critical to the emergence of competition in the wholesale gas market. It will require a careful review of the gas contracts themselves, including terms, consents required for transfer, and height of take-or-pay percentages. The uncertainties attaching this process include the question of whether the foreign seller agrees to the divestiture to a private company and the release of

BOTAS or whether BOTAS would have to continue to act as importer, effectively selling gas at the border. In any event, the outcome of the envisaged process at this stage is uncertain.

For the time being, the BOTAS gas will be the only gas on the domestic market as it will not be possible under the new Natural Gas Law for importers to enter into completely new import contracts from the existing supply sources until the existing capacities of the BOTAS contracts are used up, which is estimated by BOTAS to occur around 2010. BOTAS is also proscribed from entering into new gas purchase contracts until its market share falls below 20% of national consumption.

Transmission tariffs and connection tariffs are to be determined or approved by the EMRA. Multi-part, distance based tariffs are envisaged. Connection tariffs to the distribution system are to be set by the EMRA. Wholesale gas prices are to be freely negotiated within a framework of principles approved by the EMRA. Retail tariffs will be set on a gas cost plus operating cost and reasonable profit basis. Tariffs are to be proposed by licensees and approved each year by the EMRA. At an early stage the EMRA might consider moving to incentive based regulation (such as a CPI-X framework).

Overall, the framework established by the new Natural Gas Market Law, particularly the requirement of divestiture of gas by BOTAS (assuming that this is successful) has a strong chance of fostering a competitive gas market in Turkey within a reasonable number of years. Much obviously will depend upon the detailed rules of the market operation and infrastructure use and the implementation decisions that are to be taken by the EMRA. Critical to that assessment is the fact that Turkey has the rare advantage, from an OECD perspective, of being able to access supply sources from a number of different locations (subject to completion of new infrastructure). Competition in many gas markets in the OECD is hobbled by the fact that there is little competition in upstream supply, but because of its location that problem need not arise in Turkey. Also important to the overall assessment is that given public data on existing contracts and prospective demand growth, supply does not appear to be significantly over-contracted for very long periods with take-or-pay restrictions – it should therefore not be necessary to protect BOTAS from competition. There are nevertheless some elements of the reform plan that could be improved.

One area of potential improvement relates to storage services. It is planned that these would be privatised out of the BOTAS 11 years from now. This delay could hamper the emergence of competition because importers/wholesalers are required to have access to significant storage that will be under the control of BOTAS, which will, at least initially, be a competitor. Hence, storage will be a bottleneck facility. The law places storage companies under an obligation in the law to render storage services in an unbiased and equal way *in so long as the system is available.* The role of the EMRA in enforcing this requirement will be critical as the vague legal requirement could permit a range of subtle discriminatory actions by the storage company until such point. After the storage company is privatised its incentive to discriminate against new entrants should cease.

Much of the detail of the reform arrangements remains to be settled and implemented in secondary regulation. It is not possible at this stage to comment on these design details but several issues can be flagged for consideration by the authorities during the coming stage of policy development. This includes the incentive for BOTAS to forestall entry from potential competitors by frustrating access to gas transport or complicating gas system balancing arrangements. It will be a major task of the EMRA to ensure that the starting point for competition is fair in this respect. Particularly important in this respect will be the degree of operational separation between transmission and gas trading functions before these are structurally separated into different companies from 2009.

A similar issue concerning access to distribution networks will arise in the case of gas traders selling gas to eligible customers. Distribution companies will carry out both distribution and retail activities and will have an incentive to frustrate access by new entrants to their distribution network. In the absence of any revision to the law, which might mandate separation of distribution and retail activities, the EMRA will have to pay special attention to distribution access issues so as to promote the emergence of competition in final supply.

The gas system in Turkey is undergoing rapid development and the electricity sector is likely to become a more intensive user of gas. Policy should therefore give attention to regulatory issues that will arise from the integration of the gas and electricity markets. These issues include the relative costs of transmitting gas and electricity and the implications this has for the location of new electricity generation plant.

Conclusion

A substantial reform of the gas sector is now in prospect that will liberalise and partially privatise the sector. The reform has some close parallels with that in electricity, including a common regulator and again accords with OECD good practice benchmarks. In one respect the proposed reform goes beyond those benchmarks because a key element of the reform is a requirement for a phased divestment of import contracts by the current monopoly importer, BOTAS. This is a highly pro-competitive step, which is designed to *promote* competition rather than simply *allow* it to emerge. If successful, the ultimate prospects for competition in the Turkish market under the reform proposals are quite good compared with some other countries. This is ultimately because the location and prospective pipeline development will mean that Turkey will have the relative luxury of potential competition in upstream supply of gas from producing countries. Also important to the overall assessment is that supply does not appear to be significantly over-contracted for very long periods with take-or-pay restrictions – it should therefore not be necessary to protect BOTAS from competition. Much of the detail of the reform arrangements remains to be settled and implemented in secondary regulation and the following conclusions and recommendations can be considered in that context.

Policy options for consideration

1. For the time being, BOTAS will remain vertically integrated and its gas will be the only gas on the domestic market as it will not be possible under the new Natural Gas Law for importers to enter into completely new import contracts until the existing capacities of the BOTAS contracts are used up. Consequently, BOTAS will require close regulation by the EMRA to ensure that competition is not foreclosed by the frustration of transmission access – possible measures to address this issue prior to structural separation in 2009 would include operational separation under licensing requirements. BOTAS behavior in wholesale markets will also need close monitoring and regulation.
2. The law is not specific as to whether rate of return or incentive based regulation (such as a CPI-X framework) is to be applied for transmission tariff approval – this would seem to be a matter for the EMRA to determine in deciding general tariff principles. It would seem desirable to use incentive based regulation as soon as feasible.

3. The general plan for the separation of BOTAS into its component parts (transmission, storage and trading) and eventual privatisation could be improved in several respects. It is likely that storage will be a bottleneck facility and BOTAS could hamper imports by competing entities by making access to storage difficult for a variety of "technical" reasons and has an incentive to do so. The law requiring storage companies to provide their services to the market should be strengthened. It is not obvious why the authorities have opted to keep storage within BOTAS for so long – it would be desirable to privatised storage facilities once they become operational so as to foster the emergence of competition. Another important area where the law could be strengthened concerns the definition of distribution. In contrast to the electricity law where distribution was restricted to the wires business and a separate concept of retail services was introduced, the gas law defines distribution to include both delivery of gas through local gas pipeline networks and its retail sales. The law should be strengthened by defining distribution and retail as two separate concepts or otherwise mandating at least accounting separation between these two functions. This would facilitate the entry of independent retail companies and promote competition among supply companies that can purchase gas in the wholesale market, use the transportation services of both the transmission and the local distribution companies, and resell to final users.
4. BOTAS will have an incentive to try to over-complicate the gas balancing arrangements as the additional cost involved for new entrants could reduce the extent of competition faced by the BOTAS trading company. The EMRA will have to carefully assess the merits and respective costs and benefits of different balancing arrangements to ensure that these do not discriminate against new wholesale entrants.
5. The interaction between gas and electricity transmissions tariffs should be assessed by the regulator. There will have to be a substantial new build of gas fired electricity generation in Turkey over the decade and it would be highly desirable to avoid distortions in the choice of location of that plant which might arise from inappropriate interactions of gas and electricity transmission tariffs. This problem can be addressed in a variety of ways, such as through more sophisticated and neutral transmission pricing in both the electricity and gas sectors, or alternatively through administrative requirements in generator approval processes.

The discussion of the EMRA under the electricity section and the related conclusions and recommendations apply equally in respect of the gas sector.

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ROAD FREIGHT TRANSPORT

Introduction

The geographic location of the Turkey marks it as a potentially important transit route for surface freight between Europe and Asia, CIS or Middle East countries. Medium-term infrastructure development objectives include augmenting these intercontinental links. Planning at the European level incorporates the Turkish transport network into the Trans European transport Network (TEN). However, for the time being, various regional conflicts have significantly reduced transit flows through Turkey and in total they remain surprisingly small.

The road freight sector in Turkey is more than usually important because other freight modes, such as railways, are relatively undeveloped. Road carries around 90% of domestic freight volumes and around 40% of international freight values. This has some advantages given the poor performance of rail freight in almost all countries. On the other hand it does mean that road infrastructure is put under more pressure and congestion than otherwise and there are significant investment needs to augment the highway network – this is difficult in the present fiscal environment.

The desirable policy direction for Turkey involves the implementation of European regulatory norms within the domestic freight sector – as planned under the new Highway Transport Law before the Parliament – and further liberalisation of remaining restrictions on international freight. This will involve ongoing negotiation with other countries and is thus not entirely within the control of the Turkish authorities.

Description of the sector

The Ministry of Transport and Communications is responsible for the regulation of the industry, including the preparation and implementation of legal regulations and international agreements.

The road freight sector is unlike other network industries, in that its natural structure involves many competing firms and access to the network (roads) is relatively simple, compared with the complex co-ordination that is necessary in other transport modes or in the energy sector. Turkey is no exception. What is different about the industry in Turkey is the fact that the prevailing conditions in the international segment of the market are very different from the domestic freight segment. Turkey is a member of the European Conference of Ministers of Transport (ECMT), so the regime applying by decrees to international road freight is already substantially aligned with ECMT/EU requirements to market access, financial capacity and professional reputation. The international fleet is modern and is competitive in international transport. On the other hand the domestic freight segment has not had the usual regulation of access to market and social conditions applied to it. Unifying the regulatory framework between international and domestic segments is what the proposed Highway Transport Law is intended to achieve. This implies a very significant structural adjustment of the atomistic domestic sector. There are no quantitative restrictions on entry into international or domestic freight markets and no general price regulation.[21]

The structure of the Turkish road freight market is similar to international norms – firms are mostly small-scale and significant competition exists in the sector. There were 882 firms involved in international road freight in 2000, more than double the level in 1990, using more than 21 000 motive tractors. The industry is dominated by small firms, with more than half of the firms having between 10-25 vehicles. In the total industry, including the domestic sector, more than 800 000 registrations for tractors, trucks and tankers were in effect at the end of 2000. The international fleet is apparently large and relatively modern by European standards and by virtue of the relatively low wage level in Turkey its level of international cost competitiveness is high. Turkish vehicles dominate both export and import road traffic, accounting for a 95% share of exports and 83% of imports. There are no state enterprises that operate in the road freight sector.

There is a very large number of firms involved in the domestic sector. Data on firm numbers in the domestic sector and road freight prices are not collected systematically in Turkey but authorities regard the degree of competition as being very high. Indeed, the more important policy concern is that there is a problem of low profitability, particularly among small firms. This would make the Turkish position similar to that in the EU.

Collusion among competitors is sometimes a problem in the transport industry when there are relatively few participants in a particular market. An example of this arose in Turkey with the Competition Authority applying fines for a collusive arrangement among firms hauling imported goods from customs bond stores into the Istanbul market. The competition law applies without exception in this sector.

The international sector is hampered by the global web of quantitative market access controls

Many competition issues in the Turkish road freight sector arise in an international context because of severe limitations on market access to the EU and some other countries. Therefore, the ultimate accession of Turkey to the EU, which internally has a liberalised road transport market, offers the prospect for substantial change in the Turkish road transport market if Turkish hauliers are granted the same legal opportunities as existing EU ones.

The road freight market within the EU for EU national firms is highly liberalised, including for cabotage freight.[22] Effectively, it is a single market, with the only entrance requirement being a national licence from an EU country which permits unrestricted international and domestic carriage within the EU irrespective of the country of origin of the carrier within the EU.

In contrast the regulatory framework applying to international freight between the EU and Turkish markets and also other countries remains highly restrictive. No principle in international law guarantees foreign transport operators freedom of transport in national territories. Such rights must be established by specific agreement. This has long been a difficult area. Operations are regulated by a web of bilateral and multilateral agreements between countries that restrict quantity and capacity by limiting the number of permits that are available for a truck to make a journey between the jurisdictions.

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The basic quota of multilateral permits issued by the European Conference of Ministers of Transport (ECMT) for Turkey is 141 truck permits. Additional permit exchange for multiple licences for lower pollution trucks took the total ECMT truck permit numbers to 493 in 2001. The limited scope of the ECMT arrangement is made clear when it is recalled that there are 882 firms active in international transport using more than 20 000 motive units. Consequently, most international trade is governed under bilateral quotas which are negotiated annually under bilateral agreements with 50 different European, Asian and African countries which govern both the number and distribution of permits to engage in the trade.[23] For some countries the stock of permits is insufficient – in the final months of 2000 trade by Turkish trucks with the Russian Federation, Georgia, Italy, Austria, Romania, Hungary and France was restricted. The administrative load of this allocation system is high.

The bilateral agreements and limited number of ECMT licences means that the freight markets are fragmented – third country haulage is restricted and arranging back-haul loads is more difficult, with consequent inefficiencies. Moreover, permits are required from transit countries as well – an important "missing element" in the patchwork of regulation established by the bilateral agreements is a generalised transit agreement.

Bilateral agreements generally prohibit cabotage and an ECMT licence does not give this right either. Hence the domestic Turkish market is reserved for Turkish firms (and *vice versa*) which further fragments the market. Finally, Turkey does not exempt own account transport from bilateral permit requirements – unlike many other countries.

Viewed against the wider backdrop of trade liberalisation, and the customs union with the EU, the quantitative restrictions on international road haulage and cabotage in the respective markets are an anomaly. An ECMT paper concluded on this point that, "the plurality of bilateral agreements and their secret and peculiar character arising from particular provisions, mean that most international transport outside the European Union is provided by procedures that are far from transparent and which represent exceptions to the rules of the economy. These transport schemes do not satisfy the effective allocation of resources criteria, in other words there is no attempt to achieve the balance that would result from competition and the free play of economic processes". ECMT, 2000.

Bilateral permit arrangements are reciprocal and thus give an appearance of balance in freight transport and allow transit countries to exercise some control over freight volumes passing over their territories. But, if permits are scarce, which is not uncommonly the case, the permit system raises the cost of transport – specifically, low cost firms do not grow, rather it is firms with access to permits which tend to be those with a past presence in the industry.

It is not within Turkey's power, or any other single country for that matter to address these problems unilaterally. Efforts to address these issues within multilateral fora are "work in progress" and rapid resolution cannot be expected. Rather the challenge is to work within the system and promote liberalisation where possible. There are several other "irritants" to the industry which have a multilateral character, including restrictive visa arrangements and inconsistent technical regulations in non-EU countries.

Ultimate access to the EU would largely solve the access problem of the Turkish industry. In the interim, it will be a matter for the Turkish authorities to continue with bilateral liberalisation efforts with EU and other countries. It will be important in that respect for Turkey to demonstrate adjustment to social conditions in its freight industry that will give their counterparts some comfort that opening their markets would occur in an environment of competitive neutrality. A key in this respect will be the full implementation of the new Highway Transport Law.

The domestic sector is facing significant regulatory change

There is a very significant segmentation between the domestic and international sectors of the Turkish industry. Specifically, the domestic industry does not yet incorporate the standard entry requirements or social controls that are applicable to the international sector. Accession of Turkey to the EU commits Turkey to approximate its law with the Community law, which is what the proposed new Highway Transportation Law is intended to achieve.[24] This will represent quite fundamental regulatory change in this sector and it will take some time to adjust.

A significant number of firms presently active in the domestic sector could not meet EU consistent requirements for market access and social regulation. The authorities intend to ease the transition by creating at least 7 new contracting co-operative firms – existing firms in the domestic industry would have the option of either meeting the new regulatory requirement directly or becoming sub-contractors for the new co-operative firms. In the circumstances it appears reasonable for the transport authorities to be involved at a policy level in "seeding" such a new structure. But, there are a number of competition policy or more general industry policy issues that arise from this proposal. There should be an adequate number of co-operative firms to avoid market power and there should be no geographic market segmentation which could give rise to market power in a region. Such firms should be free to operate and subcontract on a Turkey-wide basis. And, once new firms are established, the authorities should withdraw and allow the industry structure to evolve according to underlying market forces, subject to the application of competition law. The Competition Authority will have to be vigilant under these proposals.

A hard road to reform

The authorities have indicated that they would be prepared to contemplate abolition of the cabotage reservation (which keeps the domestic freight market wholly to Turkish firms) only after full membership is achieved with the EU and a transition period would be necessary for liberalisation of third country transport. Similarly, the Turkish authorities have indicated that they would seek a time derogation for foreign hauliers access to the domestic market. In essence, the Turkish authorities are concerned about the competitive impact on domestic firms of the entry of more sophisticated and more highly capitalised foreign firms.

Equally, a common concern among transport authorities within the EU is a competitive challenge by freight operators from low wage accession countries.[25] Mutual fears of this type have underlain the long and halting steps towards liberalisation of international road freight everywhere. Where liberalisation has finally proceeded to a high degree, such as within the EU the results have been strongly positive. "Within those countries and regions which have deregulated, there have been significant falls in transport prices, substantial gains in productivity and in improvements in the quality of service. Competition has increased and profit margins have fallen; there has been substantial growth in subcontracting" (ECMT, 2000b). In particular, fears of massive losses of market share to foreign firms have not eventuated. Some problems have arisen in Europe in parallel with liberalisation, including systematic loss making and "churning" among small firms and associated regulatory avoidance – these do need to be addressed and are a forewarning for the Turkish authorities. But, such problems are not likely to be addressed through more restrictive entry conditions, as the root cause is *management* deficiencies in the small firms and deficiencies in the enforcement of existing rules. If past trends are any guide, it might be expected that foreign authorities would be similarly concerned about the competitive impact of prospective entry by low cost Turkish firms into their own domestic markets. This kind of mutual fear is likely to delay liberalisation and the specialisation that might be expected according to comparative advantage (where high wage countries/firms would specialise in complex logistics while low wage countries/firm would specialise in labour intensive haulage). The historical precedent for this conclusion is that hesitant steps to liberalise cabotage in Europe were underpinned by fall-back measures in case there was "disastrous" loss of market share – in fact, these fall-back measures were never implemented because cabotage penetration has always been minimal.

It could therefore be argued that it would be a policy of enlightened self interest if Turkey was to pursue liberalisation of cabotage wherever and whenever possible through bilateral negotiation prior to the EU accession and similarly for liberalisation of own account transport. However, were a view to prevail that such liberalisation should be held as "negotiating coin" in accession discussions then such liberalisation is not likely to occur for a considerable period.

Conclusion

The ultimate accession to the EU of Turkey and consequential market opening to road transport will be a watershed event for the industry, given the existing highly restrictive limits on international permits which are regulated mainly by bilateral agreements. Substantive derogations from the now highly liberalised EU road freight regulatory framework in its application to Turkey after its accession would be costly to both Turkey and to Europe. Turkey should continue to seek liberalisation of international trade mutually with EU and other countries.

Policy options for consideration

1. Prior to EU accession, the government should:
   - Seek to increase the number of bilateral permits and reform of the bilateral framework mutually in several dimensions.
   - Seek to increase the number of ECMT permits.
   - Seek harmonisation of bilateral agreements with EU countries in the direction of the ECMT Model agreement.
   - Participate in mutual processes to agree a multilateral transit agreement with the EU.
   - Specifically in the context of the above points, remove restrictions on liberalisation of own account transport from ECMT and bilateral agreements, mutually with EU countries and most importantly with geographically close trading partners.
   - Remove cabotage restrictions within bilateral agreements with other countries.
2. In the context of EU accession negotiations, the Turkish authorities should:
   - Limit to the greatest extent possible protectionist derogations from the freedoms that would otherwise accrue in respect of transport from the accession to the EU, either by Turkey, by EU countries or by other accession countries against Turkey.

- Strive to make any transitional periods in any such derogations as short as possible.

3. In support of the general environment for market opening, the Turkish authorities should work to ensure that:
   - Turkish technical and social regulation to the Turkish road freight industry is comparable with the range applying in EU countries and is seen to be adequately enforced.
4. In the restructuring of the domestic road freight sector, so as to accord with EU regulatory norms, it is reasonable for the government to intervene to seed a new industry structure around new firms which will contract transport from existing participants. This will ease the difficult transition for domestic participants. However, it is vital that this intervention does not entrench anticompetitive outcomes, in particular it should not give rise to any regional segmentation of the market.

Notes

1. Two companies (CEAS and KEPEZ) operate concessions that involve generation and distribution in regional areas – these account for around 2% of installed capacity.
2. Hydro capacity is less than output because of the economics of hydro systems. More generation capacity is installed than the total water flow potential because of variations in water flow through the year and between years.
3. With the exception of secondary transmission in the concession zones operated by CEAS and KEPEZ.
4. The only one distribution company operates concessions in the Kayseri region.
5. Build Operate Transfer (BOT) and Transfer of Operating Rights (TOOR).
6. Compared with economic depreciation rates.
7. Industrial plants, residential complexes of more than 5 000 dwellings, 5 star hotels, industrial zones, universities and municipal institutions are allowed to be auto-producers. Certain smaller entities are entitled to auto-produce electricity by wind or solar energy.
8. Sales may also occur to a subsidiary of the auto-producer. Negotiated prices are capped at 70% (this ratio has raised to 85% later) of the average sales price of TEAS to TEDAS prior to the enactment of the Electricity Market Law.
9. The settlements system, called the Financial Reconciliation Centre, will reconciles financial flows between the balancing market operator and entities involved in the electricity market due to differences between bilateral contracts and actual generation/consumption from the system.
10. As explained below this requirement is being further considered by the government.
11. Which face limits to the proportion of their production they can sell without assuming all of the obligations of a generator.
12. Although as the government will bear the burden in the form of lower revenue from low cost hydro generation capacity the burden of consumers is not avoided – rather it is "indirect" through the budget by virtue of the taxation channel.
13. Or voluntarily renegotiated to make the price time profile reflect economic depreciation and then allow them to be competitively bid into the new liberalised market.
14. Because thermal generation is relatively high cost it would make little contribution to offsetting the stranded costs if it were to be bundled with the hydro generation.
15. Vesting contracts are put in place to establish a starting position at the point when the new market starts. Initially, these would involve contracts for 100% of expected generation and use. The rate at which such contracts phase out – to be replaced by negotiated contracts – sets the boundary for the possible emergence of competition. It is presently contemplated that such contracts would be phased out linearly over 5 years.

16. The new law embeds this intent in the market share limits relating to the whole of the Turkish market – care will be needed in privatisation decisions to consider competition issues in the relevant functional market, which may not necessarily be Turkey-wide.

17. Experience in California, where the ISO and the Power Exchange were separated, was that they made inconsistent decisions. Other jurisdictions have successfully integrated the activities, for example in the PJM Interconnection in the mid-Atlantic states in the United States and in the Australian National Electricity Market.

18. Where electricity users bid into the market to take more electricity from the system or not take previously contracted electricity.

19. The new law embeds this intent in the market share limits relating to the whole of the Turkish market – care will be needed in privatisation decisions to consider competition issues in the relevant functional market, which may not necessarily be Turkey-wide.

20. This chapter does not address oil matters.

21. Firms are required to seek approval for maximum inter-city freight rates from regional authorities but prices below the tariff were set by negotiation. Rates could not be increased for a defined period. The Ministry retained a reserve power to regulate rates in the event of economic disturbances result in excessively high or predatory tariffs.

22. Cabotage refers to the carriage of freight with a country or between two countries by a carrier that is from neither country.

23. The bilateral agreement with Bulgaria does not set numerical limits on truck journeys but does exclude third country transport and cabotage.

24. This will replace regional level regulation applying to domestic freight moving within individual provinces or travelling less than 100 kilometres.

25. Within European policy discussions the issue of "social dumping" (including illegal employment of drivers from low cost countries) is attracting attention. See for example ECMT (2001) and (2001a) for a general discussion of the constraints to liberalisation. See ECMT (2001b) on the discussion of social dumping.

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PART II

Chapter 6

Telecommunications Sector*

* For more information see: "Background report on Regulatory Reform in the Telecommunications Industry" available at *www.oecd.org/regreform/backgroundreports*

The national context for telecommunications policies

Telecommunications have been given a high priority by policy-makers in recent years and the sector has grown substantially in relative terms during this time. It increased its weight in GDP from 1.03% in 1985 to 3.82% in 1999, while the penetration of fixed telephone lines increased from 4.5 to 28.3 per 100 inhabitants as of end of 2001. However, Turkey still ranks far below the OECD average of 52.8 lines per 100 inhabitants.

Employment in the sector fell from a peak of 93 897 in 1993 to 73 177 in 1997. However, by end-1999 employment had begun to rise again, largely due to growth in the mobile sector. Telecoms revenue per employee more than quadrupled in USD during the 1990s but, again, remains among the lowest in the OECD area.

As in most OECD countries, Turkey's telecoms industry was a state-run monopoly. This regime continued until 1994, when Turkish policy-makers responded to major regulatory and structural changes occurring internationally, particularly among EU countries. The move to liberalisation began with legislation to remove telecoms services from direct government involvement by establishing Turkish Telecommunications Inc. (Turk Telekom) as a state economic enterprise. Up to 49% private ownership was provided for. At the same time the mobile telecoms market was opened to limited competition, with two operators starting business under revenue-sharing agreements with Turk Telekom in 1994. Internet service providers started to appear under service contracts with Turk Telekom. Further steps towards liberalisation lead to the issue of licences for mobile telephone services. The two GSM 900 operators were granted 25-year licences in 1998.

In January 2000, new legislation separated policy and regulatory functions by establishing an independent regulatory body, the Telecommunications Authority, the first sectoral regulator in Turkey. Most regulatory functions of the Ministry of Transport were transferred to the Authority. At the same time, Turk Telekom was placed farther from state control by granting it independence in business operations. It was also decided to end its monopoly in fixed voice telephony by 31 December 2003.

A further change was made in May 2001 through new legislation 4673 due to pressure from the International Monetary Fund (IMF), which included accelerated privatisation of Turk Telekom in its conditions for releasing suspended financial aid. This involved giving more authority to the Telecommunications Authority (especially in relation to licensing) and providing for full privatisation of Turk Telekom, but for a "golden share" to allow the government to address security and public interest concerns. The new law provided for up to 45% foreign ownership of Turk Telekom. The law also stipulates that the monopoly of Turk Telekom will end when more than 50% of Turk Telekom shares are privatised even before the end of 2003.

Following the passage of enabling laws in 1994, 1995 and 1996, privatisation efforts for Turk Telekom commenced with an analysis of the sector and the value of the enterprise, and development of a sales strategy. A 1998 proposal to the Council of Ministers was

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for 20% of the shares to be sold to a strategic partner, followed by a public offering of 19%. The 20% block was offered by tender in June 2000, and then 33.5% in the second tender of December 2000. No bids were received at either tender.

Domestic and international factors contributed to the failure of the tender process. Investor concerns related to Turkey's general economic conditions, the competitiveness of Turk Telekom and other internal factors. Tenderers were required to include an international telecoms operator, but the limited management control attached to the tendered shares was unattractive to foreign investors. Some changes were made on the latter issue before the second tender, but these were seen as insufficient. Difficulties in attracting foreign partners were also related to the high debt levels many of these telecoms companies had incurred during 2000/2001, lead many companies to retreat from international expansion and investment. The new privatisation strategy of Turk Telekom is to be determined by the Council of Ministers.

Application for accession to the European Union

Turkey has been accepted as a candidate for EU membership (see Chapter 2). Preparation for accession has been a major driver of reform in telecoms as in other areas. Turkey has been working to align its law with those of the EU and attention is paid to ensuring newly enacted laws are consistent with EU law. The laws establishing the independent regulator and providing for the privatisation of Turk Telekom reflect this dynamic, as well as that of pressure from IMF. Telecoms regulations incorporate relevant EU decisions and directives. For example, the Tariff Ordinance conforms with the principles of efficient-cost basis, fairness, non-discrimination, transparency, and no cross-subsidisation, as provided by the EU Tariff Directive. Likewise, the Telecommunications Authority is preparing regulations on licensing, interconnection, national roaming, numbering, and number portability harmonised with the EU *acquis*.

In the short-term, Turkish priorities for alignment with the *acquis* relate to licensing and universal service and strengthening the capacities of the independent regulator. In the medium term they are to complete the transposition of EU legislation and implement comprehensive policy for the entire communications sector. In addition, the Competition Authority has emphasised the telecoms sector as a priority for harmonisation with EU competition practices and recommendations.

The recent economic crisis in Turkey and involvement of the IMF and World Bank have also had a direct impact on structural reform, in particular laws passed in 2000 and 2001 to allow in the end for 100% privatisation of Turk Telekom and the full opening of the fixed line market by 2004 or earlier if and when more than 50% of Turk Telekom's shares are privatised. These changes may not have been possible were they not conditions of release for IMF support loans.

Telecommunications market and participants

There is at present one fixed-line telephone operator (Turk Telekom) and four GSM mobile phone operators in the market. Turk Telekom's revenue grew by 60% (in TRL, or 8% in USD) between 1999 and 2000, driven primarily by expansion in its fixed telephony business. Fixed line retail call traffic decreased by 8.1% (domestic) and 7.6% (international calls) during 2001.

Limited competition has existed in the mobile sector since 1994, when a duopoly of Turkcell and Telsim was created. A tender for two GSM 1800 licences was launched in April 2000 where Is-Tim successfully bid USD 2.25 billion. This unexpectedly high bid was suspected to have been an attempt to prevent a fourth operator entering the market, as the tender for the fourth licence was to include a condition that the minimum bid must be equal to that paid by the third operator. In fact, no bid was made when the tender was held. The last entrant, Aycell (a subsidiary of Turk Telekom), was granted the fourth licence at the same price as Is-Tim. A unique and positive aspect of the Turkish mobile market is that, in contrast to other OECD countries, the incumbent company in fixed telephony entered the market only after other operators were well established.

Prospects for the mobile sector are brighter, as reflected in a rapid growth in the number of subscribers in recent years, although costs to consumers are high partly due to heavy taxes. The penetration rate reached 28.7% at the end of 2001. While Turkcell previously had a 70 to 75% market share in the duopoly market the entry of two new players can be expected to weaken this dominant position.

No decisions have yet been taken regarding (next generation) UMTS licences, but the Telecommunications Authority plans to announce the plan after conducting a market analysis.

The Telecommunications Authority is considering the possible introduction of asymmetric regulation by designating certain operators as having significant market power (SMP) and making them subject to additional obligations to control the exercise of their market power. This would be in line with the EU Open Network Provision (ONP) Directive.

Cable television services were tendered to private companies in 1991. These operate under 10 year revenue sharing agreements between the cable TV companies and Turk Telekom. There are 6 cable television operators, each with a local monopoly. Their infrastructure remains underutilised, with 900 000 subscribers compared with a capacity of 2.2 million.

Regulatory structures, institutions and processes

There are three main regulatory authorities: the Communications Supreme Board, the Ministry of Transport and the Telecommunications Authority. The *Communications Supreme Board* consists of the Prime Minister, Minister of Internal Affairs, Minister of Transport, Secretary General of National Security Council, Under-secretary of the National Intelligence Organisation and the President of the General Staff Electronic Communication. The Board, meeting a few times a year in case of a need, makes broad policy proposals to the Ministry of Transport in respect of wireless communication and monitor the progress in this respect. The Ministry of Transport provides secretariat services to the Board.

The *Ministry of Transport* is largely responsible for telecoms policy, with its former regulatory functions transferred to the Telecommunications Authority. The responsibilities of the Ministry are:

- to determine principles for establishing and developing telecommunications services in accordance with technical, economic and social and national security goals, and the overall public benefit;
- to determine telecoms service requirements and co-ordinate their provision;

- to regulate, investigate, and co-ordinate implementation of the communications services that fall outside the Telecommunications Authority's responsibilities;
- to participate in the activities of international organisations related to communications and to follow and ensure implementation of their decisions; and
- to monitor developments in the manufacture of communications equipment.

Created in January 2000, the *Telecommunications Authority* was the first sector specific independent regulator in Turkey. Its decision making body, the Telecommunication Board, comprises five members appointed by the Council of Ministers. They are legally protected from political interference, with limited grounds for dismissal available. The Authority issues licences, supervises operators and takes necessary technical and administrative measures against violations of the rules. Specific responsibilities include:

- To implement a frequency plan and ensure compliance by telecoms and broadcasting operators.
- To implement and to issue concession agreements, licences, and general authorisations.
- To regulate tariffs, contracts between service providers and users and interconnection and monitor compliance.
- To impose administrative fines on operators who breach certain regulatory and licence conditions.
- To determine and implement performance standards for telecoms systems and equipment.
- To investigate matters including anti-competitive behaviour, on its own initiative or upon complaints.
- To protect consumer interests.
- To provide opinions to all decisions of the Competition Authority relating to the telecoms sector, including those on mergers and acquisition, prior to their finalisation.
- To regulate interconnection, including determining which operators are responsible for providing interconnection, monitoring compliance and determining specific conditions and tariffs.
- To determine methods to decide tariffs, including those of leased lines, and price caps.

The Authority's responsibilities are in some ways broader than its counterparts in other OECD countries. In particular, it is authorised by law to take measures to protect national security, public order or public services as necessary. A regulator having such powers is unique in OECD countries. The exercise of such discretionary power can be highly political and is generally seen as the responsibility of elected authorities rather than an independent regulator. This mandate is too broad and should be reconsidered.

Licensing authority was transferred to the Authority in 2001 and includes determining the terms of licences, supervising compliance, and revoking licences. However, minimum licence fees are determined by the Council of Ministers on the regulator's proposal. For concession agreements, the Authority prepares plans for approval by the Council upon proposal of the Ministry of Transport.

The Authority is financed by testing fees, revenue from sales of publications, consultancy fees, fines and some budgetary funding as required. It is subject to inspection of the Court of Audits. It can investigate matters at its own initiative or upon complaint, request provision of information and documents and issue regulations or take other administrative action. It must ensure interested parties can submit representations, which are publicly disclosed. It must also protect consumer interests.

The Authority has eight main functional departments, responsible for tariffs, licences and agreements, international relations and EU co-ordination, sectoral competition and consumer rights, spectrum management, spectrum monitoring and control, technical regulations and standards and sectoral research and strategies. It is staffed mainly by former Ministry of Transport and Turk Telekom staff. There are difficulties in obtaining staff with regulatory expertise, a matter that will become particularly pressing in view of the introduction of full competition in the fixed line market in less than two years.

While staff recruitment problems are common to many OECD regulatory authorities the Telecommunications Authority is particularly constrained by being able to recruit only from the civil service and by having salary level restrictions. These restrictions limit the Authority's independence and flexibility. For example, if it wishes to recruit a private sector expert, he or she must first pass the civil service examination and then be appointed to the lowest level in the Authority. Given likely increases in private sector staff demand, the Authority should at least have flexibility to recruit from outside the public sector. In the short term, use of outside consultants may be required. In the long run, it is essential to develop internal experts. The Competition Authority and the Energy Board have more flexibility in staffing.

Relationships between the Ministry of Transport and the Telecommunications Authority

Turkey is aware of the need for close co-operation between the two organisations, and has set out their relationships in the law. For example, the Authority prepares necessary plans regarding radiocommunication and telecommunications (*e.g.* a frequency plan), and presents them to the Ministry. The Authority is directly accountable in general to the parliament (Turkish Grand National Assembly). Some specific requirements are provided in the law, as seen above. In addition, the Authority is required by a new law of January 2002 to submit its annual report to the Council of Ministers.

Turkey has an administrative court system and parties contesting the Authority's decisions could turn to it for review of procedural or substantive review. Appeal to the administrative court does not automatically stop implementation of the original decision, this issue being decided case by case. This helps reduce tactical appeals aimed at delaying the implementation of decisions. However, one or two years, or more, can be needed to complete the judicial process and costs can be prohibitive to enterprises.

Telecoms regulators in many OECD countries use public consultation as an integral part of their decision making process. Consultation helps improve both transparency and regulatory quality. Both the Authority and the Ministry of Transport use a "green paper" approach extensively, consulting by publicising a draft policy or decision and inviting comments and suggestions. However, there is no legislated requirement for such consultation.

The Authority has also been working to establish a Telecoms Policy Council to assist it in developing strategies and making decisions. Its role and status are still under discussion. Membership is likely to include the regulator itself, Turk Telekom and other telecoms companies, cable companies, lawyers, etc. Such an advisory body has the potential to improve the quality of decisions and could also enhance transparency. However, a concern is that there is currently no plan for consumer representation. Consumer involvement is essential, as consumers are often the most affected by the Authority's decisions.

Co-operation with the Competition Authority

The Competition Authority acts against anti-competitive practices in all sectors. Around one quarter of the Competition Authority's 80 staff specialise in the ICT sector which covers telecommunications. The Competition Authority has strong capacity to act in the telecoms sector.

Law 4502 provides a framework for co-operation between the Competition Authority and the Telecommunications Authority. The main requirement is that, when investigating matters in the telecoms sector, the Competition Authority must initially take into consideration the opinions of the Telecommunications Authority before taking any decision in relation to the sector, including mergers and acquisitions. The telecoms regulator may also request the Competition Authority's opinion to assist in ensuring its decisions on standard reference tariffs or that interconnections do not impede competition. Such statutory provisions help reduce uncertainty and prevent regulatory overlap, while also smoothing the exchange of confidential information for regulatory purposes. Notably, the two bodies are currently developing a protocol to address specific aspects of their working relationships.

Handling of consumer complaints

Turkey has limited formal provisions for dealing with consumer complaints in the telecoms sector. A general mechanism is the consumer rights councils run by district and provincial authorities, while the courts are also theoretically available. However, these procedures are too costly and time-consuming for most complaints and provide unsatisfactory outcomes, according to consumer groups. Complaints can be made to the Telecommunications Authority, which largely directs them to the telecoms operators who are the object of the complaint. Serious disputes that are not resolved by the operators are submitted to the Telecoms Board, which may or may not employ formal procedures. Notably, there is no formal mechanism for handling either general consumer complaints or industry complaints.

The regulator should establish complaints resolution procedures for consumers and users, following public consultation, and material on complaints and their resolution should be published regularly. Another possible means of improving complaints handling would be to encourage the development of an industry code of practice covering the industry's dealings with users. In this regard, the Telecommunications Authority has been working to establish a "consumer complaints centre" to improve consumer protections by clarifying and defining procedures for enforcement of consumer rights and for handling of consumer complaints. Furthermore, the Authority is currently preparing regulations to oblige operators to submit their standard consumer contracts for approval of the Authority. It is also working on new regulations to ensure protection of personal data consistent with EU Directive 97/66 and Draft Directive on Data Protection and Privacy on this matter.

Regulations and related policy instruments

To provide a telecom service in Turkey, a company requires an Authorisation Agreement, a Concession Agreement, a Telecom Licence, or a General Authorisation issued by the Telecommunications Authority. These are distinguished in law as follows:

- Authorisation Agreement: a contract between Turk Telekom and the Telecommunications Authority which sets out authorities, rights and obligations for the provision of telecom services.
- Concession Agreement: a contract between the Telecommunications Authority and an operator for the latter to provide telecom services and/or establish and operate infrastructure.
- Telecoms Licence: a permission by the Telecommunications Authority for the provision of telecom services and/or establishing and operating infrastructures.
- General Authorisation: a permission by the Telecommunications Authority authorising an operator to provide telecom services and/or to establish and operate infrastructures other than in other categories (ISP is an example).

A concession agreement is used when authorisation involves the allocation of scarce resources (*e.g.* frequency, satellite position, numbering); when granting particular or special rights and obligations to each operator is necessary; or when the service in question has to be offered by a limited number of operators for some reasons. A concession presupposes a nation-wide network.

Although the authority to license has been transferred to the regulator, the Ministry remains involved in concession agreements because they involve the allocation of scarce resources. The plans of authorisation regarding Concession Agreements are prepared by the regulator, then proposed by the Ministry for approval by the Council of Ministers. Minimum values of the licence fees are determined by the Council of Ministers on the regulator's proposal. Telecommunication Licence has two sub-categories; one is for when limiting the number of operators for local markets is necessary, and the other is when the limitation is not necessary. The Telecommunications Authority determines which of the form an authorisation should take.

The current legislation does not allow different provisions among operators except that fees could be differentiated reflecting different concession terms and conditions. Also, the Concession Agreements have been made publicly available upon request recently. However, the system of Telecommunication Licence accords the Authority with a discretionary power to determine the number of operators in a particular market. General Authorisation, despite the name, is in fact an individual licensing, and it is not clear how this is distinguished from the second type of Telecommunication Licence.

Best practice regulation in OECD countries is to use a licence only when a scarce resource is allocated and to use general authorisation otherwise. Turkey's licence regime could be streamlined by transforming Concession Agreements into a general Telecoms Licence with standardised and transparent conditions. In the medium term, Turkey should consider integrating different licence types "class licence" which gives free entry to all who can satisfy the general conditions. Notably, EU policy is to move member countries toward such a framework. In addition, the regulator should not have the authority to determine how many operators a certain market should have as this could be best left to the market forces.

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An urgent task for the regulator is completing and fully implementing the current licensing system. The most urgent requirement, as the regulator itself is well aware, is to determine fully the minimum values of licence fees where this has not yet been done, which the regulator proposes and the Council of Ministers approves, so that telecommunications licences could be issued fully as soon as possible.

Internet service providers (ISPs) must obtain an individual General Authorisation under the current regime. This requirement is unnecessary since ISPs should have no specific or individual obligations, not to mention that there need be no limitations on the number of ISPs nor do they need allocation of scarce resources. Turkey should consider allowing them to operate without licence or authorisation requirements, as is the case in most OECD countries at present.

The six cable TV (CATV) companies currently in operation in Turkey operate under revenue sharing agreements with Turk Telekom because of Turk Telekom's monopoly rights allowing others to build their own networks only when Turk Telekom determines that it cannot build the network in question itself. The CATV companies have invested to build up their cable TV networks, but the ownership of these networks has been kept by Turk Telekom. On the other hand, these companies have exclusive rights in each operating area. However, the current legislation has enabled the Telecommunications Authority to issue Telecommunication Licences to CATV companies for establishing and operating their own networks. It means that after 2004 at the latest when the monopoly right of Turk Telekom ends, CATV services and networks will also be brought under full competition. This may change since the Authority is presently considering giving infrastructure licences to the CATV companies which would allow for full service and network competition in this market. They will also be allowed to offer voice telephony services and Internet access services using their networks. But they have to obtain a separate licence for the Internet access services. Whether or not additional licences will be needed to offer these services is yet to be determined.

Foreign ownership

Foreign ownership is restricted to 45% of Turk Telekom. Foreigners are allowed to own no more than 49% of telecoms operators that require Concession Agreements. Such restrictions result from a Constitutional Court ruling that the telecoms and energy sectors are strategic assets. Given the need for substantial foreign investment in the sector to speed market development, these restrictions should be abolished. Turkey's commitment to accession to the EU will, in any case, require their abolition. Foreign ownership restrictions are unnecessary for reasons of security, given the alternative instruments available to governments.

Rights of way

Telecommunication operators have an in principle right to use public roads and other public areas to laying cables without fee, as long as they do not permanently hinder the primary objective of the roads, etc. However, relevant authorities reserve the right to supervise excavation work and intervene if necessary. In addition, operators must obtain permission from the General Directorate of Highways when to lay cables in newly constructed toll roads.

Mobile operators must obtain authorisation from the local government, the Ministry of Environment, and/or the Ministry of Interior under environmental, zoning, and other laws and regulations in order to build base stations. This results in a long and costly process that should be simplified via a "one-stop-shop" procedure developed by the Authority to prevent right of way issues becoming an obstacle to market entry.

Regulation of interconnection

Even after Turk Telekom's monopoly is abolished, many new entrants will be dependent on its networks to provide services to end users, while mobile operators also need roaming arrangements. Turkey is aware of the importance of establishing an interconnection regime, and has developed a regime in line with the EU Interconnect Directive. It is currently under preparation as the Interconnection Ordinance. Turk Telekom and other "interconnection providers" must provide interconnection based on the principles of equality, non-discrimination, transparency, cost-orientation, reasonable profit and under the same conditions and quality as they provide for their own services. If an agreement cannot be reached, the requesting party can apply for the intervention of the Authority. If the parties fail to reach an agreement with the Authority's mediation the Authority sets the terms, conditions and tariffs of the interconnection. Mobile telecommunication is included in this interconnection regime.

Operators may incorporate in their agreements standard reference interconnection tariffs to be published by the Authority. The law also provides for interconnection agreements to be made publicly available. So far there is neither a reference interconnection offer by Turk Telekom nor standard interconnection tariffs published by the regulator. Turk Telekom has interconnection agreements only with GSM operators.

A general consensus has emerged in the OECD on the use of the Long Run Incremental Cost (LRIC) accounting methodology as best practice in price setting for interconnections as it emulates fully competitive market price levels. The Telecommunications Authority is now developing standard interconnection tariffs with this method covering mobile and fixed networks and it should shift the interconnection regime to one based on LRIC as soon as possible.

In relation to interconnection between mobile operators, national roaming has been an issue of dispute that necessitated the regulator's intervention. Is-Tim (Aria) and Aycell, the two recent entrants to the Turkish GSM market, have not yet been able to conclude roaming agreements with Turkcell and Telsim. This is a major reason for the limited expansion of the coverage of the new entrants' networks. The operators having been unable to resolve tariff disputes among themselves, the regulator was requested to intervene, and duly determined terms, conditions and tariffs for roaming in November 2001. However, the decision has been challenged by both sides and the case is still under judicial review. This case underlines both the importance of establishing standard interconnection tariffs based on LRIC and the need to ensure that regulatory decisions remain in force while court proceedings are undertaken.

Pricing policy

Price regulation in telecoms is a responsibility of the Telecommunications Authority. It can determine the means of calculation of tariffs and cap tariffs in certain cases, such as where cross-subsidisation is necessary to cover the cost of universal service obligation, tariff rebalancing and tariffs of "dominant operators". The law states that the Authority should avoid cross subsidisation between different services. An operator is subject to price regulation when it has a dominant position or significant market power. The determination of dominance or significant market power is made annually by the Authority and publicised.

The Tariff Ordinance defines two methods for tariff approval, namely cost-based and price cap methods. The Telecoms Authority has decided to use the price cap method for all services supplied by dominant operators from 2002. Detailed application procedures for the price cap method have been provided in the Price Cap Communiqué. For the moment, Turk Telekom is the only operator subject to price regulation. The method used to approve Turk Telekom's tariffs is a Consumer Price Index – Productivity Factor (CPI – X) formula.

It is important that price regulation encourage tariff rebalancing to promote competition on the basis of efficient prices. The Telecommunications Authority has taken into account the need for rebalancing in its examination of Turk Telekom's tariffs and rebalancing has progressed over several years. For example, the price disparity between local and the more distant call categories was 20 times in 1994 but narrowed to four times by 2000. OECD experience shows that the most effective way to achieve cost-based prices is through effective competition, rather than price regulation. However, in tariff re-balancing of residential services, the regulator must handle the sensitive issue of how quickly to manage the transition from less than cost prices. Excessive tariff control can reduce tariff flexibility, and since many new entrants use the incumbents' price levels as a benchmark, such controls may reduce the impact of competition in pushing down prices. Therefore, constant review of market competition and price developments will be important, as will be efforts to streamline price control, when the Turk Telekom monopoly ends.

Quality of service

The Telecommunications Authority also regulates service quality. Service quality conditions must be included in Authorisation Agreements and in Concession Agreements under non-discriminatory terms. The regulator can include them in Telecoms Licences and General Authorisations if necessary. A common complaint among GSM operators concerns delivery of leased lines by Turk Telekom. The complaints include high prices, delayed delivery, physical quality of the leased lines, and arbitrarily changed conditions. Such problems shows the necessity of having Service Level Agreements (SLA) in place in Turkey that cover prices, delivery times, fault maintenance, and restoration. The regulator should consider requiring Turk Telekom to include such a SLA in their Reference Interconnection Offer.

Resource issues

The development of competition, and in particular in mobile communications, has increased demand for frequency spectrum in all OECD countries, including Turkey. Increasing spectrum demand increases pressure for improved spectrum allocation and more efficient spectrum use. Frequency planning responsibility lies with the Telecommunications Authority. It is also responsible for establishing rules and policy to control the issue of licences to radio operators. Most issues and decisions governing spectrum allocation are in direct responsibilities of the regulator. In respect to frequency planning, the regulator has been working to align the National Frequency Allocation Table with the EU requirements.

The initial assignment of spectrum for mobile telecoms services was not competitively determined. The third GSM licence (GSM1800) was allocated on the basis of a competitive tender in April 2000. Following the failure of the competitive tender offer for a fourth licence, Turk Telekom (Aycell) was granted the licence at the same price as paid for the third licence.

UMTS (IMT-2000) licensing has been taking place in OECD countries recently, and a number have decided to conduct spectrum auctions. The extremely high prices paid in some countries (*e.g.* the United Kingdom Treasury earned USD 35 billion for five licences and Germany around USD 46 billion for six licences) have led to some reconsideration of methods of licence allocation, especially since some operators have decided not to participate in licence tenders where prices were viewed as excessive. Thus, some countries have chosen a comparative selection process ("beauty contest") over auctions, as in Ireland, or some form of a combination of the two methods, as in Italy. Nonetheless, a well designed auction process remains the most efficient and transparent way to allocate licences.

In Turkey, the UMTS licences will be Concession Agreements because they involve allocation of scarce resources. The Telecommunications Authority will announce detailed plans for introducing UMTS in 2002, The Authority has recently taken a decision on establishing a "UMTS National Coordination Board" with the presidency of the Authority and the participation of representatives from public organisations, operators and firms to take part in granting UMTS licences in order to conduct the relevant activities. The number of operators and method of allocation have not yet been decided. The economic conditions at the time of inviting applications could be a major factor.

Another point to be mentioned regarding the mobile sector is that the regulator sees the Mobile Virtual Network Operator (MVNO – essentially resellers of leased network services) as an important means to increasing competition. However, given that competition in the mobile market is not yet fully established, an early focus on MVNOs risks diverting regulatory resources from more important areas.

A fundamental problem with the mobile sector is that of heavy taxation. While competition in the sector has brought benefits to consumers, prices would be lower if not for the heavy taxation on operators and users. End users currently pay 55 to 60% of the invoice in tax, perhaps reflecting a perception that mobile telephone is still a luxury in Turkey. However, the relatively low penetration rate of fixed line telephony underlines the importance of low cost mobile telephones as a basic need in Turkey. Penalising the mobile sector is counter to the goals of telecoms policy in Turkey and should be reconsidered as soon as possible.

Numbering issues

The current National Numbering Plan used was developed by Turk Telekom in 1993. However, administration of numbering became the responsibility of the Telecommunications Authority in 2000 and the system is now under review. Call-by-call carrier selection and carrier pre-selection (CPS) services are not available, but the regulator is planning to introduce them as soon as the monopoly of Turk Telekom is over. These are important mechanisms to allow competition to take off quickly. Number portability is an important means of promoting competition, making switching suppliers more attractive, but no regulation of this currently exists in fixed or mobile markets. The regulator should implement number portability in the mobile sector as soon as possible and prepare for its introduction to the fixed telephony market.

Universal Service Obligations (USO)

There is no explicit legal provision for universal service in Turkey, although the concept was introduced to Turkish law as "minimum service" in 2000. The requirement is consistent with EU standards. However, there is currently no implementing regulation on this matter. A key aspect is the financing of the obligation. OECD countries' experience indicates two possible mechanisms. One is establishing a fund to which all operators contribute and from which the designated USO operator (or operators) is reimbursed. Experience has shown that this option avoids distortions in interconnection, tends to be more transparent and allows designating another operator, instead of the incumbent, to provide universal service in specific areas. The other option is that a supplementary charge is added to the interconnection charge. The second method is generally less transparent and efficient and should be avoided. Moreover, it is likely to be ruled out by a forthcoming EU Directive, making it unsuitable for Turkey.

Consumer protection

Consumer interests are best enhanced through effective competition, which will deliver lower prices, improved choice and better quality. However, there is a continuing role for government. While the government and the Telecommunications Authority have been working to ensure that consumers benefit from increased competition some issues remain, as noted above. These include an adequate complaints mechanism and improved information provision. The government and the Telecommunications Authority should increase their focus on consumer interests while implementing policies and regulations to promote competition among operators. Establishing and publishing quality of service indicators will also enhance consumer choice. Further, the regulator should establish concrete procedures and time limits for handling consumer complaints. The procedure should be speedy, simple, and inexpensive for ordinary consumers.

Regulatory streamlining

While sector-specific regulations are necessary to facilitate the transition of the market to full competition, they should be progressively withdrawn as the market becomes fully competitive. This requires regular review as the market evolves. The Telecommunications Authority should consider conducting and publishing a regular review of the market, which would both assist it in discharging its own responsibilities and highlight the benefits consumers are deriving from competition.

Convergence in communications markets

Convergence between the telecommunications and broadcasting sectors is advancing rapidly, posing regulatory challenges for many OECD countries. A number have begun studying the difficult issues of convergence and the implications for the legal and regulatory frameworks covering telecoms and broadcasting. Turkey should address this issue as soon as possible, in order to ensure timely regulatory responses.

Market performance

The rationale for regulatory reform is public benefit. This section assesses the performance of the Turkish telecoms industry in delivering benefits to users and consumers. The main elements of market performance examined are network development and modernisation, services based on leading edge technology and infrastructure, lower prices, better service, increased customer choice and benefit to users.

As the experience of OECD countries has shown, the market should show dynamic growth in terms of new entry, investment and development of services following full liberalisation. However, problems with market opening could slow growth and benefits to users. In this regard, needed regulatory measures, as discussed in the previous section, must be implemented in a timely manner. It is important that the full benefits of competition are realised and passed on to users. In the shorter term, as the telecommunications market is transformed from a monopoly to a competitive market, effective regulation will play a key role in ensuring this outcome.

Market development

The telecommunication sector increased its share in GDP from 1.37% to 3.82% during the 1990s and from 1997 – 1999 accounted for 2.2% of Gross Fixed Capital Formation. The number of telephone lines expanded from 6.9 million lines in 1990 to 18.1 million by 1999, more than doubling the penetration rate from 12 lines per 100 inhabitants in 1990 to 27 per 100 by 1999. However this compared to an OECD average of 46. Turkey retains among the lowest penetration rates in the OECD, ranking 27th in 1999.

Table 6 indicates that Turkey's public telecommunications investment weakened considerably in the late 1990s and only began to pick up as the threat of competition and privatisation of Turk Telekom began to become a reality.

Table 6. **Public telecommunication investment as a percentage of revenue**

	1986-88	1989-91	1992-94	1995	1996	1997	1998	1999
Turkey	65.2	28.9	31.5	24.4	17.0	17.3	11.8	19.5
OECD average	25.8	27.5	25.0	24.0	25.4	24.4	25.1	26.6

Source: OECD, *Communications Outlook* 2001.

In tandem with network expansion, Turkey rapidly digitalised its network and the rate of digitalisation of the fixed network was higher than the OECD average in the early 1990s. However it fell below the OECD average in the latter half of 1990s as the number of countries that completed 100% digitalisation increased. Turkey has had higher digitalisation rates of the mobile network, reflecting its relatively late introduction of the services.

The mobile telecoms market started with two GSM operators in 1994. The duopoly continued until early 2001, when two new operators commenced. Cellular mobile penetration has increased from 2.5 per 100 inhabitants in 1997 to 11.8 by 1999 narrowing the gap with the OECD average. By end-2001 the penetration rate reached 28.7 per 100 inhabitants, which is higher than for the fixed network.

Commercial ADSL services and cable modem based internet access services began in the latter half of 2001. Turkey had 884 574 CATV subscribers in 2000, a 73% increase since 1997, and the figure has reached to 908 000 at the end of 2001. The CATV penetration rate was 16% at the end of 2000.

Development of competition

As noted, full liberalisation will not arrive until 2004 unless privatisation of majority shares of Turk Telekom is realised earlier. Alternative fixed communication infrastructures have not been developed, yet CATV companies operate using Turk Telekom's infrastructure. In the GSM mobile sector some benefits have accrued to consumers and users. These have mainly been seen as price decreases and an expansion in the range of services. For example, when Aria entered the market, existing operators offered 18% reductions in access fees and 50% reductions in call charges. Resolving roaming disputes and introducing number portability will further enhance competition.

Price levels in other countries provide an important benchmark to assess the relative performance of telecoms markets. The OECD compares prices of a basket of telecoms services for residential and business customers in each of the thirty OECD countries. Turkey is ranked 28th both for the business basket and for the residential basket as measured in terms of purchasing power parities.

One characteristic of the prices in Turkey is that fixed part of the price is the lowest among OECD countries. However usage charges are high. Turkey has moved to rebalance its fixed telephony tariffs, but there is further room to adjust the tariffs to reflect costs.

International telecommunication prices

Turkey had one of the highest international collection charges in the OECD as measured in US dollars in the early 1990s. They fell substantially over the latter half of the 1990s, largely due to indirect competition, *e.g.* from call-back services. Despite this improvement, the charges remained among the highest in 2000. The OECD basket of international telephone charges as of November 2001 shows that Turkey has international charges of around three times of the OECD average both for business and residential calls.

Table 7. **OECD basket of international telephone charges, November 2001**

	Business excluding tax		Residential including tax	
	USD	USD PPP	USD	USD PPP
Czech Republic	0.78	1.90	1.02	2.48
Hungary	0.92	2.10	1.48	3.36
Ireland	0.51	0.55	0.70	0.76
Portugal	0.71	1.08	0.96	1.46
Spain	0.78	1.01	1.12	1.46
Turkey	1.51	**3.98**	1.89	**4.98**
USA	0.52	0.52	1.48	1.48
OECD average	0.89	**1.27**	1.22	**1.75**

Source: OECD and Teligen.

The availability of leased lines and their price levels are important for the development of competition since new entrants initially rely on these circuits to develop service. Leased circuits are also important for the development of Internet services. Turkey's tariffs for leased lines are only slightly higher than the OECD average, and so performance in this regard is relatively good.

Turkey's prices for cellular mobile are among the highest of the OECD countries, in part due to tax treatment, as noted above. Turkey's price level ranked the 21st in August 2000 and 28th in November 2001.

The total number of Internet subscribers in Turkey was estimated at around 2.4 million at end-2001, a penetration rate of 5.5%. This represents major growth from around 0.3 million at end-1999. The number of Internet hosts per 1 000 grew 175% in the six months to January 2000, and reached 3.3 per 1 000 in October 2000. However, Turkey still belongs to a group of the lowest penetration rates of Internet hosts.

Turkey has the lowest Internet access charges among OECD countries for both peak and non-peak times. However, the number of subscribers remains small. This seems to be the result of the low penetration of fixed line telephony, relatively low incomes, and limited Turkish language content.

Quality of service

Turkey had a high rate of fault incidents on telephone lines during the 1990s. Fault rates were 56 per 100 lines per annum in 1998, despite progress over 1990s. On the other hand, the percentage of faults repaired within 24 hours in Turkey is high at 90 to 95%.

Conclusion

Turkey will be the last OECD country to take the step to full liberalisation of telecoms markets. However, the regulatory regime has a number of important strengths, particularly due to the emphasis the government and the regulator have placed on the importance of market forces in recent years. Turkey has made major changes to institutional and regulatory arrangements to prepare for the creation of competitive markets. These include creation of the first sector-specific independent regulator and transfer of regulatory functions to it, establishment of the Competition Authority, introduction of a licensing regime, an interconnection regime, price cap regulation and universal service obligations.

As full liberalisation approaches, the regulator must complete the task of putting in place a sound regulatory framework. The Telecommunications Authority is aware of the need to implement detailed regulations in virtually every aspect of the sector. The fact that the regulator is aware of the different regulatory needs is itself a strength and is indicative of a regulator working in the right direction despite limited resources.

Another strength of the regulatory regime is the extensive use of public consultation in decision-making processes by both the Ministry of Transport and the Telecoms Authority, despite there being no legal obligation to do so. This improves transparency and the quality of decisions, ensures smoother implementation, and strengthens the independence of the regulator. The planned establishment of the "Telecommunications Policy Council" will further improve the quality of the regulator's decision-making if it does not exclude consumer representation and other stakeholders. The government should further strengthen public consultation by providing a legal basis for it and requiring decisions to be published.

As in other OECD countries, liberalisation of the telecoms market has increased the involvement of the Competition Authority in the sector, necessitating closer co-operation and co-ordination between the Competition Authority and the telecoms regulator. This will become more important as the sector opens to competition. In this respect Turkish law provides a good framework for working relationships between the two institutions. The protocol of co-operation, currently under development, is important in this respect.

Competition in the GSM mobile sector has improved and has brought benefits to consumers in terms of relatively low prices compared with other areas. Despite heavy taxation, the penetration rate has already surpassed that in the fixed-telephony market. Although actual competition is still limited because two new GSM operators entered the market only in March and December 2001, and the fifth entry is not foreseen in the immediate future, competition is expected to be strengthened through further regulatory measures such as in roaming and in number portability, bringing further benefits in terms of price and service.

Although the Turkish regulatory framework provides the potential for the creation of a competitive and efficient market, some regulatory issues need to be addressed. The Telecommunications Authority, which started to function only in August 2000, has far to go to complete the necessary regulatory structure for a fully liberalised telecoms market. With massive demands on limited human resources, the regulator should make use of external expertise and draw on best practice regulation already in use in the EU. The constraints on staff recruitment have limited its capacity to take necessary measures promptly. Lack of adequate resources may also compromise its independence. It should be allowed to recruit freely and be given more flexibility in salaries payable. This will strengthen it and help ensure high quality regulations.

The monopoly structure within fixed line telephony has limited the growth of the market and hence the benefits to users. This is evident from the low penetration rate of fixed line telephone access and low take-up of Internet services despite low prices. The government should accelerate market opening if possible before 2004. At minimum they should allow for licensing and network construction before 2004 so that new entrants will be in a position to offer services immediately once full liberalisation takes place.

Full privatisation is an important part of the liberalisation process in Turkey. To enhance the likelihood of finding an appropriate strategic investor for Turk Telekom the government's direct involvement in Turk Telekom's managerial decisions through the golden share should be eliminated. Moreover, foreign ownership restrictions on telecommunications operators are unnecessary and should be abolished. Such conditions will slow investment and access to new technologies and increase the cost of capital to domestic firms. The Turkish telecommunications market needs much more foreign investment.

Finally, imposing a tax of 55-60% on GSM mobile users will have negative consequences on the sector and the economy. The government should reduce tax rates on mobile users. Any revenue loss would be partially compensated through increased revenues from increased mobile subscriptions as a result of the lower costs to users.

Policy options for consideration

1. Ensure that regulations and regulatory processes are transparent, non-discriminatory, and applied effectively.

- The licensing regime should be streamlined using a general authorisation framework, rather than individual licensing.

Although the licensing regime is recently adopted, there is much scope for streamlining it. In particular Concession Agreements should be integrated into the Telecommunications Licence. The Telecommunications Authority should not have the discretionary power to decide the number of market entrants. The General Authorisation should be transformed into a general regulatory act so that new entrants only need fulfilment of general conditions and registration rather than individual licensing.

- An interconnection framework for fixed and mobile services based on a long run incremental cost methodology is needed. This needs to be linked with a cost allocation model applied to the incumbent.

A best practice interconnection framework for the mobile sector is needed and should be prepared in advance of market liberalisation for the fixed market.

- Service Level Agreements should be established and enforced.

Turkey should have Service Level Agreements (SLA) in place covering prices, delivery times, fault maintenance, and restoration to underpin access agreements between the incumbent and new entrants.

- Regulation for line sharing and bitstream access should be put in place as part of a wider framework for full unbundling.

Although full unbundling will be necessary once the voice market opens to competition, at this stage a framework should be implemented for line sharing and bitstream access to enable ISPs to compete on equal terms with the incumbent in the provision of Internet access.

- The Telecommunications Authority should establish concrete procedures for handling consumer complaints. It should ensure that operators implement and make public a code of practice for consumers. Operators should be required to have transparent procedures for complaints handling.

Most consumer complaints are dealt with *ad hoc*. This creates consumer uncertainty. Developing concrete procedures would reduce uncertainty and improve transparency.

2. Reform regulations to stimulate competition and eliminate them except where clear evidence demonstrates that they are the best way to serve the broad public interest.

- Revenue sharing agreements of CATV operators with Turk Telekom should be changed to non-exclusive licences. Transfer of CATV networks to the operators from Turk Telekom with just compensation should be undertaken rapidly.

In many OECD countries CATV operators provide the closest alternative networks to the incumbent's local loops. Allowing CATV companies to own and operate their own networks will stimulate Internet access and will form the basis for future competition.

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- Price rebalancing should be completed as soon as possible. The costs of providing universal service should be reimbursed from a universal service fund derived from market participants.

Price rebalancing must be completed before fixed telephony opens to competition. A methodology agreed to by the industry should be used to determine the cost of providing universal service. If the regulator determines that costs are high, taking into account any benefits that may accrue from providing universal service, a funding system should be implemented to provide compensation. If this is required, a universal service fund to which market players contribute should be used.

- Foreign ownership restrictions should be reviewed, taking OECD best practice and the needs of EU accession into account.

Foreign ownership restrictions inhibit an open, efficient and dynamic market. Foreign capital is important for the achievement of universal service and the rapid development of the sector. Foreign capital is often linked with new technologies and best practice management. Governments have other, more cost-effective tools, which can be used to address concerns regarding network security and the national interest.

- Internet Service Providers should not be required to obtain a General Authorisation (individual licence).

Requiring ISPs to obtain a Telecoms Licence is unnecessary. Turkey should allow them to operate through a system of registration, as do most OECD countries.

3. Review, and strengthen where necessary, the scope, effectiveness and enforcement of competition policy.

- Explicit and concrete provisions governing forbearance and withdrawal from sector specific regulation should be considered. The Telecoms Authority should review the market regularly to evaluate the state of competition and determine when and how sectoral regulation can be withdrawn.

Even though the current necessity is the introduction of various regulations in the market, the requirement to streamline regulations and forbear from regulation, when and where appropriate, will continue to be an important task for the Telecom Authority. The market reviews of the regulator are an important initial step in this process. These should be strengthened.

Annex

Policy Proposals

Regulatory issue	Policy proposals	Chapter (recommendation number)
REGULATORY QUALITY		
A. Policies		
General quality	• **Adopt at the political level a broad policy on regulatory reform that establishes clear objectives, accountability principles, and frameworks for implementation.**	Regulatory Quality (1)
	• **Promote the systematic consideration of regulatory alternatives for new regulatory proposals, including subordinate legislation, so that the use of alternatives flows beyond the area of environmental protection to all regulatory controls.**	Regulatory Quality (7)
	• **Strengthen advocacy and the role of competition policy in regulatory analysis.**	Competition policy (5)
B. Tools and processes		
Quality of new regulations: Regulatory Impact Analysis	• **Improve the quality of new regulations by implementing across the administration a step-by-step programme for regulatory impact assessment, based on OECD best practice recommendations, for all new and revised regulations.**	Regulatory Quality (5)
	– Develop a consistent practice for assessing the impact of proposed regulations on business and on trade and investment.	Market Openness (3)
Consultation and Transparency	• **Improve transparency by establishing legal requirements for notice and comment-procedures for all ministries, agencies and independent regulators during the development and revision of regulations.**	Regulatory Quality (6)
	– Improve the transparency of the regulatory framework for trade and investment and widen the opportunities for concerned constituencies to provide input to the rulemaking process.	Market Openness (1)
	– Promote transparency in public procurement	Market Openness (4)
	– Prepare and publish a yearly regulatory plan, which sets out what issues EMRA expects to address over the year ahead and when.	Electricity Sector (3)
	– Rectify in secondary legislation the absence of a requirement for publication of annual and market development reports prepared by EMRA.	Electricity Sector (2)
	– Establish procedures for handling consumer complaints by the Telecommunications Authority. It should ensure that operators implement and make public a code of practice for consumers. Operators should be required to have transparent procedures for complaints handling.	Telecom Sector (5)
Accountability	• **Adopt a charter of regulatory practice that commits EMRA to operation on the basis of good practice in the fields of communication and consultation; consistency and predictability of decision making; internal effectiveness and efficiency; and accountability and overall transparency.**	Electricity Sector (4)
Implementation, compliance and enforcement	• **Increase significantly the attention given to compliance and enforcement of regulations.**	Regulatory Quality (10)

Regulatory issue	Policy proposals	Chapter (recommendation number)
C. Institutions		
Centre of Government	• **Establish a ministerial position to champion regulatory reform at Cabinet level and to co-ordinate regulatory reform across government.**	Regulatory Quality (2)
	• **Establish a technical oversight unit to help the minister monitor regulatory reform progress.**	Regulatory Quality (3)
	• **Clarify and streamline the legal scrutiny of draft regulations currently undertaken.**	Regulatory Quality (4)
Competition authority	• **Ensure that the Competition Authority consults with the sectoral regulators.**	Competition policy (6)
Sectoral regulators	• **Establish within EMRA an advisory private sector consultation committee composed of a balanced membership from the various industry bodies active in the sector.**	Electricity Sector (1)
	• **Improve the appeal structure from the EMRA decisions by the creation of a specialist appeal body with suitable expertise.**	Electricity Sector (5)
	• **Seek to recruit a high level of expertise, including internationally if necessary, and pay close attention to establishing merit-based personnel systems in EMRA.**	Electricity Sector (6)
	• **Consider adopting a protocol of co-operation between the EMRA and the Competition Authority to address interface issues in particular cases as well as a deeper interface issue relating to policy decisions concerning whether it is preferable to deal with a general competition matter with a regulatory instrument or through competition law. A particular example of the latter would be decisions relating to the removal of or reapplication of tariffs.**	Electricity Sector (7)
	• **Give EMRA powers to initiate or over-ride rule changes (where necessary) which are prepared by the major industry participants in order to avoid "governance" capture of market and network rules by the interests of some market players which may vary from the interests of the market as a whole.**	Electricity Sector (8)
D. Deregulation and simplification		
	• **Continue efforts to reduce administrative burdens by establishing a central registry of administrative procedures and business licences and permits.**	Regulatory Quality (9)
	• **Initiate a comprehensive review of existing regulations to ensure that regulations continue to meet their intended objectives efficiently and effectively.**	Regulatory Quality (8)
	– Continue and accelerate initiatives undertaken to streamline administrative procedures affecting business and eliminate unnecessary restrictions to business operations and trade flows.	Market Openness (2)
	– To improve transparency, streamline the telecommunications licensing regime using a general authorisation framework, rather than individual licensing.	Telecom Sector (1)
COMPETITION POLICY		
	• **Assign formal responsibility for controlling anti-competitive state aids**	Competition Policy (2)
	• **Develop a competition policy control on monopolies providing public services.**	Competition Policy (3)
	• **Limit self-regulation to pro-competitive tasks.**	Competition Policy (4)
	• **Simplify the merger notification standards and streamline the decision process.**	Competition Policy (7)
	• **Restore competition policy oversight of banking sector mergers.**	Competition Policy (8)
	• **Strengthen administrative sanctions to aid investigations.**	Competition Policy (9)
	• **Leverage and expand the Authority's reach through international co-operation.**	Competition Policy (10)

Regulatory issue	Policy proposals	Chapter (recommendation number)
MARKET OPENNESS		
	• **Enhance efforts in the adoption of international standards and use of mutual recognition.**	Market Openness (5)
	• **Promote efficiency of customs procedures.**	Market Openness (6)
	• **Seek harmonisation of bilateral agreements with EU countries in the direction of the ECMT Model agreement prior to EU accession.**	Road Freight Sector (3)
	• **Participate in mutual processes to agree a multilateral transit agreement with the EU.**	Road Freight Sector (4)
	• **Prior to EU accession, remove restrictions on liberalisation of own account transport under ECMT permits and bilateral agreements, mutually with EU countries and most importantly with geographically close trading partners.**	Road Freight Sector (5)
	• **Remove cabotage restrictions within bilateral agreements with other countries prior to EU accession.**	Road Freight Sector (6)
	• **In the context of EU accession negotiations, limit to the greatest extent possible protectionist derogations from the freedoms that would otherwise accrue in respect of transport. Aim to make any transitional periods attached to any such derogations as short as possible.**	Road Freight Sector (7)
	• **In support of the general environment for market opening, ensure that Turkish technical and social regulation to the Turkish road freight industry is comparable with the range applying in EU countries and is seen to be adequately enforced.**	Road Freight Sector (8)
	• **Reform regulations to stimulate competition: eliminate foreign ownership restrictions.**	Telecom Sector (8)
LIBERALISATION, PRIVATISATION, AND STRUCTURAL REFORM		
	• **Finish eliminating state monopolies and anti-competitive protections.**	Competition Policy (1)
	• **When privatising the electricity sector, aim to divide ownership such that, within each transmission-constrained area and for almost all demand conditions, there are at least five companies with generation that will be at the margin in most demand situations that will actively compete to set prices in wholesale electricity markets.**	Electricity Sector (12)
	• **Privatise electricity distribution/retail supply first. Consolidate distribution companies to a more efficient scale.**	Electricity Sector (13)
	• **Use the recommended regulatory plan to be published by EMRA as a means of communicating information about prospective developments in transmission pricing arrangements to the market so as to assist the privatisation process of generation assets.**	Electricity Sector (18)
	• **Privatise gas storage facilities once they become operational so as to foster the emergence of competition.**	Gas Sector (3b)
	• **In the restructuring of the domestic road freight sector, so as to accord with EU regulatory norms, it is vital that intervention to seed a new industry structure around new co-operative firms does not entrench anti-competitive outcomes. In particular, such intervention should not give rise to any regional segmentation of the market.**	Road Freight Sector (9)
	• **Strengthen the competitive framework for telecommunications: Consider explicit and concrete provisions governing forbearance and withdrawal from sector specific regulation. The Telecom Authority should review the market regularly to evaluate the state of competition and determine when and how sectoral regulation can be withdrawn.**	Telecom Sector (10)

Regulatory issue	Policy proposals	Chapter (recommendation number)
SPECIFIC REGULATORY ISSUES		
	• **Ensure that governance arrangements of the state electricity entities do not overlap and that the EMRA is punctilious in enforcing the non-discrimination requirement for access to the transmission system, in view of the common ownership of most generation and transmission at the state level prior to privatization of generation.**	Electricity Sector (9)
	• **Ensure strict regulation by EMRA of the behavior of the government trading company in the wholesale and balancing electricity market and vigilance by the Competition Authority to prevent predatory conduct in the emerging competitive segments of the market that could deter new entry by generators and traders.**	Electricity Sector (10)
	• **Mitigate and accurately measure stranded costs and provide for their recovery in a way that is fair and does not impede efficient entry or the emergence of competition on the electricity market. The minimum viable degree of generator bundling (commitment of low cost hydro to offset high cost BO, BOT, TOOR contracts) is desirable so as to obtain the maximum amount of uncommitted generation capacity that can freely compete at an early stage in the emerging competitive market.**	Electricity Sector (11)
	• **Consider allowing demand side participation in the balancing market at the earliest feasible opportunity since it could help to reduce the market power of generators.**	Electricity Sector (14)
	• **After the market has commenced, consider improving the relatively poor self-balancing incentives of a single price system for imbalance settlement that is to be initially adopted for the electricity balancing market.**	Electricity Sector (15)
	• **Apply incentive regulation to the electricity system/market operator to operate energy balancing and ancillary services functions in an efficient way.**	Electricity Sector (16)
	• **Include an effective market monitoring/surveillance unit in the market operator to detect misuse of market power and manipulative bidding strategies in wholesale electricity markets and implement early corrective policy decisions or mitigation strategies if necessary should problems emerge.**	Electricity Sector (17)
	• **Ensure that competition is not foreclosed by the frustration of access to gas transmission. This will require close regulation of BOTAS by the EMRA. BOTAS behaviour in wholesale markets will also need close monitoring and regulation.**	Gas Sector (1)
	• **Use incentive based regulation as soon as feasible in the design of general gas tariff principles by EMRA.**	Gas Sector (2)
	• **Consider strengthening the law requiring gas storage companies to provide their services to the market so as to provide for non-discriminatory regulated access.**	Gas Sector (3a)
	• **Carefully assess the merits and respective costs and benefits of different balancing arrangements to ensure that these do not discriminate against new gas wholesale entrants.**	Gas Sector (4)
	• **Assess the interactions between gas and electricity transmission tariffs as these markets integrate and consider more sophisticated and neutral transmission pricing in both the electricity and gas sectors.**	Gas Sector (5)
	• **Prior to EU accession seek to increase the number of bilateral permits in road freight transport and to reform the bilateral framework mutually to reduce their restrictiveness.**	Road Freight Sector (1)

Regulatory issue	Policy proposals	Chapter (recommendation number)
	• **Seek to increase the number of ECMT permits prior to EU accession.**	Road Freight Sector (2)
	• **Implement a transparent and non-discriminatory interconnection framework for fixed and mobile services based on a long run incremental cost methodology. This needs to be linked with a cost allocation model applied to the incumbent.**	Telecom Sector (2)
	• **Establish and enforce Service Level Agreements.**	Telecom Sector (3)
	• **Put in place a regulation for line sharing and bitstream access as part of a wider transparent and non-discriminatory framework for full unbundling.**	Telecom Sector (4)
	• **Reform regulations to stimulate competition: change the revenue sharing agreements of CATV operators with Turk Telekom to non-exclusive licences. Transfer of CATV networks to the operators from Turk Telekom with just compensation should be undertaken rapidly.**	Telecom Sector (6)
	• **Reform regulations to stimulate competition: complete price rebalancing as soon as possible. The costs of providing universal service should be reimbursed from a universal service fund derived from market participants.**	Telecom Sector (7)
	• **Reform regulations to stimulate competition: Lift the requirement for Internet Service Providers to obtain a General Authorisation (individual licence).**	Telecom Sector (9)

Source: OECD.

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