

THE SEARCH FOR EUROPE

Contrasting Approaches



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In this chapter, we document a change in the character and quality of Turkish economic growth, with a turning point around 2007. We link this change to the reversal in the nature of economic institutions. This institutional reversal, we argue, is a consequence of a turnaround in political factors. The first phase coincided with a deepening of the Turkish democracy under the prodding and guidance of the European Union. As Turkey-European Union relations collapsed and checks against the dominance of the governing party were removed, these political dynamics began to reverse and paved the way for the institutional slide.



DARON ACEMOGLU is Elizabeth and James Killian Professor of Economics in the Department of Economics at the MIT. He has received a BA in economics at the University of York, MSc in Mathematical Economics and Econometrics and a PhD in Economics, both at the London School of Economics. He has received many awards, including the John Bates Clark Medal and Honorary Doctorates from the University of Utrecht, Bosphorus University, and the University of Athens. He has published four books, among them, *Economic Origins of Dictatorship and Democracy* (joint with James A. Robinson).



MURAT ÜÇER serves as Global Source's consultant in Turkey and is co-founder of Turkey Data Monitor, as well as a senior lecturer at Koç University. Formerly, he worked as an economist at the Institute of International Finance, Credit Suisse, and the IMF. He was an advisor to the Minister of Treasury at the Turkish Treasury in 2001 and the Governor of the Central Bank of Turkey in 1997. Mr. Üçer received his BA and PhD in Economics from BoDazici University and Boston College. He has published several articles on the Turkish economy, including a book on the 2001 crisis in this country.

THE UPS AND DOWNS OF TURKISH GROWTH, 2002–2015: POLITICAL DYNAMICS, THE EUROPEAN UNION, AND THE INSTITUTIONAL SLIDE*

Though EU-Turkey relations are multifaceted, in this essay we focus on one specific aspect: the role of the EU in the improved institutional structure of Turkey during the early 2000s—and the rapid growth that this engendered—and its subsequent, more ominous contribution to the unraveling of these political and economic improvements. We start with a seldom addressed macroeconomic puzzle of Turkish growth: following its severe financial crisis in 2001, Turkey enjoyed five years of rapid economic growth, driven in large part by structural changes, productivity growth, and a broadening base of economic activity, both geographically and socially. This process stopped and reversed, however, even as the foreign and the Turkish media touted a new Turkish model immune to the “stop-go cycles” so characteristic of its economy in the 20th century.

TURKISH GROWTH IS UNDERPINNED BY INSTITUTIONAL IMPROVEMENTS AND IS BEING REVERSED BY A TURNAROUND IN THE VERY SAME INSTITUTIONAL FOUNDATIONS

From about 2007 onwards, economic growth slowed significantly, as government spending became the mainstay of the economy, and productivity growth almost fully stagnated. Underpinning the sea change was likely the reversal of the productivity-enhancing structural changes that had played a pivotal role in the previous five years. Although one could label this as just another example of the stop-go cycles, we note that it has an arguably different character. Rather than the typical stop-go cycle, in which the growth phase is unsustainable and heralds the inexorable contraction phase (because it plays out in a weak institutional environment), we argue that we are witnessing

* We thank Izak, Atiyas, Ilker Domac, Soli Ozel, Martin Raiser, Dani Rodrik, and Sinan Ulgen for very useful comments on an earlier draft. The usual caveat applies.

growth—underpinned by institutional improvements—being reversed by a turnaround in the very same institutional foundations.

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

**WE ANALYSE WHY TURKEY
UNDERWENT UNUSUALLY RAPID INSTITUTIONAL
IMPROVEMENTS STARTING IN 2001 AND WHY POSITIVE
INSTITUTIONAL CHANGES CAME TO AN END**

Second, these economic reforms, after their introduction by a caretaker government, were overseen by the popularly elected AK party (the Justice and Development Party), which, for all practical purposes, had ended the Turkish military's tutelage over politics, which had characterized the Republic's entire history. Third, and most relevant for this essay, both the economic reforms and the political changes undergirding them received a substantial boost from the general warming of EU-Turkey relations and the blossoming hopes in Turkey that accession to the EU was a real possibility if economic and political reforms continued.

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

Why then did these positive institutional changes come to an end, also bringing down both the rate and quality of economic growth in

Turkey? Once again, several factors played a role. First, the reforms initiated by the IMF and the World Bank gradually came to be reversed, with Turkey's recently institutionalized, rule-based policy framework increasingly shifting back toward discretion. The procurement law tells the story most sharply: more and more industries and items were declared exempt from the law by the ruling AK party, removing this fairly substantial barrier against corruption.

Second, and even more importantly, the AK party government, which had earlier supported the economic opening, made an about-face once it became sufficiently powerful. Gradually, the *de jure* and *de facto* control of the ruling cadre of the AK party intensified, amplifying corruption and arbitrary, unpredictable decision-making. Finally, the collapse of EU-accession talks played an arguably oversized role, both removing a powerful anchor that had tied the AK party to the reform process and undermining the support for institutional change that had grown in a fairly broad segment of the Turkish population. The turnaround in economic and political reforms was reflected very closely in the macroeconomic picture, impacting the pace and nature of economic growth from about 2007 onwards.

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

The speculative nature of our story notwithstanding, we would like to emphasize the potential lessons it contains. First, it is a hopeful story on the ability of emerging economies with weak institutions to reform rapidly and enjoy the fruits thereof. This hopeful reading is counterbalanced,

1 See, for instance, World Bank (2014).

2 For a recent statement of this view, see Rodrik (2015).

however, by two considerations. First, this process of rapid institutional change was triggered by Turkey's deep financial crisis in 2001, which left few other choices to the political elites, and second, it didn't last. All the same, it does suggest that other countries, and Turkey in particular, have an option to restart structural change and productivity growth if they can overcome their admittedly gargantuan political problems.

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

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

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

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

Basic statistics tell the story rather well. Chart 1 shows that the Turkish economy grew at almost 6% per capita (per annum), its fastest per capita growth since the 1960s. Turkey's growth performance during this period was notable not only because it was above the rates experienced by most peers, barring some exceptional cases like China and India,³

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

but also because it came with relatively high productivity growth.⁴ In sharp contrast to the earlier periods of paltry total factor productivity (TFP) growth, about half of the growth in per capita GDP during this period stemmed from TFP growth, which increased by about 3% per annum between 2002 and 2006.⁵

Chart 2 further shows that during this five-year interval, private investment rebounded sharply from a post-crisis low of 12% of GDP to around 22%. The rebound was driven largely by investment in machinery and equipment; construction investment also picked up, but by no means dominated investment during this period. Contrary to a common

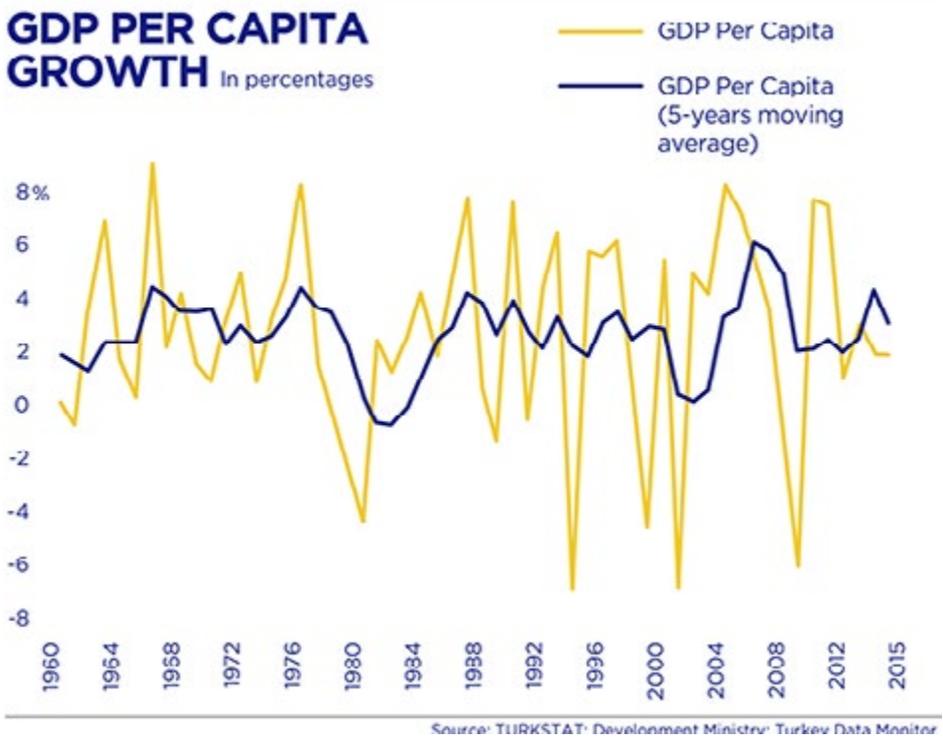


Chart 1

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

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

misperception, the manufacturing sector also did reasonably well during this period. Thanks to very strong productivity growth at around 7% per annum, the share of manufacturing in GDP in constant prices increased from around 22% in 2001 to almost 24% in 2007.⁶

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

Importantly for our story, there was also a major broadening of the economic base in two senses. Through most of the Republic’s history, economic growth had been driven by growth in the major industrial cities in the Western part of the country and spearheaded by large conglomerates in these same cities. This began to change during the first half of the 2000s, resulting in a convergence of living standards between the more advanced West and the so-called “Anatolian Tiger” cities (e.g., Konya, Kayseri, and

PRIVATE GFCF SHARE IN GDP

(exp. side, 1998 prices, in percentages)



Source: TURKSTAT; Turkey Data Monitor

Chart 2

6 In current prices (nominal terms), the share of manufacturing declined from 19% to 17% during the same period, as service deflator outpaced manufacturing deflator. But

Gaziantep). This was, in turn, driven by firm-level productivity catch-up, thanks to investments in physical and social infrastructure as well as improvements in the quality of public services in the inland regions.⁸

The second dimension of the broadening of the economic base may be even more important. The extreme levels of inequality concerning income and access to public services started declining, with some signs of “shared” prosperity previously unseen in Turkey. As comprehensively

MANY PUBLIC SERVICES UNDERPINNING THE FUTURE PRODUCTIVITY OF THE TURKISH WORKFORCE HAVE EXPANDED

detailed in a recent World Bank report, examples of this transformation are many, but they all point to the same conclusion: poverty rates declined, the middle class expanded, and income inequality contracted.⁹ For example, the headline Gini coefficient, measuring income inequality, dropped from a very high 42% in 2003 to about 38% in 2008.¹⁰ This contraction in inequality was, in part, driven by labor income growth at the bottom of the distribution, resulting from both wage growth and employment expansion.¹¹

Many public services underpinning the future productivity of the Turkish workforce, such as education, healthcare, and infrastructure, have expanded and become more equally distributed. There was also a sharp improvement in basic social services, narrowing the gap between Turkey and the rest of the OECD. This was achieved through a combination of reforms in public service delivery, significant increases in budget allocations, and changing priorities towards service delivery

importantly, as noted, real growth in the manufacturing sector kept up with broader growth in GDP. In addition, Rodrik (2009) notes that the composition of investment moved toward tradeables (i.e., manufacturing) during this period.

- 7 Chapter 4 of World Bank (2014) documents the regional as well as firm-level convergence story comprehensively. See also Hakura (2013), which includes a brief and useful discussion on the Anatolian Tigers.
- 8 See Annex I as well as Chapter 7 in World Bank (2014). See also Raiser (2014) for a brief discussion on the “inclusive” nature of Turkish growth, based on the World Bank study.
- 9 See World Bank Development Indicators.
- 10 World Bank staff observes that Turkey’s experience in this sense is more akin to East Asia and Eastern Europe than Latin America.
- 11 The World Economic Forum’s Competitiveness Index also shows significant improvements in Turkey’s infrastructure quality, at least after its first year of availability, 2006.

in less-advantaged areas. Chart 3 shows a rapid catch-up of infant mortality and life expectancy to OECD averages, with particularly striking gains in rural areas and among poorer households. The gains in education are no less noteworthy. Chart 4 shows Turkey recording the largest improvements within the OECD in the quality of education as measured by OECD's Program for International Student Assessment (PISA) scores, with gains once again disproportionately concentrated among poorer households and in rural areas.¹²

The budget allocations that have centrally contributed to these trends have been made possible by the greater fiscal space that lower interest expenditures created. This has enabled the share of health expenditures in total government expenditures to increase by about 6 percentage points from 11% in 2002 to 17% in 2007, and that of education from about 10% to almost 14%.¹³

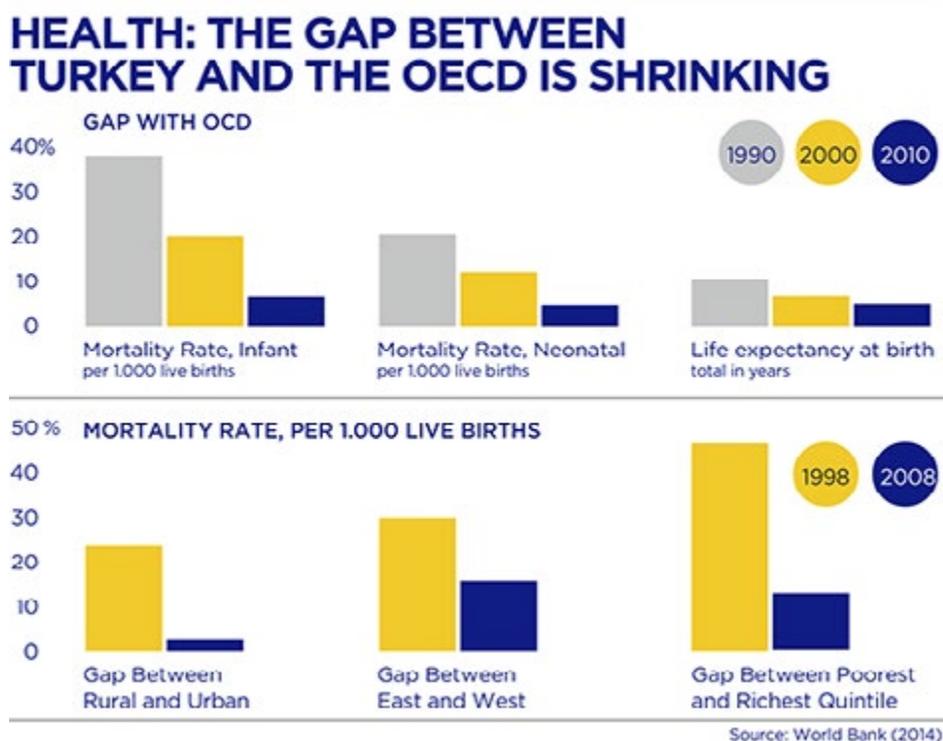


Chart 3

¹² Our estimates, based on Ministry of Development data.

¹³ The government spending over GDP figures are computed from national income accounts data.

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

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

Many aspects of this story began to change sharply around 2007. Notable is the fact that this reversal in the character of macroeconomic

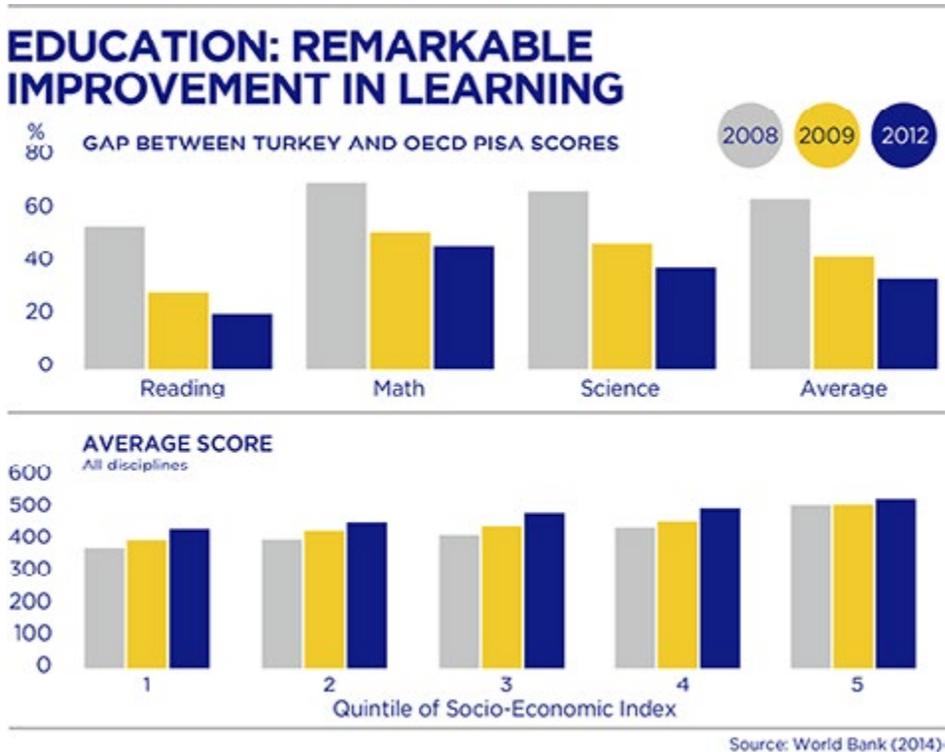


Chart 4

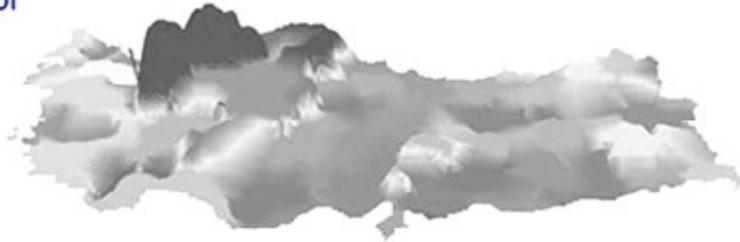
growth predated the global economic crisis. As chart 1 shows, average per capita income growth decelerated to little over 3% from 2007 to 2014, markedly lower than the aforementioned 6% growth during 2002 to 2006. The chart also makes it clear that the loss in momentum started earlier than the deepening of the global economic crisis in late 2008. The economy grew by a less impressive 4.7% in 2007, with the slowdown continuing throughout 2008, even before the global crisis hit. Corroborating this timing, chart 2 shows a deceleration in private investment around 2007, which, except during the short-lived, post-2009 rebound, stayed at levels lower than those reached in 2006 and 2007.

In this sense, the global economic crisis may have helped mask the growing weaknesses in Turkey's growth dynamics. After a sharp contraction in 2009 (by about 5%), growth rebounded during 2010 to 2011 to an unsustainable, near 9% per annum pace, fanned by massive monetary and fiscal stimulus. The Central Bank's policy rate was reduced by over 10 percentage points, with the real interest rate declining to zero-to-negative territory from the pre-crisis 7% to 8% levels. Fiscal stimulus was also substantive, increasing government spending relative

THE EQUITY OF EXPENDITURES INCREASING INVESTMENT IN UNDERSERVED REGIONS

Geographical distribution of per capita government expenditure in education

2001



2011



High

Low

Source: World Bank (2014)

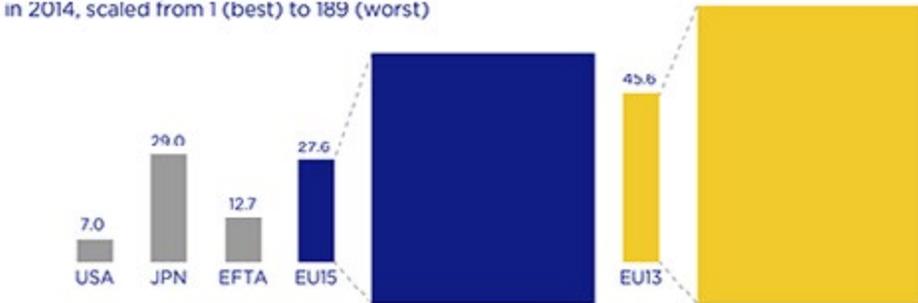
Chart 5

to GDP from 13% around 2006 to near 16%, almost completely eroding Turkey’s hitherto impressive public sector primary surplus.¹⁴ As a consequence, the contribution of government spending to GDP growth rose from about 10% from 2002 to 2006 to 25% in the later period.¹⁵

Though monetary and fiscal stimulus did bring growth back briefly during 2010 to 2011, growth in the post-2007 period as a whole has been markedly low-quality. Productivity growth has almost fully stalled, while TFP growth has also come down from its highs during 2002 to 2006 and, by some estimates, is now hovering in negative territory.¹⁶ Manufacturing productivity, growing at about 1% per annum since 2007, has been lackluster as well. There has also been no repeat of the broadening of the economic base witnessed in the early 2000s. The Gini coefficient of inequality, for example, has edged up to 40% in 2011 from 38% in 2008.

SOUTHERN AND EASTERN EUROPE MUST MAKE IT EASIER TO DO BUSINESS

Ranking of the ease of doing business in 2014, scaled from 1 (best) to 189 (worst)



Note: Averages by group are shown. EFTA here comprises Iceland, Norway, and Switzerland. The EU15 comprises Denmark, Finland, Ireland, Sweden, and the United Kingdom (North); Austria, Belgium, France, Germany, Luxembourg, and the Netherlands (Continental); and Greece, Italy, Portugal, and Spain (South). The EU13 comprises Estonia, Latvia, and Lithuania (North); Croatia, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia (Continental); and Bulgaria, Cyprus, and Romania (South).

Source: Doing Business 2015

Chart 6

14 This contribution is calculated as the change in government consumption and investment spending as percent of change in GDP.

15 See Conference Board Total Economy Database.

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

Perhaps one of the most important manifestations of this low-quality growth has been the changing nature of the current account-growth relationship. High growth was accompanied by a relatively moderate current account deficit, mostly financing the rebound in domestic investment in the 2002 to 2006 period (as depicted in chart 2 above). However, chart 6 indicates that the post-2007 pattern is quite different in nature: it combines lower growth with higher current account deficits and a sharply lower saving rate—and no higher investment rate as shown in chart 2—suggesting that the higher inflows have been largely financing higher consumption.¹⁷ The way the current account deficit has been financed during these two periods also bolsters this interpretation, with fairly long-term financing and foreign direct investment in the first period, and shorter-term flows in the second.¹⁸

Section II—Turkey’s Institutional Backdrop and the EU Relations

Though causality is much harder to establish, it is noteworthy that Turkey’s high growth episode overlapped with a period of major institutional and political changes. During this brief period of five years, Turkey’s broader institutional setting has taken a conspicuous break from the past, moving from extreme discretion towards a rule-based environment, accompanied by major structural reforms. The deepening of Turkish democracy at the time appeared potentially epochal. The relations with the EU also experienced a hopeful turn with the decision to start the accession negotiations in October 2005. In what follows, we provide the broad contours of the ebb and flow of Turkish economic institutions and then turn to political factors and the political institutional dynamics undergirding the economic changes.

The consensus view among Turkey experts is that there has been a significant break in the 2000s in terms of “delegation of the decision-making power to relatively independent agencies, and the establishment of rules that constrain the discretion of the executive” (Atiyas 2012).¹⁹

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

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

19 Prominent examples of these independent, autonomous agencies that were established in the early 2000s include Public Procurement Authority (established in 2002), Banking Regulatory and Supervision Agency (established in 1999 but commenced op-

This institutional shift from unchecked discretion of the 1990s to a more rule-based framework has had significant effect on the implementation of monetary and fiscal policies, the regulatory environment, and privatization practices. The key reform on the monetary policy front was undoubtedly the greater independence granted to the Central Bank, implemented as early as 2001. The new law defined the sole objective of the Central Bank as achieving and maintaining price stability in a context of first implicit and then formal inflation targeting, and it prohibited direct lending to the government.

On the fiscal front, institutional overhaul was substantial as well. The important steps here were the passing of two crucial laws—the Public Finance and Debt Management (PFDM) Law, of 2002, and the Public Financial Management and Control Law (PFMCL), of 2003—targeted at breaking with the destructive fiscal legacy of the 1990s with runaway off-budgetary expenditures, non-transparent borrowing practices, and lack of fiscal accountability. The objective of the PFDM was to bring all central government borrowing and guarantees under strict rules and to impose reporting requirements on all debts and guarantees. The PFMCL, on the other hand, set the main framework of the fiscal management system by establishing “principles and merits, multi-year budgeting, budget scope, budget execution, performance management and strategic planning, internal control, accounting, monitoring and reporting.”²⁰

Finally, a Procurement Law, enacted under pressure and guidance from the World Bank, in 2002, sought to ensure effectiveness, transparency, and competitiveness in the public procurement system. The Law replaced the notoriously politicized and corrupted State Procurement Law, which had been in place since the 1980s. The changes on the regulatory front were similar and also relied on the establishment of a number of independent autonomous agencies (sometimes dubbed the “European Model”) in order to strengthen rule-based decision-making and insulate the regulators from political influence.

erations in late 2000), Energy Market Regulatory Authority (established in 2001), the Telecommunications Authority (established in 2000 and recently renamed to ICTA), and Tobacco, Tobacco Products and Alcoholic Beverages Market Regulation Authority (established in 2002). The Competition Authority (established in 1994 and commenced operations in 1997) and the Capital Markets Board (established in 1981) were affected by these changes as well.

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

The bottom line is that thanks to the enactment of these comprehensive and best-practice laws, governmental control over public expenditures was enhanced and Turkey's out-of-control, off-budget expenditures (including so-called "duty losses") were greatly restricted.²¹ The early 2000s also witnessed improvements in Turkey's broader institutional environment, as can be gauged from the World Bank governance and doing business indicators depicted in chart 7, where Turkey shows solid progress in all key areas.

The corruption perception index compiled by Transparency International, depicted in chart 8, tells a similar story. There are tangible signs of lower corruption starting in 2003 (corresponding to higher values of the index), and Turkey's rank improves from around the high 70s among 175 countries in 2003 to the low 50s in the late 2000s²². However, things began to change for the worse around the time of the global crisis, with

7

GOVERNMENTS IN EUROPE ARE BIG

The world resized by government spending in US Dollars, 2009



Source: Raiser and Gill (2012)

Chart 7

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

the pace of deterioration accelerating during the AK party’s third term, which began in June 2011. This has taken the form of a virtual stalling of the structural reform efforts as well as a marked weakening in the institutional environment.

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

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EUROPE'S PENSION SYSTEMS HAVE TO SUPPORT PEOPLE FOR MANY MORE YEARS

Changes in life expectancy at 60 and effective retirement age, 1965-2007

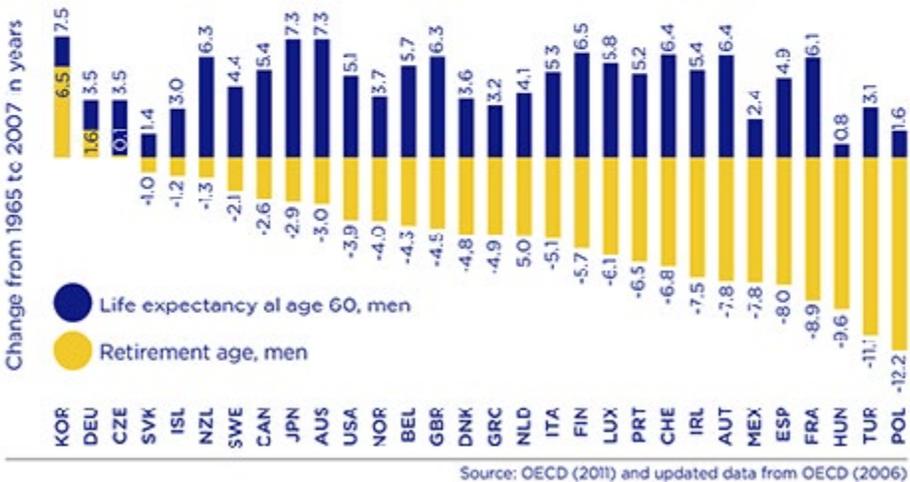


Chart 8

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

below which procurement of goods and services would be exempted from the law.²³

As documented by Gurakar and Gunduz (2015) in their very comprehensive account, both the number and the value-share of public procurement contracts that were left outside the transparent public procurement practices increased substantially during the period from 2005 onwards, reaching 44% in 2011.²⁴

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

Perhaps unsurprisingly, in light of these changes, chart 8 shows declines both in the corruption perception index and Turkey's rank, with the latter sliding 11 notches to 64, in 2014 (out of 175 countries). It is probably also not a coincidence that land and construction deals were at the very heart of Turkey's largest corruption scandal, which broke out in December 2013, and the then Minister of Environment and Urban Planning was one of the four ministers implicated in the scandal.²⁵

Setbacks can also be seen in crucial reform proposals that fully stalled. Two proposals that had been floated during the IMF program negotiations,

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

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

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

which were held throughout 2009 during the apex of the global crisis, were first resisted and then shelved for good by the AK party leadership. One of these was about creating an independent tax authority, which was greatly needed not only to insulate tax collection activities from political influence, but also to alter Turkey's tax structure, which heavily relies on indirect consumption taxes, towards direct taxes. The other proposal was about adopting a "Fiscal Rule," which would consolidate Turkey's fiscal adjustment and contain the deterioration experienced during the crisis. Though early on promoted by Ali Babacan, the Deputy Prime Minister and the Treasury Minister in charge of economic coordination, this also never got off the ground.

**LAND AND CONSTRUCTION DEALS WERE AT THE VERY
HEART OF TURKEY'S LARGEST CORRUPTION SCANDAL,
WHICH BROKE OUT IN DECEMBER 2013**

Arguably more ominous were the aggressive attacks by the government on autonomous agencies. As explained in Ozel (2015), after some de facto meddling in the affairs of these agencies (e.g., in the form of influencing the election of board members or the hiring and firing of staff), the government took formal steps by signing two decrees to law in 2011 that paved the way for more explicit intrusion from respective ministries. Of these, one (Decree No. 649) explicitly stated that the respective minister would have "the authority to inspect all transactions and activities of the related, attached and affiliated agencies" (which included the autonomous regulatory agencies), thus giving the ministers and their staff the ability to restrict the independence of these agencies. Around that time, the idea of independent regulatory institutions was been dealt another blow, with Mr. Babacan, the main reform advocate within the government, stating that "it was time for some independent agencies to re-delegate their authority" (Ozel 2015).²⁶

Meanwhile, the Central Bank, already eager to accommodate the excessively low interest rate policies pushed by the then Prime Minister

²⁶ Another episode that showed AK party's growing intolerance toward independent scrutiny was witnessed around Turkey's Court of Audits (TCA). After adopting a best-practice law with some 5-year delay in 2010, the government attempted to curb the Court's powers and the Parliament's access to proper financial reporting by way of passing new legislation in 2012. After a repeal of the Law by the Constitutional Court, the government pressed ahead with another draft law, which could, as stated in EU's

Recep Tayyip Erdogan, came under even heavier pressure for not reducing interest rates quickly enough to support growth. The whole episode was damaging not just because of its implications for macro-economic policy, but because it demonstrated the unwillingness of the government to be restrained even by the most pliable organizations.

We have argued that the turnaround in Turkey's economic performance is a reflection of the turnaround in economic policies and institutions, including the stalling or reversals in the process of much needed structural reforms. But this only provides a proximate answer to the deeper question of why economic policies and institutions improved in the first phase and then went into a reversal. We argue that both the initial improvements in economic institutions and their subsequent slide are related to political factors.²⁷

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

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

Second, the AK party came to power as a representative of an increasingly disenfranchised (or at least feeling disenfranchised) segment of Turkish society: provincial, conservative businessmen; urban poor (who were often recent migrants); and rural populations, except Kurds and Alevis (who were always viewed suspiciously by the almost entirely Sunni AK party leadership). These social groups, which were less Western, more

Progress Report of 2013, “[...] result in a distortion of the TCA's mandate and its ability to carry out independent and effective audit.” The Law is now on hold, having been withdrawn because of objections from both within and outside the Parliament.

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

religious, and more conservative, were never welcomed by the rulers of Turkey in the 20th century, the so-called “Kemalist elites” (named after their ideological commitment to the principles of the Republic’s founder, Mustafa Kemal Atatürk; often defined to include the military, the bureaucracy and big, urban-based conglomerates; and argued to be represented by the state’s party, the Republican People’s Party). This is not to deny that the conservative ideology of these groups has all too often influenced school curricula or formed the foundational rhetoric of several military regimes, most notably the one catapulted to power by the 1980 coup.

But both traditionally, and specifically during the 1990s, these groups felt increasingly excluded and were at one end of a culture war, with seemingly stronger forces on the other side—a culture war summarized, even if bombastically, by Prime Minister Recep Tayyip Erdogan’s famous statement: “In this country there is a segregation of Black Turks and White Turks. Your brother Tayyip belongs to the Black Turks.”²⁸ The AK party’s rise to power thus came to be seen as the enfranchisement of this previously-excluded group. During their early rule, they had to defend democracy (which they interpreted as respecting the electoral results rather than succumbing to a military intervention against them) as a survival strategy.

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

Fourth, the AK party came on the scene when EU-Turkey relations were undergoing perhaps their most constructive period and presented itself as a staunch supporter of EU accession. To be sure, the process leading up to the accession negotiations, launched on October 2005, was anything but smooth. Yet, the process started reasonably earnestly and with significant momentum in 2006 and had the strong backing of the Turkish public, as illustrated by chart 9.²⁹

The view at the time was that Turkish accession to the EU could proceed relatively rapidly, as summarized by a high-profile report: “Our starting assumption is that it is likely that accession negotiations would

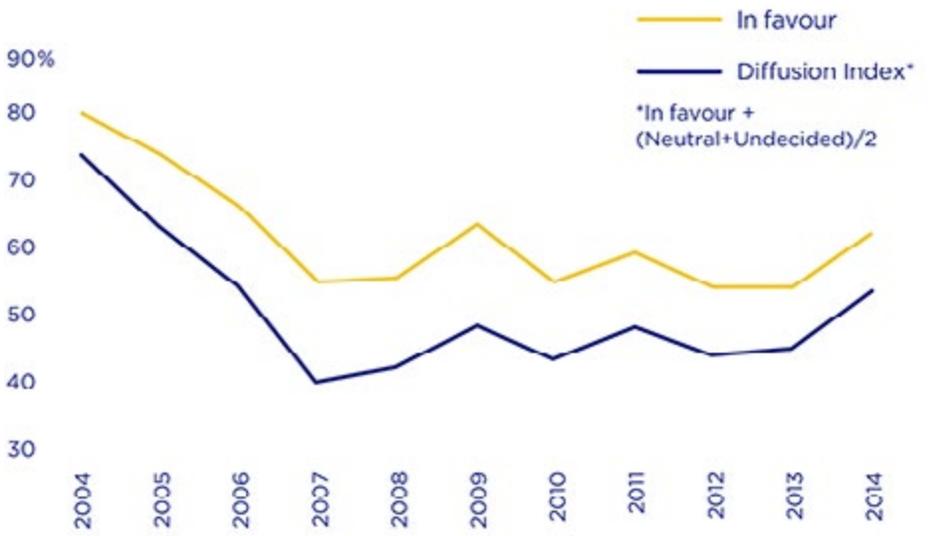
28 While the exact timing of this statement is a matter of debate, it first rose to prominence when quoted in a New York Times interview with the newly-elected Erdogan by Deborah Sontag in May 2003.

29 As detailed in Morelli (2013), while the EU Council agreed to a “Negotiating Framework” and opened the negotiations, language of the Framework was kept deliberately

start during 2005, but that they would last for quite some time, with membership materialising only around 2012-15. We therefore take a long-term perspective and explore particular areas in which the EU and Turkey could cooperate during the long interim negotiating period” (Dervis et al. 2004).

The EU accession process had at least two sorts of effects on Turkish institutions. First, on the political side, the EU shouldered a role similar to the one that the IMF and the World Bank had played on the economic side of the aftermath of the 2001 financial crisis, providing both pressure for reform and a template for best-practice legislation in the areas of civil and political rights, civilian-military relations, and judicial reform. As part of the engagement process with the EU, a number of far-reaching and difficult reforms were thus set in motion, even if many of these were finally enacted in the late 2000s. A non-exhaustive list includes improved property rights for non-Muslim religious foundations; the lifting of draconian penalties against speech construed as a critique of Turkish identity; the introduction of the ability of civilian courts to try military personnel and the banning of the trials of civilians in military

TURKISH PERCEPTION OF TURKEY'S MEMBERSHIP IN THE EUROPEAN UNION



Source: authors' calculations based on GMF Transatlantic Trends

Chart 9

courts; laws protecting children; improved trade union rights, including permission for workers to become members of more than one union simultaneously; permission for public service workers to sign collective labor agreements, removing previous bans on political and solidarity strikes; and permission for individuals to apply to the Constitutional Court in cases where their freedoms of fundamental rights are violated.³⁰

In addition, the lifting of bans against Kurdish protests and legislation allowing state-run Turkish radio and television to broadcast in Turkish; the ending of the emergency rule over the last two of the 13 Kurdish-majority provinces; the introduction of broad civilian supervision over defense expenditures; and the removal of National Security Council presence in the oversight of cinema, video, musical works, radio, and television; as well as a shift in the government's willingness to generally respect rulings by the European Court of Human Rights were also steps long-advocated by the EU and are generally interpreted as being a direct result of EU-Turkey engagement.³¹

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

All of these factors would disappear or change their character by the middle of the 2000s. The effect of the economic institutional framework put in place after the 2001 crisis ceased to have much of a determining role as the AK party elites and mayors found ways of circumventing the regulations and laws or changing them, as we recounted in the case of the procurement law, to benefit themselves or their party. The 2002 election brought the beginnings of the end of the two major center-right parties, with their votes going almost in block to the AK party in the

loose (meaning no guarantee of eventual membership was extended). Cyprus was a thorny issue from day one, exacerbated by Turkey's refusal to extend Customs Union to Greek Cyprus. This has subsequently led to EU Council blocking 8 chapters. See the annex table for a time line of EU- Turkey relations since 2005.

30 See Hale (2011).

31 See Kirisci (2011) and Gursoy (2011).

2007 elections, making it a much more formidable force in electoral politics. By 2011, the AK party commanded almost 50 percent of the vote. More importantly, the balance between the AK party (and its base) and the Kemalist forces changed significantly. Because these events are important both for understanding how the center of gravity of Turkish

**THE EU'S ANCHOR FOR TURKISH
INSTITUTIONAL REFORMS AND LEVERAGE OVER
TURKISH POLITICIANS CAME TO AN END IN 2010
AS THE ACCESSION PROCESS STALLED**

politics shifted, and how the AK party came to define itself and understand its power, it is useful to recount them in some detail.

The backdrop is the political history of Turkey in the 20th century, which was dominated by the military and state bureaucracy. The one-party rule imposed by Ataturk came to an end in the first semi-democratic elections of 1950,³² creating the Democratic Party, which fashioned itself as a representative of the same provincial business interests and conservative cultural values for which the AK party later came to speak. In 1960, the military moved against the Democratic Party and proceeded to hang its leader, Adnan Menderes. The military then engineered two more coups, in 1971 and 1980, and also brought down another Islamist party in 1997 with the threat of a coup (and subsequent action by the Constitutional Court closed the party). The generals were already unhappy about both the AK party's rise to power and their increasingly marginalized role in the 2000s, when the AK party nominated its number two, Abdullah Gul, for the presidency. The military and its civilian allies were alarmed by the fact that Gul's wife wore a headscarf and would represent Turkey in international forums and inhabit Ataturk's presidential palace.

This, combined with their general unease about the political direction of the country, made the military top brass move to threaten another coup with a web memorandum in April 2007, following the confirmation that Gul would be the next president of Turkey. Ominously, the Constitutional Court started proceedings to close the AK party for anti-secular

³² The first multi-party election in 1946 was not only called early by the ruling Republican People's Party before the opposition could organize itself, but was also marred by widespread vote-rigging (Zurcher 2004).

activities. But the situation was different in 2007 than it had been in 1960 or 1997. The AK party had already organized deeper social networks within modern Turkish society and had taken control of large parts of the bureaucracy and the increasingly heavily militarized police, while the status of the military within Turkish society was at an all-time low. This time, the military's threat came to nothing.³³

This episode not only sidelined perhaps the most powerful opponent of the AK party, the Kemalist generals, but also further radicalized the AK leadership. According to some insider accounts, leading AK figures are reported to have packed their bags during the events of April 2007, fully expecting the military to come to power and put them in jail. Their David and Goliath reading of Turkish history—where the victimized “Black Turks” are stamped out by the conspiracy of Kemalist “White Turks”—was both confirmed and embellished. They may have concluded that they had to destroy not only the anti-AK party military elites, but also tear down the institutional structures that they saw as supporting these hostile groups. It is therefore natural to see the roots of the sham Ergenekon and Sledgehammer trials that the AK party and their allies organized against journalists, former mid-ranking soldiers, and generals, in their increasingly urgent need to weaken and remove their enemies.³⁴

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

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

34 On the Ergenekon trials, see Jenkins (2011). On the Sledgehammer case, see Rodrik (2014)

also started changing support for the EU within the Turkish population. As disillusionment set in, support for EU took a tumble, falling from above 70% in 2004 to a low of 40% in 2007, as detailed in chart 9.

As enthusiasm and support for EU accession among Turks waned, and as the AK party turned East (a process that had many causes), Turkish institutions became increasingly unanchored, further damaging Turkey-EU relations. Recent remarks by Jean-Claude Juncker, President of the European Commission, summarize what has become a common stance among many European policymakers and bureaucrats: “[...] under my Presidency of the Commission [...] no further enlargement will take place over the next five years. As regards Turkey, the country is clearly far away from EU membership. A government that blocks twitter is certainly not ready for accession” (The Official Website of the EC President, My Foreign Policy Objectives, April 2014).

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

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

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

It is, of course, natural to ask why Turkish political institutions and civil society organizations failed to defend the advances and the freedoms

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

**THE WEAKNESS OF THE INSTITUTIONS PROBABLY LIES
IN THE FACT THAT THE JUDICIARY AND STATE BUREAU-
CRACY IN TURKEY HAVE NEVER BEEN INDEPENDENT**

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

Section III - Concluding Remarks and the Way Forward

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

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

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

In conclusion, we draw several lessons for the future of the Turkish institutions, Turkey-EU relations, and more broadly. The most important lesson, which, in our view, applies both to Turkey and to other emerging economies, is that even starting with weak institutions and political imbalances, rapid and high-quality growth appears feasible if the political opening for deep structural reforms and improvements in economic institutions can be found. We are fully aware that such a political opening is far from trivial, and in the Turkish case, it may have been made feasible only because the bastions of the old order, the military and other parts of the Kemalist elites, were particularly weakened. In addition, many of the traditional politicians were blemished because of incompetence and widespread corruption during the 1990s, and a deep financial crisis left no choice to a caretaker government and its successor, the AK party, but to work with the IMF and the World Bank. All the same, the rapidity with which these reforms bore fruit is a surprise to many commentators who view them as either ineffective or slow-acting.³⁵

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

35 Though they are consistent with other findings, such as Acemoglu, Naidu, Restrepo, and Robinson (2014), showing fairly rapid improvements in economic growth following democratization.

via appointments and intimidation.

Finally, we believe there are also important lessons from this episode for the future of EU-Turkey relations. Though these appear to have hit bottom at the moment, there are plenty of grounds for future engagement. To start with, closer trade ties that were initiated by the Customs Union are ongoing, and “upgrading” these ties, which seems inevitable given the developments in the global economy over the past two decades, could be one such vehicle.³⁶ More importantly, perhaps, once the current European economic crisis and the mounting refugee crisis are brought under control in the next several years, EU’s priorities may shift once again towards enlargement. Even without a full-scale turnaround of this sort, European leadership might find different formulas for closer engagement with Turkey.³⁷ An important reason for such engagement for the EU is highlighted by our account: under the right type of engagement, the EU might have significant power over Turkish institutions, capable

PROPORTION OF POPULATION

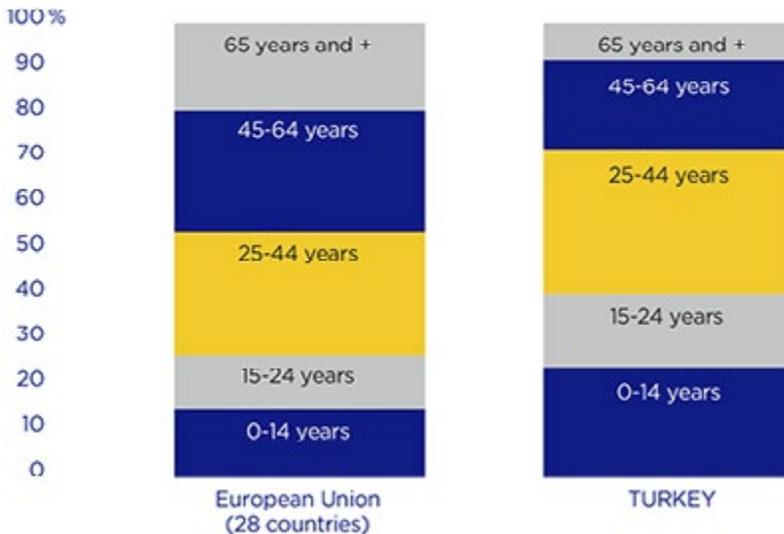


Chart 10

Source: Authors' calculations based on Eurostat

³⁶ See Ulgen (2012), Pierini and Ulgen (2014) and Kirisci and Ekim (2015).

of moving them in the direction of deeper and stronger democracy under the EU's pressure and anchor. Although this power most likely requires a willing, or at a very least pliable, partner at the helm on the Turkish side, internal political dynamics may yet nudge Turkish leaders towards such a position in the near future. Our essay also suggests that such re-engagement can generate sizable economic gains for Turkey.

But the gains are not all one-sided. This institutional power is an argument for EU engagement precisely because the EU can reap two types of major gains from closer relations with Turkey and improvements in Turkish institutions. The first one, though almost trite because of its frequent emphasis in many debates, is still important: Turkey can play a stabilizing role in the Middle East (especially in contrast to its current complicating role in the Syrian crisis).³⁸ With European nations, large and small, increasingly drawn into conflicts in the broader region and feeling their aftershocks, there is arguably a greater need for a holistic engagement with the Middle East and North Africa. This is a strategy for which a democratic Turkey, engaged with the EU, could be an invaluable asset, not only as a partner in foreign policy, but also as an exemplar of a successful Muslim democracy for the rest of the region.³⁹

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

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

³⁸ Ahtisaari et al. (2015).

³⁹ Ahtisaari et al. (2015).

TIMELINE OF TURKEY-EU RELATIONS: 2005-PRESENT

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

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