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Chapter 1

ECONOMIC GROWTH AND INSTITUTIONAL CHANGE IN TURKEY BEFORE 1980

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ABSTRACT

In recent years, a growing literature has emphasized the contribution of the social and political environment, and more specifically of institutions defined as written and unwritten rules and norms, to long term economic change. This chapter explores the linkages between economic growth and institutional change in Turkey before 1980. It begins with an overview of Turkey's record of economic growth during the century before 1980. The second section sketches a framework for understanding the linkages between institutional change and economic growth in Turkey. In order to gain additional insights into Turkey's absolute and relative growth record, the third section then reviews world economic conditions, government economic policies, the basic macroeconomic outcomes and institutional change in Turkey from 1880 to 1980, in three sub-periods.

INTRODUCTION

Modern economic growth began in Turkey during the nineteenth century. Average or per capita incomes increased almost five fold during century before 1980. Other indicators of standards of living also improved significantly. Most importantly, life expectancy at birth doubled from around 30 years to 62 years during the same period. It would be misleading to judge economic performance only in absolute terms, however. The century until 1980, especially the period after World War II, witnessed rapid increases in the standards of living in most parts of the world. On the one hand, increases in per capita incomes in Turkey were close to but slightly above averages for the developing countries during this century. On the other hand, the income per capita gap between Turkey and developed economies of Western Europe and North America widened significantly from 1820 to World War I and even further until 1950 but narrowed somewhat since. In 1980 that gap was larger than and today it is slightly smaller than what it was before World War I.

This chapter will begin with an overview of Turkey's record of economic growth during the century before 1980. All figures and series presented below will refer to the area within the present day borders of Turkey. It will then examine the process of institutional change and link it to economic growth. In recent years, a growing literature has emphasized the contribution of the social and political environment, and more specifically of institutions defined as written and unwritten rules and norms, to long term economic change. In the second section, I will sketch a framework for understanding the linkages between the evolution of institutions and economic change in Turkey during the century before 1980. In order to gain additional insights into its absolute and relative growth record, the third section will then examine world economic conditions, government economic policies, the basic macroeconomic outcomes and institutional change in Turkey in three sub-periods. The concluding section offers some observations on the interaction between economic growth and institutional change in Turkey before 1980.

1. The Long Term Growth Record

Population growth and urbanization in Turkey began in the nineteenth century but did not gain momentum until after World War II. Turkey's population increased from 13 million in 1880 to 21 million in 1950, 45 million in 1980 and 72 million in 2010. Share of population living in urban centers with more than 5000 inhabitants remained around 25 percent or lower from 1880 until after World War II but has been rising rapidly since, to 44 percent in 1980 and to more than 70 percent by 2010. Not surprisingly, urbanization has been accompanied by large shifts in the labor force. Agriculture's share in total employment declined from about 80 percent both in 1880 and 1950 to 51 percent in 1980 and to less than 30 percent in 2010. Agriculture's share in GDP similarly declined from about 54 percent in 1880 and in 1950 to 26 percent in 1980 and to about 10 percent in 2010 (Altug, Filiztekin and Pamuk, 2008).

Table 1

Rates of Economic Growth in Turkey in Comparative Perspective, 1880-1980
(annual rates of increase of GDP per capita, in percent)

	Turkey	W. Europe+US	Developing Countries	World
1880-1913	0,7	1,5	0,6	1,1
1913-1950	0,8	1,3	0,5	0,9
1950-1980	3,1	2,9	2,8	2,6
1980-2010	2,3	1,5	2,4	1,7

Source : Maddison (2007), Pamuk (2006) and Altug, Filiztekin and Pamuk (2008); figures for the most recent sub-period are approximate.

Modern economic growth arrived in Turkey in the nineteenth century. Table 1 summarizes the long trends in per capita GDP during the century before 1980 in three sub-periods on each of which I will spend more time in Section 3 below. Table 1 shows that while long term annual rates of growth of Turkey's GDP per capita were well below 1 percent until 1950 and sharply higher at more than 3 percent after 1950, they were remarkably close to global averages in each of the sub-periods. Turkey's long term growth rates lagged behind those of industrializing higher income countries until after World War II. Since then, however, they have been comparable to and slightly higher than those of Western Europe and the United States. Similarly, Turkey's rates of growth were below world averages until 1950 and have been slightly above them since 1950. In contrast, Turkey's growth rates have been slightly higher than the averages for the developing countries in all three of the sub-periods during the century before 1980. In short, Turkey's long term economic performance during the century before 1980 has been close to average. Clearly, Turkey has not been a poor performer, but neither has it been one of the miracle-producing economies in the twentieth century.

It may be useful to look into Turkey's long term growth record in more detail. Per capita incomes in Turkey and the rest of the Ottoman Empire began to rise during the nineteenth century at rates below 1 percent per annum. Yet, the gap between the high income countries of Western Europe and the United States as a whole and the Ottoman Empire widened considerably during the century before World War I, due to the rapid rates of industrialization in the former countries. GDP per capita in the area within present-day borders of Turkey in 1820 is estimated at approximately 650 purchasing power parity adjusted 1990 dollars. This equaled about 52 percent of the level of GDP per capita in the high income countries of Western Europe and the United States. In 1880, per capita GDP in Turkey stood around 850 dollars which equaled about 39 percent of the per capita income in Western Europe and the United States and 147 percent of the GDP per capita income in the developing countries of Asia, Africa and Latin America, all calculated on a population-weighted basis for the same year. For 1913, GDP per capita within the present day borders of Turkey is estimated at 1200 dollars or at 29 percent of the GDP per capita of the high income countries and at 168 percent of the per capita income of the developing areas.

Per capita incomes declined sharply during both World War I and World War II even though Turkey was not involved in the hostilities during the latter. The economy recovered rapidly after both wars, however, attaining pre-war levels in GDP per capita by 1929 and 1948 respectively. If one takes a long term view, the annual rate of growth in GDP per capita is estimated at 0.7 percent from 1880 to 1950. As a result, per capita GDP in Turkey stood at 1620 dollars in 1950. This was equal to 24 percent of the per capita income of the high income countries and 188 percent of the per capita income in the developing countries in that year.

Turkey's long term growth rates rose significantly higher after World War II. GDP per capita is estimated to have increased at 3.1 percent per year until 1980. By 1980, GDP per capita exceeded 4000 dollars, again in purchasing power parity adjusted 1990 dollars, an increase of almost five fold since 1880. This figure corresponded to about 25 percent of the level of GDP per capita in the high income countries of Western Europe and the United States, and approximately 220 percent of the GDP per capita income of the developing countries for the same year. In other words, average incomes in Turkey increased more slowly than those in high income countries from 1820 until the end of World War II. Between 1950 and 1980, Turkey's economy grew more rapidly but it was not able to close the large gap. In contrast, Turkey's growth record during the century before 1980 was better than the averages for the Middle East, Africa and South Asia, but it lagged behind Latin America and Southern Europe. (Pamuk, 2006; Altug, Filiztekin and Pamuk, 2008).

2. ECONOMIC GROWTH AND INSTITUTIONAL CHANGE

For decades it was believed that economic growth results in part from the accumulation of factors of production and improvements in their quality through investment in machines and skill formation, and in part from increases in productivity derived from advances in technology and organizational efficiency. In recent years, however, a useful distinction is being made between the proximate and the ultimate sources of economic growth. The former relates to the contributions made by the increases in factor inputs and productivity as cited above. The latter refers to aspects of the social and economic environment that influence the rate at which inputs and productivity grow. A growing literature emphasizes the importance of institutions or written and unwritten rules of a society and policies such as property rights and their enforcement, norms of behavior, political and macroeconomic stability, which affect the incentives to invest and innovate. In this new perspective, the basic function of institutions is to provide certainty and incentives for economic activity, investments, technological change and innovations. Institutions and government policies can encourage accumulation and innovation or they can encourage other activities such as corruption, theft or seeking privileges for narrow groups. Long run economic change and economic growth are attained because the underlying framework persistently reinforces incentives for individuals and organizations to engage in productive activity. Investments in physical and human capital will not be undertaken, innovations will not be attempted unless the institutions provide clear incentives for such activities. Similarly, more complex economic structures will not emerge unless institutions can reduce the uncertainties associated with such structures. For these reasons, institutiosn are increasingly seen as more fundamental determinants of economic growth and and long-term differences in per capita GDP between countries than rates of physical or human capital accumulation or research and development themselves. Economic institutions also determine the distribution of income and wealth. In other words, they determine not only the size of the aggregate pie, but also how it is divided amongst different groups in society.

Institutional economics and economic historians have come to recognize that institutions do not change quickly. Institutions from the past often have an influence on the institutions today and thus on economic outcomes today. In short, the past does have an influence on the present and history does matter. Moreover, when institutional change does occur, it is usually not in the direction of most efficient outcomes. A society rarely arrives at or creates institutions that are conducive to economic growth. In most cases, institutions have favored activities that that restrict opportunities rather than expand them. Similarly, rather than reinforcing incentives towards productive activity, in most cases states acted as instruments for transferring resources from one group to another or promoting their own survival at the expense of others. In short, the process of institutional change has not always been favorable to economic growth (North, 1990; Acemoglu, Johnson and Robinson, 2005).

The process of how economic institutions are determined and the reasons why they vary across countries are still not sufficiently well understood. Institutional economics proposes a number of causes or determinants of institutions. Most important amongst them are i) geography or resource endowments, ii) religion or more generally culture and iii) social conflict or political economy. Ottoman economic institutions have been influenced by geography or resource endowments. For example, the land regime and fiscal institutions in

Egypt were shaped to a large degree by the needs of irrigated agriculture. In the core regions of the empire, low population density tended to support peasant farms in the countryside. With the exception of Egypt, however, the geography or resource endowments of the areas covered by the Ottoman Empire were not very different from those of western Europe. For this reason, geography or resource endowments are not considered as a primary cause of the differences in economic institutions in the Ottoman Empire. For a long time, religion and/or culture have also been offered as a primary cause of the differences in economic outcomes between the Near East and western Europe. Max Weber and David Landes have offered prominent examples of this type of explanation. More recently, in a series of recent articles Timur Kuran has pointed to certain Middle Eastern institutions including ones rooted in the region's dominant religion, as past and in some cases also continuing obstacles to economic development. He has argued that these institutions did not ever cause a decline in economic activity but they turned into handicaps by perpetuating themselves during the centuries when the West developed the institutions of the modern economy (Kuran, 2003; 2004). Culture certainly has an impact on institutions but Kuran has tended to ignore the large body of evidence that Islamic societies changed their institutions over time and often circumvented or adapted the religious rules that appear to prevent economic change. As a result, he has overlooked change in Islamic societies and the varieties of Islam that emerged in response to the many different conditions. Once it is allowed that the so called Islamic rules can and do in fact change or be circumvented, it becomes necessary to understand why and how. For this reason, we believe it is best to turn to political economy for understanding the long term evolution of institutions in Middle East and more specifically in the Ottoman Empire and in Turkey.

Those in the recent institutional economics literature adhering to a social conflict or political economy explanation of economic institutions argue that because different groups and individuals typically benefit from different economic institutions, there is generally a conflict over the choice of economic institutions, ultimately resolved in favor of groups with greater political power. The distribution of political power in society is, in turn, determined by political institutions and the distribution of economic power. For long term growth, economic institutions should not offer incentives to a narrow elite but open up opportunities to a broader section of society. Economic institutions that provide incentives to invest in land, physical and human capital or technology are more likely to arise when political power is in the hands of a relatively broad group with significant investment opportunities. For this reason, political economy and political institutions are considered as key determinants of economic institutions and the direction of institutional change. The state can be a major player in this context as it maintains coercive power to enforce these rules. As the result of political struggles and alliances, the state and associated institutions moved to provide the legal framework that reinforced incentives for organizations to engage in productive activity (Acemoglu, Johnson and Robinson, 2005; Rodrik, Subramanian and Trebbi, 2004; Helpman, 2004).

Shortcomings in education and human capital are also very important in understanding not only the growth performance but also the extent and direction of institutional change in Turkey during the century until 1980. Literacy rates during the late Ottoman era and in the during first decade of the republic in the 1920s were very low, estimated at or below 10 percent. By 1950 adult (above 15) literacy had risen to 28 percent, 47 percent for men and 13 percent for women. In 1980 adult literacy rates still stood at no more than 66 percent, 81 percent for men and only 50 percent for women. These literacy rates were lower than those prevailing in Latin America, South and East Asia. During the post-World War II period, Turkey, along with other Muslim majority countries, also lagged behind other developing countries with comparable levels of per capita income in indices measuring gender equality and socio-economic development of women. In addition, there existed large differences in educational attainment levels and more generally in human development indicators between Turkey’s mostly Kurdish southeast region and the rest of the country. It is well documented that lower levels of human capital has a negative impact on rates of economic growth especially in later stages of economic development when skills and technology become increasingly important. The interaction between human capital on the one hand and economic growth and institutional change, on the other, is rather complicated and works both ways. It is true that levels of human capital influence the direction and extent of economic growth and institutional development. At the same time, patterns and extent of human capital formation also depend not only on levels of per capita income but also on the existing institutions (Altug, Filiztekin and Pamuk, 2008: 418-9).

The evolution of economic institutions in Turkey and their consequences for economic growth have not been closely studied. The next section examines structural change, industrialization and the basic macroeconomic outcomes in three sub-periods: the Ottoman decades before World War I, the interwar years or the single party era until the end of World War II and the import-substituting industrialization era after World War II and until 1980. I will thus seek to gain insights not only into Turkey’s record of economic growth, but also into the evolution of the economic institutions that played a key role in these outcomes. Briefly, Ottoman economy was opening up rapidly to international trade and international investment during the decades before World War I. While the Ottoman state tended to resist or slow down these changes, European companies together with local merchants located in the port cities were shaping the institutions of an export oriented, primary producing economy. From the Ottoman era to the interwar period, Turkey underwent major political and institutional changes. These changes favored the emergence of a more closed, more national economy dominated by the new state elites. In the absence of a strong private sector, these elites adopted a state-led industrialization strategy during the Great Depression. Despite the rhetoric to the contrary, however, the new regime remained urban based in a country where the overwhelming majority lived in rural areas and engaged in agriculture. As a result, the benefits aof these policies and institutional changes did not reach large segments of the population. Pace of structural change and economic growth accelerated after World War II. With the transition to a more open political regime and urbanization, urban industrial groups began to take power away from the state elites. Industrialization and economic development began to be controlled increasingly by the private sector located in the major urban centers. The economic institutions began to reflect those changes. This transition, however, has not been smooth or easy. For most of the last half century, political and macroeconomic instability including three military coups and a series of fragile coalitions and the shortcomings of the institutional environment seriously undermined the economy’s growth potential.

3. THREE DIFFERENT PERIODS

3.1. Open Economy during the Nineteeenth Century

For the Ottoman Empire the nineteenth century was a period of political, social and economic reforms designed and implemented by the center in order to keep the empire together in response to external and internal challenges. The reforms of *Tanzimat* (re-ordering) that began in the first half of the century in military, administration, education,law and elsewhere tended to increase the power of the central administration at the expense of the elites in the provinces. These changes brought greater internal security, strengthened property rights and tended to reduce state interventionism. One key outcome of these changes was the shift of economic activity in rural areas, especially in agriculture from the highlands towards the more fertile plains.

For the Ottoman economy the nineteenth century was a period of rapid integration into the world economy. Between 1820 and 1914 the foreign trade of the empire expanded by more than ten fold. This process was supported by a series of free trade treaties signed between the Ottoman central administration and the European countries from 1838 onwards. Ottoman exports consisted almost entirely of agricultural commodities, foodstuffs and raw materials. Rapid expansion of foreign trade also turned empire into an importer of manufactured goods, most importantly of cotton textiles, and also of foodstuffs, various machinery and intermediate goods. More than three-fourths of Ottoman external trade was directed towards industrialized Europe with Germany, France and Great Britain.

On the eve of World War I, the Ottoman economy remained predominantly agrarian. In the countryside, small peasant holdings coexisted with larger enterprises. Family enterprises with a pair of oxen and a plot of land large enough to be cultivated by a pair of oxen remained the basic unit of production. While the coastal plains were densely cultivated, scarcity of labor and availability of land prevailed in the interior regions. Commercialization of agriculture during the nineteenth century was accompanied by some shift from cereals and other subsistence crops towards cash crops and industrial raw materials. Manufacturing activity remained based mostly on artisanal forms. Modern factories using steam power such as tanneries, textile mills, flour mills, glass works, brick factories under private ownership began to emerge only towards the end of the nineteenth century. However, absence of Ottoman tariff autonomy and low tariffs on imports made it especially difficult for the new manufacturing enterprises to take root.

Another important dimension of nineteenth century globalization for the Ottoman economy was the large amounts of direct foreign investment by European firms. Close to 60 percent of this amount was invested in railroads until World War I. By linking the fertile agricultural regions to major ports, these railroads facilitated the commercialization of agriculture and integration of the Ottoman economy to world markets. European direct investment also went to other forms of infrastructure such as ports, utility companies, insurance and shipping. In contrast, foreign investment in agriculture, mining and manufacturing remained limited. (Pamuk, 1987: 55-81) Special treaties the Ottoman state agreed to sign with the European powers gave European citizens and companies special privileges such as separate courts and lower rates of taxation. These institutions created disadvantages for and discouraged the local citizens from pursuing economic activities in competition with the Europeans.

Per capita incomes were rising, albeit slowly at rates below 1 per cent per year in Turkey and in most other regions of the empire during the decades before World War I (Pamuk, 2006 and Altug, Filiztekin and Pamuk, 2008). These increases were based primarily on greater commercialization and export orientation of agriculture. In contrast, industrialization remained limited until World War I. Institutional changes during the nineteenth century were in the direction of opening up the economy to markets and global economic forces. These changes were shaped by the interaction between the Ottoman state and the European companies. The role of various domestic groups such as the landowners, both large and small, merchants and guilds in this process remained limited. While the Ottoman state tended to resist or slow down the process of globalization and the changes it brought, European companies to some extent together with local merchants located in the port cities were trying to shape the institutions of an export oriented, primary producing economy. Opening of the economy to international trade and investment under these circumstances proceeded rather slowly. As a result, Turkey was not transformed into one of the showcases of globalization such as Egypt where both the state dominated by the large landowners and the British colonial administration after 1882 actively shaped the institutions of an open economy with specialization in cotton. (Pamuk, 1992)

3.2. State-Led Industrialization in Response to the Great Depression

With the outbreak of World War I, Turkey began to move from an open economy towards a more closed, inward looking national economy. This process began with major demographic changes. The destruction and death that accompanied the Balkan Wars of 1912-13, World War I and the War of Independence, 1920-22, had severe and long-lasting consequences. Total casualties, military and civilian, of Muslims during this decade are estimated at close to 2 million. In addition, most of the Armenian populace of about one and a half million in Anatolia were deported, killed, or died of disease, after 1915. Finally, under the Lausanne Convention, approximately 1.2 million Orthodox Greeks were forced to leave Anatolia, and in return, close to half a million Muslims arrived from Greece and the Balkans after 1922.

As a result of these massive changes, the population of what became the Republic of Turkey declined from about 17 million in 1914 to 13 million at the end of 1924 (Behar, 1995; Shorter, 1985; McCarthy, 1983; Eldem, 1970). The population of the new nation-state had also become more homogeneous, with Muslim Turks and the Kurds who lived mostly in the southeast making up close to 98 percent of the total. Agriculture, industry and mining were all affected adversely by the loss of human lives and by the deterioration and destruction of equipment, draft animals and plants during the war years. GDP per capita in 1923 was approximately 40 percent below its 1914 levels (Özel and Pamuk, 1998).

The former military officers, bureaucrats and intellectuals who assumed the positions of leadership in the new republic viewed the building of a new nation-state and modernization through Westernization as two closely related goals. They strived, from the onset, to create a national economy within the new borders. The new leadership was keenly aware that financial and economic dependence on European powers had created serious political problems for the Ottoman state. At the Lausanne Peace Conference (1922-23), which defined, amongst other things, the international economic framework for the new state, they succeeded in abolishing the regime of privileges for the European citizens and companies. The parties also agreed that the new republic would be free to pursue its own commercial policies after 1929. The government saw the construction of new railroads and the nationalization of the existing companies as important steps towards the political and economic unification of the nation state inside new borders. The foreign capital stock declined sharply during the interwar period due to purchases of European firms and voluntary departures.

Despite its rhetoric to the contrary, the regime's priorities lay with the urban areas. It considered industrialization and the creation of a Turkish bourgeoisie to be the key ingredients of national economic development (Mardin, 1980). Nonetheless, the new regime abolished the much-dreaded agricultural tithe and the animal tax in 1924. This move represented a major break from Ottoman patterns of taxation and a significant decrease in the tax burden of the rural population. While this decision has been interpreted as a concession to the large landowners, the new leadership was more concerned about alleviating the poverty of the small and medium sized producers, which made up the overwhelming majority of the rural population. In the longer term, the abolition of the tithe and tax-farming helped consolidate small peasant ownership. The recovery of agriculture provided an important lift to the urban economy as well. By the end of the 1920s, GDP per capita levels had attained the levels prevailing before World War I (Özel and Pamuk, 1998).

The principal mechanism for the transmission of the Great Depression to the Turkish economy was the sharp decline in prices of agricultural commodities. These adverse price movements created a sharp sense of agricultural collapse in the more commercialized regions of the country, in western Anatolia, along the eastern Black Sea coast and in the cotton-growing Adana region in the south (Tekeli and Ilkin, 1977: 75-92; Tezel, 1986: 98-106). Earlier in 1929, even before the onset of the crisis, the government had begun to move towards protectionism and greater control over foreign trade and foreign exchange (Tezel, 1986: 139-62). As the unfavorable world market conditions continued, the government announced in 1930 a new strategy of etatism, which promoted the state as a leading producer and investor in the urban sector. A first five-year industrial plan was adopted in 1934 with the assistance of Soviet advisers. By the end of the decade, state economic enterprises had emerged as important and even leading producers in a number of key sectors, such as textiles, sugar, iron and steel, glass works, cement, utilities and mining (Boratav, 1982: 172-89; Tezel, 1986: 197-285; Tekeli and Ilkin, 1982). Etatism undoubtedly had a long-lasting impact in Turkey, and later in other countries around the Middle East. However, the initial efforts in the 1930s made only modest contributions to economic growth and structural change. For one thing, state enterprises in manufacturing and many other areas did not begin operations until after 1933. Close to half of all fixed investments by the public sector during this decade went to railroad construction and other forms of transportation. In 1938, state enterprises accounted for only 1 percent of total employment in the country. Approximately 75 percent of employment in manufacturing continued to be provided by small-scale private enterprises (Tezel, 1986: 233-7).

Available estimates suggest GDP per capita grew at average annual rates of more than 3 percent during the 1930s, despite the absence of expansionary fiscal and monetary policy. One important source of the output increases after 1929 was the strong protectionist measures adopted by the government ranging from tariffs and quotas to foreign exchange controls, which sharply reduced the import volume from 15.4 percent of GDP in 1928-29 to 6.8

percent by 1938-39. Import repression created attractive conditions for the emerging domestic manufacturers, mostly the small and medium-sized private manufacturers. There is another explanation for the overall performance of both the urban and the national economy during the 1930s, which has often been ignored amidst the heated debates over etatism. Thanks to the strong demographic recovery, agriculture—the largest sector of the economy, employing more than three fourths of the labor force and accounting for close to half of the GDP—did quite well during the 1930s (Shorter, 1985).

Although Turkey did not participate in World War II, full-scale mobilization was maintained during the entire period. The sharp decline in imports and the diversion of large resources for the maintenance of an army of more than one million placed enormous strains on the economy. Official statistics suggest that GDP declined by as much as 35 percent and the wheat output by more than 50 percent until the end of the war. In response, the prices of foodstuffs rose sharply and the provisioning of urban areas emerged as a major problem for the government. Under these circumstances, etatism was quickly pushed aside. Large increases in defense spending were financed by monetary expansion. High inflation, wartime scarcities, shortages and profiteering accentuated by economic policy mishaps soon became the order of the day. As declining production and sharply lower standards of living combined with increasing inequalities in the distribution of income, large segments of the urban and rural population turned against the Republican People's Party, which had been in power since the 1920s. The war years, rather than the Great Depression and etatism era, thus appear to be the critical period in the political demise of the single party regime.

To sum up, Turkey underwent very significant political and institutional changes during the interwar period. These changes favored the emergence of a more closed, more national economy dominated by the new state elites. In part because the private sector or the emerging Muslim bourgeoisie was still weak, the new state elites adopted the strategy of etatism or state led industrialization during the Great Depression. While many economies turned inward during this period, the Turkish experience was certainly more radical than most. It is clear that history and institutions inherited from the past contributed significantly to the emergence of etatism as the new strategy. The new policies focused mostly on the urban areas, however. As a result, the institutional changes and the increases in standards of living did not reach large segments of the population. Nonetheless, despite two world wars and the Great Depression, per capita levels of production and income in Turkey were 30 to 40 percent higher in 1950 than those prevailing on the eve of World War I.

3.3. Return to ISI after WWII

Domestic and international forces combined to bring about major political and economic changes in Turkey after World War II. Domestically, many social groups had become dissatisfied with the single party regime. The agricultural producers, especially poorer segments of the peasantry, had been hit hard by wartime taxation and government demands for the provisioning of the urban areas. In the urban areas, the bourgeoisie was no longer prepared to accept the position of a privileged but dependent class, even though many had benefited from the wartime conditions and policies. They now preferred greater emphasis on private enterprise and less government interventionism (Keyder, 1987: 112-4; Boratav, 2003: 93-101).

International pressures also played an important role in the shaping of new policies. The emergence of the United States as the dominant world power after the war shifted the balance towards a more open political system and a more liberal and open economic model. Soviet territorial demands pushed the Turkish government towards close cooperation with the United States and Western alliance. The U.S. extended the Marshall Plan to Turkey for military and economic purposes beginning in 1948.

Agriculture-Led Growth

The shift to a multi-party electoral regime brought Democrat Party to power in 1950. Undoubtedly the most important economic change brought about by the Democrats was the strong emphasis placed on agricultural development. Agricultural output more than doubled from 1947, when the pre-war levels of output were already attained, through 1953 (SIS, 2003). A large part of these increases were due to the expansion in cultivated area, which was supported by government policies and the Marshall Plan. The agriculture-led boom meant good times and rising incomes for all sectors of the economy. It seemed in 1953 that the promises of the liberal model would be quickly fulfilled. These golden years did not last very long, however. With the end of the Korean War, international demand slackened and prices of export commodities began to decline. With the disappearance of favorable weather conditions, agricultural yields declined as well. Rather than accept lower incomes for the agricultural producers, who made up more than two thirds of the electorate, the government decided to initiate a large price support program for wheat, financed by increases in the money supply. The ensuing wave of inflation and the foreign exchange crisis, which was accompanied by shortages of consumer goods, created major economic and political problems for Democrat Party, especially in the urban areas (Sunar, 1984). One casualty of the crisis was the political as well as economic liberalism of the Democrat Party. Just as it responded to the rise of political opposition with the restriction of democratic freedoms, in most economic issues the government was forced to change its earlier stand and adopt a more interventionist approach. It finally agreed in 1958 to undertake a major devaluation and began implementing a IMF and OECD-backed stabilization program.

Agricultural output began to increase more rapidly after World War II at about 3 percent per annum until 1980. This higher rate of growth was supported by rapid increases in the amount of land under cultivation. Thanks to the availability of land, the total area under cultivation more than doubled during the decade after World War II. After the land frontier was reached, a shift occurred towards more intensive agriculture in the 1960s. In this new phase, output rose more slowly but yields and land productivity increased more rapidly with the use of new inputs, agricultural machinery and equipment, fertilizers, irrigation and high yielding varieties of seeds.

The 1950s also witnessed the dramatic acceleration of rural-to-urban migration. Both push and pull factors were behind this movement, as conditions in rural areas differed widely across the country. The development of the road network also contributed to the new mobility (Zürcher, 1993: 235; Keyder, 1987: 135-40; Kasaba, 1993). Despite the large and persistent productivity and income differences between agriculture and the rest of the economy, the strength of small and medium-sized land ownership slowed down the movement of labor to the urban areas. Small and medium-sized land ownership combined with another Ottoman legacy, state ownership of land, to moderate urban inequalities during decades of rapid urbanization Many of the newly arriving immigrants were able to use their savings from rural areas to build low cost residential housing (*gecekondu*) on state lands in the urban areas. They soon acquired ownership of these plots. To this day, agricultural producers and their descendants, many of whom are now urbanized, continue to view the Democrat Party government and especially the prime minister Adnan Menderes, a large landowner, as the first government to understand and respond to the aspirations of the rural population. The Democrat Party also offered the first example of a populist economic policies in modern Turkey. Not only did it target a large constituency and attempt to redistribute income towards them, but it also tried to sustain economic growth with short-term expansionist policies, with predictable longer-term consequences.

Import Substituting Industrialization (ISI)

One criticism frequently directed at the Democrats was the absence of any coordination and long term perspective in the management of the economy. After the coup of 1960, the military regime moved quickly to establish the State Planning Organization (SPO). The idea of development planning was supported by a broad coalition: the Republican People's Party with its etatist heritage, the bureaucracy, large industrialists and even the international agencies, most notably the OECD (Milor, 1990).

The economic policies of the 1960s and 1970s aimed, above all, at the protection of the domestic market and industrialization through ISI. Governments made heavy use of a restrictive trade regime, investments by state economic enterprises and subsidized credit as key tools for achieving ISI objectives. The SPO played an important role in private sector decisions as well, since its approval was required for all private sector investment projects which sought to benefit from subsidized credit, tax exemptions, import privileges and access to scarce foreign exchange. The agricultural sector was mostly left outside the planning process (Hansen, 1991: 352-3; Barkey, 1990; Öniş and Riedel, 1993: 99-100).

The emerging ISI model of the 1960s represented a combination of the old and the new. State economic enterprises whose roots went back to the etatist era began to play, once again, an important role in industrialization. This role, however, was quite different in comparison to the earlier period. During the 1930's when the private sector was weak, industrialization was led by the state enterprises and the state was able to control many sectors of the economy. In the new ISI era, in contrast, the private sector began to take over. Big family holding companies, large conglomerates which included numerous manufacturing and distribution companies as well as banks and other services firms, emerged as the new leaders.

For Turkey, the years 1963 to 1977 represented what Albert Hirschman has called the easy stage of ISI (Hirschman, 1982). The opportunities provided by a large and protected domestic market were exploited, but ISI did not extend to the technologically more difficult stage of capital goods industries. The shortcomings of the education system played an important role in this outcome. Export orientation of manufacturing industry also remained weak. Until the end of the 1970s, Turkey continued to obtain the foreign exchange necessary for the expansion of industrial production primarily from traditional agricultural exports and remittances from workers in Europe. Nonetheless, the ISI policies were successful bringing about economic growth, especially in the early stages. GNP per capita increased at the average annual rate of 4.3 percent during 1963-1977 and at 3.5 percent per annum including the crisis years of 1978-79. Rate of growth of manufacturing industry was considerably higher, averaging more than 10 percent per annum for 1963-1977. A significant part of these high rates of overall growth was due to the shift of a large part of the labor force from the low productivity agricultural sector to the higher productivity urban sector (SIS, 2006).

While industry and government policy remained focused on a large and attractive domestic market during this period, they all but ignored exports of manufactures, and this proved to be the Achilles' heel of Turkey’s ISI. The export sector’s share in GDP averaged less than 4 percent during the 1970s, and about two thirds of these revenues came from the traditional export crops. A shift towards exports would have increased the efficiency and competitiveness of the existing industrial structure, acquired the foreign exchange necessary for an expanding economy and even supported the import substitution process itself in establishing the backward linkages towards the technologically more complicated intermediate and capital goods industries.

There existed an opportunity for export promotion in the early 1970's, especially in the aftermath of the relatively successful devaluation of 1970. By that time, Turkish industry had acquired sufficient experience to be able to compete or learn to compete in the international markets. For that major shift to occur, however, a new orientation in government policy and the institutional environment was necessary. The overvaluation of the domestic currency and many other biases against exports needed to be eliminated. Instead, the successes obtained within a protected environment created vested interests for the continuation of the same model. Most of the industrialists as well as organized labour, which feared that export orientation would put downward pressure on wages, favored the domestic market oriented model. Moreover, political conditions became increasingly unstable during the 1970’s. The country was governed by a series of fragile coalitions with short time horizons. As a result, the government made no attempt to shift towards export oriented policies or even adjust the macroeconomic balances after the first oil shock of 1973 (Barkey, 1990: 109-67).

The Crisis of ISI

The short-lived coalitions chose to continue with expansionist policies at a time when many industrialized countries were taking painful steps to adjust their economies. Turkey’s existing policies could be sustained only by a very costly external borrowing schemes. In less than two years it became clear that the government was in no position to honor the outstanding external debt stock, which had spiraled from 9 percent to 24 percent of GDP (Celasun and Rodrik, 1989). By the end of the decade Turkey was in the midst of its most severe balance of payments crisis of the postwar period. As rising budget deficits were met with monetary expansion, inflation jumped to 90 percent in 1979. The second round of oil price increases only compounded the difficulties. With oil increasingly scarce, frequent power cuts hurt industrial output as well as daily life. Shortages of even the most basic items became widespread, arising from both the declining capacity to import and the price controls. The economic crisis, coupled with the continuing political turmoil, brought the country to the brink of civil war (Keyder, 1987: ch. 8).

Perhaps the basic lesson to be drawn from the Turkish experience is that an ISI regime becomes difficult to dislodge owing to the power of vested interest groups who continue to benefit from the existing system of protection and subsidies. To shift towards export promotion in a country with a large domestic market required a strong government with a long term horizon and considerable autonomy. These were exactly the features lacking in the

Turkish political scene during the 1970s. As a result, economic imbalances and costs of adjustment increased substantially.

Turkey began the post-World War II era with a strategy emphasizing agricultural development but settled on the ISI model, after a severe foreign exchange crisis compounded by policy mistakes. History certainly did matter in the shaping of Turkey's post-war ISI during the 1960s. The state enterprises from the etatist 1930s were accompanied and eventually led by the rising private sector in Istanbul and more generally in the north-west region of the country. While the inward oriented ISI model allowed for high and steady growth rates, rising real wages and agricultural incomes for almost two decades, the attractiveness of the large domestic market made it very difficult to shift towards exports. Political instability exacerbated the problems of the ISI strategy. The institutional environment deteriorated sharply during the 1970s. Another severe and costly crisis at the end of the decade paved the way for the radical opening of the economy to the forces of globalization in 1980.

4. CONCLUSION

This chapter has explored the linkages between economic growth and institutional change in Turkey during the century before 1980. It has emphasized the distinction between the proximate and the ultimate sources of economic growth. The former relates to the contributions made by the increases in factor inputs and productivity. The latter refers to aspects of the social and economic environment in which growth occurs. In this context, economic institutions are viewed as the key determinants not only of long-term economic growth, but also of how the total output or income is divided amongst different groups in society. I have also argued because there is generally a conflict of interest over the choice of economic institutions, political economy and political institutions are key determinants of economic institutions and the direction of institutional change.

During the nineteenth century, the Ottoman state and European interests interacted to change the institutions of a mostly agricultural economy and open it to foreign trade and investment. In the twentieth century, Turkey's transition from a rural and agricultural towards an urban and industrial economy occurred in three waves, each of which served to increase the economic and political power of urban and industrial groups. Increases in the economic and political power of these groups enabled them, more or less, to shape the economic institutions in the direction they desired. Each of these waves of industrialization and economic growth, however, was cut short by the shortcomings or deficiencies of the institutional environment. The first wave occurred during the 1930s. After a series of institutional changes undertaken by the new republic, a small number of state enterprises led the industrialization process and the small scale private enterprises in a strongly protected economy. Etatism promoted the state as the leading producer and investor in the urban sector. Ultimately, however, political and economic power remained with the state elites and these economic and institutional changes remained confined to the small urban sector.

Turkey's second wave of industrialization began in the 1960s, again under heavy protection and with government subsidies and tax breaks. Rapid urbanization steadily expanded the industrial base. The etatist legacy was important and the state economic enterprises continued to play an important role as suppliers of intermediate goods. Political and economic power began to shift away from the state sector, however. The new leaders were the large scale industrialists and the holding companies in Istanbul and the northwestern corner of the country. With the rise of political and macroeconomic instability in the 1970s, industrialization turned increasingly inward and short-term interests prevailed over a long-term vision, culminating in a severe crisis at the end of the decade. Turkey's inward oriented economic strategy that went back to the era of the Great Depression thus began to change after 1980.

Ever since the Young Turk era, governments in Turkey supported the emergence and growth of an industrial bourgeoisie. Helped by the growth of the urban sector and successive waves of industrialization, this private sector has been gradually wresting control of the economy away from the state elites in Ankara (Keyder, 1987; Buğra, 1994). For most of the twentieth century, the leading industrialists had been from the Istanbul region. The new economic strategy favoring a more open economy and export-led growth after 1980 widened the industrial base further to new centers across Anatolia. The rising bourgeoisie of these new industrial centers began to challenge the Istanbul-based industrialists in the 1990s. The AKP government of the recent years has been supported by these emerging elites in the provinces.

While economic power has shifted from Ankara to Istanbul and more recently towards new industrial groups in the provinces, the shift in political power and the move towards more pluralist politics have been far from easy or simple. Turkey's political system often produced fragile coalitions and weak governments which have sought to satisfy the short term demands of various groups by resorting to budget deficits, borrowing and inflationary finance. The political and macroeconomic instability also led to the deterioration of the institutional environment. Rule of law and property rights suffered, and public investment including expenditures on education declined sharply. The weak governments were too open to pressures from different groups or even individual firms or entrepreneurs seeking favors. As a result, the pursuit of favors or privileges from local and national governments was a more popular activity for the producers than the pursuit of productivity improvements or competition in international markets.

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