FOREIGN DIRECT INVESTMENT IN DEVELOPING ECONOMIES AND TURKEY;

THE ROLE OF INSTITUTIONS

by

Devrim Dumludağ

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Title : Foreign Direct Investment in Developing Countries : The Role of Institutions

The aim of this dissertation is to investigate the relationship among foreign direct investment and institutions in developing countries.

In this dissertation I examine the role of macroeconomic variables and institutions as determinants of foreign direct investment flows by applying panel data regressions in developing economies.

In addition, I apply a questionnaire survey to the executives of 52 multinational corporations operating in Turkey in order to reveal the impact of institutional variables on foreign direct investment.

Atatürk İlkeleri ve İnkılap Tarihi Enstitüsü'nde Doktora derecesi için Devrim Dumludağ tarafından Ağustos 2007'de teslim edilen tezin kısa özeti

Başlık: Gelişmekte Olan Ülkelerde ve Türkiye'de Yabancı Sermaye Yatırımları; Kurumların Rolü

Bu tezin amacı gelişmekte olan ülkelerde Yabancı Sermaye Yatırımlarının belirleyicileri arasında kurumsal değişkenlerin rolünü incelemektir.

Makroekonomik ve kurumsal değişkenlerle Yabancı Sermaye Yatırımları arasındaki ilişkiyi analiz etmek üzere, öncelikle, gelişmekte olan ülkelerde panel data analizi uygulanmıştır.

Daha sonra, Türkiye'de faaliyette bulunan 52 yabancı sermayeli firma yöneticisinden sağlanan anket sonuçları ile kurumsal değişkenlerin Yabancı Sermaye Yatırımları üzerindeki etkisi ayrıntılı olarak incelenmiştir.

NAME OF AUTHOR: Devrim Dumludağ
PLACE OF BIRTH: Üsküdar/İstanbul
DATE OF BIRTH: 19/11/1975

GRADUATE AND UNDERGRADUATE SCHOOLS ATTENDED:

Boğaziçi University.
Boğaziçi University.
Marmara University.

DEGREES AWARDED:
Doctor of Philosophy in History, the Atatürk Institute for Modern Turkish History, 2007, Boğaziçi University.

Master of Arts in in History, the Atatürk Institute for Modern Turkish History, 2002, Boğaziçi University.

Bachelor of Arts in Economics, 1998, Department of Economics, Marmara University.

AREAS OF SPECIAL INTEREST:
Foreign Direct Investment in Developing Countries, Economic Growth and Institutions

PROFESSIONAL EXPERIENCE:
Research Assistant, Department of Economics, Marmara University, Istanbul, 2000- .

AWARDS and SCHOLARSHIP:

- Mention Award from YASED (International Investors Association) Research Competition VI for the article : "Doğrudan Yabancı Yatırımlarda Devlet - Özel Sektör İlişkisi : Sivil Toplum Örgütlerinin Rolü. (2005)

- First Summer School of the Marie Curie Research Training Network 'Unifying the European Experience: Historical Lessons of Pan-European Development': Economic Growth in the Extremely Long Run. (2006)

- Boğaziçi University Foundation, Fund for academic activities (2007)

- UE-funded RTN network Unifying Europe, and the ESF-funded Globaleuronet network (full wee waiver) (2007)

PUBLICATIONS:

- "Güney Kore'nin Sanayileşme Sürecinde Devletin Rolü", *İktisat Dergisi*, No. 404(2000).

- "Baltalimanı Anlaşması, Osmanlı İmparatorluğu ve Küreselleşme" in *Globalizasyonun Yansımaları*, edited by Ugur Selçuk Akalın. İstanbul: Akademi Yayınları, 2002.

- *The Political Economy of Foreign Direct Investment in Turkey, 1950-1980* M.A. Thesis (İstanbul: Boğaziçi University, 2002).

- "Türkiye'de Yabancı Sermaye Yatırımlarının Tarihsel Gelişimi", *Toplum ve Bilim*, no.96 (Bahar 2003).

-"Küreselleşmeyi 'Büyük Dönüşüm' Üzerinden Okumak" *Marmara Üniversitesi İİBF Dergisi*, 19, no.1 (2004).

-"Foreign Direct Investment in Turkey, 1950-1980: A Comparative Study". *Öneri*, 26, (2005).

-"Doğrudan Yabancı Yatırım Hareketlerinde Yatırım Promosyon Ajanslarının Rolü – Türkiye Örneği", *Marmara Üniversitesi İİBF Dergisi*, 21, no.1 (2006).

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To Behiye Nur Yetkin

TABLE CONTENTS

PREFACE

This dissertation is a result of years of study. For my Master of Art thesis, which was written at Boğaziçi University in 2002, I studied Foreign Direct Investment (FDI) in Turkey for the period 1950 – 1980, during which time FDI inflows to Turkey were extremely lower than other developing economies such as Brazil, Argentina and Mexico. I asked the question: "Why did Turkey receive less FDI flows than similar developing countries?" What I found is that in order to understand the reasons, it is necessary to pay attention to non-economic factors as well as economic indicators such as profit orientation, growth of a market or market size. However, in my M.A. thesis, I emphasized the importance of non economic facts, rather than offering a comprehensive theoretical framework.

In this dissertation I intend to build a theoretical framework focusing on the questions of why developing countries differ vastly in their success in attracting FDI, and, in specific, why Turkey, from the beginning of the republican era, has received lower level of FDI inflows than similar developing countries until the last few years.

In order to examine the issue entirely, first, the motives of investing abroad should be investigated. To answer the question "why does foreign direct investment occur?" numerous theories focus on the firm-level analysis however, the role of institutions on FDI flows remains seriously understudied.

For a decade, the relationship between institutions and Foreign Direct Investment has been receiving growing attention. One of the reasons is that in the economic growth literature, the number of studies mentioning the importance of institutions as determinant of economic growth has increased.

As Foreign Direct Investment is, by and large, related to economic growth, therefore, studying the link between FDI and institutions has become relevant. Second, the role of institutions in transition economies, especially the link between the quality of institutions and FDI in these countries, has led scholars to focus on the quality of institutions as determinants of FDI in developing countries.

The major focus of this dissertation is on the relationship between political, social and economic institutions and FDI in developing economies, and in specific, in Turkey. In this study, I argue that macroeconomic factors such as market size and growth rates affect FDI flows in a positive way; plus, I assert that one should also look at the quality of institutions, in order to understand the uneven distribution of FDI in developing countries.

Explanations for distribution of FDI flows are either nonexistent or generally ad hoc. This dissertation explores how social economic and political institutions help explain these cross-country variations in FDI flows. In other words I argue that FDI flows are not simply a matter of rational efficiency maximization, but socially constituted and shaped by institutions and social networks.

The methods used in this dissertation are theoretical review and empiric studies including panel data regressions, and a questionnaire survey.

One criticism of quantitative work is the inability to test causal mechanisms. In my empirical analysis, in addition to using an econometric model, I engaged in substantial fieldwork in 2006. I applied a questionnaire survey to explore the mechanisms linking macroeconomic variables and political institutions to FDI flows, and interviewed representatives of Multinational Corporations (MNCs) operating in Turkey. In these interviews I asked both open-ended and closed ended questions regarding the factors were important in multinationals selecting investment locations, and I followed up these questions with specific questions on how they evaluated the importance of specific policies and institutions. Also, I had the opportunity to conduct interviews with some of the representatives of nongovernmental organizations.

Before introducing the chapters, I should state that the econometric models and questionnaire surveys contain several restrictions. First, I use institutional variables as well as macroeconomic variables in the econometric model. Macroeconomic indicators can be accessed easily from several prestigious international organizations such as the International Monetary Fund (IMF) and the World Bank.

However, institutional variables are not so easily quantifiable and accessible. For instance, the numeric value of inflation does not bother anyone, yet a corruption level with a numeric value like "2" showing that high corruption occurs in specific country may be perceived as unfamiliar to some. In order to solve the problem and quantify the institutional variables such as government stability, the rule of law and corruption, several international organizations have conducted questionnaire surveys in over 100 countries and their findings are quite equivalent.

Second, the questionnaire survey in this dissertation covers the period from 2001 to 2006. However, there is a possibility that the respondents answered the questions considering the year in which they were answering, even though I mentioned the importance of the period 2001-2006 in the introduction of my questionnaire survey. However, I strongly believe that the limits of the empiric analysis do not diminish the importance of the dissertation. Most of the studies in the new institutional economics face such difficulties with carrying the enthusiasm of introducing new methods and approaches to the existing literature. In other words, including the social variables in the econometric models is accepted as a courageous and precious effort in order to examine the impact of institutional variables on economic growth, foreign direct investment, and the investment environment.

Outside the introductory and concluding chapters, this dissertation is divided into three main parts. In the first

part, I examine theories of FDI and the effects of FDI on host countries and I include institutions into the mainstream FDI theories. The second part includes the empiric study. Panel data regressions include 67 developing countries for the period 1984-2005. Because of the high correlation between institutional variables, I applied factor analysis and principal components analysis in order to examine the impact of institutional variables on FDI. The third part comprises the historical process of FDI in Turkey. The main purpose here is to propose a periodization for FDI in Turkey. This part is followed by the analysis of recent FDI performances of Turkey. In the last part, I examine the relationship between macroeconomic and institutional variables and FDI conducting a survey to the executives of MNCs operating in Turkey for the period 2001-2006.

CHAPTER 1

INTRODUCTION

As the volume of international investments substantially increased in the post World War II period, the number of studies examining the question “Why do firms invest abroad?” increased, in parallel. Economists have studied FDI extensively and their findings are very straightforward. Most of them focus on economic indicators, leaving out the role of institutional variables. In most of the models, institutions are accepted as exogenous parameters and hence, these models remain insufficient to explain the unequal distribution of FDI in developing countries. In this dissertation I argue that in order to understand why developing countries attract different amounts of FDI, one needs to pay attention to the role of institutions as determinants of FDI.

Recently, in the international literature, studies on the impacts of institutions have been pioneered by economic historians studying the differences in the economic growth performance of the countries in the world. Since the late 1990s, the number of studies mentioning the importance of institutions determining economic growth increased significantly. A number of scholars such as Knack and Keefer, Mauro, Hall and Jones, Acemoğlu, Johnson and Robinson have emphasized that political, institutional and legal environment of a country, to a great extent, determine the economic performance.[1]

These studies emphasize that the institutional structure of a country is a key explanation of cross-country differences in both growth rates and income per capita. The low level of economic, financial and political risks, efficient protection of civil and property rights, the functioning of law and judicial systems, the enforcement of laws and contracts and low level of corruption have been related to higher prosperity of a country.

At the same time, as mentioned, there has been a growing interest in the determinants of foreign direct investment (FDI) in developing countries. Since 1980, with the liberalization of developing economies, the volume of FDI has grown significantly. The recent experience of a number of countries – especially in Central Europe and East Asia – has shown that FDI can play a crucial and catalytic role in the development process.[2] Hence, FDI is perceived by many governments of developing countries as one of the most stable

[1] S. Knack, and P. Keefer "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures", *Economic and Politics* 7(1995), pp. 207–227; P. Mauro "Corruption and Growth," *Quarterly Journal of Economics* 110 (1995), pp. 681–712; D. Acemoğlu, S. Johnson and J. A. Robinson "The Rise of Europe: Atlantic Trade, Institutional Change and Economic Growth" *NBER Working Papers* (2002); D. Acemoğlu, S. Johnson and J. A. Robinson "Institutions as the Fundamental Cause of Long-Run Growth" in *Handbook of Economic Growth* ed. Philippe Aghion, Steven N. Durlauf(Amsterdam: North-Holland, 2005).

[2] FIAS, *A Diagnostic Study of the Direct Foreign Investment Environment in Turkey* (Washington: The World Bank, 2001), p.vii.

components of capital flows and an important factor for economic growth. As the FDI-promoting effect of good institutions may be an important channel of their overall effect on growth and development, to study the links between FDI and institutions has become relevant.

In this dissertation I follow several ways to analyze the impact of macroeconomic variables and institutions on FDI in selected developing countries and in one specific case, Turkey. The study comprises both historical review and empirical analyses for recent period. In the empirical analysis, first, I apply panel data regressions. In detail I use dependent variables (FDI), independent macroeconomic variables (such as inflation, GDP, GDP per capita, openness of the economy), and social-political independent variables (such as socioeconomic conditions, democratic accountability, corruption, investment profile, government stability, political rights, civil liberties). The dataset includes series from 1984 to 2005 for 67 developing economies. I use IMF statistics, and the World Development Indicators 2006 (WDI) for the macroeconomic variables, and the Political Risk Services Data Set and Freedom House for the institutional variables.

In addition to the econometric model, I study the effect of macroeconomic and institutional variables on FDI in Turkey in the republican era.

Turkey, which has one of the most liberal encouragement laws of Foreign Direct Investment in the world, did not receive a satisfactory amount of FDI until 2005. The issue becomes more interesting when a number of international institutions, scholars and government officials in the mid-1990s announced that Turkey has a potential of 30 billion dollars FDI inflow, whereas the country received only 800 million dollars annually during the decade.[3] The inadequate flow of FDI is not a characteristic of the 1990s; the level of FDI inflows to Turkey has remained low since the 1920s.

I examine the FDI in Turkey by offering a periodization between 1920 and 2005. Plus, I investigate the role of macroeconomic and institutional variables as determinants of FDI in Turkey for the recent period. For this purpose, I conduct a questionnaire survey to the 52 executives of MNCs operating in Turkey.

However, before revealing the results of the empiric studies and the historical process of FDI in Turkey, a theoretical framework needs to be built. In the next chapters, FDI patterns in the world and the theoretical framework are presented.

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[3] J. E. Garten, "The Big Emerging Markets", *Columbia Journal of World Business* 31(2)(1996); Devlet Planlama Teşkilatı, *Sekizinci Beş Yıllık Kalkınma Planı* (Ankara: DPT, DYY ÖİK Raporu, 2000).

CHAPTER 2

PATTERNS OF FOREIGN DIRECT INVESTMENT

Foreign Direct Investment Trends in the World

One of the most notable features of economic globalization has been the increased importance of foreign direct investment around the world.

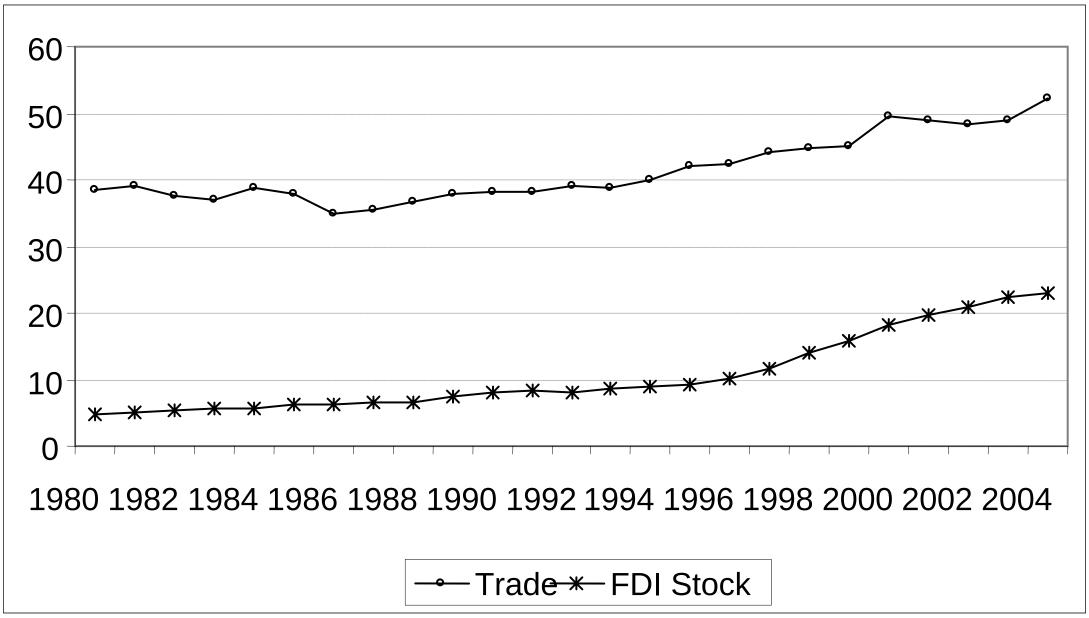

Fig. 1 Trade and FDI stock as percentage of GDP - World
Source: UNCTAD, 2006, WDI, 2006.

With the trends of globalization, liberalization in foreign currency and trade regimes, the volume of trade and FDI increased throughout the world. As seen from Figure 1, since the early 1980s, Foreign Direct Investment stock has grown rapidly - faster than world trade. The dramatic rise in FDI flows in recent years stands out as one of the most decisive factors in globalization of economic activity and FDI is viewed as a measure of the extent to which a country or a region is integrating into the world economy.

However, in the nineteenth century, until 1914, private capital flows (which can also be termed portfolio investment), in the form of bonds and debt investments, was a much more important component of international financial flows than foreign direct investment.[4]

As the major characteristics of FDI are considered in the nineteenth century, first, it should be stated that the flow of foreign investment (portfolio investment plus FDI) mostly took place between developed countries. However, as Table 1 shows, about four-fifths of the foreign capital stake in 1914 was directed to developing countries. This is a highly different picture than today. The manufacturing investments oriented towards local markets were mainly concentrated in Europe (including the U.K., Russia) and the U.S. FDI in the late developing countries, especially in Latin America was

[4] In 1914, about seventy percent of total United Kingdom and French long term investments consisted of government and railways bonds. Douglass C. North, "International Capital Movements in Historical Perspective" in U.S. Private and Government Abroad ed. Raymond Mikesell (Eugene: University of Oregon Books) 1962. pp.20-21.

concentrated in the production of raw materials and export-oriented commodities such as rubber, sugar, tobacco, tea, coffee and cocoa. In addition, FDI in these countries also was concentrated in the service sector, in areas, banking and infrastructure investments such as railroads.[5]

Table 1. Estimated Stock of Accumulated FDI by Recipient Country or Area

	1914		1938		1960		1971		1978	
	$m	%	$m	%	$bn	%	$bn	%	$bn	%
Developed	5.2	37.2	8.3	34.2	36.7	67.3	108.4	65.2	251.7	69.6
North Amer. USA	1.4	10.3	1.8	7.4	7.5	13.9	13.9	8.4	42.4	11.7
W. Europe	1.1	7.8	1.8	7.4	12.5	22.9	47.4	28.5	136.2	37.7
Developing	8.9	62.8	16	65.7	17.6	32.3	51.4	30.9	100.4	27.8
L. America	4.6	32.7	7.5	30.8	8.5	15.6	29.6	17.8	52.5	14.5
Africa	0.9	6.4	1.8	7.4	3.0	5.5	8.8	5.3	11.1	3.1
Asia	3.0	20.9	6,1	25.0	4.1	7.5	7.8	4.7	25.2	7.0
Middle East	0.4	2.8	0.6	2.6	1.5	2.8	2.5	2.1	8.2	2.3
TOTAL	14.1	100	24.3	100	54.5	100	166.3	100	361.6	100

Source: J. H. Dunning, J. H. "Changes in the Level and Structure of International Production: The Last One Hundred Years" in International Investment, ed. Peter J. Buckley, Aldershot, Hants, (England; Brookfield, Vt., USA: E. Elgar, 1990)p.7 (International and unallocated for the years 1971 and 1979 3.9 and 2.6).

Furthermore in the nineteenth century, language, cultural, political and trading ties as well as geographical distance played more important roles in the decision making process of foreign investment than they do today. For instance seventy two percent of U.S. investment was in other parts of

[5] FDI in the Ottoman Empire followed the same pattern. For e detailed study see Ş. Pamuk, *The Ottoman Empire and European Capitalism. 1820-1913: Trade, Investment and Production* (Cambridge: New York: Cambridge University Press, 1987) pp.55-81.

the American continent, while there was a strong colonial content in British, French and Belgian involvement in developing countries.[6]

During the nineteenth century foreign investment activities and flow of portfolio investment reached very high levels. In the second half of the nineteenth century the ratio of the transfers flow from Britain was equivalent to four percent of GNP of those years. This ratio reached to seven percent of GNP in 1914.[7]

The interwar years witnessed a significant decrease in the expansion of FDI. This was due mostly to the negative effects of the Great Depression began in the U.S. in 1929. In this period, Great Britain was no longer willing to play the role of leader of the international economic system, which had negative repercussions on international trade because of a lack of strong international currency and international institute's regulation trade activities. Plus, beggar-thy-neighbor policies had negative influences on international trade.

The negative effect of the Great Depression on portfolio investment was greater than on FDI especially due to the collapse of financial markets. Furthermore, the international capital stake rose quite substantially in the inter-war years. In this period, the Americas continued to attract more than two-thirds of the U.S. direct investment stake; the role of

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[6] John H. Dunning, "Changes in the Level and Structure of International Production: The Last One Hundred Years" in International Investment, ed. Peter J. Buckley, Aldershot, Hants, (England; Brookfield, Vt., USA: E. Elgar, 1990), p.6.

[7] Ibid, pp. 6-8.

U.S. participation in Europe fell in the 1920s and recovered somewhat in the 1930s, as did European investments in the U.S. There were also new MNCs emerged in such as new oil investment (in the Gulf of Mexico), and non-ferrous metals (in Latin America) in the developing countries in the inter-war years.

After the Second World War, the international direct investment stake rose modestly between 1945 and 1960. In this period, the share of FDI stock increased significantly. Also, the pre-war trend for MNCs to favor developed countries for new investment activities continued after 1945. The expansion of MNCs activities in developing countries decreased. In 1914, two-thirds of the capital stake had been directed to developing countries; by 1938 this had fallen to fifty-five percent, and in 1960 it was nearly forty percent. In other words, the rate of increase of foreign firm activities in developed countries was much higher than that in developing countries.[8]

Between 1950 and 1980, most FDI activities in developing countries were in manufacturing, with chemicals and machinery. One of the characteristics of FDI in this period was the concentration of MNCs in the production of commodities for domestic markets rather than focusing on the production of export-based commodities and raw materials, as in the nineteenth century.

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[8] In this period, the U.S. and the European based MNCs mostly concentrated in the developed countries. However, unlike other MNCs of developed countries, Japanese based MNCs mostly invested in the sectors in developing countries which they have comparative disadvantages until 1980. Yet, this pattern has started to change after 1980 see: K. Froot "Japanese Foreign Direct Investment *NBER Working Paper Series* no.3737, 1991.

Until 1980, the annual net flow of FDI to developed countries was $15 billion. However after 1980, the net flow of FDI to developed countries jumped to $175 billion in 1988 and reached $250 billion in 1997. Also in developing countries, a rapid increase in FDI inflow was observed. The annual net flow of FDI to developing countries jumped from $15 billion in 1980 to $50 billion in 1995 and $150 billion in 1997.[9]

Table 2. Estimated Stock of Accumulated FDI by Recipient Country or Area (%)

	1985	1990	1995	2000	2005
Developed	75.4	80.0	75.6	69.5	71.2
North Amer. USA	22.6	22.0	19.3	21.6	16.0
Europe	37.5	45.5	44.8	39.5	46.7
Developing	24.6	19.9	24.1	29.2	26.2
Latin America	6.9	5.4	5.8	7.0	6.8
South and S.-E. Asia	9.3	8.6	13.1	17.2	13.8
West Asia	4.3	2.0	1.5	1.0	1.4
Middle East	5.0	3.3	3.1	2.6	2.6

Source: UCTAD, 2006.

The same trend is seen in the FDI stock share of developing countries. After a long period, FDI stock share of developing started to increase after 1990. While Latin America in the nineteenth century received the largest share of FDI stock, in the 1990s, South and South-East Asia replaced its position by receiving over 13 percent FDI stock of total world FDI stock. The share of the Middle East continued to remain insignificant at the rates close to 3 percent in this period.

[9] UNCTAD, Report by the Secretariet of the UNCTAD (Geneva: UNCTAD, 1999), p.116.

As seen in figure 2, since 1980, the FDI inflows to developing countries have been substantially increasing and compared to other capital flows, has remained the largest component of net resource flows to developing countries. In these countries, governments believe that FDI will help economic development and they try to attract FDI through policies and investment incentives designed to increase investor interest in an attempt to benefit from the potential economic development. Hence, with the liberalization of many developing economies, FDI has become a crucial medium through which developing economies become unified on a global basis. As seen in Figure 2, the volume of FDI inflows has the highest share in total resource flows.

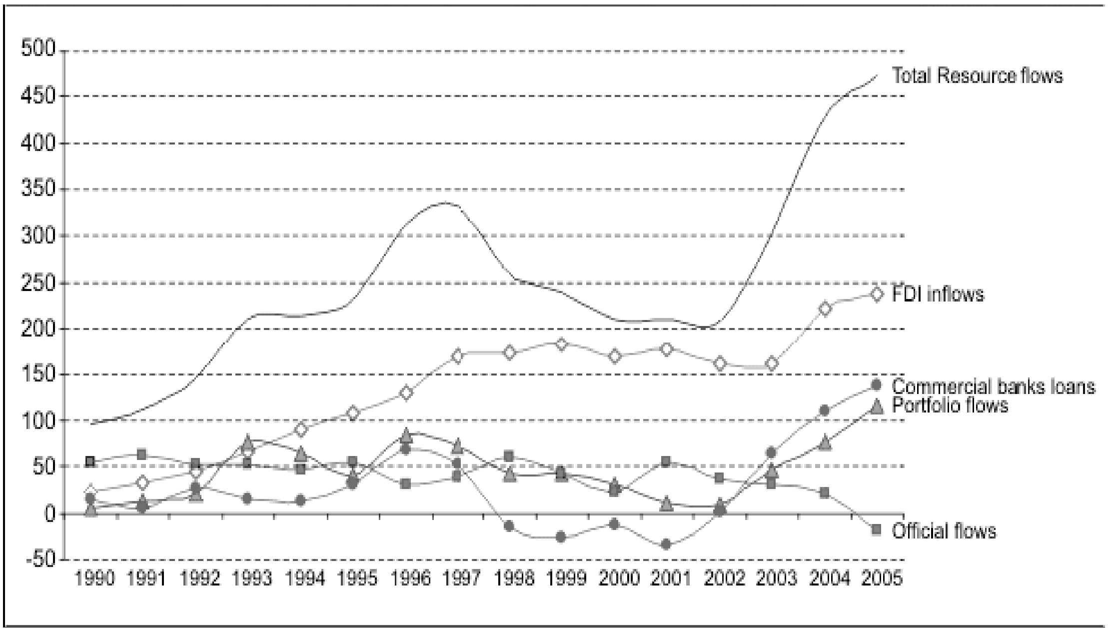

Fig. 2 Total net resource flows to developing countries, by type of flow, 1990-2005 (Billions of dollars)
Source: UNCTAD Handbook of Statistics, 2006:5, based on World Bank 2006.

FDI Flows in Recent Period

The increase in FDI flows in the world was substantial in 2005. Flows rose by 29 percent to reach $916 billion, having already increased by 27 percent in 2004.[10]

Although FDI increases continuously during the last decade its growth is unevenly distributed between the economic regions of the world. FDI inflows are dominated by the developed countries. After three years of decline, due to slow-moving growth between 2000 and 2003, inward FDI in developed countries started to increase. FDI inflows into developed countries rose by 37 percent to $542 billion. In percentage terms, the share of developed countries increased, to 59 percent of global inward FDI. Of this, $422 billion went to the 25-member EU. The United Kingdom – the largest single recipient of global FDI – received $165 billion. Other major FDI recipients that registered significant increases in their FDI inflows, included France ($64 billion), the Netherlands ($44 billion) and Canada ($34 billion). Inflows into the United States amounted to $99 billion, a significant decline from 2004.[11]

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[10] UNCTAD, *World Investment Report, FDI from Developing and Transition Economies: Implications for Development* (Geneva: UNCTAD, 2006), p.1.

[11]Services gained the most from the surge of FDI, particularly finance, telecommunications and real estate. The predominance of services in cross border investments is not new. What *is* new is the further and sharp decline in the share of manufacturing. Cross-border Mergers and Acquisitions, especially those involving companies in developed countries, have spurred the recent increases in FDI. The value of cross-border M&As rose by 88 percent over 2004,

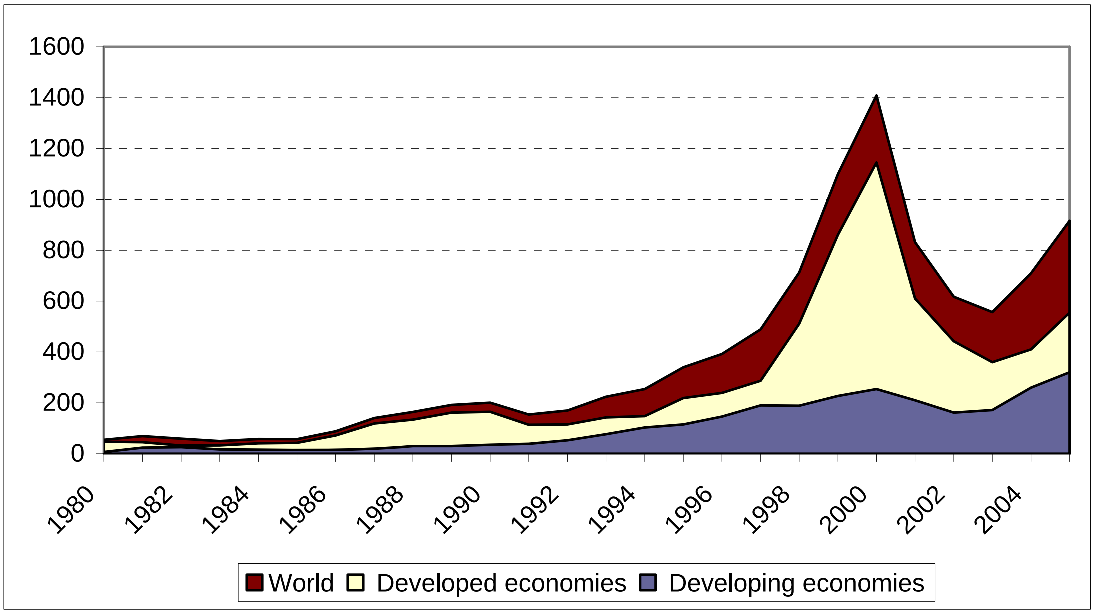

Fig. 3 FDI inflows in US Dollars at current prices in billions.
Source: UNCTAD, 2006.

On the other hand, FDI inflow to developing countries rose to the highest level ever recorded; $334 billion. Growth in 2005 was broad-based geographically as in the previous year, but higher in developed than in developing countries. Thus, despite record inflows into developing countries, the share of developing countries in the world FDI inflows fell slightly to 36 percent.

Although the share of FDI increases in both developed and developing countries, there is a massive variation in FDI performance across countries. In other words, not all regions receive the same amount of FDI. South, East and South-East Asia are the main magnets for inflows to developing countries. FDI inflows into these regions reached $165 billion in 2005, corresponding to 18 percent of world inflows. About two-thirds went to two economies: China ($72 billion) and Hong Kong,

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to $716 billion, and the number of deals rose by 20 percent, to 6,134. UNCTAD, *World Investment Report*, 2006, pp.2-10.

China ($36 billion). The South-East Asian sub-region received $37 billion, led by Singapore ($20 billion) and followed by Indonesia ($5 billion), Malaysia and Thailand ($4 billion each). Inflows to South Asia were much lower ($10 billion), though they grew significantly in several countries, with the highest level ever for India of $7 billion.[12]

FDI inflows into the 14 economies of West Asia soared by 85 percent, the highest rate in the developing world in 2005, to reach a total increase of about $34 billion.[13]

Latin America and the Caribbean saw inflows of $104 billion, representing a small rise over 2004. Excluding the offshore financial centers, inflows increased by 12 percent, to reach $67 billion in 2005.

FDI flows to South-East Europe and the CIS in 2005 remained at a relatively high level ($40 billion), increasing only slightly over the previous year. Inflows were fairly concentrated: three countries – the Russian Federation, Ukraine and Romania, in that order – accounted for close to three-quarters of the total. The countries of the region have different policy priorities related to inward and outward FDI,

[12] Over half of the inflows to the region came from developing home economies, mostly within the region. The figures for inward stock show significant growth in the share of these sources over the past decade, from about 44 percent in 1995 to about 65 percent in 2004, with a corresponding decline in the share of developed-country sources. UNCTAD, *World Investment Report*, 2006.

[13] Manufacturing FDI has been increasingly attracted to South, East and South-East Asia, although specific locations have changed as countries have moved up the value chain. The sector continues to attract large inflows, especially in the automotive, electronics, steel and petrochemical industries. There is, however, a shift towards services in the region, in particular banking, telecommunications and real estate.UNCTAD, *World Investment Report*, 2006.

reflecting their varying economic structures and institutional environments.

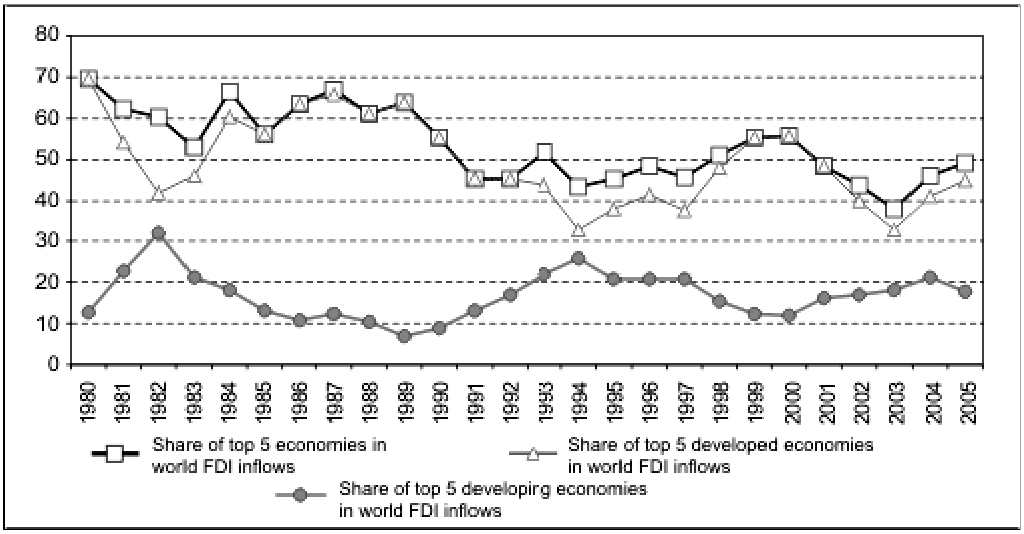

Fig. 4 Concentration of FDI inflows: the share of the top 5 FDI recipients in the world total, 1980-2005 (Per cent).
Source: UNCTAD, World Development Report, 2006, p.4.

As seen in Figure 4, FDI flows are unevenly distributed among countries in the world. The share of developed countries has remained between 60 and 75 percent, in general, while the share of developing countries has remained between 15 and 35 percent for more than 30 years. In addition, the share of top five economies in the world FDI inflows was 70 percent in 1980 and it was 50 percent in 2005. Five developing economies attracted nearly 20 percent of FDI flows in 2005. Plus, it should be mentioned that the amount of FDI for the remaining developing countries was not evenly distributed. Therefore asking the question, “Why do developing economies attract FDI unevenly?” seems reasonable.

Before answering the question by giving details about the empiric results of econometric model and questionnaire survey, to propose a theoretical framework is crucial. In the next chapter, theories of the determinants of FDI and the effects of FDI on host economies are discussed. After a brief survey of mainstream theoretical approaches, institutional variables are introduced to the model.

CHAPTER 3

DETERMINANTS OF FOREIGN DIRECT INVESTMENT: THEORETICAL FRAMEWORK

Concepts, Definitions

This dissertation focuses on one of the most stable of the international capital flows, Foreign Direct Investment (FDI). According to one of the oldest definitions of Foreign Direct Investment, by Kindleberger, FDI is referred to as long-term capital flow and differs from portfolio investment by taking place in kind, through the exchange of property (patents, technology or machinery) and by acquiring control of a company.[14] It also differs from other kinds of international capital movements in that direct investment proceeds by the reinvestment of profits and accompanied by varying degrees of control, plus technology and management.[15]

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[14] Charles Kindleberger, *American Investment Abroad* (New Haven: Yale University Press, 1969), p.2.

[15] However, some definitions put more emphasis on the "control" factor. OECD recommends that a direct investment enterprise be defined as an incorporated or unincorporated enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise….An effective voice in the management, as evidenced by an ownership of at least 10 percent, implies that the

Investing abroad by MNCs constructing subsidiaries called "Greenfield Investment", whereas, these firms may also invest abroad, a common form in developed countries, by investing in established firms, through mergers and acquisitions, or through privatization programs (called as Brownfield Investment). Several developing economies have received this form of FDI due to the privatization programs took place especially after 1980.

The motives for investing abroad either by establishing a new corporation or investing in established firms have received remarkable attention from scholars. Their main concern is answering the question: What explains patterns of FDI flows across the globe?

Determinants of Foreign Direct Investment

FDI remains a firm-level decision, but countries have differed in their abilities to attract it. In order to understand the reasons why countries attract different amounts of FDI, a brief overview of the existing literature on the determinants of FDI will be examined.

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direct investor is able to influence, or participate in the management of an enterprise; it does not require absolute control by the foreign investor" (OECD, (Organization for Economic Cooperation and Development); *OECD Benchmark Definition of Foreign Direct Investment*, 3d Edition (Paris: OECD, 1996), p.8. For a detail study about definitions of FDI, see R. E. Lipsey, "Foreign Direct Investment and the Operations of Multinational Firms: Concepts, History and Data. *Working Paper 8665 National Bureau of Economic Research* 1050 Massachusetts Avenue Cambridge:NBER, MA 02138 (December 2001).

The existing literature on the determinants of FDI, which I call the "mainstream approach to FDI" focuses on the economic determinants, and ignores, or underestimates, the role of political, economic and social institutions as determinants of FDI. I argue that institutions play an important role in attracting higher levels of FDI inflow to the host country and in this dissertation the role of institutions is integrated to the mainstream theories of FDI.

The literature on determinants of FDI is very new. The early writings on FDI go back only to the 1950s. Until the 1960s, except for a few works by political economists, there was no systematic explanation of, model of or theory on FDI activities. Foreign investment was recognized as a part of international trade activities, and generally explained by trade theories.[16]

After the Second World War, as FDI flows increased significantly, studies on determinants of Foreign Direct Investment increased. Stephen Herbert Hymer made the first theoretical approach.[17] He was one of the first scholars to separate FDI from portfolio investment and initiated a new literature on the determinants of FDI.

Hymer, first, asserted that FDI took place not because of

[16]In the nineteenth century some political economists investigated the nature of foreign investment. However, their main concern was the functioning and the future of capitalism rather than generating a theory of FDI. See V.I. Lenin, *Imperialism: The Highest Stage of Capitalism* (New York: International Publishers,1977), pp.63-88. J.A. Hobson, *Imperialism: a Study* (Ann Arbor: University of Michigan Press,1965).

[17] Stephen H. Hymer, *The Theory of International Operations* (Cambridge, MA: MIT press, 1976).

a higher marginal rate of return in perfect capital markets as the neoclassical economists assume but because the corporation making the investment possessed some special skill or techniques not available to local entrepreneurs that it could exploit only though direct ownership. In his doctorate dissertation, he mentioned that the monopolistic advantages such as technology or product differentiation that corporations have enable them to compete in markets around the world.[18]

Through 1960 and 1970 new theories of FDI were introduced. Vernon used the product life cycle approach, which is based on the existence of market imperfections across nations, to develop a theory of foreign direct investment.[19] Later, Caves argued that monopolistic advantages, which are created by both advertising and research and development investments, characterize not just specific firms but rather firms within oligopolistic industries.[20] Knickerbocker showed evidence that the timing of U.S. MNCs' FDI is largely determined by their oligopolistic reaction "follow the leader" theory to competitors' investment.[21] While industrial organization models were the dominant line in studying FDI until the 1970s, a new theory, called "internationalization theory," was proposed to

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[18] Ibid; pp.34-38.

[19] Raymond Vernon, "International Investment and International Trade in the Product Cycle", *Quarterly Journal of Economics* (May, 1966),p.191.

[20] R. E. Caves, "International Corporations: The Industrial Economies of Foreign Investment". *Economica* (February, 1971), pp. 1-27.

[21] F.T. Knickerbocker, *Oligopolistic Reaction and Multinational Enterprise* (Boston: Harvard University, 1973).

explain how firms are involved in international operations and make resource commitments to foreign markets. The term "internationalization" is used to describe an evolutionary process in which the firm gradually increases its international involvement.

In the 1970s, Dunning's eclectic paradigm dominated the literature. Dunning introduced the concept of "OLI" as a theoretical framework to analyze the determinants of FDI. This framework considers FDI as determined by Ownership, Location and Internalization advantages of firms investing abroad.[22] The ownership advantage refers to a product or a production process to which local firms do not have access. It could refer to a patent or an intangible advantage like a reputation for quality. The location advantage comes directly from the foreign market, such as low factor prices or consumer access, along with trade barriers or transport costs, which makes FDI more profitable than exporting. Finally, the internalization advantage is a concept that explains why a firm prefers investing rather than licensing.[23] The internalization advantage implies that since markets for intermediate products are difficult to organize, these transactions can be handled more efficiently within the firm by an internal hierarchy rather than by the external market.[24] When market transaction

[22] J. H Dunning, *Studies in International Investment* (London: George Allen & Unwin, Ltd.,1970).

[23] John H. Dunning, *International Production and the Multinational Enterprise* (London: Allen and Unwin, 1981).

[24] P. Buckley and M. Casson, *The Future of the Multinational Enterprise* (London and Bsingstoke: Mcmillan, 1976).

costs exceed the governance costs of a hierarchical structure, the firm will expand to absorb the transaction in the foreign market.[25]

The OLI paradigm has remained the center of FDI theory and other scholars have expanded on this framework.

More recently, the motives of FDI have been examined in two categories. In this view a firm realizes the investment to better serve the local market or to get lower-cost inputs, or both. In other words, FDI can be divided into "horizontal" or "market-seeking" FDI, and "vertical" or "efficiency seeking" FDI.[26]

The first involves building plants in a host country to supply the local market. This approach is done to reduce the costs that arise from supplying the market through exporting, in which case, market size and high tariffs play a large role in determining profitability. The latter category of vertical FDI is production cost-minimizing, where firms seek to produce in lower cost locations or seek inexpensive inputs in order to export their product. Inexpensive inputs include natural resources, raw materials, or low-cost inputs such as labor. Finally, Asset Seeking FDI is the most recent motive for FDI to be identified. It refers to a strategy that aims to access and exploit technological assets in overseas countries. Developed countries are the main recipients for R&D

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[25] John H. Dunning, "Trade, Location of Economic Activity and the MNE: A Search for an Eclectic Approach" in B. Ohlin, ed., *The International Allocation of Economic Activity* (London: Holmes and Meier, 1977), pp.395-418.

[26] C.A. Michalet "Strategies of Multinationals and Competition for Foreign Direct Investment" *Foreign Investment Advisory Service, Occasional Paper* no.10 (Washington: The World Bank,1997). pp. 12-15.

investment, but countries such as Hungary, Czech Republic, India and Brazil are also attracting more and more Research and Development projects. Asset seeking MNCs focus on the skilled labor availability, research institutes, large supply of graduate labor, created assets including innovative capacity, technological adoption, and technical skills when choosing an investing location.

The differentiation between the first two is that market-seeking FDI aims at penetrating the local markets of the host country, whereas efficiency-seeking FDI is interested in creating new sources of competitiveness for firms.[27]

In various studies, the size of host country markets is the most popular explanation for FDI. The types of market-size variables include: Gross Domestic Product (GDP), GDP per capita, GDP growth and population as seen in studies by Agarwal, Wheeler and Mody, Chakrabarti.[28] While Singh and Jun find that export orientation is one of the strongest explanatory variables, Chakrabarti found that openness to trade was the strongest variable affecting FDI.[29] Nunnenkamp

[27] For a detailed study see J.R. Markusen "The Boundaries of Multinational Enterprises and the Theory of International Trade", *Journal of Economic Perspectives*, Vol.9, Spring (1995); S. L. Brainard, "An Empirical Assessment of Proximity –Concentration Trade-Off Between Multinational Sales and Trade", *NBER, Working Papers,* no. 4580(1993).

[28] J. P. Agarwal, "Determinants of Foreign Direct Investment: A Survey". *Welwirtschaftliches Archiv* no.116(1980),pp.739-773; D. Wheeler and A. Mody, "International Investment Location Decisions: The Case of U.S. Firms", *Journal of International Economics*, 33, no. 1 (1992), pp. 57-76; A. Chakrabarti, "The Determinants of Foreign Direct Investment: Sensitivity Analyses of Cross-Country Regressions", *Kyklos*, 54, no. 1 (2001), pp. 89-113.

[29] K. Jun and H. Singh, "The Determinants of Foreign Direct Investment in Developing Countries", *Transnational Corporations*, 5, no. 2 (1996), pp. 67-105.

found that the traditional determinants (GDP per capita, GDP growth, population, administration, entry restrictions and risk factors) remain the dominant factors shaping the distribution of FDI.[30] The non-traditional determinants (cost factors, taxes, factors of production, sufficiently qualified labor and openness to trade) also affect FDI but not as much as the traditional determinants. Studies done by Markusen and Venables begin with the observation that most FDI is motivated by "market-access" reasons.[31]

Business Theories of FDI

In addition to economic theories of FDI, business theories of FDI have been developed by scholars, most of them from business schools. They discuss that while profit maximization is the most important motive taken into consideration during the process of making an investment decision, it is not the only motive. The growth of a firm, penetration into a new market, market size, matching or forestalling a competitor's move, minimum levels of risk and uncertainty, financial regulations of the host country, foreign exchange for repatriation, and availability of cheap labor are as important as the profit motive when considering

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[30] P. Nunnenkamp "Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game?" Kiel Institute for World Economics Duesternbrooker Weg 120 24105 Kiel (Germany) *Kiel Working Paper* no. 1122 (2002).

[31] J.R. Markusen and A.J. Venables, 'Foreign Direct Investment as a Catalyst for Industrial Development', *European Economic Review*, 43, no.2 (1999), pp. 335-56.

investment abroad. They have reached conclusions through the use of questionnaires conducted with firms doing business abroad.[32]

In sum, these theories argue as the firm grows, it continues to grow abroad. Plus, the costs of overseas investment encourage firms to go abroad if these firms have specific advantages over local competitors, such as access to finance, technology, product differentiation, marketing capabilities, managerial skills, and economies of scale.

The Effects of FDI on Host Economies

In the literature the numbers of studies mentioning the positive contributions of FDI have been increasing. These studies state that the positive effects of FDI will lead to higher levels of economic growth.

Although a growing consensus suggests that FDI flows have positive effects on the national economy, there are also studies mentioning the negative affects of MNCs on host economies.

In this study I do not explore the positive or negative impacts of FDI for developing countries. Rather, my focus is on the effect of institutions on FDI. Therefore, without going into detail, a brief survey of the effects of FDI on host economies is presented here.

[32] For some of the studies relying on questionnaire surveys, see J. C. Schreiber, *US Corporate Investment in Taiwan* (New York: The Dunellen Company, 1970); Y. Aharoni, *The Foreign Direct Investment Decision Process* (Boston: Harvard University, Graduate School of Business Administration, 1966); E.T. Penrose "Foreign Investment and the Growth of the Firm", *Economic Journal*, no.66 (June 1956), pp. 220-235.

The debates around the effects of FDI on host economies dominated literature in developing countries, especially in the 1970s. In these countries, the main discussion was whether FDI just exploits the country's resources or has a positive effect on the economy.

In specific studies on the effects of FDI are divided into three main branches including the neoclassical school, the dependency school (and the World System approach) and finally bargaining literature.

The neoclassical school examines the welfare costs and benefits of FDI and emphasizes that the economic benefits of FDI are more relevant than the economic costs of FDI. Scholars studying the impact of MNCs argue that FDI can have positive impacts on domestic economies. For instance, Lall argued that FDI is important for development because it results in the transfer of technology and knowledge, the creation of jobs, boosting productivity and enhancing competitiveness and entrepreneurship.[33] Graham and Krugman, in the article "Economic Impact", argued that the benefits of FDI can be categorized in two groups: the facilitation of trade in goods and services, and external benefits.[34] In some cases, transaction costs may be reduced when international trade takes the form of FDI and FDI facilitates trade in goods, services and knowledge. The most frequently cited external

[33] S. Lall, *Foreign Investment, Transnationals and Developing Countries* (London: Macmillan, 1977).

[34] E. M. Graham and Paul R. Krugman, "Economic Impact" in *Foreign Direct Investment in the United States*, Second Edition (Washington DC: Institute for International Economics, 1989), pp. 28-29.

benefit is the introduction of new technology. [35] In this view, new technology includes not only science-based production but also management skills to the host country.[36]

The dependency school leads the second approach studying the relationship between FDI and the host country. Dependency theorists have long argued that FDI causes serious negative political and economic consequences. In this view, FDI affects the very political, social and economic structure of the host country, weakening the country and its development as a result of increasing dependency on FDI.[37] Furthermore, the dependency school argues that the benefits of foreign investment are unequally distributed between the MNC and the host country and MNCs employ capital incentive technologies when they move in, adding to the host country's rate of unemployment and worsening the distribution of income.[38]

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[35] For empirical studies attempt to examine the actual role of FDI in technology transfer, see R. Barrell, and N. Pain. "Foreign Direct Investment, Technological Change, and economic growth Within Europe", *Economic Journa*l, no. 107(1997), pp. 1770-1776. Markusen, pp.169-189.

[36] However, the technological progress brought by FDI is generally assumed to be beneficial by definition, and this is true in general only to the extent that technical progress is a free good. Therefore, the return on the technology should not be absorbed only by foreign companies, if so the only benefit of the country would be revenues from the taxation of the earnings of technological capital. See: H. G. Johnson, "The Efficiency and Welfare Implications of the International Corporations", in Charles Kindleberger (ed), *The International Corporation* (Cambridge MA: MIT Pres, 1970), pp. 44-45.

[37] T. D. Santos. "The Structure of Dependence," *American Economic Review* (May, 1970). pp.231-234.

[38] C. Chase-Dunn,"The Effects of International Economic Dependence on Development and Inequality: A Cross-National Study," *American Sociological Review*, 40(December 1975), p. 720; H. W. Singer and Javeda A. Ansari. *Rich and Poor Countries* (London: Boston: Unwin Hyman, 1992), pp. 241-244.

The effect of foreign investment on the balance of payments has also been an area of research and debate. Especially in the 1970s, some scholars claimed that MNCs exhaust surplus from developing countries and, according to their view, profit repatriation can easily exceed the total value of the original investment.[39] Some scholars such as Evans go further and argue that MNCs also distort the host country political processes by collaborating with local elites, by using their influence in their home countries to keep host government in line.[40] Gereffi argues that, even worse, these MNCs also preempt the development of local industries and firms.[41]

In the 1970s, some scholars examined the effects of MNCs from a bargaining approach perspective. The approach holds that the relative power of MNCs and host governments is a function of the conditions of the firm, industry and the country involved. The main question here is to determine who gets the benefits after the investment takes place. At first, when a firm controls something that a government wants, the firm's power would be improved in any bargaining process between the parties. Over time, the bargaining power relationship can shift to "obsolescing bargain," which refers

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[39] Dos Santos, p. 234.

[40] P. B. Evans, *Dependent Development: The Alliance of Multinational, State, and Local Capital in Brazil* (Princeton, N.J.: Princeton University Press.,1979); T. H. Moran, "Multinational Corporations and Dependency: A Dialoge for Dependentistas and Non Dependentistas" *International Organization* 32, no.1 (Winter 1978) pp. 80-94.

[41] Gary Gereffi, *The Pharmaceutical Industry and Dependency in the Third World* (New Jersey: Princeton University Press, 1983).

to the decline of the power of a firm when it has heavily invested in the host country.[42]

In the early interactions, the balance of power and benefits often favor the MNCs. Although the developing country controls access to its markets, the enterprise has more important bargaining assets through its control of capital, technology and managerial skills. Finally, after the MNC invests in the host country, the host country starts to gain the bargaining power; it forces the balance of benefits to shift in its favor in specific industries.[43]

However, the host country may be in difficulty gaining power in all fields. For instance, in the 1970s, although governments in Brazil were successful at directing the MNCs to the manufacture sector because of their control over the access to the markets and resources, they did not gain the same success when trying to direct MNCs in the pharmacy sector; the MNCs bargaining power was stronger than the bargaining power of the Brazilian governments in the pharmaceutical sector.[44]

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[42] Vernon, pp. 96-104.

[43] The MNCs bargaining power relies on; technology, managerial skills, capital and access to markets. Host country bargaining power relies on; market size, rate of growth, access to raw materials, transportation and communication. For a detailed study see J. M. Grieco, "Between Dependency and Autonomy: India's Experience with the International Computer Industry" *International Organization* 36, no.3 (Summer, 1982), p.610.

[44] Dependency school argues that what bargaining that does take place is over marginal issues, and sees very little chance of developing countries' being able to try to attain fundamentally greater control over MNCs operating in their economies. See Peter Evans, *Dependent Development: The Alliance of Multinational, State, and Local Capital in Brazil* (New Jersey: Princeton University Press, 1979); Gereffi; Stephen J. Kobrin, "Testing the Bargaining Hypothesis in the

I argue that MNCs may provide important contributions to the global economy, in specific to the host economy if the right institutional environment exists. Therefore in the next chapter the role of institutions as determinants of FDI is examined.

Manufacturing Sector in Developing Countries", *International Organization* 41 no.4 (Autumn, 1987), pp.619-621.

CHAPTER 4

DETERMINANTS OF FOREIGN DIRECT INVESTMENT: THE ROLE OF INSTITUTIONS

An Overview

As seen in previous chapters, studies of FDI flows at the firm level focus on why and how firms decide to undertake direct investments abroad. These studies emphasize that firms as profit maximizing agents are motivated by exploiting their own advantages abroad, such as access to patented technology, specific management or marketing skills or ownership of brand names. This view is firm-level centered, yet, the role of social, political and economic institutions has rarely been treated. Analyses generally treat institutions as exogenous and there is little effort to understand why institutions vary across countries.

However, I believe that good institutions are supposed not only to attract FDI inflow but also have positive influence on development through the promotion of investment in general, which faces less uncertainty and higher expected rates of return.

This dissertation tries to empirically verify the argument that institutional factors such as enforcement mechanisms, political and economic stability, civil and political rights and corruption are critical in explaining the behavior of the foreign direct investment inflows in developing economies (and in case of the Turkish economy).

The Role of Institutions

Before giving details about the empiric study, first, the definitions and types of institutions should be mentioned. In this thesis I do not aim to provide a comprehensive list of studies in the New Institutionalist Economics literature. The focus is on identifying a set of key institutional variables that has an impact on FDI.

Here, after a brief explanation of institutions, I present a survey of literature examining the specific institutional variables and Foreign Direct Investment. Finally, I propose an econometric model examining the role of macroeconomic and institutional variables as determinants of Foreign Direct Investment in emerging economies for the period 1985 to 2004.

Institutions

A nation’s institutional framework is the most important factor determining its economic performance over time. Yet, in economic theory, the role of institutions has often been ignored completely.

The word "institution" has a variety of meanings in the institutional economics literature. In this thesis "institutions" are accepted as "the rules of the game" in a society which is defined by North:[45]

> Institutions are the rules, the regulations, (humanly devised constraints) that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions and codes of conduct), and formal rules (constitutions, laws, property rights).[46]

Institutions reduce the uncertainty involved in human interaction by giving us patterns for our behavior. In addition, institutions lead to a fall in both transaction and information costs by reducing uncertainty and establishing a therefore stable structure to facilitate interactions.[47]

North, unlike the neoclassical approach to economic growth, mentioned that differences in institutions are the fundamental explanation of comparative growth. This approach towards economic growth was fresh to the literature because economic growth literature was dominated by the neoclassical approach.

The first generation of the growth models tried to answer the question of why some countries are much poorer than others. These models R.F. Harrod, E.D. Domar, Solow, Swan,

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[45] Douglass. C North. Institutions, *Institutional Change, and Economic Performance* (New York: Cambridge University Press, 1990), p.3.

[46] Douglass C. North "Institutions" *The Journal of Economic Perspectives* 5; no. 1. (Winter, 1991), p.97.

[47] North,1990, p.3.

Cass and Koopmans explain differences in income per capita in terms of different paths of factor accumulation. In these models, cross-country differences in factor accumulation are due either to differences in saving rates, total factor productivity growth or other exogenous parameters.[48] Further studies improved growth models by mentioning the importance of research activities, human capital and government expenditures.[49]

The New Institutionalist approach introduced the role of institutions into the economic growth literature. The studies focused on the quality of domestic institutions as a key explanation of cross-country differences in growth rates and income per capita. In other words, the field of the New Institutional School suggests that differences in institutions are the fundamental explanation of comparative growth.[50] Recent studies put emphasis on the importance of institutions as

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[48] R. F. Harrod, " An Essay in Dynamic Theory", *Economic Journal,* 59 (March, 1939); R. Solow, "A Contribution to the Theory of Economic Growth", *Quarterly Journal of Economics* 70, no.1, (1956), pp. 65-94; E. D. Domar, "Capital Expansion, Rate Of Growth And Employment", *E.M* 14 (1946); D. Cass, "Optimum Growth in an Aggregate Model of Capital Accumulation," *Review of Economic Studies*, no.32(1965), pp.233-240; T. W. Swan, "Economic Growth And Capital Accumulation", *Economic Review 32*, (1956); T. C. Koopmans, "On the Concept of Optimal Economic Growth," in *The Economic Approach to Development Planning*, (Amsterdam: North-Holland, 1965).

[49] P.M. Romer, "Increasing Returns and Long Run Growth"*, Journal of Political Economy*, 94, no.5(1986), pp. 1002-1037; R. Lucas, "On the Mechanics of Economic Development", *Journal of Monetary Economics*, 22, no.1(1988) pp. 3-42; R. J. Barro, "Government Spending in a Simple Model of Endogenous Growth", *Journal of Political Economy*, no.98(1990), pp. 103-125.

[50] Douglass C. North, and and Robert P. Thomas, *the Rise of the Western World: A New Economic History* (Cambridge UK: Cambridge University Press, 1973).

determination of growth.[51]

According to North:

> The formal economic constraints or property rights are specified and enforced by political institutions, and the literature simply takes those as a given. But economic history is overwhelmingly a story of economies that failed to produce a set of economic rules of the game that induce sustained economic growth. The central issue of economic history and of economic development is to account for the evolution of political and economic institutions that create an economic environment that induces increasing productivity.[52]

Types of Institutions

New Institutional Economics (NIE) suggests that institutions do three main things important to markets: they reduce transactions costs from inadequate information (arising from informational asymmetries and the administrative costs of reducing informational asymmetries); define and enforce property rights; and determine the degree of competition by defining the terms of market entry.[53]

Institutions can be economic, political or social in nature. Tax laws are generally economic institutions, though they have social elements as well, especially in regards to income distribution. Laws that govern the election of presidents or prime ministers are political institutions. Laws that create and govern crime and punishment are social

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[51] D. Acemoğlu, S. Johnson and J. Robinson "Institutions as the Fundamental Cause of Long-Run Growth" (2005).

[52] North, 1990, p.98.

[53] In the New Institutional Economics most scholars accept market as a social institution, which facilitates exchange whereas neoclassical economics define market as the interaction between supply and demand to determine the equilibrium market price. See R. H. Coase "The Nature of the Firm: Origin" *Journal of Law, Economics, & Organization*, Vol. 4, no. 1 (Spring, 1988), pp. 3-17.

institutions. All of these types of institutions are important. In fact, a country's political institutions often dictate how other institutions are created.[54]

Economic institutions determine the "economic rules of the game"–in particular, the degree of property rights enforcement, the set of contracts that can be written and enforced, and some of the rules and regulations that determine the economic opportunities open to agents (individual property rights, commercial law, contract law, patent law, the type of credit arrangements, etc.). Economic institutions matter for economic growth because they shape the incentives of the key economic actors in society; in particular, they influence investments in physical and human capital and technology, and the organization of production.

Political institutions help to regulate the limits of political power and determine how political power changes hands (constitution, electoral rules, the number of veto players, etc).

The institutional framework has three components: formal rules, informal rules, and enforcement mechanisms. Formal rules are the written rules of a society. Laws governing contracts, crime, political systems, product information, the imposition of tariffs or quotas, the regulation of banks, and so on are all formal institutions.[55] Formal rules can be created by firms as well as governments.

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[54] North, 1990, p.48.

[55] North,1990, pp. 36-61.

Informal rules are the unwritten rules of a society. These include culture, norms of behavior, codes of conduct, and so on. Citizens of a country grow up learning all kinds of unwritten norms and attitudes and informal rules differ across nations (for example, meal times are often set by custom).

The third component of the institutional framework is enforcement. Institutions often are ineffective if they are not enforced. For example, a nation can have antitrust laws that prevent firms from becoming monopolies, but if the government does not enforce such laws, businesses may act as if the antitrust law did not exist. Some institutions are self enforcing (for example, driving on the right side of the road when no police are in sight). Enforcement is not an all-or-nothing phenomenon. Countries may enforce laws strongly, marginally, or not at all. Enforcement is an integral part of a nation's institutional framework and may be the single most important element in explaining differences in economic performance.[56]

One of the important impacts of institutions on markets is that institutions reduce transactions costs from inadequate information. Transaction costs are the costs of negotiating, measuring, and enforcing exchanges.[57] In his well-known

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[56] North, 1990, pp. 54-61.

[57] Transaction costs theorem first examined in the article by Ronald Coase. The theorem is also known as Coase Theorem. Especially in the 1970s the role of transaction costs on MNCs mentioned took place in several studies in the FDI literature. See R. H. Coase, "The Nature of the Firm," *Economica*, no. 3 (1937), pp.386-405; R. H. Coase "The Problem of Social Cost," *Journal of Law and Economics*, no. 3(1960), pp.1-44.

article, Ronald Coase mentioned that neoclassical economic theory assumes that the process of exchange is costless. The costless-exchange assumption was implicit in economic models, which means all exchanges are made in the context of good information with no possibility of one party's not honoring the agreement.[58] However, Coase emphasized that this assumption rarely holds in the real world. Hence, negotiating an agreement can be a long and costly process. All sides to the exchange must bargain with one another even when they are in bitter position. In addition, transaction costs include the costs of enforcing exchanges. Once an agreement is reached, the parties to the agreement must honor their commitments. But there is always the chance that the other part will not do so. If there is no enforcement mechanism to penalize and deter contract breakers, then either side to an agreement can achieve short term gains by not fulfilling its part of agreement. Lack of enforcement makes the exchange much riskier.

I believe that institutions and transaction costs play important role in the economic performance of a country. In addition, the existence of an informal economy directly affects the functioning of institutions, therefore the economic performance of the country. In order to sustain high growth rates, to attract more FDI, developing countries should promote exchange by lowering transaction costs and encouraging trust; the state should protect private property rather than expropriate it.

[58] Coase, "The Nature of the Firm," pp. 386-387.

A good example of the role of institutions affecting the economic performance takes place in the East and Central European countries. The absence of institutions represents a serious problem for business, especially in transition economies with their heritage of a socialist system. With the dissolution of the planning system, at the start, there was a commonly shared belief that "free regulated markets", "laissez faire" would solve every problem. However, they lacked both the knowledge of how to use, establish the market mechanism.[59] Under such conditions, transaction costs were very high due to lack of information about local firms, regulatory frameworks, bureaucracy and the court system. In the following years, as political and institutional environment improved, the high transaction costs in transition economies have been reduced.[60]

I believe that the more strengthened the economic, political and social institutions are the higher the FDI inflow that country will receive. The stronger the political and social institutions in a country are, the higher the FDI inflow realized will be.

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[59] Karl Polanyi in the "Great Transformation" emphasizes the social construction of a market society in the nineteenth century. According to Polanyi, there was nothing natural about laissez faire; the free markets could never have come into being merely by allowing things to take their course. Laissez faire itself was enforced by the state. See Karl Polanyi, The Great Transformation, The Political and Economic Origins of Our Time (Boston: Beacon Press, 1957), p.13. Also see Peter Evans, *Embedded Autonomy States and Industrial Transformation* (Princeton: Princeton University Press,1995).

[60] K. E. Meyer, "Transition Economies" in A. Rugman and T. Brewer (eds.) *Oxford Handbook of International Business* (Oxford: Oxford University Press, 2001).

Arguments about the Effects of Some Institutional Variables

Corruption

Although many studies agree on the positive effects of institutional variables on FDI, the impact of some variables are open to question. In the international literature there is a debate on the impacts of some institutional variables on FDI. One of these variables is corruption.

The uneven distribution of FDI in developing countries may limit the potential for growth; therefore it is important to try to understand the reasons for that. One of the explanations for the low level of FDI flow is the high level of corruption in these countries. Corruption is defined by secrecy and illegality, the misuse of public power for private benefit and has variations across different economic activities[61]

Corruption within the political system is a threat to foreign investment by distorting the economic and financial environment, reducing the efficiency of the government and

[61] Corruption can affect every sector and level of the government, from the top executive, legislative and judicial branches down to regional and local officials. It is therefore a potential threat to all sectors and institutions within a country.

business by enabling people to assume positions of power through patronage rather than ability, and introducing inherent instability into the political process.[62] There are various studies demonstrating the harmful effects of corruption on economic growth and development. In addition, recently, various studies have been examining the effects of corruption on FDI.

However, there is a reliability problem with the corruption. Due to the lack of reliable data on corruption, testing the theories becomes difficult, though; the number of studies dealing with the issue by using various comparative methods has been increasing. In order to measure the level of corruption in a country, various international organizations such as the Political Risk Service (PRS), Transparency International (TI), the World Business Environment Survey (WBES) of the World Bank, the Global Competitiveness Report, and the Freedom House apply questionnaire surveys or other methods to a number of MNCs operating in host economies.[63] Using these data scholars examine the relationship among corruption and economic growth and FDI.

Corruption can affect FDI directly by tarnishing the

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[62] S. Wei,"Why is Corruption so Much More Taxing than Tax? Arbitrariness Kills" *NBER Working Paper* no. 6255 (1997).

[63] The measure for perception is a combination of various studies that evaluate how business people and the public in general view the level of corruption within a country. The countries measured are rated on a scale from 1-10, where 1 is very corrupt and 10 is the least corrupt. In an attempt to analyze the reliability of data on corruption, by comparing several indices Wei founded that similar results indicate that these measurements of corruption are fairly reliable. S.J. Wei, "How Taxing is Corruption on International Investors?" *Review of Economics and Statistics*, 82, no.1 (2000), pp. 1-11.

perception of the stability and quality of an investment potential. Foreign investors perceive corruption as an impediment to invest in the host country. Corruption is seen as an extra cost for operations.

However, the effect of corruption on economic growth, in specific, on FDI, has been subject to debate. Some argued that, bribes act as speed money and help avoid bureaucratic inefficiencies, plus, corruption is claimed to have a beneficial face which is known as the "greasing the wheel."[64] In other words, according to this view, corruption has harmful long-term effects, but it can "grease the wheels" of the economy in the short-term. Also, in cases of developing countries, where the government is inefficient, corruption may be the only way to encourage investment by offering alternative ways to conduct business.

However, over time, the empirical evidence of the negative effects of corruption has steadily increased. For instance, Paulo Mauro uses the Business International (BI) indices to argue that corruption does in fact hurt growth and investment. According to Mauro, corruption can affect FDI directly by ruining the perception of stability and quality of an investment potential. In other words, investors may not prefer to invest because of extra costs. In his study on 67 countries, he found that if a country could heighten the

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[64] N. Leff "Economic Development through Bureaucratic Corruption" *American Behavioral Scientist* (1964), pp.8-14. Huntington argued that a "rigid, over centralized dishonest bureaucracy" is better than a "rigid, over centralized, honest bureaucracy".See S. Huntington *Political Order in Changing Societies* (New Haven: Yale University Press, 1968).

efficiency of its administration and improve its corruption score from four out of ten to six out ten, the rate of investment would increase by three percent and the growth rate would increase by 0.5 percent.[65]

There are several studies examining the link between corruption and FDI. Habib and Zurawicki examine the impact of corruption on FDI. They examine the level of corruption and also look at the difference in the corruption level between the host and home country. Their analysis provides support for the negative impacts of both. The results suggest that foreign investors generally avoid corruption because it is considered wrong and it can create operational inefficiencies.[66] Wei, in his study, found a result that shows that corruption has a negative effect on FDI.[67]

Wheeler and Mody emphasize that corruption, an element of a composite index, had strong negative impact on MNCs operating abroad.[68] Gastanga, Nugent and Pashamova examine the relationship between political variables and found that low corruption levels affect FDI positively.[69] Smarynzka and Wei

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[65] P. Mauro, "The Effects of Corruption on Growth, Investment and Government Expenditures: A Country Analysis," in *Corruption and the Global Economy*. Ed. Kimberley Ann Eliot (Washington, D.C.:Institute for International Economics, 1997).

[66] M. Habib, and L. Zurawicki "Corruption and Foreign Direct Investment" *Journal of International Business Studies Studies* no.33, Second Quarter (2002).

[67] Wei, pp.1-11.

[68] D. Wheeler and A. Mody "International Investment Location Decisions: The Case of U.S. Firms", *Journal of International Economics,* no.33 (1992), pp.57-76.

[69] V. Gastanaga, Jeffrey Nugent and Bistra Pashamova, Host Country Reforms and FDI Inflows: How Much Difference Do They Make?, *World Development*, 26, no. 7 (1998), pp. 1299-1314.

argue that host country corruption induces foreign investors to favor joint ventures over wholly owned firms.[70]

One should be careful about generalizing the causes and effects of corruption among countries. Corruption can become very much a part of a country's life and the causes and effects can be seen in its history and society. Since there are different types of corruption, there are also different solutions.

The Effect of Democracy on FDI

Governments in developing countries, in order to attract FDI, aim to provide a climate more hospitable for foreign investors by altering patterns of domestic economic policy, and even by challenging the capacity for democratic government.[71]

Several scholars mention the importance of the impact of democracy on economic growth and FDI. For instance, Olson argued that ensuring property rights is a central element of economic development and these result in the growth of democracies at faster rates than authoritarian regimes in

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[70] S. J. Wei, and Y. Wu, "Negative Alchemy? Corruption, Composition of Capital Flows and Currency Crises," *National Bureau of Economic Research Working Paper* 8187, Cambridge, MA. (2001).

[71] N. M. Jensen, "Democratic Governance and Multinational Corporations: Political Regimes and Inflows of Foreign Direct Investment", *International Organization,* no.57 (Summer 2003), pp. 587-616.

which ensuring property rights are not credibly committed by autocrats.[72] In his book Jensen states that the overall effect of democratic institutions should be positive and democracies should be associated with higher inflows of FDI. He states that information, representation, and credibility in democracies make easier things for foreign investors.[73] In this way, foreign investors may find avenues to pursue favorable policies, either directly or indirectly. Foreign investors can lobby government officials directly for their preferred legislative outcomes in democracies, but not in autocracies. The difficulties of influencing policy in authoritarian regimes negatively affect overall FDI inflows.

Even more importantly, MNCs may find vested interests in the democratic systems already in place. A foreign MNC, once it sinks capital into a country, shares many of the same preferences as domestic producers. If these democratic systems take the domestic producers' interests into account, the government will provide legislation favorable to the domestic producers and foreign investors.[74]

However, the studies on the effects of democracy on macroeconomic performance and FDI are relatively divergent in the literature. Some studies question the contribution of democratic regimes on FDI. For instance, Jessup argues that

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[72] M. Olson, "Autocracy, Democracy and Prosperity", in *Strategy and Choice*, ed. R.J. Zeckhauser (Cambridge: MIT Press, 1991).

[73] N. M. Jensen, *Nation States and the Multinational Corporation, A Political Economy of Foreign Direct Investment* (New Jersey: Princeton University Press, 2006), pp.72-100.

[74] Ibid., p.79.

authoritarian regimes in developing countries attract more international development; Oneal states that authoritarian regimes provide investors with higher returns in developing countries which may affect the investment decision.[75]

According to these views, authoritarian regimes, in the bargaining process, may offer businesses the opportunity to influence policy decisions as well. In his study, Resnick analyzes how democratic transition affects FDI, and not considering the role of property rights independent of democratic institutions, he emphasizes that transition to democracy has a statistically significant negative effect on FDI[76]

On the other hand, more recently, Przeworski and Limongi argue that the relationship between democracy and economic growth is more complex than once thought.[77] In a statistical analysis Przeworski, Limongi, Alvarez and Cheibub find that there is no difference between the growth rates of democratic and authoritarian regimes.[78]

In his comprehensive work Jensen argues that democratic institutions have a significant impact on FDI. In his book he examines the relationship between FDI and democratic

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[75] J. R. Oneal, The Affinity of Foreign Investors for Authoritarian Regimes. *Political Research Quarterly* 47, no.3 (1999), pp.565-588.

[76] A. L. Resnick, "Investors, Turbulence, and Transition: Democratic Transition and Foreign Direct Investment in Nineteen Developing Countries" *International Interactions* 27, no.4 (2001), pp.381–398.

[77] A. Przeworski, and Fernando Limongi, "Political Regimes and Economic Growth." *The Journal of Economic Perspectives* 3, no.3 (1993), pp.51-69.

[78] A. Przeworski, M.E. Alvarez, J. A. Cheibub and F. Limongi, Democracy and Development: Political Institutionsand Material Well-Being in the World, 1950-1990 (Cambridge: Cambridge University Press, 2000).

institutions using a number of ordinary least squares (OLS) regressions. The first set of regressions relies on cross-sectional data for 80 countries on the determinants of FDI in the 1990s. These regressions reveal that democratic political institutions promote as much as 78 percent more FDI flows than authoritarian regimes.

In his book, a second set of regressions use panel data to explore the effects of democratic institutions on FDI inflows from 1970 to 1998 for over 100 countries. As with the cross-sectional results, regressions uncover that democratic institutions have a positive and statistically significant effect on FDI inflows. Moreover, these flows prove massive, with democratic institutions attracting almost 70 percent more FDI as a percentage of GDP.

In the third set of empirical tests, Jensen corrected for the selection bias in democratic institutions by using a treatment effects selection model. Democratic institutions in low-income countries seldom survive, collapsing into authoritarian regimes and leaving us with few observations of democracy in these low-income countries. Since these lower income countries often attract high levels of FDI as a percentage of GDP, the standard OLS regressions are biased against democratic institutions.

Using this selection model, Jensen found the regressions biased and the effects of democratic institutions on FDI vastly underestimated. The selection-corrected estimated of the effects of democracy emerge roughly three times larger than the OLS results. Democratic institutions positively affect FDI inflows even more than originally estimated.[79]

Scholars not only studied the effect of democracy and corruption on FDI inflows. There are several studies examining the role of other institutional variables as determinants of FDI. In the next chapter, the literature on FDI-institutions, the methodology of empiric studies will be mentioned in detail.

[79] Jensen, pp. 72-100.

CHAPTER 5

EMPIRICAL MODEL

Foreign Direct Investment in Developing Economies

The first empirical study in this dissertation includes panel-data regressions of 67 developing economies. Before introducing the definitions of variables and equations, the FDI performance of developing economies needs to be analyzed.

With the increasing globalization, changes in government policies in trade and investment environment facilitate FDI into these economies. Due to their growth performances and huge market sizes, many of these economies became attractive for many MNCs.

Nowadays, economies of many developing economies grows significantly, their industries are structurally changing and their markets are promising but volatile.

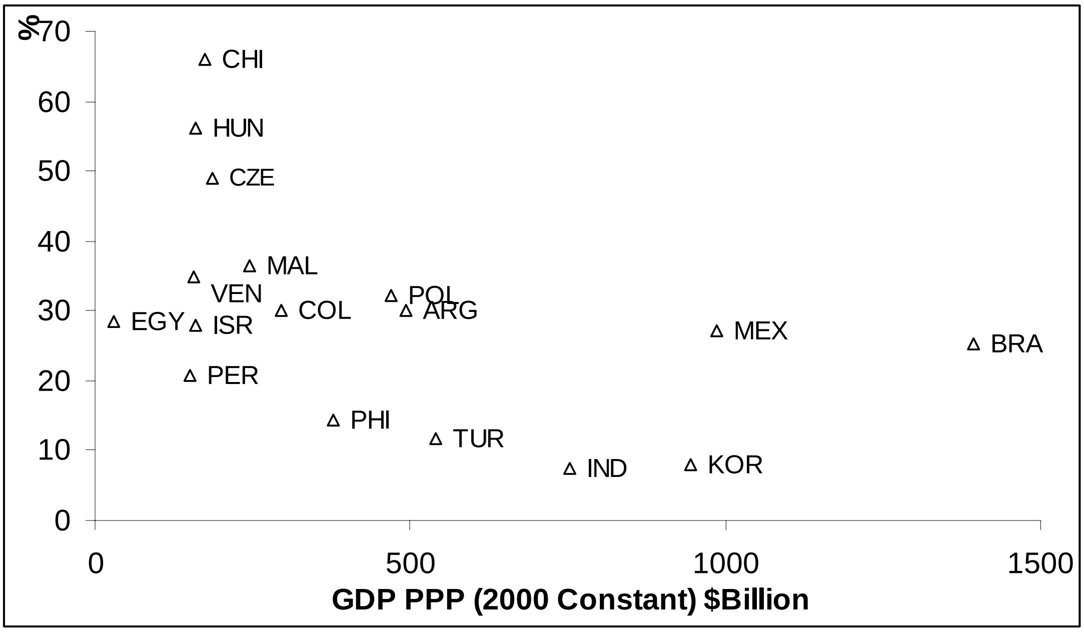

Fig. 5 FDI stock as percentage of GDP in selected developing economies - 2005.
Source: UNCTAD (2006), WDI (2006).

Comprising more than half of the world's population, many developing economies are often featured with strong market demand and high growth rates. The recent progress they have made in economic liberalization, especially after 1980 is noteworthy. In many of these countries the entry of MNCs is welcome as it represents an inflow of foreign savings into the country, supplementing domestic savings and directly increasing the level of investment.

However, the FDI performances of these countries vary. Figure 5 shows the FDI stock as percentage of GDP in some of the developing economies. Czech Republic, Hungary and Chile are the most successful countries receiving FDI stock over 50 percent of their GDP. On the other hand, Philippines, Turkey, Korea and India receive low level of FDI stock when compared to their market sizes.

The uneven distribution of FDI stock in these countries can be analyzed by taking into consideration that these economies are not homogeneous. The size of markets, economic growth rates and economic development stages vary among countries. Further, the stage of economic development, political, regulatory and legal regimes differ across emerging markets.

Some of these differences are seen clearly in the table 3. Several international institutions offer indices demonstrating the position of political, economic and financial risks as well as economic freedom, civil rights in these countries.

Table 3. Selected Developing Economies – Rankings - 2005

Countries	Market Size	Market Growth	Commercial Infrastructure	Economic Freedom	Country Risk	Overall Market Potential
HONG KONG	21	12	1	2	2	1
SINGAPORE	24	6	5	9	1	2
CHINA	1	3	14	24	11	3
S. KOREA	6	19	3	7	4	4
ISRAEL	22	13	4	6	6	5
HUNGARY	23	23	6	3	5	6
CZECH REP.	20	22	1	2	3	7
POLAND	11	14	7	4	8	8
INDIA	2	8	22	16	14	9
MEXICO	5	18	15	10	10	10
RUSSIA	3	21	9	23	15	11
THAILAND	13	5	16	12	12	12
MALAYSIA	17	2	13	17	9	13
CHILE	18	11	8	1	7	14
TURKEY	9	9	10	18	19	15
EGYPT	14	7	19	22	16	16
PERU	19	4	21	11	20	17
BRAZIL	4	15	12	13	17	18
INDONESIA	7	10	20	20	22	19
PHILLIPPINES	10	17	24	13	18	20
ARGENTINA	12	16	11	15	24	21
S. AFRICA	8	20	23	8	13	22
VENEZUELA	15	1	18	21	23	23
COLOMBIA	16	24	17	19	21	24

Source: Market Potential Indicators for Emerging Markets, Michigan State University Center for International Business Education and Research (2006).

In this context, the differences of the country performances attracting FDI can be explained with other variables such as differences in commercial infrastructures, economic freedom and country risk levels in these countries. Table 3 demonstrates interesting results; India, with a rank of 2 when market size is considered, stands at the rank of 9 when other variables economic freedom, country risk and commercial infrastructure are introduced into the list. When market size, market growth and commercial infrastructure are considered, Turkey stands at the rank of 9. Whereas, according to other facts such as economic risk and country risk, Turkey’s position falls to subsequently 18 and 19. At the end, Turkey’s overall market potential ranks 15. The economic freedom risk and country risk index lead a decrease at the position of Turkey’s overall market potential.

Table 4. Ranking Period 2001 - 2005

Countries	2005	2004	2003	2002	2001
HONG KONG ch.	1	1	1	1	3
SINGAPORE	2	2	2	2	1
CHINA	3	4	5	5	4
S.KOREA	4	3	3	3	2
ISRAEL	5	5	4	4	6
HUNGARY	6	6	6	6	8
CZECH REP.	7	7	7	7	5
POLAND	8	9	8	8	7
INDIA	9	8	9	10	8
MEXICO	10	11	10	11	12
RUSSIA	11	12	15	13	17
THAILAND	12	13	12	12	10
MALAYSIA	13	14	13	17	13
CHILE	14	10	11	9	14
TURKEY	15	15	14	14	18
EGYPT	16	16	19	21	-
PERU	17	21	18	18	-
BRAZIL	18	20	17	16	16
INDONESIA	19	17	16	22	19
PHILLIPPINES	20	18	20	19	15
ARGENTINA	21	19	23	15	11
S. AFRICA	22	22	21	20	20
VENEZUELA	23	24	22	23	21
COLOMBIA	24	23	24	24	-

Source: Market Potential Indicators for Emerging Markets, Michigan State University Center for International Business Education and Research (2006)

Since 2001 Hong Kong (China) dominated the rankings, followed by Singapore and China. Interestingly, Central and European countries, Poland, Czech Republic, and Hungary, also called economies in transition, are placed at the top of the list. On the other hand, Turkey, Brazil and Argentina rank lower scores, mostly not related to the market size, but to economic freedom and country risk indices.

Literature Survey

As mentioned before, there is a vast literature on the determinants of FDI. The empirical studies vary in terms of the variables, methodologies, the characteristics of FDI and the countries. The main variables affecting the FDI flows can be classified into two categories, market-oriented variables and institutional-oriented variables. The role of these variables on FDI flows into countries changes with the time and the conditions. In this study I constricted the empirical literature to the highest priority on studies focusing on institutional variables.

In the literature there are many empirical studies mentioning the importance of institutional variables. A number of studies mention that lack of political and economic stability, unclear regulatory frameworks, an inexperienced bureaucracy, an underdeveloped court system, and corruption deter more FDI inflows to host economies.

Empirical research on the impact of host country institutions on FDI has demonstrated that the general institutional, social and legal framework influences FDI. Nigh, Schneider and Frey, Wheeler and Mody show the relevance of political variables. Jun and Singh find that both "political risk" and "operations risk" significantly discourage FDI.[80]

An efficient legal infrastructure reduces institutional uncertainties for foreign investors, facilitates establishment and enforcement of contracts and in various other ways reduces the transaction costs in an economy. Prior research focused in particular on the impact of intellectual property rights protection on FDI, given the political sensitivity of this particular issue. Oxley and Smarzynska found that weak property rights inhibit FDI inflows.[81]

Habib and Zurawicki examine the impact of corruption on FDI.[82] They examine the level of corruption and also look at the difference in the corruption level between the host and home country. Their analysis provides support for the negative impacts of both. The results suggest that foreign investors generally avoid corruption because it is considered wrong and

[80] Wheeler, and Mody; Jun and Singh.

[81] J.E. Oxley, "Institutional Environment and the Mechanisms of Governance: The Impact of Intellectual Property Protection on the Structure of Inter-Firm Alliances," *Journal of Economic Behavior and Organization* 24 (1999), pp. 283-310; B.K. Smarzynska, "Composition of Foreign Direct Investment and Protection of Intellectual Property Rights in Transition Economies", *CEPR Working Paper no. 2228* (Centre for Economic Policy Research: London, 1999).

[82] M. Habib and L. Zurawicki, "Corruption and Foreign Direct Investment", *Journal of International Business Studies*, 33, no.2, Second Quarter (2002), pp. 291-307.

it can create operational inefficiencies. Wei found a result that shows that corruption has a negative effect on FDI. In addition, he mentions the weak enforcement mechanisms and political instability mean uncertainty for FDI and affects investment decision negatively.[83]

Wheeler and Mody examine American firms investing abroad and write that political risk factors, the functioning of the bureaucracy, corruption and judicial system have strong impact on these firms.[84] Using a time series analysis, Jun and Singh found that when political risk is high FDI affected negatively.[85] Gastanga, Nugent and Pashamova examine the relationship between political variables and found that high enforcement mechanisms, low corruption levels affect FDI positively.[86] Smarynzka and Wei argue that host country corruption induces foreign investors to favor joint ventures over wholly owned firms.[87] In his study Jensen examines the relationship between democratic rights and FDI and argues that a country which protects democratic rights receives more FDI than other countries. In other words, multinational firms prefer to invest in countries in which democratic rights are

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[83] Wei.

[84] Wheeler and Mody.

[85] Jun and Sing.

[86] V. Gastanaga, J. Nugent and B. Pashamova, "Host Country Reforms and FDI Inflows: How Much Difference Do They Make?", *World Development* 26, no. 7 (1998), pp. 1299-1314.

[87] B.K. Smarzynska, and S.J. Wei (2000), "Corruption and Composition of Foreign Direct Investment: Firm-Level Evidence," *NBER Working Paper 7969*.

under protected.[88] Maskus, studying the impact of intellectual property rights on FDI, finds that a one per cent increase in degree of patent protection in host economy raises US investment stock by 0.45 per cent.[89]

Ray and Nigel explore the relative importance of the host country's labor institutions and agglomerations using an industry-level panel data set on the location of investments by US multinational firms in Europe.[90] They report that centripetal and centrifugal forces are both important. They state that the removal of barriers to trade and capital mobility within the European Union has changed the permeability of national borders and hence the location advantages of member states and the Union as a whole. FDI has risen significantly in all the major European economies.

Firms and their activities have increasingly become multinational, with important implications for the design of national policies. Labor costs continue to affect investment locations, but so does the scope to benefit from agglomeration economies. Inward investments appear to have important effects on the economic performance of host economies.

They claim that both findings point to a need for a greater understanding of the role played by host country

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[88] M. Busse, "Transnational Corporations and Repression of Political Rights and Civil Liberties: An Empirical Analysis," *Kyklos*, 57, no. 1 (2004), pp. 45-66.

[89] K. E. Maskus, "Intellectual Property Rights and Foreign Direct Investment", *Policy Discussion Paper 22*, Centre for International Economic Studies, University of Adelaide (2000).

[90] B. Ray and, N. Pain "Domestic Institutions, Agglomerations and Foreign Direct Investment In Europe", *European Economic Review* 43 (1999).

institutions in attracting and implementing new ideas and technologies. The potential for agglomerations to attract new investments which then influence the growth process has important implications for national policies.

There is also a vast literature on the effects of human capital on FDI. The first group of studies rarely found a positive relationship between human capital and FDI. For instance, Root and Ahmed showed that among the 58 developing countries, none of their proxies for human capital (literacy, school enrolment, and the availability of technical and professional workers), were statistically significant determinants of inward FDI.[91] Schneider and Frey, using data for 54 developing countries, found the share of an age group with secondary education to be a less significant determinant as compared with other economic and political influences.[92] Hanson, using a sample of 105 developing countries, showed that the adult literacy rate was not an important determinant of FDI as compared with other socio-political variables.[93]

All these cross-country studies showed that human capital was not necessarily an important input for inward FDI. This conclusion is consistent with the fact that the period of the 1960s to 1970s was when FDI in developing countries was

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[91] F. Root and A. Ahmed, "Empirical Determinants of Manufacturing Direct Foreign Investment in Developing Countries", *Economic Development and Cultural Change* 27 (1979) pp. 751-767.

[92] F. Schneider, and B. Frey, "Economic and Political Determinants of Foreign Direct Investment", *World Development* 13 (1985), pp. 161-175.

[93] J.R. JR. Hanson, "Human Capital and Direct Investment in Poor Countries", *Explorations in Economic History* 33 (1996), pp. 86-106.

concentrated on market and resource seeking, rather than efficiency seeking were more important.[94] Thus, demand for higher-educated labor appears to have been less crucial during this period.

The second group of cross-country analyses including more recent data emphasizes the importance of human capital as a significant determinant of FDI. Noorbakhsh et al., using a dataset that covers the 1980s to the mid-1990s, empirically tested the hypothesis that the level of human capital in host countries may affect the geographical distribution of FDI. These empirical findings are: (a) human capital is a statistically significant determinant of FDI inflows; (b) human capital is one of the most important determinants; and (c) its importance has become increasingly greater through time.[95]

Nunnenkamp and Spatz report that efforts to provide better education and training would enhance the economic growth effects of FDI in developing countries.[96] The major difference in the results compared with the first group of studies, apart from the econometric precision, should come from the fact that they used a more recent dataset that

[94] J. H. Dunning, "Determinants of Foreign Direct Investment: Globalization Induced Changes and the Role of FDI Policies", Background Paper for the *Annual Bank Conference on Development Economics* held in Oslo, World Bank, Washington, D.C. (2002).

[95] F. Noorbakhsh, A. Paloni, and A. Youssef, "Human Capital And FDI Inflows To Developing Countries: New Empirical Evidence" *World Development* 29, no. 9 (2001), pp. 1593-1610; Dunning.

[96] Nunnenkamp, P. and J. Sspatz (2002), "Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game?", *Transnational Corporations* 2, no. 2 (August 2002).

contains relatively more high value-added manufacturing firms. Indeed most MNCs operating in developing countries during the late 1980s and 1990s tend to be efficiency-seeking and asset seeking types and/or subcontracting.[97] Hence, high skilled labor force is expected to be crucial.

In sum, it can be argued that cross-country evidence indicates that human capital is an important determinant for inward FDI especially among efficiency-seeking MNEs, while not being an important determinant among market or resource-seeking MNCs.

Nunnenkamp investigated whether the relative importance of traditional and nontraditional determinants of FDI in developing countries changed or not by making use of comprehensive survey data from the European Round Table of Industrialists, complemented by more conventional sources on investment conditions in 28 developing countries since the late 1980s.

He found that little has changed so far. He claimed that traditional market-related determinants are still the dominant factors shaping the distribution of FDI. If at all, the bias of foreign direct investors in favor of large host countries has become stronger, rather than weaker. Non-traditional determinants such as cost factors, complementary factors of production and openness to trade, though mostly revealing the expected correlation with FDI, have typically not become more important with the proceeding globalization.

[97] Dunning, "Changes in the Level and Structure of International Production: The Last One Hundred Years" in International Investment, ed. Peter J. Buckley, Aldershot, Hants, (England; Brookfield, Vt., USA: E. Elgar, 1990).

He claimed that this is not to say that policymakers can do little to improve the attractiveness of developing countries to FDI. The availability of local skills has become a relevant pull factor of FDI in the process of globalization.[98]

The governance indicators developed by Kaufmann, Kraay and Zoido-Lobatón were used to explore the role of institutional variables as determinants of the location of FDI. These indicators are constructed on the basis of information gathered through a wide variety of cross-country surveys as well as polls of experts, and are available for a large cross-section of countries. Each indicator represents a different dimension of governance: political voice and accountability, political instability, government effectiveness, regulatory burden, rule of law, and graft.[99]

Kinoshita and Campos examine the factors accounting for the geographical patterns of FDI inflows among 25 transition economies by utilizing panel data between 1990 and 1998. They classify the location determinants into three categories: the first is country-specific advantages such as low-cost labor, large domestic market, skilled labor force, adequate infrastructure, and proximity to the Western European markets. The second are institutions, macroeconomic policy and other

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[98] P. Nunnenkamp, "Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game?" *Kiel Institute for World Economics* Duesternbrooker Weg 120 24105 Kiel (Germany) *Kiel Working Paper* no. 1122 (2002).

[99] D. Kaufmann, A. Kraay, and P.Zoido-Lobaton, "Aggregating Governance Indicators", *Policy Research Paper* 2195, The World Bank (1999).

policies that facilitate business-operating conditions. The third is the persistent pattern of FDI driven by agglomeration economies.

Using the fixed effects and GMM models, they relate per capita FDI stock as a function of these three broad categories of variables. Their main finding is that the most important determinants of FDI location are institutions and agglomeration economies that override the importance of other economic variables. They also found that the region's FDI is motivated by the abundance of natural resources and labor cost. The poor quality of the bureaucracy is found to be a deterrent to foreign investors as they conceive it as a high transaction cost which directly affects profitability of their investment projects. A similar argument is made with respect to the rule of law, which was also found to be an important determinant of FDI in transition economies. Furthermore, foreign investors prefer transition countries that are more open to trade and with fewer restrictions on FDI as the destinations of their investment. They also found that progress on economic reform (external liberalization) plays a large role. Finally, institutions, agglomeration, abundance of natural resources and infrastructure are crucial factors for FDI.[100]

[100] Yuko Kinoshita and Nauro F. Campos, "Why Does FDI Go Where it Goes ? New Evidence from the Transition Economies", *Williamson Institute Working paper*, 573 (2003).

Li and Resnick offer a theory that synthesizes and extends the conflicting expectations in previous studies. How political institutions affect FDI inflows should mesh with why firms go abroad based on this premise. They derived a theory suggesting that democratic institutions affect FDI inflows both positively and negatively.

The empirical findings based on OLS with PCSE and a sample of 53 developing countries from 1982 to 1995 support their main argument that democratic institutions affect FDI inflows to developing countries via competing causal avenues. Increases in democracy yield improved property rights protection, which encourages FDI inflows Meanwhile, increases in democracy also reduce FDI received by this set of Late Developing Countries. They state that incremental improvements in property rights protection are likely to induce a more attractive environment for foreign direct investors without requiring wholesale restructuring of state-society relationships, for instance, attempts to increase bureaucratic competence or provide enhanced contract enforcement could go a long way toward setting a country apart from competitors for FDI.

Conversely, states that are unable to improve property rights protection may have to amend that weakness with more incentives in tax holidays, discounts on land purchases, or exclusive access to natural resources. Superior property rights provision may thus provide an avenue for attracting investors with less sacrifice of state resources, not to mention the benefits that other actors in the economy would enjoy under a system with clearer costs and incentives.

They claim that as new democracies set up democratic institutions that may adversely affect their ability to attract FDI, these democracies may not yet be ready to provide offsetting improvements in property rights protection because they need to consolidate power and avoid conflicts with powerful domestic actors. Over time, however, the consolidation of democratic governance should bring about better property rights protection, improving the prospect of getting more FDI inflows Countries experiencing a transition from democracy to autocracy would face the challenge of persuading foreign investors into believing the credibility of their property rights protection.[101]

Larrain and Tavares analyzed the effect of openness to foreign direct investment on corruption. It addresses the issue of causality by using a new set of instrumental variables that rely on geographical and cultural proximity to the major originators of FDI outflows. They found that foreign direct investment is a robust determinant of corruption. Larger FDI inflows decrease national corruption.[102]

Busse and Carsten explore the linkages between political risk, institutions and foreign direct investment inflows by

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[101] Q. Li and A. Resnick "Reversal of Fortunes: Democratic Institutions and Foreign Direct Investment Inflows to Developing Countries" *International Organization* 57 (Winter, 2003).

[102] B. F. Larrain and J.Tavares "Does Foreign Direct Investment Decrease Corruption?" Cuadernos De Economia 41(2004), pp. 217-230.

using different econometric techniques for a data sample of 83 developing countries and the period 1984 to 2003. They employed 12 different indicators for political risk and institutions in the empirical analysis. They found that the investment profile, internal and external conflict, ethnic tensions and democratic accountability are important determinants of FDI flows. Across different econometric models, the relative magnitude of the coefficients for the these political indicators are largest for government stability and law and order, indicating that changes in these components of political risk and institutions are highly relevant for investment decisions of multinationals.[103]

Methodology and Variables of the Econometric Model

Scholars when applying econometric models use data collected by international organizations. However, institutional variables are not readily available.

To meet the needs for an in-depth and exhaustively researched analysis of the non-economic variables such as potential risks to international business operations, several organizations created statistical models to calculate risks and backed it up with analyses that explain the numbers and examine what the numbers do not show. The result is a

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[103] M. Busse, and C. Hefeker "Political Risk, Institutions and Foreign Direct Investment", *HWWA Discussion Paper* 315 (2005).

comprehensive system that enables various types of risk to be measured and compared between countries.

The data measuring the quality of institutional variables are produced by independent private firms who provide consulting services to international investors such as the PRS Group publishing the *International Country Risk Guide* (*ICRG*), the Freedom House (FH), or the Transparency International (TI). To a certain extent, these indices provide very similar information on various aspects of institutions. However, some should pay attention to the facts that first indices can be considered to be subjective and more important, they measure the perceptions of governance quality rather than its actual quality.

Therefore, in this dissertation, what I am concerned about is not the actual institutional quality, but its perceptions on the quality of institutions.[104]

In this dissertation, the effects of both macroeconomic and institutional variables on FDI inflows are analyzed in 67 developing economies. The dependent variable is the FDI inflows/Gross Domestic Product (GDP).[105] This measure is useful to compare the relative FDI performances of the countries. As explanatory variables, macroeconomic variables are GDP growth,

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[104] For more detail about the "perception of institutions" see Ahmet Faruk Aysan, Mustapha Kamel Nablı, and Marie Ange Veganzones—Varoudakis "Governance institutions and private investment: An Application to the Middle East and North Africa" in *The Developing Economies*, XLV-3 (September 2007): 339–77.

[105] The Data are from UNCTAD, 2006.

GDP per capita (PPP), openness (Export+Import/GDP), and GDP deflator. Political and economic institutional variables are democratic accountability, civil liberties, political rights, law and order, corruption, government stability, investment profile, and socioeconomic conditions.

Definitions of the Variables

The first category of explanatory variables includes macroeconomic variables. As stated in the previous chapters, market size is one of the most widely proven significant determining variables in FDI location. If foreign investors are looking to sell their product or service to the host country, the economic potential of the targeted region is of utmost importance. This will be measured by GDP per capita. Because of differences in consumer purchasing power more-developed countries often attract more FDI than less-developed ones. This measure should have a significant impact on FDI inflows because it indicates market wealth and purchasing power. The variable is converted to international dollars using purchasing power parity (PPP) rates for comparability between countries. GDP per capita as an indicator of economic development is expected to affect FDI inflows positively. Data are from the IMF.[106]

In addition to GDP per capita, I use of GDP growth. GDP growth indicates a precondition for economic expansion.

[106] IMF, World Economic and Financial Surveys World Economic Outlook Database April 2007 Edition.

Economic growth should affect FDI inflows positively; hence, I include GDP growth as independent variable. Data are from the WDI.[107]

Openness indicates integration of a country into World Economy. It is estimated as exports plus imports, as a percentage of GDP and it is expected to be significant because it demonstrates the openness and trade abilities of the host country. The data are from WDI.[108]

The last macroeconomic variable in the model is GDP deflator (annual percent). Many developing economies experienced high levels of inflation in the 1980s and 1990s. Inflation not only deters foreign investment but also investment environment in a country. Therefore, low inflation is expected to attract FDI while high inflation rates deter FDI. The data are from the World Development Indicator.[109]

The second category of explanatory variables includes political institutions.

Government Stability (GS) is a measure of the government's ability to stay in office and carry out its declared program(s), depending upon such factors as the type of governance, cohesion of the government and governing parties, approach of an election, and command of the legislature.

Corruption within the political system that is a threat, especially in the long-run, to foreign investment by

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[107] World Development Indicators, 2006.

[108] Ibid.

[109] World Bank, World Developmet Indicators, 2006.

distorting the economic and financial environment, reducing the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability, and introducing inherent instability into the political process.

Investment Profile (IP) is an assessment of factors affecting the risk to investment that are not covered by other political, economic and financial risk components. The risk rating assigned is the sum of three subcomponents: Contract Viability/Expropriation, Profits Repatriation and Payment Delays.

Socioeconomic conditions (SC) indicator is an assessment of the socioeconomic pressures at work in society that could constrain government action or fuel social dissatisfaction. The risk rating assigned is the sum of three subcomponents; unemployment, consumer confidence and poverty.

Law and Order (LA) are assessed separately, with each sub-component comprising zero to three points. The Law sub-component is an assessment of the strength and impartiality of the legal system, while the Order sub-component is an assessment of popular observance of the law. Thus, a country can enjoy a high rating – 3 – in terms of its judicial system, but a low rating - 1 – if it suffers from a very high crime rate of if the law is routinely ignored without effective sanction (for example, widespread illegal strikes).

The institutional strength and quality of the bureaucracy (BQ) is another shock absorber that tends to minimize revisions of policy when governments change. Therefore, high points are given to countries where the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services. In these low-risk countries, the bureaucracy tends to be somewhat autonomous from political pressure and to have an established mechanism for recruitment and training. Countries that lack the cushioning effect of a strong bureaucracy receive low points because a change in government tends to be traumatic in terms of policy formulation and day-to-day administrative functions.

Political rights (PR) enable people to participate freely in the political process, including the right to vote freely for distinct alternatives in legitimate elections, compete for public office, join political parties and organizations, and elect representatives who have a decisive impact on public policies and are accountable to the electorate. Civil liberties (CL) allow for the freedoms of expression and belief, associational and organizational rights, rule of law, and personal autonomy without interference from the state.

Methodology

Before introducing the model, the methodology should be initiated. In this dissertation, the econometric model includes two approaches; factor analysis and principal component analysis. This is because of there is high correlation between variables.

Table 5 shows that there are high correlations between the institutional variables. Using factor analysis these institutional variables can be explained in terms of a much smaller number of variables called factors. The purpose of factor analysis is to discover simple patterns between the variables and reduction of number of variables, combining two or more variables into a single factor. In order to test if I could use factor analysis for this variable group I use Kaiser-Meyer-Olkin criterion.[110] Computed Kaiser's MSA is bigger than 0,5. It indicates that factor analysis could be used. I use maximum likelihood method for factor analyzing.

Using Minimum average partial method I found 2 factors. The first group DEMOC includes Civil Liberties (CL), Political Rights (PR) and Democratic Accountability (DA). The second group POL includes Government Stability (GS), Investment Profile (IP), Bureaucratic Quality (BQ), Law and Order (LO), Corruption and Socioeconomic Conditions (SC). Their factor loadings can be seen in the appendix.

[110] For detailed information see appendix.

Table 5. Correlation for institutional variables

	BQ	DA	GS	IP	LO	N_CL	N_PR	SC
BQ	1.000000	0.406254	0.223212	0.344010	0.437876	0.212655	0.246968	0.412445
DA	0.406254	1.000000	0.168704	0.367918	0.302073	0.531678	0.595366	0.086496
GS	0.223212	0.168704	1.000000	0.598368	0.343915	0.090128	0.065509	0.038455
IP	0.344010	0.367918	0.598368	1.000000	0.331729	0.332767	0.300780	0.332150
LO	0.437876	0.302073	0.343915	0.331729	1.000000	0.174831	0.173786	0.351615
CL	0.212655	0.531678	0.090128	0.332767	0.174831	1.000000	0.868202	0.090053
PR	0.246968	0.595366	0.065509	0.300780	0.173786	0.868202	1.000000	0.101990
SC	0.412445	0.086496	0.038455	0.332150	0.351615	0.090053	0.101990	1.000000

The first equation (eq1) includes only macroeconomic variables:

$$FDI\_inflows\_Gdp = \text{-}2.818641 + 0.000173 * Gdp\_pc\_ppp + 0.078 * Gdp\_growth$$
$$+0.052689 * Openness - 3.82\text{E-}06 * Gdp\_def$$

The second equation (eq4) includes both macroeconomic and institutional variables:

$$Fdi\_inflows\_Gdp = -\text{-}2.177220 + 0.000109 * Gdp\_pc\_ppp$$
$$+0.062488 * Gdp\_growth + 0.049188 * Openness - 4.95\text{E-}06 * Gdp\_def$$
$$+0.666885 * DA + 0.536699 * POL$$

Estimation Results

Equations (1) and (4) have been estimated on an unbalanced panel of 67 developing countries over 1984-2005 using the OLS estimations technique. Four sets of regressions have been conducted, each one with a different institutional indicator.

Table 6 indicates the estimation results with Panel Fixed effects for the equation 1 Table 1 presents the estimation's results of equations (1) and (2) when "macroeconomic conditions", "democratic accountability" and "political stability" are taken into consideration respectively. In the

Table 6. Determinants of FDI, the role of macroeconomic and institutional variables for 67 developing economies 1984-2005

	Eq1	Eq2	Eq3	Eq4
C	-2.818641 (0.284220)***	-2.524737 (0.288135)***	-2.546381 (0.293447)***	-2.177220 (0.297557)***
GDP_PC_PPP	0.000173 (3.95E-059)***	0.000151 (3.94E-05)***	0.000141 (4.04E-05)***	0.000109 (4.04E-05)***
GDP_GROWTH	0.078413 (0.016547)***	0.073894 (0.016480)***	0.068999 (0.016733)***	0.062488 (0.016591)***
OPENNESS	0.052689 (0.004295)***	0.050499 (0.004286)***	0.051619 (0.004295)***	0.049188 (0.004271)***
GDP_DEF	-3.82E-06 (2.15E-06)*	-5.12E-06 (2.14E-06)**	-3.57E-06 (2.14E-06)*	-4.95E-06 (2.13E-06)**
DEMOC		0.606131 (0.118154)***		0.666885 (0.118271)***
POL			0.452479 (0.125385)***	0.536699 (0.124922)***

Sources: The macroeconomic series are from WDI and IMF. The institutional variables have been processed from various international sources. The "democratic accountabilityality" DEMOC and "political stability" POL indexes are from PRS (2006) and Freedom House (2006) data.
***, **, and * indicates significance at 1%, 5%, and 10% level, respectively. For the country sample see appendix.

A significant conclusion of the model consists in validating the mainstream theory of the firm in the case of developing countries. The macroeconomic variables have the expected signs, which imply that anticipations of economic growth, GDP per capita and openness of the economy induce more FDI. In addition, the inflation appears to exert a negative and significant effect on FDI.

Both variables are highly significant, indicating that market related factors constitute major factors for the entrepreneurs to establish operations abroad.

In the following equations I add institutional variables one by one. The equation 4 includes the all macroeconomic and institutional variables. One of the most interesting outcomes concerns the quality of democratic accountability and political stability indices, which both give positive and significant coefficients at the 1 percent level in the equation (4). This result confirm that a low level of corruption, a good quality of bureaucracy, protected political rights and civil liberties, a reasonable investment environment, a better law and order, and government stability are of first importance for the foreign investors' decisions to invest. In other words, the increase in perception of the quality of institutions affects FDI inflows positively.

The coefficients of all macroeconomic and institutional variables are statistically significant. Again all signs are as expected.

In conclusion, an important result from empirical analysis is that macroeconomic variables have a strong impact on FDI inflows. In addition, institutional variables used in the equations also have important effect on FDI flows.

Principal Components Analysis

In order to confirm the results of factor analysis, principal components analysis is introduced to the dissertation.

The methodology is the same with the factor analysis. I divide institutional variables into two groups with the same names; DEMOC and POL. DEMOC includes CL, PR and DA. POL includes IP, GS, Corruption, LO, BQ and SC. The equations, principal components and loadings are at the below.

Eq1;

$$Fdi\_inflows\_Gdp = -1.807502 + 6.66\mathrm{E}-05 * Gdp\_pc\_ppp$$
$$+0.057561 * Gdp\_growth + 0.047372 * Openness - 5.03\mathrm{E}-06 * Gdp\_def$$
$$+0.244721 * DA + 0.687027 * POL$$

Eq4;

$$Fdi\_inflows\_Gdp = -2.326162 + 0.000115 * Gdp\_pc\_ppp$$
$$+0.063071 * Gdp\_growth + 0.050718 * Openness - 4.01\mathrm{E}-06 * Gdp\_def$$
$$+0.524903 * GOV$$

Table 7. The DEMOC Indicator

Component	Eigen Value	Cumulative Proportion
PC1	2.343134	0.7810
PC2	0.528918	0.9574
PC3	0.127948	1.0000

Table 8. Loadings

Variable	PC 1	PC 2	PC 3
N_CL	0.600483	-0.427562	0.675730
N_PR	0.614894	-0.293333	-0.732025
DA	0.511200	0.855071	0.086764

DEMOC = pc1 * (0.7810/0.9574) + pc2 * (0.1763/0.9574)

Table 9. The POL Indicator

	Eigen	Cumulative

Number	Value	Proportion
PC1	2.577193	0.4295
PC2	1.314895	0.6487
PC3	0.806480	0.7831
PC4	0.547529	0.8743
PC5	0.441562	0.9479
PC6	0.312341	1.0000

Table 10. Loadings

Variable	PC 1	PC 2	PC 3	PC 4	PC 5	PC 6
BQ	0.466171	-0.208069	-0.043562	-0.726545	-0.456950	0.028681
CORRUPTION	0.339637	-0.526170	0.437696	-0.061226	0.642188	0.007749
GS	0.343980	0.609048	0.306733	-0.009470	0.099438	0.637711
IP	0.422484	0.490487	-0.228931	-0.090684	0.333537	-0.639570
SC	0.382274	-0.239725	-0.748922	0.288428	0.134931	0.366220
LO	0.473690	-0.104245	0.314875	0.613905	-0.489336	-0.221981

POL = pc1 * (0.4295/0.7831) + pc2 * (0.2191/0.7831) + pc3 * (0.1344/0.7831)

Table 11. The GOV indicator

Number	Eigen Value	Cumulative Proportion
PC1	3.204928	0.4006
PC2	1.602346	0.6009
PC3	1.093847	0.7376
PC4	0.715638	0.8271
PC5	0.574502	0.8989
PC6	0.418182	0.9512
PC7	0.265867	0.9844
PC8	0.124689	1.0000

Table 12. Eigenvectors (loadings)

Variable	PC 1	PC 2	PC 3	PC 4	PC 5	PC 6	PC 7	PC 8
BQ	0.355449	0.248195	0.346719	-0.334617	-0.536186	0.524221	-0.132283	0.008445
DA	0.410244	-0.236257	-0.000361	-0.384031	-0.316569	-0.675044	0.244748	0.112257
GS	0.257546	0.371123	-0.647204	-0.007104	0.016960	0.233199	0.567103	0.027192
IP	0.393533	0.250910	-0.347936	0.412291	-0.184246	-0.237828	-0.627587	-0.082208
LO	0.326915	0.342151	0.141125	-0.444777	0.713727	-0.081655	-0.203169	-0.031069
N_CL	0.398155	-0.464411	-0.020705	0.197721	0.214205	0.284437	-0.053822	0.675713
N_PR	0.405262	-0.477945	0.026620	0.126194	0.139349	0.196438	0.110339	-0.721468
SC	0.233495	0.347443	0.564624	0.563624	0.057850	-0.180013	0.388303	0.041955

GOV= (0.4006/0.7376*PC1 + 0.2003/0.7376*PC2 + 0.1367/0.7376*PC3)

Table 13. Determinants of FDI in developing economies 1984-2005 (Principal Components Analysis)

	Eq1	Eq2	Eq3	Eq4
C	-2.447698 (0.291598)***	-1.895822 (0.301764)***	-1.807502 (0.303315)***	-2.326162 (0.299567)***
GDP_PC_PPP	0.000134 (3.99E-05)***	7.63E-05 (4.06E-05)*	6.66E-05 (4.07E-05)*	0.000115 (4.10E-05)***
GDP_GROWTH	0.070019 (0.016496)***	0.059649 (0.016412)***	0.057561 (0.016404)***	0.063071 (0.016754)***
OPENNESS	0.050867 (0.004275)***	0.047766 (0.004255)***	0.047372 (0.004250)***	0.050718 (0.004287)***
GDP_DEF	-5.04E-06 (2.14E-06)**	-4.47E-06 (2.10E-06)**	-5.03E-06 (2.11E-06)**	-4.01E-06 (2.13E-06)*
DEMOC	0.466172 (0.093943)***		0.244721 (0.098804)**	
POL		0.775276 (0.097728)***	0.687027 (0.103852)***	
GOV				0.524903 (0.106365)***

In addition to the DEMOC and POL variables, in order to complete the analysis, I have substituted in this system of equation including the aggregate indicator of governance (*GOV*), which is calculated as the principal component analysis of all the initial indicators. GOV provides a summary of the two measures of institutional variable.

Results of the regressions are reported in Table 13. This last set of estimations confirms most of the results obtained in the factor analysis. The aggregate indicator of governance appears to have a positive and significant coefficient, which validates the importance of this factor for the foreign firm's decisions to invest.

However, there are several institutional variables which are not displayed in the models due to lack of available data.

In order to see the impact of other institutional variables such as enforcement of contracts, competition policy of the governments, protecting property rights and etc., I conduct a questionnaire survey in the case of Turkey. However, before revealing the results of survey, a comprehensive analysis of FDI in Turkey will be examined.

CHAPTER 6

THE TURKISH CASE

Introduction

In this dissertation, in addition to the empiric model studying emerging economies, I also examine the impact of institutional variables on FDI in specific case of Turkey. In the following chapters to examine the FDI issue in Turkey entirely, the detailed historical process of FDI in Turkey will be surveyed. At the end, the questionnaire survey results will be revealed in order to examine the relationship between macroeconomic and institutional variables and Foreign Direct Investment, for the recent period.

As mentioned, in order to attract higher amounts of FDI, numerous developing countries have liberalized their investment environment since 1980.[111] Turkey is not an

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[111] Policy changes still continue nowadays. For instance, a total of 205 policy changes were identified by UNCTAD in 2005. In terms of regional distribution, Africa accounted for 53 policy changes, followed by Asia and Oceania (48), developed countries (44), South-East Europe and the CIS (39) and Latin America and the Caribbean (21). Most of the changes in 2005 made conditions more favorable for foreign companies to enter and operate. The types of measures most frequently adopted were related to sectoral and cross-sectoral liberalization (57 policy changes), promotional efforts (51 policy changes), operational measures (22 policy changes) and FDI admission (19 policy changes). *World Invest Report*, 2006, p.iv.

exception. In terms of regulatory trends relating to investment, the pattern since the 1980s has persisted: the volume of regulatory changes have facilitated FDI. They have involved simplified procedures, enhanced incentives, reduced taxes and greater openness to foreign investors. However, not all countries succeed at attracting FDI as they expected. The volume of FDI flows differ among the countries.

One of the countries which did not succeed at attracting FDI as expected is Turkey. As mentioned before, Turkey, which has a vast market potential in the world, received low levels of FDI inflows until 2005. Compared to many developing countries that have attracted and benefited from significant inflows of FDI, Turkey did not succeed in increasing FDI inflows even though significant increase in FDI flows due to globalization process in the 1990s. Plus, the low level of FDI inflows is not a characteristic of the recent period. Turkey, from the beginning of the Republican Era, attracted low level of FDI inflows.

Below, offering a periodization, I evaluate the FDI performance of the country, the attitudes of government to FDI, and the relationship between economic conjuncture and FDI.

A Periodization for FDI in Turkey

Foreign Direct Investment in the Ottoman Empire

In the nineteenth century, with the arrangements signed between the Ottoman Empire and several European countries, there was a climate encouraging the operations of foreign companies. These companies established enterprises in various sectors such as service (banking, finance), transportation (railways), and energy (electricity). Especially foreign companies built up monopolies dominating the basic services.

Before 1914, most of the FDI was placed in infrastructure such as railroads and ports rather than in production activities such as agriculture or industry. More than 80 joint stock companies were controlled by foreign capital, operating in the Ottoman Empire in 1910.[112] It is interesting that the number of firms containing foreign capital only reached this number in the 1960s.

The Ottoman Empire essentially had an open economy based on the exportation of agricultural outputs. While the share of export in GDP was 13 percent, in 1913 the ratio FDI stock/GDP

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[112] Ş. Pamuk, *The Ottoman Empire and European Capitalism. 1820-1913: Trade, Investment and Production* (Cambridge: New York: Cambridge University Press, 1987), p.63.

was approximately 2 percent.[113]

Between 1888 and 1914 the rate of growth of FDI was higher than the rate of growth of foreign lending to the Ottoman government. FDI in the Ottoman Empire was concentrated two sub-periods; between 1888 and 1896 FDI exceeded 30 million pounds. Most of this capital inflow was directed towards railroad construction. FDI remained limited before 1875, particularly during 1876 and 1887. Between 1905 and 1913 more than 17 million pounds of FDI was invested and again the largest share of these funds went to railroad construction.[114]

The distribution of foreign capital stock according to country of origin in the Ottoman Empire at the end of 1913 demonstrates the French domination with 50.4 percent, followed by Germany with 27.5 percent, and Britain with 15.3 percent.

As for the sectoral distribution of FDI, railroads, with close to two-thirds of directly invested foreign capital stock in 1914 emerge as the most important area for FDI. On the other hand, FDI in agriculture was rather insignificant until 1914.[115]

Finally, the concentration of FDI in the Ottoman Empire in railroads and infrastructure is harmonious with the basic

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[113] GDP Estimation for 1913 is taken from the study of S. G. Altug, A. Filiztekin and S. Pamuk "Sources of Long Term Economic Growth in Turkey, 1880-2005" *CEPR conference* European Growth and Integration since the Mid-Nineteenth Century, 2006.

[114] Profit transfers arising from FDI only exceed 1896 new capital inflows. Especially operations railroads were profitable plus, the timing of this major wave can be explained to some extent by international forces and reducing the cost of transportation. Pamuk, p.64.

[115] Ibid., p. 66.

patterns of investment during the nineteenth century revealed by European investors around the world.

First Years of the Republican Period

After the Turkish War for Independence, although the new Turkish Republic abolished the capitulations and aimed to impede the domination of foreign firms in the public sector, its attitude toward FDI remained positive and the local entrepreneurs were encouraged to collaborate with foreign firms.[116] The capitalist development strategy adopted in the 1920s was harmonious with FDI activities and the collaboration of local firms with the foreign firms. In his speech to Izmir Economic Congress in 1923, Ataturk was highly critical of the Capitulations in the Ottoman Empire. Despite this criticism, he declared that Turkey was open to FDI as long as it respected the country’s laws, accepted national treatment without seeking extraterritorial privileges, and yielded mutual gains.[117]

However, after 1929, the Great Depression affected the activities of foreign firms operating in Turkey (some stopped production) in a negative way. During the 1930s, new FDI flows

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[116] K. Boratav, *Türkiye İktisat Tarihi 1908-1985* (İstanbul : Gerçek Yayınevi, 1995). Also see Y. S. Tezel, *Cumhuriyet Döneminin İktisadi Tarihi (1923 – 1950)* (İstanbul: Tarih Vakfı Yurt Yayınları, 2000), p.196.

[117] A. Afetinan, *İzmir İktisat Kongresi, 17 Şubat-4 Mart 1923* (Ankara: Türk Tarih Kurumu, 1989).

into Turkey decreased to very low levels.[118] FDI flows also stagnated throughout the world during the depression years.

The negative effects of the depression on the financial system of the country led the Turkish governments to put restrictions on financial transactions which, in the end, deterred FDI inflows to Turkey until 1950.[119] In addition, "etatism" giving priority to the state activities rather than the private sector affected the positions of foreign firms in the development process. In other words, as the role and share of the state enterprises increased in the economic development process, the relative importance encouraging FDI as an economic policy decreased in this period.[120] Plus, the expropriation of foreign firms between 1928 and 1944 made the investment climate not attractive to foreign investors. Due to these facts (international conjuncture and government actions in financial markets, and etatism) although lack of statistics for the period, it can be easily argued that FDI flows to Turkey remained too low between 1930 and 1950.[121]

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[118] A. G. Ökçün *1920-1930 yılları arasında kurulan Türk Anonim Şirketlerinde Yabancı Sermaye* (Ankara : Sermaye Piyasası Kurulu , 1997).

[119] With law No. 1447 about "securities, stocks and bonds and foreign Exchange markets", the Exchange and expropriation of foreign currency, stocks and bonds were realized under the control of government. Law No. 1567, about the protection of the value of Turkish currency, regulated foreign Exchange and capital market.

[120] Tezel, p.201.

[121] N. Selik, *Türkiye'de Yabancı Özel Sermaye (1923-1960)* (Ankara:Siyasal Bilgiler Fakültesi, 1961).

Post War Period

After the end of the Second World War, major political and economic changes took place between in the World and Turkey. Turkish governments, due to both international conjuncture and domestic pressure, turned towards an open economic model.[122] The new economic policies gave signals for encouraging FDI flows by changing or improving the laws.[123]

The 1950s witnessed the subsequent enactments of foreign encouragement laws of FDI in Turkey. One of the earliest foreign encouragement laws in the world was adopted by the Republican Peoples' Party (RPP) in 1950, the law No.5583. Although the name of the law was "encouragement of FDI", in actual, it did not offer attractive provisions. Mostly, for this reason, after a short period of time, a new encouragement of FDI was enacted in 1951.

Although the RPP initiated changes in political and economic policies, as the winner of the 1950 elections, the Democrat Party put more emphasis on liberal policies. Hence, the new government replaced the Law No. 5821 with the old one,

[122] For the development policies about the period see İ. Tekeli and S. İlkin, *Savaş Sonrası Ortamında 1947 Türkiye İktisadi Kalkınma Planı* (Ankara : Orta Doğu Teknik Üniversitesi, 1974) pp.6-10.

[123] For instance, in by-law No.13, arranged in 1947, a new regulation was made for the "protection of the Value of Turkish Currency" which brought encouragement of foreign investment by mentioning FDI could operate and invest in the specific sectors which were important for the economic development of the country. Plus, foreigners that invest in these specific sectors gained the advantage to transfer profit and capital without having to apply for permission from the Ministry of Finance.

Law No.5583. The purpose of enacting a new law was to diminish the restrictions and to clarify the indefinite articles of FDI. However, these concrete measures did not lead to a significant increase in FDI flows to Turkey.

Finally, in August 1954, a new encouragement law of FDI was enacted. "The Law No. 6224", recognized as one of the most liberal encouragement laws of FDI, and was in force until 2003 with minor changes. Law No. 6224 brought very liberal provisions. It abolished restrictions on the transfers of profits, dividends and interest to ten percent of the capital as well as the restriction of foreign direct investment in certain specified areas of economic activity.

However, the law included an ambiguous article which was used by governments as a tool to deny investment permission to some foreign investors. According to this article, foreign investment should contribute to the economic development of Turkey and should be in a field of activity open to Turkish private enterprise. In addition, foreign investment should not entail any monopoly or any special concessions.[124]

The government by enacting law no. 6224 aimed at an increase in FDI with the purpose of reducing the shortage of foreign exchange that took place in the country in 1953 and 1954. Increasing FDI inflows, in the end, would help to decrease the balance of payment deficits.[125] However, the laws

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[124] K. Oksay, *Türkiye'de Yabancı Sermaye Yatırım Kılavuzu* (İstanbul: Doğan Kardeş, 1967).

[125] Also there are other views about the law's timing. For instance, according to Eralp foreign encouragement laws coincided with the period when the local bourgeoisie was attempting to collaborate with the MNCs. See A. Eralp, "Türkiye'de İzlenen İthal İkameci Kalkınma

that were enacted subsequently in the first half of the 1950s did not attract FDI as expected[126].

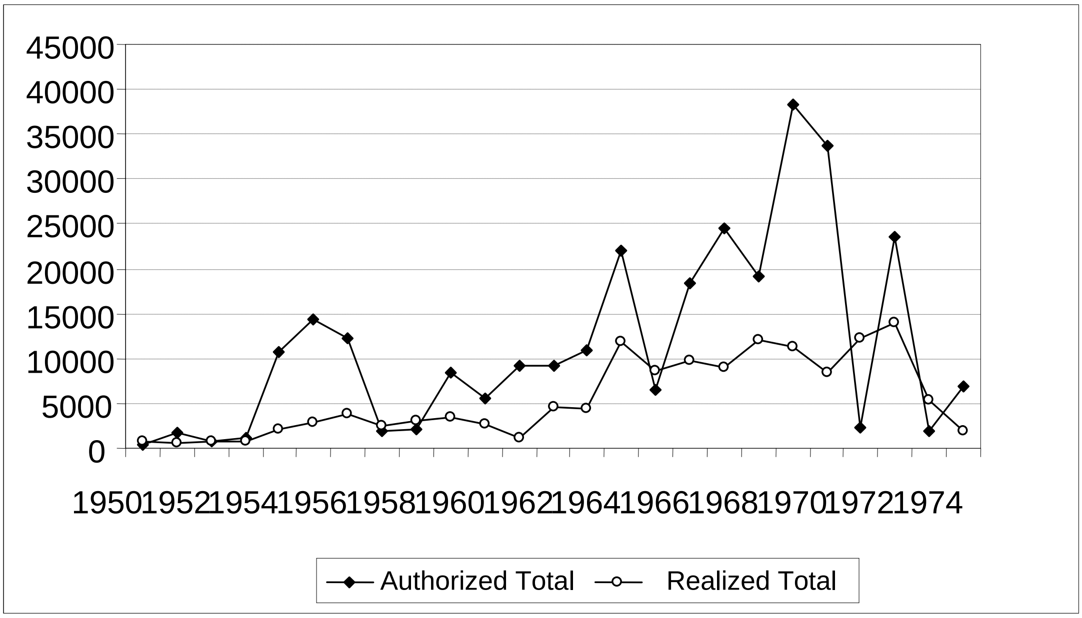

Fig. 6 Inward FDI with current prices - (US Dollars-thousand)
Source: Erdilek, A. *Direct Foreign Investment in Turkish Manufacturing* (Tubingen: Mohr,1982), Appendix.

As seen in Figure 6 the amount of realized FDI did not exceed $15 million annually between 1950 and 1974. In spite of the subsequently enacted FDI laws, the inflow of FDI was below $5 million annually in the 1950s. The obvious increase in FDI inflows took place in the 1960s, yet again; the realized investment was below $15 annually. What is interesting here is the big difference between the realized and authorized investments during the whole period.

Stratejisi ve Yabancı Sermaye" in *METU Studies in development*, Special Issue (1981) p.623.

[126] From 1950 onwards, foreign direct investment entered into Turkey according to four main categories. These were Laws No. 5821 and No. 6224, long-term credits of the Turkish Industrial Development Bank of Recovery and Development, Petroleum Law No. 6326 (which was enacted on March 1954), special Law No. 7462 about the Ereğli Iron and Steel Factory (which was enacted in 1960).

One of the reasons for this divergence was the political and economic instability. During 1958-1960, under the economic stabilization program designed by the IMF and the OECD, the Turkish economy was still too risky for new FDI. Most of the investors preferred to wait for the suitable time after taking the investment permission.[127] For instance, the ratio of realized investment of authorized investment was only 30 percent between 1951 and 1965. Most of the time foreign investors tried to receive permissions before their competitors, and after, preferred to wait for the appropriate time to invest.

The divergence between the actual and realized investment gives a significant idea about the political and economic instability for the period.

1960 – 1970 Period

Especially in the 1960s, substantial demand for domestic commodities (due to significant increase in real wages) and the growth of the domestic market are expected to encourage the inflow of FDI to Turkey. However, in the 1960s both authorized and realized foreign investments continued to be statistically insignificant, in spite of significant growth of

[127] Until 2003, foreign investors had to apply for investment permission. After receiving permission they had a chance to either invest at the time, or wait for a period of time or abandon the process. Therefore, the authorized FDI and the actual FDI used to be different generally.

domestic market.[128] In this period, called the golden age of ISI, the economic growth rate was seven percent and the manufacturing sector's growth rate was between 11 and 12 percent.[129] As mentioned, MNCs mostly invested in the manufacturing industry especially between 1950 and 1980 in developing countries. In Turkey, like in other countries, operations of foreign firms mostly concentrated in the manufacturing industry.

Table 14. Sectoral Distribution of FDI - 1965

Sectors	% of Capital
Agriculture	0.21
Mining	1.25
Manufacturing	95.20
Building	0.92
Services	2.34

Source: Tuncer, p.87, Ashkin, p.88.

As seen in table 14, 95.2 percent of FDI was concentrated in manufacturing industry in Turkey in 1965. In the end of the 1970s this ratio decreased to 85 percent. Although there were ardent discussions in the parliament about encouraging FDI in the agricultural sector, foreign firms did not prefer to invest this sector. Roughly 2.5percent of total foreign capital invested in the service sector. However, owing to the changes in the international economic conjuncture and the

[128] This fact can be strengthened by reference to the proposed first five-year development plan about foreign direct investment. The five-year development plan forecasted the need of $50 million annually FDI inflow since the beginning of the plan in 1963. However, not only realized investment but also authorized investment had not reached the $50 million level since 1951. See Devlet Planlama Teşkilatı, *First Five-Year Development Plan, 1963-1967* (Ankara: Turkish Republic Prime Ministry, 1963) pp.237-239.

[129] Z.Y. Herschlag, *Turkey the Challenge of Growth* (Leiden: E. J. Brill, 1968).

changing economic development policies of the Turkish governments the share of service sector began to increase significantly after 1980.

In 1960, with the military intervention, the new regime sought to quicken the pace of development by relying to a great extent on state plans in which, the ISI strategy was institutionalized. With the establishment of the State Planning Organization (SPO) in September 1960, the development plans were based on long-term models rather than short-term policies and were obligatory for the public sector and only problem-solving for the private sector.[130] They maintained the coordination between the economic sectors and the agents, achieved economic growth and economic stability, and encouraged the inflow of foreign investment.[131]

In this period, some of the problematic issues in FDI regulations were mended by the office, however, some of the ambiguous articles led the office to act in an inconsistent manner when deciding about FDI approvals. For instance, as mentioned, foreign companies were not obliged to realize investment immediately following the granting of investment permission, which means they could realize investments whenever they wanted. Actually, many firms had preferred to wait for some years to invest in Turkey because of the

[130] In 1967, Law 933 amended Law 6224, abolishing the Committee to Encourage Foreign Investment, and transferring the FDI authority to the SPO.

[131] In the first development plan, the balance of payments effect received focus rather than the technological and employment effects of FDI. Plus, in this plan, for the first time the problem of low realized investments was mentioned.

political instability. In this way they had the chance to invest under conditions suitable for investment. However, foreign investors having investment permission made it difficult for domestic firms and other foreign investors to get approval for investments in the same area. This situation also blocked the entrance of other foreign companies willing to invest at that time and created and strengthened the oligopoly conditions in the Turkish economy.[132]

The SPO noticed this dilemma and decided to cancel the investment permissions of foreign companies if their investments were not realized after a certain period. In other words, all authorized investments had to be implemented within specific time periods, which were contained in their decrees and the Turkish government canceled unimplemented decrees.[133]

Another problem involved an article of Law No. 6224, concerning the contribution of FDI to the economic development of the country. According to Law No. 6224, foreign companies could realize investment in all sectors of the economy, provided it aided the country's economic development. It was not clear, however, how this was to be determined. Many representatives of foreign companies claimed that the SPO used this provision as a tool to discriminate against MNCs.[134]

One of the issues with which the SPO dealt was the technology and export effect of FDI. Especially in the second

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[132] D. Dumludağ, *The Political Economy of Foreign Direct Investment in Turkey 1950-1980* (M.A. thesis, Istanbul : Boğaziçi University, 2002), p.64.

[133] Ibid., p.65.

[134] Ibid., p.67.

half of the 1960s, in public, some debates had arisen about the contribution of foreign firms to economic growth, technological progress, and employment in Turkey.[135] Thereof, the technological contribution of multinational corporations (MNCs) was emphasized in the second development plan. However, most of the requirements were not met by foreign investors.

Table 15. Production Effect of FDI (manufacturing - million TL)

Years	Realized production	Production of private sector	Contribution of FDI to production	% (3/1)	% (3/2)
1961	17,496	11,258	800	4.58	7.11
1962	19,439	12,209	603	3.10	4.91
1963	20,084	12,464	963	4.80	7.73
1964	24,368	14,996	1,248	5.12	8.32

Source: Tuncer, p.99.[136]

Although SPO dealt with the output effect of FDI, in the first half of the 1960s the contribution of FDI in total output did not exceed 5 percent average.

[135] For instance, see D. Avcıoğlu, *Türkiye'nin düzeni : dün, bugün, yarın* (Ankara : Bilgi Yayınevi, 1969); K. Bulutoğlu, *100 soruda Türkiye'de Yabancı Sermaye* (İstanbul: Gerçek yayınevi, 1970).

[136] As ninety-five percent of FDI concentrated in manufacturing sector, analyzing the production statistics of FDI in this sector gives a significant idea about the effect of FDI in Turkish economy. Plus we there is a lack of confident data about the other sectors. Tuncer, in his study, calculated the contribution of FDI to production by using the data of a questionnaire conducted by SPO and foreign companies. The results of the questionnaire give some information about the sales amounts of foreign companies.

Contribution of FDI to Business Entrepreneurship

Despite the subsequently enacted laws, the level of FDI flows into Turkey remained very low in the 1950s and 1960s. However, the FDI that entered into Turkey played a significant role in the capital accumulation process of the private sector. Before the foreign exchange crisis of 1954, trade regulations were used to be liberal and many entrepreneurs in Turkey favored the distribution of import goods over production. After 1954, with the foreign exchange crises, the government adopted strict measures regarding trade and adopted an Import Substituted Industrialization (ISI) strategy that hindered free trade activities. This turn in economic policies led entrepreneurs in Turkey to become the producers of the commodities that they had imported earlier.[137] Especially, the Turkish Industrial Development Bank (*Türk Sınai ve Kalkınma Bankası*), created in 1950, played a significant role in the development of some well-known industrial enterprises in the 1950s. Nearly all of the big businesses established in this period obtained credits from the TIDB.[138]

[137] A good example of the entrepreneurs' attitude towards the severe foreign exchange crisis is described very well in the autobiography of Nahum who was one of the siginificant managers of Koc holding,one of the leading industrialist groups in Turkey. According to Nahum Vehbi Koç, the founder of the holding, was convinced of the necessity of industrialization in Turkey due to the lack of foreign exchange, and the import limitations of the government. The Group agreed to start with the assembly production of the goods which imported before. For instance, the company decided to build a factory for the assembly production of Ford vehicles.Bernar Nahum: *Koç'ta 44 yılım* (İstanbul: Milliyet Yayınları, 1988), p.253.

[138] One of the largest industrial ventures of the Sabancı Group, the Bossa textile factory, was established on the basis of TIDB credits. The credits of the TIDB was a turning point in Eczacıbaşı Group's business career. Nejat Eczacıbaşı, the founder of the Eczacıbaşı

In the 1960s, as the ISI policies deepened, high tariff rates and the restriction of finished goods created favorable conditions for foreign firms. As Stephen Hymer notes, under conditions where firms are protected by the state from international competition, foreign firms with the advantage in technology, distribution and management enjoy high profit rates.[139] In Turkey, these firms also enjoyed state support in the production of intermediary goods to supply cheap inputs for the private sector.

In the second half of the 1950s, as the favorable conjuncture for exporting disappeared, under protectionist conditions, foreign firms decided to invest rather than export certain products to Turkey. At that time, this choice was in harmony with the view of Turkish entrepreneurs. The shortage of foreign exchange led these entrepreneurs to turn towards producing the commodities that they had imported before.

However, the lack of sufficient capital stock, technological knowledge, and managerial skills led Turkish industrialists to offer partnerships to foreign investors.[140]

Group, was among the first enterpreneurs who apply to the TIDB for industrial credit for producing drugs under a foreign licence. For detailed studies, see Ç. Keyder, *Türkiye'de Devlet ve Sınıflar* (İstanbul : İletişim Yayınları, 1989), p.193; A. Buğra, *State and Business in Modern Turkey A Comparative Study* (New York: State University of New York Press, 1994), p.122.

[139] According to Hymer, if a foreign company prefers to invest abroad it should have specific advantages over the domestic companies because national companies have the general advantage of better information about their country in areas such as the economy, language, and law. Hymer,p.34.

[140] A useful example take place in ,one of the big industrialists in Turkey, Sabancı's autobiography. In his book, he mentions that in a late industrialization country where technology is important and scarce, knowledge of foreign production process becomes very important. For such examples see S. Sabancı, *Bıraktığım Yerden*

By collaborating with local firms, foreign firms began to manufacture their products in Turkey. This cooperation strengthened the transformation of local merchants into industrialists.[141] In addition, entrepreneurs who possessed know-how entered the business scene with an initial advantage.[142]

Hence, it would be not wrong to argue that although the amount of the inflow of FDI into Turkey was insignificant statistically, the contribution of FDI in the transformation of local merchants into industrialists and in the industrialization process was essential and that there was collaboration between foreign firms with local entrepreneurs rather than competition.

Even if the protectionist policies adopted by the government and encouragement Law No. 6224 regarding FDI were favorable for foreign companies to invest in Turkey, the increase in the inflow of FDI was not as great as expected between 1954 and 1960. This can be explained by the economic and political instability, and inflation in this period. Especially, at the end of the 1950s, Turkey was unable to borrow from abroad and external pressures and political unrest forced the Democrat Party to announce a stabilization program

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Hayatım, (İstanbul: Doğan Kitapçılık, 2005); C. Dündar, *Özel Arşivinden Belgeler ve Anılarıyla Vehbi Koç* (İstanbul: Doğan Kitapçılık, 2006).

[141] A. Krueger, "Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences" *NBER, A Special Conference Series*, 10 (1978), p.268.

[142] Many well-known industrial groups such as Borusan, Tekfen, Enka, E.C.A, Profilo, STFA, Alarko and Altınyıldız were established in the 1950s and most of them cooperated with foreign firms in this period. Buğra, p.67.

which included the moderation of government expenditures and a de facto devaluation in August 1958. For instance, the amount of realized FDI decreased in 1957 compared to the previous years as a result of the expectations of a devaluation and economic instability.[143]

1970 – 1980 Period: A Change in Attitude towards FDI

The 1970s witnessed several economic and political instabilities in both Turkey and in the world. In developing countries, the easy stage of ISI came to an end and the foreign exchange crisis and increasing dependency of imports led them to shift towards export promotion. Plus, most of the developed and developing countries were negatively affected by the 1974 oil crisis.[144] However, FDI flows in the world

[143] The foreign exchange crises in the mid-1950s had a negative influence on the foreign firms operating in Turkey. Some firms intend to leave the country under the scarcity of foreign exchange. For instance, the regional manager for Southern Europe and the Near East of the Alpha Petroleum Company was considering Alpha's position in Turkey because Türk Alfa A.Ş. was having increasing difficulty in obtaining dollars to pay its parent company for purchases of refined oil products, which it marketed in Turkey. In the end, the managers thought that if Alpha were to pull out of Turkey it would lose its present crude supply position in the rapidly growing Turkish market and continued its activities. See D.R. Robinson, *Cases in International Business* (New York: Rinehart and Winston, 1962), p.65.

[144] However, owing to the remittances sent by workers in Europe, with the support of the foreign exchange reserves and an accommodating monetary policy, Turkey did not experience the negative impacts of the oil crisis simultaneously with other countries in 1974 and the growth rate of the economy reached 8.9 percent in 1975 and 1976. Yet, borrowing abroad and expansionary policies only delayed the crisis. Turkey found itself in its most severe balance of payments crisis in 1978 and 1979. See Ş. Pamuk and R. Owen. *A History of Middle East Economies in the Twentieth Century* (Cambridge: Harvard University Press, 1999).

continued their steady increase. During the 1970s, the FDI inflows to Turkey continued to be statistically insignificant and fluctuated.[145] In addition, Figure 7 shows the FDI inflows to Turkey in comparison with those of Brazil and Mexico.

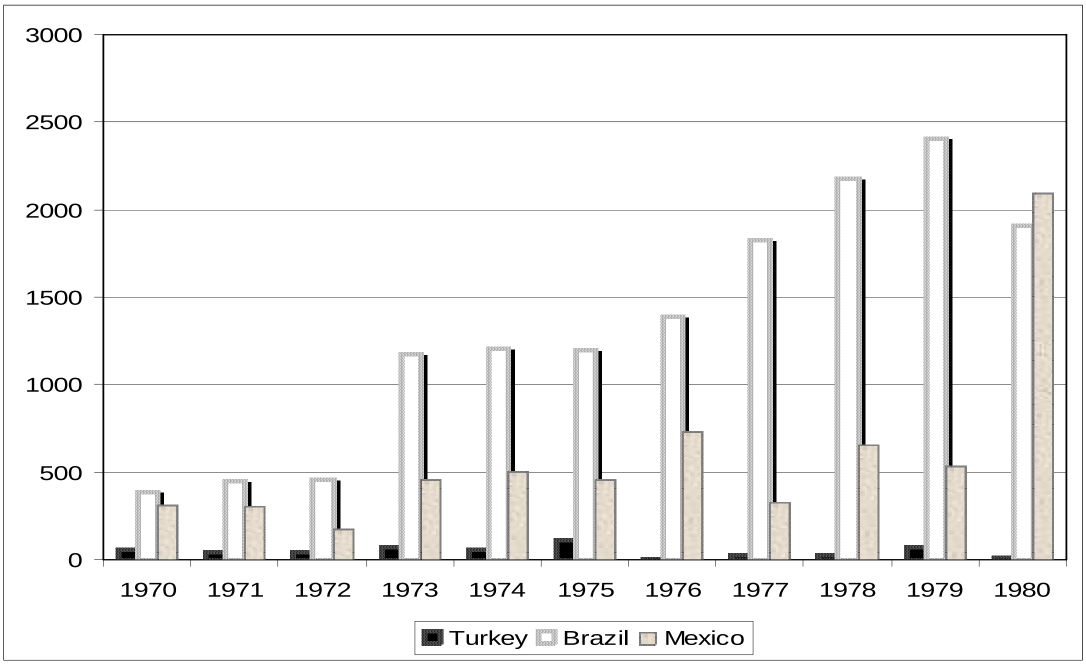

Fig. 7 FDI inflows US dollars with current prices (million dollars)

Source: UNCTAD, 2006.

Although governments in these countries took active measures towards FDI in the 1970s, Brazil and Mexico attracted much more FDI than Turkey. In Brazil, until the late 1970s, the entry of foreign investment was encouraged and promoted by various incentives and very few restrictions were imposed on such inflow. With few exceptions, all sectors of manufacturing

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[145] By 1976, 106 firms containing foreign capital were operating in Turkish economy. This amount began to decrease slightly after that year. By the end of 1977 the number of firms with foreign capital was 99. 86 of these firms were operating in the manufacturing sector. 11 firms were operating in the service sector, one in mining, and one in agriculture. In 1979, the number of firms decreased to 91. See Taner Berksoy, S. A. Doğruel and F. Doğruel ,*Türkiye'de Yabancı Sermaye* (İstanbul: Tüses, 1989).

industry were open to foreign investments through wholly foreign-owned subsidiaries. Policies toward foreign direct investments remained relatively stable during the 1960s and 1970s. In the second development plan (1975-1979), however, some concern was expressed about the large and unregulated inflow of foreign investments. The second development plan emphasized the need to define the role of foreign companies in the national development strategy and to implement this role through appropriate policy measures and instruments. Despite these measures, including reduced government incentives, foreign investments increased considerably during the period 1976 -83, from 9 billion to $ 22.3 billion.[146]

In Mexico, during the 1950s and 1960s, with the growing demand for a variety of consumption goods and intermediate products, the government followed a policy of import substitution, and foreign and domestic companies were given many incentives, including duty-free import of machinery, permission to import used equipment, tax concessions, and a high level of protection through tariffs and quantitative import restrictions. A large number of MNCs mostly form the US but also from the United Kingdom and other Western European countries set up subsidiaries to manufacture various consumer goods, including consumer durables and intermediate products. The automobile industry, which assembled more than 20 models of cars in Mexico in the 1960s, with limited local content in most cases, was typical of the pattern of foreign investment

[146] UNCTAD 2006. For FDI in Latin America see R. Grosse, *Multinationals in Latin America* (London: Routledge, 1989).

at that time.[147]

However, in Turkey the picture was somewhat different from that of Brazil and Mexico, except growing government intervention which was problematic in the Turkish case.

As mentioned before, after the second half of the 1960s, in the development plans, the export contribution of FDI was stated. For instance, between 1973 and 1977 the government put the export commitment of five percent of the total production of FDI per year and it was difficult to realize this amount for many foreign firms. In 1972, the Erim government decided to increase the share of local content in foreign firms. Also in the 1970s governments demanded that foreign firms bring technology with them into the Turkish economy. However, many foreign investors found the demands of the Turkish government for increases in export commitments and local content irrational.

Table 16. Exports of Foreign Firms Containing Foreign Capital in Total Sales (as percentage)

Sector	Exports / Total Sales of Foreign Firms		
	1973	1975	1976
Manufacturing	2.8	3.1	2.7
Mining	100	95.2	82.3
Agriculture	15.4	15.7	7.3
Service	2.1	2.4	43.3
Total	3.3	3.6	3.3

Source: Uras, 1979, p.214.

[147] R. Grosse, *Multinationals in Latin America* (London: Routledge, 1989); D. C. Bennett and K. E. Sharpe, *Transnational Corporations Versus the State, the Political Economy of the Mexican Auto Industry* (Princeton University Press, 1985).

One of the expected contributions from MNCs is to increase their exportation. Especially in the 1970s, the Turkish governments started to bargain with the MNCs and attempted to direct them to export-oriented sectors. As seen from the Table 8, the implementations of the governments did not increase the amount of exports in terms of the total sales of foreign firms. In the manufacturing industry, in which MNCs heavily invested, exports of firms containing foreign capital were 2.8% of their total sales in 1973, 3.1% in 1975 and 2.7% in 1976.

Figure 8 shows that inward FDI stock as percentage of GDP fluctuated during the period. Plus, especially in the second half of the 1970s, the ratio of FDI to GDP was below 0.1 percent, which is an insignificant ratio.

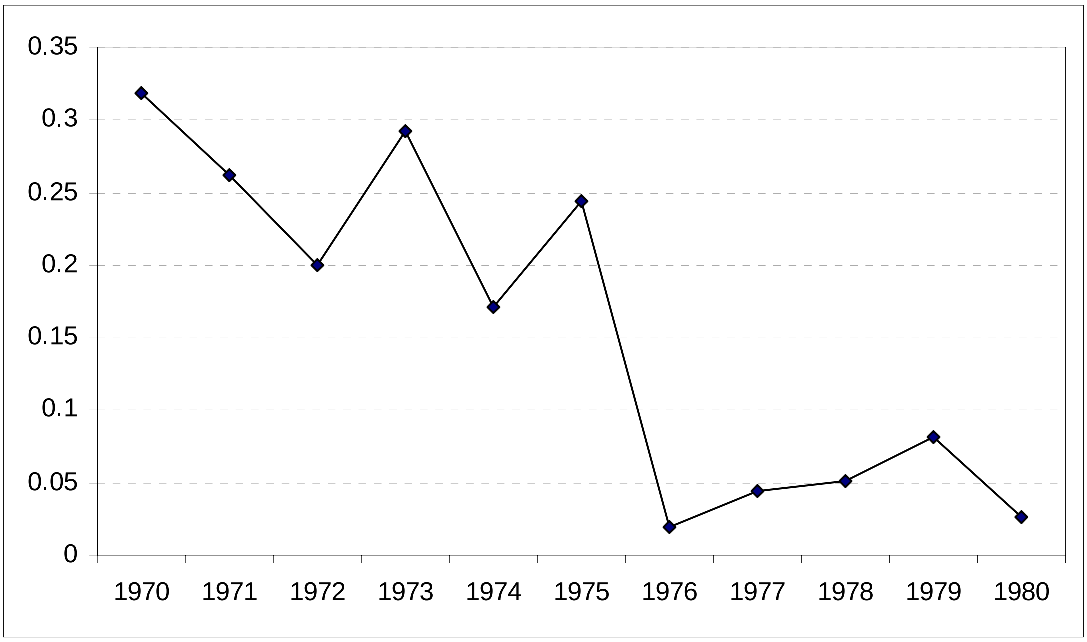

Fig. 8 Inward FDI Stock as percentage of GDP in Turkey
Source : UNCTAD, 2006

One of the reasons for the fluctuations was a scarcity of foreign exchange. In the 1970s the scarcity of foreign exchange, especially after 1976, obstructed transferring profits and obtaining imported inputs. The inputs of the MNCs, as well as domestic companies, mostly relied on imported intermediary and capital goods.

Table 17. Exports and Imports of Firms Containing Foreign Capital 1970 ($m)

	Exports(1)	Imports(2)	(1)-(2)Deficit
Final Goods Sector	11.8	6.5	5.3
Intermediary Goods S.	9.6	100.0	-90.4
Capital Goods Sector	3.8	182.6	-178.8
Total	25.2	289.1	-263.9

Source: C. Alpar, Çokuluslu şirketler ve Ekonomik Kalkınma (Ankara: Ankara İktisadi ve Ticari İlimler Akademisi, 1977), p.178.

Due to the scarcity of foreign exchange, firms containing foreign capital had difficulties in obtaining foreign exchange. As seen in Table 17, the imports of foreign firms depended mostly on intermediary and capital goods. This can be explained by the inadequacy of local producers in producing commodities which require technology, management skill, and economies of scale. This picture also shows the failure of the ISI strategy as the firms became more dependent on foreign inputs in the later step of the model.

In addition to the economic and political instability in the 1970s, although Law No. 6224 remained in effect, the attitudes of governments towards FDI changed in this period. After 1971, the non-party government under the premiership of Nihat Erim adopted new measures which indicated a shift from the liberal foreign investment policy. The new government announced that future applications for FDI would be judged on provision for majority Turkish ownership, capacity for export, ability to induce an inflow of technology, and utilization of economies of scale.[148] In reality, the demands of the Turkish governments had not been met by the MNCs. The Turkish government's demand for increases in export commitments increase in local content and restrictions on the local credits available to FDI firms were harshly criticized by the MNCs operating in Turkey. They found the Turkish government's

[148] D. Ashkin, *Evaluation of Private Foreign Investment Climate in Turkey.* Florida State University, D.B.A., (1972).

demands irrational.[149]

The change towards foreign firms was mostly due to the firms containing foreign capital did not fulfill the export requirements. The officers of SPO and the governments often influenced the necessity of the export contribution of foreign firms. In addition the ideological thoughts and attitudes that were dominant in the political atmosphere were also significant, affecting the activities and investment of foreign firms.

Especially in the 1970s, host countries put pressure on MNCs to bring their technology with them and the MNCs were directed to export-oriented sectors. For instance some of the Latin American countries and India gained bargaining power over the MNCs by controlling capital and access to its markets and directed them in their favor in the 1970s. In Mexico, in the late 1960s and early 1970s, the earlier policy of unrestricted inflow of foreign capital and technology began to be questioned seriously.

In the early 1970s, the government introduced new regulatory measures for foreign direct investment. The large increase in imported equipment and intermediate goods and components resulted in major deficits in the balance of trade, which became a growing concern to the government.

One of the demands of the host country was the technological contribution of the MNCs. However, MNCs did not want to share their technological advantage which brought them

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[149] A. Erdilek, *Direct Foreign Investment in Turkish Manufacturing* (Tubingen: Mohr, 1982), p.22.

high profit rates. Although Brazil was successful at directing the MNCs to the manufacturing sector because of its control over the access to its markets and resources, it did not gain the same success when trying to direct MNCs in the pharmacy sector because, the MNCs' bargaining power was stronger than the bargaining power of the Brazilian government in the pharmaceutical sector.

In contrast to the successful efforts (in some sectors) in Mexico and Brazil, it is hard to argue that the bargaining strategy of the Turkish government worked in any sector.

The foreign firms were quickly affected by the new improvements and the regulations of the Turkish governments. Figure 6 reveals that after 1972 the level of inward stock of FDI as a percentage of GDP had begun to fall, especially sharply after 1975.

In sum, the foreign exchange crisis that took place in the second half of the 1970s had a great impact on the MNCs operating in Turkey. They had trouble getting the foreign exchange to transfer to their corporate headquarters. In addition to the foreign exchange crisis, the bargaining policies of the governments, and the economic and political instability in the country obstructed higher levels of FDI flow into Turkey.

An Evaluation of the 1950-1980 Period

During the 1970s and earlier, Turkey like many other developing countries adopted an inward-looking import substitution strategy, combined with widespread state ownership of companies throughout the manufacturing sector and some important services. The provisions of Law No. 6224 seemed liberal and compared favorably with the investment laws of many countries. However, between 1951 and 1980, a total of $230 million in capital came through this channel.[150] Since its inception in 1954, the flow of private capital into Turkey remained far below expectations.

One of the reasons is that, in this period of Turkey actually lacked the political and economic stability to provide an attractive investment environment for investors. In the 1960s and 1970s, several coalition governments and two military coups showed Turkey to be politically unstable in its second experiment with democracy.

The period 1974-1979 also witnessed rising political instability and widespread violence between political factions and ideologies, which drastically worsened the environment for FDI.

[150] The statistics of FDI flows between 1950 and 1980 differ in various studies. The State statistics (DPT) and the World Bank, UNCTAD statistics differ to a large extent in this period.

What can be understood by these facts is that there is no direct relationship between the regulations about FDI and the inflow of foreign capital. In other words, the inflow of foreign capital can not be increased only by liberal regulations alone. If the inflow of foreign capital is below the expected level, the reason must be sought elsewhere.

The Role of the Bureaucracy

A regulatory framework is only as good as its implementation. Administrative barriers that reduce the efficiency of the regulatory system due to inefficient administration or procedures can have an enormous negative impact on foreign investors. An inefficient bureaucracy often results in investment plans that become outdated for the investor, unnecessary costs for management time not efficiently used, and expensive equipment and employees that are idle.

In Turkey, bureaucratic procedures surrounding the investment process were often lengthy, unnecessarily cumbersome, and unpredictable. The administrative procedures did not reflect international best practice. For instance, acquiring establishing a firm permit or a trademark registration could take many months or even years.

In most of developed countries, the bureaucracy tends to be somewhat autonomous from political pressure and to have an established mechanism for recruitment and training. The institutional strength and quality of the bureaucracy is another shock absorber that tends to minimize revisions of policy when governments change. However, in Turkey, there has been a disparity between the governments and the bureaucracy when FDI is considered.

Actually the position of the bureaucracy in Turkish politics is a somewhat profound issue which requires special attention. However, in this thesis I will not examine the role of, and historical progress of the bureaucratic organization. Instead, I emphasize the points related with the investment climate in Turkey.

In the Ottoman Empire, regarding the role of bureaucracy during the reforms, newer codes were established if a new code was necessary and the old codes maintained. As a result, duality occurred which created a complex hierarchical environment that made work impossible. Second, the Ottoman bureaucracy never went under a total reform. While they viewed western societies as an ideal, they did not really understand the role of the bureaucracy in those societies.[151]

During the Republican era several reforms were initiated,

[151] Stanford J. Shaw, "The Central Legislative Councils in the Nineteenth Century: Ottoman Reform Movement Before 1876" *International Journal of Middle East Studies* I (1970), pp.30-32.

however, the efforts remained insufficient.[152] After the end of the Second World War, several foreign experts, with the support of Turkish ministries, conducted research in order to propose a reform program. However, the projects never became active.[153]

According to several scholars, the political parties were not concerned about administrative reforms in regard to the requirements of the industrialization process. On the other hand, in this period, interest groups did not propose a model revealing how the bureaucracy should function in order to meet the requirements of entrepreneurship. Under such circumstances the Turkish political and administrative environment maintained its patrimonial characteristics. In 1959, a scholar stated at the time that although administrative reforms took place thanks to political developments, bureaucracy still had the power and ability to manipulate government policies.[154]

The situation was not different in the 1980s, with regard to voluntary interest group associations, too. When asked in 1981 why employers did not articulate their demands unequivocally and in a straightforward fashion, the chairman of the Turkish Industrialists' and Businessmen's Association replied, "In this country, our philosophy has always been that of taking the paternal state (*devlet baba*) as paramount,

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[152] Metin Heper, *Türk Kamu Bürokrasisinde Gelenekçilik ve Modernleşme – Siyaset Sossyoloji Açısından Bir İnceleme* (İstanbul: Boğaziçi Üniversitesi Yayınları, 1977), p.70.

[153] C. H. Dodd, "The Social and Educational Backgrounds of Turkish Officials", *Middle Eastern Studies* (April, 1965), pp.71-83.

[154] Kemal H. Karpat, *Turkey's Politics: The Transition to a Multi-Party System* (New Jersey: Princeton University Press, 1959), p.150.

refraining from challenging it, and of pursuing an economic policy not in spite of, but along with the paternal state."[155]

Consequently,

> individual members of the private sector often by-passed their interest group associations and attempted establishing "clientala" relations with government officials. There has been an endless effort on their part to co-opt highly placed bureaucrats to develop "smooth" relations with the bureaucracy.[156]

A democracy adopted by the conscious decision of the state elites rather than as a consequence of rising social groups, however, could not be conceived as a system of rule through which sectional interests would be reconciled. This development is highly different from Jensen's emphasis on democracy.

Therefore, although governments seemed to favor FDI inflows, the ambiguous arts of the FDI laws were used as tools to hinder FDI by the Turkish bureaucracy. For instance, Article 1 of Law No. 6224 implied that FDI had to benefit the economic development of the country. This vague law over the years became open to use as a tool for the bureaucracy and sometimes for the government to discriminate against some FDI activities. Hence, especially for foreign firms, the SPO and the red tape of public institutes were responsible for the low inflow of FDI. There was, in other words, a clear discrepancy between the law and its bureaucratic implementation.

In a closed economy in which foreign economic relations

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[155] Metin Heper "The State and Interest Groups with Special Reference to Turkey" ed. Metin Heper *Strong State and Economic Interest Groups. The Post-1980 Turkish Experience* (Berlin; New York: de Gruyter, 1991), p.17.

[156] Ibid., p.17.

are subject to extensive state control, each connection with foreigners also involves an encounter with the state authority. Many foreign investors accused the Turkish bureaucracy of straight and simple violation of the law in order not to implement its various provisions. For instance, the bureaucracy did not allow the capitalization of intangible rights reduced and even stopped royalty payments in the 1970s.[157]

One of the important obstacles for foreign firms was the long waiting period to receive permission from the Council of Ministers. In the 1970s, the average time between a firm's application for permission and its publication in the Official Gazette was about two years. Another problem was the SPO's unwillingness to process the FDI applications quickly enough. The SPO often increased the red tape for the application procedures for foreign firms so that the permissions for foreign firms would be delayed at least for three or four months. The SPO officers denied that the SPO was anti-FDI and blamed the delays on political facts and a shortage of expert personnel. The last fact was the main problem of the institutions, which were responsible for evaluating FDI applications. For instance, there were only a few experts in the Ministry of Commerce's (MOC) FDI division and they were fired for political reasons when the new government came into power. Hence, with no skilled employees, as the chief of the

[157] Erdilek,p.14.

MOC's FDI division stated, his division was no longer capable of evaluating the FDI applications on a technical level.[158]

The Single Agency Problem

Lack of consistency of the implementation of laws and regulations in different municipality authorities is another area that requires attention. Before 1980, at some point investors might receive two contradictory permits from different authorities in Turkey. However, lack of coordination between administrators or policy-makers on the national and municipal levels results in inconsistent behavior of the administration. Laws and regulations were not applied by local administrators on the same standard as on the national level. Local politicians in some cases might delay the issuance of necessary permissions for unrelated reasons. A prospective foreign firm could be forced to get as many as 23 signatures from various official authorities in order to receive FDI permission, which could take as long as three years.[159]

In sum, until 1980, one of the facts affecting the FDI application process was the lack of a strong and efficient organization dealing with the FDI application process. In addition, coordination was lacking between the institutions dealing with FDI.

Also, the application procedure was complicated and

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[158] Ibid., p.24.
[159] Dumludağ, p. 87.

required many steps before realizing the investment. According to foreign encouragement Law No. 6224, first, the FDI application was submitted to the Ministry of Commerce. Then, if the application was in fulfillment of its requirements the MOC sent the application to the SPO (before the establishment of the SPO it had been the Committee of Encouragement of FDI).

The SPO evaluated the net economic and technological benefits for the country within the framework of the development plans. If the evaluation of the SPO was favorable, then the application was sent back to the MOC. From there, a draft of the foreign firm application was sent by the MOC to the Council of Ministers (COM) for political approval. The draft had to be signed by all cabinet ministers before it could become finalized. The final decree went into effect with its publication in the *Official Gazette*.[160]

The Effect of Public Opinion

Owing to the bitter experience with the capitulations in the nineteenth century in the Ottoman Empire, FDI has always been viewed with suspicion in Turkey. Especially in the 1960s and 1970s the subject of FDI was at the center of a heated debate in Turkey. As a result, in this period, the literature in this field is characterized by mixed feelings and most of the arguments put forward, both for and against FDI, were based on political tendencies, ideological antipathy to

[160] Baran Tuncer, *Türkiye'de Yabancı Sermaye Sorunu*. (Ankara: Ankara Üniversitesi Siyasal Bilgiler Fakültesi Yayınları, 1968). P.77.

private enterprise in general, and extreme nationalism. Plus, these studies rely on unreliable statistical data. It was astonishing to find that FDI statistics are different in every study done in this period.

In the 1960s, many debates also took place in the parliament and in the press. These were mostly about the improper functioning of the foreign firms. For instance, one foreign firm, although it had taken the approval to produce the raw materials for pills, produced baby’s food, which was in no way related to the approved category.[161] Another criticized subject was the insignificant contribution of the foreign firms to the Turkish economy. Most of the foreign firms assembled imported inputs. They were criticized for disregarding the local content and increasing the dependency on foreign exchange.

In the 1970s, although ideological attitudes were mostly in favor of FDI, government obstacles increased significantly. For instance, during the coalition governments, some decrees were blocked for more than a year because of the lack of one or two signatures. In addition, the competition between the political parties mostly increased employee circulation in the departments dealing with FDI and this diminished the number of skilled personnel in these departments.

[161] Güngör Uras, *Türkiye’de Yabancı Sermaye Yatırımları* (İstanbul: Formül Matbaası,1979).

CHAPTER 7

POST 1980 PERIOD

A Change in the Attitude towards FDI

1980 marks a turning point for many developing countries including Turkey. After 1980, most of these countries integrated into the international economy through liberalizing their economies. The governments, especially in Latin America, suffering the negative impacts of hot money transactions turned towards FDI, as a reliable foreign source, in order to realize sustainable growth rates. In these countries, FDI laws including several restrictions were replaced by new laws offering significant incentives to foreign investors. As a result of opening economies, and governments' positive attitudes, FDI inflows were significantly increased into developing economies.

In the same way, with the 24 January 1980 program, Turkey's integrated into the world economy through several measures. The economy became much more open to international trade and later, financial markets. The government launched an economic stabilization and structural adjustment program aimed at encouraging a private-sector-led, export-oriented growth.

The program included a flexible exchange rate, incentives to promote exports, deregulation of interest rates to promote domestic savings, reform of state enterprises, and import liberalization. Plus, quantitative restrictions on imports were also removed, and tariffs were significantly reduced. When the Turkish Lira became convertible, the country received significant amount of portfolio capital flows. However, Turkey's integration with the world economy through FDI continued to remain weak in comparison to other developing countries.

In Turkey, after 1980 the attitude of governments' toward FDI issue changed dramatically. Governments, in order to attract foreign firms, revised the regulations concerning FDI. Before, there had been a lack of a strong and efficient organization dealing with the FDI application process. In the 1980s, all restrictive regulations about FDI implemented in the 1970s were eliminated. The negative attitudes of the public and of the bureaucracy softened gradually.

First, with decree No: 8/168, a newly created Foreign Direct Investment Department, within the SPO, acquired the consolidated authority which had been previously split among several different government agencies to manage the relations with foreign firms.[162]

Second, Law No. 6224, encouraging FDI, still remained in effect with minor but important changes and the red-tape was

[162] Asım Erdilek "Turkey's New Open Door Policy of Direct Foreign Investment: A Critical Analysis of Problems and Prospects", *METU Studies in Development,* no.13 (1986), p.173.

by and large reduced. For instance, the 49 percent foreign ownership limit, which was introduced in 1971, was removed in this period. Also new measures were taken in the foreign employee regulation.

Third, a significant change took place in the public opinion. Since 1980 there has been a great interest of the public in the FDI issue. This is an important development when the excited discussions about the FDI issue in the parliament and public in the 1960s are considered.

And finally, in 1980, in order to inform the public about issues regarding FDI, a foreign investors association (YASED) was established.[163] YASED held conferences in order to change the suspicious attitude in the public towards FDI.

Although significant measures were taken in order to attract FDI inflows in the 1980s, the amount of FDI increased annually but not as expected. The graph in figure 9 demonstrates FDI inward stock as percentage of GDP in Turkey, which after a short period of acceleration from 13 percent in 1980 to 15 percent in 1984, began to decrease considerably by the end of the 1980s. The share of FDI inward stock stagnated in the 1990s.

[163] The name of the organization was changed to International Investors' Association in 2005. (Logo remains the same).

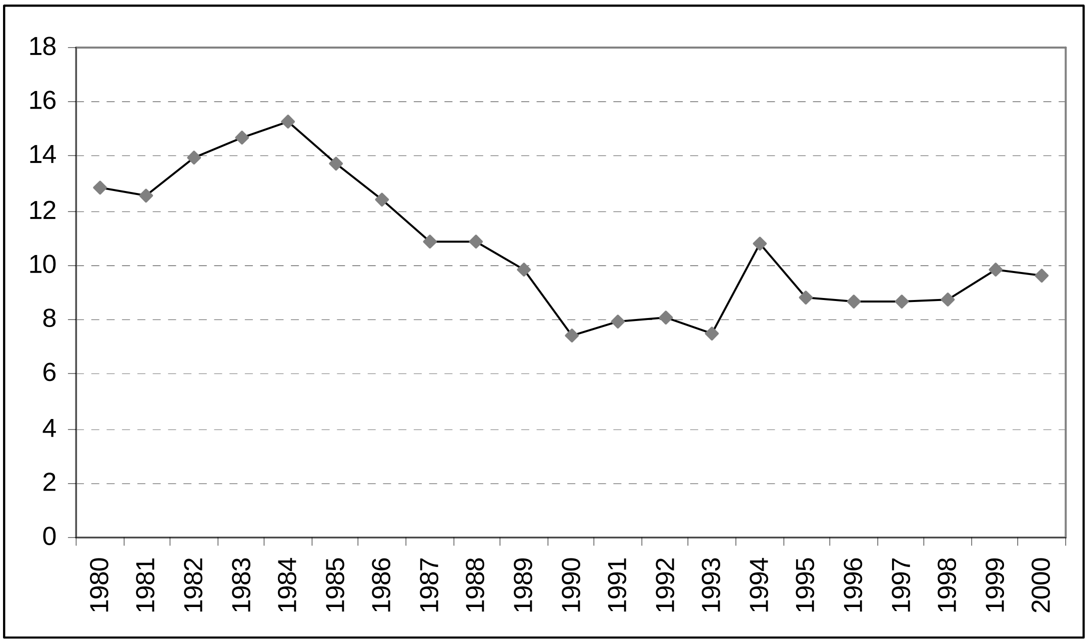

Fig. 9 FDI inward stock as percentage of GDP in Turkey
Source: UNCTAD, 2006.

There are several reasons for the substantial increase in the first half of the 1980s. The Turkish government transformed the repayment of commercial credits borrowed from foreign financial agents into foreign direct investment.[164] Also an export-oriented strategy and increasing trade relations between Turkey and countries in the Middle East attracted foreign firms motivated by vertical strategy.

The level of FDI inflows with current prices as US dollars, continued to remain low in the 1990s. The average of FDI inflows was $170 million during the 1980s. This can be considered as a success when the $227 million total FDI inflow to Turkey is considered. However, after 1980 FDI flows into developing countries increased rapidly.

[164] Cillov 1983.

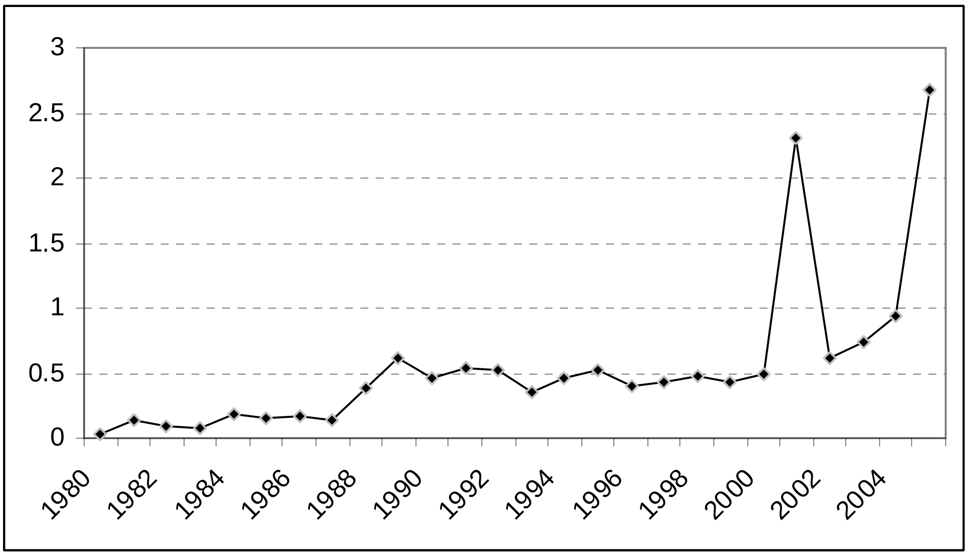

Fig. 10 Inward FDI inflows as share of GDP in Turkey
Source : UNCTAD, 2006.

In the 1990s average annual FDI inflow of $770 million fluctuated between $680 and $980 million. A comparison of the FDI levels of Turkey, Brazil and Mexico gives an idea of Turkey's performance during the period.

In the 1990s the inflow of FDI to Turkey reached 1 billion annually. However, when we compare Turkey with other developing countries such as Brazil and Mexico we see that Turkey was not successful at attracting FDI in relative terms. For instance, Brazil attracted two times grater FDI than Turkey in 1990; in 2000, the ratio reached 1:40. The ratio between Mexico and Turkey was 1:1.5 in 1990; however, the ratio reached 1:15 to the disadvantage of Turkey.

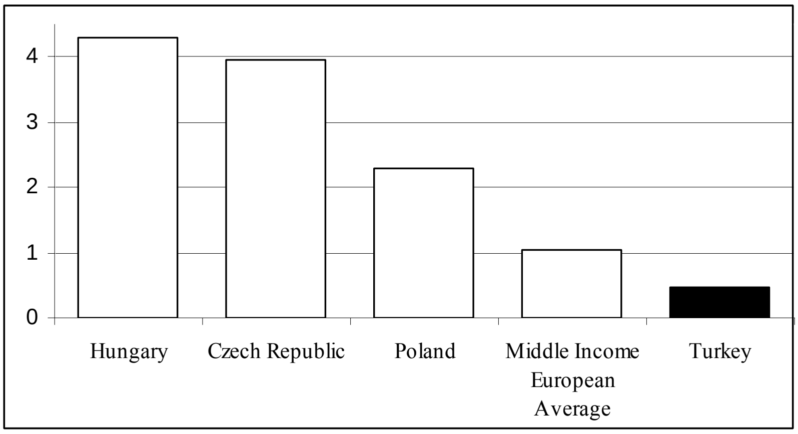

Fig. 11 Average FDI Inflows as a percentage of GDP, 1990-99 (%)
Source: FIAS, 2001.[165]

In the 1990s countries of former communist regimes entered into the competition for FDI. With faster and more thorough reforms in many of them, very well educated workers, technical, and scientific personnel, success in fighting inflation, greater geographic proximity to the EU as well as, in total, a very large and unsaturated market, led Central and East Central countries to receive more FDI flows than Turkey. Hungary, Poland and the Czech Republic became major targets of FDI – not only from Western Europe but from the USA and to some extent from Asia as well.

The failure of Turkey’s FDI performance in this period can be explained by several economic and non-economic factors.

The 1990s called the lost decade in Turkey due to severe, subsequent economic crises. The political and economic

[165] Middle income European countries include Albania, Belarus, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, FYR, Poland, Romania, Russian Federation, and Slovak Republic.

instability obstructed higher amounts of inflow of FDI. While in the 1970s executives of foreign firms typically complained about the negative attitude of governments, in the 1990s they mostly complained about the macroeconomic and political instability.[166] In this period, Turkey had 9 coalition governments in 10 years. By this way there was no chance for government's ability to carry out its declared programs, and its ability to stay in office.

Economic growth was increasingly infrequent, with sharp rises and falls, including a financial crisis in 1994, followed by a severe recession. Inflation accelerated and exceeded 100 percent in 1994.[167]

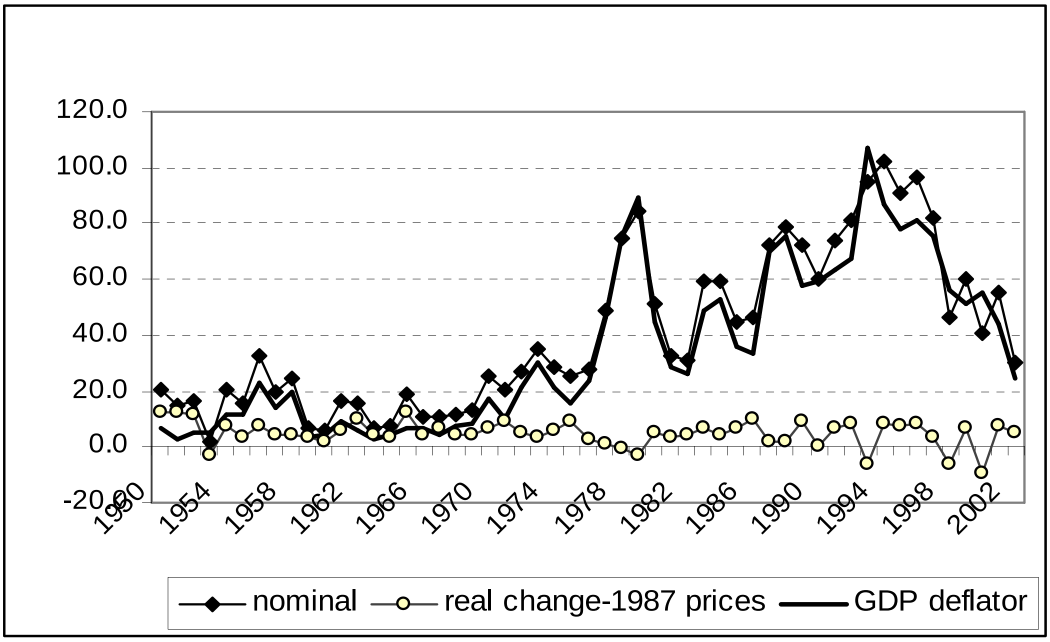

Fig. 12 Inflation and GDP growth in Turkey (%)
Source: State Statistics Institute, 2006.

[166] D. Erden, *A Survey of Foreign Direct Investment Firms in Turkey* (İstanbul:Boğaziçi Üniversity, 1996).

[167] On the other hand, inflation may not be a serious problem in some cases. For instance, Brazil, Mexico and Argentina attracted significant FDI inflows altough high inflation took place in these countries in the 1980s.

In this period, governments, in order to diminish public budget deficits, attracted portfolio capital transactions rather than promoting FDI inflows. The importance of FDI as a source for sustainable growth rates lost its importance. Attracting FDI remained shadowed by hot money. The lack of success in reducing the inflation rate, as well as instability in government, contributed to reinforce the perception of Turkey as an unstable and unpredictable place to invest. In sum, the Turkish Government was unable to facilitate and promote an attractive investment environment through stable and market oriented economic policies. Financial crisis and continuous economic and political instability deterred not only foreign investors but also local entrepreneurs.

The Effect of Globalization: Changing Rules

As the globalization process increased the FDI flows in the world, developing countries turned towards active policies rather than wait and see attitude depend on liberal encouragement laws of FDI.

Especially, in the 1990s, in most developing countries, new investment codes were promulgated that removed many of the restrictions and impediments that had limited FDI in the past, replacing them with a variety of investment incentives and guarantees. These include the freedom to remit profits, the removal of limits on the level of foreign equity, and the establishment of Investment Promotion Agencies.

The most significant incentive was the establishment of Investment Promotion Agency (IPA). Increasing competition for attracting FDI between developing countries bring new measures with it and the number of IPAs increased significantly after 1990. FDI promotion, in any form, became an important economic development strategy for countries of all levels of economic development. Between 1991 and 1998 alone over 58 countries initiated IPA. Annually, 30 new IPAs were established in the period.[168] By 2003, IPAs operated in 160 countries and 250 regions in the world.[169] Interestingly numerous IPAs have moved from passively attempting to contact interested investors. These kinds of tactics stem from advertising in magazines, and conferences targeted to encourage individual contact between investment agencies and MNCs that could potentially provide FDI.

Beyond investment promotion, countries have also taken bold steps in the liberalization of the investment regimes, allowing for further penetration of MNCs into domestic markets. According to UNCTAD reports 1,035 worldwide laws governing FDI were introduced from 1991 and 1999. Where 94 percent of these created more favorable environment for

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[168] H. Loewendahl and E. E. Loewendahl "Turkey's Performance In Attracting Foreign Direct Investment Impications of EU Enlargement". *European Network of Economic Policy Research Institutes Working Paper* No.8 (2001), p.1.

[169] J. Morisset, "Does a Country Need a Promotion Agency. A Small Analytical Model Applied to 58 Countries" *Policy Research Working Paper*. The World Bank Foreign Investment Advisory Service (2003)p.3.

MNCs.[170]

However, in Turkey, an IPA could not be established as in the form of other country IPAs.[171] Plus, the strategy of Under secretariat of Treasury General Directorate for Foreign Investment in Turkey does not include active policies such as those of the IPAs in such places as Korea, the Republic of Ireland or Singapore.[172]

Recent Period: Structural Change

At the end of 1999, Turkey adopted a three-year economic stabilization and structural reform program with the support of the International Monetary Fund (IMF). However, after the subsequent crises of November 2000 and February 2001, the program collapsed. The support of the IMF and the World Bank continued and structural reform and economic stabilization programs continued. Turkish governments decisively adopted administrative reforms and the Turkish Parliament approved a sweeping revision of the country's codes to bring them closer to European Union norms.

Significant reforms were approved especially in the financial sector. In order to strengthen the quality of economic institutions, new measures were adopted. At the end

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[170] UNCTAD, World Investment Report, 2006, p.iv.

[171] There is a web site "invest in turkey" which navigates information platform for international entrepreneurs considering why and how to invest in Turkey. See http://www.investinturkey.gov.tr

[172] For a detailed study about IPAs and the case of Turkey see: D. Dumludağ, "Doğrudan Yabancı Yatırım Hareketlerinde Yatırım Promosyon Ajanslarının Rolü", *Marmara Üniversitesi İİBF Dergisi*, 1, 2006.

of the period the rate of inflation decreased to fewer than 10 percent. The economy experienced high growth rates while there was no progress in diminishing the unemployment level.

The coalition government and succeeding AKP government paid special attention to inward FDI and approved legislative revisions concerning FDI. A new FDI encouragement law was enacted in 2003, the complicated entrance procedures were simplified, and for the first time, the state accepted to work in accordance with non-governmental organizations and the private sector in order to improve the investment environment for foreign investor.

Plus, in support of these efforts, Foreign Investment Advisory Service of the World Bank has been asked to analyze the business climate in Turkey and prepare this report which indicates the government willingness to attract more FDI inflows to Turkey. For this purpose Foreign Investment Advisory Service (FIAS) prepared a report, based on extensive field work consisting of surveys and interviews that declared that administrative barriers hinder more FDI flows into Turkey.

In this period, for the first time, remarkable measures were taken showing the decisive attitude of governments towards attracting FDI. As mentioned, the existing law of FDI, which dated back to 1954, was replaced by the new foreign investment Law No. 4875 in June 2003. This law replaced the old FDI approval and screening system with a notification and registration system, bans nationalization without fair compensation, guarantees national treatment to foreign investors, does not restrict FDI in any sectors or impose any performance requirements, eliminates the old minimum capital limit, grants foreign investors full convertibility in their transfers of capital and earnings, allows them to own property without any restrictions, and recognizes foreign investors' right to international arbitration.

Second a Coordination Council for improving the investment climate (CCIIC) consisting of government and private sector representatives was established. The council included government and private sector representatives and aimed to improve the investment environment in Turkey. For this reason the council formed several technical committees for in-depth study of individual issues that concern the improvement of the investment environment.

Third, for the first time under the presidency of the prime minister of Turkey, the Advisory Investor Council held its first meeting in 2003. The council consisted of the chief executive officers or chairpersons of 15 foreign affiliates such as Citigroup, Siemens and Toyota.[173] The council held its first meeting, chaired by the Prime Minister, in March 2004, identifying 13 key areas on which the government was advised to focus its efforts to improve the FDI environment. After its second meeting, chaired by the Prime Minister, in April 2005, the council commended the government for its progress in improving the FDI environment, drawing attention to 10 important issues that needed to be worked on.

[173] For the participants in the Advisory Council see appendix.

In 2000 the number of firms containing foreign capital was 5328. In 2003 the number of firms was 6511. During the 18 month period between the enactment of Law 4875 in June 2003 and the end of 2004, 2,461 new FDI firms came into existence and 634 national firms became FDI firms, with total FDI inflow of $3.8 billion, 80 percent of which originated from the EU.[174]

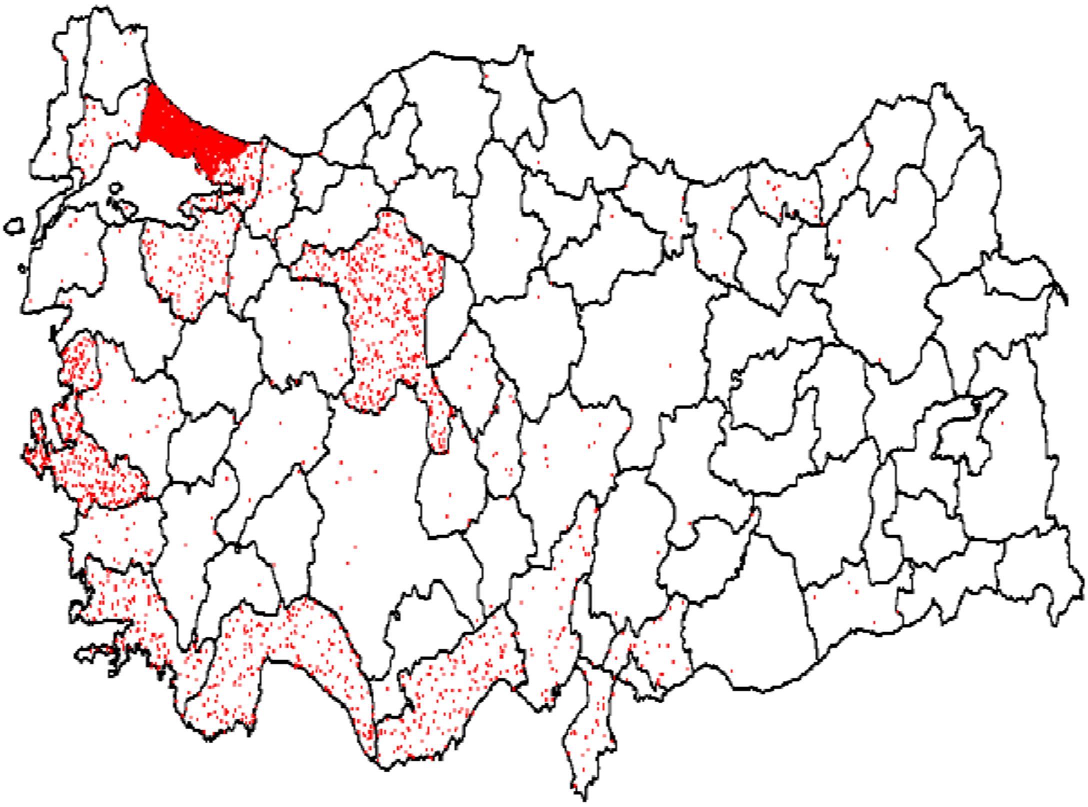


Fig. 13 The distribution of FDI according to cities in Turkey between 1954-1999
(1 point in red = 1 firm)
Source: T.C.Başbakanlık Hazine Müsteşarlığı Uluslararası Doğrudan Yatırımlar 2005 Yılı Raporu (Ankara: Yabancı Sermaye Genel Müdürlüğü, 2006), p.30.

[174] Republic of Turkey Prime Ministry Undersecretariat of Treasury, Statistics, 2007.

As seen from figure 13, FDI concentrated in major industrialized and urbanized cities. Plus, seashore of the country attracted FDI because of the role of tourism.

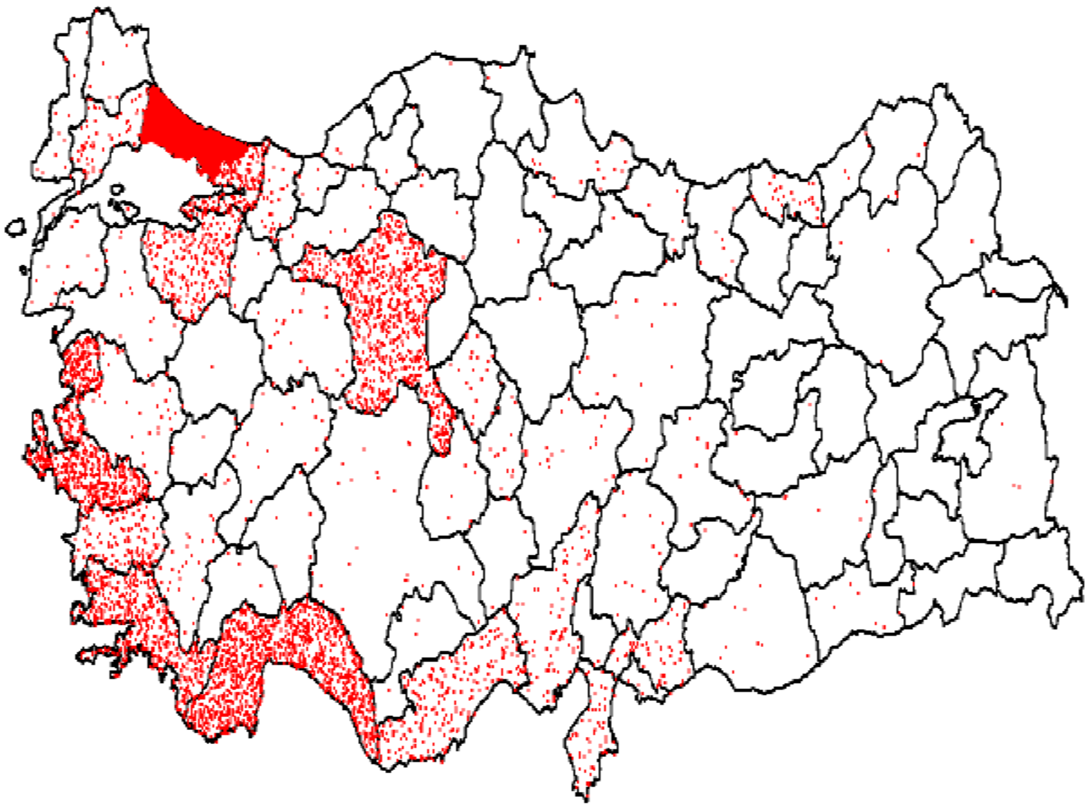
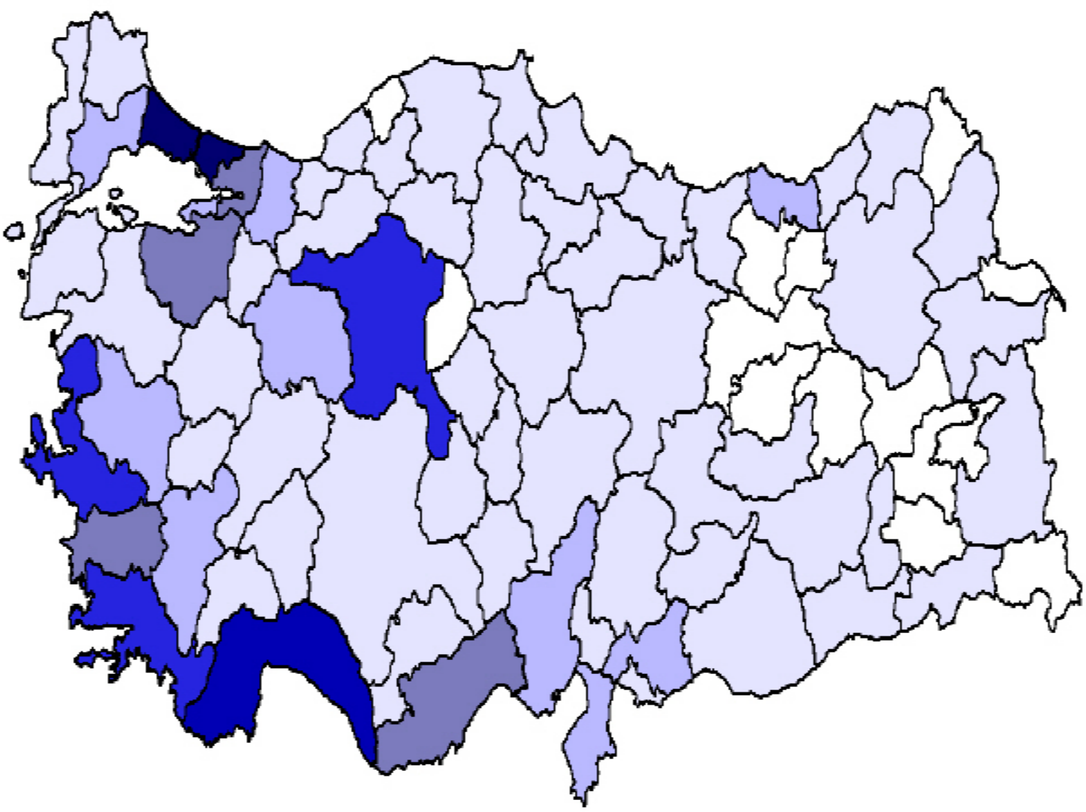


Fig. 14 The distribution of FDI according to cities in Turkey between 1954-2005
(1 point in red = 1 firm)

Source: T.C.Başbakanlık Hazine Müsteşarlığı Uluslararası Doğrudan Yatırımlar 2005 Yılı Raporu (Ankara: Yabancı Sermaye Genel Müdürlüğü, 2006), p.32.

Since the new FDI law, 6,000 new FDI firms were established in Turkey. Between 1954 and 1999, the cumulative of foreign firms was 4,192. However, most of the newly established firms are small and medium scale and most of them are far away to be called as MNCs.

Figure 14 demonstrates that by 2005, most of the foreign firms concentrated in major cities; Istanbul, Ankara, İzmir, Antalya, Bursa and industry centers Kocaeli, Tekirdağ and Bursa.



Color	Number of Firms		Number of Cities		Number of Firms		Number of Cities
	>= Minimum	< Maximum			>= Minimum	< Maximum	
	0	1	13		250	250	4
	1	25	49		1000	1000	1
	25	100	10		1200	6780	1
	100	250	4				

Fig. 15 Distribution of FDI in regions and cities between 1954-2005.
Source: T.C.Başbakanlık Hazine Müsteşarlığı

The distribution of 11,685 firms containing foreign capital is seen in figure 15. Istanbul attracted 6,776 of these firms where as Antalya attracted 1,175. In Ankara 885 foreign firms are operating whereas the number is 731 in Izmir. Muğla has 546 firms, Bursa 247, Mersin 239 and Kocaeli has 155 foreign firms operating in Turkey.[175]

According to the ISO (Istanbul Chamber of Industry), in 2004, among the largest 1,000 industrial firms, there were 223 FDI firms, which accounted for 40 percent of the total sales, 49 percent of the total value-added, 44 percent of the total profits, 44 percent of the total exports, and 27 percent of the total employment.[176]

In sum, although FDI received attention from the governments since 1980, the intense efforts in order to increase the FDI inflow have taken place since 2001. The coalition government and succeeding AKP government approved legislative revisions concerning FDI. A new FDI encouragement law was enacted in 2001, the complicated entrance procedures were simplified, and for the first time, the state accepted to work in accordance with non-governmental organizations and the private sector in order to attain a higher level of FDI inflow.

However, these concrete efforts did not increase the FDI inflow as expected. The FDI inflow was $982 million in 2000; it reached $3.2 billion in 2001. However, the increase of FDI inflow did not continue, rather, it fluctuated. The inflow was $1 billion in 2002, $575 million in 2003 and $2.7 billion in

[175] European countries dominate the breakdown of foreign firms by country with 6,153 firms (with Germany, 2,145; England 926) followed by United States with 624 firms.

[176] İstanbul Chamber of Industry, 2005.

2004.[177] These data suggest that the inflow of FDI remained far below the expected $30 billion potential inflow level.[178]

FDI Performance of Turkey in a Comparative Perspective

As mentioned several times, despite these efforts, Turkey has never been able to attract the substantial FDI inflows that would be expected from a nation with a strategic location between Europe, the Middle East and Central Asia. Turkish FDI levels have stagnated during the 1990s while total FDI worldwide increased by a factor of 12. This lack of interest by multinational companies becomes even clearer when FDI inflows are adjusted for the size of the economy. Over the last decade, the average FDI inflows to middle-income countries in Europe was 1.1 percent of GDP compared to less than 0.5 percent in Turkey. As shown in the following figure, this disparity is considerably greater when Turkey is compared to the countries investors consider to be its main regional competitors: Hungary, the Czech Republic, and Poland.

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[177] UNCTAD, *Handbook of Statistics*, 2006.

[178] This thesis focus on FDI in Turkey until 2006. This is because FDI inflows to Turkey, in 2006, reached $20 billon for the first time in history. It is too late to say that Turkey will attract over 20 billion dollars continuously. This increase, as the share of mergers and acquisitions is considered, may be a temporary increase. Hence, in order to propose a complete analysis, a couple of years should pass.

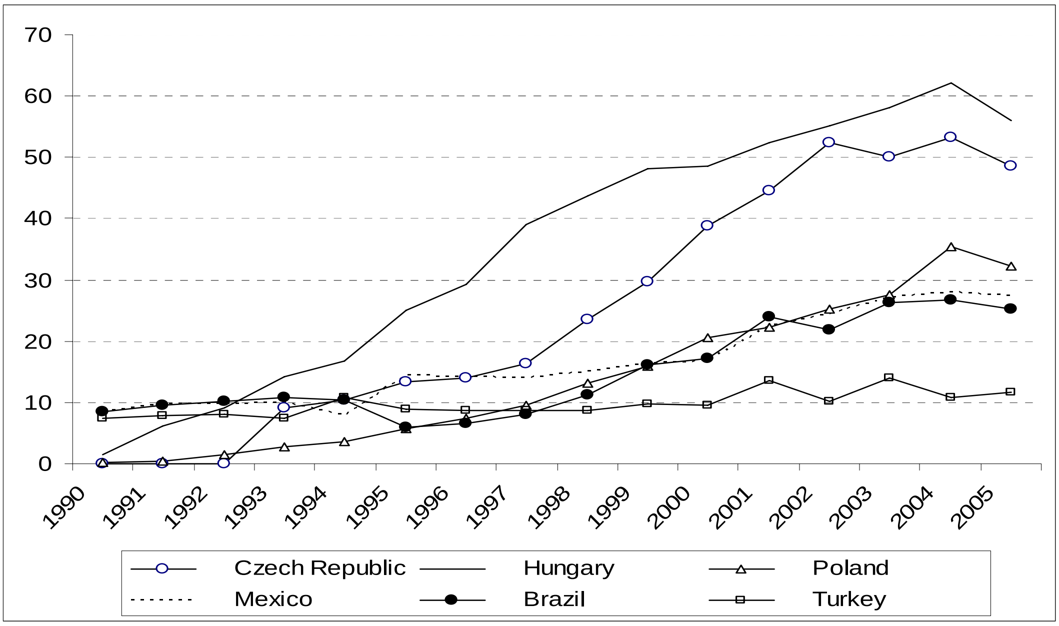

Fig. 16 Inward FDI Stock as percentage of GDP in Selected Emerging Economies
Source: UNCTAD, Handbook of Statistics, 2006.

Figure 16 reveals the inward FDI stock levels of selected emerging economies as a percentage of GDP. Comparing Turkey with other emerging economies such as Brazil, Mexico, Hungary, Czech Republic, and Poland, it can be argued that the inward FDI performance of Turkey is ineffective. The level of FDI stock in Turkey remained stagnant at approximately 10 percent during the 1990s, fluctuated after 2000 and reached approximately 12 percent in 2005. Whereas inward FDI stock of all other countries increased significantly. Hungary and the Czech Republic are the most successful countries at attracting increasing inward FDI stock.

The transition economies of Central and Eastern Europe, although entering the competition in the beginning of the 1990s, attracted more FDI in comparison to Turkey in the period.

Another way to view Turkey's relative FDI performance as a host country is in terms of two indices developed by UNCTAD: The FDI Performance Index and The FDI Potential Index.

Table 18. Inward FDI Performance Index – Results

Rank	Economy	Score
1	Azerbaijan	17.687
2	Brunei Darussalam	13.664
3	Hong Kong, China	9.724
4	Estonia	8.439
5	Singapore	8.294
6	Luxemburg	7.229
7	Lebanon	7.045
8	Malta	6.664
9	Bulgaria	6.351
10	Congo	5.859
11	Belgium	5.596
12	Mongolia	5.442
13	Iceland	4.972
14	Georgia	4.829
15	United Arab Emir.	4.797
16	Sudan	4.636
17	Congo (Dem. Rep.)	4.581
18	Angola	4.548
19	Jordan	4.524
20	Trinidad and Tob.	4.47

Source: UNCTAD, 2006

Table 19. The Inward FDI Performance Index - Rankings

Selected Countries	Period: 2003-2005	2002-2004	2001-2003	2000-2002
Czech Republic	32	25	13	10
Hungary	40	46	33	27
Poland	57	75	68	56
Mexico	75	79	61	64
Brazil	82	62	46	37
Argentina	83	82	82	85
Turkey	95	111	110	109

Source: UNCTAD, 2006.

The Inward FDI Performance Index ranks countries by the FDI they receive relative to their economic size. It is the ratio of a country's share in global FDI inflows to its share in global GDP.[179]

A value greater than one indicates that the country receives more FDI than its relative economic size, a value below one that it receives less (a negative value means that foreign investors disinvest in that period).

The Performance Index is shown for three-year periods to offset annual fluctuations in the data. The indices cover 141 economies for as much of the period as the data permit; however, some economies in transition could not be ranked in the early years for lack of data or because they did not exist as separate countries. The indices exclude tax havens, which for tax rather than productive reasons tend to have massive FDI inflows in relation to their economic size.

The Inward FDI Performance Index of the country

$$= \frac{\textit{The FDI inflows in the } i^{th} \textit{ country / World FDI inflows}}{\textit{GDP in the } i^{th} \textit{ country / World GDP}}$$

According to the inward performance index, Turkey ranks at 95 with a score of 0.917. This low score indicates that Turkey receives less FDI than its relative economic size. Interestingly, Turkey's performance was relatively better at

[179] The index captures the influence on FDI of factors other than market size, assuming that, other things being equal, size is the "base line" for attracting investment. These other factors can be diverse, ranging from the business climate, economic and political stability, the presence of natural resources, infrastructure, skills and technologies, to opportunities for participating in privatization or the effectiveness of FDI promotion.

the end of 1980s. Turkey had a rank of 70 with a score of 0.502 in the period 1988-1990. During the 1990s, Turkey's position moved backward.

The Inward Performance Index, alone, does not give sufficient information about the performance of a country because it assumes non-market related other factors such as the business climate, economic and political stability, the presence of natural resources, infrastructure, skills and technologies, to opportunities for participating in privatization or the effectiveness of FDI promotion as equal.

A more complex index, the Inward FDI Potential Index, captures several factors (apart from market size) expected to affect an economy's attractiveness to foreign investors. It is an average of the values of 12 variables.[180]

GDP per capita, an indicator of the sophistication and breadth of local demand, with the expectation that higher income economies attract relatively more FDI is geared to innovative and differentiated products and services. The rate of GDP growth over the previous 10 years demonstrates a proxy for expected economic growth. The share of exports in GDP captures the openness and competitiveness of a country. The average number of telephone lines per 1,000 inhabitants and mobile telephones per 1,000 inhabitants are indicators of modern information and communication infrastructure. Commercial energy use per capita gives an idea of the availability of traditional infrastructure. The share of R&D

[180] Values are scores between zero, for the lowest scoring country, to one, for the highest and of 12 variables, no weights are attached in the absence of *a priori* reasons to select particular weights.

spending in GDP captures local technological capabilities. The share of tertiary students in the population indicates the availability of high-level skills. And finally, country risk, a composite indicator, captures some macroeconomic and other factors that affect the risk perception of investors. The variable is measured in such a way that high values indicate less risk. The world market share in the exports of natural resources gives an idea about the availability of resources for extractive FDI. The world market share of imports of parts and components for automobiles and electronic products captures participation in the leading TNC integrated production systems. The world market share of exports of services seizes the importance of FDI in the services sector that accounts for some two-thirds of world FDI. The share of world FDI inward stock indicates the attractiveness and absorptive capacity for FDI, and the investment climate.

Table 20. Inward FDI Potential Index - Results Rank Economy Score

Rank	Economy	Score	Rank	Economy	Score
1	United States	0.637	11	Netherlands	0.407
2	United Kingdom	0.449	12	Iceland	0.403
3	Canada	0.446	13	Finland	0.401
4	Luxemburg	0.443	14	Belgium	0.400
5	Singapore	0.439	15	Hong Kong, China	0.398
6	Norway	0.436	16	France	0.390
7	Sweden	0.432	17	Korea, Rep.of	0.382
8	Germany	0.421	18	Australia	0.376
9	Ireland	0.414	19	Taiwan prov. China	0.374
10	Qatar	0.408	20	Switzerland	0.371

Source : UNCTAD, 2006.

Table 21. The Inward FDI Potential Index Rankings

Selected Countries	Period: 2003-2005	2002-2004	2001-2003	2000-2002
Hungary	37	40	41	43
Czech Republic	39	39	42	42
Poland	43	43	44	46
Mexico	53	51	50	49
Argentina	67	66	77	52
Turkey	68	72	72	74
Brazil	71	70	68	73

Source: UNCTAD, 2006

Table 20 demonstrates that, according to the FDI Potential Index, developed countries dominated the top of the rankings. In these countries the indicators mentioned above are powerful, so that the inward FDI stock attractiveness of these countries is very high.

Here, Turkey has a better position than Inward FDI performance index, however, still standing behind other emerging markets. Central and East European countries are more successful than selected Latin American countries. The strength in education and infrastructure in these countries makes them attractive, especially for firms motivated by vertical strategy.

All these facts strengthen the hypothesis that Turkey receives a low level of FDI inflows when its market size, growth rates are considered. This dissertation argues that economic and political instability, weak protection of intellectual property rights, inability to enforce contract law, widespread corruption, weak and an unpredictable legal system acted as major deterrents of FDI in Turkey until 2005.

According to the matrix of the FDI potential and FDI performances of the countries, Turkey takes place within the list of countries that have high FDI potential but low FDI performance.[181]

Another measure of FDI related performance is the competitiveness index. Table 22 shows the ranks and scores for Turkey, other developing economies. The GCI ranking for Turkey at 59, up 12 positions from last year, confirms the pace of the progress made. However, last among the countries shown in Table 22, Turkey ranks a dismal 111th in the macro economy pillar, reflecting the continued vulnerability of its economy to external shocks. Despite bold reforms undertaken in recent years and a sharp improvement in the management of the public finances in the aftermath of the 2001 crisis, gross public debt levels (72.8 percent of GDP) and the budget deficit (5.9 percent of GDP) are still very high by international standards, severely constraining the ability of the authorities to respond to pressing needs, beyond servicing of the public debt. Indeed, Turkey ranks 86th and 115th, respectively, in these two indicators in 2005.

[181] UNCTAD, *World Investment Report*, 2006, p.6.

Table 22. Global Competitiveness Index: Performance of Turkey and Selected Developing Economies - 2005

Country/Economy	Global CI		Institutions		Infrastructure		Macroeconomy		Health/ Primary education		Higher education/ training		Market efficiency		Technological readiness		Business sophistication		Innovation	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score
Brazil	66	4.03	91	3.29	71	3.29	114	3.42	47	6.54	60	4.10	58	4.21	57	3.50	38	4.61	38	3.56
Czech Rep.	29	4.74	60	3.8	33	4.50	42	4.81	58	6.42	27	5.04	41	4.43	26	4.74	29	4.96	28	3.98
Malaysia	26	5.11	18	5.12	23	5.09	31	4.97	42	6.58	32	4.80	9	5.24	28	4.64	20	5.29	21	4.53
Mexico	58	4.18	69	3.68	64	3.41	54	4.63	31	6.71	71	3.88	48	4.35	56	3.51	52	4.30	58	3.29
Hungary	41	4.52	46	4.2	48	4.05	98	3.94	66	6.39	30	4.93	37	4.61	35	4.17	49	4.34	31	3.82
Poland	48	4.30	73	3.6	57	3.64	70	4.34	26	6.76	33	4.79	64	4.16	51	3.56	63	4.13	44	3.47
Indonesia	50	4.26	52	4.04	89	2.72	57	4.52	72	6.35	53	4.25	27	4.93	72	3.17	42	4.53	37	3.60
Turkey	59	4.14	51	4.05	63	3.46	111	3.58	78	6.28	57	4.15	47	4.35	52	3.56	39	4.58	51	3.35
Romania	68	4.02	87	3.4	77	3.05	97	3.94	69	6.38	50	4.34	76	4.03	49	3.59	73	3.89	68	3.14
Bulgaria	72	3.95	109	3.1	65	3.41	35	4.92	39	6.61	62	4.05	90	3.75	68	3.21	84	3.59	87	2.93

The current account deficit has mushroomed to near 7 percent of GDP. With structural vulnerabilities, high levels of public debt and a burgeoning current account deficit, Turkey is at a disadvantage with respect to other emerging markets which have gone through similar crises of their own in recent years—e.g., Russia, Brazil, Argentina, Korea, Thailand, all of them in a much stronger position now.

The disappointing ranks registered for health and primary education (78) and, to a lesser extent, for higher education and training (57) confirm the urgent need to improve the Turkish educational system, which is thought to be "overcrowded, under-funded and uninspiring." the primary enrolment rate is close to 90 percent—the quality of that education is often inadequate, due to a shortage of teachers and very modest facilities. Considering the central role of education in providing Turkey with the qualified human resources needed to upgrade its economy and raise national prosperity, the government should develop a consistent strategy to train more teachers, ensure that girls (especially in rural areas) have equal access, and invest more efficiently in primary and secondary education.

On the other hand Turkey achieved a high rank of 39 in the business sophistication pillar of the GCI, particularly for the quality and quantity of networks and supporting industries (33), above all except the Czech Republic, Brazil and Malaysia in Table 22. This strongly suggests that while Turkey does have a large sophisticated industrial and service sectors which are already operating at high levels of efficiency, adopting advanced technologies, efficient production processes, and exploiting economies of scale with respect to their competitors elsewhere in Europe, particularly the new members in central and Eastern Europe.

The snapshot emerging from the GCI leads to the following conclusions: with its rank of 59 and a score of 4.14, Turkey, quite predictably, finds itself toward the bottom of the ranking shown in Table 14, performing better than several countries.

The above analysis indicates the country's readiness to evolve to a more advanced stage of development. But it also underscores the simultaneous importance for the Turkish authorities to intensify current efforts aimed at reducing macroeconomic vulnerabilities, improve access to better education for all citizens, foster the development of more transparent and efficient institutions, better functioning markets, and achieve European and world-class standards of human and minority rights protection and freedom of expression.[182]

Having examined the relationship between economic and political context and FDI in Turkey, and having analyzed the comparative FDI performance of Turkey in detail, in the next chapter, the results of questionnaire survey are interpreted in order to understand the role of institutional variables as determinants of FDI inflows in Turkey.

[182] Global Competitiveness Index edited by A. L.-Claros , M. E. Porter , X. Sala-i-Martin and K. Schwab (Hampshire: Macmillan Publishers, 2006.

CHAPTER 8

QUESTIONNAIRE SURVEY: THE CASE OF TURKEY

Literature Review

To the knowledge of this author, there are a small number of studies examining the impact of economic, social and political institutions on foreign direct investment. However, there are several studies examining the motives of FDI by using macro data, industry data, and firm level data. Here, there is a brief literature survey about the determinants of FDI in Turkey.

At the beginning of the 1960s, Mehmet Selik, in his descriptive study, *Türkiye'de Yabancı Özel Sermaye (1923-1960)* (Foreign Direct Investment in Turkey 1923-1960) explained regulations concerning FDI between 1923 and 1960 in detail.[183] He also described the relationship between the petroleum law and FDI inflow to Turkey.

Erol H. Esiner, in his 1966 study *Türkiye'de Sınai Yatırımlarda Yabancı Sermaye* (Foreign Direct Investment in

[183] Selik,1961.

Turkish Industry), stressed the urgent need for foreign capital and technical know-how. He considered the Turkish Foreign Encouragement Law as a liberal one, but found faults in its implementation.[184]

Türkiye'de Yabancı Sermaye Sorunu (Foreign Direct Investment Problem in Turkey) (1968), by Baran Tuncer, represents the most serious and scientific research undertaken in Turkey on the subject of FDI in the 1960s.[185] It is comprehensive and objective and it seems to be the result of extensive documentary research. In my opinion, this is the first study that examines the issue from within a theoretical framework in Turkey. Tuncer examines the relationship between the necessity of foreign funds in developing countries and FDI inflow to these countries. He explains the need for foreign capital in Turkey; the channels through which foreign capital had been imported up to that date, and the importance of private foreign investment as a percentage of total external funds and their contribution to the Turkish economy. The study concludes that the place of foreign investment in the total private investment in Turkey is not important and its effect on employment is not significant because of its concentration in capital intensive operations.

Türkiye'de Yabancı Sermaye Kılavuzu (A Guide to Foreign Direct Investment in Turkey), by Kazım Oksay, is a guide to

[184] Erol H. Esiner, *Türkiye'de Sınai Yatırımlarda Yabancı Sermaye*, 1966

[185] Tuncer, 1968.

foreign investment in Turkey.[186] In this descriptive study, in great detail, every legal and procedural step to be taken by the potential investor in Turkey is explained.

100 Soruda Yabancı Sermaye (Foreign Direct Investment in 100 questions) by Kenan Bulutoğlu deals with the issue of foreign investment in Turkey by answering 100 questions about it.[187] However, the book lacks guidelines on how to improve the investment climate and how to encourage a greater inflow of the foreign capital urgently needed for the development of Turkey.

The Evolution of Private Foreign Investment Climate in Turkey, with Particular Reference to American Investors by D. Askhin is a valuable work written in the 1970s. The main objective of the study is to ascertain the nature of the obstacles and impediments to the greater flow of private foreign investments into the country.[188] Askhin uses techniques such as documentary research, questionnaire surveys, and personal interviews. He shows the dimensions of foreign firms containing foreign capital in Turkey, the attitudes of these firms towards the Turkish economy, the investment and financial climate, government applications and public opinion.

Türkiye'de Yabancı Sermaye Yatırımları (Foreign Direct Investment in Turkey) by Mehmet Şahin, argues that the statistical data were unreliable. Şahin spent his time searching for reliable data. He also used the results of

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[186] Oksay, 1967.

[187] K. Bulutoğlu, *100 soruda Türkiye'de yabancı sermaye* (İstanbul: Gerçek yayınevi, 1970).

[188] Ashkin, 1972.

questionnaires (79 of 112 firms containing foreign capital). This study differs from its contemporaries in that it examines the motives of FDI in detail. Şahin presents a survey of FDI theories starting with Hymer, Kindleberger, and Dunning. At the end of his study, according to his questionnaire results, he confirms that FDI inflow in Turkey is below the level expected in the period examined and then offers suggestions in order to attract more FDI.[189]

In 1979 Güngör Uras, who is a former DPT expert, wrote a book titled *Türkiye'de Yabancı Sermaye Yatırımları* (Foreign Direct Investment in Turkey). During his research, he administered a questionnaire to the staff of a number of firms containing foreign capital. His initial aim was to show dimensions of FDI in Turkey. Actually, he presents a theoretical framework, examines the motives of FDI, and looks at the Turkish case to ascertain whether the investments were realized according to these facts.[190]

Direct Foreign Investment in Turkish Manufacturing by Asım Erdilek investigates the microeconomic causes and effects of FDI in Turkish manufacturing. Erdilek collected data from individual firms directly (46 of 83 firms) through extensive interviews and a questionnaire designed for the study. His work shows the contribution of FDI into manufacturing sector,

[189] M. Şahin, *Türkiye'de Yabancı Sermaye Yatırımları* (Ankara: Ekonomik ve Sosyal Yayınlar, 1975).

[190] Uras, 1979.

clarifies the low level of FDI inflow into Turkey, and offers policy suggestions.[191]

Türkiye'de Yabancı Sermaye Yatırımları (FDI in Turkey) by Rıdvan Karluk discusses the dimensions of foreign firms containing foreign capital in Turkey. In addition, Karluk looks at other country cases and furnishes examples. In Turkey he administered questionnaire to 51 of 146 firms. Like other researchers, he found that FDI inflow was insignificant.[192] Although his study comprised many country experiences, his theoretical survey remains insufficiently conclusive.

A Survey of Foreign Direct Investment Firms in Turkey, by Deniz Erden, was published in 1996. The purpose of the study was to develop a general profile of the FDI firms operating in Turkey. Without creating a theoretical framework, Erden presents the questionnaire results acquired from 217 of 2,358 firms. Erden evaluates the export, employment, and tax revenue contributions of FDI firms and reveals the attitudes of these firms toward the Turkish economic climate and government policies.[193]

An Analysis of the Dimensions of Western Foreign Direct Investment in Turkey is a doctorate dissertation by Ekrem Tatoğlu at the University of Leeds. He provides an empirical analysis of the core dimensions of FDI activity based on primary data collected from Western multinationals engaged in either wholly owned subsidiaries or joint ventures and from

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[191] Erdilek, 1982.
[192] R. Karluk, Türkiye'de Yabancı Sermaye Yatırımları (İstanbul: İstanbul Ticaret Odası, 1982).
[193] Deniz Erden *A Survey of Foreign Direct Investment Firms in Turkey* (İstanbul: Boğaziçi University, 1996).

local Turkish firms which are partners in joint ventures in Turkey.[194]

While there are some other studies dealing with FDI in Turkey in the form of articles, books or chapters in books, the studies mentioned here are the best known and most comprehensive ones. Their common elements are that the authors administered questionnaires to FDI firms, they relied on primary sources, in some cases generated their own statistical data by collecting sources, and they examined the contribution of FDI firms to Turkish economy, the reasons for the low level of FDI inflow and finally, most of them offer similar suggestions to increase the inflow of FDI.

On the other hand, not all of them built strong theoretical frameworks from an institutional perspective or conducted complete surveys of theoretical studies. While some of them focus on the macroeconomic or micro economic variables as determinants, some conduct surveys and list the results without coherent theoretical framework.

In a recent study, Foreign Investor Advisory Service of the World Bank (FIAS) conducted reports, mentioning the importance of institutions without building a theoretical framework.

As mentioned before, Foreign Investment Advisory Service (FIAS) of the World Bank Group was asked in September 2000 to study the FDI environment and make recommendations for its improvement, as part of the World Bank Group's 2001-2003

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[194] E. Tatoğlu *An Analysis of the dimensions of western foreign direct investment in Turkey* (Leeds, U.K.: University of Leeds, 1998).

Country Assistance Strategy for Turkey, which stressed the importance of FDI repeatedly and underscored the role of FIAS in improving Turkey's FDI environment.

FIAS, with the support of the Turkish government and with cooperation of the private sector, prepared two studies: A Diagnostic Study of the Direct Foreign Investment Environment in Turkey in February 2001, and Turkey: Administrative Barriers to Investment in June 2001.[195]

The reports pointed administrative barriers political and economic stability, slow and partial judicial system as an impediment to new investments and suggested workshops and establishment of study groups focusing on the issues company registration, sectoral licensing, land access and site development, taxation and incentives, intellectual property rights, investment legislation and investment promotion.

According to the first report, the Turkish administration has been fixated on control instead of service and enforcement. This control, combined with lack of accountability and transparency, and exercise of discretion, has resulted in widespread corruption. The second report focus on the list of issues relating to company registration and reporting, location and operation of FDI companies; among the operational issues are taxation, trade and customs regime, and intellectual and industrial property rights.

The analyses of these issues are followed by specific recommendations including the establishment of an Investment

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[195] FIAS. *A Diagnostic Study of the Direct Foreign Investment Environment in Turkey* (Washington: The World Bank, 2001); FIAS Turkey Administrative Barriers to Investment (Washington: The World Bank, 2001)

Promotion Agency (IPA) for reform. Its conclusions emphasize the need to build the political will required for an action plan with broad support and to monitor improvements as that plan is implemented.

Questionnaire Survey

The results from the econometric model and literature survey show that there is a significant relationship between institutional variables and FDI. However, the regression results do not include every type of institutional variables because of the problem of quantifiable data. Therefore in order to make a more complex analysis I include a questionnaire survey and interviews with the executives of multinational corporations, representatives of non-governmental organizations and bureaucrats in the specific case of Turkey.

The questionnaire not only examines the impact of institutional variables on FDI, but also the effect of horizontal and vertical strategies is examined. The case study of how institutional, horizontal and vertical variables affect FDI in Turkey is a result of field work of twenty weeks. The questionnaires were sent in October 2006 and the receiving of the results was completed in February 2007. The questions examine for the period between 2001 and 2006.[196] The answers of the questions are converted to numeric values from (very low: 1 to very high: 5, very unimportant to very important 1:5). The questionnaire survey was drafted in such a manner as to follow a systematic comparison of the surveys of the World Bank and UNCTAD.

The MNCs firms are at the top 500 big (according to initial capital stock) MNCs in located on the website of the Treasury. All participants in the study were guaranteed complete confidentiality in their responses. Hence, in-keeping with this confidentiality clause the data presented in this paper is based upon the summary statistics drawn from the database of survey respondents.

The questionnaire sent by mail to 300 executives of MNCs. However, 52 executives return their surveys. 18 firms replied that they were either unable or unwilling to participate in the study, most stating company policy and/or confidentiality issues as reasons for their nonparticipation. A further 40 questionnaire packets were returned unopened and given the fact that these firms had recently relocated.

In the survey, 40 of 52 respondents were general managers; five of them were finance managers, four of them marketing managers and three of them assistant general managers.

The sectoral distribution of responding firms is demonstrated in Figure 17.

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[196] I was concerned if the respondents reply the survey considering only the year 2006. In order to minimize this, at the questionnaire, the importance of regarding the period 2001-2006 essentially mentioned. However, there is no guarantee that all respondents act in accordence to this fact.

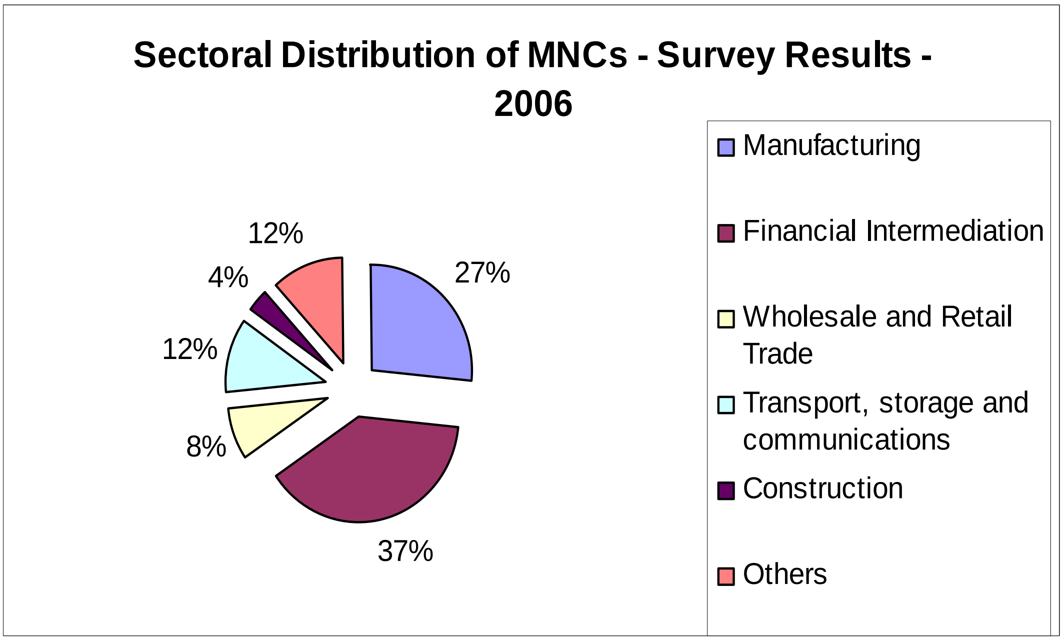

Fig. 17 Sectoral Distribution of MNCs - Survey Results - 2006
Others: agriculture, electricity, real estate, wholesale and retail trade.

Thirty-seven percent of the firms belong to financial intermediation; manufacturing is the second largest sector with a share of 27 percent to which the respondents belong. The transport, storage and communications sector is the third largest sector with 12 percent. Wholesale and Retailed Trade has eight percent, whereas, construction sector has a share of four percent. Other sectors, including agriculture, electricity, real estate, wholesale and retail have 12 percent in total.

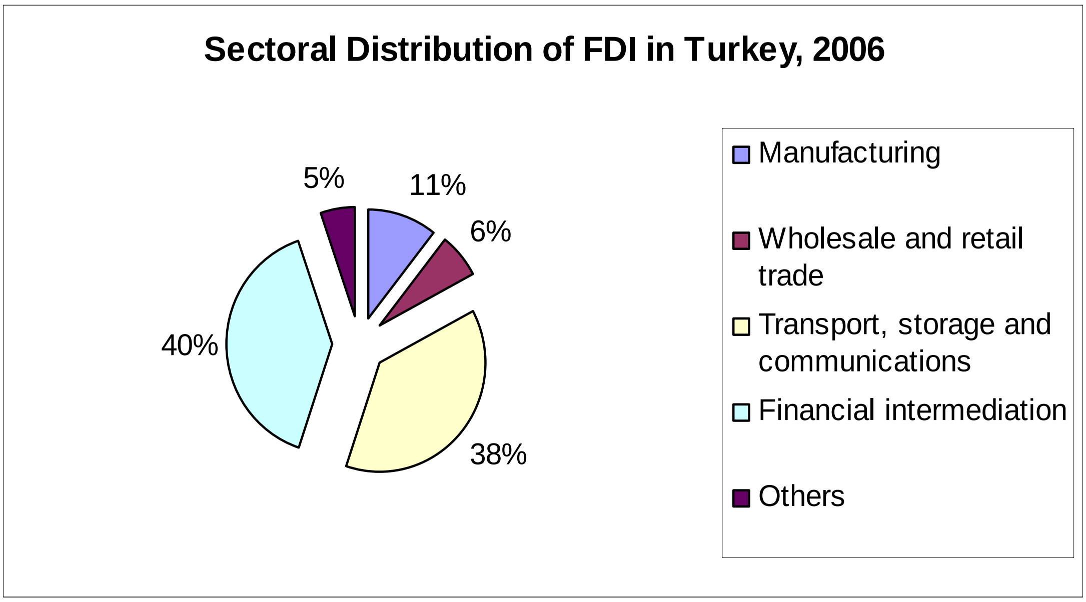

Fig. 18. Sectoral Distribution of FDI in Turkey.
Others: Agriculture, construction, electricity, gas and water supply, health and social work, hotels and restaurants, real estate.

On the other hand, the sectoral distribution of MNCs operating in Turkey by 2006 can be seen in figure 18. According to figure 18, 40 percent of the MNCs in Turkey operate in the financial intermediation sector. The transport, storage and communications sector has a share of 38 percent, very close to financial intermediation. Third largest sector MNCs belong to is manufacturing with a share of eleven percent. The wholesale and retail trade sector has a share of five percent.

The sectoral distribution of respondents firms is similar with the sectoral distribution of total MNCs in Turkey, except the second largest sector is manufacturing with 27 percent in the questionnaire survey, whereas it is the third largest sector with a share of 11 percent. On the other hand, the transport, storage and communications sector is the second largest sector with 38 percent in Turkey it has a share of 12 percent in the survey.

Table 23 – Motives for Foreign Direct Investment in Turkey

Horizontal Strategy

Indicators	Number of Responses	Mod	Mean	Standard Deviation
Growth of the market	51	5	4.29	1.183
Size of the market	52	4	3.69	0.781
Penetration into a new market	52	3	3.33	1.167
Anticipation of relatively high profits	52	2	3.29	1.210
To watch or forestall a competitor's motive	50	1	2.38	1.455

Executives of MNCs agree that Turkey's one of the strongest attractions is its large domestic market. The consensus on this is very strong, and is seen in every survey.[197]

Table 23 demonstrates that growth of the market with a mean 4.29 is the initial motive for foreign investors operating in Turkey. The size of the market with a mean 3.69 and penetration into a new market with a mean 3.33 show that the Turkish economy is attractive for foreign investors regarding horizontal strategy. To watch or forestall a competitor's motive with the lowest mean 2.38 implies that foreign investors pay attention to market size economy more than just forestalling a competitor's action.

High mean scores of horizontal strategy (higher than vertical strategy) reveal that the most important motives are

[197] In the FIAS field survey, conducted through YASED to 56 foreign investors in Turkey, more than 50 percent of existing investors have invested in Turkey for its large domestic market, skilled and cost-effective labor (FIAS,2001).

the market size related indicators. The executives, during the interviews, mentioned the importance of the growth of the market and added that thanks to stabilization policies, they expect continuous high growth rates.

Table 24. Motives for Foreign Direct Investment in Turkey

Resource, Efficiency, Asset Seeking Strategy	Number of Responses	Mod	Mean	Standard Deviation
Cheap labor	51	3	3.37	1.183
Export base for neighboring markets	49	4	3.24	1.234
Availability of skilled labor	51	4	3.22	0.808
Availability of industrial infrastructure	52	3	3.12	1.132
Cost of transportation, and inter.products	48	3	3.08	0.895
Innovative capacity, technological skills, technological adoption	47	4	3.06	1.009
Gaining access to raw materials	50	3	2.78	1.250

From Table 24 it could be suggested that although horizontal strategy is a priority for foreign investors, vertical strategy also plays an important role for them. Turkey scores higher in availability of skilled labor Turkey scores higher in availability of skilled labor than its Eastern European competitors. In 2000 Turkey ranked eighth in the world in terms of the availability of competent senior managers, (plus, ranked third in the world for the average number of hours worked per year) well ahead of Hungary 31st , Poland 40th and the Czech Republic 46th.[198]

In Turkey not only cheap labor for foreign investors is appropriate (with a mean 3.37), but the availability of skilled labor is also important with a mean score of 3.22.

[198] IMD, "World Competitiveness Yearbook," 2000. Other comparisons in this document show other dimensions of competitive nature of the Turkish work force.

Some should take into account that most of the respondents belong to financial intermediation which require skilled labor in most cases. As export base for neighboring countries, with a mean of 3.24 is also significant. Turkey is located between Europe and the Middle East and Caucasus. Therefore several foreign investors consider Turkey as an export base for these countries or regions. The availability of industrial infrastructure has a mean of 3.12. With a mean score of 2.78, gaining access to raw materials is at the bottom of the list. Interestingly gaining access to raw materials does not play an important role for foreign investors. Turkey is not rich in petrol, iron or electricity or such kinds of resources, therefore foreign investors do not prefer to choose Turkey just in order to gain access to raw materials.

Table 25. Motives for Foreign Direct Investment in Turkey

Economic Indicators and Economic Environment	Number of Responses	Mod	Mean	Standard Deviation
Long term strategy (adjustment and stabilization	52	4	3.85	1.017
Foreign exchange policy	47	4	3.34	1.069
Trade regulations	49	3	3.10	0.984
Investment incentives	50	2	2.98	1.000
Investment Promotion	50	2	2.88	1.172
Investment facilitation	49	2	2.86	1.190
FDI track record	46	2	2.70	0.940

Table 25 supports the idea that foreign investors welcome long term strategy of the governments and the way that policies were applied. Long-term strategy including adjustment and stabilization policies has a mean score of 3.85.

Turkey experienced foreign exchange shocks during the 1990s and the volatility of exchange started to decrease after 2001. Therefore in Table 6 we see that foreign investors are pleased with foreign exchange policies of the government. Foreign exchange policy has a mean of 3.34. The trade regulations indicator has a mean of 3.10.

As mentioned before, Turkey was unable to succeed in establishing a promotion agency until recently. The results of the questionnaire survey in this section indicate that executives of the MNCs operating in Turkey find that investment incentives, investment promotion, FDI track record and investment facilitation are not prior motives for their company to invest in Turkey. Investment promotion has a mean score of 2.88.

In the previous chapters the effect of globalization on FDI attraction strategies of the developing countries were mentioned. Turkey would need to engage in a concerted and focused marketing effort to advertise itself as an attractive investment location abroad. However, Turkey currently does not have an agency with a strong and clear mandate, setup and budget to do investment promotion. Within this perspective, Turkey would benefit from establishing an investment promotion agency and developing a long-term FDI promotion strategy for several reasons; First, prospective investors, even the largest firms, do not systematically search the world for opportunities. Information is imperfect and risk perceptions may not conform wholly to reality. The search for opportunities is a bureaucratic process whose initiation and direction may be swayed by many factors, some of which are not purely objective.

In the world the number of countries that have IPA is increasing significantly. Many countries such as Malaysia, Poland, the Czech Republic, Hungary, Ireland, Israel, and Singapore have active IPA. The IPAs of these countries build techniques include advertising in general and specialized media; participate in investment exhibitions; facilitate investment missions from source countries; and conduct general information seminars on investment opportunities. Although by themselves they will not generate a lot of additional investment, image building is useful when the reality in a country is better than the perception held by the international investment community. Some IPAs go further and use the techniques including direct mail campaigns, industry or sector-specific investment missions or informational seminars, and one-on-one, face-to-face meetings with selected potential investors. In addition, several IPAs assist investors who are thinking about investing, or have decided to invest, or who have already invested. Techniques include counseling, expediting the processing of applications and permits, and providing post-investment services.

Finally, effective investment promotion agency does not only function as a marketing agency, but provides the government with continuous and reliable feedback about potential difficulties or shortcomings in the policy, legal and administrative framework related to FDI. Through this policy advocacy function, such an agency becomes a central element in the policy reform process.

In the survey, investment incentives with a score 2.98, investment facilitation with a mean score 2.86 and FDI track record with a mean 2.7 are at the bottom of the list.

The Role of Institutional Variables

Table 26. Barriers to Foreign Direct Investment in Turkey

(General)	Number of Responses	Mod	Mean	Standard Deviation
Political instability	52	5	4.37	0.817
Macroeconomic instability	52	5	4.35	0.738
Exchange rate risks	49	4	3.92	1.017
Inflation	47	4	3.89	0.759
Insufficient development of financial markets	49	3	3.22	1.066
Slow progress of privatization prog.	48	3	3.02	1.101
Possible obstacles against EU membership process	47	2	2.89	1.088
Competition from Central and East European Countries	48	3	2.88	1.044

In Turkey for foreign investors political and macroeconomic instability are seen as the most significant facts that hinder higher inflows of FDI. Stability is a crucial factor when it comes to FDI because it is a way that investors measure the security of their investment. It indicates the likelihood that the government in power will be destabilized in unconstitutional or by violent means. Where investors are uncertain about a country's political and economic stability they adopt a "wait and see" attitude.

In the survey, political instability has a mean of 4.37 and macroeconomic instability has a mean of 4.35. Stability is a crucial characteristic of an economy that investors want to see prior to establish their investment in a host country. Political and economic stability enhances the amount of predictability and the ability to forecast future events. In

Turkey, some link political stability with a single-party government rather than with coalition parties ruling the country. However, indicators of political stability are government effectiveness, regulatory quality, and the rule of law. Most investors, when creating a business plan or project proposal, want to be able to estimate costs, competition, regulations, and potential returns. Economic stability can be captured in macro-economic indicators, such as inflation and growth. It can be argued that only if the country can provide a politically and economically more stable and open environment, can more specific efforts, targeted at improving the investment environment directly, be effective.

High means of exchange rate risk and inflation reflect that respondents consider the 2001-2006 period when answering the survey. If the survey had been applied five years earlier the mean scores would be much higher. However, the exchange risk and risk of inflation with mean scores of 3.92 and 3.89 are welcome as deterrent indicators for investors.

Insufficient development of financial markets has a 3.22 mean score. Progress in establishing financial infrastructure and capital markets is important for foreign investors because it facilitates access to local capital markets. The better developed markets encourage business to set up operations, as they can access complementary local finance more easily, and face lower transaction costs for local financial services such as the payment system. However, foreign investors may substitute locally raised capital for capital raised on international capital markets, which would lead to a reduction of recorded FDI inflow. Nonetheless, the received consensus is that the former effect dominates over the latter.

Although in many studies the positive effect of privatization on FDI is emphasized, interestingly the slow progress of privatization programs does not have a priority as an obstacle of higher FDI inflow with a mean score 3.02.

Privatization is a signal to multinational investors that a country is ready to foster a competitive market economy. FDI can also be very useful to a nation's privatization process by bringing in additional management expertise and marketing channels. Given that Turkey needs significant FDI to enhance its infrastructure and to achieve its privatization goals, it needs a good environment for privatization and private participation in infrastructure. It also needs to privatize to attract even more FDI.[199]

Also possible obstacles against EU membership do not have a priority as an obstacle for higher FDI inflow with a mean score of.

Interestingly, respondents do not identify Central and East European countries as primary competitors of Turkey. However, during the FIAS field mission in 2000, more than 50 foreign and domestic firms interviewed identified Hungary, Poland, and the Czech Republic as primary competitors of Turkey for FDI attraction. This finding is also supported in

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[199] A FIAS study on "Facilitating Foreign Participation in Privatization," for a sample 36 countries implementing privatization programs concluded that every dollar of privatization revenues attracted on average an additional 88 cents in FDI. See F. Sader, Facilitating Foreign Participation in Privatization, FIAS Occasional Paper no. 8, Washington, DC, 1996.

the study of the Loewendahl, H. and E. Ertugal-Loewendahl study.[200]

Table 27. Barriers to Foreign Direct Investment in Turkey

Institutions, Administrative Barriers	Number of Responses	Mod	Mean	Standard Deviation
Anti-competitive practices by government	47	4	3.98	0.872
Consistency/predictability of officials' interpretations of regulations	51	4	3.92	0.744
Unstable and unreliable, non transparent legal and regulatory framework	50	5	3.84	1.131
Problems with recognition of patent rights	48	4	3.81	0.915
Corruption	45	4	3.80	1.079
Start up procedures	49	3	3.76	0.990
Too many days to resolve a commercial dispute in the country's courts	46	3	3.59	0.884
Lack of enforcement of laws and Contracts effectively	50	4	3.54	1.014
Complex, slow and expensive property registration process	48	3	3.54	0.824
Delays in the courts	48	3	3.50	0.968

Table 27 demonstrates significant results regarding institutional variables. Anti-competitive practices by the government (with a mean 3.98), consistency and predictability of officials' interpretations of regulations (with a mean 3.92), unstable and unreliable, non-transparent legal and regulatory framework (with a mean 3.84) problems with recognition of patent rights (with a mean 3.81) and corruption (with a mean 3.80) are significant facts hindering the higher level of FDI inflows for foreign investors.

Beyond the establishment of markets as basic institution for the exchange of goods and services, regulatory institutions such as a competition policy are required. While liberalization has been rapid throughout the developing

[200] FIAS, 2001 and Loewendhall 2001.

countries including Turkey, the process of designing and implementing competition policy has been far more complex.[201]

Governments in the less reformed countries continue to protect the markets of their local firms, even at the sub-national level. Studies, especially those focusing on transition economies reveal that only successful implementation has a strong positive relationship with the economy-wide intensity of competition, whereas the mere existence of rules does not.

The rule of law refers to the enforceability of contracts, something on which foreign investors place great importance. Investors want to know that their rights and their business will be protected when operating abroad. Corruption diminishes the rule of law, most simply because some businesses do not operate within the law and this reduces fair competition.

Unstable and unreliable, a non-transparent legal and regulatory framework with a mean 3.84 is regarded one of the most important deterrent factors by respondents. This is because an efficient legal infrastructure reduces institutional uncertainties for foreign investors, facilitates the establishment and enforcement of contracts and in various other ways reduces the transaction costs of doing business in an economy. Turkey has fallen behind many other developing countries in effective liberalization of its legal framework,

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[201] P.G. Hare and J. Batt, M. Cave, and S. Estrin, 'Introduction' in P. Hare, J. Batt and S. Estrin (eds.) *Reconstituting the Market, The Political Economy of Microeconomic Transformation* (Harwood Academic: Amsterdam, 1999), pp. 1-30.

and in its enforcement practices to reap the benefits of the rapid globalization that is transforming international economic relationships.

Poor implementation of existing legislation is one the main problems in Turkey. Missing implementing rules and administrative guidelines, inconsistent application of laws, incompetent bureaucrats in charge, and lack of judicial enforcement are the issues mentioned most frequently by foreign investors in interviews.

In the perspective of foreign investors, legislative reform in Turkey does not appear to be sufficiently reliable. Adopted laws are often not implemented on time.

One of the executives replied the question about the newly enacted laws: "Are you satisfied with the progress in the judicial system? By giving an answer, governments may carry on enacting laws; however, we are suspicious about the way they are interpreted." Another point frequently raised by investors is a lack of confidence in the impartiality and quality of the commercial courts. Plus, most of the executives mentioned that unstable, non-transparent legal and regulatory framework make the Turkish business environment difficult to operate. Some argued that recently enacted law about the recognition of patent rights are not applied with sensitivity.

Corruption is another issue raised by investors. While the recent government efforts to curb corruption deserve much praise, investors suggested that they do not trust in the impartiality of administrators in critical cases, especially in customs administration and municipal level procedures such as site development. Corruption is marked in the Transparency International’s year 2000 corruption perceptions index Turkey ranks 50th among 90 nations listed.

Table 28. Transparency International Rankings

Country rank	Country	2005 CPI score	2000 CPI Score
1	Iceland	9.7	9.1
2	Finland	9.6	10
	New Zealand	9.6	9.4
4	Denmark	9.5	9.8
5	Singapore	9.4	9.4
6	Sweden	9.2	9.4
40	Hungary	5	5.2
	Italy	5	4.6
	South Korea	5	4
47	Czech Republic	4.3	4.3
48	Brazil	3,7	3.9
49	Mexico	3.5	3.3
	Peru	3.5	4.4
	Turkey	3.5	3.8
50	Poland	3.4	4.1
51	India	2.9	2.8

Source: Transparency International 2006.

Most of the executives I interviewed mentioned that corruption is a deterrent factor for foreign firms. I asked whether corruption may make things easier in the first steps of the investment process. In other words, I asked the question whether corruption is effective in the short-term or not. All the answers emphasized that large corporations pay special attention to the institutional organization of the corporations. An institutionalized corporation pays special attention to certainty when operating in another country. Corruption makes things uncertain in a business environment which in the end may have negative affect on all firms operating in the long run.

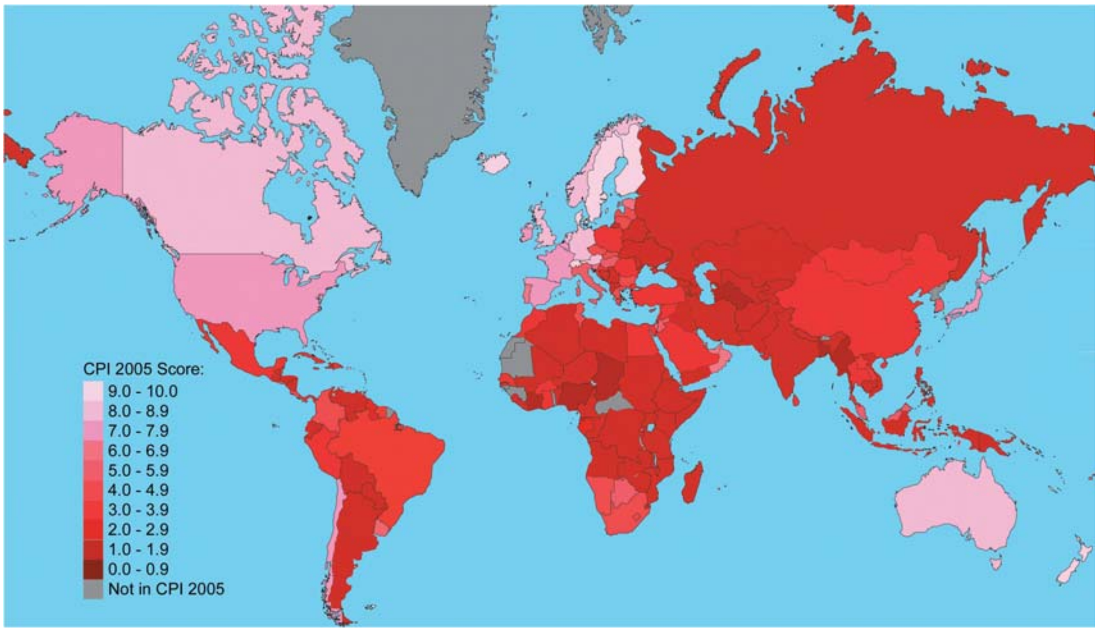

Fig. 19 Corruption Perceptions Index - 2005
Source: Transparency International, 2006.

The weakness of the judicial system and enforcement of contracts and the recognition of property rights create a feeling of insecurity and arbitrariness. Under such circumstances, the long-term commitment of substantial investment funds seems risky if plans are challenged or overturned from day to day, or whenever an official is replaced. The weakness of the judicial system causes the increasing and unrestrained power of such officials. Plus, in countries in which the enforcement mechanisms are weak, the share of informal economy is large, in parallel. In other words, compliance with the formal institutions is too costly and the government does not have the power to effectively enforce its costly rules in these countries.

Table 29. Doing Business in 2005 – Selected Developing Economies

Economy	Starting a Business					Dealing with Licenses			
	Rank	Procedures (number)	Time (days)	Cost (% of income per capita)	Min. capital (% of income per capita)	Rank	Procedures (number)	Time (days)	Cost (% of income per capita)
Argentina	96	15	32	13.4	6.6	123	23	288	55.8
Brazil	106	17	152	10.1	0	136	19	460	184.4
Chile	28	9	27	10.3	0	45	12	191	125.2
China	141	13	48	13.6	946.7	151	28	359	101.1
Colombia	78	12	43	25.3	0	59	12	150	693.8
Czech R.	85	10	40	9.5	39	111	31	266	16.8
Egypt	123	10	22	104.9	739.8	169	30	263	1,067.10
H. Kong, C.	5	5	11	3.4	0	62	22	160	24.1
Hungary	80	6	38	22.4	79.6	141	25	212	279.1
India	102	11	71	62	0	154	20	270	678.5
Indonesia	161	12	151	101.7	97.8	129	19	224	364.9
Israel	12	5	34	5.3	0	99	21	215	93.5
Malaysia	66	9	30	20.9	0	134	25	281	85.1
Mexico	93	9	58	15.6	13.9	28	12	142	105
Peru	118	10	102	38	0	116	19	201	366.3
Philippines	99	11	48	20.3	2	112	23	197	122.6
Poland	99	10	31	22.2	220.1	142	25	322	92.7
Singapore	11	6	6	0.9	0	10	11	129	24
South Africa	49	9	35	8.6	0	39	16	174	37.1
Thailand	23	8	33	6.1	0	6	9	127	17.6
Turkey	47	8	9	27.7	20.9	145	32	232	167.8
Venezuela	124	16	141	27.8	0	107	13	276	545.8

Source: The World Bank, 2006.

It is important to improve the enforcement of dispute resolution and "conflict of interest" legislation. However, in Turkey the executives that I interviewed emphasized that some of the laws in Turkey are ambiguous and therefore difficult to enforce. The rule of law is perceived as weak by foreign investors. This problem can be improved by creating an independent dispute resolution mechanism or by improving the legitimacy of those responsible for regulating legal disputes and contracts.

Table 30. Doing Business in 2005 – Selected Developing Economies

Economy	Protecting Investors			Enforcing Contracts			
	Rank	Disclosure Index	Investor Protection Index	Rank	Procedures (number)	Time (days)	Cost (% of debt)
Argentina	96	6	4.7	65	33	520	15
Brazil	58	5	5.3	117	42	616	15.5
Chile	18	8	6.3	70	33	480	16.3
China	114	10	4.3	59	31	292	26.8
Colombia	33	7	6	141	37	1,346	20
Czech Republic	81	2	5	55	21	820	14.1
Egypt	114	5	4.3	157	55	1,010	18.4
Hong Kong, China	3	10	8.7	10	16	211	14.2
Hungary	114	2	4.3	11	21	335	9.6
India	33	7	6	173	56	1,420	35.7
Indonesia	58	8	5.3	144	34	570	126.5
Israel	5	7	8.3	107	31	585	22.1
Malaysia	3	10	8.7	78	31	450	21.3
Mexico	133	7	4	82	37	415	20
Peru	18	7	6.3	106	35	381	34.7
Philippines	151	1	3.3	50	25	600	14.8
Poland	43	7	5.7	111	41	980	10
Singapore	2	10	9.3	23	29	120	14.6
South Africa	9	8	8	42	26	600	11.5
Thailand	33	10	6	43	26	425	17.5
Turkey	58	8	5.3	69	34	420	17.4
Venezuela	162	3	2.7	125	41	435	28.7

Source: The World Bank, 2006.

Not only are the administrative procedures time-consuming; enforcement procedures for commercial cases at the courts take much longer than many other countries. Table 29 shows that cases in Turkey and in several emerging economies take often more than a year. This is worse than in Poland (an average of 6 months, though in Warsaw up to 40 months), Hungary (80-90% solved within 1 year) and Czech Republic (average of 1.5 years). However, it is essential to note that the key policy strategy of these nations has been to recognize the problem and take action to improve the situation, while Turkey has only recently recognized the problem.

The protection of intellectual property rights is particularly important for industries with a high degree of innovation such as computer software developers and pharmaceuticals. With globalization of production locations, good IPR protection is now more and more important to attract world-class technology and export-oriented plants.

The protection of intellectual property rights is particularly important for producers with a high rate of innovation like computer software developers or pharmaceuticals, as well as producers of products with well-known trademarks like some beverages, cloths, or automobiles. As globalization has taken hold, good IPR protection is becoming more and more important to attract world-class technology and the export-oriented plants that have to use it.

As in other dimensions of the business environment in Turkey, the major problems in IPR protection are caused not so much by inadequate laws as by a lack of effective enforcement. Internationally known brand names and trademarks are increasingly subject to illegal exploitation and pirating. Since 1992, the US Treasury has listed Turkey on its Priority Watch List, under its Special 301 provision for continuous violation of intellectual property rights.[202]

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[202] FIAS, 2001.

Whole legal framework for intellectual property rights is relatively new in Turkey, and much effort has been spent on fulfilling obligations stemming from the membership of the WTO and the accession to the EU.

In the survey, administrative barriers such as complex, slow and expensive property registration process and too many days to resolve a commercial dispute in the country's courts have 3.59 and 3.50 mean scores. The mean scores are significant although these indicators stay behind the several institutional variables at the list.

The Quality and Integrity of Public Services

The overall quality and efficiency of services gives an idea about the legislation, infrastructure, and the sensitivity towards protecting property rights. As they find these services attractive, they inform the quality of the services to the foreign investors outside the country.

The overall quality and efficiency of services delivered by the following public agencies or services: (1 very bad to 5 very good)

Table 31. Functioning of Institutions and Public Services

Indicators	Number of Responds	Mod	Mean	Standard Deviation
Property rights	49	3	3.14	0.890
Labor regulations	49	3	3.04	1.060
Business licensing	47	3	3.02	0.737
Tax regulations/administration	49	3	2.69	0.713

When the quality and integrity of public services are considered, it can be argued that indicators such as property rights, labor regulations and business licensing have moderate mean scores except for the quality of tax regulations and administration. Property rights has a mean score 3.14; labor regulations; 3.04, and business licensing 3.02. Executives, during the interviews, mentioned that tax regulations were complex, inefficient and hence, a deterring factor for FDI inflows.

Table 32. Infrastructure and Legislation (1 very bad 5 very good)

Indicators	Number of Responds	Mod	Mean	Standard Deviation
Communication service	52	4	3.87	0.793
The electric power	51	4	3.51	1.189
Transportation service	52	3	3.40	0.774
Roads	50	3	3.22	1.016
Functioning of government	51	3	3.16	1.007
The parliament	50	3	2.80	0.857
Judicial system	52	3	2.65	0.861

Table 32 demonstrates that whereas indicators belonging to infrastructure have high mean scores, administrative and legislative issues have relatively low scores. Communication service is at the top of the list with a mean score of 3.87. Electric power has a mean score of 3.51, while transportation service has a score of 3.40 and the quality of roads has a mean score of 3.22. On the other hand, the quality of the functioning of government comes after the indicators of infrastructure with a mean score of 3.16. The score of 2.86 for the parliament and 2.65 for the judicial system reveal that foreign investors are suspicious about the quality of legislative and administrative functioning.

As seen from the survey, the functioning of the judicial system and the predictability of rules and regulations are perceived as significant by respondents. In order to get specific results, I asked questions regarding the year 2001 and the year 2006, in order to see whether any progress had taken place in five years on these specific issues. In order to get specific results, I offered specific statements and asked if the respondents agreed with the statements or not.

Table 33. Statement: "In general, information on the laws and regulations affecting my firm is easy to obtain"

Years	2001			2006		
Number of firms	Agree	Disagree	No Idea	Agree	Disagree	No Idea
51	15	12	24	37	4	10

The responses to the statement reveal that there was progress in obtaining information on the laws and regulations affecting respondents' firms. Considering the year 2001, 15 respondents stated that receiving information on the laws and regulations, whereas regarding the year 2006 the number of respondents agreeing with the statement reached 37. Twelve respondents disagreed with the statement for the year 2001 whereas this number decreased to four for 2006. The number of indifferent respondents decreased from 24 for 2001, to 10 for 2006.

Table 34. Statement 2: In general, interpretations of regulations affecting my firm are consistent and predictable

	2001			2006		
Number of firms	Agree	Disagree	No Idea	Agree	Disagree	No Idea
51	8	27	16	22	17	12

Especially during the interviews, one of the important tasks that executives faced was the interpretations of regulations. Most of the executives stated that, although significant changes took place in many areas such as the legislative and judicial system, and different interpretations of laws affect their operations negatively. However, the table demonstrates that over the years, the number of respondents considering the interpretations of regulations as predictable and consistent increase significantly. Regarding 2001, eight respondents believed in the consistency and predictability of regulations whereas, by 2006, the number increased to 22. While the share of respondents decreased, the number of indifferent respondents, only slightly changed.

These results suggest that for the respondents, access to the information of laws and regulations, and the predictability and consistency of the regulations regarding their business improved during five years.

Predictability

Table 35. Changes in economic and financial policies are (1:highly unpredictable 5: highly predictable)

Indicators	Number of Responses	Mod	Mean	Standard Deviation
Changes in rules, laws and regulations	51	3	2.37	0.999
Changes in economic and financial policies	50	3	2.22	0.996

However, according to respondents, while the predictability and consistency of regulations related with their business increased, in general they are skeptical about the certainty and predictability of the general policy changes in the country. The lowest mean scores in the survey are related to the predictability in changes of rules, laws and regulations (2.37 mean score) and changes in economic and financial policies (2.22). Law-making procedures often lack participation of the people subject to it. Business organizations in Turkey complain that they are often not consulted when important legislation for the business environment is being drafted; this is again indicates that most officials do not see investors as a constituency which they should heed. The business community feels left out in the democratic process of discussing changes in the legislation.

Conclusion for the Empirical Study

In this dissertation, I use two empiric studies including an econometric model and a questionnaire. The econometric model reveals that macroeconomic variables are significant as determinants of FDI. Plus, several institutional variables affect FDI flows positively. In the questionnaire survey, I had a chance to see the impact of more institutional variables on FDI. What I find is that both macroeconomic and institutional variables have significant impact on FDI inflows. While, I do not see any relationship between corruption and FDI, in the questionnaire survey, the corruption is perceived as negative factor as determinant of FDI. In addition, the questionnaire survey results are compatible with other surveys of institutional corporations.

CHAPTER 9

CONCLUSION

In this dissertation, my results point out that the effect of macroeconomic indicators such as market size, growth rate, GDP per capita on FDI is positive. In addition, what this dissertation suggests is that institutional variables such as; low level of corruption, government stability, enforcement of contract law, functioning of judicial system, transparent, legal and regulatory framework political and economic stability, intellectual property rights, efficiency of justice and prudential standards have also significant impact on FDI in developing countries. These hypotheses are also valid for the Turkish case.

These results make a real contribution to the empirical literature by validating the role of a large set of institutional variables on foreign direct investment flows.

The results of the dissertation are encouraging in the sense that efforts towards raising the quality of institutions (especially in the Turkish case) may help developing countries to receive more FDI, hence help them to enjoy of higher GDP per capita.

The findings presented in this dissertation, when incorporated with the existing works on FDI, provide an explanation of the distribution of foreign direct investment across countries. The empirical results point to the importance of political and economic institutions for foreign direct investment.

The theoretical framework and the empirical study in this dissertation reveal that the nature of the interaction between MNCs and each country is the result of a more complex set of factors than only market size or market related variables orientation. It takes place within the host country’s unique economic, social, and legal structures; it involves institutions.

Generally, legal infrastructures, including legal system development and enforcement, are generally weak in most developing countries. Bribery and corruption are obviously more invasive in emerging markets than advanced economies. It is generally less difficult to enact and develop various laws, but political, social, historical or cultural factors often impede the implementation and enforcement of these laws. The roles of law and judicial systems differ among countries. The gap between the law on the books and the law in practice can be vast. Legal standards tend to be ideals, not necessarily achievable.

A stable, reliable, business climate will lower costs, thereby encouraging FDI. Avoiding problems with regulatory, bureaucratic and judicial hurdles, property rights, enforceable contracts, performance and content requirements, or bribe payments will be seen as positive because they reduce risk and uncertainty. Basically, the more obstacles that companies perceive they will have to face in a host country, the less attractive it becomes. The ability to communicate, to access information and to transport internally is useful to investors because they can reduce costs of developing the infrastructure necessary to them.

Then the key to economic growth, to attract higher levels of FDI is finding the right institutional framework that will unlock a nation's wealth potential.

The difference of developing economies is they do not undertake radical changes in their formal institutional framework. Developing economies may need to change their economic policies and improve the efficiency of the existing institutions.

Then, what new or strengthened institutions will increase the attractiveness of an economy to FDI inflows? Which political institutions provide FDI to attract higher levels of FDI flow? Furthermore, what will be the role of the state at the right institutional framework?

As mentioned before, the spontaneous emergence and functioning of markets argument failed in Russia in the mid-1990s. As Karl Polanyi emphasized years ago, it was understood that the functioning of markets requires institutions and here, the state plays a significant role.

The right debate on institutions, then, is not about the size of the state, but its role and its effectiveness, that is, its quality. Institutional reform –adapting institutions to perform new roles and functions in harmony with social needs – is a key ingredient of successful reform for developing countries, including Turkey.

Conclusion for the Turkish Case

Recently, Turkey has made considerable progress in modernizing its business legislation. In the first half of the 1980s there were major reforms, and a second wave that began in the mid-1990s is still underway. While there are some gaps in the body of laws and regulations, poor implementation of existing legislation is the main problem. Missing implementing rules and administrative guidelines, inconsistent application of laws, incompetent bureaucrats in charge, and lack of judicial enforcement are the main problems.

In order to increase the quality of institutions in order to enjoy high economic growth rates and receive high levels of FDI inflows the state should adopt several policies such as introduction of independent regulatory agencies in various fields such as competition, banking, and telecommunications; adoption of modern legislation to protect industrial property rights; invitation of all relevant business association to comment on draft legislation.

I believe that efforts towards raising the quality of institutions (especially in the Turkish case) may help developing countries receive more FDI; hence help them enjoy of higher GDP per capita.

In conclusion, the ability of countries to benefit from investment activities is influenced by active policies. By providing the appropriate legal and institutional environment, host country governments can create conditions that will not only attract foreign investors, but also encourage local firms to expand their investment or to establish new operations.

APPENDIX A

COUNTRY SAMPLE

Countries Included in the Regressions with High-Quality Private Investment Data (67 Countries)

Algeria	Angola	Argentina	Bangladesh
Bolivia	Botswana	Brazil	Bulgaria
Burkina Faso	Cameroon	Chile	Colombia
Congo	Costa Rica	Cote d'lvoire	Czech Republic
Dominican Republic	Ecuador	Egypt	El Salvador
Ethiopia	Gabon	Ghana	Guatemala
Guinea	Guyana	Honduras	Hong Kong
Hungary	India	Indonesia	Iran (Is.Rep.)
Israel	Jamaica	Jordan	Kenya
Madagascar	Malawi	Korea (South)	Malaysia
Mali	Mexico	Morocco	Mozambique
Nicaragua	Nigeria	Pakistan	Panama
Paraguay	Peru	Philippines	Poland
Senegal	Singapore	South Africa	Sri Lanka
Syrian A. Republic	Thailand	Togo	Trinidad and Tobago
	Turkey	Uruguay	
Tunisia	Uganda		Venezuela
Zambia	Zimbabwe		

APPENDIX B

FACTOR ANALYSIS

Table 1. Kaiser's Measure of Sampling Adequacy Factor

	MSA
BQ	0.812422
-CL	0.648760
CORRUPTION	0.722596
DA	0.817637
GS	0.521575
IP	0.648647
LO	0.779073
-PR	0.641195
SC	0.562240
Kaiser's MSA	0.682332

Table 2. Loadings

	F1	F2	Communality	Uniqueness
BQ	0.252434	0.576206	0.395737	0.849397
-CL	0.872058	0.027706	0.761253	0.236223
CORRUPTION	0.172899	0.408804	0.197015	0.975294
DA	0.600097	0.311355	0.457058	0.604062
GS	0.070363	0.431288	0.190960	0.989448
IP	0.307158	0.484339	0.328930	0.884439
LO	0.179625	0.602603	0.395396	0.812053
-PR	0.995968	-0.008292	0.992021	0.007977
SC	0.105272	0.442236	0.206655	0.973236
Factor	Variance	Cumulative	Difference	Proportion
F1	2.348815	2.348815	0.772606	0.598421
F2	1.576209	3.925024	---	0.401579
Total	3.925024	6.273840		1.000000

Table 3. Ordinary correlations

	N_CL	N_PR	DA
N_CL	1.000000		
N_PR	0.868210	1.000000	
DA	0.533396	0.595737	1.000000

Table 4. Ordinary correlations

	BQ	CORRUPTION	GS	IP	SC	LO
BQ	1.000000					
CORRUPTION	0.431472	1.000000				
GS	0.225273	0.018046	1.000000			
IP	0.344476	0.045719	0.598424	1.000000		
SC	0.412484	0.265579	0.039017	0.332288	1.000000	
LO	0.439087	0.438021	0.345452	0.332192	0.351758	1.000000

Table 5. Ordinary correlations

	BQ	DA	GS	IP	LO	N_CL	N_PR	SC
BQ	1.000000							
DA	0.406254	1.000000						
GS	0.223212	0.168704	1.000000					
IP	0.344010	0.367918	0.598368	1.000000				
LO	0.437876	0.302073	0.343915	0.331729	1.000000			
N_CL	0.212655	0.531678	0.090128	0.332767	0.174831	1.000000		
N_PR	0.246968	0.595366	0.065509	0.300780	0.173786	0.868202	1.000000	
SC	0.412445	0.086496	0.038455	0.332150	0.351615	0.090053	0.101990	1.000000

Table 6. Statistics

	BQ	DA	GS	IP	LO	N_CL	N_PR	SC
Mean	5.620479	6.831736	7.172911	6.531231	6.226071	-6.723633	-6.425300	5.223375
Median	6.000000	6.800000	7.000000	6.208333	6.000000	-6.856000	-6.856000	5.000000
Maximum	12.00000	12.00000	11.58333	12.00000	12.00000	-1.714000	-1.714000	10.91667
Minimum	0.000000	0.000000	1.000000	1.000000	0.000000	-12.00000	-12.00000	0.708333
Std. Dev.	2.970176	2.597826	2.176709	2.076836	2.504106	2.469795	3.183298	1.637970
Skewness	-0.163251	0.009550	-0.091483	0.342469	0.120540	-0.195860	-0.166416	0.058710
Kurtosis	2.473226	2.283529	2.244629	2.876708	2.335387	2.355170	1.758483	3.169617
Jarque-Bera	23.54181	31.48522	37.02394	29.68601	30.63537	34.89030	101.2625	2.608421
Probability	0.000008	0.000000	0.000000	0.000000	0.000000	0.000000	0.000000	0.271387
Sum	8267.725	10049.48	10551.35	9607.441	9158.550	-9890.464	-9451.617	7683.585
Sum Sq. Dev.	12968.26	9920.588	6964.952	6340.473	9217.700	8966.831	14896.08	3943.930
Observations	1471	1471	1471	1471	1471	1471	1471	1471

APPENDIX C

Political Risk (Points) by Components - March 2005 (THE PRS GROUP)

COUNTRY	A	B	C	D	E	F	G	H	I	J	K	L	OVERALL RISK
Argentina	8.0	4.5	5.5	9.5	9.5	2.5	4.0	6.0	3.0	6.0	4.5	3.0	66.0
Brazil	7.5	5.0	7.5	10.5	11.0	2.0	4.0	6.0	2.5	3.0	5.0	2.0	66.0
Chile	8.5	7.5	11.5	11.5	10.5	4.5	4.0	6.0	5.0	5.0	4.0	3.0	81.0
China,P. R.	11.0	8.0	7.0	10.5	10.0	2.0	3.0	5.0	4.5	5.0	1.0	2.0	69.0
Colombia	8.5	4.5	9.0	6.0	8.5	3.0	2.0	5.0	1.0	5.0	4.5	2.0	59.0
Czech Republic	5.5	6.5	11.5	10.5	11.0	2.5	6.0	6.0	5.0	3.0	5.5	3.0	76.0
Egypt	10.0	5.5	6.5	10.0	10.5	1.5	3.0	3.0	4.0	6.0	2.0	2.0	64.0
Hong Kong	6.5	9.0	12.0	10.5	10.5	4.0	5.0	5.0	4.5	5.0	2.5	3.0	77.5
Hungary	8.5	7.5	11.5	11.5	10.5	3.0	6.0	5.5	4.0	4.0	6.0	3.0	81.0
India	8.0	3.5	9.0	8.5	9.5	2.5	4.0	2.5	4.0	2.5	6.0	3.0	63.0
Indonesia	7.0	2.5	6.0	9.0	11.0	1.0	2.5	1.0	3.0	2.0	5.0	2.0	52.0
Israel	8.5	7.0	10.0	8.5	8.0	3.0	2.5	2.5	5.0	2.0	6.0	4.0	67.0
Korea, R.	8.5	8.5	10.0	9.5	8.0	2.5	4.0	6.0	5.0	6.0	6.0	3.0	77.0
Malaysia	10.5	9.0	9.0	10.0	10.5	2.5	5.0	4.0	4.0	4.0	4.5	3.0	76.0
Mexico	6.5	8.0	11.5	10.0	11.0	2.0	4.5	5.5	3.0	3.0	6.0	3.0	74.0
Peru	5.0	6.0	8.0	7.0	10.5	2.5	5.0	6.0	3.0	3.0	5.0	2.0	63.0
Philippines	9.5	5.0	9.5	6.5	11.0	2.0	3.5	3.0	2.0	5.0	5.0	3.0	65.0
Poland	6.0	5.5	11.5	9.5	10.0	2.0	6.0	5.0	4.0	6.0	6.0	3.0	74.5
Singapore	11.0	9.5	12.0	10.5	10.5	4.5	5.0	4.5	5.0	6.0	2.0	4.0	84.5
S. Africa	10.5	4.0	11.0	9.0	10.5	2.0	5.0	5.0	2.5	4.0	5.0	2.0	70.5
Thailand	10.5	7.5	8.5	8.0	10.0	1.5	4.0	5.0	2.5	4.0	4.5	2.0	68.0
Turkey	10.0	6.5	8.0	10.0	9.5	2.5	4.0	5.0	4.5	2.5	5.5	2.0	70.0
Venezuela	8.5	3.5	2.5	7.0	9.0	1.5	0.5	5.0	3.0	5.0	4.0	1.0	50.5

A	Government Stablity	12	G	Military in Politics	6
B	Socioeconomic Conditions	12	H	Religious Tension	6
C	Investment Profile	12	I	Law and Order	6
D	Internal Conflict	12	J	Ethnic Tensions	6
E	External Conflict	12	K	Democratic Acc.	6
F	Corruption	6	L	Bureaucracy Quality	4

APPENDIX D

Global Competitiveness Index - Indicators

Financial markets: Sophistication and openness

Financial market sophistication
* Ease of access to loans
* Venture capital availability
* Soundness of banks
* Local equity market access

Pillar: Technological readiness

Technological readiness
* Firm-level technology absorption
* Laws relating to ICT
* FDI and technology transfer
* Cellular telephones (hard data)
* Internet users (hard data)
* Personal computers (hard data)

Pillar: Business sophistication

Networks and supporting industries
* Local supplier quantity
* Sophistication of firms' operations and strategy
* Production process sophistication
* Extent of marketing
* Control of international distribution
* Willingness to delegate authority
* Nature of competitive advantage
* Value-chain presence

Pillar: Innovation

* Quality of scientific research institutions
* Company spending on research and development
* University/industry research collaboration
* Government procurement of advanced technology products
* Availability of scientists and engineers
* Utility patents (hard data)
* Intellectual property protection
* Capacity for innovation

Pillar: Infrastructure

* Overall infrastructure quality
* Railroad infrastructure development
* Quality of port infrastructure
* Quality of air transport infrastructure
* Quality of electricity supply
* Telephone lines (hard data)

Pillar: Macroeconomy

* Government surplus/deficit (hard data)
* National savings rate (hard data)
* Inflation (hard data)
* Interest rate spread (hard data)
* Government debt (hard data)
* Real effective exchange rate (hard data)

Pillar: Market efficiency

Good markets: Distortions, competition, and size

Distortions

* Agricultural policy costs
* Efficiency of legal framework
* Extent and effect of taxation
* Number of procedures required to start a business(hard data)
* Time required to start a business (hard data)

Competition

* Intensity of local competition
* Effectiveness of antitrust policy
* Imports (hard data)
* Prevalence of trade barriers
* Foreign ownership restrictions

Size

* GDP – exports + imports (hard data)
* Exports (hard data)

The Global Competitiveness Index

Institutions

Public institutions

* Property rights
* Ethics and corruption
* Diversion of publics funds
* Public trust of politicians
* Undue influence
* Judicial independence
* Favoritism in decisions of government officials

Government inefficiency (red tape, bureaucracy and waste)

* Wastefulness of government spending
* Burden of government regulation

Security

* Business costs of terrorism
* Reliability of police services
* Business costs of crime and violence
* Organized crime

Private institutions

Corporate ethics

* Ethical behavior of firms
* Accountability
* Efficacy of corporate boards
* Protection of minority shareholders' interests
* Strength of auditing and accounting standards

Pillar: Health and primary education

Health

* Medium-term business impact of malaria
* Medium-term business impact of tuberculosis
* Medium-term business impact of HIV/AIDS
* Infant mortality (hard data)
* Life expectancy (hard data)
* Tuberculosis prevalence (hard data)
* Malaria prevalence (hard data)
* HIV prevalence (hard data)

Primary education

```
      * Primary enrolment (hard data)

Pillar: Higher education and training

Quantity of education

      * Secondary enrolment ratio (hard data)
      * Tertiary enrolment ratio (hard data)

Quality of education
      * Quality of the educational system
      * Quality of math and science education
      * Quality of management schools

On-the-job training

      * Local availability of specialized research and training
services
      * Extent of staff training
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APPENDIX E

FOREIGN DIRECT INVESTMENT LAW IN TURKEY

Law No. 4875

Date of Passage: 5 June, 2003
Date of Official Gazette: 17 June, 2003

OBJECTIVE AND SCOPE

Article 1. The objective of this Law is to regulate the principles to encourage foreign direct investments; to protect the rights of foreign investors; to define investment and investor in line with international standards; to establish a notification-based system for foreign direct investments rather than screening and approval; and to increase foreign direct investments through established policies. This Law establishes the treatment to be applied to foreign direct investments.

DEFINITIONS

Article 2. The terms used in this Law shall have the following meanings:

a) Foreign investor:
1) Real persons who possess foreign nationality and Turkish nationals resident abroad, and
2) Foreign legal entities established under the laws of foreign countries and international institutions,

who make foreign direct investment in Turkey.

b) Foreign direct investment:

i) Establishing a new company or branch of a foreign company by foreign investor,
ii) Share acquisitions of a company established in Turkey (any percentage of shares acquired outside the stock exchange or 10 percent or more of the shares or voting power of a company acquired through the stock exchange)

by means of, but not limited to the following economic assets:
1) Assets acquired from abroad by the foreign investor:
- Capital in cash in the form of convertible currency bought and sold by the Central Bank of the Republic of Turkey,
- Stocks and bonds of foreign companies (excluding government bonds),
- Machinery and equipment,
- Industrial and intellectual property rights;

2) Assets acquired from Turkey by foreign investor:
- Reinvested earnings, revenues, financial claims, or any other investment-related rights of financial value,
- Commercial rights for the exploration and extraction of natural resources.

c) The Undersecretariat: The Undersecretariat of Treasury.
PRINCIPLES CONCERNING FOREIGN DIRECT INVESTMENTS

Article 3.

a) Freedom to Invest and National Treatment
Unless stipulated by international agreements and other special laws:

1. Foreign investors are free to make foreign direct investments in Turkey,
2. Foreign investors shall be subject to equal treatment with domestic investors.

b) Expropriation and Nationalisation
Foreign direct investments shall not be expropriated or nationalised, except for public interest and upon compensation in accordance with due process of law.

c) Transfers
Foreign investors can freely transfer abroad: net profits, dividends, proceeds from the sale or liquidation of all or any part of an investment, compensation payments, amounts arising from license, management and similar agreements, and reimbursements and interest payments arising from foreign loans through banks or special financial institutions.

d) Access to Real Estate
Companies may freely acquire real estate or limited rights in rem through a legal entity established or participated by foreign investors in Turkey, provided that such acquisitions are permitted for Turkish citizens.

e) Dispute Settlement
For the settlement of disputes arising from investment agreements subject to private law and investment disputes arising from public service concessions contracts and conditions which are concluded with foreign investors, foreign investors can apply either to the authorised local courts, or to national or international arbitration

or other means of dispute settlement, provided that the conditions in the related regulations are fulfilled and the parties agree thereon.

f) Valuation of Non-Cash Capital
Non-cash capital is valued within the regulations of Turkish Commercial Law. In case that stocks and bonds of companies established abroad are used as foreign capital share of foreign investors, the values determined by the relevant authorities in the home country, or by the experts designated by the courts of the home country, or any other international institutions performing valuations will be accepted.

g) Employment of Expatriates
Work permits are issued by the Ministry of Labour and Social Security for foreign personnel to be employed in the companies, branches and entities established within the scope of this Law.

In accordance with the Article 23 of the Law on Work Permits for Foreigners No. 4817 dated 27 February 2003, the definition of the key personnel within the scope of the Regulation the companies and the entities with foreign capital which shall be in the context of the Regulation, and other special procedures and principles concerning the work permits of the key personnel will be determined in a Regulation to be prepared jointly by the Undersecretariat of Treasury and the Ministry of Labour and Social Security,

Provisions stipulated in Article 14, paragraph 1, sub-paragraph (b) of Law No. 4817 will not be applicable to those personnel to be employed within the context of this Regulation. The conditions under which the provisions stipulated in paragraph 1 of Article 13 of Law No. 4817 are to be applied to key foreign personnel employed will be specified in the Regulation.

h) Liaison Offices
The Undersecretariat is authorised to permit foreign companies established under the laws of foreign countries to open liaison offices, provided that they do not engage in commercial activities in Turkey.

DETERMINATION OF POLICIES AND DATA COLLECTION

Article 4. Considering the objectives of the development plans and annual programs, the general economic status of the country, trends in international investments and the opinions of the relevant public institutions and private sector professional organisations, the Undersecretariat is authorised to determine the general framework of policies concerning foreign direct investments, and for this purpose to participate in the activities of other organisations. The consent of the Undersecretariat shall be taken before any amendment or enactment of a regulation related with foreign direct investments.

For the purpose of establishing and developing an information system related to foreign direct investments, the Undersecretariat is authorised to request statistical information concerning the investments from all public establishments and institutions and private sector professional organisations.

Foreign investors shall submit the statistical information on their investments according to the procedures and principles to be determined by a regulation to be enacted by the Undersecretariat. Such information cannot be used as evidence other than for statistical purposes.

OTHER PROVISIONS

Article 5.

a) Existing Companies with Foreign Capital
The companies with foreign capital established pursuant to Law No. 6224 dated 18 January 1954 shall be subject to this Law, reserving their granted rights.

b) Regulations
The implementing principles for this Law will be determined in a regulation to be prepared by the Undersecretariat within one month following the publication of the Law.

c) Repealed Provisions
The Law for Encouragement of Foreign Capital No. 6224 dated 18 January 1954 is repealed.

The references made to Law No. 6224 in the legislation are considered as referring to the related provisions of this Law.

d) Any amendments concerning the articles of this Law can only be done by means of amending or appending provisions to this Law.

PROVISIONAL ARTICLE 1. The provisions of the decrees, communiqués and circulars in effect, which are in conformity with this Law, shall remain in force until new regulations for the implementation of this Law take effect.

EFFECTIVENESS

Article 6. This Law shall come into force on the date of its publication.

ENFORCEMENT

Article 7. The provisions of this Law shall be enforced by the Council of Ministers.

Regulation for Implementation of Foreign Direct Investment Law

PART I

Objective, Scope, Basis and Definitions

Objective and Scope

Article 1 – The objective of this Regulation is to designate the procedures and principles of the issues that are laid down within Foreign Direct Investment (FDI) Law No. 4875 dated 5 June 2003.

Basis

Article 2 – This Regulation is prepared in accordance with Article 5, Paragraph (b) of FDI Law No. 4875.

Definitions

Article 3 – With regard to the implementation of this Regulation;

"Undersecretariat" means, the Undersecretariat of Treasury,
"General Directorate" means, the General Directorate of Foreign Investment,
"Law" means, Foreign Direct Investment (FDI) Law No. 4875, dated 5 June 2003.

PART II

Data Requests

Statistical Data to be Provided from Authorities and Institutions

Article 4 - The Undersecretariat obtains FDI data through Data Sharing Protocols it will set up primarily with Central Bank of the Republic of Turkey, Capital Market Board, Ministry of Industry and Commerce, Ministry of Finance, The Union of Chambers and Commodity Exchanges of Turkey, Trade Registry Offices and other relevant public authorities and institutions and public professional organisations and NGOs, or through other procedures.

Within this framework, the relevant Trade Registry Offices shall send to the Undersecretariat;

a) One copy of the "Company or Branch Office Establishment Declaration Form and Petition" to be filled by the relevant persons, at the phase of company or branch office establishment within the context of Law,
b) One copy of the amendments in the articles of association of these companies, subject to registration and announcement,
c) One copy of the "Register of Shareholders" or "Register of Attendants" submitted to the Trade Registry Offices by these companies.

Data to be Requested from Companies and Branch Offices

Article 5 - a) Companies and branch offices subject to the provisions of the Law shall submit to the General Directorate;

1) Information on their capitals and operations, in accordance with the "FDI Operations Data Form" given as Annex I of the Regulation, on annual basis, latest until the end of May every year,
2) Information on the payments made to their equity accounts, in accordance with the "FDI Capital Data Form" given as Annex II of the Regulation, within 1 month following the payment,
3) Information on share transfers made between current domestic or foreign shareholders or to any domestic or foreign

investor outside the company, in accordance with the “FDI Share Transfer Data Form” given as Annex III of the Regulation, and latest within 1 month following the realization of the share transfer.

b) If domestic companies, which are not subject to the provisions of the Law; becomes subject to the provisions of the Law via,

1) Participation of a foreign investor in the company, or
2) Participation of a foreign investor who is not already a shareholder of the company during the capital increase of the company,

they shall submit the information on the share transfers, in accodance with the “FDI Share Transfer Data Form” given as Annex III of the Regulation, to the General Directorate latest within 1 month following the realization of the share transfer.

PART III

Liaison offices

Establishment of Liaison Offices

Article 6 – The Undersecretariat is authorized to grant permits and extend such permits to companies established in accordance with the laws of foreign countries to open liaison offices in Turkey, provided that they do not carry out commercial activities in Turkey.

Applications for establishment and extension shall be finalized within 5 days following the application, provided that the necessary information / documents are complete and proper.

Applications of foreign companies to establish liaison offices so as to operate in sectors subject to special legislation, such as money and capital markets, insurance, etc., will be assessed by authorities and institutions authorized by the relevant special legislation.

Application Documents

Article 7 – The following documents have to be submitted to the Undersecretariat for establishing a liaison office in Turkey:

a) The original copy of the “Certificate of Activity” of the parent company approved by the relevant Turkish Consulate or approved in accordance with the provisions of the Convention Abolishing the Requirement of Legalisation for Foreign Public Documents, prepared on the basis of the Hague Conference on Private International Law,
b) Operational report or balance sheet and income statement of the parent company,
c) The original copy of the certificate of authority issued to the name of the person who is appointed to carry out the operations of the liaison office,

d) The original copy of the power of attorney in case that another person will carry out the establishment transactions of the liaison office.

Provisions Regarding Liaison Office Operations

Article 8 – The following provisions govern the operations of liaison office:

a) Liaison offices, having received their establishment permit, shall send a copy of the tax office registration document to the General Directorate latest within 1 month. Liaison offices shall notify the General Directorate of any change of address latest within 1 month.
b) Liaison offices shall send the "Data Form for Liaison Office Activities" given as Annex IV of the Regulation, to the Undersecretariat every year latest until the end of May, so as to inform the Undersecretariat about their activities of the previous year. Documents certifying that the previous year's expenses of the office have been covered by foreign currency transferred from abroad, have to be enclosed as well.
c) Liaison offices are granted operation permits of 3 years at most. For extensions, successive extensions of maximum 3 years each may be granted by taking into consideration the activities of previous years and plans and objectives for the future.
d) In the case that the liaison office terminates its activities, the "termination and examination of business note" to be received from the relevant tax office has to be submitted to the General Directorate. Liaison offices cannot claim any money transfer except the residue arising due to the termination and liquidation.
e) The Undersecretariat might cancel the permits of liaison offices ascertained to have violated the legislation and shall notify the relevant authorities thereof.

PART IV

Miscellaneous Provisions

Company Types

Article 9 – The companies, which can be established or participated by foreign investors are "companies" designated in the Turkish Commercial Code and "unincorporated partnerships" designated in theTurkish Code of Obligations.

Partnerships established through agreements under names such as ordinary partnerships, consortiums, business partnerships, joint ventures that do not conform to the explicit features of the company types designated in the Turkish Commercial Code are deemed unincorporated partnerships for the implementation of this Law.

Turkish Citizens Residing Abroad

Article 10 – Turkish Citizens certifying that they are residing abroad with the work or residence permits, are regarded as foreign investors with regard to the implementation of the Law.

Changes in Data Forms

Article 11 – The General Directorate is authorized to make any changes in the data forms annexed to this Regulation.

Provisional Article 1 –The General Directorate is authorized to deal with the Investment Permit Certificates issued in accordance with the Law Concerning the Encouragement of Foreign Capital No: 6224 and Foreign Capital Framework Decree that was put into effect by Council of Ministers' Decree No: 95/6990 on 7 June 1995 and the Communique concerning this Decree, until the investments involved are finalized and provided that the acquired rights are uphold.

Effectiveness

Article 12 – This Regulation will become effective on the date of its publication

Enforcement

Article 13 – The provisions of this Regulation will be enforced by the Ministry of State to which the Undersecretariat of Treasury is associated.

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