


## Chapter 9

# Is Turkey a Favorable Environment for FDIs?

### Institutional Outlook to EU–Turkey FDI Flow

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#### **ABSTRACT**

*The aim of this chapter is to measure the impact of institutional variables such as economic freedom and democracy on foreign direct investment from the European Union to Turkey. In this framework, the author models institutional factors affecting foreign direct investments. The model includes economic freedom index, political rights, civil liberties of Turkey, and Gross Domestic Products of selected European countries. In theoretical part, the perspective of institutional economics on economic freedoms and democracy is discussed. A brief literature about the relationship between foreign direct investments and economic freedoms and democracy is revealed. Stochastic frontier analysis was used in the implementation to show the relationship between variables and efficiency of European countries' foreign direct investments to Turkey. Proposals for policy implication have been made in the conclusion part. This chapter shows civil liberties and economic freedom index have positive effect on foreign direct investments that supports institutionalists.*

#### **INTRODUCTION**

Institutional economics reveals that the institutional structure that constitutes the political and social environment of the countries should be operated effectively. In this context the factors like the low perception of corruption, strength of property rights, protection of political-economic rights and freedoms, ensuring political stability, the rule of law etc. should be intact. The effective functioning of the institutions will prevent waste of resources in the country, eliminate market failures, decrease the uncertain-

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ties, diminish transaction costs, create positive externalities, create a safe environment for investments. Achieving high level of development of countries will be provided to the extent that economic institutions and institutional structure can promote production-investment decisions. This investment can be foreign investment as well as domestic ones.

The interaction between institutions and Foreign Direct Investment (FDI) has been obtaining increasing attention. One of the reasons is that the number of studies mentioning institutional importance as a determinant of economic growth has increased in the literature on economic growth. Therefore, as FDI is largely linked to economic growth, it has become important to study the link between FDI and institutions. In emerging economies, the role of institutional parameters as indicators of FDI is crucial. With the expanding globalization since 1980, adjustments in trade and investment environment policies of emerging market governments are facilitating FDI in these markets. These economies have become attractive for many multinational corporations due to their growth performance and large market sizes. An emerging market can be described as a country where its national economy is growing rapidly, its industry is changing structurally, its market is tempting but volatile, its regulatory environment promotes economic liberalization and the adoption of a free - market system, and its government is lowering organizational and bureaucratic control over business operations (Dumludağ and Sükrüoğlu, 2007:134-135).

In addition to the geo-political position of Turkey have democratic and secular political system and free market compared to the Middle Eastern neighbors. In other words, Turkey is closer to western standards in comparison to other Middle Eastern countries. The European Union is one of the most capital-exporting regions to the global economy and has also a continuous increase in direct investment to Turkey. Turkey have some causal agents such as low and abundant factor of production, a robust consumer profile and dynamic labor market. Because of these factors European Union does not want to lose Turkey market. So, EU increases investments to Turkey. The Customs Union treaty signed between Turkey and the EU in 1996, it has also accelerated foreign direct investment coming to Turkey from the EU. Also in this process, in particular the European Union including Turkey took against the Copenhagen criteria. Copenhagen Criteria, which is democratic and transparency criteria of the European Union has been active in investment decisions will make foreign investors to Turkey.

Consequently, the purpose of this study is to measure the impact of institutional variables such as economic freedoms and democracy on FDIs between the European Union and Turkey. In this context, the next section reveals the perspective of Institutional Economics on Economic Freedoms and Democracy, in the second chapter literature review of the linkage between FDIs and Economic Freedoms and Democracy is given, the section three and four consist of econometric methodology of the study, data and empirical findings, respectively. Finally, findings are discussed in the last section.

## **The Perspective of Institutional Economics on Economic Freedoms and Democracy**

Economic freedom is a compound that seeks to describe the level to which an economy is a market economy — that is, the level to which it involves the facility of voluntary contracts under a stable and predictable rule of law upholding contracts and preventing private property, with limited interventionism in the form of government ownership, regulations and taxes. It is likely for purely theoretical reasons that economic freedom is an important factor accounting for economic growth. The incentives faced by economic players (entrepreneurs, inventors, financiers, industrialists, and others) are strongly influenced by the institutions in place, which, as Douglass C. North (1990) figures out, may be ineffective or effec-

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