Does Institutional Structure Matter in Attracting Outward FDI Flows from Turkey?:
Panel Study*

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Abstract: This study attempts to find if there is any effect of host countries’ legal system and property rights on the behavior of Turkish foreign direct investment (FDI). For this aim, bilateral FDI outstock data of Turkey, and the ratings of legal system and property rights of the host countries are put into use. The data utilized in the study are unbalanced and cover the years between 2001 and 2012. FDI flows from Turkey prefer the countries with advanced legal structure and developed property rights. The main components of the legal structure, and property rights determining the movement of Turkish FDI stock are judicial independence, impartial courts, protection of property rights, integrity of the legal system, legal enforcement of contracts, and reliability of police. Results are robust when the inflation rate, real effective exchange rate, natural resources endowment, and GDP are included in the analyses as the main determinants of the FDI.

Keywords: Outward FDI, legal system, property rights, panel data analysis.

JEL Codes: E02, F21, P14

Kurumsal Yapı Türkiye'den Gelen Doğrudan Yabancı Sermaye Yatırımlarını Çekmede Önemli midir?: Panel Veri Analizi


Anahtar Kelimeler: Doğrudan Yabancı Yatırım, Hukuk Sistemi, Mülkiyet Hakları, Panel Veri Analizi.

JEL Kodları: E02, F21, P14

1. Introduction

Market has evolved into a political institution with its economic functions since it is established. And the complexity of the legal system and the quality of its implementation in the economy have become the basic elements for achieving a balanced order in the market. Effective enforcement of law and continuous advancement in the legal structure guarantee the protection of property rights. By so doing, a safe market environment is created for entrepreneurship. Therefore, it has become a necessity for governments to exist as an economic agent protecting the market structure. Attraction for capital emerges as an additional benefit of this structure. Indeed, in the form of a shift in policies, protectionism is a potential danger for worldwide mainstream development and world economic growth. So, the protection role of governments consists solely of the protection of property rights. International Monetary Fund (IMF) stated that “A shift toward protectionism would reduce trade and cross-border investment flows, harming global growth” (IMF, 2017, p. xvi). In this regard, how the property rights are protected and how the legal structure is established within a country are the main institutional features that determine the direction of the global capital flows.

This study aims to find the role host countries’ legal system and property rights play on the movements of

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the Turkish FDI outstock. It is important whether the legal system is functioning properly and whether the property rights are duly protected in a country because these give an idea about the level of economic freedom of that country. So, this research is a contribution to the literature on economic freedom and FDI. Unlike the existing literature, composite index is not utilized in the study because it does not give details of the freedom concept. Instead, a specialized index on the legal system and protection of property rights is put into use to go deeper in the subject. This shows how the institutions perform within an economy. In addition, rather than a mere FDI variable, bilateral FDI outstock data are used to detect the capital flows. So, it would give an opportunity to make a comparison of the effect of institutional structure of the host economy and the pivot economy on the size of the capital flows from pivot economy. Panel data techniques are used to determine the nature of this relationship considering the period between 2001 and 2012. The rest of this study is as follows. Part 2 is a summary of the theoretical background and the literature. Part 3 reveals the features of the data and the methodology. Empirical findings are discussed in part 4 while part 5 is a conclusion of the study.

2. Theoretical Background

The literature focusing on the determinants of FDI flows is mainly built on the structure of the pivot economies. In the study, they examine the factors that determine outward FDI transactions, Kyrkilis and Pantelidis (2003) find that country-specific characteristics, such as real GNP and exchange rate of the home country have utmost importance on the FDI decisions. However, the host country characteristics are nonnegligible as well. Duanmu and Güney (2009) try to identify the properties of the host economies that attract especially China and India-originated FDI flows. Large size of the market, and low corporate tax rate are the institutional factors that capital holders care in China and India. Imports from the pivot economy and low economic growth in the target economy are the other important elements for home country capital owners. Investors specifically from China take into account economic openness and advanced institutional structure of the host country (Duanmu and Guney, 2009). Political regime of China might be the reason why investors care mostly openness and developed institutions.

Daude and Stein (2007) claim that institutional quality has the key role to attract not only more FDI, but also domestic capital holders to invest. Predictability in the economic policies and the enforcement of the rules in economy make the host economy environment more desirable. According to Mishra and Daly (2007), advanced institutions of the host countries have a positive effect on the FDI outstocks of the pivot economy. Especially, “the strength and impartiality of the legal system, popular observance of law, strength and quality of bureaucracy and government stability” stand out as the main factors that attract FDI flows. Bénassy-Quéré et al. (2007) identify the bureaucracy, corruption, information, banking sector and legal institutions as the leading factors that determine the inward FDI. Groh and Wich (2012) compose an index for which they determine key factors such as “economic activity, the legal and political system, the business environment, and infrastructure” so that they are able to rank 127 countries with respect to FDI attraction. Therefore, institutional structure, economic freedom, natural resource endowments, infrastructure, and the political regime are the integral parts of an economy, which investors consider as a whole.

Investors take the quality of the institutions and judicial system of the target economy into consideration. By signing bilateral investment treaties, they clear up their doubts about the institutions in the economy they plan to invest. Even, in some cases, bilateral investment treaties work as a guarantee for sustained institutional quality of the host economy. Hence, increasing number of those kind of treaties in developing countries results in a rise in the FDI inflows (Neumayer & Spess, 2005). However, in economies like China, there is enough evidence that these foreign investor-friendly agreements do not apply to domestic firms (Huang, 2003). Thus, treaties may not exactly demonstrate the development level of the institutional structure in the host economy. On the contrary, this gap can be accepted as an indicator that economic freedom is not institutionalized sufficiently, and democratic regime is not interiorized. Li’s (2005) study shows how the lack of good governance attracts FDI inflows to China. Globerman and Shapiro (2003) shows that countries suffering from not receiving US FDI do not have free and transparent markets, or effective government. And, their legal systems are not constructed on English-originated common law. Economic freedom and its institutional variables are equally important in attracting FDI for all different parts of the world such as Western Europe and Sub-Saharan Africa. The effects of institutions such as the legal system, respect for the rule of law however are not that much important in attracting FDI in Western Europe. Yet, they are given priority in Sub-Saharan Africa (Fofana, 2014). That is, while some institutions
effect FDI inflows equally in different economies, some may not. It depends on the development level of the host economy.

The political regime guaranteeing the economic freedom, and the natural resources of the host economy is also an important aspect of the topic. For instance, Asiedu and Lien (2011) show that democracy has a negative effect on the FDI in economies where natural resources have a high export share. However, democracy displays a more attractive environment for capital inflow in economies where resources have low export shares. For Kostevc (2007), the government itself is a necessary institution to create the required legal system that is desired by FDI. Except the economies with endowment of natural resources, having a stable and efficient legal system with private property rights protection are prerequisites to have foreign investors.

With the neoliberal transformation that have been taking place in the aftermath of 1980, multinational corporations become the determining global actors in both economy and policy making. So, the economic freedom, legal and economic institutions of the host countries have gained great importance in the eyes of those companies in terms of investing their capital in a certain economy. But, according to Gopinath and Echeverria (2004), trade and FDI transactions have to be studied separately to decide on the institutional requirements that investors consider. It is unlikely that trade transactions require information about the regulations, institutional and governance performance of host economies. But these are the key features that have to be considered to decide on the target economy of the FDI (Gopinath and Echeverria, 2004). Hassan (2015) also examines the investor preferences on outward FDI locations based on the host country economic institutions. Multinational business groups care about low corruption, low tax burden, and enhanced business regulations. Campos and Kinoshita’s (2003) study reveal that low bureaucratic quality, more restrictions, and less openness to trade deter FDI.

Rather than the institutions or the legal systems, Smarzynska (2002) focuses on the effects of intellectual property rights protection on the composition of FDI. Weak intellectual property rights protection discourages investors from stepping into the potential host economy. For Ali (2010) et al., the most significant institutional elements that determine FDI are related to property rights. Any study disregarding this factor would be deficient because other measures of institutional quality do not acquire the necessary information of property rights protection.

Kobeissi’s (2005) focuses on the effect of governance, legal system, and economic freedom on the FDI in the Middle East and North Africa. While the governance is the most important factor, economic freedom is the least important factor that foreign investors care in the region. But, in the study using 1975-2004 data of 85 countries, Azman-Saini et al. (2010) argue that economic freedom boosts FDI inflow. Target economies’ capacity to absorb and adopt new technology and benefits of FDI inflow increases. Brenton, Di Mauro and Lücke (1999) asserts that economic freedom is in a positive association with FDI movements. In addition to the institutional structure of the economy, host economy’s economic freedom level has become an important feature that multinational companies consider when deciding on making investments. In the study they examine the effects of economic freedom on the outward FDI, Anwar and Mughal (2012) show that the size of government, market regulations and the convenience for foreign trade are the main components of the economic freedom that Indian capital owners take into account. But the legal structure is not as important as those structural elements in the eyes of Indian investors (Anwar and Mughal, 2012).

The current literature provides controversial results about the determinants of the direction of the FDI transactions. As noted by Duanmu and Güney (2009), those determinants vary among economies based on the country-specific factors. For instance, the perception of economic freedom and the value attached to it does not mean the same to every investor. To begin with, economic freedom is a broad subject to detect its impact on the FDI. Therefore, the legal structure status and the property rights approach in the host economies are considered as the indicators of economic freedom. And the effect of economic freedom in attracting FDI is examined by this way throughout this research. Focus of the literature is on what determines FDI inflows or FDI outflows in general by using panel data. But both the host economy and the source economy characteristics are important on shaping the behavior of FDI. Therefore, by focusing on the Turkish outward FDI stocks, this study inherently includes country-specific factors of both parties.

2. Data and Methodology

2.1. Data

Legal system and property rights are considered as the indicators of economic freedom. And the data for
these are retrieved from the Fraser Institute (2017) which generates an economic freedom index for 159 countries. There are 42 independent variables forming the economic freedom index in which there are five basic areas. Legal system and property rights is one of the five areas that measure economic freedom in part. In addition, there are 9 components of the legal system and property rights. These are judicial independence, impartial courts, protection of property rights, military interference in rule of law and politics, integrity of the legal system, legal enforcement of contracts, regulatory restrictions on the sale of real property, reliability of police, and business costs of crime. Each component is measured on a scale of 0-10. For a more meaningful interpretation of the empirical results, logarithmic transformation of the indices is used. However, there are observations with zero value for military interference in rule of law and politics, and regulatory restrictions on the sale of real property. So, to pursue the analyses, 0.01 is added to each observation of these components and no information is lost by this way.

Turkish FDI outward stock data are from Bilateral FDI Statistics of United Nations Conference on Trade and Development (UNCTAD) (2014) and they are in millions of US $. The dataset is composed of 91 countries. Logarithm of the values are put into use, but there are negative values due to bilateral characteristics of the data. Overall distribution has to be shifted based on the lowest observation value which is -528 for Bahrain in 2010. So, 529 is added to each observation to be able to use logarithm

Four control variables are utilized in addition to economic freedom indicators. GDP (constant 2010 US $) is used as the indicator of host economies’ market size. Ores and metals exports as the percentage of merchandise exports is used to show the effect of natural resources endowment. There is a potential endogeneity problem because this indicator can be both the result and the motivation of the outward FDI stock (Anwar and Mughal, 2012: 2997). So, to avoid the possible endogeneity problem, the natural resources endowment is used with one-year lag. Inflation and exchange rate variables are employed as the measures of macroeconomic stability in the target economy. For this purpose, annual consumer price index and real effective exchange rate index (2010=100) are used. World Development Indicators DataBank of the World Bank (2017) is used as the source of the data for control variables. While log of contracts rating; regulatory restrictions on the sale of real property rating; reliability of police rating; and transforms of the GDP and real effective exchange rate index are utilized for an intuitive interpretation, inflation rates and ores and metals exports are left as original. For, the last two are already in percentage values.

2.2. Methodology

We try to find the effect of the host countries’ legal system and property rights structure on attracting Turkish FDI. The analyzed time period is between 2001 and 2012. Data is unbalanced. Random Effects (REM) and Fixed Effects models (FEM) are chosen as the estimation technique based on the results of the Hausman tests. Selected model types are displayed underneath each table. Following basic univariate and multivariate Fixed Effects Models are estimated, respectively.

\[
\text{LOGFDI}_{it} = (\alpha + \tau_t) + \beta_1 \text{LOGPROXY}_{it} + u_{it}
\]

\[
\text{LOGFDI}_{it} = (\alpha + \tau_t) + \beta_1 \text{LOGPROXY}_{it} + \beta_2 \text{ORE}_{it} + \beta_3 \text{LOGGDP}_{it} + \beta_4 \text{LOGEXCHR}_{it} + \beta_5 \text{INFLATION}_{it} + u_{it}
\]

And, the following basic univariate and multivariate random time effect models are estimated, respectively.

\[
\text{LOGFDI}_{it} = \alpha + \beta_1 \text{LOGPROXY}_{it} + (\tau_t + u_{it})
\]

\[
\text{LOGFDI}_{it} = \alpha + \beta_1 \text{LOGPROXY}_{it} + \beta_2 \text{ORE}_{it} + \beta_3 \text{LOGGDP}_{it} + \beta_4 \text{LOGEXCHR}_{it} + \beta_5 \text{INFLATION}_{it} + (\tau_t + u_{it})
\]

where \(i\) subscript is for the \(i\)-th country’s observation at time \(t\) for the corresponding variable, \(\alpha\) is the intercept term and \(\tau_t\) stands for the time-specific effects which affect all countries in the same manner. That is, \(\tau_t\) is variant across time but not across the countries. \(u_{it}\) is idiosyncratic error term. \(\text{LOGPROXY}\) represent logarithmic value of: legal system and property rights; judicial independence rating; impartial courts rating; protection of property rights rating; military interference in rule of law and politics rating; integrity of the legal system rating; legal enforcement business costs of crime rating. That is, legal system and property rights is used as a proxy for economic
freedom. And, 9 components of the legal system and property rights are considered as proxies of the economic freedom separately. So, 20 different models are estimated in total including the ones with control variables.

3. Results

As it is seen from Table 1, host countries’ legal system and property rights are in a positive association with the FDI movements. Results are statistically significant even if the level of significance is 1%. And they are robust after the control variables are added to the regression. Even the magnitude of the positive effect of legal system and property rights on the FDI increases. The coefficient rises from 0.4989 to 0.63 after the control variables are included. Natural resources endowment of the host economy negatively effects the Turkish FDI outstock. But host economy’s market size is in a positive relationship with the Turkish FDI outstock. While, the effect of inflation rate is statistically insignificant, the other macroeconomic stability variable; log of real effective exchange rate is found to be in a positive relationship with Turkish FDI outstock. However, the coefficient is significant at 10% significance level.

Table 1: Legal system and property rights and Turkish FDI outward stock

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>(1)</th>
<th>(2)</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Log of FDI</td>
<td>Log of FDI</td>
</tr>
<tr>
<td>Log of legal system and property rights</td>
<td>0.4989***</td>
<td>0.6300***</td>
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<tr>
<td></td>
<td>(0.0732)</td>
<td>(0.1131)</td>
</tr>
<tr>
<td>Natural resources endowment (ores and metals exports)</td>
<td>-0.0109***</td>
<td>-0.0109***</td>
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<tr>
<td></td>
<td>(0.0040)</td>
<td>(0.0040)</td>
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<tr>
<td>Log of market size (GDP)</td>
<td>0.0244*</td>
<td>0.0138</td>
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<tr>
<td></td>
<td>(0.0138)</td>
<td>(0.0138)</td>
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<tr>
<td>Log of real effective exchange rate</td>
<td>0.4158*</td>
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<tr>
<td></td>
<td>(0.2214)</td>
<td>(0.2214)</td>
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<tr>
<td>Inflation</td>
<td>0.0115</td>
<td>0.0115</td>
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<tr>
<td></td>
<td>(0.0070)</td>
<td>(0.0070)</td>
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<tr>
<td>Constant</td>
<td>5.5830***</td>
<td>2.7948**</td>
</tr>
<tr>
<td></td>
<td>(0.1306)</td>
<td>(1.1008)</td>
</tr>
<tr>
<td>Selected Model</td>
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<td>REM</td>
</tr>
<tr>
<td>Observations</td>
<td>645</td>
<td>431</td>
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<tr>
<td>Countries</td>
<td>79</td>
<td>51</td>
</tr>
</tbody>
</table>

***p<0.01, **p<0.05, *p<0.1

Standard deviations are in the parentheses.
Table 2: Components of legal system and property rights and Turkish FDI outward stock

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<tbody>
<tr>
<td>Log of judicial independence rating</td>
<td>0.1730*** (0.0449)</td>
<td>0.2430*** (0.0696)</td>
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<tr>
<td>Log of impartial courts rating</td>
<td></td>
<td></td>
<td>0.2276*** (0.0507)</td>
<td>0.2388*** (0.0720)</td>
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<tr>
<td>Log of protection of property rights rating</td>
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<td></td>
<td></td>
<td>0.2050*** (0.0569)</td>
<td>0.2120** (0.0880)</td>
</tr>
<tr>
<td>Log of military interference in rule of law and politics rating</td>
<td></td>
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<td></td>
<td></td>
<td>0.0806*** (0.0263)</td>
<td>0.0776** (0.0319)</td>
</tr>
<tr>
<td>Log of integrity of the legal system rating</td>
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<td></td>
<td></td>
<td>0.2775*** (0.0701)</td>
</tr>
<tr>
<td>Natural resources endowment (ores and metals exports)</td>
<td>-0.0101** (0.0042)</td>
<td>-0.0103** (0.0041)</td>
<td>-0.0103** (0.0042)</td>
<td></td>
<td></td>
<td>0.0109*** (0.0041)</td>
<td></td>
<td></td>
<td>-0.0107** (0.0045)</td>
<td></td>
</tr>
<tr>
<td>Log of market size (GDP)</td>
<td>0.0270* (0.0152)</td>
<td>0.0330** (0.0140)</td>
<td>0.0302* (0.0155)</td>
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<td></td>
<td>0.0390*** (0.0140)</td>
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<td>0.0508*** (0.0148)</td>
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<tr>
<td>Log of real effective exchange rate</td>
<td>0.4053* (0.2437)</td>
<td>0.4261* (0.2271)</td>
<td>0.3825 (0.2501)</td>
<td></td>
<td></td>
<td>0.5387** (0.2284)</td>
<td></td>
<td></td>
<td>0.3445 (0.2380)</td>
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<tr>
<td>Inflation</td>
<td>0.0061 (0.0076)</td>
<td>0.0044 (0.0071)</td>
<td>0.0033 (0.0077)</td>
<td></td>
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<td>-0.0021 (0.0067)</td>
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<td>0.0029 (0.00715)</td>
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<tr>
<td>Constant</td>
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<td>3.5450*** (1.2033)</td>
<td>6.1121*** (0.0807)</td>
<td>3.3232*** (1.1257)</td>
<td>6.1191*** (0.1000)</td>
<td>3.6016*** (1.2255)</td>
<td>6.3098*** (0.0538)</td>
<td>2.9026*** (1.1384)</td>
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***p<0.01, **p<0.05, *p<0.1
Standard deviations are in parentheses.
Table 2-Continued: Components of legal system and property rights and Turkish FDI outward stock

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<td>Log of legal enforcement of contracts rating</td>
<td>0.2561***</td>
<td>0.2420**</td>
<td>0.2420**</td>
<td>0.2420**</td>
<td>0.2420**</td>
<td>0.2420**</td>
<td>0.2420**</td>
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<td>Log of regulatory restrictions on the sale of real property rating</td>
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<td>Log of reliability of police rating</td>
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<td>Log of business costs of crime rating</td>
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<td>Natural resources endowment (ores and metals exports)</td>
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<td>-0.0071*</td>
<td>-0.0129**</td>
<td>-0.0110**</td>
<td>-0.0110**</td>
<td>-0.0110**</td>
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<td>Log of market size (GDP)</td>
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<td>0.0569***</td>
<td>0.0330*</td>
<td>0.0462**</td>
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<td>Log of real effective exchange rate</td>
<td>0.4389*</td>
<td>0.4959**</td>
<td>0.575</td>
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***p<0.01, **p<0.05, *p<0.1
Standard deviations are in parentheses.
Results are similar to Table 1 when the 9 components of the legal system and property rights are treated as independent variables one by one. Log of the host economy ratings on judicial independence, impartial courts, protection of property rights, military interference in rule of law and politics, integrity of the legal system, legal enforcement of contracts, reliability of police are positively associated with Turkish FDI outstock. Also, even if control variables are included, these are still statistically significant. But, the positive relationship with regulatory restrictions on the sale of real property, and business costs of crime becomes statistically insignificant when the natural resources endowment, market size and macroeconomic stability variables are added as control variables in the estimation. As in Table 1 in the case of the composite index, log of natural resources endowment is in a negative relationship with log of Turkish FDI outstock. Yet, log of market size has a positive effect on the log of Turkish FDI outstock. Coefficients of inflation has no significance in any of the models. Positive coefficients of the log of real effective exchange rate are insignificant or weakly significant. But it does not reveal a structure to form a pattern.

4. Conclusion

To sum up, economic freedom is a very broad topic to explore its role on the capital movements. But, components of it such as legal system and property rights are more concrete to start and gather information. Multinationals and international capital holders attach importance to regulations and the institutional structure of the legal system in the target economies. Judicial independence, impartial courts, and application of law within legal structure are important issues for investors. Protection of property rights and how the enforcement of contracts are effective in the host economies are aspects most of the capital holders care because they want to guarantee the safety of their investment. The statistical results of the analyses lead us to conclude that high quality of institutions in the host economies have a positive effect on the outflow of source country FDI stocks. Increasing the quality of institutional structure, efforts to form a predictable environment by using economic policies are crucial steps. These have vital importance for developing countries to resemble source countries so that gathering more FDI is possible.

However, this is a summary of only the Turkish FDI behavior. It is highly likely that the origin of the capital is a main determinant shaping the FDI movements. Premature and unregulated legal structure and ineffective protection of property rights could attract some investors based on the origin of their capital because the higher the risk, the higher the return is. Hence, data on different pivot economies could generate very different findings about the effects of economic freedom on the routes that FDI follows. This study focuses on the effects of only one part of the economic freedom. Yet, the external validity of the findings requires further research on the other parts of the economic freedom. Therefore, additional analyses on the other related parts of the economic freedom are needed. Different samples may give different results about the FDI flows. For instance, a sample from underdeveloped regions such as Sub-Saharan Africa, or a sample composed of countries with unorthodox political regimes would potentially generate results opposite to the findings of this study. Thus, country-comparison is necessary to find out if the empirical results are robust in different pivot economies.

REFERENCES


