Institutional quality similarity, corruption distance and inward FDI in Turkey*

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In this paper we investigate the impact of institutional differences as a determinant of Turkish FDI inflows from OECD economies. We focus on the corruption distance between the home and host countries as a crucial part of institutional quality. Our results confirm that FDI flows are higher when they come from countries with low differences in corruption with Turkey. Conversely, FDI flows are negatively affected when there exists a large difference in corruption between the investing country and Turkey. This is explained by the ability of firms to obtain a higher return from their resources and capabilities in those environments with a similar idiosyncrasy to the one of their home country.

In diesem Beitrag untersuchen wir den Einfluss institutioneller Unterschiede als einer Determinante türkischer FDI-Zuflüsse aus dem OECD-Wirtschaftsraum. Als entscheidender Bestandteil institutioneller Qualität gilt der Korruptionsabstand zwischen den Heimat- und Gastland. Unsere Ergebnisse bestätigen, dass FDI-Ströme höher sind, wenn sie aus Ländern mit geringeren Korruptions-Unterschieden kommen. Umgekehrt werden FDI-Ströme negativ beeinflusst, wenn es einen großen Unterschied in der Korruption zwischen dem Investitionsland und der Türkei gibt. Dies wird durch die Fähigkeit der Unternehmen eine höhere Rendite aus ihren Ressourcen und Fähigkeiten in einem Umfeld zu erzielen, das ihrem Heimatland ähnliche Eigenschaften aufweist, erklärt.

Keywords: Foreign Direct Investment; Turkey, OECD countries; institutional differences; corruption; multinational enterprises (JEL: F21, F23, D73)

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1. Introduction

Turkey has been considered as an attractive target country for developed MNEs for nearly a decade. Turkish booming economy reached $ 775 billion in 2011 and attracted $ 108 billion in FDI between 2004 and 2011. Furthermore, Turkey is projected to be the fastest growing economy among the OECD countries during 2011-2017 with an annual average growth rate of 6.7%. By the end of 2012, its foreign trade volume of $ 388 billion (export: $ 152 billion, import: $ 236 billion) and population reached 75 million half being under the age 30[6]. Nevertheless, the level of FDI-inflow stayed behind the potential level for a country starting the European Union membership negotiations.

We suggest that one of the possible reasons could be the differences in institutional quality between Turkey and major investing countries which deter FDI flows. The concept of institutional quality in emerging countries is receiving an increasing amount of attention given its pivotal role to attract inward FDI flows (Bevan/Estrin 2004; Wernick et al. 2009). Poor institutional quality usually translates into higher rates of corruption (Kaufmann et al. 2003). Several studies have pointed to the additional costs and risks that corruption in the host country represent for Multinational Enterprises (MNEs) (Mauro 1995; Wei 2000a; Wei 2000b; Brouthers 2008). Others, however, have not found a significant relation (Wheeler/Moody 1992; Alesina/Weder 2002; Busse/Hefeker 2005) or even report a positive one as it sometimes "grease the wheels" of business and speeds up bureaucratic processes (Leff 1964; Olson 1993; Egger/Winner 2005). However, to the best of our knowledge, studies dealing with the impact of institutional quality differences between home and host countries are relatively scarce (see Habib/Zurawicki 2002; Cuervo-Cazurra 2006; Brada et al. 2012 for notable exceptions).

We empirically test the impact of (dis)similarities in institutional quality between host and investing countries as a factor of FDI flows. To do so, we have analyzed a sample of Turkish inward FDI flows from 2002 to 2010 through a gravity model in which we have included the distance between the corruption levels of the investing country and Turkey. Our results show that lower institutional quality differences between home countries and Turkey positively influence inward FDI flows whereas, conversely, investments from countries with a very dissimilar institutional environmental quality are reduced. This is explained by the fact that MNEs are "cognitive imprinted" by their country of origin (Stinchcombe 1965) and, consequently, they benefit from owning and developing skills and resources appropriate to the host environment and tend to invest more heavily on those countries with a similar idiosyncrasy to the one of their home country to reduce uncertainty and transaction costs (Cuervo-Cazurra/ Genc 2008; Brada et al. 2012).

[6] Turkish Statistical Institute, www.turkstat.gov.tr (accessed February 12, 2013).

The remainder of the paper is organized as follows. Section 2 provides a brief overview of the literature on institutional differences and corruption. Section 3 describes the data, the variables, and the model, including the diagnosis of multicollinarity. Section 4 presents the empirical results and Section 5 concludes.

2. Literature review

According to North (1991), institutions are humanly devised constraints that structure political, economic and social interactions. Either formal or informal, institutions directly affect transaction and production costs by setting out the norms and regulations governing transactions. However, when there is a lack of respect for the rules and regulations and therefore institutional quality is poor, corruption is likely to arise (Kaufmann et al. 2003).

Corruption may be defined as the abuse of power to obtain private benefits and includes payments of bribe, embellishment, favoritisms, inappropriate use of influences or irregular payments in public contracting (World Bank 2000). As previously mentioned, there are two views of corruption: one negative where corruption increases costs and uncertainty, and another one positive where corruption helps avoid the costs of operating in a poorly-regulated environment (Cuervo-Cazurra 2008). In fact, literature simultaneously offer several empirical studies corroborating the role of corruption as "sand" decreasing FDI (Mauro 1995; Wei 2000a; Wei 2000b; Brouthers 2008), as "grease" increasing FDI (Leff 1964; Olson 1993; Egger/Winner 2005) or with no significant effect (Wheeler/Moody 1992; Alesina/Weder 2002; Busse/Hefeker 2005), depending on the specific research context and setting under study. However, we try to advance one step further and analyze the role of corruption *distance* between home and host countries. In other words, could differences in the quality of domestic institutions affect the outcome of cross-country differences in attracting FDI?

Distance is usually employed metaphorically to refer to differences between two countries (Hakanson/Ambos 2010) and has a central role on international business research (Ambos/Hakanson 2014; Hutzschenreuter et al. 2014). Distance is a multidimensional concept traditionally associated to higher obstacles for foreign direct investment (FDI) (Berry et al. 2010). The concept of distance encompasses several different components, such as cultural, administrative, geographic and economic (Ghemawat 2001). Corruption is part of the administrative distance and a component of political risk and institutional quality (Jimenez 2010; Jimenez/Delgado 2012).

Contrary to the prevailing view, distance does not always engender negative outcomes as a barrier for the firm (Tung/Verbeke 2010) and may be seen under some circumstances as a source of opportunities (Hutzschenreuter et al. 2014; Jimenez et al. 2013). In fact distance may have potential fruitful consequences associated to being different which may outweigh the costs (Ambos/Hakanson

2014). Thus, firms can sometimes transform the apparent disadvantage of higher distance into opportunities for arbitrage, complementarity or creative diversity (Ghemawat 2001; 2003; Shenkar et al. 2008; Zaheer et al. 2012), by accessing knowledge, talent, resources or experience not available in closer markets (Hitt et al. 2006). However, a higher distance in corruption (as well as in other facets of distance), implies greater difficulties and challenges to correctly understand and interact in the host market that MNEs need to overcome when investing abroad. As Hakanson and Ambos (2010: p.195) claim "the general assumption in most studies is that the more different a foreign environment is as compared to that of a firm's (or an individual's) country of origin, the more difficult it will be to collect, analyse and correctly interpret information about it, and the higher are therefore the uncertainties and difficulties – both expected and actual – of doing business there".

Therefore, we argue that bilateral distance (similarity) between home and host countries in corruption levels will have a negative (positive) impact on the levels of inward FDI, because firms tend to invest more heavily when they are familiar with the host-market conditions (Habib/Zurawicki 2002). MNEs from corrupt countries are more likely to develop skills and capabilities to deal with a corrupt and bribe-seeking host governments (Brada et al. 2012). Experience accumulation is an important mechanism through which organizations develop capabilities (Zollo/Winter 2002) making subsequent investments in corrupted countries easier to those firms which come from corrupted environments (Jimenez 2010; Jimenez/Delgado 2012). Previous experience and exposure – i.e. the extent to which the subsidiary may be in contact with, or subject to, a specific threat (Adger 2000; Dai et al. 2013) – to corruption seems therefore crucial elements to develop political capabilities as an organizational learning mechanism that transform routines into knowledge (Jimenez et al. 2014).

On the other hand, firms from less corrupt countries not used to environments with little protection to firm-specific assets such as technology, brands, patents, etc. will find corrupt countries less attractive and prefer countries where they can benefit more from their competitive advantages (Brada et al. 2012). In this sense, both firms from corrupt countries and non-corrupt countries are more prone to invest in locations with similar conditions to the ones under which they are used to operate because that is where their resources and capabilities are more useful (Cuervo-Cazurra/Genc 2008). As Stinchcombe (1965) explains, firms are "imprinted" by the conditions in their countries of origin, allowing the development of mental models that are used to interpret the environment and guide the company's actions under conditions of uncertainty (Walsh 1995). We therefore argue that investment flows will be higher when MNEs are able to rely on these mental models, something that is much more likely when they face a similar institutional environment and a lower distance in corruption levels.

3. Methodology

3.1 Sample and variables

Our dependent variable is the inward FDI flow in millions of dollars received each year in Turkey from 2002 to 2010 from OECD countries[7]. By measuring FDI in millions of dollars we are able to include zero or negative investments (divestments) in the sample, which are impossible to calculate if the variable is measured in the logarithm in thousands of dollars. In addition, any nonlinear transformation including a logarithmic transformation of the dependent variable may lead to inconsistent estimates (Santos Silva/Tenreyro 2006; Jimenez 2011).

We rely on the gravity model estimated by McCallum (1995) so frequently used in the literature (Anderson/van Wincoop 2003; 2004). Originally intended to explain interprovincial and interstate between Canada and US, it accounted for the home and host gross domestic production, geographical distance and border dummies. We draw on this model and use a set of explanatory variables to explain Turkish inward FDI flows that also includes home country GDP (host country is dropped because all the flows we analyze are targeted towards Turkey) and geographical distance. In particular, we use the CEPII bilateral geographical distance, which is defined as the number of kilometers separating the largest cities in the home and host countries weighted by their share in national population.

The McCallum´s model included border dummies, but Turkey does not share a border with any OECD country except Greece. Instead, we include two variables to account for economic attractors such as belonging to the European Union, a supranational body where the adhesion of Turkey is being considered, and the signature of a bilateral investment treaty (BIT) between the investing country and Turkey. We then augment the traditional gravity model, controlling for the institutional differences between the home and host countries. To do so we use corruption as a proxy and rely on a well-known measure, the Index of Perception of Corruption calculated by the Heritage Foundation.

As previously mentioned, corruption is part of the administrative distance between two countries and a component of political risk and institutional quality (Jimenez 2010; Jimenez/Delgado 2012). However, our focus is not the level of corruption of the host country (which would be the same for all investing countries as we analyze Turkish inward FDI), but the bilateral distance between the home and host countries. Thus, we aim to take into consideration the fact that firms tend to invest in those places where their resources and capabilities are more useful, which usually happens in environments with similar conditions to the ones under which they are used to operate (Cuervo-Cazurra/Genc 2008).

[7] Chile, Estonia, Israel and Slovenia were not included due to data unavailability.

Therefore, we include the differences between the scores of the investing country and Turkey to take into account the higher uncertainty faced by those MNEs coming from countries with lower levels of corruption. In addition, we also provide the results of the models using the absolute value of the scores difference between the investing country and Turkey, to control whether the results depend on the direction of the difference or they are simply caused by the fact that the firm is investing in an environment with different characteristics (i.e. regardless of the levels of corruption being better or worse than at home).

Finally, we also include a set of country dummies that will capture the effect of any particular home-country characteristic which may increase the propensity to invest abroad and a set of time dummies to account for unobservable historical events.

We collected the data from the following sources: OECD, UNCTAD, CEPII and Heritage Foundation. Annex 1 shows the descriptive statistics for the dependent, independent and control variables included in the model.

3.2 Model

Our dataset covers inward FDI in Turkey from OECD countries from 2002 to 2010, so we are able to conduct a longitudinal study instead of a cross-section one. Therefore, we rely on the panel data technique which allows us to incorporate the temporal dimension into the analysis.

The first step is to determine whether a fixed effects (FE) or a random effects (RE) model is required. To do so, we performed a Hausman test to check if the common effects are correlated with the explanatory variables, in which case a fixed-effects model should be chosen. However, the test confirmed that this was not the case, so we employ a random effects model.

As it is standard practice in the literature, we use one-year delays in all the explanatory variables in order to analyze their impact on the inward FDI flows in the following year.

3.3 Diagnosis of multicollinearity

Annex 2 offers the matrices of correlation and the Variance Inflation Factor (VIFs) of the independent variables. Given the low coefficients and that all VIFs values are found below the limit of 10 recommended by Neter et al. (1985), Kennedy (1992) and Studenmund (1992) and even below the stricter limit of 5.3 proposed by Hair et al. (1999), it may be affirmed that there are no serious problems of multicollinearity.

4. Results

Annex 1 shows the results of the gravity model employed to analyze inward FDI in Turkey from OECD countries. Model 1 includes the differences between the

corruption scores of the investing country and Turkey (plus the other explanatory variables home country GDP, geographical distance, European Union membership, bilateral investment treaty signature and country and temporal dummies). The results confirm our hypotheses as they show a negative and significant coefficient for the corruption measure. That means that Turkish inward FDI flows tend to come from countries with relatively higher corruption levels, as firms from these places face lower uncertainty and transaction costs than their counterparts from countries with lower levels. In addition, geographical distance shows a non-significant coefficient, confirming the lower role of geographical distance as a barrier to FDI in the age of globalization, lower transportation costs and improved information and communication technologies (ICTs).

In Model 2 we replace the differences between the corruption scores with the absolute value of those differences and maintain the rest of the explanatory variables. The results show again a negative and significant coefficient for the corruption measure, which confirms that this effect is not just caused by the direction of the difference, but by the fact that firms tend to invest in locations where they can find conditions that resemble those that predominate at home. Conversely, they tend to avoid investing in a non-familiar environment which translates into higher uncertainty. By following this strategy, they can increase the value of their resources and capabilities, sometimes even transforming apparent disadvantages into competitive advantages in certain markets (Cuervo-Cazurra/ Genc 2008).

As robustness tests, we checked whether the models would be any different if we replaced the EU27 variable for a EU15 (i.e. dropping the 12 countries that joined the EU in 2004 and 2007). However, the results show no significant changes. We also tested a different corruption measure, replacing the Index of Perception of Corruption with the Control of Corruption Index included in the World Governance Indicators (Kaufman et al. 2010). Models 3 and 4 offer the results obtained when we included this alternative measure of corruption, replicating Models 1 and 2 respectively. Despite the fact that the coefficient of the difference in corruption scores is still negative in both models, it is only significant in Model 4 (i.e. when we use the absolute value of the differences) but not in Model 3. This means that the results from Model 1 should be taken with caution, but confirms our previous findings from Model 2 that institutional differences between home and host countries play a significant role on FDI flows and that this effect is not due to the direction of the difference, but to the fact that resources and capabilities are more useful when they are used in similar environments to those where they have already been successful. Conversely, dissimilar environments discourage FDI as they increase the uncertainty about the appropriateness of our resources and capabilities to the host market.

As an additional robustness test, in Model 5 and 6 we consider the possibility that the dependent variable is self-explanatory of its behavior. That would mean

that previous FDI flows partially explain current FDI flows, although it is not possible to anticipate the sign of this effect. Either MNEs could continue and expand investments as they –or MNEs from the same home-country– get more familiarized with the country or they could favor new markets not previously exploited instead of locations where they are already present. To control for this possibility, we introduced the dependent variable as an explanatory variable in the gravity equation, using a one year lag. The models, however, show very similar results to those previously discussed and verify our findings as both estimations of differences in corruption scores keep their significant negative coefficients. Previous FDI flows, meanwhile, show a significant positive coefficient in both models, suggesting a re-investing FDI strategy in which investment flows increase as firms become more familiar with the country or they notice that other companies from their home-country have successfully invested there. As a final robustness test and following the procedure suggested by Brada et al. (2012), we also added to the models additional explanatory variables that may be added to the gravity model, such as factor endowment differences (measured by the difference between home and host countries per capita GDP) or tax differences (using the KPMG tax survey) but the results remained unchanged[8].

5. Conclusions

In this paper we have investigated the impact of institutional differences between home and host countries as a determinant of FDI flows. To do so, we have analyzed a sample of Turkish inward FDI flows from 2002 to 2010 through a gravity model in which we have included the differences between the corruption levels of the investing country and Turkey.

Our results confirm that FDI flows are higher when they come from countries with low differences with Turkey, and they decrease when the investing country has a very different corruption score. This is due to the fact that MNEs are able to obtain a higher return from their resources and capabilities in environments with a similar idiosyncrasy to the one of their home country. Thus, FDI flows tend to come from countries whose MNEs face lower uncertainty and transaction costs in their operations in Turkey due to their higher familiarity degree with the characteristics of this market. In addition, the results show that this finding is not contingent on whether a country has a lower or higher corruption score, as the differences measure in absolute value has shown more robust and stable results.

Our results also suggest that the role of geographical distance as a main determinant of FDI flows is decreasing (Castellani et al. 2013). Globalization and the improvement of the information and communication technologies have led to the consideration of a "flat world" (Friedman 2005). While arguing for the exist-

[8] Results available from the authors upon request.

ence of a globally integrated market without barriers or borders is excessive, geographic distance is no longer such a great obstacle to most firms. Instead, it seems like firms feel themselves capable of managing operations located far away as long as they minimize the uncertainty derived from the institutional environment by locating their foreign investments in countries where they previous experience at home is more useful and valuable.

5.1 Managerial implications

Our results have important implications for practitioners. Our results highlight the importance of institutional proximity when MNEs are considering an investment in a foreign country. Managers should therefore analyze, understand and compare the characteristics of their home country and those of the potential location of their subsidiaries in order to accurately identify, assess and overcome the challenges and difficulties that they will encounter in the host market. Another implication of our results is that having a home country with relatively poor institutional environment may represent an opportunity for MNEs to successfully invest in other locations with similar conditions. Being already familiar with the particular characteristics of the host-country can be a crucial advantage that some foreign firms can tap into to support their advantage abroad and enjoy a better competitive position in relation to the other international competitors. Obviously the results are also interesting for domestic Turkish companies in order to better understand what kind of foreign competitors are more likely to threaten their market position at home.

Finally, we also contribute to the literature by showing the relevance of other non-geographical facets of distance, specifically the institutional quality distance between home and host countries. In addition, our paper underlines the need for a more fine-grained analysis of the impact of distance on corporate strategy in general and FDI in particular. Distance is a complex and multidimensional concept that we, as researchers, have not fully explored yet.

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Annex

Annex 1: Descriptive statistics

Variables	N.	Average	Standard Deviation	Minimum	Maximum
Inward FDI	261	259.88	696.39	-333	5701
GDP	261	5.62	.63	3.94	7.11
Geographical Distance	261	3.51	.33	2.81	4.22
EU15	261	.51	.50	0	1
BIT	261	.76	.42	0	1
Corruption Difference	261	3.47	1.99	-1.1	6.6
Corruption Difference (Absolute value)	261	3.50	1.93	0	6.6

Annex 2: Correlations matrices and VIFs

	1	**2**	**3**	**4**	**5**	**6**	**7**	**VIFs**
1. GDP	1							1.53
2. Geographical Distance	.286	1						2.37
3. EU15	.002	-.450	1					1.64
4. BIT	.220	-.470	.336	1				1.57
5. Corruption Difference	-.197	.265	.214	-.187	1			1.49

	1	**2**	**3**	**4**	**5**	**6**	**7**	**VIFs**
1. GDP	1							1.53
2. Geographical Distance	.286	1						2.40
3. EU15	.002	-.450	1					1.66
4. BIT	.220	-.470	.336	1				1.57
5. Corruption Difference (Absolute value)	-.192	.288	.210	-.214	1			1.53

Annex 3: Results table: main models and robustness tests

VARIABLES	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
GDP	-687.58 (2630.09)	-682.93 (2588.6)	-1171.99 (2593.79)	-1159.26 (2559.71)	893.68 (3122.01)	616.68 (3064.44)
Geographical Distance	2130.84 (6692.84)	2106.29 (6568.16)	3471.46 (6581.15)	3414.74 (6478.88)	-2089.75 (7957.36)	-1326.74 (7783.94)
EU27	639.12 (1354.45)	635.59 (1332)	881.95 (1337.34)	872.50 (1318.39)	-236.88 (1609.49)	-88.83 (1577.81)
BIT	-344.80 (296.60)	-357.33 (294.95)	-291.89 (304.82)	-295.75 (301.30)	-467.06 (332.90)	-487.79 (331.72)
Corruption Difference	-241.35** (131.47)		-473.05 (311.45)		-275.32** (144.18)	
Corruption Difference (Absolute value)		-247.17** (117.77)		-502.01* (282.36)		-247.90** (127.94)
FDI previous year					.261*** (.069)	.256*** (.071)
Country Dummies	Included	Included	Included	Included	Included	Included
Year Dummies	Included	Included	Included	Included	Included	Included
Constant	-1779.83 (8238.37)	-1662.23 (8007.89)	-3764.363 (8037.84)	-3575.017 (7844.07)	3837.53 (9793)	2737.90 (9475.49)
N	261	261	261	261	232	232
Groups	29	29	29	29	29	29
Observ. per group	9	9	9	9	8	8
Wald	147.02***	147.72***	145.28***	146.68***	168.43***	168.62***

Standard Errors in parentheses * p < 0.10; ** p < 0.05; *** p < 0.01

The number of countries varies in accordance with the availability of the data introduced in the model.

Coefficients of dummy variables not included.