PRESS RELEASE OF THE WORKING PAPER 2/05

Location choices of multinational companies in transition economies: A literature review

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OBJECTIVE

The aim of the paper is to identify determinants of location choices of FDI in transition economies, introducing an analysis at the regional level, which has not yet gained sufficient attention in existing research. Special attention is being paid to FDI flows to transition economies, since they owe their economic and social transformation to a large extent to foreign firms, which introduce knowledge, technology and new opportunities into these emerging markets. The working paper contributes to the provision of a thorough theoretical framework on location choices of multinational companies (MNCs) by integrating the institutional and proximity components within the empirical results on traditional economic factors that attract FDI to certain localities within transition economies. The working paper provides an analytical framework for the further empirical analysis of the enterprise survey of 153 foreign firms in three regions of Ukraine on location choice of MNCs towards the location-specific determinants of foreign investment decisions and embeddedness within the regional economy. This press release will give an overview of the most important conclusions and results of the working paper 2/12 of the SEARCH project.

MAIN RESULTS

The reasons of such a significant rise of transition economies on the global FDI arena originate from the past. Since 1990s Central and Eastern European countries have undergone profound transformations of their economic and social systems in a pursuit of change from planned socialist economic systems towards market economies. Substantial economic liberalization, which underpinned these transformations, resulted in transition markets becoming popular destinations for FDIs from abroad. The range of factors, that attract foreign investment, is very broad considering the fact that all Central and Eastern European markets move away from their communist legacy and have established themselves as the new untapped markets with a big potential of consumer demand, plenty of resources, low cost production locations and strategically important access to new knowledge and labour. On the other hand, transformation from the Soviet past towards a new capitalist system included the transition of the regional economic systems shaped by the socialist industrialization, which meant a distribution of industries without an efficient market-based economic rationale behind it. During the transition period, their regional industrial structures lost their right to exist and became locations without a competitive future if industrial development was still based on the paradigm of planned development rather than economic efficiency. Thus, after the collapse of the Soviet Union and consequently of the socialist industrialization system all regions were left with socialist legacy which included a certain social platform, i.e. socialist mentality, and economic prerequisites originating in industrialised economic system with a respective infrastructure. Nevertheless, MNCs do choose emerging markets of transition states as their primary investment locations, being attracted by a range of traditional economic factors, proximity aspects, and institutional parameters.

MNCs base their location decision on their preliminary motivation, namely resource-seeking, market-seeking or efficiency-seeking. Depending on the incentives of going abroad, investors search for precisely those local factors available at the host location which will satisfy their initial aim of investment. Therefore, these factors differ with regard to the motivation of internationalization. These local region-specific factors are 2nd level determinants, while proximity and institutional quality are the 1st level determinants. While the 2nd level determinants gain relative importance with respect to the motivation an investor has towards entering the hosting economy, for instance, market potential is relatively more important for a market-seeking investor, rather than for a resource seeking investor, 1st level determinants are assessed by all investors regardless of their motivation. Proximity and institutional quality play the role of the first filter since they decide whether a host location is considered by MNCs at all. If an MNC is not attracted by these factors, it may not enter the market, because firstly, these are the factors which MNCs face first when entering the market, and secondly, the attractiveness of other location determining factors is positively related to institutional quality and proximity parameters of a certain region. If the firm passes through the first filter, namely if the institutional quality and the proximity of the hosting location is assessed as sufficiently good by the investing firm, then it focuses on the 2nd level determinants corresponding to its preliminary motivation of going abroad. Thus, the second filter represents the motivation-specific determinants. And again if a company is not attracted by these, i.e. these factors do not satisfy its initial motivation, the hosting location with these factors stops being interesting for this company. Nevertheless, a feedback loop between the two levels exists. For example, if the market size or growth is very attractive as in the case of China and to an increasing degree in Russia, MNCs might be willing to invest in these locations even if the institutional environment is still hostile. In the following part of this chapter we will discuss precisely both levels of determinants for MNC's investment location decisions.

Investors in post-Soviet transition economies are motivated by resource- and market-seeking incentives. This means that the location choice of MNCs in post-communist states is determined by the location advantages of two main types: abundance of available resources, which enable production at low cost, and emerging markets, which offer high demand or growth potential. Proximity to the European Union and to the firms of the same sector play important roles in the formation of "agglomeration effects", which foster creation of a certain industrial milieu attracting further investments. A special attention is paid to the role of institutional quality and local business culture in pulling FDI inflows to certain locations. Institutions, both formal and informal, are place- and path-dependent in their nature. Therefore, institutions of a certain locality, which is hosting the investment of an MNC, moderate the transaction costs in the hosting markets and determine the access to the local networks, which are essential for the MNC to successfully embed within the new environment. The link between the formal institutions and local business culture determines to what extent the embeddedness of a foreign firm will go smoothly within a specific context of the regional economic system of a certain locality.