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

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Abstract

This paper explains the location choices of multinational companies (MNCs) in a transition economy by institutional quality, proximity, and traditional economic factors. Based on a thorough theoretical framework the paper contributes to the literature on MNCs and location choices by introducing an analysis of institutional determinants at the regional level within a transition economy perspective which has not gained sufficient attention in existing research. The paper also introduces a set of hypotheses for testing empirically the location choices of MNCs in Ukraine on the basis of the results of the enterprise survey held in the three regions of Ukraine.

Keywords: Location determinants, FDI, multinational company, transition economy, enterprise survey

JEL Classification: D23, F21, F23, R11

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I. Introduction

The role of foreign direct investment (FDI) for economic growth and development of states, regions and cities has been widely investigated recently (Bevan and Estrin, 2004; Dunning, 1993; Meyer and Nguyen, 2005). While the impact of multinational companies' (MNCs) activities on the economic development of the countries hosting their subsidiaries has been discussed quite comprehensively in the literature, the regional level and the factors behind the geographical distribution of FDI at the sub-national level have not gained sufficient attention (Cantwell and Iammarino, 2010).

Special attention has been paid to FDI flows to transition economies, which 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 transition from socialism to capitalism and the integration of Central and Eastern European countries into the world economy proceeded through international trade and capital flows, which encouraged growth and innovation and facilitated the restructuring of firms and sectors (Bevan and Estrin, 2004). Foreign-owned firms usually possess higher labour productivity, innovation potential, supplier and customer networks than incumbent firms when entering new markets. FDI flows from developed countries towards emerging economies becomes an important transmitter of economic resources and serves as a catalyst for development and attraction of further investments (Frenkel et al., 2004).

Foreign investors assess overseas locations with regard to market opportunities and obstacles. They are mainly interested to invest into the locations which offer advantages in terms of proximities, market growth, lower costs, strategic resources, and favourable institutional conditions in order to maximise their return on investment. Institutions contribute substantially to the location advantage, since the specific institutional setting at the location of a business activity is of great importance in large and decentralised emerging markets. Transition states have opened their economies for inflows of foreign capital since their socio-political transformation. But despite the spread of market institutions at the national level, the business environment at the regional and local level faces frequent changes of policies, institutional rules, and attitudes which reduce the enforceability and predictability of institutions for potential foreign investors.

The factors that attract MNCs towards certain markets and economies are unevenly distributed among countries and regions. While some regions are clearly benefitting from attractive initial conditions, which pull in foreign investment that further fosters the transition process, regions which do not have such favourable conditions lag behind and perform relatively poor (Barrell and Pain, 1999). Thus, the regional variation in the institutional environment at different locations represents an important extension of the original reasoning about foreign firms choosing specific markets (Meyer and Nguyen, 2005). This is of even bigger importance for countries which share a border with the European Union (EU) and are not yet the members of the EU, but part of the European Neighbourhood Policy (ENP). It is supposed that geographical distance to the EU border has an impact on the institutional quality and, thus, the investment decisions of MNCs. An advantageous position of regions closer to the border and capital regions is expected.

The range of specific host region determinants for the attraction of FDI is generally divided into two broad groups: traditional economic factors and institutional factors (Frenkel et al., 2004; Bevan et al., 2004; Kang and Jiang, 2012). Traditional economic factors are based on the systematic conceptualisation of FDI location choices by Dunning (1993) in his eclectic paradigm OLI, which stands for ownership, location and internalisation advantages. The importance of specific traditional location factors attracting FDI according to Dunning depends on the motives of the investor, namely natural resource seeking, market seeking, efficiency seeking and strategic asset seeking. Based on these motives, the paper will describe a broad range of region specific economic factors, such as cost-related parameters, market-related factors, availability of local knowledge and technology, and agglomeration forces that all have a significant impact on the propensity of MNCs to invest abroad.

The relevance of the institutional perspective for location choices of MNCs has gained a much wider audience recently. It focuses explicitly on the embeddedness of firms into local institutional environments (Kostova and Zaheer, 1999). Foreign firms become highly dependent on the institutional factors at the chosen location for investment and have to adapt themselves (at least to a certain degree) to the local institutional framework in order to gain legitimacy and integration within the regional economic system. FDI from developed into developing countries depends even more on institutional parameters, since developed country MNCs are used to a business environment shaped by a set of rather complete market-based institutions in their home markets (Kang and Jiang, 2012). Nevertheless, these MNCs are often big players in their industry and have the power to shape institutional contexts in the host country due to their large size, superior capabilities and dominant position in global value chains. Thus, an interdependent perspective on institutional quality, location choices of MNC, and institutional change is needed.

The aim of the paper is to identify determinants of location choices of FDI in transition economies, based on empirical evidence of an enterprise survey of 153 foreign-owned firms, carried out in three regions in Ukraine within the project "SEARCH: Sharing knowledge assets: interregionally cohesive neighbourhoods" funded by the European Union within the Seventh Framework Programme for Research (FP7). The analysis of the results of the enterprise survey aims at answering the following research questions:

1. What are the motivations, aims and strategic orientations of the foreign investors coming to different regions of Ukraine?

2. What are the region specific factors that determine the location choices of foreign firms in Ukraine?

3. How does regional institutional quality in Ukraine have an impact on the propensity of foreign firms to invest in certain regions in Ukraine?

The conceptual framework of the paper deals not only with place specific characteristics of the receiving country, but takes a broader look at the motives of foreign firms to invest in local capabilities in the host region. The results of the survey will also uncover the link between initial aims of MNCs and their strategic orientation in the host region. This approach will provide a comprehensive picture of patterns of location decisions for FDI in transition economies and more specifically in Ukraine. The paper contributes to the provision of a thorough theoretical framework on location choices of MNCs by integrating the institutional and proximity components within the empirical results on (1) traditional economic factors that attract FDI to certain localities within transition economies, specifically Ukraine and (2) institutional and proximity parameters of regions that attract or distract MNCs in order to determine the impact of the institutional environment and proximity advantages of certain regions on the propensity of foreign firms to invest in certain regional host markets.

The paper consists of the following parts: Chapter II describes internationalization of MNCs, explaining the focus of the paper on the FDIs towards transition economies and the reasoning behind a company's decision to internationalize; Chapter III presents the conceptual framework of the paper and discussion on the main determinants of the location choices of MNCs; Chapter IV introduces the analytical framework of the paper with the main hypothesis of the empirical research; Chapter V covers data and methods; Chapter VI provides the results of empirical analysis of the dataset of the enterprise survey in Ukraine; Chapter VII follows with the discussion of the results; and Chapter VIII deals with the summary of the whole paper.

II. Internationalization of multinational companies

2.1 Foreign direct investments in transition economies

According to UNCTAD (2012) FDI inflows to transition economies, which include South-East Europe and the Commonwealth of Independent States (CIS), increased in 2011 by 25% up to $92 billion, whereas the increase of FDI flows towards developed and developing economies was about 21% and 11% respectively. Developing and transition economies continue to account for more than a half of the world's FDI inflows, comprising 45% and 6% of global FDI inflows respectively (UNCTAD, 2012). Indicators suggest that transition economies will continue with the same pace of growth rate of FDI inflows in the mid-term (Table 1).

Table 1. World FDI inflows, billions of dollars

Region	FDI inflows			Share			FDI inflows projections		
	2009	***2010***	***2011***	***2009***	***2010***	***2011***	***2012***	***2013***	***2014***
Developed economies	606,2	618,6	747,9	50,6%	47,3%	49,1%	735-825	810-940	840-1020
Developing economies	519,2	616,7	684,4	43,3%	47,1%	44,9%	670-760	720-855	755-930
Transition	72,4	73,8	92,2	6,0%	5,6%	6,0%	90-110	100-130	110-150

economies									
World	1197,8	1309,0	1524,4	100%	100%	100%	1495-1695	1630-1925	1700-2110

Source: UNCTAD (2012)

Executives of the major MNCs have rated the economies of developing and transition states among top 10 destinations of their FDI until 2014 according to the World Investment Prospects Survey 2012-2014. In 2011 Ukraine together with Russian Federation and Kazakhstan belonged to the group of the highest FDI inflows, namely the group of above 5 billion of dollars investments (UNCTAD, 2012). Thus in Table 2 we can observe, that Russia and Ukraine hosted together more than 90% of greenfield investments in 2011, which contributed to the overall two thirds of greenfield investments being hosted by developing and transition economies.

Table 2. FDI flows and stock in CIS in 2011, millions of dollars

Region	**FDI inflows, millions of dollars**	**As % of CIS**	**FDI stock, millions of dollars**	**As % of CIS**	**Value of greenfield FDI projects**	**As % of CIS**
CIS	84539	100%	672253	100%	17485	100%
Armenia	525	1%	5046	1%	83	0%
Azerbaijan	1465	2%	9113	1%	435	2%
Belarus	3986	5%	12987	2%	127	1%
Kazakhstan	12910	15%	93624	14%	383	2%
Kyrgyzstan	694	1%	1274	0%	-	-
Moldova, Republic of	274	0%	3163	0%	0	0%
Russian Federation	52878	63%	457474	68%	15503	89%
Tajikistan	11	0%	993	0%	-	-
Turkmenistan	3186	4%	16627	2%	-	-
Ukraine	7207	9%	65192	10%	954	5%
Uzbekistan	1403	2%	6761	1%	-	-

Source: UNCTAD (2012)

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 (Majocchi and Strange, 2007). 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.

The extent to which regions have managed the post-socialist transformation has an impact on the FDI inflows to these locations. Since foreign investors strive to minimize their costs in order to marginally benefit from their investments, they aim at getting embedded in to the regional economic system of the host country. For such an embeddedness to take place foreign investors try to avoid regions with strong socialist industrialisation heritage due to the difficulty of integration into the different cognitive, social, organisational and institutional environment. Therefore, path-dependency of the economic system influences location choices and the intensity of local embeddedness of foreign firms, particularly in the case of post-Soviet transition states.

2.2 Imperatives of a "multinationality" of firms

The location choice of an MNC is of a strategic importance, because the factors which attract foreign firms to certain locations determine the firm's competitiveness in the long run. International strategies of transnational companies are centred on tapping selective knowledge and strategic location-bound resources in order to improve the comparative advantage of an internationalizing firm over the non-internationalizing (Porter, 1994). Internalisation theory developed by Buckley and Casson (1967) and extended by Hennart (1982) states that transnational companies strive to act in such a way so that to develop their internal specific advantages, which they can then exploit while internationalizing. Hymer (1976) contributes to the internalisation theory with the line of thinking that any firm decides to invest abroad only when the benefit of exploiting firm-specific advantages outweigh the relative cost entering foreign markets. Internalisation theory was also very much supported by Dunning (1980, 1988) with his eclectic paradigm. The paradigm OLI deals with three theories of FDI, where:

- "O" stands for **ownership advantages**. Ownership advantages refer to the firm-specific assets, both tangible and intangible, that firm possesses, specifically with regard to the property competences, which enable a company to marginally outreach its competitors in terms of profitability. Any firms have a certain set of internal advantages, over which it has monopolistic rights that allow using those advantages for the clear benefit of the firm. These advantages can be divided into three groups (Denisia, 2010):
    - *monopoly advantages* – privileged access to the market through having property rights on certain patents, trademarks and limited resources;

  - *technology advantages* – knowledge important for enforcement of innovation and upgrading activities;
  - *economies of large size* – economies of scale, scope, learning.

- "L" stands for **location advantages**. Location advantages are all those factors a specific location owns, that attract foreign companies to the hosting location. Advantages of a certain country or even region can be divided into economic advantages, institutional advantages and social advantages. All these location-specific parameters enable an MNC to become more profitable with either lower costs involved or better access to specific knowledge, which becomes a strategic asset on the way to outperforming competitors.
- "I" stands for **internalisation advantages**. Internalisation advantages refer to those advantages which are brought to the firm by owning production within a specific location rather than by licensing or joint-venture agreements. When the benefits of producing the products by itself are higher for the firm than costs of not doing it, then the firm might choose entering a new market through the FDI entry mode.

The strategic importance of factors for choosing a particular location when investing abroad depends on the motivation to relocate a value-added activity. Dunning (1993, 2000) identifies four main motivations for FDI, namely, market seeking, resource seeking, efficiency seeking and strategic asset seeking. *Resource seeking* investors strive for the availability of cheap natural resources, labour, physical infrastructure. Natural resources play a very important role in the decision of an MNC to enter the market, because they are often an important prerequisite for making use of the market and the strategic assets this market can offer. Historically, foreign investors were attracted by natural resources such as minerals, raw materials and agricultural products. Central and Eastern European countries are well known for the abundance of natural resources as one of the most important determinants of FDIs. Availability of oil and gas, land and sea are voted to be top-ranked by foreign investors coming to Russia, Azerbaijan, Kazakhstan and Ukraine (Kudina and Jakubiak, 2008). Therefore, the growth of FDI flows to countries of the Commonwealth of Independent States (CIS) in 2011 is determined by natural resource-seeking FDIs, mostly Greenfield investments in mining, quarrying and petroleum (UNCTAD, 2012).

Market seeking investors are attracted by the host country's market size, its income per capita, market growth and consumer demand in order to benefit from the economies of scope and scale. Within market-seeking strategies, proximity plays a very important role, because MNCs are encouraged to invest in those locations, where potential suppliers and customers are already present. Moreover, MNCs are very much bounded by localisation economies, which results in a tendency to invest, where other firms from their home countries and/or the same sector of economic activity have already established their presence. The market-seeking motive has also been acknowledged as a very important determinant for FDI locations in post-Soviet states. After the transformation these countries have undergone in 1990s, their markets have been established as an emerging platform for new untapped opportunities (Ledyaeva, 2009). Nowadays the vast majority of FDI inflows attracted by the CIS countries are determined by continuously strong growth of local consumer markets (UNCTAD, 2012).

Efficiency seeking investors aim at reaching more efficient division of labour or specialization of assets (Dunning, 2000). Reduction of entry barriers and transport costs usually enable the efficiency seeking FDIs to grow. This makes them sequential to the first two types of foreign investment motivations. Foreign investors when entering new markets because of the natural resources abundance or new market opportunities strive to organize their business activities at a host location in such a way so that to benefit from the optimization of labour division. Therefore, in this paper we will not focus in detail on this motivation of FDI, treating it as the one related to the first and second types of foreign investment motivations.

Strategic asset seeking investors are motivated by an opportunity to rationalize the structure of the market-seeking investment so that the foreign firm benefits to the most from the from its geographically spread activities (Kudina and Jakubiak, 2008). The main purpose of these investors is to gain from different local-specific factor endowments, culture, institutional environment, specific knowledge and technologies available at the host markets. Firms go abroad when they already have certain unique capability they want to develop further. Therefore, MNCs expand in order to gain access to those capabilities, which are essential for the development of their own capabilities, but are not available at their home markets (Cantwell, 1989). Given the limited technological capabilities and human capital endowment of ENP countries compared to EU countries, strategic asset seeking is not yet expected to be an investment motive of major importance.

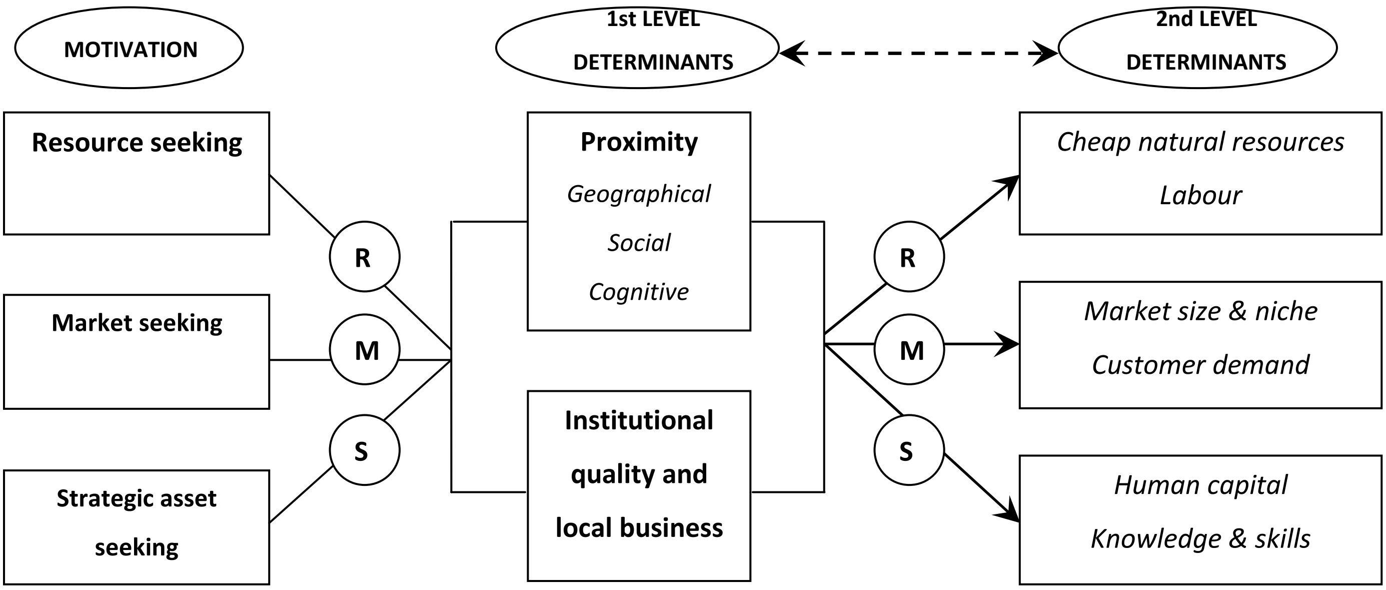
The OLI paradigm stresses out one important aspect any firm considers before its internationalization. This is referred to a transnational company's decision to enter a foreign location based on the maximised economic efficiency, i.e. the trade-off between the costs, involved in setting the production at a different location abroad, and the costs of exporting the products from the home to a hosting country. This reasoning is approved by the gravity approach (Bevan and Estrin, 2004). The gravity theory states that the decision of an MNC to go abroad is determined by the relative market sizes of the home and host countries and their distance from each other. Distance is then viewed as a measure of the transaction costs involved when going abroad. Thus, the costs of adjustment to the local market in terms of language, culture and logistics among many others are supposed to rise when the distance increases. The gravity model introduces an important parameter, such as proximity, as one of the factors that have a strong impact on the firm's decision to invest in a specific market. We will further discuss proximity in detail within our conceptual framework.

III. Conceptual framework

The analysis of the location choices of MNCs in transition economies, specifically in Ukraine, is threefold: analysis of the aim of foreign investors towards the region specific hosting market, identification of the 1st

level determinants and analysis of the 2nd level determinants of the location choice of the foreign investment (Figure 1).

Figure 1. Conceptual framework



Source: provided by author

If MNCs decide to internationalize, they 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. We call these local region-specific factors 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.

3.1 Agglomeration effects and proximity

Economic geographers have for a long time acknowledged that firms in the same industries are drawn to the same location in order to benefit from geographical proximity, which results in positive "agglomeration effects" (Boschma, 2005; Malmberg and Maskell, 2006; Cooke, 2001). Firms' clustering within certain regions causes the formation of pecuniary and technological externalities, which explain the industry localization (Head et al., 1995). The reason for this is that localization of companies provides a pool of workers with common skills range, a certain knowledge base, which enables the firms exchange knowledge and technology, benefiting in such a way from technological spillovers. Therefore, firms tend to choose those locations, where there is a substantial representation of firms from the same industry in order to benefit from the factor endowment.

Agglomeration economies have been widely recognized as one of the major motives for FDI flows (Krugman, 1991; Cantwell and Iammarino, 2000). Positive externalities of agglomeration effects, which are reached by co-location of FDI, are crucial for the productivity of a firm. Agglomeration economies are associated with the localization economies, or industrial clustering, and urbanization economies. Localization economies arise when a range of firms from the same sector co-locate within one locality. A number of empirical studies have proved the positive impact of location- and industry-bound agglomeration benefits on the extent of intensification of FDI inflows towards certain locations (Head et al., 1995; Majocchi and Presutti, 2009). Marshallian agglomeration externalities based on the specialization paradigm support stated above in the following three ways. Firstly, firms tend to co-locate, which causes agglomeration externalities to emerge, because this allows them to develop specialized labour available at a specific location. Secondly, in such a way firms provide a non-tradable input, which is industry-bound, because they develop common technologies and infrastructure, which leads to economies of scale. Thirdly, sharing ideas and exchange of experience result in intensification of cooperation between economic actors. This leads to the enforcement of agglomeration benefits that become a clear determinant for further FDIs to the location (Bunnell and Coe, 2001). The urbanization economies provide the benefits for companies to be located within one urban location. Larger cities with a certain level of developed infrastructure potentially offer more benefits than smaller cities. Among such advantages urbanization economies offer the most prominent are proximity to the market, suppliers and customers, labour pool, knowledge and technologies, transport and communication infrastructure.

Boschma (2005) described such types of proximity as cognitive, social, organizational, geographical and institutional, which all have a strong impact on the decision of companies to co-locate. Thus, he defines cognitive proximity as the closeness to the firms from the common knowledge base in order to make the knowledge transfer easier and less costly. Therefore, we would also assume that FDIs in transition economies will focus on the regions with a wide presence of the firms of the same industry. The notion of social proximity is derived from the initial perspective that economic activities are embedded within certain social contexts. In such a way Boschma (2005) defines social proximity as socially embedded relationships between economic actors at the level of firms. Since, social context impacts the outcomes of such relationships, it becomes an important factor in the decision making of a foreign investor with regard to a certain location. Under organizational proximity Boschma (2005) means the availability of organizational networks, which will facilitate the transactions involving knowledge exchange and decrease the uncertainties. When an MNC decides on the location of its subsidiary, it assesses the importance of this location for the further learning and innovation. For this purpose, which drives the development and growth of any business, the availability of common knowledge, social context, organizational networks, common institutional environment and close geographical distance between the other firms of the industry are all of a tremendous importance. Localized learning introduced by Malmberg and Maskell (2006) also clearly states the value of a spatial proximity to different factors important for firms to learn and in such a way develop their competitive advantages. Transnational companies investing abroad tend to localize their business operations with regard to regional economic specialization. The decision of choosing specific location is based on the pursuit of preventing the exploration of excluded possibilities, when a different location with a different market, institutions and knowledge base can enforce unexpected opportunity costs, which MNCs want to omit within their expansion. In such a case we assume that highly industrialized regions of post-Soviet states will attract those firms that will benefit from already existing infrastructure and intra-sectoral firms' networks of customers and suppliers. With respect to geographical proximity, it refers to physical distance between economic actors (Boschma, 2005). The less this distance is, the better can firms benefit from knowledge externalities. Therefore, we assume that proximity to the EU and thus to the firms from the home country will have a positive impact on the FDI inflows into those regions of post-Soviet states, that are close to the EU border. In this case these regions will benefit from the less socialist industrialization heritage and will attract foreign firms by the opportunities of social fit and easier embeddedness process into the regional economic system.

Thus, foreign firms enter new markets aiming at an absolute benefit of being close to the source of the development of their competitive advantage and costs saving possibilities arising in the process of such growth. Proximity to certain factors important for the firm to grow is an essential requirement to develop the business in the most efficient way. Following the reasoning of proximity to any of the important factors, MNCs come up with opportunities of agglomeration effects, which bring them an advantage of the optimal dispersion of resources, which results in the decreasing of costs in the long run.

Under institutional proximity as a factor, that determines location choices of FDI, we mean institutional quality, which can either attract a foreign investor or not. The quality of institutions is discussed in detail further in the paper.

3.2 Institutional quality and local business culture

Institutions are viewed by firms as one of the elements of the location advantages, introduced within the OLI paradigm. Institutional differences at different locations stand out to be an important factor in the decision making with regard to internationalizing not only to the new countries, but even to the new regions within those countries. Thus, just as institutions at the national level attract the inflows of FDIs to the countries, institutions at the sub-national level attract investment to the regions (Meyer and Nguyen, 2005). Settling within certain regions, firms get embedded into the regional economic systems. The success of their business operations in these regions depends on the factor endowments of the specific region. Institutions are one of the major factors that determine the way a firm will integrate itself into the local economic system. Under institutional quality we mean the degree to which institutions create firm-friendly favourable conditions, which are coherent over time with high predictability of changes aimed at facilitation of doing business within certain geographic areas. Both formal and informal 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. North (1990) states, that institutional environment establishes formal an informal rules of the game, which reduce uncertainty and transaction costs. In such a way impacting the business strategies of local domestic firms, there is a specific institutional mi-lieu created, which plays the role of a filter for foreign firms striving to invest into the new market. Bevan et al. (2004, p. 45) support the ideas stated above with “legal, political and administrative systems tend to be internationally immobile framework whose costs determine international attractiveness of the location”.

When a firm decides whether or not to enter a certain market its main objective is to gain market legitimacy. Establishment and maintenance of legitimacy in the new local-specific environment is very important within the foreign expansion of any MNC. Kostova and Zaheer (1999, p. 64) define organizational legitimacy of an MNC as “the acceptance of the organization by its environment, which is vital for its organizational survival and success”. The authors identify three factors that frame organizational legitimacy: the environment’s institutional parameters, the organization’s characteristics and the process of legitimacy that impacts how the environment views the organization. The organizational legitimacy is analysed in such a way through the processes of overcoming entry barriers by a foreign firm in the hosting economy and by adapting to the existing cultural environment. The entry barriers a market has towards incoming flows of capital and goods are created by institutional environments, which frame the activities of these markets. Therefore, an entry barrier is one of the first elements of an institutional framework the MNC faces when entering the market. Again coming back to the transaction costs theory and internalisation theory, when the costs of overcoming the entry barriers of the new market for a foreign firm outweigh the potential profit the firm can make in this new market within the development of its competitive advantage, the firm will not internationalize to this specific market. MNCs try to identify in which locations the institutional constraints are less repressive (Kang and Jiang, 2012). In such a scenario, institutional elements of a certain economy become the bottleneck of the firm's decision of whether to invest or not in this economy. Cultural adaptation of an MNC in the market although being an important factor in successful embeddedness of a firm within the local economic system, is not a sufficient condition for the organizational legitimacy to take place (Kostova and Zaheer, 1999). The reason to this lies in the fact that organizational legitimacy of a foreign firm is socially constructed, which means that there should be a definite fit between the formal institutional component and the way the foreign firm is integrated within the latter and an informal institutional environment, which makes the organization being ingenuously accepted by the local market. Thus, MNCs in the hosting markets face three pillars of institutional environments, namely the regulatory, the cognitive and the normative (Scott, 1995). When taking decision on entering a new market, a firm assess not only the regulatory pillar of institutions, i.e. local laws and regulations, but also the cognitive pillar of cognitive structures of society and the social pillar of societal values this society embraces (Kostova and Zaheer, 1999). Such a multi-pillar assessment of the hosting institutional environment is an important key in the decision of a firm to invest in a certain market. Within the regulative pillar of institutions it has been empirically proved that stable economic policy, security of property rights, less ownership restriction and bureaucracy have a positive impact on the propensity of foreign firms to invest in these locations. With respect to the cognitive pillar, foreign firms before taking the decision of whether to invest into a certain location or not assess the routines of the domestic firms in the markets, which form a specific local cognitive structure. This is needed to percept the behavioural pattern of the future suppliers and customers the foreign firm will cooperate with. At this point trade relations are being framed by the local institutional environment and the latter influences the whole expansion strategy of an MNC. Within the normative pillar of institutions cultural distance between the foreign firm and the domestic firm in terms of pre-established informal rules and norms, local business culture, gives a hint for the foreign firms on the level of difficulty of embeddedness into the local economic system.

Local business culture in the transition economies becomes very important especially with regard to viewing institutions as the determining factor of the FDI location choice. Under local business culture we mean social code of conduct, behaviors and routines, which define social acceptance of certain formal and informal institutional rules and business practices and are widely acknowledged by the individuals residing within certain localities. The link between formal and informal institutions, of which business culture is a part of, is also determined by the fact, that formal rules, or constraints of the institutional structures, form certain frameworks of opportunities for the business agents, who select between the code conduct, which is either permitted or prohibited. These incentives or stimuli, which establish a certain structure of the society, also facilitate to a certain extent the framework of predictable and non-predictable behavior, or, in other words, an overall framework of the stability or instability of the environment, which in its turn is the prerequisite of the formation of the specific local business culture of every locality. 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 directly depends on the attractiveness of the local rules of game, i.e. local business culture, to this firm.

The legal framework of the transition economies has drastically changed after the collapse of the Soviet Union. The institutional transition of regions in post-Soviet countries hinders rather than supports economic growth since the institutional legacy of the past still prevails in many areas of the economy (Tridico, 2011; Nagy, 2002). Post-Soviet governments did not manage to effectively change their institutional environments and the fit between formal and informal institutions is still lacking. Therefore, Western businesses entering Eastern and Central European markets face higher transaction costs, because they have to adjust to the normative and regulatory pillar of institutional environments with a lower quality than in their home market, to the cognitive pillar of post-Soviet legacy, and post-communist informal mind-set. Nevertheless, MNCs do choose emerging markets of transition states as their primary investment locations, although their region specific locations differ according to their readiness to deal with the path-dependent institutions. According to Bevan et al. (2004), the reason for this is that firms try to find ways to benefit from certain peculiarities of institutions in post-socialist states in two ways. Firstly, the change of ownership in the post-Soviet states enabled privatization of many formerly state-owned firms. This leads to the development of a private sector and firms tend to be attracted by private firms to do business with these new players due to their higher profitability, urge for new business opportunities, and market friendly corporate cultures. Moreover, privatization allows for acquisitions of formerly state-owned firms or monopolies by MNCs, which became one of the major modes of entry for foreign firms. Secondly, institutional transition implies the establishment of a new financial infrastructure, which at its infancy stage offers low costs for its financial services. This becomes an important attractive factor for foreign firms to enter a certain new market and make use of complementary local finance. In addition, foreign banks and other financial services providers were attracted to these new markets.

3.3 Resources, markets, and strategic assets

International investment flows are determined by “push” and “pull” factors of a certain locality. Thus, “push” factors are those determinants that influence the outflow of the capital from the home region, whereas “pull” factors are the ones that attract foreign capital into the host region. In this paper we will specifically focus on the “pull” factors that have an impact on the decisions of foreign companies to invest in the host region. According to Dunning (1988) FDI is attracted by regions, where it is possible to combine the ownership advantages with the location specific advantages of the host regions by internalization. Foreign companies entering Eastern and Central European states search for inputs they could integrate into their global operations (Majocchi and Strange, 2007). Kudina and Jakubiak (2008) carried out a survey of 120 foreign-owned companies in Moldova, Georgia, Kyrgyzstan and Ukraine and identified that 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.

Resource-seeking investments

Kang and Jiang (2012) state, that getting control over natural resources is one of the major motivations of FDI activities. Among the resources the host location can offer the most important are supposed to be the natural resources of a country or a region, per capita income, labour market conditions, infrastructure (Barrel and Pain, 1996). The natural resources or raw materials play an important role for the delivery and processing operations of firms. Proximity to the suppliers of specific raw materials is also a prominent issue in choosing locations for foreign investments. Labour market conditions include the cost of labour, the degree of unionization, the unemployment rates and the availability of skilled or unskilled labour depending on the purpose of investment. Labour costs are tremendously important with regard to export operations of manufacturing activities, because as long as low labour costs do not lead to low productivity they will always represent an advantageous condition of any location. Bevan and Estrin (2004) empirically proved that labour costs are negatively associated with FDI. Infrastructure is also seen as an important determinant for the location choice of MNCs. Transportation, communication networks, logistics connections and industrial infrastructure have proved to play an important role in attracting foreign investors (Bevan and Estrin, 2004). Particularly for manufacturing firms the availability of such facilities as water utilities, electricity, fuel and waste management is important in order to set up production at a certain location.

Market-seeking investments

Resmini (2000) suggests that the majority of FDI towards Eastern and Central European countries is determined by the aim of serving the local market. Foreign firms, while co-locating within certain markets, strive to capitalize on the effect of market enlargement and the effect of competition setting. The market enlargement effect refers to the satisfaction of the local demand and the establishment of a new customer base as the primary aim of foreign firms. The competition setting effect is related to the fact that MNCs are trying to outrun their competitors in taking the lead of untapped niches with their products in the new markets. At this point such market specific aspects as income level, size of population, market facilities, consumer characteristics and future growth potential is taken into account by foreign investors when entering new markets. Bevan and Estrin (2004) empirically proved the positive relationship between market size and FDI inflows. Within the realm of emerging markets, import-export regulations stand out to be of major concern for foreign investors. International business theory states the more globally oriented the host country is, the more open it should be for foreign investors. This means that the trade barriers should be reduced to a minimum. This is obviously related to the discussion above on institutional quality.

IV. Analytical framework for further research

The further assessment of the location choices of MNCs in the transition economy will be based on the case of Ukraine, where an enterprise survey of 153 foreign-owned was carried out. The survey focused, among other issues, on location choices and location patterns of FDIs in Ukraine. The firms were asked to rate the importance of different factors, which played a role in their investment decision; to choose the initial aims of investment with respect to serving the local market or just using the market as the resource base for manufacturing facilities with further re-import by the mother company; to contemplate about the strategic orientation of the subsidiary in the local market. Moreover, the survey covered questions on business culture and institutional environment. The results allow to link the institutional quality at a certain location to the location choice of MNCs in this region.

In order to answer the research questions introduced at the beginning of the paper, the following three hypotheses are formulated:

> ***H1.*** *MNCs investing in the Capital region of Ukraine are motivated by market-seeking and aim at serving the local market, whilst the decision of foreign firms to invest in the Eastern and Western regions of Ukraine is determined by resource-seeking, which leads to these regions becoming the resource base for export-oriented manufacturing of foreign investors.*

The Western region on Ukraine leads in terms agricultural production and is rich in land resources, whereas the Eastern region still has a strong legacy of socialist industrialization and therefore, possesses a certain physical infrastructure with all the resources needed for such an infrastructure to work. The capital region in Ukraine is the region with the highest purchasing power and concentrated pool of suppliers and customers within a range of market niches. Therefore, we assume that the market will be the main incentive for foreign forms to invest in the Capital region, whilst the existing resources will attract foreign investors to invest in the Western and Eastern regions.

Having assumed that FDIs to the Capital region are driven by the interest of foreign investors in the market and in the bordering regions these are the resources which play an important role, we further hypothesise those FDIs driven by the market potential will focus on serving the needs of the local market in order to benefit from it. On the other hand, those investments attracted by abundance of resources will presumably aim at using the current location as a resource base for manufacturing purposes and the outputs of the production cycle will be exported.

H2a. *Proximity to the EU and the weaker socialist industrialization heritage of the Western region attract FDI to this region, whereas availability of good infrastructure and proximity to other firms from the same sectors (as the remains of the socialist industrialization) are the dominant factors for MNCs to invest in the Eastern region.*

The Western region of Ukraine is the EU-bordering region and the Eastern region of Ukraine borders Russia. Historically, the Eastern region has been under the influence of communist regime much longer than the Western region. Therefore, we assume that the legacy of communist past is weaker in the West and stronger in the East. Thus, we presume that proximity advantages to the EU border combined with a perspective of easier embeddedness into the less post-communist social context will attract FDI inflows to the Western region of Ukraine. Historically determined strong legacy of socialist industrialization in the Eastern part of the country results in such an important advantage as still existing good infrastructure with a pool of suppliers and customers related to this infrastructure. Therefore, we hypothesise that proximity to other firms from the same sectors as well as availability of the physical infrastructure will to a larger extent influence the location of MNCS in the East of Ukraine.

H2b. *MNCs in the Western region strategically focus on setting new brands and products mostly due to the higher openness of the region as a result of the weaker socialist industrialization heritage, whereas those foreign firms investing in the Eastern region strategically focus on short-term opportunities in established markets due to the difficulty of embedding themselves into the strong legacy of post-Soviet economic system.*

According to stated in the previous hypotheses with regard to the socialist industrialization heritage we assume that the Western part of Ukraine is more open in a cognitive sense to new ideas and innovation, since the roots of Soviet regime are not so strong in the West as they are in the East. Thus, the absorptive capacity of the firms in the EU-bordering region will be higher in comparison to the locked in the post-Soviet regime East, where the social context is much more framed by the remains of the communist past. A difficulty to change the post-socialist mind-set will lead to foreign investors focusing on rather short-terms in the established markets.

H3. *The higher the institutional quality of the region, the more attractive this region is towards incoming FDIs. Therefore, the superior institutional quality of the Capital region has a positive impact on the propensity of foreign firms to invest into the region, resulting in institutions playing an important determining role in the investment decisions of foreign firms in Kyiv region.*

Considering high regional differences with respect to institutional quality in Ukraine, we assume that the Capital region benefits from access to better government support, which presumably leads to better institutional quality in the region. Since we have established in our previous discussion that institutional quality of a location is an important factor in determining location choices of MNCs, we assume that in the region with high institutional quality it plays an important role in attracting MNCs.

V. Summary

The literature review of location choices of MNCs in transition economies shows that a firm decides to internationalize if this will enforce the growth and development of the competitive advantage of the latter in the long run. A range of traditional economic factors impact the firm's decision on a specific location for its investment, such as availability of resources, market demand, strategic assets, possibility to efficiently optimize the division of labor. Which factors do impact the location choice decision depends on the motivation of internationalisation, namely market seeking, resource seeking, efficiency seeking or strategic asset seeking. Moreover, it is highly acknowledged that agglomeration economies and proximity definitely impact the decision of a firm locate within a specific environment, so that to get easily embedded into the latter.

Except for the traditional economic factors impacting the firm's decision to go abroad targeting a certain location, institutional quality and the local business culture play a very important role, especially in the transition economies. Both formal and informal 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. Thus, the literature review enables to hypothesise on the location choices of MNC in transition economies, taking the case of Ukraine where an enterprise survey of 153 foreign-owned was carried out. The results of the survey focusing on the determinants of the location choices of foreign firms coming to Ukraine will be used in order to test empirically the hypotheses set with respect to the literature review.

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