



POLICY NOTE OF THE WORKING PAPER 2/14

Location choices of multinational companies in Ukraine

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OBJECTIVE OF RESEARCH

The research introduced in this working paper explains the location choices of multinational companies (MNCs) in a transition economy by traditional economic factors and institutional quality. Based on a thorough theoretical framework and a set of hypotheses, empirical data of an enterprise survey of 153 foreign firms in three regions of Ukraine in the year 2012 is analyzed. The data contains information on location choice of MNCs, assessment of institutional quality, and embeddedness within the regional economy. The paper contributes to the literature on MNCs and location choices by introducing an analysis of a set of foreign direct investment (FDI) location choice determinants at the regional level within a transition economy perspective, which has not gained sufficient attention in existing research. The aim of the research is to identify determinants of location choices of FDI in transition economies, based on empirical evidence of an enterprise survey, carried out in three regions in Ukraine, and to introduce thorough policy implications targeted at increasing attractiveness of transition states towards FDI.

SCIENTIFIC METHODS

The empirical data of the enterprise survey is represented by a set of a standardized questionnaire data with closed likert scale questions. The questionnaire consisted of 6 thematic blocks. One separate block was devoted to the location choices and location patterns of FDIs, asking the survey firms to rate on the scale from unimportant to very important such factors, as lower costs, market demand, human capital and knowledge, infrastructure, preferential policies and subsidies, proximity to customers and suppliers, proximity to other foreign firms from the same country and sector as well as to the EU border. The firms were also asked to

indicate their initial aim of investment, i.e. whether they aimed at re-importing the produced goods from Ukraine to their home countries, using in such a way the Ukrainian market solely as a resource base, or the initial goal of investment was selling the products in the Ukrainian market only in such a way serving the latter. The survey also focused on the investigation of institutional environment, covering among others the questions of the assessment of the quality from very good to very bad of such aspects of an institutional framework at the current location as enforceability of legislation and regulation policies, physical and intellectual property rights protection, reliability of oral contracts and agreements as well as central and regional government support.

Descriptive analysis of the distribution of firms assessing the determinant factors of their location choice decision as very important, important and unimportant factors was carried out. Crosstabs descriptive analysis covered the assessments of the factors playing a role in the investor's location choice decision with regard to the differences between three regions, namely differences between the capital region Kyiv, the Western close to the EU border region Lviv and the Eastern far from the EU border region Kharkiv. The multinomial logit regression model with the regional dummy as an dependent variable estimating the probability of a foreign firm to enter Kyiv region, Lviv region or Kharkiv region was also introduced. After multicollinearity check the following variables as control dummies were chosen: ownership type, the home country of the investor, sector, location choice determinant factors, initial aim of the investment and institutional quality composite indicator.

POLICY VALUE-ADDED

The results of the research led to certain policy implications. The objective of these policy implications is to increase the attractiveness of European Neighbourhood Policy (ENP) states as the host economies for the future FDI inflows, since the latter play a determining role in economic growth of transition states. Policy implications are evidence-based and refer to the following results. Market seeking investors will most probably invest in the capital region Kyiv, rather than in the bordering regions Lviv and Kharkiv. Large market potential, better access to resources and higher institutional quality of the capital will attract greenfield investors. Close to the EU border Lviv region except for having an absolute advantage of being proximate to the EU border, pulls in investors due to its human capital concentration. These findings go in line with an assumption of the less post-Soviet legitimacy of the Western region Lviv, whereas in close to the CIS border region Kharkiv the old industrial infrastructure as the remains of the planned economy is still present. This leads to the attraction of the foreign investments originating from CIS to serve the local market with pre-established customer-supplier networks. Overall better institutional quality of the capital results in the attraction to the latter of FDI firms assessing institutional environment at the current location as of good quality. This supports the argumentation of the importance of the institutional environment as a pull factor for FDI inflows, but also indicates an uneven government support of regional economic systems, leading to a disproportional regional development.

Important regional- and national-level policy implications applicable to Ukraine as one of the ENP states, based on the above stated empirical results, are the following. Firstly, there is a need of development of strategic region specific assets as the location advantages of the target regions by regional governments. Such strategic assets are human capital, concentrated knowledge pools, highly skilled labour and technology oriented infrastructures. This could potentially lead to the attraction of more strategic asset seeking investors, which would increase the competitiveness of certain regions, on the one hand, and provide an alternative to the market seeking motivation of the majority of MNCs, since the potential of the market is a limited asset by itself. Secondly, there is a need to encourage investing firms to serve the local market rather than use the regional economic systems as solemnly resource bases. This could be possibly achieved by the targeted development of local infrastructures, especially in Lviv region, where the tendency of incoming investors is to re-import manufactured goods abroad. By the targeted development of local infrastructures we mean the support of local SMEs in building customer-supplier networks and clusters of sector-specific firms by the national and regional governments as well as public institutional centres. Thirdly, there is a need to introduce equal national and regional government support in terms of overall regional institutional quality and preferential government treatment to both the capital and bordering regions. This will lead to introduction of FDI friendly local institutional frameworks, which will positively affect FDI inflows, since institutional quality does have an important impact on the inward foreign investments. This could be achieved by the means of region specific FDI incentives, such as creation of business incubators and stimulation of inter-firm cooperation between domestic and foreign firms, introduced by both local government officials as well as regional entrepreneurship communities.