The Role of Location Advantages of the Republic of Moldova for Transnational Corporations and FDI towards European Integration

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Abstract

The article provides an overview of the key insights resulting from international business research on the interactions between location advantages and the competitiveness of transnational corporations and FDI. It describes the relative contribution of home country specific advantages and host country specific advantages to transnational corporations' competitiveness; it concludes that host country specific advantages, and in this case particularly Republic of Moldova's country specific advantages, may become increasingly important to integrate into European Union, to achieve global competitiveness and to attract FDI.

Keywords: business, competitiveness, transnational corporations, European Union

Nowadays world economy is passing through deep and controversial changes: market globalization, multidimensional development of competition, transformation of economic processes, traditional principles are obsolete, there is a need to reorient and restructure the national economies in order to succeed. Transnational corporations through foreign direct investments can help and support developing economies to pass this period faster and successfully.

Stephen Hymer (in 1960) was the first author to focus on foreign direct investment as a tool used by transnational corporations (TNCs) to transfer and exploit abroad proprietary resources. His view was that they would face location disadvantages vis-à-vis indigenous firms in host countries such as language and cultural barriers, lack of knowledge on the local socio-economic and business system, expropriation risks, which have been synthesized under the heading of "liability of foreignness". This implies that TNCs producing in host countries would not benefit to the same extent as indigenous firms from localized network spillover effects or synergies from the combination of firm level and host country location advantages. [1]

At the beginning of XXI-st century, John H. Dunning's eclectic paradigm, also known as OLI Model, has become the leading conceptual framework for the analysis of international expansion patterns of business firms. The idea behind the Eclectic Paradigm is to merge several isolated theories of international economics in one approach.

Three basic forms of international activities of companies can be distinguished as: Export, FDI and Licensing. The so-called OLI-factors are three categories of

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advantages that Dunning added to the Internationalization Theory (the theory says that transactions are made within an institution if the transaction costs on the free market are higher than the internal costs. This process is called internalization.), namely the ownership advantages, location advantages and internalization advantages.

- Ownership advantages (trademark, production technique, entrepreneurial skills, and returns to scale) refer to the competitive advantages of the enterprises seeking to engage in Foreign Direct Investments (FDI). The greater the competitive advantages of the investing firms, the more they are likely to engage in their foreign production.
- Location advantages (existence of raw materials, low wages, and special taxes or tariffs) refer to the alternative countries or regions, for undertaking the value adding activities of TNCs. The more the immobile, natural or created resources, which firms need to use jointly with their own competitive advantages, favor a presence in a foreign location, the more firms will choose to exploit their Ownership specific advantages by engaging in FDI.
- Internalization advantages (advantages by own production rather than producing through a partnership arrangement such as licensing or a joint venture) refer when Firms may organize the creation and exploitation of their core competencies. The greater the net benefits of internalizing cross-border intermediate product markets, the more likely a firm will prefer to engage in foreign production itself rather than license the right to do so.[1, p.157]

One of the problems with Dunning's eclectic paradigm is that it is too eclectic. Indeed, in many ways, each of the three motives for FDI is overdetermined. This is especially true for Ownership advantages. According to Dunning, these include not only the firm's intangible assets, such as knowledge, brands, organizational structure, and management skills, but also natural factor endowments; manpower; capital; the cultural, legal and institutional environment; and industry market structure. Obviously the latter set of Ownership advantages is easier to analyze as country factors. However, Dunning argues that such country factors can somehow be turned into Ownership advantages. Going one step further, Dunning (in 1993) argued that Ownership advantages could explain the ability of TNCs to form alliances. TNCs do this by taking advantage of common governance structures across borders, such that relational assets are created which allow firms to access resources controlled by partners. This is a form of business networks or alliance capitalism, driven by a very broad interpretation of Ownership advantages.

In a similar manner, Dunning has a very broad definition of location advantages. Here it is host country Location advantages that matter, including market size, natural resources, aspects of the infrastructure, the education system, governance structures, and other aspects of political and government activity. Given that firms can lobby governments to obtain shelter type Ownership advantages, the distinction between Location and Ownership advantages is difficult to make. For example, when a TNC is given access to natural resources (ownership of an oil well, a forest, or a mine), a host country Location advantage is transformed into an Ownership advantage.

Finally, Internationalization advantages are clearly strongly linked to Ownership advantages. Indeed, without the institutional form of the TNC it is difficult to see how Ownership advantages could exist on their own without being owned

(internalized) by the firm. In their essence, intangible knowledge assets are an example of the firm replacing the market [4]. Dunning seems to argue that the Internationalization advantage only relates to transaction costs, such that an Ownership advantage is needed to explain organizational, financial, and institutional advantages. This distinction between transactional ownership advantages and asset ownership advantages was introduced by Dunning and Rugman (in 1985).

An important contribution of this theory is that the specific location characteristics which contribute to competitive advantage vary for different countries, sectors and firms (Dunning, 1992). It is interesting to observe that, at the firm level, the location advantages appear to include several elements such as the firm's experience with foreign involvement, psychic distance variables and attitudes to risk diversification. Another contribution of Dunning's paradigm (1998) is that it allows identification of the key location advantages of four different types of international production, such as:

1. natural resources seeking,
2. market seeking,
3. efficiency seeking, and
4. strategic asset seeking.

One of the great strengths of the model is that it highlights the complexity of determining the practical implications for managers and public policy makers of specific location advantages.[1]

Analyzing these four types of international production, we can see that natural resource seeking FDI occurs when firms identify specific host country locations as an attractive source of natural resources at the lowest real cost. However, even in this case, additional location advantages such as good transport infrastructure, an effective institutional and legal framework has been identified as needed too. In this case, FDI is usually associated with the exports of resource based products from the host country. However, in return, this may improve the location advantages of the home country both for the production and exports of goods which use the imported resources as a low cost or high quality input. As intra-firm trade replaces inter-firm trade, an unfavorable taxation regime in a specific country- whether the home or host nation – can be overcome as a location disadvantage by shifting profit, but not the production itself from the nation with the unfavorable regime. FDI should therefore not be viewed only as an outcome of existing location advantages but it may be helpful to the creation of new location advantages.

So, we can see that the identification of location advantages becomes much more complex during the involvement of international production, however, the home country will export capital intensive goods with high technology content and the host country will mainly export resource or labour intensive products with a low knowledge content.

The second type of international production, market seeking FDI, has an effect of immediate import substitution and often leads to trade creation [Rugman 1990]. This can occur when the newly established subsidiary uses intermediate outputs from the home country in its own production process and it becomes a mechanism for additional exports in other product areas for the home country, and the final product can also serve for the export to third country markets.

Efficiency seeking FDI, as the third type of FDI, leads to even higher complexity as regards the location advantages of the countries involved. This type of FDI is usually trade creating at the firm level, because it reflects a rationalization of the TNC's operations and a specialization of the subsidiaries in its internal network. This increases the intra-firm knowledge and goods flows, and the international exposure of the subsidiaries. It is important to understand the importance of location advantages to the firm, because the Firm specific advantages (FSA) and location advantages meet at the subsidiary level, and it influences the specific role given or earned by the subsidiary in the firm [Rugman 1990]. The subsidiaries may act as "globally rationalized", performing a particular set of activities in the vertical chain or they can have a regional product empowerment. In the case of a vertically integrated chain, intra-firm trade is likely to increase, building upon the location advantages benefiting each subsidiary, thereby leading to an increase of both intermediate goods trade and international production [Cantwell 1994].

Regarding the forth main type, strategic asset seeking FDI [Weson 1993], we observe that the assets of foreign firms are secured by new plants and acquisitions or joint-ventures, to create synergies with the existing pool of assets through common ownership. A good example is the R&D performed in host countries rather than the home country which constitutes the key location advantage which leads to FDI. Due to the fact that the acquired assets sourced from the host country are linked to a localized innovation system and the TNC as a whole may get access to at least some spillovers from that innovation system, so backwards, the localized innovation system may benefit from being associated with the foreign TNC.

In addition to the four main motives for FDI, there are some motives that appear related to location factors, such as escape investments (made to avoid home country restrictions), which obviously reflect the absence of government restrictions in the host country; and trade supporting investments with the goal to facilitate home country imports or exports through building on host country location advantages (for example, to help in purchasing of inputs, logistics activities, after sales service, etc). So, as a conclusion, we may observe that it is precisely the nature of a company's specific advantages and the type of country specific advantages it faces, that will determine whether a particular production activity will be located in a foreign country through FDI and internationalization will occur.

The reasons why individual firms engage in international activities are the centre concern. And the key seems to be market imperfections, which prompt companies to internalize cross border activities. In many respects, this is not very different from what firms do inside national borders. [Dunning and Narula (1996b: pp.7-9)] As such, internationalization can be seen as just another dimension of the growth of the firm (Buckley, 1993b). Nonetheless, this is a dimension unlike the others. On the one hand, countries differ in their legal, political and cultural characteristics, which generates a whole set of managerial problems. On the other hand, transnationality changes the very nature of the firm, and can be in itself a source of competitive (ownership) advantages. As any disadvantage faced by any firm, those associated with doing business in a foreign country are neither permanent nor universal. Internationalization is a learning process. It can be managed through a process of progressive commitment of resources,

starting in more familiar countries and moving to ever more distant ones. If the internalization of ownership advantages explains why TNCs exist at all (Dunning, 1991), only this dynamic approach to internationalization can describe the process of the development of a transnational corporation.

However, in order to understand the way international production is organized worldwide a last critical element is needed. And that is the importance of locational factors. Only the interaction between the internalization of ownership advantages with location advantages can explain the configuration of TNCs' activity worldwide. This seems to be a description of the eclectic paradigm (Dunning, 1979), except that it cannot be dissociated from the dynamic elements of the investment development trend. A TNC engages in foreign direct investment (FDI) as it realizes some types of advantages from investing in foreign countries. Ownership of specific advantages drives national firms' involvement in international expansion. Firms with specific advantages also find it in their interest to locate their production overseas where the host country has certain location-specific advantages, and to internalize the value-adding activities of international production where (structural and/or transactional) market imperfection exists (Kindleberger, 1969; McManus, 1972; Buckley and Casson, 1976; Hymer, 1976; Dunning, 1981; Rugman, 1981).[1]

The Republic of Moldova has an untapped FDI potential, which ranges from agriculture and agri-business, through ITC and other services, to a number of manufacturing industries. Most of these industries are strongly export-oriented, with exports growing in most cases rapidly during the past decade and testifying to Moldova's international competitiveness in a range of products. Export-orientation does not put limits on the market size as long as competitiveness continues. The Republic of Moldova has for many years to come a unique advantage, not shared by many countries: a secured access to two large regional markets, those of the EU and CIS countries. Its key asset for export-oriented production includes competitive semi-skilled and skilled human resources. FDI potential extends to infrastructure services such as energy generation and distribution and, notably, to renewable energy. It also includes future infrastructure projects, where foreign investors can be attracted to public-private partnerships. Yet the existing FDI potential does not necessarily equal investment opportunities for foreign investors. In some cases these opportunities are pretty straightforward, such as in manufacturing industries, while in others, such as in agriculture and agribusiness, they are not. If the Republic of Moldova wants to attract more FDI, it has to transform the potential into opportunity and to exploit opportunities where they already exist. This will require concerted actions on many fronts. At the same time, the Republic of Moldova should start building potential for better, higher value added FDI, and, for that matter, for better domestic production in the future. So far, with few exceptions such as IT services, the country has relied in export-oriented production on attracting FDI into rather simple operations, benefitting from semi-skilled or unskilled human resources. Such production is characterized by low value added and products competing on price rather than on quality. The Republic of Moldova has a comparative advantage in such operations, which will hold for some time, and therefore should exploit its potential to the full, as it at present has hardly any other potential. But such operations are footloose; they stay in a country as long as its

human resources are cheap and move to other countries when they become too expensive. Therefore, they are not sustainable in the long term and they have to be gradually replaced with higher grade operations, for which the country should prepare ground. In other words, the Republic of Moldova has to move up the value chain of industries and activities, existing and new ones.[3]

So, to see how the Republic of Moldova can integrate into the internationalization process we should remark what are the main country's location advantages [5]:

- Favorable geographical position at the crossroads of commercial routes;
- Proximity to large world markets (European Union and Commonwealth of Independent States);
- Platform for manufacturing and exporting both to CIS and to the EU;
- Competitive general corporate income tax (CIT) rate in the region – 12%;
- Tax and customs framework close to the EU one;
- Considerable network of operational Double Tax Treaties and Investment Protection Agreements;
- Market access trough 42 Free Trade Agreements including:
  WTO members (worldwide)
  DCFTA
  CEFTA members (most Balkan countries)
  CIS members
- Entrepreneurial activities under preferential terms and conditions developed in free economic zones (FEZ)
- Well skilled / multilingual workforce
- Relatively low employment costs
- Improved legal framework regulating entrepreneurial activity
- Starting a business – fast and easy to handle
- Investment opportunities through privatization of public property and public-private partnership.

As a general rule, countries that offer TNCs what they seek stand a greater chance to attract FDI, or more FDI. While investing abroad, TNCs seek access to natural resources and national and international large and dynamic markets. They also seek cost reductions from production abroad, enabled by access to competitive inputs in host countries, notably, but not only, to unskilled and skilled labour. And finally they seek national enterprises, they can acquire, fitting into their strategies. As a result, natural resources, markets, competitive production inputs and strategic assets are key four economic attractions of host countries seeking to attract FDI. What are key Moldova's attributes in light of these attractions? The Republic of Moldova hardly has any natural resources, apart from fertile land and good climate, suitable for competitive agriculture. Its domestic market is small, but Moldova is centrally located, between two large regional markets, to which it has relatively free access. Access to two large markets determines FDI potential in export-oriented manufacturing, tradable services and agriculture. This potential is enhanced by the availability of cheap, semi—skilled and in some activities skilled, trainable work force and investment opportunities in Free Economic Zones, where incentives and utilities are offered to exporting manufacturing

investors and in Industrial Parks, which offer infrastructure. Small domestic market does not rule out the possibility of attracting investors into small scale manufacturing and services catering to domestic market. The lack of natural resources can be seen as an opportunity: Moldova can import raw materials from where they are cheapest and process them for exports or domestic market (where scale would be sufficient), or both.[3]

The German Economic Team Moldova (GET Moldova), during its analysis of FDI attraction to Moldova, advises the Moldovan government and other Moldovan state authorities such as the National Bank on a wide range of economic policy issues in order to improve country's location advantages. Competition for foreign direct investment (FDI) is tough as many potential investment locations try to attract scarce and increasingly footloose foreign capital. The data on Moldova's FDI inflows and stock suggest that the country has only been partly successful in attracting foreign investors. The level of foreign capital invested per capita lags behind other peer economies and the structure of FDI is biased towards services. Manufacturing industries – which are usually more capital intensive and require thus a higher commitment from investors – are yet underrepresented and agriculture almost completely failed to attract FDI. In the opinion of the investors, business associations and other stakeholders, there are a number of issues that inflate the cost and/or increase the risk of investing in Moldova. Thus, removing such problems is the key for increasing FDI to Moldova. The German Economic Team Moldova emphasized several recommendations in order to help Moldova to improve its country location advantages.

Firstly, there is a need to improve legislation. One of such issues is the ban of land purchasing for foreign investors. While there are many workarounds for insiders and established investors, this ban is deterring new potential investors and increases the cost, and the risk, of doing business for existing ones. Indeed, given the many ways of circumventing the ban, aligning legislation with reality would be quick win and low cost recommendation for improving the FDI climate. More complex, nevertheless important, is the issue of labour laws. Despite high headline spending on education investors have difficulties to find and retain skilled workers. A major problem is a lack of options to tie workers to the company and, thus, provide the incentives for employers to invest in training and education. Consequently, know-how transfer, a crucial aspect of FDI, is severely inhibited. Furthermore, curricula and methods of further education are partly outdated. Secondly, the problematic relationship between government and business is a major barrier for FDI. The risk of investing in Moldova is particularly high due to the frequent arbitrary implementation of legislation by state bodies. Furthermore, often and sudden changes in legislation, which are not consulted with stakeholders, increase the cost and risk of running a business. Thirdly, the current "personalized approach" of attracting investments, where high level policy makers would champion investors, is not without problems. While policy makers have a role to play in facilitating FDI, an "institutional approach" centred on a well-resourced MIEPO would reduce the risk for potential investors. [2]

Most of the German Economic Team Moldova recommendations could be implemented in the short term and at a very low cost. This means that Moldova could in

fact significantly improve its investment climate soon and inexpensively, thus inducing higher FDI inflows.

At the current moment, the Republic of Moldova has a chance to take all the advantages from signing the DCFTA and benefit of its location advantages. Neighboring with the European Union, the main source of foreign direct investments in Moldova offers advantages that should be used correctly and for that, the following should be taken as recommendations:

- To enhance European course;
- Continue to promote the regulation reform;
- To create a clear concept referring to the role of TNCs and FDI for the Republic of Moldova's economy;
- To elaborate strategies and policies for attracting TNCs according to country's location advantages;
- To define and approve the economic spheres which require investments, meanwhile not to reject investments in other sectors;
- To invest in infrastructure and find a permanent source for investments in this field;
- To evaluate occasionally the policies for attracting FDI and TNCs in our country for optimizing the benefits;
- To assure that Moldova's performances in improving the investment climate are observed by investors from the entire world.

There are diverging views about the attractiveness of Moldova as an investment destination. On the one hand, existing foreign investors seem to consider Moldova as a satisfactory investment destination. While there is ample room for improvement of the business climate, those businesses largely maintain their presence and, in some cases, even expand their ventures. Moldova continues to take steps toward developing a stronger economy, reforming a cumbersome regulatory framework, combating corruption and adopting reforms aimed at improving the business climate. Poor physical infrastructure, cumbersome licensing procedures, excessive permit requirements, and proliferation of fee-for-services to public authorities and commercial organizations all contribute to a business environment that remains among the most challenging in the region.

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