



PRESS RELEASE OF THE WORKING PAPER 5.19

**The role of local institutional environment for the development of
multinationals and SMEs in Ukraine: transition economies perspective**

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OBJECTIVE

The objective of the working paper is to identify the interrelatedness between formal and informal institutions as a prerequisite of the quality of local institutional environment, which impacts the development of MNEs as well as small and SMEs within a certain economic system, based on the empirical evidence from the enterprise survey carried out in Ukraine as one of the transition economies of the European Neighborhood Policy states. The goal of the analysis of the co-dependence between a formal institutional framework and local business culture is to provide ENP countries, which are still transition economies, with a theoretical and empirical perspective on the possible ways to grow economic potential through provision of high quality institutional environments, based on the important pre-requirement – fit between formal and informal institutions. This press release will give an overview of the most important conclusions and results of the working paper 5/12 of the SEARCH project.

MAIN RESULTS

The working paper summarizes the main theoretical perspectives concerning the interdependence of institutions and local business culture. Formal and informal institutions are equally important for the collaboration between the actors of economic systems. The working paper introduces the discussion concerning the definition of institutions and business culture before analyzing the models of interrelatedness between formal and informal institutions in different capitalism formations, namely cooperative capitalism, collective capitalism, competitive capitalism and proprietary capitalism.

Thus, Ukraine as one of the European Neighborhood Policy states, a transition economy on the way of catching up, is ascribed to cooperative and collective capitalisms, where pre-established informal institutions impact significantly the efficiency of formal ones. Transition of economic systems of an emerging state requires an availability of fit between new formal rules and old informal code of conduct. Ensuring of such a fit between formal and informal institutions proves that in cooperative and collective capitalisms firms operate within the "bottom-up" model, namely on the basis of non-market socially shared norms and behaviors, which force formal laws and regulations adjust to the latter.

The working paper presents a multiscalar approach towards analysis of the interdependence between institutions and local business culture, aiming at getting a more profound insight into the links between various levels of institutions and institutional governance and the local business culture rooted within the very core of the socio-economic system. It is observed that institutions, subsidiaries of MNEs in a host economy and domestic SMEs are all affected by the local business culture at the sub-national level, namely the level of regions and localities, which makes it the most influential for the overall embeddedness of firms within regional economic systems.

The working paper introduces an analytical framework for the empirical investigation of the primary data of the enterprise survey, carried out in Ukraine. The analysis is based on three main hypotheses and is aimed at firstly, analysis of the region-specific institutional quality and the determinants impacting the latter; secondly, investigation of the relationship between formal and informal institutions as an important pre-requirement of regional economic development in transition economies; and thirdly, analysis of the role local institutional environment plays in the embeddedness of the subsidiaries of MNEs in the host market and domestic SMEs within the regional economic system.

Thus, with the help of the descriptive crosstabs analysis and the binary logit regression model there is a difference identified between the Capital and the bordering regions of Ukraine in their assessment of the quality of institutions, with the Capital region leading in its positive assessment of the latter and bordering regions stating bad quality of institutional environment. Moreover, the Capital region leads in terms of the positive assessment of the informal aspects institutional environment, namely the reliability of oral contracts and agreements, which states close interrelation between formal and informal components of an institutional framework. Thus, the high quality of formal rules and regulations leads to the good quality of informal code of conduct, which is an important complimentary element to

the overall quality of institutional environment. Local business culture influencing organizational behavior in a transition economy becomes an important pre-requisite of a successful integration of formal constitutions into regional economic system. The differences between periphery regions, bordering radically different economies, namely the EU states in the case of the Western region of Ukraine and Russia in the case of the Eastern region, are not significant in assessing the quality of local institutions.

MNEs tend to assess institutional quality better than domestic SMEs. This leads to a possible conclusion that foreign subsidiaries might create their own institutional environments through the means of deinstitutionalization, rather than opposing institutional rules of the host economy, being used to the standards of their home countries. Preferential treatment of the government towards FDI also plays an important role in determining the reasons why MNEs assess institutional environment in the host location better than domestic SMEs. Thus, MNEs being attracted by local governments win in terms of better institutional endowments in comparison to domestic SMEs. This could negatively affect SMEs development in the host countries.

As an important policy implication, we could define the need to encourage government support of bordering regions in order to avoid uneven regional development of a transition state. Special attention should be paid to the enforceability of legislation in both Kharkiv and Lviv region and intellectual property rights protection in the West. Central government support should also be directed not only to the capital, but also to the bordering regions in order to firstly, boost interregional cooperation of firms located in different regions and secondly, in order to foster economic growth in different parts of the country with regard to regional location-specific competitive advantage opportunities. Government support of domestic new private SMEs should also be of a strategic importance in order to encourage entrepreneurship development as an important pre-requirement of institutional quality overall, since SMEs can better grow within business friendly institutional frameworks. Domestic new private firms need the most support from the regional governments. Therefore, the latter should focus on introduction of region-specific incentives for domestic SMEs growth. These can be creation of regional special free zones, tax free areas, and business incubators. The above policy inferences apply most directly to the national and regional governments of Ukraine, as well as policy makers and public officials. The policy implications will have their greatest impact on the new domestic private SMEs as

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the main generators of the development and growth of entrepreneurship with the regional economic systems.