



POLICY NOTE 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 OF RESEARCH

This working paper addresses the issues of the interdependence of institutions, both formal and informal, as an important prerequisite of a high quality institutional environment, which plays a determining role in the economic growth of domestic SMEs and multinationals hosted in a transition economy. Furthermore, the working paper focuses on the embeddedness of firms within different levels of institutional governance, introducing a multiscalar approach of institutional co-dependence. An overview of the theoretical concepts of the impact of local business culture on the institutional frameworks and further path-dependency of the latter proves an urge of carrying out further empirical research, based on the primary data of the enterprise survey of 458 firms held in three regions of Ukraine in the year of 2012. The research aims at firstly, analysis of the region-specific institutional quality and the determinants impacting the latter; and secondly, identification 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.

SCIENTIFIC METHODS

The empirical data of the enterprise survey carried out in Ukraine is represented by a set of standardized questionnaire data. There were two questionnaires developed: one for the subsidiaries of MNEs located in Ukraine and one for the domestic firms, both with closed likert-scale questions. Each questionnaire consisted of 6 thematic

blocks. One separate block was devoted specifically to the investigation of institutional environment, covering the questions of the assessment of the quality of such aspects of an institutional framework as: enforceability of legislation and regulation policies, physical and intellectual property rights protection, reliability of oral contracts and agreements, central and regional government support. The time span referred to by the survey firms was the last 5 years from the year 2012. In order to analyze the perceptions towards institutional quality at a certain location the survey firms were asked to assess on the scale from 5 (very good) to 1 (very bad) the quality of the above elements of institutional environment.

Crosstabs descriptive analysis of the assessments provided by the survey firms was run with regard to the differences between three regions (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); differences by the type of ownership (brown field FDI, greenfield FDI, domestic SMEs with post-Soviet context and domestic new private SMEs); differences by regions within different ownership groups. Binary logit regression model was introduced for each of the six aspects of institutional environment separately and for the composite indicator of institutional quality for the purpose of robustness check. The composite indicator of institutional quality on the basis of equal weighting with 25% weight devoted to each of the four institutional aspects, provided that physical property rights protection and intellectual property rights protection were treated as one property rights protection indicator and central government support and regional government support were combined into one government support indicator. After multicollinearity check the following control variables were used in the binary model: regional dummy, ownership dummy, size of the firm in terms of logged number of employees, total sales and total exports, sector dummy, number of employees with higher education and number of employees involved in R&D together with the embeddedness indicators, such as cooperation with foreign suppliers and customers in the current region, where the survey firm is located, and in the rest part of Ukraine.

POLICY VALUE-ADDED

The empirical analysis of the enterprise survey data introduced the following results. Firstly, there is a difference 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 of 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.

Secondly, subsidiaries of MNEs hosted in Ukraine tend to assess local 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.

The policy objective of the working paper is to identify possible policy implications towards bridging the gap between the capital and bordering regions with regard to the differences in the respective institutional quality characteristics and government support of the new private domestic SMEs over foreign firms as an important pre-requirement of entrepreneurship growth. The findings of the research potentially imply the following policies based on the evidence obtained from the empirical results, applicable to the national and regional economic systems of Ukraine as an ENP state within the time span of the next decade. Firstly, there is a need to encourage the national government to support bordering regions in order to avoid

uneven regional development of a transition state. Special attention by the regional governments of the bordering regions as well as respective policy makers 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 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.

Secondly, 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 private SMEs growth. These can be creation of regional special free zones, tax free areas, and business incubators.

By and large, 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 they are the main generators of the development and growth of entrepreneurship within the regional economic systems.