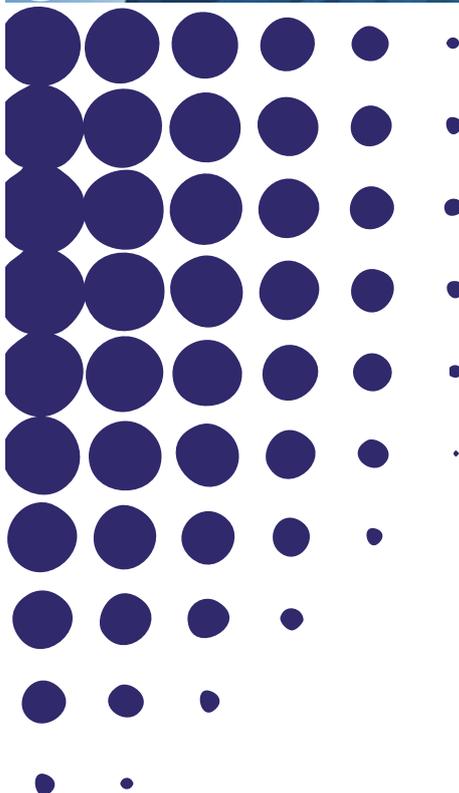


WP5/19 SEARCH WORKING PAPER

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

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

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Abstract

The paper aims at the analysis of the interrelatedness between formal and informal institutions as a prerequisite of the quality of local institutional environment, which impacts the development of multinational enterprises (MNEs), as well as small and medium size enterprises (SMEs) within a certain economic system. The role of MNEs, their subsidiaries in the host markets and cooperation of the latter with the domestic SMEs, are investigated with regard to the embeddedness of firms within the local institutional system based on the paradigm of a multiscalar approach in a transition economy. The paper empirically analyzes the primary data of the enterprise survey, carried out in Ukraine as one of European Neighborhood Policy (ENP) states. The focus of empirical analysis is centered on the assessment of institutional quality and its region-specific characteristics by firms, the determination of the differences in local institutional quality perceptions by MNEs and domestic SMEs and identification of the prerequisites of such disparities.

Keywords

Institutions, institutional quality, local business culture, enterprise survey

JEL Classification

E02, O43, R10

I. Introduction

Institutions represent an important component of any economic system. Formal and informal institutions are equally important for the collaboration between business actors of the latter. While formal institutions impose rules, laws and legislation, informal institutions provide a set of shared understandings, beliefs and behaviors, which unite all the elements of the system under common knowledge (Hall and Soskice, 2001). In such a way local institutional environment is equally supported by both formal and informal institutions, which have to be coherent in order to foster economic development. In transition economies with prevailing context-specific economic past, the fit between formal and informal institutions is of a tremendous importance. When rules and laws imposed by the higher official regime are not adjusted to the existing pre-established code of conduct in the society at transition, formal constitutions may not work within the current informal environment (Tridico, 2011).

The paper will introduce the discussion concerning the definition of institutions and the interrelatedness between formal and informal institutions as an important prerequisite of overall institutional quality within different capitalism formations, namely cooperative capitalism, collective capitalism, competitive capitalism and proprietary capitalism. Different capitalism systems perform differently, because institutional endowments have diverse functional characteristics. Thus, in cooperative and collective capitalisms, the business processes are coordinated by non-market institutions and shared individual agreements, whereas in competitive and proprietary capitalisms these are institutions, which rule the game. The paper will focus on Ukraine as a transition economy of the ENP. In this paper we will provide empirical evidence on the enterprise survey, carried out in 458 manufacturing firms in Ukraine. We also ascribe Ukraine to cooperative and collective capitalism groups, because local business culture with its socially shared ethics largely affects institutions, which is the similar story for all transition states (Tridico, 2011).

The enterprise survey in Ukraine aimed at empirical investigation of the quality of local institutional environment within the following research questions:

1. Are there regional differences in the quality of institutions in Ukraine?
2. How do subsidiaries of MNEs and domestic SMEs located in different regions of Ukraine assess the quality of institutions deployed in the country?
3. What determines the differences in the assessment of institutional quality by MNEs and domestic SMEs?

By answering the above research questions, the paper aims 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.

The paper is organized as follows: Part II covers institutional embeddedness of firms, introducing a discussion on the interrelatedness of formal and informal institutions, multiscale institutional co-dependence and importance of institutions for the subsidiaries of MNEs in the host location and domestic SMEs; Part III introduces the analytical framework of the paper with three main hypotheses of the empirical research; Part IV covers data and methods; Part V provides the results of empirical analysis of the enterprise survey in Ukraine; Part VI follows with the discussion on the results; and Part VII summarizes the paper introducing policy implication.

II. Institutional embeddedness of firms

2.1 Formal and informal institutions within local institutional environment

The notion of institutions has become a widely acknowledged topic of scientific debates on institutional change and role of institutions for the development and growth of national and regional economic systems. However, there is still no one widely accepted definition of institutions. Thus, North (1991, p. 97) states that “institutions are humanly devised constraints that structure political, economic and social interaction”. The author introduces formal institutions, such as political and economic rules and contracts, and informal institutions, such as codes of conduct, conventions, attitudes, values and norms of behavior. Formal institutions are subordinate to informal institutions in a sense that they are the deliberate means used to structure the interactions of a society in line with the norms and values that make up its informal institutional environment. According to this way of thinking a formal component of institutions (rules and laws) is formed under the influence of an informal component (traditions, social norms and behaviors, culture and attitudes). North’s definition implies that policy making, which attempts to change the formal institutions of a society without measures to adjust informal institutions in compatible ways, will have marginal success. For example, difficulties arise when a governing body can influence the evolution of society’s formal institutions in a direct way, yet the less tangible informal institutions remain unaltered outside the direct influence of public policy. While informal institutions can be shaped, they are likely to resist change and take time to evolve towards new social norms. According to Williamson (2000) in his social analysis of economics of institutions the level of informal institutions and customs, traditions, norms and religion develop within centuries or even millenniums in a spontaneous way, whereas formal institutions and governance need on average 10 years to get established in the society. Thus, ‘radically different’ performance of economies can exist over long periods of time as a result of the embedded character of informal institutions, because originally these are the humans that impose certain constraints that in their turn frame economic interactions (North, 1990).

Hodgson (2006) introduces institutions through the realm of social rules that constrain societal interactions. Institutions are believed to be embedded in social interactions, because on the one hand, they constrain them and on the other hand, they enable them. The constraining function originates from the perspective of formal institutions, those rules, laws and regulations that impose certain frameworks and limits on social and economic interactions. The enabling function is derived from the fact that institutions as such depend on the thoughts and activities of individuals in a society. This means that originally institutions can only work efficiently when they are embedded in the society adjusted to inexplicit, cultural environment.

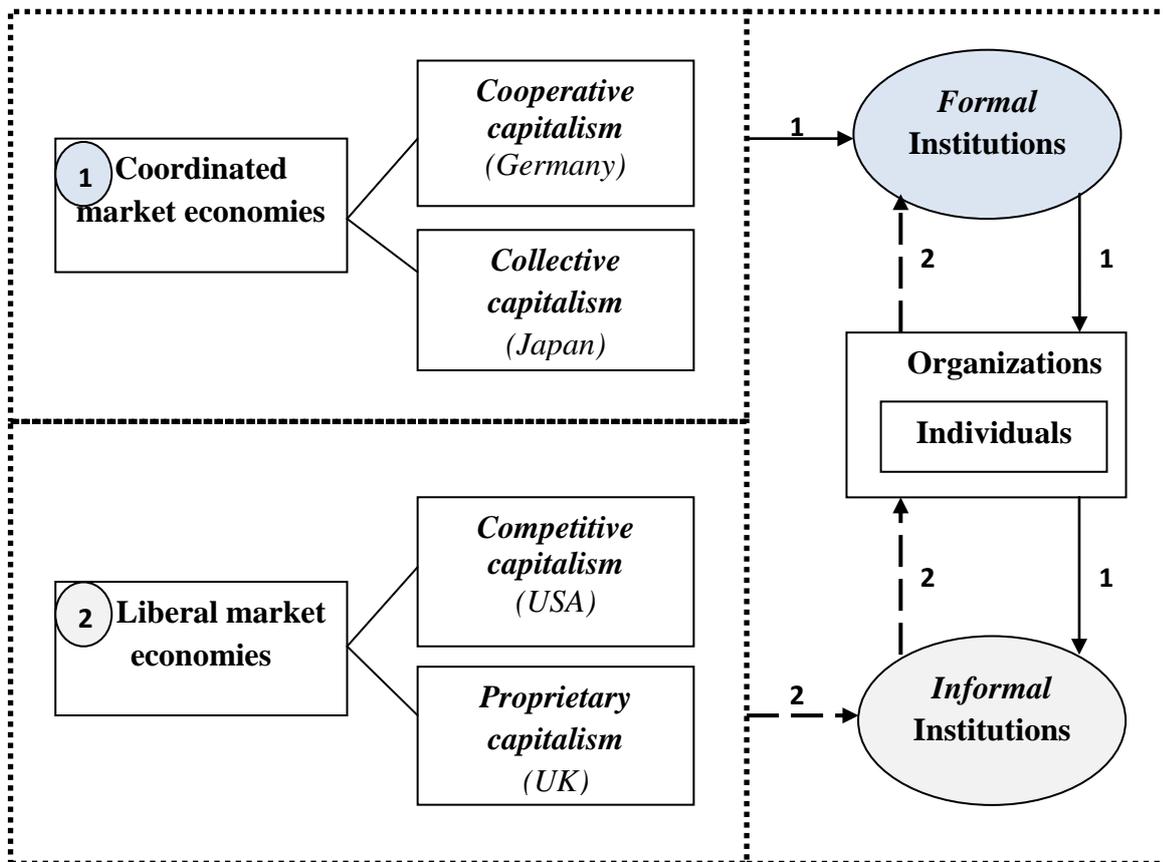
The interrelatedness between formal and informal institutions not only proves the importance of social and cultural platform for the effective introduction of formal governance, but also leads to the notion of local business culture as an important part of local institutional environment. Before defining local business culture, we refer to Di Maggio and Powell (1983) and their formulation of culture. The authors state that culture is a set of shared understandings and experiences, gathered within some common action. 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. For the formation of local business culture the following conditions must be met: availability of a group of individuals, which make the part of the business entity within certain local dimension; introduction of characteristic common behaviors by these individuals; and integration of these behaviors towards business practices forming in such a way business routines. Thus, Hodgson (1998) through defining institutions as established and accepted norms of a group behavior, firstly, already involves a number of certain actors making up a group (possibly firms within one institutional and cultural environment) and secondly, the authors associate these behavioral norms with "socially transmitted information", which is a part of local business culture. Proximity plays a defining role in the formation of local business culture within certain informal institutional environment. Institutional geographers view geographical proximity as the prerequisite of development of such important elements of local business culture as local rationalities and traditions of behavior, tacit knowledge and face-to-face exchange, social habits, norms and routines, and the sociology of communication and interaction in local economic networks (Amin, 1999). The author also proves that an economy is not solemnly a collection of firms, but rather a "composition of networks and collective influences which shape individual action; a highly diversified set of activities owing to the salient influence of culture and context; and subject to path-dependent change due to the contribution of inherited socio-institutional influences" (Amin, 1999, p. 4).

The link between formal and informal institutions 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 a specific local business culture of every locality.

Another way to investigate the interrelatedness between formal and informal institutions is through the paradigm of business ethics and divergent capitalisms approach (Figure 1). Stajkovich and Luthas (1997) offer a model describing the basic elements of business ethics based on the social cognitive theory. The model explains that business ethics formation depends on the triadic interaction among the specific institutional environment, personal factors of individuals and organization behavior, all within a particular context of national culture. We would integrate the notion of national culture within the framework of different types of capitalism structures or political economies, which impact institutional differences in different countries (Whitley, 2000; Hall and Soskice, 2001).

Figure 1: Factors affecting the formation of local business culture



Source: Own draft by author

In Figure 1 we can see the interconnection between varieties of capitalism, influencing formal and informal institutions, organizations and individuals. According to Hall and Soskice (2001) there are two types of economies: liberal market economies (the USA, the UK, Australia, Canada, New Zealand, and Ireland) and coordinated market economies (Germany, Japan, Switzerland, the

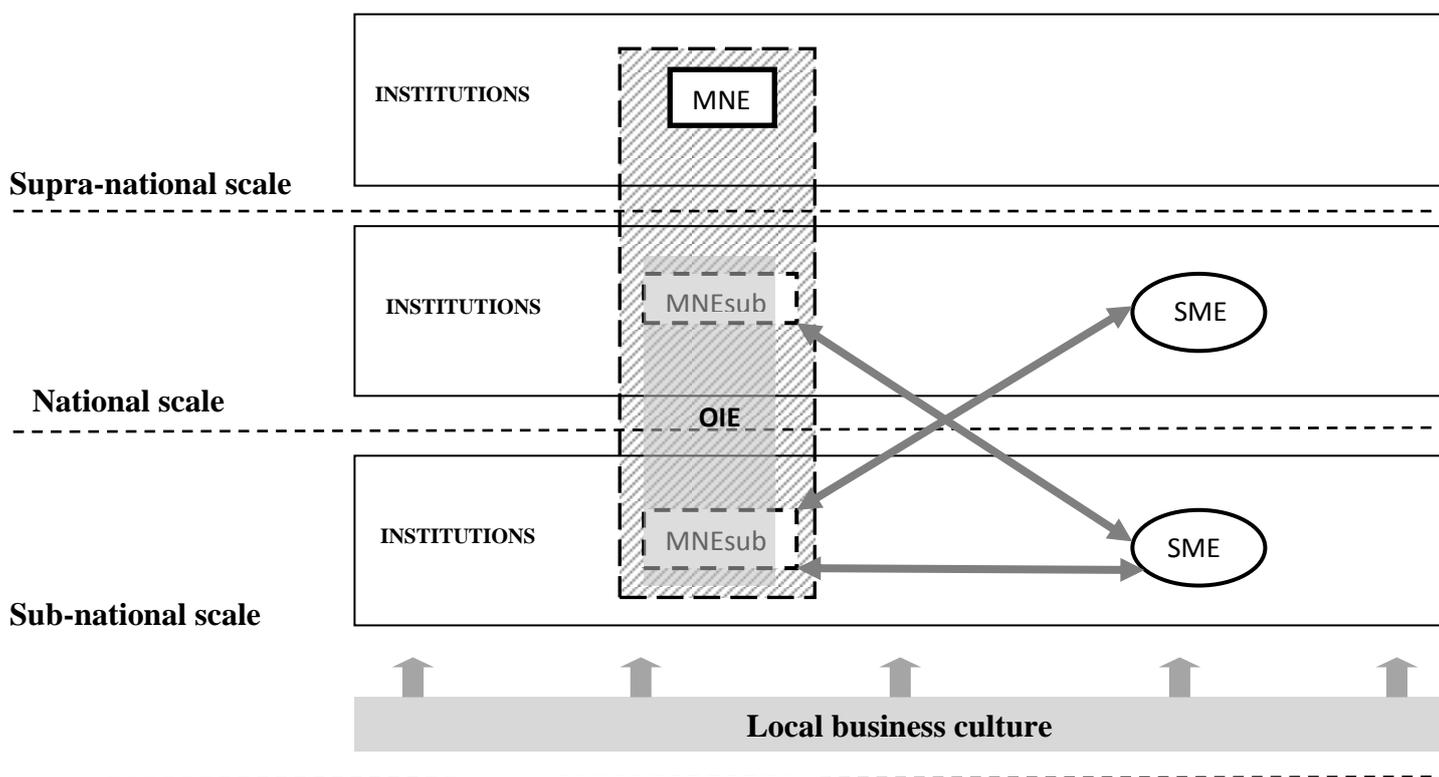
Netherlands, Belgium, Sweden, Norway, Denmark, Finland, and Austria). Cooperative capitalism of Germany and collective capitalism of Japan belongs to coordinated market economies, whereas competitive capitalism of the USA together with proprietary capitalism of the UK are the ones fitting into liberal market economies. The main difference between the capitalism formations of coordinated and liberal economies is that in cooperative and collective capitalisms of coordinated economies firms depend more on the non-market relationships while constructing their core competencies, and in competitive and proprietary capitalisms of liberal market economies firms regulate business processes through hierarchies and market arrangements (Whitley, 2000; Hall and Soskice, 2001). Thus, the arrow numbered 1 coming from coordinated market economies shows that in competitive and proprietary capitalisms these are formal institutions that impact organizations, which then form certain informal behaviors in order to correspond to the formal legislations. This is the “top-down” model of interrelatedness between formal and informal institutions. The arrow numbered 2 goes from liberal market economies in the direction to informal institutions and shows that these are informal regulations in cooperative and collective capitalisms that influence organizations and individuals and therefore impact the formal rule of law, which in its turn adjusts to the pre-established code of conduct in the society. This is the “bottom-up” model of interrelatedness between formal and informal institutions. Thus, in Ukraine, a transition economy at the state of catching up, pre-established informal institutions and therefore local business culture impact significantly the efficiency of formal institutions. This assigns Ukraine to the “bottom-up” model of interrelatedness between formal and informal institutions. Transition of economic systems of the majority of emerging states requires an availability of fit between new formal rules and old informal codes of conduct (Martin, 2000; Tridico, 2011). Ensuring of such a fit between formal and informal institutions proves, that in cooperative and collective capitalisms firms operate in such an institutional environment, where the overall institutional quality depends on both its formal and informal component.

2.2 Multiscalar institutional co-dependence

In this part of the paper we will introduce the three scales of institutions, namely supra-national, national and sub-national scales together with foreign and domestic SMEs embedded in institutional environments at these scales. Introduction of the multiscalar approach towards the analysis of the quality of institutional environment impacting business activities of firms aims 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. Based on Bunnell and Coe (2001) the scales are viewed as relatively socially formed, which makes them connected to each other through a series of simultaneous actions at each of the scale. Keeping in mind that each of the above scales has different local institutional regimes, our focus will mainly lie within the sub-national scale of institutions, namely level of regions and localities. This is where the institutions

become especially place-dependent and the interrelatedness with the local business culture is also the most significant. Nevertheless, supra-national and national levels of institutions are also situated within the complex interactions of different institutional scales and therefore, play their important roles in the formation of interrelatedness between each of the scales (Figure 2).

Figure 2. Institutions and firms co-dependence in a transition economy, multiscale approach



Source: Own draft by author

Note: MNE – mother company; MNEsub – subsidiary of a MNE in the host market; SME – domestic SME; OIE – own institutional environment created by the subsidiaries of MNEs in the host country.

Figure 2 presents three scales of institutions and three economic actors: MNEs together with their subsidiaries in a host market and domestic SMEs. Sub-national scale of institutions is the lowest level, because this is the level of regions and localities. At this local level local business culture as a part of informal institutional environment is formed. Thus, as we have stated earlier in cooperative and collective capitalisms with transitional stage of economic development the “bottom-up” model is present, when informal institutions influence firms and require therefore formal institutions to adjust to the pre-established social routines in the society.

Supra-national institutions are situated at the highest scale, because global institutions are not that much closely linked to the local business activities of a separate state. When talking about supra-national institutions we mainly refer to global institutional units within the triad of the following world regions: North America, Western Europe, and East Asia. Supra-national institutions are concerned

with internationally accepted rules of competition, trade and monetary regulations (Martin, 2000). Global institutions serve as the so-called linkages within the regionalization structure of the contemporary world, involving national states as the members of the global decision-making platforms. In such a way global institutions set the rules, constitutions and regulations and transmit them to the national member states for further execution. Any state being a member of a global supranational unit strives to adjust its national institutional framework then to the global, international “code of conduct”. Thus, global institutions become important carriers of rules and standards by MNEs, which when entering international markets automatically transmit those “rules of the game” to the host country through its subsidiary. When a multinational company enters foreign market, it already faces multiple embeddedness (Meyer et al., 2011). Multiple embeddedness is an embeddedness of a multinational firm at the level of the home country and at the level of the host economy within a specific local context of the later as shown by a shattered quadrant joining a mother company and its subsidiaries in Figure 2. At the home country level, the multinational company is affected by the global or even supra-national level institutions. This is where firms build their original resource endowments, which enforces their internationalization. These endowments are transferred together with a subsidiary towards the host country, introducing specific constraints on the business activities taking place at the sub-national level (Meyer et al., 2011).

At the level of the host economy, on the other hand, the subsidiary of a MNE is also subject to the institutional framework of the latter through the influence of formal and informal institutions at the national and sub-national levels. This is when the second case scenario may emerge and MNEs start to create their own institutional environment around them as shown by a grey quadrant joining subsidiaries from the national and sub-national levels in Figure 2. This can be partly explained by what Oliver (1992) calls deinstitutionalization, when the established and common to the MNEs institutionalized organizational practice disentangles, because organizations fail to reproduce practices they are originally used to within new locations aiming at fast and efficient adjustment to the local rules. In emerging economies formal institutions are very dominant in ruling economic processes and therefore the burden of governance on the MNEs can also be in place. MNEs, nevertheless, not only correspond to the existing institutional environment, but also contribute to the emergence of a new one (Chung and Beamish, 2005). Moreover, the government institutions of transition economies are interested to feed the demand for foreign capital inflows and as a result introduce preferential treatment and attractive institutional frameworks to the new comers, which affects how MNEs embed into the local host environments. As Farrell et al. (2004) put it, MNEs are attracted easily by tax holidays, import duty exemptions, subsidized land and power, offered by host governments as an incentive to enlarge the foreign capital stock in the countries. The finding of Meyer et al. (2009) that greenfield investors choose certain locations primarily by the flexibility of the host institutional

environment also support our above discussion on MNEs tending to develop their own institutional environment as an adjustment strategy to the regional economic system. Those FDI starting in a new economy from scratch assess the quality of local institutional environment from the perspective of the possibility to create certain local microsystem backing up the investor in its further embeddedness into the regional economic system. Creation of an own institutional environment on the basis of the government preferential treatment at first hand is one of the ways to adjust easier to the existing hosting environment.

Cooperation between multinationals' subsidiaries and domestic SMEs as expressed through the grey arrows in the Figure 2 plays also a very important role for the embeddedness of firms into the local institutional environment and therefore should be controlled for when assessing the perceptions of both types of firms towards the quality of local institutional environment. As Jindra et al. (2009) state, foreign subsidiaries in transition economies tend to embed into the regional economic systems through the intensified linkages with domestic SMEs, which are backed up by the extensive autonomy of MNEs in the host location. Such an autonomy provides the subsidiary with enough space to create their own supplier-customer networks for business operations, that result in a form of certain own institutional environment framing these networks in the long run.

National level institutions play a prominent role in the emerging economies when speaking about FDI and economic growth within the institutional environment of the host economy. Under national level institutions we mean national financial system, national labor and property rights laws, tariffs and taxes regulations. Institutional differences at the national level between different states serve as a reason for the difference in economic organization, development and growth scenarios of these states (Martin, 2000). Being embedded in different institutional frameworks, economic systems all over the world differ dramatically. National scale becomes also an important unit of economic activity not only because at this level institutions trigger economic differences, but also because the overall tendency nowadays is that economic processes not only concentrate upwards to the global scale, but also downwards to the national and sub-national levels (Bunnell and Coe, 2001).

Sub-national scale is the level of regions and localities. This is where local government structures, local employees' associations and local region specific regulations concerning land use and resources planning are introduced. Regions and localities at this scale are viewed as arenas supported by institutional environments. Local institutions are "the rules, conventions and regulations that define the territory (a region or locality) and its usage, which in turn depend on sometimes conflicting values and modes of thought" (Rafiqui, 2009, p. 345). In this respect when institutions are there for constituting the environment of regions and localities, there is a need to take into account the fact that institutions may be transformed by individuals according to their level of acceptance of the latter. At this level we can observe the most interconnection between the local business culture and regional

economic system through the high levels of embeddedness of sub-national institutions into the regional business culture framework, and through the path- and place-dependency of regional or local institutions.

Integration of institutions at the sub-national scale into the system of local pre-established and socially accepted informal rules of the game is very important for the further embeddedness of domestic and especially foreign firms within the regional economic system. This is explained with the help of sociological institutionalism, which underlines that institutions should be viewed as “culturally specific social networks of trust, reflexive cooperation, and obligation which underpin economic behavior and relationships” (Martin, 2000, p. 83). Therefore, the role of region specific informal networks of trust, knowledge transfer and collaboration is very important in fostering the embeddedness of local firms. Granovetter (1985) also stated that economic institutions are framed through the paradigm of allocation of economic resources through social networks. He discovered that the efficiency of local specific institutions depends on the interactions within social networks of this locality. Thus, for example, an acceptance of rules and regulations imposed by regional institutions concerning getting access to buildings, land, materials and resources of a specific region highly depends on the extent to which use of personal contacts, for instance, is popular in solving the above concerns. Williamson (2000) in his model of economics of institutions has also proved that the top level of informal institutions is the social embeddedness level of customs, codes of conduct and socially accepted norms, which introduce given informal constraints towards the next level of formal institutions.

According to Martin (2000) institutional path-dependence is most significantly expressed at the regional or local level. This is where the culture, traditions, social rules and norms, behaviors and religion are situated. Local business culture with its pre-existed social norms and accepted behavioral routines is also constrained by the shadow of the past. At the same time being the bottom line in Figure 2 and directly impacting the interrelatedness of regional institutions referred to above local business culture determines the dependence of sub-national scale institutions on the patterns and routines of the past. Rafiqui (2009) also refers to the path-dependency of local specific institutions and their adaptation towards pre-established local business culture. The author distinguishes between institutions-as-rules and institutions-as-equilibra. Under institutions-as-rules, the way how institutions influence perception (an important element of a local business culture) is meant and under institutions-as-equilibra, the way how existing patterns of behavior influence perception is understood. Institutions-as-rules theorists use institutional path-dependence to explain the evolutionary nature of institutional change. Thus, Rafiqui (2009) stresses, that for institutional change to happen at a regional scale, a complicated process of change of beliefs and norms on the bottom level of the local culture has to take place beforehand. Path-dependence in such a way originates on the one hand, from firms that

resist any kind of change, because they are already embedded into certain cultural environment and their business practices are adjusted to the latter; and on the other hand, from the role perception plays in creating these institutions. It is the connection between perceptions and beliefs, institutions and firms that make path-dependence such an important element for describing the link between local business culture and sub-national institutions.

Path-dependence of region specific institutions, closely related to the local business culture of this region can have both positive and negative effects. The positive role of path-dependence is expressed through the obvious need of formal institutions to co-evolve together with informal institutions and local business culture to be efficient and for the necessary evolutionary change to occur. The negative output of sub-national institutions depending on the pre-established local business culture is the possibility of institutional lock-in to take place (Rafiqui, 2009). Being dependant on the social rules and norms, local institutions may resist change for further economic development. For example, when local business culture is based on oral agreements and use of personal contacts, local institutions will be unwilling to introduce contract enforcement, although it is important for the overall enforceability of legislation and regulation policies.

Another important dimension of region specific institutions is institutional place-dependency. As Martin (2000) puts it, institutions as such may be not the only reason for the geographically uneven development, but they enable, constrain and frame economic activities in spatially different manners. Local institutions become more and more important in shaping the local and regional economic performance. Thus, localization of a certain industry within a regional economic system fosters development of specialized local institutional environments, which reduce transaction costs and increase local economic competitiveness. Economic geographers also identify place-dependency of institutions at sub-national level referring to “local institutional thickness”. Martin (2000) defines it with the help of four elements: strong presence of institutions such as local authorities, chambers, labor unions, research centers; high level of interaction between these institutions; availability of well-defined structures aimed at minimization of inter-institutional conflict; and collective integration into regional socioeconomic development. Under circumstances of such “local institutional thickness” at the regional level there is a high probability of formation of a specific institutional regime, which will clearly reflect on the local business culture. This facilitates the emergence and development of clusters of firms, because firms are prone to function in the institutional environment, which is already adjusted to the pre-existing business culture. It enables closer collaboration between firms, better knowledge transfer, which fosters higher spillover effects among local firms (Martin, 2000). This is especially relevant for Ukraine as a transition economy with post-Soviet past. The prerequisites of a planned economy, which was the case for the communist times in the Soviet Union, were based on the uneven regional division of states according to economically efficient and inefficient regions of the latter.

Thus, those regions considered to be efficient in terms of economic output in hard industry, which was the main driver of the Soviet economy, were supposed to be strategic localities for development of regional economic systems. The government directed financial support towards the development of a technological base at these specific strategic locations, which would work according to the Soviet plan. This led to the emergence of industrial zones in Ukraine, like the Eastern part of the country close to other Soviet Union member states, which historically were treated by the government as strategic sources of economic wealth. As a result the existing institutional environment at these industrial zones may differ from the institutional environment in other, “less strategic”, parts of the state. Thus, the Western region of Ukraine located geographically in the agricultural zone of the country has always been an important agricultural zone. Considering that the main focus of the Soviet Union was on the hard industry, the Western region received much less support, which also resulted in a lesser impact of the communist legacy on the institutional environment at this location.

The same situation concerns the difference in institutional endowments between the capital region and the rest of the state in case of emerging markets. Capital regions in transition economies usually have better infrastructure, serving as commercial hubs (Heidenreich, 2003). The state being interested to support such an urban agglomeration contributes to the development of a higher quality of institutional environment (Fedorov, 2002). The disproportionality of the regional developments of the transition economies towards higher developed capital regions and lower developed peripheries is also the outcome of preferential government treatment, availability of financial support, foreign capital and better opportunities due to a more developed market in the capital hub (Heidenreich, 2003). Such opportunities in their turn also attract a better pool of qualified human capital, which serves as an important driver of economic progress due to knowledge transfer by highly skilled employees. Santos et al. (2012) state, that there is a positive relationship between the economic development of a region and availability of highly skilled motivated entrepreneurs in this region. Capital region being a high-income region tends to attract more qualified workers, which create new working places that attract more and more knowledge and human resources over time. Therefore, place dependency of institutions within different regional economic systems is an important factor to be taken into account when analyzing the quality of local institutional environments and their impact on SMEs development.

2.3 Importance of institutions for SMEs development

Any newly created firm or a start-up enters in a sense already pre-established institutional environment, with all the rules, laws and constitutions which are for a long time there in the market. Therefore, in order to survive firms have to adjust to the existing institutional frameworks possibly by the means of creating their own institutional endowments that would fit to the overall local institutional environment. Institutions are the rules of the game in a society that function as constraints and opportunities shaping human interactions, cooperation of firms and organizations. Applied to the

field of entrepreneurship, institutions represent a set of rules that articulate and organize economic, social and political interactions between individuals and social groups, which impacts business activity and economic development (Thornton et al, 2011). Malmberg and Maskell (2006) view institutional setup as one of the most prominent factors that matter, when firms choose where to build up their competitive advantages with regard to special activities they perform. They argue that particular sets of national, regional, or local institutions gradually develop over time in response to the fact that firms settle down in a specific environment and once a dominating institutional pattern has been created, it will attract those firms and individuals most compatible with it.

Asheim and Gertler (2003) stress out the importance of institutional environment for firms by the necessity of the latter to innovate. Innovation in such a case must be based on the following activities: interactions and knowledge flows between economic entities such as firms (customers, suppliers, competitors), research organizations (universities, other public and private research institutions), and public agencies (technology transfer centers, development agencies). The authors argue, that the transmission of tacit knowledge requires face-to-face interaction between partners who already share the same language, i.e. ‘codes’ of communication, rules and norms, fostered by a shared institutional environment. Common institutional environment becomes one of the unique regional assets, which facilitates and strengthens the development of local advantage. Maskell and Malmberg (1999, p. 181) argue: “it is the region’s distinct institutional endowment that embeds knowledge and allows for knowledge creation which – through interaction with available physical and human resources – constitutes its capabilities and enhances or abates the competitiveness of the firms in the region”.

Spatial concentration of interacting firms sharing a common social and institutional context is an obvious prerequisite to socially organized, interactive learning processes and further technological and organizational upgrading. In such conditions the regional economic system is born with its shared attitudes, values, norms, routines and expectations – local business culture – that influences the practices of firms in the region. This common local business culture, that shapes the way that firms interact with one another in the regional economy, is a product of commonly experienced institutional forces (Asheim and Gertler, 2003). It fosters local firms to integrate within certain clusters, which encourages the development of a particular institutional structure (Bathelt et al., 2004). This process of institutional building is triggered by the establishment of ‘communities of practice’, when agents are bound together through day-to-day interactions, based on the same expertise, a common set of technological knowledge and similar experience with a particular set of problem-solving techniques. Communities of practice in such a way lead to the generation of distinct routines, conventions and other institutional arrangements. Common institutions and procedural rules are established incrementally, constantly being reshaped by experience (Lawson and Lorenz, 1999). This is extremely important for global networks of firms, in which business actors all around the world, embedded in

different socio-institutional and cultural environments, are engaged. Once such a network has been successfully established and works effectively based on a common set of institutions it provides substantial advantages to that local agent:

- Possibilities to go beyond the routines of the local cluster;
- Understanding of different institutional regimes in order to communicate and interact with actors in other parts of the world through global networks;
- Systematic influences of institutions, especially between different national environments, preventing the diffusion of universal operational standards or a single ‘best practice’.

Establishment of certain institutional structures favoring regional economic development leads to the emergence of institutional proximities between different regions and localities. Institutional proximity provides the environment with economic agents that share the same rules, habits and values, which encourages the development of common trust between the companies. There is also a synergy effect of institutions when institutional proximity is relevant, namely if we are talking about institutional complementarities arising when one institution increases the return from complementary institutions (Boschma, 2005).

III. Analytical framework

Critical analysis of the role of local institutional environment for the development of multinationals and SMEs revolves around getting primary data from firms with regard to their assessment of the main institutional determinants of their economic activities. Therefore, an enterprise survey was carried out in three regions of Ukraine. The survey firms among other questions were asked to assess the quality of formal and informal institutions in their local regional economic systems. The survey questions were developed with the aim to answer the research questions we have introduced at the beginning of the paper, on the basis of which the following hypotheses were formulated:

H 1. Quality of the institutional environment in the Capital region of Ukraine is higher than that of the Western and Eastern regions.

H 2. The Western region of Ukraine gains in terms of higher institutional quality in comparison to the Eastern region.

H 3. Local institutional quality of the host regions is assessed lower by the subsidiaries of MNEs in comparison to domestic SMEs.

The first hypothesis follows our analysis of the place-dependency of institutions and the importance of sub-national level in the formation of local institutional environment. Thus, we assume that there are region specific differences between the quality of institutions in different regions. As we have indicated earlier in our theoretical discussion in transition economies institutional quality of the capital region is supposed to be higher than in the bordering regions due to uneven regional development with highly developed capital regions as important commercial hubs with a concentrated pool of highly skilled human capital in comparison to lagging behind periphery.

The second hypothesis aims at the analysis of the differences in institutional quality of the Western region of Ukraine as the close to the European Union border region and the Eastern region, which borders post-Soviet states. We assume that path-dependency of post-communist institutions and the dominant role of historically pre-established social “code of conduct” in the Eastern region of Ukraine as a member of Soviet Union will determine the respective difference in the quality of institutional environments of the Western and Eastern regions with regard to their geographical proximity to different states. This hypothesis also refers to our previous argument on the importance of fit between formal institutions and informal institutions. This is the case when formal institutions are inefficient, when rules and regulations that they impose do not work within the actual local business culture.

The third hypothesis is based on the paradigm introduced within the multiscalar approach in Figure 2, which states that multinational companies entering new markets transmit the global rules and standards, inherited from their home countries, towards host countries. When MNEs enter transition economies markets, the costs of embedding within the local institutional environments rise. This results in the perception of a quite low quality of institutional environment by foreign firms, whereas domestic SMEs are already used to certain local institutional frameworks. Being much more institutionally locked in comparison to MNEs, domestic SMEs do not encounter the low quality of institutional environment to an extent MNEs do.

IV. Data and methods

The enterprise survey in Ukraine lasted for four months, having been launched in April, 2012 and finished in July, 2012. Overall 305 domestic SMEs and 153 subsidiaries of MNEs from the food and machinery & equipment sectors were surveyed in different three regions of Ukraine: the capital region Kyiv, close to the EU border region Lviv (the Western region) and far from the EU border region Kharkiv (the Eastern region). The criteria of selection of the regions were based on the FDI inflows in these regions and geographical position towards the EU border. According to the data of the State Statistical Committee of Ukraine Lviv region is the first in terms of FDI inflows in the Western part of Ukraine and Kharkiv region the is the first in terms of FDI inflows in the Eastern part of Ukraine (Table 1).

Table 1. FDI distribution by regions of Ukraine

Regions of Ukraine	FDI increase, reduction per year, \$ million		FDI cumulatively starting from the beginning of investment on October 1, 2011, \$ million	FDI per person cumulatively starting from the beginning of investment, \$	
	2009	2010		2009	2010
Western region					
Volyn region	63,2	11,7	246,6	321,6	332,8
Zakarpattia region	7,3	-1,1	340,1	293,0	291,7
Ivano-Frankivsk region	134,7	-92,5	622,2	460,8	393,9
Lviv region	240,6	75,2	1 363,9	473,2	503,7
Chernivtsi region	1,7	0,5	63,4	68,6	69,1
Capital region					
Kyiv (city)	2 387,9	2 634,1	24 016,8	7 031,9	7 946,2
Kyiv region	178,1	77,5	1 702,8	887,4	935,3
Eastern region					
Donetsk region	107,8	424,7	2 292,2	366,1	464,6
Lugansk region	243,3	-6,3	747,3	275,0	274,7
Sumy region	85,5	114,1	348,3	207,1	307,0
Kharkiv region	472,8	622,7	2 776,7	754,6	985,0

Source: Provided by author, based on the State Statistical Committee of Ukraine

The criteria of selection of the sectors of the survey firms were determined by the strong presence of companies with FDI in these sectors (Table 2). The survey companies were selected randomly from the manufacturing firms. Our focus on manufacturing firms was threefold. Firstly, in order to analyse the embeddedness of MNEs and domestic SMEs into the regional institutional and economic systems of a host transition economy we needed to identify the business processes, which involved exchange of knowledge, such as innovation activities, organizational upgrading and customers-supplier interactions, which are all related to the production processes. Secondly, while developing the survey we were interested in the linkage between institutional quality as the prerequisite of MNEs to invest in Ukraine and their further propensity of technological upgrading within collaboration with domestic SMEs, which constitutes a manufacturing cycle. And thirdly, we aimed at investigation of the real input of foreign investors into the comparative advantage of such a post-communist state as Ukraine, where hard industry based on production activities is of a strategic importance.

Table 2. FDI inflows in the targeted regions in 2010, by sectors, millions of USD

Regions	Food, beverages and tobacco	Pharmaceutical and chemical products	Machinery and equipment	Basic metals and fabricated metal products	Pulp and paper products	Manufacture of textiles and wearing apparel, leather and related products	Wood and wood products, furniture
Kyiv region	481,1	75,2	699,4	67,6	112,8	148,8	23,1
Lviv region	64,3	38,2	107,6	34,5	41,9	35,9	58,3
Kharkiv region	146,5	54,3	286,4	87,9	57,4	28,6	24,5

Source: Provided by author, based on the State Statistical Committee of Ukraine

The sampling frame was based on the firms' directory and accounts of the State Agency of Investment and National Projects Management of Ukraine. Overall 2000 companies (1137 domestic SMEs and 863 subsidiaries of MNEs) from the food and machinery & equipment sector have been contacted by phone. 400 companies were successfully interviewed face-to-face and 58 companies have filled out the questionnaires themselves and were contacted by phone afterwards to ensure the correctness of the given answers. The distribution between surveyed and contacted MNEs and domestic SMEs in the sampled three regions is provided in Table 3. We can clearly observe that there is no significant difference between the regional distributions of response rates, whereas the response rates of domestic SMEs are nearly two times higher than that of MNEs.

Table 3. Response rate in different regions

	Lviv region	Kyiv region	Kharkiv region	TOTAL
Survey subsidiaries of MNEs	50	53	50	153
Contacted foreign firms	280	298	285	863
<i>Response rate</i>	<i>17,9%</i>	<i>17,8%</i>	<i>17,6%</i>	<i>17,7%</i>
Survey domestic SMEs	100	105	100	305
Contacted domestic SMEs	350	402	385	1137
<i>Response rate</i>	<i>28,6%</i>	<i>26,1%</i>	<i>26,0%</i>	<i>26,8%</i>
Total surveyed firms	150	158	150	458
Total contacted firms	630	700	670	2000
Total response rate	23,8%	22,6%	22,4%	22,9%

Source: Provided by author

The empirical data of the enterprise survey is represented by a set of a standardized questionnaire data. There were two questionnaires developed: one for the MNEs and one for domestic SMEs, 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. In order to analyze the perceptions towards institutional quality at a certain location we asked the survey firms to assess on the scale from 5 (very good) to 1 (very bad) the quality of the above elements of institutional environment.

We ran the crosstabs descriptive analysis of the assessments provided by the survey firms 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 (Annex 1). By brownfield FDI we mean those subsidiaries of MNEs, which entered the Ukrainian market and acquired an existing production site for future business operations. Greenfield FDI group encompasses those subsidiaries, which built new production sites in Ukraine. Domestic SMEs with post-Soviet context are the ones which are either the spin-offs of government conglomerates, or were privatized or have state ownership, i.e. those who have any connection to the government and planned economy of the past. Domestic new private firms are basically Ukrainian young start-ups, built by the young generation and therefore having little if none link to the post-Soviet past.

We ran the binary logit regression model 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 results of the binary regression are presented in Table 4. We have built 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. Thus, we came up with equal weights of enforceability of legislation, property rights protection, reliability of oral contracts and agreements and government support. Since the questions on the above parameters were likert scale from 1 (very bad) to 5 (very good), in the binary model they were recoded into 1, i.e. good and very good quality of the parameter of institutional environment (answers 4 and above on the likert scale), and 0 – average, bad and very bad quality of the parameter of institutional environment (answers less than 4 on the likert scale).

After multicollinearity check as control variables we used 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. Regional and ownership dummy were chosen as independent variables in order to check the hypotheses we have introduced earlier. Controlling for size of the firm intended to check whether it could affect the assessment of the quality of local institutional environment with regard to an assumption that the size of the firm affects its embeddedness into the regional economic system on the basis of the market share and networks, which could lead to a better adjustment to the local institutional environment. Introduction of a sector dummy within the independent variables of the model served the purpose of checking whether the assessment of the local institutional environment depends on certain industry targeting and preferential treatment of certain sectors by the government. Human capital indicators, i.e. number of employees with higher education and number of employees involved in R&D, aimed at controlling for the impact of a better absorptive capacity of a firm leading to a higher embeddedness of the latter into the local economic system on the assessment of the quality of institutional environment.

V. Results

The first part of the results concerns crosstabs descriptive analysis of a dataset of the empirical survey of 458 companies in three regions of Ukraine. The analysis aims at identification of significant differences in the assessment of the quality of institutional environment in different regions of Ukraine and by different types of ownership. As we can see from the assessments of the different aspects of institutional environment in different regions in Table 1.1 (Annex 1) the Capital region Kyiv leads in terms of good assessment of local institutions with around 40% of firms rating institutional quality in Kyiv as good and very good, except for central and regional/local government support aspects being rated as of good quality only by 30% of firms. In the bordering Lviv and Kharkiv regions on average only around 25% of firms rate the chosen aspects of institutional environment as of good and very good quality. Moreover, the general trend is that around 50% of firms in Lviv and Kharkiv regions rate institutional quality as bad. Significant differences are also observed concerning central government support, which is rated as of bad quality by 70% of firms in Lviv and 65% in Kharkiv, but by only 40% of firms in Kyiv. Interestingly, Kyiv region also leads in terms of good assessment of the reliability of oral contracts with around 40% of firms assessing this aspect as of good and very good quality in comparison to twice less firms rating oral agreements as reliable in Kharkiv region. The assessment of the institutional quality by region within four ownership types proves a similar trend with Kyiv region leading in terms of positive assessment of the quality of institutional environment in all groups of firms. Thus, around 55% of greenfield FDI firms rate institutional quality as high in Kyiv, while only around 20% of domestic SMEs in the capital region positively assess the latter (Table 1.3, Annex 1).

Table 1.2 (Annex 1) shows the general trend that MNEs assess the institutional quality at the present location higher than domestic SMEs, and the majority of domestic SMEs assess the

institutional quality quite low. Moreover, greenfield FDI MNEs assess the quality of institutional environment at the highest rate, while domestic new private firms score the worst. On average up to 45% of greenfield FDI firms assess the institutional quality at the present location as good and very good, whereas for domestic new private firms this figure stands for only around 20%. The parameter of central and regional government support turns out to be the most divergent between different ownership groups. Thus, while MNEs still keep the pace in scoring these aspects of institutional environment as good and very good, only around 10% of domestic new private SMEs view government support as of good quality. Although domestic SMEs with post-Soviet context rate government support higher than new private firms, the average share of firms with post-socialist past assessing government support is also below the one of both brown and greenfield FDI firms. Greenfield FDI firms also assess the reliability of oral contracts and agreements as of good and very good quality, since more than 55% of firms from this group voted for the highly reliable oral code of conduct.

The outcome of the binary logit regression model in Table 4 is coherent with the above results of the descriptive crosstabs analysis. Regional and ownership dummy have significant negative impact on the assessment of institutional quality as a composite indicator in reference to Kyiv region and greenfield FDI firms. Regional dummy is not significant for physical property rights protection, reliability of oral contracts and agreements and regional government support. In the case of comparison of Kharkiv region with Lviv region there is only significant positive impact of regional dummy in the case of intellectual property rights protection. Cooperation with foreign suppliers in the current region turns out to have a significant positive impact on the assessment of the quality of enforceability of legislation and reliability of oral contracts and agreements, whereas cooperation with foreign customer in the rest of Ukraine has a significant negative impact on the informal parameter of institutional environment. A higher significance of the impact of cooperation with local suppliers and customers rather than national ones could possibly indicate that regionalization factor plays an important role in the differences of the assessment of institutional quality in different locations. This supports our previous discussion on the importance of the place dependency of institutions.

The sector dummy with food and beverages sector as a control group gets only significant in the case of regional government support with the negative relationship. Human capital indicator, namely the number of employees with higher education, impacts significantly positively the assessment of the reliability of oral contracts and agreements. For this indicator regional dummy was not significant, but ownership dummy proved to have a significant negative impact in reference to greenfield FDI firms, which also goes along with our above descriptive results. Number of employees involved in R&D is not significant throughout the model, which could be explained by low R&D activity of firms in the sampled sectors of the enterprise survey in Ukraine. Nevertheless, overall size of the firm in terms of

the number of employees has positive significant impact with regard to overall institutional quality, enforceability of legislation, intellectual property rights protection and regional and central government support. Concerning control for total sales it gets significant with negative relationship towards reliability of oral contracts and agreements. Total exports variable does not indicate any significant relationship towards the dependent variables of the binary logit regression model.

Table 4. Binary logit regression model

	IQ	EL	PPR	IPR	ROC	CGS	RGS
Regional dummies (Kyiv region as control group)							
Lviv region	-,936***	-,828***	-,452	-,763**	,034	-,845**	-,148
Kharkiv region	-,867***	-,528*	-,436	-,081	-,209	-,730*	-,332
Regional dummies (Lviv region as control group)							
Kyiv region	,936***	,828***	,452	,763**	-,034	,845**	,148
Kharkiv region	,069	,300	,015	,682**	-,242	,116	-,185
Ownership dummies (Greenfield FDI as control group)							
Domestic SMEs with post-Soviet context	-1,281***	-,936**	-,566	-,989***	-1,499***	-1,128***	-1,237***
Domestic new private firms	-1,754***	-1,090***	-1,180***	-1,570***	-1,386***	-1,717***	-1,867***
Brown field FDI	-,936**	-,277	-,374	-,911**	-1,486***	-,911**	-,490
Sector dummy (Food & beverages sector as control group)							
Machinery & equipment sector	-,032	,081	-,275	,150	-,095	-,206	-,643**
Size of the firm							
Log of # of employees	,744**	,511*	,005	,585**	-,033	,652**	,804**
Total sales	-,019	-,001	-,006	-,011	-,031***	-,012	-,005
Total exports	,000	,002	,006	,001	-,005	,003	-,007
Human capital							
# of employees with higher education	-,006	-,004	,003	-,005	,009**	-,006	-,002
# of employees involved in R&D	,005	-,009	,009	-,010	,009	-,007	,008
Embeddedness							
Cooperation with foreign supplier in the current region	,007	,019*	,010	-,011	,030**	,011	-,008
Cooperation with foreign supplier in the rest of Ukraine	,002	-,005	,006	,008	,001	-,010	,017
Cooperation with foreign customer in the current region	,008	,003	,014	,018	-,023	-,020	,023
Cooperation with foreign customer in the rest of Ukraine	-,019	-,014	-,025	-,023	-,038*	-,008	-,021
<i>Model fit</i>							
<i>Omnibus Test of Model Coefficients (Sig.)</i>	,000	,000	,002	,000	,000	,001	,000
<i>Correctly classified cases by the model</i>	82%	78%	73%	76%	72%	85%	79%
<i>Nagelkerke R Square</i>	,213	,138	,114	,144	,150	,153	20%
<i>N</i>	415	421	422	418	421	420	420

Source: provided by author

Note: IQ – composite institutional quality indicator; EL – enforceability of legislation; PPR – physical property rights protection; IPR – intellectual property rights protection; ROC – reliability of oral contracts and agreements; CGS – central government support; RGS – regional government support; *Significant at the 0.10 level; **Significant at the 0.05 level; ***Significant at the 0.01 level

VI. Discussion

The results of the descriptive analysis and the binary logit regression model towards the assessment of the quality of different aspects of institutional environment allow us to accept our first hypothesis that the institutional quality in the Capital region is better than that of the bordering regions. The availability of more companies in Kyiv region that rated institutional quality of the majority of the elements of local institutional framework as good and very good proves that in the Capital region firms feel more comfortable within the regional institutional environment. The uneven regional economic development, being affected by the uneven quality of the regional institutional systems, is also proved by the fact that half of the firms rate institutional quality as bad in the bordering regions. Moreover, the results of the binary logit model prove that the probability of firms in Lviv and Kharkiv region rating institutional quality as good and very good is lower than the probability of firms doing so in Kyiv region. The Capital region also leads in terms of the reliability of oral contracts and agreements according to the descriptive statistics results, which together with higher overall institutional quality in Kyiv region would let us assume that the informal institutional component is as important as the formal one. Formal rules and laws seem to function when they fit with informal business culture. Thus, when the quality of formal legislations is high, it owes to some extent to the informal pre-established code of conduct, which contributes to the integration of formal institutions into the society. Higher institutional quality of the capital could be explained with a twofold reasoning. Firstly, the capital region in a transition economy is a commercial hub which concentrates the best developed infrastructure, established networks of customers and suppliers, access to knowledge and technological potential. In such a way the capital becomes the source of opportunities while attracting business actors from other regions, where the regional economic system is weaker. This leads to the emergence of the second reason, why the capital region outstrips the bordering regions, which results in the development of a better institutional environment in the latter. Being the high-income region, the capital attracts human capital, namely highly qualified employees and entrepreneurs, who can introduce their expertise in exchange for better work places and wider opportunities. Especially this concerns subsidiaries of MNEs, which are based in the capital, because this is where the better qualified people are. Except for highly knowledgeable migrants coming from the periphery regions to the capital for better opportunities, there is also a wide range of specialists pulled to the capital primarily due to better education opportunities. These are attracted by a better university and research networks in the capital. Therefore, highly knowledgeable human resources in their turn attract FDIs, seeking for experts in their fields. Provided all this, the regional economic system of the capital in a transition economy becomes the driver of the national economic system, which serves as an incentive for the government to support the development and growth of the capital. This leads to, on the one hand, introduction of such a business-friendly institutional environment in the latter, which positively impacts economic and business activities of its actors, leading to their better assessment of institutional

quality; and on the other hand, to the lagging behind of the bordering regions, which do not receive enough of the government support.

Central government support is consequently also directed mostly to the Capital region, which in such a way only negatively affects the differences in regional development. Thus, Lviv region, being less industrialized in comparison to Kharkiv region, seems to be the least supported by the central government. However, the regression results with Lviv region as control group show that only in terms of intellectual property rights protection Kharkiv region significantly differs from Lviv region, meaning that the probability of firms assessing positively intellectual property rights protection in Karkiv region is higher than in Lviv region. Therefore, we cannot accept our second hypothesis that Lviv region has higher institutional quality than Kharkiv region.

Industrialization of the Eastern part of Ukraine as the remains of the post-Soviet times seems to still have a legacy today, since it is more difficult to change already existing system rather than to create something new. Lack of motivation of the interested parties to transform the system of the past resulted in the government support of the existing system, which influences the formation of local business culture and therefore, informal institutional environment, impacting the economic development in the long run. The government support of the existing system results in preferential treatment of those firms located in the Eastern part of the country since these are the main economy generators. This results in neglecting potentially new sources of economic growth, such as close to the European Union Western part of the country, which is in a need of government support and business friendly environment. In such a way, there might be an institutional lock-in of the Eastern part of Ukraine at place, which could possibly serve as one of the reasons of uneven regional development of the country. On the other hand, we cannot argue that the Western region of Ukraine was not affected by the Soviet planned system, since the Soviet Union economy was all about equal national and regional economic treatment of its members. The only difference in the Soviet regulation of the East in comparison to the West of Ukraine was in the prioritizing of regions and sectors with regard to government support. This meant that while the Western part of the country was an agricultural center, the government was less interested to develop its economic and institutional infrastructure, since there was the more industrialized and strategic East serving as the first priority. This resulted in the existence of the remains of the Soviet legacy in both Western and Eastern parts of the country. What matters even more is how the national government treats different regional economic systems today. Central and regional government support being much more directed towards industrial East could be explained by the willingness of the state to get the maximum of the existing running system with established infrastructure and networks of firms, focusing on the hard industry as the driver of the economy. This seems to be the remains of the Soviet times, when supporting the old, possibly less efficient, system was chosen over creating a new source of economic wealth.

MNEs on general assessing institutional quality higher than domestic SMEs makes us reject our third hypothesis that foreign firms, being used to the global institutional quality standards, will be more affected by the inefficiencies of the local institutional environment of the host regions. The regression results show that domestic SMEs, specifically domestic new private firms, have the highest significant negative relationship towards positive assessment of institutional quality overall and different six aspects of institutional environment. This means that the lowest probability of assessing institutional environment as of good and very good quality belongs to domestic new private firms in comparison to greenfield FDI firms. This could be explained by our earlier line of argument that MNEs tend to create their own institutional environment. The fact that greenfield FDI firms rate the quality of institutional environment even higher than brownfield FDI group could possibly mean that foreign subsidiaries entering the host economy from scratch, i.e. aiming at building their own production sites, tend to introduce new customer-supplier networks, attract better government treatment since they provide substantial capital and technological base to the location, which all results in the emergence of a local microsystem around MNEs. This microsystem exists on the basis of a certain institutional environment the new comers create, which results in their better assessment of institutions, since the latter are adjusted to the needs of the MNEs. Moreover, larger firms are more likely to assess institutional environment as of high quality, which also could lead to a possible conclusion that larger firms get better embedded into local economic systems and benefit from it.

New private domestic firms, on the other hand, seem to be the most discriminated by the local institutional environment, which could let us assume that the government does not support domestic SMEs enough to introduce friendly institutional frameworks for the start-ups and young generators of economic wealth. This also could be explained by no willingness of the state to encourage and support the new system, which requires introduction of an institutional environment, which will foster the development of new domestic SMEs. The more precise focus of the state on attraction of MNEs as the sources of capital over support of national business agents impacts negatively entrepreneurship climate in the transition economy, which is one the main determinants of the SMEs development prospects in the country.

VII. Summary

The paper deals with the discussion of the interrelatedness of formal and informal institutions as the pre-requisite of the high quality institutional environment in a transition economy, regional differences of the quality of institutions and embeddedness of MNEs and domestic SMEs within local institutional frameworks. There is a conceptual framework developed after a theoretical discussion, based on the multiscalar approach to institutional co-dependence and integration of foreign subsidiaries together with domestic SMEs into the local institutional framework of a transition economy. The paper discovers both theoretically and empirically with the help of the results of the

enterprise survey carried out in Ukraine, firstly, the availability of subnational differences in the quality of institutions in Ukraine and secondly, the divergence of perceptions of MNEs and domestic SMEs towards the quality of local institutional environments.

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

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ANNEX 1

Table 1.1

Assessment of the quality of the aspects of institutional environment *by region*

	(Very) good	Neutral	(Very) bad	Chi-Test
Enforceability of legislation and regulation policies /n=457/				
Kyiv region	38,6%	25,9%	35,4%	***
Lviv region	17,4%	28,9%	53,7%	
Kharkiv region	21,3%	32,0%	46,7%	
Physical property rights protection /n=458/				
Kyiv region	41,1%	23,4%	35,4%	**
Lviv region	28,0%	30,0%	42,0%	
Kharkiv region	24,7%	30,0%	45,3%	
Intellectual property rights protection /n=457/				
Kyiv region	38,7%	25,2%	36,1%	***
Lviv region	18,1%	33,6%	48,3%	
Kharkiv region	25,3%	31,3%	43,3%	
Reliability of oral contracts / agreements /n=457/				
Kyiv region	39,2%	31,6%	29,1%	***
Lviv region	34,0%	38,7%	27,3%	
Kharkiv region	26,2%	27,5%	46,3%	
Central government support /n=456/				
Kyiv region	29,1%	29,7%	41,1%	***
Lviv region	10,7%	18,7%	70,7%	
Kharkiv region	10,8%	23,0%	66,2%	
Regional and / or local government support /n=456/				
Kyiv region	31,6%	31,6%	36,7%	***
Lviv region	24,7%	20,7%	54,7%	
Kharkiv region	17,6%	25,7%	56,8%	

Source: provided by author

Note: *Significant at the 0.10 level; **Significant at the 0.05 level; ***Significant at the 0.01 level.

ANNEX 1
Table 1.2

Assessment of the quality of the aspects of institutional environment *by type of ownership*

	(Very) good	Neutral	(Very) bad	Chi-Test
Enforceability of legislation and regulation policies /n=453/				
Brown field FDI	34,4%	36,6%	29,0%	***
Greenfield FDI	44,8%	20,7%	34,5%	
Domestic SMEs without FDI with post-Soviet context	23,4%	29,7%	46,9%	
Domestic new private SMEs	17,2%	27,0%	55,7%	
Physical property rights protection /n=454/				
Brown field FDI	38,7%	31,2%	30,1%	***
Greenfield FDI	50,0%	17,2%	32,8%	
Domestic SMEs without FDI with post-Soviet context	32,6%	25,6%	41,9%	
Domestic new private SMEs	20,7%	31,6%	47,7%	
Intellectual property rights protection /n=450/				
Brown field FDI	32,3%	34,4%	33,3%	***
Greenfield FDI	48,3%	10,3%	41,4%	
Domestic SMEs without FDI with post-Soviet context	28,6%	27,8%	43,7%	
Domestic new private SMEs	16,8%	36,4%	46,8%	
Reliability of oral contracts / agreements /n=453/				
Brown field FDI	30,1%	43,0%	26,9%	***
Greenfield FDI	55,9%	25,9%	19,0%	
Domestic SMEs without FDI with post-Soviet context	26,6%	33,6%	39,8%	
Domestic new private SMEs	32,8%	28,7%	38,5%	
Central government support /n=452/				
Brown field FDI	20,4%	31,2%	48,4%	***
Greenfield FDI	34,5%	25,9%	39,7%	
Domestic SMEs without FDI with post-Soviet context	18,1%	24,4%	57,5%	
Domestic new private SMEs	8,6%	19,5%	71,8%	
Regional and / or local government support /n=452/				
Brown field FDI	34,4%	28,0%	37,6%	***
Greenfield FDI	44,8%	22,4%	32,8%	
Domestic SMEs without FDI with post-Soviet context	25,2%	23,6%	51,2%	
Domestic SMEs private	12,6%	28,2%	59,2%	

Source: provided by author

Note: *Significant at the 0.10 level; **Significant at the 0.05 level; ***Significant at the 0.01 level.

ANNEX 1

Table 1.3

Assessment of the quality of the aspects of institutional environment *by region within ownership groups*

		(Very) good	Neutral	(Very) bad	Chi-Test
Enforceability of legislation and regulation policies /n=453/					
Brown field FDI	Kyiv region	50%	44,4%	5,6%	*
	Lviv region	40,0%	28,6%	31,4%	
	Kharkiv region	22,5%	40,0%	37,5%	
Greenfield FDI	Kyiv region	65,7%	14,3%	20,0%	***
	Lviv region	14,3%	35,7%	50,0%	
	Kharkiv region	11,1%	22,2%	66,7%	
Domestic SMEs without FDI with post-Soviet context	Kyiv region	39,6%	24,5%	35,8%	***
	Lviv region	8,7%	34,8%	56,5%	
	Kharkiv region	17,2%	31,0%	51,7%	
Domestic new private SMEs	Kyiv region	15,4%	28,8%	55,8%	n.s.
	Lviv region	9,8%	21,6%	68,6%	
	Kharkiv region	23,9%	29,6%	46,5%	
Physical property rights protection /n=454/					
Brown field FDI	Kyiv region	50,0%	27,8%	22,2%	n.s.
	Lviv region	40,0%	22,9%	37,1%	
	Kharkiv region	32,5%	40,0%	27,5%	
Greenfield FDI	Kyiv region	71,4%	8,6%	20,0%	***
	Lviv region	21,4%	35,0%	42,9%	
	Kharkiv region	11,1%	22,2%	66,7%	
Domestic SMEs without FDI with post-Soviet context	Kyiv region	41,5%	24,5%	34,0%	n.s.
	Lviv region	25,5%	29,8%	44,7%	
	Kharkiv region	27,6%	20,7%	51,8%	
Domestic new private SMEs	Kyiv region	17,3%	30,8%	51,9%	n.s.
	Lviv region	23,5%	35,3%	41,2%	
	Kharkiv region	21,1%	29,6%	49,3%	
Intellectual property rights protection /n=450/					
Brown field FDI	Kyiv region	33,3%	33,3%	33,3%	n.s.
	Lviv region	28,6%	34,3%	37,1%	
	Kharkiv region	35,0%	35,0%	30,0%	
Greenfield FDI	Kyiv region	65,7%	14,3%	20,0%	***
	Lviv region	21,4%	7,1%	71,4%	
	Kharkiv region	22,2%	0,0%	77,8%	
Domestic SMEs without FDI with post-Soviet context	Kyiv region	43,1%	21,6%	35,3%	**
	Lviv region	13,0%	32,6%	54,3%	
	Kharkiv region	27,6%	31,0%	41,4%	
Domestic new private SMEs	Kyiv region	17,6%	33,3%	49,0%	n.s.
	Lviv region	11,8%	43,1%	45,1%	
	Kharkiv region	19,7%	33,8%	46,5%	
Reliability of oral contracts / agreements /n=453/					
Brown field FDI	Kyiv region	38,9%	44,4%	16,7%	n.s.
	Lviv region	28,6%	40,0%	31,4%	
	Kharkiv region	27,5%	45,0%	27,5%	

Greenfield FDI	Kyiv region	60,0%	20,0%	20,0%	n.s.
	Lviv region	50,0%	42,9%	7,1%	
	Kharkiv region	44,4%	22,2%	33,3%	
Domestic SMEs without FDI with post-Soviet context	Kyiv region	34,0%	35,8%	30,2%	**
	Lviv region	23,4%	40,4%	36,2%	
	Kharkiv region	17,9%	17,9%	64,3%	
Domestic new private SMEs	Kyiv region	30,8%	30,8%	38,5%	**
	Lviv region	43,1%	35,3%	21,6%	
	Kharkiv region	26,8%	22,5%	50,7%	
Central government support /n=452/					
Brown field FDI	Kyiv region	38,9%	33,3%	27,8%	n.s.
	Lviv region	22,9%	28,6%	48,6%	
	Kharkiv region	10,0%	32,5%	57,5%	
Greenfield FDI	Kyiv region	54,3%	25,7%	20,0%	***
	Lviv region	7,1%	35,7%	57,1%	
	Kharkiv region	0,0%	11,1%	88,9%	
Domestic SMEs without FDI with post-Soviet context	Kyiv region	30,2%	34,0%	35,8%	***
	Lviv region	6,4%	14,9%	78,7%	
	Kharkiv region	14,8%	22,2%	63,0%	
Domestic new private SMEs	Kyiv region	7,7%	26,9%	65,4%	n.s.
	Lviv region	5,9%	11,8%	82,4%	
	Kharkiv region	11,3%	19,7%	69,0%	
Regional and / or local government support /n=452/					
Brown field FDI	Kyiv region	44,4%	33,3%	22,2%	**
	Lviv region	48,6%	20,0%	31,4%	
	Kharkiv region	17,5%	32,5%	50,0%	
Greenfield FDI	Kyiv region	57,1%	22,9%	20,0%	*
	Lviv region	28,6%	28,6%	42,9%	
	Kharkiv region	22,2%	11,1%	66,7%	
Domestic SMEs without FDI with post-Soviet context	Kyiv region	34,0%	34,0%	32,1%	***
	Lviv region	17,0%	12,8%	70,2%	
	Kharkiv region	22,2%	22,2%	55,6%	
Domestic new private SMEs	Kyiv region	7,7%	34,6%	57,7%	n.s.
	Lviv region	13,7%	26,5%	60,8%	
	Kharkiv region	15,5%	25,4%	59,2%	

Source: provided by author

Note: *Significant at the 0.10 level; **Significant at the 0.05 level; ***Significant at the 0.01 level