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Rule of Low as Factor of Investments in Ukraine

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Abstract:

Purpose: *The purpose of this article is to study the dependence of investments in the Ukrainian economy on two components of the rule of law, namely, the protection of property rights and the fight against corruption (according to the American Heritage Foundation).*
Design/Methodology/Approach: *Empirical assessments were made for two periods – 2000-2019 and 2010-2019, which aims to test the resilience of the obtained results to structural changes, which characterize the period after the global financial crisis of 2008-2009.*
Findings: *The inverse relationship between the monetary unit's devaluation (in nominal and real dimensions) and investments is very convincingly traced, which can be explained by the significant import intensity of investment goods and technologies. The received dependence means that any attempts to maintain the hryvnia's reduced exchange rate, as observed since mid-2020, threaten to stagnate domestic investments.*
Practical Implications: *According to the data of 2000-2019, it was found that more reliable protection of property rights can be considered as a factor of increasing investments, but the corresponding favorable effect weakens in the post-crisis period of 2010-2019. This corresponds to the empirical research for foreign countries, and at the same time, it allows to assert that the property rights had a stronger effect on the investments in the 2000s when state property was privatized and consolidated.*
Originality/Value: *The budget deficit clearly hinders investments, which can mean preferences for private consumption and raw materials branches. Money overhang, which is determined by the difference between the actual and trend values of the monetary aggregate M2, could stimulate investments in the 2000s, but in the post-crisis decade of 2010-2019 creates a clear negative effect.*

Keywords: *Rule of law, investments, exchange rate, cointegration.*

JEL Classification: *C22, E02, E22, K10.*
Paper Type: *Research study.*

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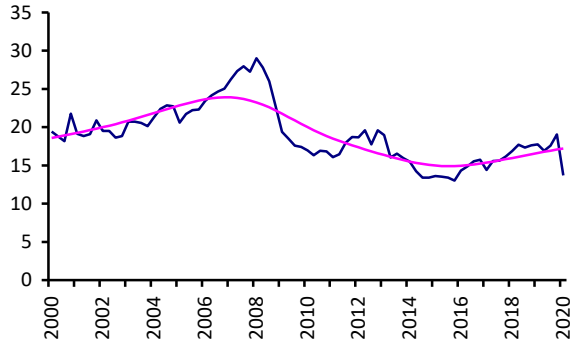
1. Introduction

Legal factors are no less important for the investment process than the regulatory environment or microeconomic stability. Despite the repeated attempts to improve the investment climate, the level of Ukraine investments remains low, which hinders the modernization of the economy and overcoming the structural deformities (Palyvoda, 2018). As experts state, the main reason for this situation is the lack of the rule of law, which entails insecurity of property rights (raiding), corruption of state bodies and local self-government bodies, instability of the regulatory base of economic activity, its focus on protecting the interests of domestic monopolists (Vlada i biznes v Ukrayini, 2019). Problems for investors are created by the judicial system's opacity and corruption in local and central authorities (Malko, 2015; Onishchenko, 2016). Political instability and fluctuations of exchange rates negatively impact exchange rates (Aksyonova and Novak, 2018).

To increase investment attractiveness, it is proposed to improve the legal protection of investors (Zeldina, 2018), improve the regulatory basis, and create an effective mechanism for counteracting corruption (Tereshchenko, 2015). With the change of government in July 2019, changes in tax policy were announced, to implement international standards of tax control (BEPS) and fulfill Ukraine's obligations under the Association Agreement with the EU, legislative initiatives to reduce pressure on business and strengthen protection of property rights (Vlada i biznes v Ukrayini, 2019). However, a radical increase in investment has not been achieved yet. As of the end of 2019, domestic investments amounted to only 19% of GDP, much lower than the pre-crisis values of 2000-2008 (Figure 1). With the onset of the COVID-19 crisis, another drop in investments was the third in recent years. Despite the significant number of proposals to increase Ukraine's investments, including legal and institutional factors, there is a lack of proper empirical assessments of the relevant functional relationships.

Figure 1. *Volumes of investments in Ukraine (% of GDP), 2000-2019.*



Source: *Calculated according to the IMF International Financial Statistics (www.imf.org/data).*

The purpose of this article is to study the dependence of investments in the Ukrainian economy on two components of the rule of law, namely, the protection of property rights and the fight against corruption (according to the American Heritage Foundation). The problem is relevant in terms of the need to find ways to intensify the investment process in Ukraine, which certainly involves a combination of macroeconomic and institutional (legal) factors.

2. Literature Review

The investment process depends on many factors. From the point of view of the rule of law, the legal basis's stability and the effectiveness of legal norms are important. In a broader context, it is influenced by the state of the economy, investment infrastructure, exchange rate, fiscal policy, the state of the financial and credit system, population savings, etc. (Tretyak, 2013). In Ukraine, ensuring property rights is called a critical point of state economic policy and tax reform and medium-term budget planning (Vlada i biznes v Ukrayini, 2019). Specifically, it is about reforming the state registration system of property rights and providing opportunities for judicial protection against raiding. It is proposed to introduce a registration system of property rights (Torrens title), to form the International Court of Justice in Ukraine, including the Appeals Chamber, to conduct privatization exclusively through open tenders, etc.

The Law of Ukraine "On Introducing…" adopted in October 2017, provides several novelties with both positive and negative consequences for investors (Zeldina, 2018). The positive ones include:

- the return of legislation to a three-level distance court system;
- unification of civil, economic, and administrative processes and coordination of the jurisdiction of these courts;
- delimitation of the competence of commercial and civil courts about claims for protection of business reputation.

At the same time, it is stated that the special legislation on protection of the investor's rights does not meet the goals of sustainable development, is outdated and declarative.

Foreign studies show the dependence of investments and closely related financial market infrastructure on protecting property rights and compliance with contract law (Beck and Levine, 2004; Haggard *et al.*, 2008). As provided by the Monterrey Consensus, the protection of investment (including physical and intellectual property rights) is a necessary condition for developing a healthy investment environment (OECD, 2006). Not only the legal system as such is important, but also the ability of legal institutions to adapt to changes in the environment. If such adaptation is slow, there is a serious shortage of capital, and therefore there is no opportunity to increase investments.

According to 423 firms from 12 developing countries, it was found that the protection of investors is more important than regulatory norms (Alan *et al.*, 2020). Similar results were obtained in another study for 29 developing countries (Korutaru and Biakpe, 2013). The inverse dependence of investments on entering the market was obtained for OECD countries (Alesina *et al.*, 2006). The rule of law factors promotes investments in China (Fu, 2019). On the other hand, non-compliance with contracts is associated with stagnation of Argentina's investment and income (Prados de la Escosura and Sanz-Villarroya, 2009).

The arguments about the negative dependence of investments on corruption, which is usually considered an integral component of the rule of law, are intuitively obvious when calculating the Heritage Foundation index (Heritage Foundation, 2020). Corruption reduces efficiency, raises costs, decreases productivity, and increases instability (Shleifer and Vishny, 1993). Accordingly, there are powerful obstacles to increase investments (Mauro, 1995; Méon and Sekkat, 2005), including reorientation to less productive activities (Dal Bó and Rossi, 2007). Corruption actions undermine firms' investments and innovations (Asiedu and Freeman, 2009).

On the other hand, corruption creates opportunities to accelerate investment decisions (Dirdi, 2013). Somewhat paradoxically, the effectiveness of corrupt practices is enhanced by the presence of "organized" crime, which reduces the overall financial burden and informational asymmetry that firms face in their local environments (Krammer, 2013). On the other hand, the efficiency of bribes is mitigated by formal and informal (trust) institutions' quality.

According to the data of more than 5,000 firms in 96 countries, it is revealed that corruption has a negative and significant effect on investment growth for firms in transition countries but has no significant impact on firms in Latin America and Sub-Saharan Africa (Asiedu and Freeman, 2009). Moreover, corruption is the most important determinant of investment growth for transition countries (among other variables, firm size, firm ownership, trade orientation, industry, GDP growth, inflation, and openness to trade are taken into account). According to Business Environment Survey (BEEPS) data for 2012–2013, corruption hinders investments, first of all, for innovation firms (Botrić and Božić, 2015). Estimates for Russia reveal a strong negative effect of corruption on aggregate investment in fixed capital, but not an investment made by state-owned companies (Zakharov, 2019). A negative impact of corruption on investment activity has been obtained recently, according to the data of firms from 90 developing and transition economies (O'Toole and Tarp, 2014).

Simultaneously, the relationship between the observance of the rule of law and investments has not been found for Turkey (Çeliköz and Arslan, 2010). In this country, the opposite is true: the quality of legal institutions improves as investments increase; that is, the causality is reversed. The authors conclude that legal factors may not have the expected favorable impact on the investment process

for low-income countries. In this context, it is stated that for the countries of the former Soviet Union, such an element of the legal status as corruption is less important for investments if a relatively high level of economic freedom is achieved (Kenisarin and Andrews-Speed, 2008). Using the BEEPS 2012–2014 database, it was found that corruption led to increased product innovation in Balkan and former Soviet countries, while these factors do not create any significant impact on innovation activity within Central European countries (Kuzman *et al.*, 2008). The favorable impact of the fight against corruption on innovation was obtained according to individual firms' data in 27 countries of Eastern Europe and Central Asia (Karaman, 2017).

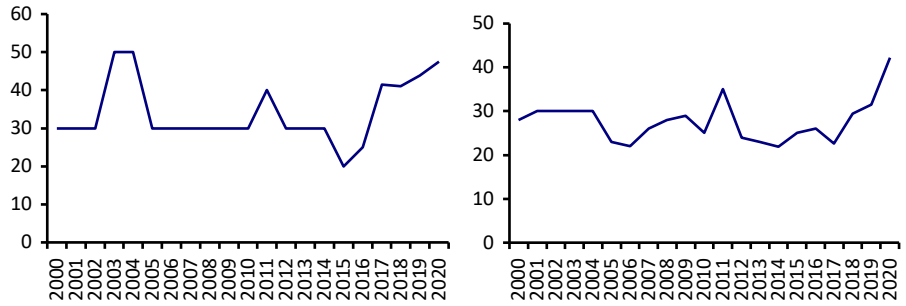
Another study from Eastern Europe and Central Asia for the period of 2002-2008 found that bribery could increase a firm's output and employment growth significantly while deterring that firm's labor productivity and innovation (Wu and Meeks, 2020). The stimulating effect of corruption is due to the reduction of time for access to productive resources. In post-Soviet countries, greater market competition increases the number of bribes paid (Dialby and Sylwester, 2015). In some works, the nonlinear nature of the link between corruption and investments for European countries is obtained (Pastusiak and Pluskota, 2017; Wen *et al.*, 2020).

3. Initial Data and Research Methodology

To study the impact of legal factors on the volumes of investments in Ukraine, investment (% of GDP), the indicators of property rights protection and anti-corruption from the Heritage Foundation, LAW1t, and LAW2t, respectively (in both cases, the situation in the country is assessed on a scale from 0 to 100, and increasing the values means better results), were used. Data for Ukraine show an improvement in law rule in both aspects over the last few years (Figure 2). During 2014-2020, the protection of property rights increased from 20 to 47.5, and the fight against corruption increased from 21.9 to 42.6. Current Ukrainian indicators can be compared with the values of LAW1t and LAW2t for several neighboring countries: Poland - 63.1 and 42.8; Romania - 72.5 and 56.1; Slovakia - 73.1 and 41.7; Hungary - 64.8 and 45.7; Belarus - 63.2 and 48.4; Moldova - 60.5 and 31.7; Russia - 56.8 and 44.4. Since the rule of law indicators from the Heritage Foundation are provided on an annual basis, the corresponding quarterly LAW1t and LAW2t data are obtained using the exponential smoothing method.

Additionally, the basic statistical model uses the exchange rate indicators, Et (UAH per dollar), and terms of trade, Tott, which is calculated based on the ratio of world prices for export goods (metals and agricultural products) and import goods (energy). In both cases of the exchange rate and terms of trade, it is a change in relative prices, which affects the value of imported investment goods and the structural proportions in the economy.

Figure 2. *Indicators of the rule of law from the Heritage Foundation, 2000-2019.*



a) protection of property rights; b) fight against corruption

Source: *Heritage Foundation (www.heritage.org/index).*

The extended model adds indicators of the budget balance, BDt (% of GDP), and the monetary overhang, which is the deviation of the monetary aggregate M2 from the equilibrium trend, M2Ct (%). To check the stability of the obtained results, the real effective exchange rate indicator RERt (index, 2010=100), which takes into account inflation and changes in the hryvnia exchange rate not only against the US dollar but also other world currencies according to the structure of export-import operations, was also used.

Statistical tests ADF (Augmented Dickey-Fuller Test) and PP (Phillips-Perron Test) show non-stationarity in the levels of all indicators of the base model, while their first differences are stationary (Table 1). This means the presence of the so-called unit root, or I (1). Instead, the budget balance indicators and money overhang (to a lesser extent) are stationary in levels, which is quite expected, as they do not assume the presence of a trend component. Nevertheless, both variables are included in the extended statistical model to study the resilience of the main functional dependencies to take into account the parameters of macroeconomic policy.

Table 1. *Unit roots test results*

Variables	ADF		PP	
	Level	Δ	Level	Δ
$INVEST_t$	–1.23	-7.85^{***}	–1.43	-7.97^{***}
$LAW1_t$	–0.28	-5.83^{***}	–0.64	-5.82^{***}
$LAW2_t$	–0.38	-5.85^{***}	–0.15	-5.84^{***}
E_t	–0.32	-3.31^{**}	–0.07	-6.17^{***}
RER_t	–1.57	-8.55^{***}	–1.73	-8.57^{***}
TOT_t	–1.97	-7.45^{***}	–2.17	-7.51^{***}
BD_t	-4.34^{***}	-12.53^{***}	-4.17^{***}	-13.41^{***}
$M2C_t$	-2.70^{*}	-9.33^{***}	-2.96^{**}	-9.36^{***}

Note: ****, ** and * mean rejection of null hypotheses at 1%, 5% and 10% level, respectively; Δ is the operator of first differences.*

Source: *Own elaboration.*

Since all basic model indicators have a unit root, that is I (1), the Johansen test for cointegration becomes necessary. The obtained results show the presence of at least one cointegration equation (Table 2). This means a strong long-term relationship between the volume of investments, the rule of law indicators, exchange rates, and trading conditions. Since the studied variables are non-stationary and cointegrated, this provides for estimating functional dependencies using one of the estimation methods for this type of data: FOLS or DOLS.

Baseline statistical model presents as follows:

$$INVEST_t = a_1 LAW1_t + a_2 LAW2_t + a_3 E_t + a_4 TOT_t. \quad (1)$$

It can be assumed that the protection of property rights is unequivocally favorable for investment ($a_1 > 0$), while the anti-corruption factor looks rather ambiguous ($a_2 <> 0$). Since in low-income countries, investment usually depends on imports of goods and technology, it can be assumed that the depreciation of the exchange rate has a negative impact ($a_3 < 0$). Redistribution of investments in favor of raw materials industries that are less technological and import-intensive, has a similar effect. Dependence on trading conditions does not seem straightforward ($a_4 <> 0$). If raw materials exports create useful spillovers for other sectors, investments can be expected to increase. However, in the case of crowding out investments from non-raw materials sectors, a negative effect can be expected, as the need for aggregate investments decreases.

***Table 2**. Johansen Test Statistics for $INVEST_t$, $LAW1_t$, $LAW2_t$, E_t, TOT_t*

Number of cointegrating equations		Trace Statistic	0.05 Critical Value	P-values	Max-Eigen Statistic	0.05 Critical Value	P-values
H_0: $r = r_0$	$r = 0$	107,95	69,82	0,00	82,58	33,88	0,00
	$r = 1$	45,37	47,86	0,08	24,35	27,58	0,12
	$r = 2$	21,02	29,80	0,35	12,28	21,13	0,52
	$r = 3$	8,74	15,48	0,39	8,40	14,26	0,34
	$r = 4$	0,33	3,84	0,56	0,34	3,84	0,56

***Source:** Own calculations.*

In the extended model, the inclusion of indicators of the budget balance and money overhang allows for various interpretations, which to some extent goes beyond this study, so let's limit ourselves to just two remarks. First, an increase in the budget deficit can be favorable for investments if we have significant public investments, or the reduction in taxes is transformed into an increase in investments. However, in the case of an "eating" budget deficit, we will have the opposite effect. Second, an increase in the money supply above some equilibrium value, determined by the demand for goods and services, may also be useful for increasing investments.

However, in the case of inflation expectations and concomitant expectations of hryvnia devaluation, a decrease in investments is more likely.

4. The Results Obtained

To empirically assess the factors of domestic investments, the method of dynamic cointegration regression (Dynamic Ordinary Least Squares - DOLS) was chosen, which better considers the lag structure of functional dependencies. Four lags and one leading period were used for all specifications, with constant included in the model. This assumption seems logical since the investment decisions are usually based not only on current but also expected and retrospective independent variables. Empirical estimates were made for two periods of 2000-2019 and 2010-2019, aiming to test the resilience of the obtained results to structural changes, which characterize the period after the global financial crisis of 2008-2009. Table 3 presents the corresponding estimates for two models, namely basic and extended. In all cases, the stationary residues, as shown by the ADF test, allow adequate interpretation of the obtained results. The coefficient of determination R2 shows higher explanatory power for the extended statistical model, including the budget balance and money overhang, but the corresponding value for the basic model is also high.

Estimates for the basic model show a favorable direct dependence between the compliance with the property rights and investments, which weakens in 2010-2019. Quite the opposite is true for the fight against corruption; that is, the dependence is inverse and intensifies for 2010-2019, when anti-corruption actions in Ukraine became more systematic and purposeful. Considering the instruments of economic policy, the inverse dependence of investments on the fight against corruption remains but becomes less significant from 2010 to 2019. Simultaneously, the direct relationship between the compliance with the property rights and investments disappears, but still is stored according to the data of 2000-2019.

***Table 3**. Long-term determinants of investments (considering the nominal exchange rate)*

Independent variables	Dependent variable – $INVEST_t$			
	Baseline model		Extended model	
	2000–2019	2010–2019	2000–2019	2010–2019
$LAW1_t$	0,199 (3,66***)	0,065 (2,13**)	0,218 (4,57***)	–0,007 (–0,206)
$LAW2_t$	–0,163 (–7,19***)	–0,295 (–2,28***)	–0,787 (–4,73***)	–0,177 (–3,09*)
E_t	–0,205 (–3,31***)	–0,033 (–1,40)	–0,190 (–4,01***)	–0,250 (–12,38***)
TOT_t	–9,145 (–3,05***)	–5,741 (–2,99***)	–1,920 (–0,50)	6,750 (4,58**)
BD_t	—	—	0,729 (4,34***)	1,732 (11,51***)
$M2C_t$	—	—	0,151 (2,08**)	–0,412 (–4,49***)
R^2	0,79	0,78	0,85	0,97
ADF	–5,65***	–5,86***	–7,01***	–7,76***

Note: ****, ** and * denotes statistical significance at 1%, 5% and 10% level, respectively.*
Source: *Own creation.*

The obtained results allow us to state that property rights had a stronger impact on investments in the 2000s when state property was privatized and consolidated. The inverse dependence on the fight against corruption can mean problems with public investments, like Russia (Zakharov, 2019), or gain from accelerating investment decisions (Dirdi, 2013; Wu *et al.,* 2020) or the ways to circumvent stringent regulatory restrictions (Krammer, 2013). On the other hand, the obtained results may reflect the domestic investment process's specifics, which remain opaque and dependent on various schemes. When anti-corruption bodies destroy such schemes, the volumes of investments decrease. It is noteworthy that almost half of the investments come from Cyprus, and most of them are Ukrainian money laundered with the help of offshore companies (Onishchenko, 2016). This feature does not indicate the high quality of the investment process, which does not contribute to overcoming the economy's raw material orientation. It can be assumed that the departure from the raw material model will affect the nature of the relationship between corruption and investments because innovations and investments in the technology sector mainly require the restriction of corruption (Fu, 2019; Wu *et al.*, 2020).

Improving trade conditions hinders increased investments in the basic model, but considering macroeconomic policy instruments, this dependence remains only for the 2000–2019 sample. For the post-crisis period of 2010-2019, the dependence between trade conditions and investments becomes favorable, indicating a greater raw material orientation of the domestic economy.

Regardless of the regression model specification and time sample, the devaluation of the hryvnia hinders the increase in investments (only in one specification such dependence lacks statistical significance). Improving the budget balance is unequivocally beneficial for investments, especially in the last decade. It can be assumed that the budget deficit hinders investments due to the expectations of price and monetary instability or inefficient redistribution of resources in favor of consumer spendings.

According to the obtained results, the money overhang could have been a factor in increasing investments in the 2000s, when the Ukrainian economy was being re-monetized, but recently the dependence has changed to the opposite. Most likely, this means that the excess of money supply creates expectations of accelerating inflation or (more importantly) devaluation of the hryvnia. The weakening of monetary policy does not lead to an increase in investments in Ukraine.

With the alternative indicator RER (Table 4), the positive impact of property rights protection on investments weakens (this result is preserved in only one specification). Simultaneously, there is an inverse dependence between progress in the fight against corruption and investments. There is also no objection to the inverse relationship between the exchange rate (considering inflation) and investments and the direct dependence on the budget balance, which looks very

stable in the extended model. Like the estimates with the inclusion of the nominal exchange rate Et (Table 3), in the post-crisis period, the dependence of investments on-budget surplus increases significantly.

***Table 4**. Long-term determinants of investments (considering the real exchange rate)*

Independent variables	Dependent variable – $INVEST_t$			
	Baseline model		Extended model	
	2000–2019	2010–2019	2000–2019	2010–2019
$LAW1_t$	0,160 (2,54**)	–0,030 (–1,15)	0,089 (1,57)	–0,028 (–0,43)
$LAW2_t$	–1,175 (–6,88***)	–0,212 (–2,11**)	–0,321 (–2,13**)	–0,616 (–5,18**)
RER_t	–0,038 (–3,90***)	–0,005 (–1,76*)	–0,107 (–4,89***)	–0,099 (–3,91**)
TOT_t	–6,476 (–1,83*)	–6,646 (–4,43***)	–3,627 (–1,12)	–4,776 (–1,69)
BD_t	—	—	0,725 (3,98***)	1,891 (8,83***)
$M2C_t$	—	—	0,054 (0,58)	–0,514 (–2,37*)
R^2	0,76	0,77	0,84	0,90
ADF	–5,14***	–5,70***	–6,59***	–7,11***

Note: ****, ** and * denotes statistical significance at 1%, 5% and 10% level, respectively; Student's t-Statistic in parenthesis.*
Source: *Own creation.*

The negative impact of the money overhang is preserved for the sample of 2020-2019, while the corresponding regression coefficient loses statistical significance for the longer sample of 2000-2019. In the extended model, the dependence of investments on trading conditions disappears, which can be explained by RER calculation's peculiarities, which consider price tendencies in the world raw material markets.

5. Conclusions

The study shows the long-term impact of certain components of the rule of law on Ukraine's investments, which does not seem straightforward. There are grounds to consider the improvement of the situation with the property rights guarantees as a factor of stimulating investments, especially for the 2000s, but the impact of anti-corruption measures seems quite the opposite. This somewhat unusual result can be explained by the easier access to resources through the participation in corrupt schemes or reduced investment time, as found in some studies. In a broader context, the "constructiveness" of corruption as a factor of the investment process highlights one of the major obstacles for developing technological industries, which mostly do not require corruption. The change of the dependence between corruption and investments from direct into inverse is a powerful challenge for the institutional reforms in Ukraine.

The inverse relationship between the monetary unit's devaluation (in nominal and real dimensions) and investments is very convincingly traced, which can be

explained by the significant import intensity of investment goods and technologies. The received dependence means that any attempts to maintain the hryvnia's reduced exchange rate, as observed since mid-2020, threaten to stagnate domestic investments. There is also no doubt about the negative impact of the budget deficit, which can be realized through the expectations of price and monetary instability or inefficient redistribution of resources in favor of consumer spendings. The money overhang could be useful for investments in the 2000s, but recently the impact has changed to negative. This means that calls for emission support of economic growth, which are also not lacking recently, will reduce investments. The dependence on trade conditions is mostly negative or neutral.

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