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Political origins of financial structure

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There is growing policy interest in the role of financial structure in promoting development. However, very little is known about how different financial structures emerge and evolve. In this paper we empirically assess the political origins of financial structure. Using difference–in difference estimation and annual data, we study the effects of democratization on financial structure in a sample of 96 countries covering the period 1970–2005. Democratization here corresponds to the event of becoming a democracy. We find that democratization leads to a more market-based financial system. Democratic change could also be incremental rather than a one off. To identify the effect of incremental democratic change on financial structure we estimate a separate model and find that democracy matters. We also find that countries with substantial democratic capital are more likely to have a market-based financial structure. Our main results are robust to a variety of controls, Arellano–Bond GMM estimation, alternative measures of democracy and financial structure, and across different samples. *Journal of Comparative Economics* **41** (4) (2013) 979–994. Department of Economics, University of Sussex, United Kingdom.

1. Introduction

The existence of well functioning financial markets are essential for overcoming the effects of information asymmetries and transaction costs that prevent the direct pooling and investment of society's savings. When financial markets work well, empirical evidence suggests that it is not only good for growth but also growth is more likely to be pro-poor (Levine, 2005; Beck et al., 2007). Even though there is growing consensus on the positive relationship between finance and development, a long standing debate however is on the relative virtues of bank-based and market-based financial systems. The success of market-based systems in the United Kingdom and the United States supports the viewpoint that market-based systems are superior in promoting growth and therefore should be adopted by the emerging market economies in Eastern Europe, Latin America and Asia. However, the role of bank-based systems in the industrialization of Germany and Japan provides a strong counter example. Cross-country evidence on the growth promoting virtues of one system over the other, on the other hand, remains inconclusive (Levine, 2002; Tadesse, 2002).

In spite of a growing policy interest on the role of financial structure in promoting development, very little is known about how different financial structures emerge and evolve. Broadly agreeing with this view Levine (1997, p. 702) writes, "We do not have adequate knowledge of why different financial structures emerge or why financial structures change?" In this paper we empirically assess the origins of financial structure. In particular, we focus on the role of political institutions. Political institutions and the quality of government could influence the nature of information asymmetries

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and transaction costs and shape financial structure. In a country with non-democratic political institutions the information gap between a politically connected investor and an average saver could be wider because the former could easily seek credit for a bad project using political connections and the latter would be completely oblivious of such risk. In such a situation, a bank-based system could serve better in solving the information problem. Furthermore, non-democratic governments could use their regulatory powers to create segmented monopolies for banks and thus creating a bank-based system. Banks in return could share a part of their rent resulting from regulated entry with the political elite (Haber, 2008). Such a bank-based system with restricted entry would also benefit the incumbent political elite as this would severely constrain credit access of their political adversaries. The monopoly arrangement between the banks and the political elite however would break down with more political competition as the regulatory and political cost of sustaining the monopoly would increase. As a result, a market-based financial system would start taking over from the monopolistic banks. In summary, theory predicts that democratic political institutions could be one of the major determinants of financial structure.

We find evidence that indeed democratic political institutions matter for financial structure. Using difference–in difference estimation and annual data, we study the effects of democratization or political liberalization on financial structure in a sample of 96 countries covering the period 1970–2005. Democratization or political liberalization here corresponds to the event of becoming a democracy. We find that democratization leads to a more market-based financial system. In particular, permanent democratization leads to one third of a sample standard deviation (=0.72, see column 1 Table 3) increase in the financial structure activity[1] measure. In other words, permanent democratization explains 69% of the difference in financial structure in the United States (a predominantly market-based country with a score of 0.42) and Germany (a predominantly bank-based country with a score of −1.46) in the year 1995.

Democratic change could also be incremental rather than a one off. To identify the effect of incremental democratic change on financial structure we use panel data covering the period 1970–2005 and 96 countries. We find that a one unit increase in the democracy score (which corresponds to a 20 point increase in POLITY2 scale) leads to 2.9 unit increase in the financial structure activity measure. This is indeed a large effect. The magnitude of the effect is 94% of the actual difference in financial structure between the United States (a market-based country) and Mexico (a bank-based country) in 1995. We also find that countries with substantial democratic capital are more likely to have a market-based financial structure. Democratic capital corresponds to a long history of democracy. Our main results are robust to a variety of controls, Arellano–Bond GMM estimation, alternative measures of democracy and financial structure, as well as across different samples.

We make the following contributions in this paper. First, we present an empirical analysis of the political origins of financial structure. By using difference–in-difference estimation in a macrocontext we are able to estimate the causal effect of democratization on financial structure. Furthermore, we are also able to estimate the effect of incremental democratic change on financial structure. Our results in this regard are novel. Second, we use panel data for our analysis which is a significant departure from the existing empirical studies on financial structure.

The literature on financial development and economic growth is large.[2] Recently some studies have also looked at the impact of financial structure on economic growth (Levine, 2002; Tadesse, 2002; and Chakraborty and Ray, 2006). The determinants of financial structure literature however are relatively small. To summarize, it is perhaps fair to say that the following four strands of thought stand out.

The first is the political institutions view of financial structure. The main idea is that non-democratic states create rent for the existing banks by using their political power and regulations to restrict entry. In return, the near monopoly banks share a part of their rents with the political elite. However the control of the banks over the financial sector diminishes with political competition as the political elite are no longer able to restrict entry (Haber, 2008; Wallis, 2008). Haber (2008) show that the above theory explains the difference in financial structure in the United States and Mexico. Political competition in the United States led to a better developed and market-based financial system. In contrast Mexican politics was dominated by a small number of Mexican born Spanish elite who restricted entry into the financial sector. The result was an underdeveloped bank-based financial system. Sylla (2008) also presents a similar explanation for American financial development. He argues that political unification, limited government achieved through horizontal and vertical separation of power, and strong leadership[3] helped achieve the 'financial revolution' in the United States in the late eighteenth century. We however could not locate an empirical study reporting systematic evidence on the role of political institutions in determining financial structure.

The second is the legal origin view of financial structure pioneered by La Porta et al. (1998). The principal idea behind this theory[4] is that the British justice system evolved to protect private property holders against the crown. As a result it puts a lot of emphasis on protecting the rights of the private property holder. In contrast, the French justice system evolved to reduce the discretionary power of the corrupt judiciary. Therefore the state chose to codify legal procedure as much as possibly to make the judiciary close to redundant. In the long-run this resulted into an increase in the power of the state vis-à-vis the individual. Therefore, private property rights are relatively weaker in the French legal tradition. Private property rights are crucial to financial development as it protects the rights of the investor. Therefore countries that have acquired British legal tradition through conquest, colonization, or imitation tend to have better financial markets than French legal tradition countries (La Porta et al., 1998; Beck et al., 2003). One can easily extend this theory to include financial structure as countries with better property rights

[1] Section 2 explains the financial structure activity measure. Also see Appendix A1.
[2] See Levine (1997) and Beck and Levine (2005) for a survey of this literature.
[3] Sylla (2008) highlights the role played by the first US Treasury Secretary Hamilton in engendering the 'US financial revolution'.
[4] This theory however is contested by many. See for example, Pagano and Volpin (2001) and Rajan and Zingales (2003).