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# Credit market frictions and political failure ☆

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ABSTRACT

We study how an excessively favorable regulatory environment for banks could arise even with a perfectly competitive credit market in a median voter world. In our occupational choice model with heterogeneous wealth endowments, market failure due to unobservability of entrepreneurial talent endogenously creates a misalignment between surplus maximizing reforms and reforms that are preferred by the median voter, who is a worker. This is in contrast to the world without market failure where the electorate unanimously vote in favor of surplus maximizing institutional reforms. This paper illustrates how market failure could lead to political failure even in the benchmark political system that is free from capture by interest groups.



## 1. Introduction

Capital market failures arising due to informational and institutional frictions prevent individuals and economies from reaching their full potential and can lead to poverty traps (Banerjee and Newman, 1993; Galor and Zeira, 1993). Similarly, governments can fail to implement surplus-maximizing policies due to political economy reasons, which we can refer to as *political failure*. However, the interplay of market failure and political failure is an understudied subject, and an important one for policy makers.

The political economy approach to development has emphasized how concentration of political power in the hands of an elite may allow the elite to distort the market outcome in their favour, and this typically leads to inefficiencies.[1] In this paper we highlight the reverse link, namely that market failure may lead to political failure even when political power is uniformly distributed.[2]

In our model, entrepreneurial talent and wealth endowments are independently distributed. When talent is unobservable there is adverse selection in the credit market, since the probability of repayment depends on the entrepreneur's talent. The competitive market responds to this imperfection by screening agents based on their collateralizable wealth.

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[1] This is most evident when elites lobby for barriers to entry (Djankov et al., 2002). Acemoglu (2003) makes the argument that concentration of political power may lead to distortion of the market through manipulation of factor prices in ways that benefit the political elites.

[2] For a discussion of somewhat different notions of political failure see Besley (2006).

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Thus, occupational choice (wage labor versus entrepreneurship) is affected by both endowments and general equilibrium prices. The Stiglitz and Weiss (1981) credit rationing problem for poor but talented agents and the de Meza and Webb (1987) over-lending distortion for agents who are neither poor nor talented can simultaneously exist in our economy. Some high-ability agents who would be entrepreneurs in a full-information world become workers as they are credit-rationed from lack of collateral. Conversely, some low ability agents who would be workers in a full-information world become entrepreneurs in a pooling equilibrium, where they receive the same interest rate as high ability entrepreneurs with the same collateral.

Asymmetric information about the quality of entrepreneurs generates a misalignment of interests between total surplus, which depends on the quantity and quality of firms, and the share of surplus going to workers, which depends only on the demand for labor determined by the quantity of firms. We show that this leads to preferences over policies that defeat surplus-maximizing reforms, even though markets are competitive and no group earns economic rents.

Given that the median voter in our economy is a worker and not an entrepreneur, the feasibility of an institutional reform depends on its effects on workers' welfare. We focus on two types of institutional reform: one aimed at improving the security of property rights in general, versus another aimed at facilitating the liquidation of assets used as collateral. A general property rights protection reform makes wealth more effective as collateral, inducing exit of low types and entry of high types. This is always desirable in terms of total surplus because it does not alter occupational choices. While this adjustment is efficient, its overall effect on labor demand, and consequently on wages, is ambiguous. As a result, these reform proposals may be blocked by the median voter.

The second type of reform helps banks directly by making liquidating collateral easier, which raises efficiency. It also indirectly raises labor demand by allowing expansion of loans to more firms, which leads to lower average firm quality. Therefore, even without invoking bankers' interest group power, liquidation reforms receive political support because they raise labor demand and wages. However, as we show, this is not always necessarily welfare enhancing. Excessive liquidation can reduce the quality of the pool of entrepreneurs, as rich low types crowd out poor high types.

On the one hand, a general property rights protection reform increases surplus but may not benefit the median voter. On the other, a banking reform always appeals to the median voter, but has an ambiguous effect on surplus. This is the main message of this paper – surplus maximizing policies may not be politically feasible while politically feasible policies may not be surplus-maximizing due to the effect of information asymmetries in the financial sector and its effect on the labor market via occupational choice.

In order to realign the median voter's incentives with total surplus maximization, a property rights protection reform should be accompanied by a redistributive scheme that eliminates the occupational choice distortions. The optimal redistribution mechanism needs to make taxes conditional on two things: occupational choice and collateral. If the government does not possess information about the value of collateral of different entrepreneurs, the only transfer mechanisms that are feasible are standard redistributive taxes without such conditionality. In this case we show that for countries that are poor in terms of aggregate wealth and human capital, the efficient reforms remain infeasible even when allowing for transfers. This suggests that when reforms are subject to political feasibility, the likelihood of surplus-maximizing reforms goes up with the level of development.

Instead of taking political classes or interest groups as exogenous and studying the impact of their alignment on various inefficiencies, we derive the potential inefficiencies in the political alignment directly from economic fundamentals, namely, the nature of technology and the informational environment in the economy.[3] Hence this paper differs from other models of endogenous policies in that the heterogeneity which causes households to choose inefficient policies is itself the endogenous outcome of asymmetric information.[4] Moreover, market failures and political failures may complement each other in generating economic inefficiencies.

In terms of the model of the economy, there are other papers that deal with occupational choice and financial development in a general equilibrium setting, but ours is the first paper to analyze the consequences for political alignments on property rights protection reforms.[5] Our result that efficient financial reforms are more difficult to pass by majority rule in economies with low wealth and low human capital may remind the reader of similar findings in Rajan and Zingales (2006). They show how low average levels of endowments can create constituencies that combine to perpetuate an inefficient *status quo* against educational reform. The main mechanism in our paper, namely the contrast between workers' welfare and total surplus when it comes to property rights protection, is present in a different form in Biais and Mariotti (2009), where the induced inefficiencies are on bankruptcy reforms.

The possibility of workers blocking technological improvements through unions has been studied (e.g., Schmitz, 2005; Alder et al., 2014), but the channel we emphasize highlights the pivotality of workers' political interests and preferences even when there are no unions.

The paper is organized as follows. We set up the basic model with credit and labor markets in Section 2, and characterize the equilibrium contracts and occupational choice in terms of ability and wealth given the informational and institutional

[3] In this regard, the mechanism that our paper identifies relates to a theme present in both Marxist and Neo-Classical theories of institutions, namely, economic forces shape the base over which the political superstructure is built. See Chapter 1 in Bardhan (1989) for a review of the common themes in these literatures concerning the theory of institutions.

[4] See e.g. Boyer and Laffont (1999), Perotti and Volpin (2004), and Caselli and Gennaioli (2008).

[5] See for example Ghatak et al. (2001, 2007), and Buera et al. (2011), and the references therein.