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Firm growth and political institutions☆

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ABSTRACT

Using a large sample of firms from 46 countries, we investigate the impact of political institutions on firm growth. We find that tighter political constraints stimulate firm growth and that this positive impact is more pronounced in weak legal environments. Our results are economically significant and robust to a number of sensitivity tests, including alternative proxies for political institutions, alternative measures of firm growth, additional controls, firm- versus country-level regressions, as well as when we address the endogeneity of political constraints. Our results suggest that reforms aimed at improving a country's political institutions can significantly impact firm growth, and that it is indeed through improved political institutions that firms are incentivized to invest in profitable projects.

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1. Introduction

Extant research posits that market imperfections create a wedge between a firm's internal and external costs of financing and thus constrain its ability to invest in profitable projects. The extent

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of these constraints differs across countries. According to the legal view of finance, cross-country variation in firms' cost of external financing is driven by the underlying legal and financial systems that firms face. Rajan and Zingales (1998), for instance, argue that financial development reduces firms' cost of external financing, which contributes to higher firm growth and in turn economic growth by allowing firms to channel increased external funds toward more profitable investments. Demirgüç-Kunt and Maksimovic (1998) empirically identify legal and financial system characteristics associated with the long-term financing of firm growth, and show that a greater proportion of firms use external financing in countries where legal systems score high on an efficiency index.

More recent studies (e.g., Milhaupt and Pistor, 2007; Keefer, 2008; Roe and Siegel, 2008; Choy et al., 2011; Boubakri et al., 2014) however, highlight the primacy of political institutions in driving financial development and hence cross-country differences in firms' cost of external financing.[1] For instance, Qi et al. (2010:204) observe that "...our understanding of how legal institutions impact financial development and economic growth may be incomplete." Empirical evidence supporting the primary importance of political institutions appears in Bhattacharyya and Holder (2014).

In this paper, we provide the first firm-level evidence on the importance of political institutions to firm growth, and on their interdependence with legal institutions in determining firm outcomes. We conjecture that political institutions influence firm growth even after taking into account the impact of legal institutions, as documented in Demirgüç-Kunt and Maksimovic (1998). Our understanding of the determinants of firm growth is crucial because it "[c]an provide insights into the dynamics of the competitive process, strategic behavior, the evolution of market structure, and even the growth of the aggregate economy" (Carpenter and Petersen, 2002:298). Additionally, understanding firm growth determinants is important for the policy implications one can draw from such analysis. Indeed, any insights into what constrains firm innovation and growth will help governments design appropriate policies to tackle these issues and create investor-friendlier environments where firms can strive to grow and contribute to overall economic growth.

Political institutions may *directly* affect firm growth through their impact on policy risk, that is, on uncertainty about future government policies. This conjecture follows Acemoglu and Robinson (2012) who argue that the quality of political institutions is an important determinant of the quality of contracting institutions and the economic policies chosen by politicians. Tighter political constraints (i.e., political institutions characterized by checks and balances) are related to a lower level of corruption. In countries with a less predatory government, firms do not need to shelter cash for fear of expropriation and hence are more likely to invest in profitable projects (Caprio et al., 2013). Moreover, tighter political constraints raise the cost of policy changes and thus allow governments to credibly commit to stable policies, further encouraging firms to invest (Stasavage, 2002). In contrast, weaker political constraints lead to higher policy risk, in which case investors and managers will be more wary of policy reversals (e.g., Gulen and Ion, 2013).

The above arguments suggesting that political institutions affect firms' propensity to invest and hence grow are echoed by the theoretical discussion put forward by Henisz (2004) on how discretionary policy-making (policy volatility or uncertainty) affects aggregate growth. The basic logic is that checks on governments impose constraints on government opportunism and secure property rights, which boosts investment, and therefore economic growth. The author further argues that "[c]hecks and balances on the discretion of policy-makers will be positively associated with policy stability, ceteris paribus" and that "[c]hecks and balances on the discretion of policy-makers will moderate the impact of macroeconomic shocks on policy outcomes" (Henisz, 2004:7). He concludes that "[t]he conventional wisdom that holds that political and institutional checks and balances that constrain policymakers' discretion serve to limit policy volatility and thus encourage investment and economic growth appears well founded. In particular, non-conventional forms of revenue generation and capital expenditure appear particularly sensitive to the structure of a nation's political institutions" (Henisz, 2004:17).

In addition to this direct effect, political institutions may affect firms' growth *indirectly* through a variety of country- (i.e., legal institutions, financial development) and firm-specific (e.g., market

[1] Throughout the paper, we use the terms *political institutions* and *political constraints* interchangeably.

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