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Growth, financial development, societal norms and legal institutions*

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Abstract

Do societal norms help to explain cross-country differences in financial development? We analyze whether societal norms, in addition to legal institutions, have an impact on financial development. In particular, we address the implications of the inclusion of societal norms on the analysis of the impact of financial development on economic growth. Our first conclusion is that societal norms indeed are important in explaining stock market capitalization, while this is not the case for the supply of bank credit. Secondly, the value added of including societal norms in models that explain financial development or, indirectly, economic growth largely coincides with the inclusion of formal institutions, like legal variables.

JEL classification: G15; K4; Z1

Keywords: Finance; Growth; Institutions

1. Introduction

There is a renewed interest in the old debate on the relationship between financial development and economic growth. A central issue in this debate is whether the development of stock markets or banks is more appropriate to promote economic growth. Nowadays, proponents of the so-called legal view of financial development argue that the distinction between a bank and a market-based financial system is as such irrelevant. For instance, Levine (1998,

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2000, 2001) and Levine et al. (2000), using cross-country data from La Porta et al. (LLSV hereafter, 1997, 1998) on differences in corporate law, regulation and law systems, show that it is more important to establish a general legal environment in which financial systems can operate efficiently. The legal view argues that only that part of financial development that is dependent on the legal system is important for fostering economic growth.

We examine whether the inclusion of societal norms should be considered in this type of analysis. We treat societal norms as candidate additional determinants of financial development and investigate whether both informal and formal institutions are relevant in explaining cross-country differences in financial development and its impact on economic growth. We do not attempt to provide a definite answer to the relevance of societal norms for financial development, but we merely want to point out that if institutions are thought to be relevant for financial development, it may be worthwhile to include informal institutions as well.

This paper is organized as follows. In the next section we explain why it is relevant to consider societal norms in explaining financial development. In Section 3, we discuss to what extent a cross-country classification based on societal norms differs from a classification based on legal indicators. This provides information on societal differences and similarities between and within legal origin groups. In Section 4, we present estimation results of the relevance of societal norms and legal rights in explaining stock market and banking development. In Section 5, we investigate the relevance of these norms together with legal institutions in explaining the importance of the (exogenous part of) financial development for economic growth. Section 6 summarizes and concludes.

2. Why consider societal norms in explaining financial development?

Culture is defined to be the collective programming of the mind, which distinguishes the members of one group or category of people from another. As known, culture is learned, not inherited. Cultural differences manifest themselves in various ways: the deepest manifestation of culture is the set of values. Values are broad tendencies to prefer certain states of affairs over others. Norms are the standards for values that exist within a group or category of people. More superficial differences in culture can be found in symbols and rituals. Values are at the core of economic behavior and could help explain differences in financial development and partly complement (or substitute for) the effect of legal indicators.

We propose to include societal norms in the analysis of financial development. One first argument to study societal norms in addition to, e.g. legal indicators comes from the interest shown by other studies in this field. For instance, Berglof and Von Thadden (1999) argue that countries can develop non-legal institutions, such as moral sanctions or worker participation in management, for stopping expropriation. Rajan and Zingales (2000) stress the role of the political structure rather than specific legal rules in explaining differences in the degree of investor protection. If other institutions than the legal ones emphasized in the LLSV-work matter, countries might be classified wrongly if the classification is based solely on the legal indicators as suggested by LLSV, and it is here that the potential relevance of informal institutions comes to the fore. The Netherlands, for instance, is classified in the French legal origin group and indeed shows weak investor protection. However, The Netherlands has a