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Law, regulation and institutions for financial development: Evidence from India

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ABSTRACT

This paper revisits the "finance–growth" thesis from the perspective of the determinants of financial sector growth such as legal and institutional developments and financial regulation in the Indian context. With the help of newly constructed indices of procedural law, regulation and institutional development, within a multivariate VAR framework, Granger causality tests and policy simulations are employed to investigate the long run causal relationships between the determinants and the financial sector. The results show that legal and institutional developments and financial deregulation cause financial sector growth with a considerable feedback and further finance causes economic growth.

1. Introduction

The finance–growth nexus has been one of the most vibrant research issues in economics in recent years. The basic question is whether financial sector causes economic growth or the causality runs the other way or whether there are any other factors that cause both financial sector growth and economic growth. Recent literature surveys conclude that financial sector is a catalyst for economic growth (Levine, 1997, 2005; and World Bank, 1989). Understanding the institutional environment for financial sector development has recently attracted considerable attention from both theorists and empiricists (Fergusson, 2006; Beck and Levine, 2003). One such school, 'Law and Finance', emphasises the differences in legal

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origin in explaining the difference in financial sector development across countries (La Porta et al., 1997, 1998, Djankov et al., 2007).

Empirical law and finance studies drawing from comparative law literature have made use of cross-country indices on shareholder and creditor protection to establish a positive relationship between law and finance (La Porta et al., 1997, 1998). Although the evidence shows that the quality of substantive law and judicial enforcement is weak in most of the developing countries, India, a common law country, has developed the substantive law on par with most of the developed countries. India fares well in both the indices particularly in the index of investor protection India is ranked among the most protected countries in the sample with a value of 5 out of 6 and 4 out of 4 in the index of creditor rights. However, India, with a relatively underdeveloped financial system, emerges as an outlier in cross-country regressions, which use an index of substantive Law on books as a measure of investor protection.

This result is paradoxical if one assumes that the law on books is implemented efficiently. One reason for poor financial sector performance could be weak enforcement of enacted law and inefficient procedural law (Visaria, 2006). Recent developments in law and finance literature emphasise on enforcement in assessing the strength of property rights protection and contract enforcement. If the recovery of bad debts is routed through courts, then enforcement problems will be associated with the efficiency of the judiciary measured by disposal rate and number of judges per population. Contrary to these strands of literature, recent phenomenal growth in Indian financial sector in the liberalisation era is despite of very little progress in the substantive law governing finance matters. Enforcement, measured by disposal rate and judges per thousand, has not improved either. This prompts us to look for 'something else' that might have led to this phenomenal growth.

We argue that the supporting structure i.e. the procedural laws, which help implement general laws in a manner that minimise the costs of implementation and speed up the process of redress, are important for efficient implementation of the Laws on the book. For example, from the developing country perspective, any procedural development that reduces the cost of availing legal services and swift contract enforcement would help in enforcing the institution of property rights protection, and, in particular, creditor and investor protection. Such supporting laws improve investor/creditor confidence in the system and increase the total credit advanced in a credit-constrained economy. Thus, a good substantive law, which is in the interest of the creditors, and *ancillary procedures* that help in the swift enforcement of the law on books would lead to lowering of the risks associated with lending and lead to higher external finance.

The thesis that having good supportive law is crucial to operationalize substantive law is illustrated by examining the legal developments pertaining to the financial sector in the Indian context. To capture the provisional innovations in the law pertaining to financial sector in India that makes enforcement quicker and the legal service cheaper, this paper constructs an index of procedural law development. Further to capture institutional development in India, we use the index of property rights protection provided by Heritage foundation and extend the financial repression index of Demetriades and Luintel (1997).

We hypothesise that legal, institutional and regulatory factors would act upon the financial sector and lead to economic growth. In doing so, the paper incorporates legal and institutional developments and regulatory measures into the model of long run relationship between finance and growth and examines the causal link, if any, in the Indian context. India is an interesting testing ground to analyze the long run impact of institutional developments, as there were significant legal, regulatory and institutional developments in the past decades.

This paper extends the literature on law and finance in two aspects. First, we construct country specific indices for India which captures enforcement and procedural changes, and regulatory environment and use standard institutional measures to capture specific details. Second, we utilise modern multivariate time series techniques such as Johansen's cointegration technique and Granger causality tests to test long run causal relationship between financial sector and it is determinants and eventually economic growth. Further, we reinforce the results obtained using conventional techniques by conducting counterfactual policy simulations.

The paper proceeds in seven sections. Section 2 begins with a brief review of the literature on law, financial development and its effect on growth and also identifies the gap in law and finance literature. Section 3 provides an outline of legal and regulatory developments in Indian financial sector. Section 4 elaborates on the variables used in the study and the methodology used for constructing indices of legal,