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Political Institutions and Financial Development: An Empirical Study

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Summary. — This paper examines whether political institutional improvement promotes financial development, using a panel dataset of 90 developed and developing countries over 1960–99. The empirical evidence reveals a positive effect of institutional improvement on financial development at least in the short-run, particularly for lower income countries. The preliminary evidence by a before–after event study indicates that a democratic transformation is typically followed by an increase in financial development.

Key words — political institutions, financial development, globalization, East Asia, Thailand

1. INTRODUCTION

Over the last few decades, there has been a substantial increase in financial development in many developing countries. The average ratio of private credit to GDP increased from 23% in 1980 to 32% in 2000, while the average ratio of liquid liabilities to GDP rose from 32% in 1980 to 42% in 2000 in developing world. On the political front, during 1980–2000 there were 62 developing countries undertaking significant institutional reforms toward democracies. [1] Do the above economic and political events in the developing world interact in important ways?

Much work has been done to explore the relationship between institutional improvement, especially political liberalization, and economic growth. The existing research in this field does not unanimously establish the consequences of political reform for economic development. Instead, it is made up of one line of research supporting positive consequences, another line stressing negative consequences and some maintaining ambiguous views. How does democratic process to improve institutional quality influence financial development, especially in countries with low GDP *per capita,* high ethnic and religious divisions, or specific legal origins?

The importance of institutional improvement for financial development has been implicitly indicated by Clague, Keefer, Knack, and Olson (1996) and Olson (1993), who argue that, in comparison with autocracies, democracies better facilitate property rights protection and contract enforcement, encouraging investment directly. In recent research on the political economy of financial development, Pagano and Volpin (2001), Rajan and Zingales (2003) and Beck, Demirguc-Kunt, and Levine (2003) highlight the role of political intervention and institutions in the financial development. In examining what forces lead government to undertake reforms to enhance financial development, Huang (2009) finds that the extent of democracy is one of the significant forces. However, there has been little research that directly studies the impact of democratic process for institutional improvement on financial development.

This analysis mainly carries out a dynamic panel data study, focusing on 90 developed and developing countries. It examines the impact on financial development of democratic process in a broader sense, in terms of institutional improvement rather than political transformation. [2] The bias-corrected Least Square Dummy Variable estimator proposed by Kiviet (1995) and recently developed by Bruno (2005) is the central method of this study and is compared with the system GMM estimator proposed by Arellano and Bover (1995) and Blundell and Bond (1998).

Before proceeding to the econometric analysis, this research provides some preliminary evidence with a before-and-after event comparison to study probably the most important institutional change, namely political transformation from an autocratic regime to a democratic regime. It focuses on 33 countries that underwent a democratic transformation during 1960–2000 subject to data availability for financial development. This exercise examines the responses of the level of financial development and the volatility of financial development after a regime transition.

This paper shows that improved institutional quality is associated with increases in financial development at least in the short run, especially for lower income countries, ethnically divided and French legal origin countries. The before and after event study also indicates that in general democratic transitions are typically preceded by low financial development, but followed by a short-run boost in financial development and greater volatility of financial development. The findings of this research underline the influence of institutional reform over the supply side of finance and shed light on the strong and robust relationship between institutional quality and economic performance.

The remainder of the paper proceeds as follows. Section 2 presents a brief review of the literature on institutions, democratization, and finance. Section 3 describes the sample and measures that are used in this study. Section 5 presents the empirical results followed by a description of dynamic panel data methods in Section 4. Section 6 concludes.

2. INSTITUTIONS, DEMOCRATIZATION AND FINANCE

This section briefly outlines the theoretical background and motivation of this research. It discusses the role of institutions in financial development and the possible links between democratic process and finance.

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Research on the effect of institutional reform on general economic performance is associated with substantial controversies. Some argue that the democratic process enhances fundamental civil liberties, stable politics, and an open society; promotes property rights protection and contract enforcement; discourages corruption and lawlessness, and fosters economic growth (Clague *et al.,* 1996; Minier, 1998; Olson, 1993; Persson, 2005). On the contrary, under pressures from different interest groups, democratic structures may suffer from inefficiency in decision-making and difficulty in implementing viable policies for rapid growth. "Premature" democracy in developing countries possibly lowers the economic growth rate, and even results in economic disorder, political instability, and ethnic conflict (Blanchard & Shleifer, 2000; Persson & Tabellini, 1992). Tavares and Wacziarg (2001) show that "the overall effect of democracy on economic growth is moderately negative"; more specifically, an increase in human capital accumulation is offset by a decrease in physical capital accumulation in the process of democratization.

Research on the role of institutions in financial development has been substantial, especially research on the effects of the legal and regulatory environment on the functioning of financial markets. A legal and regulatory system involving protection of property rights, contract enforcement, and good accounting practices has been identified as essential for financial development. Most prominently, La Porta *et al.* (1997,1998) have argued that the origins of the legal code substantially influence the treatment of creditors and shareholders, and the efficiency of contract enforcement. [3] Among others, Mayer and Sussman (2001) emphasize that regulations concerning information disclosure, accounting standards, permissible practices of banks, and deposit insurance do appear to have material effects on financial development.

Another significant work in this context is Beck *et al.* (2003), which extend the settler mortality hypothesis due to Acemoglu, Johnson, and Robinson (2001) to financial development. They argue that the colonizers, often named as extractive colonizers, associated with an inhospitable environment aim to establish institutions that privilege the small elite group and potentially ignore private property rights, while the colonizers, often named as settler colonizers, in more favorable environments are more likely to create institutions that support private property and balance the power of the state. Accordingly, institutions in the extractive environment tend to block financial development, while those in settler colonies are more conducive to financial development.

The recently developed "new political economy" approach regards "regulation and its enforcement as a result of the balance of power between social and economic constituencies" (Pagano & Volpin, 2001). It centers on self-interested policy makers who can intervene in financial markets either through overall regulation or individual cases for purposes such as career concerns and the promotion of group interests. Rajan and Zingales (2003) emphasize the role the interest groups, especially the incumbent industrial firms and the domestic financial sector, can play in the process of financial development. [4]

Arguably, countries controlled by elite groups are more inclined to protect the interests of elite from the bulk of society, restrict participation in the political system, and so on. The more power held by the elite groups, the more autocratic the system, the more obstacles for financial development. This tends to suggest that institutional reform intending to limit the influence of elite group over policy making, widen suffrage in the political system, respect basic political rights and civil liberties, remove institutional obstacles, and enhance institutional efficiency is beneficial to financial development. Girma and Shortland (2008) study the impact of democracy chrematistics and regime change on financial development, showing that both democracy and regime change promote financial development. [5] Apart from Girma and Shortland (2008), research directly exploring the impact of democratic process for institutional improvement on financial development has been lacking.

This research might contribute to our understanding of the structural determinants of financial development. Looking at this issue is also significant for examining whether institutional innovation contributes to an improved investment climate. This is because commonly used financial development indicators such as the ratio of liquid liabilities to GDP and the ratio of credit issued to the private sector to GDP are generally forward-looking. Better financial development is then an early indication of a better investment environment.

3. MEASURES AND DATA

(a) *The sample*

This research studies the impact of institutional improvement on financial development, controlling for GDP, trade openness, aggregate investment, and black market premium. The measures and data for financial development and institutional improvement are explained in more detail below. Information on the classifications of income levels, region dummies, ethnic fractionalization, and legal origins is obtained from the World Bank Global Development Network Database (GDN) (2002). The data for GDP, trade openness, and aggregate investment are from the Penn World Table 6.2. Data for the black market premium are from the GDN (2002).

This study focuses on a panel of 90 non-transition economies over the period 1960–99 with 5 observations per country. Averaging data over non-overlapping, eight-year periods enables us to abstract from business cycle influences and to examine both short-run and long-run effects. The countries included for this analysis are those undertaking some political reforms to improve institutional quality, but not necessarily experiencing a democratic transition over 1960–99. The sample excludes the East European countries, which became democracies and independent only following the end of the Cold War. [6] The selection of countries is based on the Polity index, "polity2" of the PolityIV Database explained below. We naturally use data up to the end of 20 century, which is partly because of data availability for some important variables, like black market premium, [7] and partly because annual data for 40 years are sufficient for a dynamic panel data study.

(b) *The measure and data for financial development*

The aggregate measure of financial development in this context is denoted by *FD*. Since there is no single aggregate index in the literature, we use principal components analysis to produce a new aggregate index. Ideally, the principal component analysis should be based on indicators from the banking sector, stock market, and the bond market so as to capture different aspects of financial development. However, data on stock market and bond market development are rarely available before 1975 or even later, so the analysis focuses on financial intermediary development.

The measure is based on three widely-used indicators of financial intermediary development and is as follows [8]:

1. Liquid liabilities (LLY), calculated as the liquid liabilities of banks and non-bank financial intermediaries (currency plus demand and interest-bearing liabilities) over