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The politics of financial development: The role of interest groups and government capabilities

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ABSTRACT

Although financial development is good for long-term growth, not all countries pursue policies that render full financial development. This paper builds on an extensive political economy literature to construct a theoretical model showing that the intensity of opposition to financial development by incumbents depends on both their degree of credit dependency and the role of governments in credit markets. Empirical evidence for this claim is provided, and the results suggest that lower opposition to financial development leads to an effective increase in credit markets' development only in those countries that have high government capabilities. Moreover, improvements in government capabilities have a significant impact on credit market development only in those countries where credit dependency is high (thus, opposition is low). This paper therefore contributes to this rich literature by providing a unified account of credit market development that includes two of its main determinants, traditionally considered in isolation.

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1. Introduction

Financial development, defined as the existence of deep and stable credit markets in an economy, is good for economic growth (Levine, 2005). An economy without credit cannot move forward (Levine, 1997; Levine and Zervos, 1998; Rajan and Zingales, 1998; Beck et al., 2000b; Levine et al., 2000). At the most basic level, credit is the mechanism through which savers connect to borrowers, enabling firms to carry out investment projects that are the basis for the process of capital accumulation. But credit does not only foster economic growth through investment. It also promotes productivity growth in a number of ways: by helping firms sustain long gestation periods when developing new technologies or processes (Aghion et al., 2005); by fostering a better allocation of resources across firms and economic sectors (Bencivenga et al., 1995; Jeong and Townsend, 2007; Buera and Shin, 2009; Arizala et al., 2009), and by reducing the incidence of informality, understood as lack of firm or worker registration, or tax evasion and social security registration avoidance (Catão et al., 2009). Finally, access to finance allows firms to cope better with macroeconomic volatility (Cavallo et al., 2009).

Why then do so many countries have low financial development? Literature stresses two explanations. One has to do with structural conditions that either limit demand or hinder the ability of some countries to meet rising demand (limited supply). Deficiencies in demand are determined by the stages of country development: economies in the early stages of industrialization and economic development do not have the need for deep and highly sophisticated financial markets. Deficiencies in supply are tied to underlying structural conditions of a society that create impediments for the formation viable financial sectors. A particularly influential strand of the literature in this current period focused on the role of the legal system. It may be the case that a country's legal framework, which is usually inherited from colonial times, significantly determines the extent to which the contemporary legal system protects minority shareholder and creditor rights, thereby conditioning the development of financial markets (La Porta et al., 1997).

Although compelling, some of the implications that arise from this set of explanations do not square well with the evidence, at least as unique explanations. For example, there seems to be quite a lot of heterogeneity in financial development across countries, even within the subset of countries with the same legal origin. At the same time, the history of financial development is one of advances and reversals, something that is hard to reconcile with the idea of structural determinants of financial development.

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Therefore, it is necessary to find theories that complement the structural views using more variable factors (Rajan and Zingales, 2003a).

Another strand in the literature looks at how the workings of political institutions shape political actors' incentives to provide financial development. The literature focused on two interconnected explanations. On the one hand, it concentrated on the role of interest groups as obstacles for financial development. In this way, incumbent interest groups that may see their profits eroded would oppose the policies that would foster financial deepening. The most cited work (Rajan and Zingales, 2003a) suggests that financial development might foster competition by allowing entry to credit-constrained firms, which weakens the position of incumbents, both in industry and in finance. In the industrial sector, for example, incumbent firms can provide themselves their own financing and thus prefer to limit credit in order to prevent others from entering, thereby limiting competition.[1] Rajan and Zingales (2003a) argue that this creates a compact political constituency against financial development. The incentives and strength of interest groups to fend off financial development will be lower the more open the economy is to both trade and finance. This hypothesis is supported empirically by the work by Baltagi et al. (2009).

On the other hand, as summarized in Haber et al. (2008), the government may also have the incentive to limit financial development in order to draw resources from banks and credit markets, regardless of the structure of interest groups in society. Consequently, even though favoring financial development may be welfare-enhancing, government officials in some countries may prefer maintaining a lax financial institutional environment, which does not promote credit, in case they need to draw funds from the system.[2] Governments would be less inclined to "play the system" (be more willing to improve financial regulations and lower restrictions for financial development) to the extent that fiscal and financial management capacities are greater.[3]

In this paper we build on these contributions and provide a unified political economy story of financial development that hinges on the interaction between heterogeneous interest groups and government policymaking capabilities. That is, first, we expand the research in Rajan and Zingales (2003a) by allowing incumbents to be heterogeneous in terms of their position regarding financial development to check if that may generate different attitudes towards greater credit availability.[4] This heterogeneity of incumbents comes from the fact that within an economy there are sectors that are intrinsically more dependent on credit (as developed originally in a previous article by Rajan and Zingales (1998)). Consequently, under some conditions, this heterogeneity in terms of how much each firm (in each sector) depends on the availability of credit generates heterogeneous behavior in terms of firms' positions regarding financial development. For those incumbents who are very dependent on credit, even though financial development may erode their profits by fostering competition, it may also boost their profits by providing them with cheaper resources to operate and expand their operations. If these sectors are big enough actors in the economy, then the response against financial development by the incumbents described by Rajan and Zingales (2003a) may be weaker or even altogether nonexistent. For the whole economy, the overall level of opposition to financial development that governments may face would depend on the combination of how dependent on credit the economic sectors in that economy are and the "size" of these economic sectors. In other words, opposition to financial development in a given country hinges on the relative size of the economic sectors that rely most heavily on financial credit.

Second, we combine incumbents' interests and their potential effect on policymaking with the ability of the government to avoid distorting financial markets financial development. Building on insights in Haber et al. (2008), we argue that in countries where governments have lower state capacities, public officials are more pressed to direct credit to finance their own operations, thereby curtailing credit flows to the private sector.[5] All in all, this implies that the availability of credit for the private sector—a key feature of financial development—will tend to be lower in lower-capabilities environments.

Therefore, our argument is that financial development should be higher in those countries in which interest groups might have a lower incentive to block its development and where the government has less need to abuse the financial system in order to finance its operations. Summarizing, our hypothesis is that the actual level of financial development observed in a given country at a point in time is the result of the interaction of these two factors.

In order to test this hypothesis we use sector-level panel data to build a cross-country dataset with proxies for the sizes of the interest groups that may have different attitudes towards financial development. We regress measures of financial development against these proxies, and also against measures of country-level institutional capabilities and their interaction.

To preview our results, we find that lower opposition to financial development will result in an effective increase in credit markets' development only in those countries which have high government capabilities and improvements in government capabilities would only have an impact in those countries in which credit dependency is high. In economic terms, as reported in Table 1, we find that an increase in a country's average credit dependency roughly equal to the difference in this measure between Ecuador and Belgium would imply an average increase in financial development between 0% and 25% of GDP, depending on the level of government capabilities. Similarly, we find that an increase in government capabilities roughly equal to the dif-

[1] In their analysis, they assume that incumbents are a homogenous group both in industry and the financial sector, and both prefer limiting financial development. Regarding the incentives for the latter group, the authors argue that financial institutions may prefer limiting financial development because they may lose certain "assets" such as "human capital" from the development of financial markets.

[2] Fry (1995) describes some of the mechanisms used by the government to finance its operations through the financial system, such as increasing reserve requirements, requiring institutions to hold government bonds at yields below the world market rate, and exploiting state-run banking institutions.

[3] Besley and Persson (2009) make a similar argument. Less developed economic institutions (lower tax revenues and lower financial development) are expected in those countries that have not been able to invest in increasing state capacities. Similarly, Bai and Wei (2000) and Dreher and Siemers (2005) argue that lower government capabilities, measured in terms of higher corruption, would also imply lower financial development because of the lower ability of the government to raise revenues.

[4] A recent paper by Braun and Raddatz (2008) also introduces heterogeneous incumbents—dividing them between promoters and opponents of financial development—and find this heterogeneity to be significant to explain financial development. As will be explained below, the main differences here are that: (i) we do not have to decide ex ante about how to split the groups, and (ii) we combine the role of the heterogeneity with that of government capabilities.

[5] Recent Argentine history on pension reforms provides a good example of government actions that may hinder the development of credit markets. One of the reasons why Argentina reformed its pension system in 1993 from a public pay-as-you-go system to one based on individual accounts, market capitalization and private management was to foster credit in the economy (e.g., by letting funds' managers invest the savings in the local stock market). However, successive administrations affected the original intent by forcing funds to hold a higher and higher share of public debt, which was affected by the default, and by finally scrapping the system and returning to a public PAYG system (see El Cronista (2009) for a chronology of events). In Chile, a country with higher government capabilities (Scartascini et al., 2008, 2009) the outcomes of the reform process have been the opposite (Rofman et al., 2008).

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