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Local financial development, socio-institutional environment, and firm productivity: Evidence from Italy

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ABSTRACT

This paper uses the case of Italy to investigate the effects of local financial and socio-institutional development on productivity. The analysis employs firm-level productivity data and exploits variations in banking sector development, judicial enforcement, and social capital across Italian provinces. After controlling for potential endogeneity, our empirical results suggest that the real effects of financial development are conditional on the quality of the socio-institutional environment. In particular, we find that the positive effects of greater financial depth on productivity are stronger when the socio-institutional environment is sufficiently developed. Therefore, to exploit potential productivity gains stimulated by financial development, it is necessary to achieve a higher-quality socio-institutional environment, including reducing the duration of civil trials.

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1. Introduction

When we observe substantial differences in output per worker among firms, it is important to know whether the causes are related to a lack of highly productive investment *opportunities* in the economy or to *barriers* that prevent firms from exploiting these opportunities.

Insufficient availability of credit is frequently indicated as a barrier to entry, innovation, productivity, and growth, and improved access to financial resources typically has positive effects on the performance of the real sector (for a survey, see Levine, 2005). However, there is evidence that certain of these relationships are non-linear and the effects of financial development might depend on several factors, such as the initial level of financial development (see for instance, Rioja and Valev, 2004a, 2004b; Coricelli et al., 2008).

The objective of this paper is to further explore the non-linearity of the effects of financial development. In particular, this paper gauges whether increasing availability of credit has differential effects on firms' productivity in areas with socio-institutional environments of varying quality (i.e., in areas with different productive opportunities).

We focus on the case of Italy, which is particularly appealing because Italy is characterized both by large differences in terms of income and productivity across provinces and by highly segmented local financial markets, as effectively documented by Guiso et al. (2004a, 2004b). Similarly, the efficiency of judicial enforcement, the presence of organized crime, and, in general, the level of social capital and the quality of institutions vary widely among Italian provinces. In particular, there is a sharp divide between the

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north and the south of Italy with respect to each of these factors. However, there is also significant variation within these two large regions that we are able to capture by analyzing information at the province level.

Our empirical analysis covers the 2000–2007 period, and we employ firm-level data for productivity and province-level data for the characteristics of the financial markets and socio-institutional environments. Our main results show that greater financial depth, measured as the ratio of bank credit to value added, has positive and significant effects on firms' productivity only in provinces with better socio-institutional environments.

In terms of policy implications, our main results indicate that socio-institutional development is a necessary condition to achieve returns in productivity from greater credit availability to the private sector. We characterize the socio-institutional environment with a composite index that includes variables for social capital, violent crime, and the quality of judicial enforcement, and we also focus in particular on how (and to what extend) the length of civil trials and bankruptcy proceedings condition the effects of financial development. Reforms aimed at improving judicial efficiency are high on the policy agendas of numerous countries, including Italy, and are typically viewed as a fundamental step in improving the enforcement of contracts. All else being equal, the results show that an increase in the availability of credit has a larger effect on firm productivity in provinces with shorter civil trials and bankruptcy proceedings.

Our findings indicate that the sequence of reforms is crucial, which is an idea that was previously suggested by Hausmann et al. (2005), among others, who emphasized that the timing of economic and institutional reforms i) determines the effectiveness of the reforms' impact on the economy and ii) depends on the initial context and the country's characteristics. Furthermore, reforms can be divided into two categories: those that affect barriers to economic growth and those that affect the opportunities for such growth. Removing barriers in an environment in which opportunities for growth are limited or absent will not be effective. Accordingly, reforms that aim to remove barriers to growth should be enacted either jointly with or after reforms that aim to make the environment conducive for the creation of business opportunities. In our analysis, as in Hausmann et al. (2005), reforms that affect the financial sector impact barriers to growth, whereas reforms that affect the socio-institutional context determine the set of growth opportunities.

The rest of the paper is organized as follows. Section 2 reviews the relevant literature and pays particular attention to empirical evidence. Section 3 contains our empirical analysis: in Section 3.1, we present the data and the model specification; in Section 3.2, we discuss the econometric strategy and the main estimation results; in Section 3.3, we show some robustness checks related to the use of different indicators for the quality of the socio-institutional environment; and in Section 3.4, we present the results related to the role of an efficient system of judicial enforcement. Finally, Section 4 concludes.

2. Credit, socio-institutional factors, and productivity: a background

The idea that the effects of local financial development on productivity are conditioned on socio-institutional development builds on earlier literature that focuses on the following issues: i) the role of financial development, ii) the direct role of socio-institutional development on productivity, and iii) the indirect role of socio-institutional development through its effect on the financial system. The objective of this section is to briefly review the previous contributions on which we base our testable hypothesis.

Numerous studies have shown the positive effects of financial development on several aspects of the real sector (see Levine, 2005 for a review). In this paper, we are interested in the relationship between the availability of financial resources in local banking markets and firm efficiency, as proxied by firm productivity.[1] Firms' adoption of new production processes or technologies depends on the availability of external finance, which is more easily accessible when banking markets, including those at the local level, are more developed. Credit availability allows firms to borrow and spread costs over time, which increases their efficiency and the likelihood that they will engage in innovation. Furthermore, deeper financial markets are typically associated with better screening of projects and entrepreneurs, which allows credit to be more appropriately allocated toward high-productivity firms (for a discussion, see Pagés, 2010).

Firms also typically suffer as a result of institutional underdevelopment (Beck et al., 2005). In this paper, we focus our attention on three socio-institutional dimensions: the quality of the judicial enforcement, the level of social capital, and the presence of criminal activities. These factors vary significantly across Italian territories and are relevant to explaining firms' productivity.

The quality of judicial enforcement influences transactions between private actors and between private actors and public institutions (see, for instance, Djankov et al., 2003; Claessens and Klapper, 2005). Better and faster court enforcement reduces uncertainty among the parties to a transaction and therefore reduces opportunistic behaviors and costs. Certainty in transactions allows firms to rely on a wide spectrum of relationship opportunities, even when personal or network interactions are not yet established between the parties. Previous studies have focused on a single country and have exploited local variations in the quality of the judicial enforcement to assess its effects on firm performance and productivity.[2] In particular, Ponticelli (2013) argued that firms face fixed costs when adopting technology and their capacity to pay the fixed costs depends on the quality of contractual enforcement by the courts. He studied Brazil and found that the introduction of improvements in bankruptcy legislation had a larger positive effect on firm productivity in counties with less congested courts (i.e., in counties with a higher-quality court enforcement).

Like the legal system, active social networks also reduce opportunistic behavior by enforcing informal norms (reputation), facilitating the dissemination of information and ideas, and encouraging cooperation among a network's members (Coleman, 1988).

[1] A greater quantity of (and easier access to) credit in local banking markets can also increase firm entry (Black and Strahan, 2002; Bonaccorsi di Patti and Dell'Ariccia, 2004; Cetorelli and Strahan, 2006) and innovation (Benfratello et al., 2008), which can ultimately improve the efficiency of the economic system and economic growth (Guiso et al., 2004a; Vaona, 2008; Hasan et al., 2009; Fernandez de Guevara and Maudos, 2009).

[2] See, for instance, Chemin (2012), who studied the effects of judicial reform implemented in India in 2002 and found that increasing the speedy disposal of civil suits resulted in fewer breaches of contract, encouraged investment, and facilitated firms' access to finance; and Laeven and Woodruff (2007), who analyzed the legal-economic framework in Mexico and showed that the legal system affects firm size by reducing idiosyncratic risk faced by firm owners.

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