Emerging Markets Review 13 (2012) 650–673

Contents lists available at SciVerse ScienceDirect

Emerging Markets Review

journal homepage: www.elsevier.com/locate/emr

Financial development and the evolution of property rights and legal institutions[☆]

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ARTICLE INFO

Article history:
Received 1 February 2012
Received in revised form 11 September 2012
Accepted 22 September 2012
Available online 29 September 2012

JEL classification:
F30
N20
O43

Keywords:
Property rights
Institutions
Financial intermediaries
Economic development

ABSTRACT

Using a panel of 129 countries over the period from 1965 to 2008, we examine the role of financial development in the evolution of property rights and legal institutions. We postulate that changes in the level of financial development change the costs and benefits of, and the demand for property rights institutions. We predict, and find, a positive causal relationship between the level of financial development and the subsequent quality of property rights institutions, even after we control for country level heterogeneity and reverse causality. Furthermore, our analysis suggests that this relationship is especially strong in emerging market countries.

1. Introduction

The literature on law and finance emphasizes the positive correlation between institutional development and financial development. The majority of the studies assert that the laws which protect property rights and promote the enforcement of financial contracts foster higher levels of financial development (La Porta et al., 1997, 1998; Levine, 1999; Levine et al., 2000; Acemoglu et al., 2002, 2005; Claessens and Laeven, 2003; Billmeier and Massa, 2009). In this paper we argue that the positive link between institutional development and financial development is due not only to the positive effects of institutions on financial development

☆ We would like to thank Chris Anderson, Bob DeYoung, Harold Mulherin, Annette Poulsen, seminar participants at the University of New Hampshire and the 2008 meetings of the Financial Management Association and the Southern Finance Association, for many useful comments. Any errors of analysis and interpretation are our own.
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1566-0141/$ – see front matter
http://dx.doi.org/10.1016/j.ememar.2012.09.005

but also can be explained, at least in part, by the effect of exogenous changes in financial development on the quality of institutions. Financial development itself has a *positive causal* effect on the quality of property rights and legal institutions in a country.

The framework for our study is the model of institutional change advocated by Demsetz (1967, 2008) and North (1971, 1981, 2005). This model of institutional change asserts that institutional innovations emerge when the social benefits of the innovations exceed the costs. Changes in the environment, or technology shocks, change the benefit–cost possibilities of different institutional arrangements and stimulate the demand for new institutions or changes to existing arrangements. In this paper, we argue that exogenous changes in financial development change the costs and benefits of particular institutional arrangements. In fact, our main hypothesis is that an increase in the level of financial development will lead to a demand for, and emergence of higher quality legal and property rights institutions.[2]

The intuition behind our argument is a simple one. On the benefits side, higher quality legal institutions increase the value of existing or potential financial arrangements (e.g., by lowering the risk and uncertainty). Property rights institutions generally require fixed costs to set up and maintain. However, once we have exceeded a threshold level of financial exchange within the economy, the cost of these institutions will be exceeded by the benefits and the society will evolve towards institutions that seek to capture these benefits. This process will lead to higher quality institutions. A simple example of this is the emergence of securities law (and enforcement). It is costly to set up and maintain institutions for enforcing the contracts and property rights involved in securities transactions, but once the securities markets have reached a tipping point, the benefits will exceed the costs. The institutions that emerge (with its supporting cast of lawyers, solicitors, investigators etc.) will make it less costly to improve the general quality of the institutions in the country as a whole. Exogenous change in the level of financial development could itself arise from technology shocks, an influx of groups with well developed financial networks, demographic shocks, etc. The underlying hypothesis of our paper is that if we control for the other historical, geographical, political, and cultural determinants of the property rights institutions, there should be a positive *causal* relationship between the exogenous changes in financial development and the quality of a country's property rights institutions.

We test our hypothesis using a panel of 129 countries over the period from 1965 to 2008. Our primary measure of financial development is PRIVATE CREDIT from the World Bank database and it equals financial intermediary credits to the private sector divided by the gross domestic product. We measure the quality of a country's property rights institutions using the Legal Structure and Security of Property Rights Index from the Economic Freedom of the World: 2010 Annual Report (Gwartney et al., 2010).

We find strong evidence to support our hypothesis of a positive relation between PRIVATE CREDIT and *subsequent* quality of property rights. For example, when we sort the countries into quartiles based on the change in the level of PRIVATE CREDIT between 1970 and 1985, we find that the quartile of countries that had the biggest increase in PRIVATE CREDIT subsequently had a significantly bigger increase in the quality of property rights in the period between 1985 and 2000, than the quartile of countries that had the biggest decrease in the level of PRIVATE CREDIT.

In our regressions we specifically address the two major endogeneity concerns that arise in our analysis—country level heterogeneity and reverse causality. First, we control for several country characteristics, which may jointly influence the quality of the property rights institution and financial development. These include the wealth of the country (GDP per capita), foreign aid, the size and scope of government spending, trade openness, the magnitude of foreign direct investment (FDI), access to sound money (money growth, inflation, freedom to own foreign accounts), regulation of credit, labor and business, legal origin, culture (dominant religion), politics (ethnic fractionalization, membership in OPEC), and geography (latitude). Second, we include country-fixed effects to control for unobservable heterogeneity across countries. Finally, we control for reverse causality using the dynamic panel GMM estimator of Arellano and Bond (1991), Arellano and Bover (1995), and Blundell and Bond (1998). Across all our specifications we find a significantly positive relation between PRIVATE CREDIT at any point in time and the quality of property rights institutions 5 years later. This association is economically significant. For example in our fixed effects specifications, we find that, on average, a 1 standard deviation increase in PRIVATE CREDIT is associated with a 0.1 standard

[2] Throughout this paper we define property rights institutions broadly construed as those legal, social and cultural institutions which enforce and arbitrate contracts between private parties, restrain the predatory power of the government over individuals and the predatory power of some groups of individuals over other individuals.