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Impact of the legal and institutional framework on the financial architecture of new economy firms in developing countries

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Abstract

This paper analyses the impact of the legal and institutional framework on the financial architecture of new economy firms in developing countries. Apart from the more conventional institutional and legal barriers, which are advanced by the recent law and finance literature, the analysis in this paper focuses on the importance of the information and communications technologies (ICT) environment, as a potentially important barrier to the development of the business sector in general, and new economy firms in particular. This analysis confirms the importance of this ICT environment for (a) the asset structure (and the creation of intangible assets), (b) for the financial structure, and ultimately, (c) for firm growth.

JEL: G31; G32; K10; O4
Keywords: Developing countries; New economy; Information and communications technologies; Law and finance; Legal constraints

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1. Introduction

The importance of the institutional and legal environment for the development of financial markets and economic growth only recently attracted attention of research in corporate finance, in particular the so-called law and finance literature. This new research area was initiated by the seminal papers of La Porta et al. (1997, 1998). These papers focused on investigating the relationship between a country's legal framework and its financial development.

In their first paper, La Porta et al. (1998) examine whether laws on investor protection differ across countries and whether these differences matter for corporate finance. Investors' rights, in La Porta et al. (1998), are both shareholder rights as well as creditor rights. The different bundles of rights to which an investor is entitled are determined by laws and are not inherent in the securities themselves, implying that legal rules matter. In line with comparative legal scholars, La Porta et al. (1998) classify the national legal systems of 49 countries into four families of law. [1] Their results show that investor protection is determined by the legal family to which a country belongs.

In a follow-up article La Porta et al. (1997) show that the legal environment is highly relevant for the size and extent of a country's capital markets. An investor is only willing to surrender funds to a company in exchange for securities, if he is protected against expropriation by management. A good legal environment, as measured by both legal rules and the quality of enforcement, therefore expands the ability of companies to raise external finance through either debt or equity. Using three equity measures (ratio of stock market capitalization to GNP, the number of listed domestic companies and the number of initial public offerings) their regression results show that low shareholder protection causes smaller equity markets as well as lower access of firms to external equity. Similar results are found with regard to the debt market. Using two different indicators, [2] their results show that debt finance is more accessible in common law than in French civil law countries. To conclude, La Porta et al. (1997) offer strong evidence that the legal framework has a large effect on the size and the breath of capital markets across countries.

Examining the impact of property rights and the enforcement of these laws using a sample of 39 countries, Claessens and Laeven (2003) extend the existing law and finance literature. Their empirical results not only show that weaker legal frameworks diminish the availability of external resources, but also show an asset-substitution effect, i.e. the investment in more fixed assets relative to intangible assets compared to firms operating in a strong legal environment, because of weaker

[1] Historically speaking, common law is case law developed by precedents from judicial decisions. Common law countries include the UK, the United States, Canada and British colonies. Civil law countries, on the contrary, are characterized by the codification of abstract rules and rely heavily on legal scholars. Civil law countries can be divided into three families: French (a.o. France, Belgium, Spain, Portugal and several Latin American countries), German (a.o. Germany, Austria, Czechoslovakia, Hungary, Italy and Switzerland) and Scandinavian.

[2] The total bank debt of the private sector and the total face value of corporate bonds, both relative to GNP.