

Chapter 1

Political Institutions and Financial Development

STEPHEN HABER, DOUGLASS C. NORTH,
AND BARRY R. WEINGAST

A broad consensus exists among economists that there is a strong positive association between the extent of a country's financial development and the material well-being of its population. There is also consensus that causality runs from financial development to economic growth: countries do not have large banking systems and securities markets because they are wealthy; they are wealthy *because* they have large banking systems and securities markets (King and Levine 1993a, 1993b; Levine 1997, 1998; Levine and Zervos 1998; Rajan and Zingales 1998; Levine, Loayza, and Beck 2000).

Considerably less consensus exists, however, when trying to understand why there is a high degree of variance in financial development across countries. If it is common knowledge that a key input to economic growth is a large financial system, then why don't poor countries simply create the conditions necessary for financial development?

Broadly speaking, scholars provide two answers to this question—which as shorthand we shall call the legal origins view and the political institutions view. The legal origins view argues that contemporary levels of financial development are largely determined by a country's colonial history: countries that were colonized by Great Britain, and that therefore adopted the legal institutions of British common law, provide better protection to minority shareholders and hence have larger financial systems than countries that adopted the French Civil Code. Politics and political institutions, according to this view, either do not matter (La Porta et al. 1998) or they

matter but are less important than legal origin (Beck, Demirgüç-Kunt, and Levine 2003; Levine 2005).

The political institutions view suggests that legal origin has little effect on financial development (Rajan and Zingales 2003; Acemoglu, Johnson, and Robinson 2004; Lamoreaux and Rosenthal 2005; Acemoglu and Johnson, forthcoming; see also North 1981, 1990). Rather, financial development is an outcome of specific laws and regulations, which are the product of politics and political institutions. At its core, the political institutions view is concerned with the government's inherent conflict of interest: the growth of banks and securities markets is not possible without a government that can enforce financial contracts; but the government relies on those same banks and markets to provide it with a source of finance. Unless there are self-enforcing political institutions that limit the government's authority and discretion, it will have strong incentives to govern the financial system so as to facilitate its own political survival, at the expense of the development of the securities markets and banking systems that can finance the private economy.

The resolution of the debate about the causes of financial development and underdevelopment is not purely an academic matter: the legal origins view and the political institutions view imply very different policy prescriptions. If the legal origins view is right, then financial system development can be accomplished by reforms to legal codes—in particular, by strengthening the rights of financial claimholders generally, including those of minority shareholders and creditors. If the political institutions view is right, then what is needed are far-reaching institutional reforms designed to limit the authority and discretion of public officials. In the absence of political reform, tinkering with legal codes might actually make countries worse off: the process of reform may allow vested interests to shape the new laws to their advantage, or newly empowered regulators might use their authority to behave opportunistically vis-à-vis private economic agents.

The essays in this book—the result of three years of research and discussion among the chapter authors and editors—come down on the side of the political institutions view. They do more, however, than take sides in a debate. Indeed, it has become commonplace in the social sciences to observe that “institutions matter.” The challenge taken up by the authors in this book is to explore *which* political institutions matter and *how* those institutions matter.

As the chapter by Richard Sylla makes clear, financial systems are composed of private banks, securities markets, a money supply, a central bank, and a system of public finance. Some of these entities, most particularly the

banks and the securities markets, tend to be predominantly under the control of private economic agents. The other entities—the money supply, the central bank, and the system of public finance—tend to be predominantly under the control of the government. None of these entities, however, operates in isolation from the others. For example, the government's system of public finance uses private securities markets to place its bonds. Similarly, the central bank often controls the number of corporate charters granted to private banks, as well as sets their reserve requirements and regulates their lending practices. Private banks, to cite another example, play a crucial role in the development of stock and bond markets: banks often serve as underwriters for corporate bond issues, and banks are often among the first corporations whose shares are traded on organized stock exchanges.

The implication is that the government can decisively influence the development of private banks and securities markets. For example, the government can force the banks to lend it their deposit base by establishing reserve requirements (and then increasing reserve requirements); grant corporate charters only to politically favored constituents; refuse to enforce financial contracts when the debtors are from politically crucial groups; or expropriate the holders of government securities by defaulting on the public debt.

Private investors, of course, are not potted plants. They know that their wealth is subject to expropriation if the authority and discretion of government are not limited by political institutions. In the presence of this risk, investors therefore behave accordingly: most will refrain from investing their wealth in banks, in public corporations, or in government debt, whereas a small portion may deploy their wealth but require compensation, in the form of high rates of return, for the risk of doing so. In short, the actions of private investors have implications for the amount of credit available to the government.

Governments and private investors interact to generate a broad range of institutions that affect the size and structure of the financial system. To cite an obvious example, when the authority and discretion of government are not limited by political institutions, bankers seek compensation for expropriation risk by demanding that the government constrain the number of bank charters it will grant. The government, needing a financial sector from which it can borrow, accedes to the demands of the bankers for regulated entry but, in turn, requires that the banks provide credit to the government. The result is a concentrated banking sector that earns monopoly rents—some of which are then shared with public officials as individuals (in the form of bribes) and with the government in general (in

the form of lines of credit at below market interest rates or in the form of bank shares granted to the government gratis) (see Haber, Razo, and Maurer 2003, chap. 4).

Limits on government discretion that are weak or not binding also have consequences for the enforcement of contract rights, and weak contract rights, in turn, have negative consequences for the development of banks and securities markets. The very same institutions that make property rights transparent and enforceable, and that allow private parties to enforce financial contracts—for example, up-to-date and accurate property registers, efficient police and courts—also facilitate the government's ability to expropriate property. In societies in which the authority and discretion of the government are not limited, individuals and firms not only have weak incentives to lobby for the creation of institutions that make their property rights transparent and enforceable but they also have strong incentives to frustrate the development of those institutions. The effect of weak property rights, of course, is that financial development is stunted: banks limit the types of contracts that they write and limit the range of individuals with whom they will write contracts; individuals tend not to purchase shares in corporations that are outside their direct control; and individuals and firms are reluctant to purchase corporate debt.

Precisely because political institutions are the key to the development of the banking systems and securities markets that finance the private economy, the essays in this volume focus on those political institutions and how they connect to the development of banks and markets. The following five chapters—by Haber, Sylla, Wallis, Keefer, and Barth, Caprio, and Levine—focus on how the political institutions that limit government affect the development of banking systems. The next three chapters—by Gourevitch and Shinn, Summerhill, and Musacchio—focus on how the political institutions that limit government affect corporate governance and the development of private stock and bond markets.

We begin with three chapters that use historical case studies to explore how political institutions and banking systems jointly evolved over time. The first of these, “Political Institutions and Financial Development: Evidence from the Political Economy of Bank Regulation in Mexico and the United States,” by Stephen Haber, traces the process by which the banking systems of the United States and Mexico developed from independence to 1913. Haber's analysis indicates that the major reforms in banking law in both countries were motivated by governments seeking sources of public finance, and that one feature of those government initiatives was constraints on competition.

The difference in long-run outcomes was not caused by differences in the motivations of the U.S. and Mexican governments but by the institutions that limited those governments. Attempts to constrain competition in U.S. banking failed because they were inconsistent with the competitive nature of the political system. Attempts to constrain competition in Mexico succeeded because the Mexican political system lacked the broad range of *mutually reinforcing institutions*—federalism, separation of powers, electoral suffrage, and party competition—necessary to constrain public officials. As a result, the Mexican government was able to structure the regulations governing banking so as to maximize short-run government revenues and permit rent seeking by public officials. In contrast, American officials faced a range of these institutional constraints that led to different outcomes. Whereas the centralized political control in Mexico allowed Mexican officials to create a system of segmented monopolies, the decentralized system in the United States created competition among jurisdictions and levels of government. Officials in the United States seeking to maximize revenue from the banking system were therefore led to create a competitive system.

The next two chapters, by Richard Sylla and John Wallis, focus on the U.S. case in detail. Both make a strong case for the pivotal role played by political institutions in the process of American financial development. Sylla's chapter, "The Political Economy of Early U.S. Financial Development," demonstrates that the political structure of the United States, as well as the leadership exerted by particular individuals, led the United States to a modern financial system beginning in the 1790s. He also demonstrates that changes in leadership resulted in financial reversals in the 1810s and 1830, even though the underlying legal institutions of British common law did not change.

Wallis's chapter, "Answering Mary Shirley's Question, or: What Can the World Bank Learn from American History?" continues this line of analysis, looking at U.S. financial development through the nineteenth century. He exploits the considerable variance across states to demonstrate that British legal origin did not inevitably lead American states to adopt policies that were positive for financial development. Indeed, American states experimented with many different ways of creating and regulating banks and developed new institutions that did not draw on their British inheritance. Initially, the American banking system was much like that of Mexico: a cartelized industry providing rents both to banks (as favored governmental constituents) and to the state. Competition among states, as noted, led over several decades to a more competitive banking system.

Do the results from these in-depth case studies travel beyond the U.S. and Mexican cases? Philip Keefer's chapter, "Beyond Legal Origin and

Checks and Balances: Political Credibility, Citizen Information, and Financial Sector Development,” employs large- n techniques to look at political institutions and financial development in cross section—and his results are broadly consistent with those that emerge from the country case studies. Keefer demonstrates that legal origin primarily proxies for political phenomena. His analysis also shows that variables that proxy political institutions come up as statistically significant even when controls for legal origin are introduced. Finally, he demonstrates that the influence of political institutions on financial development works, at least in part, through the security of property rights.

Governments that are not limited by institutions can behave opportunistically vis-à-vis private banks. From this it follows that much of the advice given by multilateral institutions to developing countries—they should strengthen the hand of bank regulators so as to promote financial development—might actually be counterproductive. In the context of weak limits on the authority and discretion of public officials, strengthening the hand of bank regulators might allow them to use their increased supervisory power to extract rents from banks or encourage banks to lend to politically favored groups. James Barth, Gerard Caprio, and Ross Levine test this implication econometrically in their chapter, “The Microeconomic Effects of Different Approaches to Bank Supervision.” They show that the traditional public interest view of regulation, in which regulators are presumed to be motivated by promoting social welfare, does not square with the evidence: rather, regulators are apt to be privately interested. In the context of weak limits on political officials, these authors conclude that regulatory systems that focus on information disclosure are more likely to promote financial development than regulatory systems that focus on strong supervision by government regulators.

The impact of political institutions extends beyond banking systems: they also affect the development of securities markets. We begin our discussion of the political economy of securities market development with a large- n analysis by Peter Gourevitch and James Shinn, “Political Drivers of Diverging Corporate Governance Patterns.” They question the dominant view, that the strength of minority shareholder rights is determined by legal origin, and demonstrate that legal family does not fully capture the political processes at work in the creation of the laws covering corporate governance. Their analysis indicates not only that a wide variety of institutions matter for a country’s approach to corporate governance but that these institutions change within countries over time.

If political institutions, rather than legal origin, determine the develop-

ment of financial markets, then it follows that we should observe the growth of securities markets in French Civil Code countries. We therefore turn to two case studies of Brazil. The first study, by William R. Summerhill, "Credible Commitment and Sovereign Default Risk: Two Bond Markets and Imperial Brazil," demonstrates that between 1824 and 1889 Brazil had a government whose authority and discretion were limited by formal political institutions. The Constitution of 1824 placed multiple veto points on the sovereign's ability to tax, spend, borrow, or default. In addition, beginning in the 1850s monetary policy was delegated to a quasi-private entity, the Banco do Brasil. The result was that the Brazilian government was able to borrow progressively larger sums at progressively lower interest rates.

The second study, "Legal Origin vs. the Politics of Creditor Rights: Bond Markets in Brazil, 1850–2002," by Aldo Musacchio, demonstrates that Brazil also developed an extremely active market for corporate bonds after 1890, when the rights of creditors were made even stronger than they had been during the 1824–89 period studied by Summerhill. Thus, regardless of the existence of a civil law system, turn-of-the-century Brazil had a larger corporate bond market than many contemporary European countries. It also had a larger market for corporate bonds than Brazil does today.

The chapters by Summerhill and Musacchio both explore why Brazil's bond market ultimately fell apart. Summerhill argues that the erosion of limits on government after the military coup of 1889 meant that the government could borrow and spend without check. Ultimately, this lack of checks damaged the quality of Brazilian sovereign debt issues. Musacchio further points out that creditor rights were diminished after 1930, when Getulio Vargas came to power via another military coup. Bondholders no longer had primacy in the case of corporate bankruptcy: they came behind workers and government tax liens. The net result was that private markets for debt dried up.

The final chapter, "Conclusion: Economics, Political Institutions, and Financial Markets," by Douglass C. North and Mary M. Shirley, ties together many of the themes that run through the eight preceding chapters. They point in particular to three issues. First, politics and political institutions, rather than legal origin, appear to be determinative of financial development. Second, countries undergo both financial revolutions and financial reversals, as the Brazilian case illustrates. Third, there tends to be congruence between the openness and competitiveness of political systems and the openness and competitiveness of their financial systems.

The implications of the themes highlighted by North and Shirley are far reaching and have obvious implications for developing countries. They

suggest, for example, that China's combination of competitive markets and repressive style of government is inherently unstable and that one or the other will change. They also suggest, however, that the creation of a competitive political system is not a phenomenon that is well understood by social scientists. In short, they suggest that the essays in this volume should not be taken as the last word on the political economy of financial development but should be taken as a call for a turn toward more microlevel analysis of the politics and economics of economic change.

References

- Acemoglu, Daron, and Simon Johnson (Forthcoming). "Unbundling Institutions." *Journal of Political Economy*.
- Acemoglu, Daron, Simon Johnson, and James Robinson (2004). "Institutions as a Fundamental Cause of Long Run Growth." In Philippe Aghion and Steve Durlauf, eds., *Handbook of Economic Growth*. Amsterdam: North-Holland.
- Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine (2003). "Law and Finance: Why Does Legal Origin Matter?" *Journal of Comparative Economics* 31: 653–75.
- Haber, Stephen, Armando Razo, and Noel Maurer (2003). *The Politics of Property Rights: Political Instability, Credible Commitments, and Economic Growth in Mexico, 1876–1929*. Cambridge, UK: Cambridge University Press.
- King, Robert G., and Ross Levine (1993a). "Finance and Growth: Schumpeter Might Be Right." *Quarterly Journal of Economics* 108: 717–38.
- (1993b). "Finance, Entrepreneurship, and Growth: Theory and Evidence." *Journal of Monetary Economics* 32: 513–42.
- Lamoreaux, Naomi, and Jean-Laurent Rosenthal (2005). "Legal Regime and Contractual Flexibility: A Comparison of France and the United States during the Era of Industrialization." *American Law and Economic Review* 7: 28–61.
- La Porta, Rafael, Florencio López-de-Silanes, Andrei Shleifer, and Robert W. Vishny (1998). "Law and Finance." *Journal of Political Economy* 106: 1113–55.
- Levine, Ross (2005). "Law, Endowments, and Property Rights." *Journal of Economic Perspectives* 19: 61–88.
- (1998). "The Legal Environment, Banks, and Long Run Economic Growth." *Journal of Money, Credit, and Banking* 30: 596–620.
- (1997). "Financial Development and Economic Growth: Views and Agenda." *Journal of Economic Literature* 35: 688–726.
- Levine, Ross, Norma Loayza, and Thorsten Beck (2000). "Financial Interme-

diation and Growth: Causality and Causes.” *Journal of Monetary Economics* 46: 31–77.

Levine, Ross, and Sara Zervos (1998). “Stock Markets, Banks, and Economic Growth.” *American Economic Review* 88: 537–58.

North, Douglass C. (1990). *Institutions, Institutional Change, and Economic Performance*. Cambridge, UK: Cambridge University Press.

——— (1981). *Structure and Change in Economic History*. New York: W. W. Norton.

Rajan, Raghuram G., and Luigi Zingales (2003). “The Great Reversals: The Politics of Financial Development in the 20th Century.” *Journal of Financial Economics* 69: 5–50.

——— (1998). “Financial Dependence and Growth.” *American Economic Review* 88: 559–86.