Duisenberg school of finance - Tinbergen Institute Discussion Paper

TI 13-034/IV/DSF53

# The Political Economy of Finance

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**The Political Economy of Finance**[1]

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February 2013

Abstract

This survey reviews how a recent political economy literature helps explaining variation in governance, competition, funding composition and access to credit. Evolution in political institutions can account for financial evolution, and appear critical to explain rapid changes in financial structure, such as the Great Reversal in the early XX century, unlike time-invariant legal institutions or cultural traits. Future research should model the sources and consequences of financial instability, and to predict how major redistributive shocks will shape regulatory choices and financial governance.

Introduction

In the literature inspired by North (1980), economic exchange is shaped by political, legal and cultural institutions. Institutions are combinations of formal norms and informal "rules of the game", highly persistent because deeply embedded in social expectations. These rules complement contracts and laws in allocating value and risks across transacting parties, and thus economic incentives to cooperate as well as to invest.

The quality of institutions can explain economic renewal and growth across countries through the formation of productive capital in all its forms. Thus real investment, financial development, technology and education (as accumulated human capital) are endogenous "manifestations" of growth, rather than primary determinants.

[1] This paper owes most to Steve Haber. I also thank comments from many readers, in particular Ross Levine, Andrei Shleifer, Bernard Yeung, Marco Pagano, Atif Mian, Bruno Biais, and Nicola Gennaioli. All errors remain my responsibility.

Keywords: political institutions, property rights, investor protection, financial development, access to finance, entry, banking. JEL codes: G21, G28, G32, P16

What institutions are critical for finance? Financial contracting enables a separation of ownership and control, separating income and control rights over assets and allowing diversification and specialization. Thus protection of investor rights is necessary to induce savers to invest, and affects the size of intermediated capital as well as its composition and allocation. Prudential regulation has a complementary role, containing any negative spillovers for the rest of the economy.

What institutions shape the financial rules of the game? The literature has identified three main candidates: legal, cultural, and political institutions (La Porta et al, 1998; Acemoglu and Johnson, 2005; Rajan and Zingales, 2003a; Guiso, Pazienza and Zingales, 2004). The contributions of different type of institutions are hard to disentangle, as it is in part a matter of definitions.[2] Investor protection requires legal rules but also enforcement, and thus supporting political institutions. Legal origins has been proposed as a shaping cause (LaPorta et al 1997, 1998). While none disputes the evidence on larger capital markets nowadays in common law countries, the arguments and historical interpretation why they may be better at supporting finance are very controversial. LaPorta ea (2008) now favor a cultural interpretation, and "adopt a broad concept of legal origin as a style of social control of economic life".[3] Persistent cultural values such as religion or social capital do appear to affect financial development, eg by providing trust and social support for contractual enforcement or resistance to abuse (Stulz Williamson, 2003; Guiso et al, 2004; Licht et al, 2011). As there are extensive reviews (e.g. Beck, Demirgüç-Kunt Levine, 2003, Acemoglu Johnson, 2005, LaPorta et al 2007), this review will focus on identifying distinctive effects of political institutions on financial structure. This is understood as a broader concept than financial development, usually defined as capital market scale, since it includes breadth of access, competition and stability issues.

Our starting insight is that time-invariant institutions, such as legal origin and persistent cultural characteristics make them poor candidates to explain phases of rapid

[2] Contractual enforcement requires both legal rules and executive support. Judicial review may be equally seen as a legal or a political institution limiting government discretion. Ideological preferences may reflect economic interests as well as cultural values. Informal political institutions include cultural attitudes facilitating citizen mobilization against abuse.

[3] This is consistent with evidence that voluntary adoption of legal codes has stronger effects than their imposition by conquering colonial powers (Berkowitz Pistor Richard 2002).

financial evolution.[4] Evolution in political institutions has long been seen by historians as natural candidates to explain the emergence (and decline) of modern banking and public debt in free Italian cities during the Renaissance, the earlier development of financial activities in the Netherlands and Britain relative to more autocratic European countries (North and Weingast, 1989; de Vries and van der Woude, 1997), or even the involution of private corporations in Ancient Rome in the transition from the republican system to the empire **(**Malmendier, 2005). This view is here summarized and complemented by recent economic insight on how major shocks have different impact on financial structure depending on the underlying political institutions (Rajan Zingales 2003; Acemoglu et al 2005; Perotti von Thadden 2006; Dari-Mattiacci et al, 2013).

We first review conceptual models on how the distribution of political power affects finance. The starting point is the insight that an unconstrained autocracy undermines financial accumulation (North and Weingast, 1986). Historically, once royal power becomes subject to the law, only a small economic elite becomes enfranchised. This phase of financial development exhibit limited competition, preferential access and limited entry (Acemoglu 2008; Perotti Volpin 2012). Over time, political broadening under the pressure of emerging groups promotes more intermediated savings as well as broader access to credit (Benmelech Moskowitz 2007; Rajan Ramcharan, 2011).

While broader participation tends to lead to market deepening, the relationship is not necessarily monotonic. Financial structure differs markedly across democracies, only in part explained by legal differences (LaPorta et al, 1997, 1998). Structural differences actually broadened in the early XX century (Rajan Zingales 2003), when the distinction between market- and bank-based systems emerged, leading to the "Varieties of Capitalism" view in political science (Soskice and Hall, 2001). Recent models of democratic choice provide testable interpretations, relevant as they are able to explain observed variation also across civil law countries. Broader suffrage makes median income voters the pivotal group. Political factors such as the electoral system or wealth distribution shape political preferences and government decisions on regulation and investor rights (Pagano Volpin, 2005; deGryse, Lambert and Schwienbacher 2012). A

[4] Of course, legal rules and laws do evolve in response to economic pressure (Horwitz 1976) and thus act as a proximate cause of financial evolution. A purely functional view of legal change should be balanced by the degree of legal autonomy (Harris 2000), related to political institutions constraining executive power.

majority in a more unequal society may prefer a more corporatist model to limit competition and risk and more solidaristic solutions, e.g. delegating long term savings to a state pension system (Perotti von Thadden 2006; Perotti Schwienbacher 2011). Such a political majority may arise from an alliance of inside capital and inside labor prevails over dispersed investor and consumer interests (Pagano and Volpin, 2005). We review how these interpretations have been validated by studying how variation in redistributive shocks across countries relate to subsequent financial reversals.

This survey does not set out to cover the literature on financial development and economic growth (Levine, 2004), nor the lobbying models in the public choice literature, nor normative explanations of financial structure. It is beyond its scope to explain the roots of political institutions or their evolution.[5] It does not seek to disentangle political ideology from economic preferences. Ideologies at the extreme of the political spectrum share a preference for limits to free trade and competition. Inside labor and inside capital may form corporatist alliances against small investors (Pagano Volpin, 2005; Pagano Volpin, 2006), just as right wing governments may distort financial market outcomes to ensure re-election (Aghion Bolton 1990; Biais Perotti 2002).[6]

In Section One we discuss the emergence of limited government as the creation of safe property rights for at least a subset of the population, and as a precondition for financial development. Section Two discusses constrained regimes as political participation increases. Section 3 focuses on variation in financial structure among representative democracies.

[5] Initial conditions, such as legal origin or climate have been proposed (LaPorta et al, 1997, 1998; Engermann and Sokoloff 1997, 2002; Acemoglu et al 2001). Political evolution is often explained as a response to competitive pressure, either from internal opponents (Acemoglu Robinson 2006) or from external political or economic competitors (eg Keyssar 2000). External shocks, whether negative (wars) or positive (trade and technological revolutions) may also strengthen specific interests (eg. Rajan Zingales 2003; Acemoglu et al 2005)

[6] Political ideology is not easily defined, and poor at explaining historical turning points. Radical liberalizations in Europe and Latin America have been often implemented by left-wing governments, while corporatist policies constraining product and financial markets implemented under conservative parties. For a broader view on this theme, see Gourevitch and Shinn (2008).

## Section 1 Political Regimes and Financial Structure

Our point of departure is that financial accumulation and intermediation concerns fungible, transferable wealth uniquely vulnerable to expropriation. Thus, a precondition for developing financial contracting is that opportunism be constrained by some institutional force. While a variety of society-based enforcement mechanisms may exist, contracting among strangers in anonymous markets, the essence of financial intermediation, cannot thrive without reliable enforcement of contractual and property rights.

### From Anarchy to Autarchy

Anarchy arises when no central authority achieves a monopoly on violence, a situation described by Olson (1993, 2000) as “roving banditry”. By definition, under anarchy no entity guarantees property rights. Competition among warring factions implies that any delay in seizing assets weakens their ability to fight. Anarchy thus undermines accumulation and transacting, particularly in the financial system. Indeed, in periods when there were no stable state institutions, such as during the early Middle Ages, there is no record of financial transactions. Private property rights over land, well defined under the Roman Empire, took centuries to be clearly re-established. No arm length finance could exist among strangers. Trade was local and cash based, and the rare contracts for long distance trade finance were enforced via clan linkages (see Greif, 1993), or religious associations such as the Templars.

Anarchic societies cannot sustain economic development. At some point power becomes concentrated by foreign conquest or by an authoritarian leader who defeats or co-opts other factions. Olson (1993, 2000) and McGuire and Olson (1996) modeled dictators as an improvement over anarchy, achieved by “stationary bandits” who established military superiority over all competitors. A stable dictator may prey upon the economy at a long-run revenue-maximizing rate, protecting some property rights and even invest in some public goods. Yet the commitment problem persists, and deteriorates when competition for power reduces the planning horizon. [7]

As the allocation of local power became more stable, some contract-based finance emerged as merchant courts were formed in European market towns. "Free cities" were run by merchants who paid or fought off the local lord to enjoy protection from expropriation. It is in these cities that the modern public debt market was created and built up on an historically unprecedented scale. Some of the funds accumulated by merchants were lent to kings. But periods of peaceful accumulation were followed by sudden royal defaults or seizures. In their search for funding for war and lifestyle, the autocratic kings of France, Britain and Spain routinely bankrupted their Genoese, Florentine and Jewish bankers. They also debased their coinage, and sold unique privileges and monopoly rights. Also these entitlements were often seized or reassigned, especially when autocrats came under military pressure.

Inability to commit destroys private finance, and reduces state funding. The lack of safe payment and credit mechanisms reduces economic activity and military capacity. Stable autocratic regimes can only create some financial accumulation via direct state control, such as royal mints or royal banks.[8] State control over finance is also naturally sought by autocrats to maintain bargaining power over the private elite, and avoid creating power centers that may challenge their authority, as in Tsarist Russia (Anan'ich 1999). Contemporary examples include Iraq under Saddam Hussein or Haiti under François and Jean Claude Duvalier. These countries had no financial markets, but managed a small state banking sector.

In political science, the consensus is that no single formal institution, whether a constitution, electoral suffrage, or the existence of political parties, marks the transition to limited government and democracy. Totally unconstrained dictators quite rare, as

[7] In the Mexican Revolution of 1910-20, competing factions preyed upon banks in their fight for territorial control (Maurer 2002), more than on capital in manufacturing, mining, or agriculture (Haber, Razo and Maurer 2003). As real asset value depends on the application of specific skills, this reduce the incentive to expropriate them (Rajan and Zingales 2003a) relative to financial capital which is easily redeployable.
[8] Early examples were the creation by Egyptian pharaohs and Mesopotamian rulers of state controlled granaries, which lent to farmers at high rates while providing a basic payment system.

autocrats face competition for power.[9] Historically, most dictators are removed not by uprisings or democratic transitions but by internal coups (Tullock 1987) that re-establish autocratic regimes under new strongmen. Competition for power forces dictators to share power with individuals in control organizations—the military, the police, and the bureaucracy. Authoritarians often use constitutions, staged elections, and political parties to align the incentives of these critical supporters. As potential veto players, they must be granted some share in the wealth captured by the political system. Privileges for this political elite include monopoly rights, barriers to entry, or preferential fiscal and legal treatment. These barriers rewards investment under high expropriation risk and their removal may trigger a withdrawal of support (Haber, Razo, and Maurer 2003). They can thus support a modest amount of investment even under unlimited government.[10]

A classic story of economic entrenchment via control over finance is Mexico during the regime of Porfirio Díaz (1876-1911). The Mexican dictator created a highly oligarchic financial market to compensate bankers for expropriation risk (Maurer and Gomberg 2005), and bankers aligned politicians' incentives by giving them lucrative positions on bank boards (Maurer 2002). The concentrated banking industry controlled access to capital, and sustained high concentration in downstream industries (Maurer and Haber 2007). In contrast, federalist Brazil had a more decentralized power distribution. This led to less concentrated capture of rents, more developed financial markets and a more competitive industrial sector.

In conclusion, societies with unlimited government are dominated by a personal alliance between a political elite and an entrenched economic elite, maintain high oligopolistic rents and barriers to entry, and a financial systems which limit access to connected individuals. Dictators thus cannot easily gain support by promising a broadening of access to opportunities. Lack of commitment under absolute control causes the failure of the Coase theorem, under which market contracting can resolve any inefficiency (Acemoglu 2003).

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[9] The idea that pure autocratic rulers are inherently insecure was common among thinkers of antiquity, such as Thucydides, Plato, and Aristotle (Ober 1998), and is one of the central preoccupations of Machiavelli's The Prince (2005). See also Tullock 1987; Bueno de Mesquita et. al 2003; and Haber 2006.

[10] Recent examples of shared control over the financial system by an economic and a political elite have emerged in Liberia, Indonesia and Russia.

Supporting commitment to protect investment, therefore, requires the devolution of political power. Acemoglu and Robinson (2006) show how a ruling elite will agree to an expansion of political rights to credibly limit executive power in the future. Vesting some power to a broader group constrains the executive ability of any rival who may seize power in the future, and be tempted to expropriate the old elite.

The next section moves to study finance under limited government.

**The Emergence of Limited Government**

Limited government arises when the authority of public officials is constrained by institutions that grant political power to some fraction of the population. This group will form an economic elite that defines its status by explicit rules and property rights rather than by political appointment or personal privileges.

The first recorded example of such a government is Athens (Ober 1988), ruled by citizen assemblies. In the modern world, Italian city states such as Genoa or Venice and the Dutch Republic were ruled by a powerful merchant class, which sustained financial development and the first large scale markets in public debt. As no political power could expropriate lenders well represented in government, development of public and private finance could take place (de Vries and van der Woude 1997; Neal 1990; Dari Mattiacci et al 2013).

The classic study remains North and Weingast's (1989) analysis of England's Glorious Revolution. After 1688, the Crown could no longer call or disband parliament, which gained the exclusive authority to raise new taxes and to audit Crown expenses. The Crown also lost prerogative powers over courts, and was made subject to the common law, while the judiciary was made independent. Parliament created the Bank of England, to which it delegated financing of expenditures, thereby tying the hands of future Parliaments to repay its creditors.[11] This allowed the British Government to

[11] Stasavage (2003) shows that Parliament constrained debt default because lenders were able to join coalitions with other legislators, trading support on other issues in exchange for debt repayment. Jha (2012) offers evidence that support for Parliament rule was boosted by the development of joint stock companies, which enabled anyone to invest in trade and helped overcome traditional merchant-landowner differences.

borrow from private capital markets on a scale and at rates unimaginable prior to 1688, and financing England's rise to global military hegemony. [12]

The safeguards for state debt repayment did not extend to private capital issues. At the time, a few colonial enterprises were allowed to be incorporated.[13] Yet the full development of private bond and equity markets, necessary to sustain England's subsequent industrial revolution, had to wait until the interests of the entrepreneurial class became better represented. Parliaments had been historically an occasional gathering of aristocrats and landowners to negotiate their financial arrangements with the king. Even after it wrestled control from the king in 1688, its composition included only the richest members of the emerging classes. As of 1828, the right to vote in the UK was still limited to less than 20% of the male population. Suffrage was extended to citizens without property only in the course of the XIX century.

Until then, financial regulation still reflected the interests of an oligopolistic elite, anxious to guard access to finance. Limited liability was granted extremely sparingly upon an act of Parliament. The Bank of England was for centuries the sole bank with corporate status allowed to operate in London. All other banks of issue had to operate as partnerships with at most six partners, and thus forego limited liability and liquid tradeable shares. Cottrell and Newton (1999) argue that excessive privileges for the Bank of England were not positive for Britain's early financial development.

Summerhill (forthcoming) describes the related example of Imperial Brazil (1822-1889), where the Crown was limited by Parliament and the Council of State. In contrast to twentieth century Brazil, it never defaulted on its public debt and enjoyed low borrowing rates. Yet safe property rights for investors in public debt did not lead to broad access to credit. The political agreement that avoided public default also allowed incumbents to limit competition, by restrictive incorporation laws or limited chartering of private banks. Brazil's private sector finance developed only after the fall of the creation of a federal republic in 1888. The central government lost its monopoly on bank chartering or incorporation laws after the 1891 Constitution gave its regional economic

[12] The Dutch Republic had earlier a limited government regime, which gave an early advantage in private colonial investment in Asia over England and autocratic European powers (Dari Mattiacci et al 2013).
[13] A clear relationship of private capital and limited government is found in cross-section analysis (Barth, Caprio, and Levine 2006) and within countries over time (Haber, North, and Weingast 2007).

elites clout. The federal government quickly pushed through a series of financial reforms, expanding bank charters and creating an inclusive incorporation law, extending limited liability for shareholders while strengthening creditors rights (Haber 1998, 2003; Musacchio 2007). Within three years, the number of banks in Brazil nearly tripled, and massive equity issues generated a rapid spurt in industrial development. Haber (1997, 1998, 2003) contrasts Brazil's thriving financial markets with autocratic Mexico, where emerging sectors such as the textile industry were much more concentrated, as well as less efficient.

In conclusion, the early stages of limited government entrench strong rights for an economic elite that is broader and more efficient than a royal court, but soon forms a political block restraining further financial development and entry. Oligarchic economies seek to maintain strong protection of traditional property rights (e.g. land ownerships and land servitudes), while discouraging institutions that may grant access to opportunities for emerging groups (commercial codes, education, banking competition). [14] Acemoglu (2008) argues that autocracies may invest more at low stage of development if democratic voting under high inequality would produce very high redistributive taxes, but will ultimately lag behind others. Technological progress demands human capital accumulation and specialization (Aghion, Alesina and Trebbi 2007).

[14] A politically connected elite whose interests are guaranteed via direct arrangements with public officials prefer weaker property rights that enables them to prey on the assets of other members of society (Sonin, 2003).

## Section 2: The broadening of political participation

A significant increase in political participation in Europe took place during the nineteenth century. The French revolution produced a violent shock to the traditional *ancien regime*, abolishing aristocratic privileges, redistributing church land and streamlining access to justice with the Code Civil.[15] After the Restoration, most countries responded to increasing political unrest at first by a traditional repressive approach, but soon had to relent and broaden political participation. After a period of increasingly frequent riots and the Paris revolution of 1830, the traditional British elite saw the necessity to grant a progressive expansion of political rights to reflect the emergence of industrial and commercial interests along with its Industrial Revolution. The 1832 Reform Act was a first step in a process of expanding suffrage rights for males to broader social groups outside property owners, in the process creating a political basis for broader access to economic opportunities. The liberalization of entry in banking took place alongside a progressive expansion in suffrage, just as in France and other continental European states. The broadening of voting rights was even faster in the US, where most states moved towards broad suffrage rules during the first half of the century. A key driver of political change was competition across the new states joining the Union to attract scarce population and capital (Keyssar 2000), and choosing to grant voting rights to new residents even if they were not property owners. This exogenous process enables Benmelech and Moskowitz (2005) to create a panel test to validate the association between suffrage laws and financial regulation within the same country. Their results conclusively show that as local suffrage broadens, US states chose legislation improving access to finance, relaxing bank charter rules, usury and incorporation law to include less wealthy entrepreneuers.[16]

In more traditional Europe, the second half of the nineteenth century saw the political emancipation of the merchant and industrial class, which reinforced demand for financial reforms. Thanks to its earlier development of limited government, Britain had

[15] The Code Civil introduced standard contracts and limited judge discretion. While this may have limited contractual innovation, it facilitated enforcement among unequal parties (Gennaioli and Perotti 2012).
[16] This association persisted after general suffrage. Rajan and Ramcharam (2011) show that concentrated land ownerships across US counties both in the 1880s and 1930s helps explain local financial competition.

an advantage in financial contracting, but even its financial system needed to become more open and competitive to satisfy a booming demand for capital. At the same time, there was strong pressure for legal development. English and American courts moved away from traditional notions protecting established rights and servitudes, for instance in land use and strict liability, which constrained the more intense use of assets required by industrial activities. Horwitz (1976) illustrates the evolution of legal practice from a rigid view of property rights typical of an agrarian society toward a more utilitarian view. This could support a more intensive use of common resources as required by interests of an entrepreneurial class. [17]

The interests of the emerging classes soon became enshrined in commercially oriented legislation and more open regulation in Continental Europe, e.g. in France under Napoleon III.[18] The early advantage in financial development Britain may have enjoyed was rapidly eroded by late XIX century. Incorporation laws and bank chartering were relaxed, and capital markets funded rapid capital accumulation in Continental Europe and Japan. Funding for rapid industrial catch up was led in Germany by investment banks, which relied massively on bond markets to channel savings to industry.

At the turn of the XIX century, the codification movement sought to increase access to contractual enforcement, and to reduce the cost of transacting. Commercial codes, necessary to standardize contract and improve access to legal enforcement, were introduced even in common law countries by the end of the century, to facilitate trade among diverse individuals across greater distances. The UK Bill of Exchange Act of 1871 finally eliminated the risk of legal challenges to promissory note holders due to traditional common law contracting rules. This removed obstacles to freely negotiable securities, and enhanced the liquidity of financial claims (Gennaioli and Perotti, 2012).[19]

[17] Unlike what has been posited in the legal origins literature, most common law judges were quite resistant, and state codification was necessary for legal innovation (Horwitz 1976).

[18] For an analysis of the late XIX century progress in financial legislation in France, see Lamoreaux and Rosenthal, 2004; on Germany, see Franks, Mayer and Wagner, 2006. These accounts show how investor protection in these countries improved rapidly as demand for capital rose, and on disclosure standards and contractual flexibility were comparable to those in the UK.

[19] State codification was needed as no private solution was possible under common law. Private agents could not instruct judges to ignore rules on ownership transfer or liability. This helps explaining the central role played by UK and US security laws in supporting investor protection, just as in civil law countries (Dams 2006; Jackson Roe 2009). It is inconsistent with the legal origins view that judge made law offered an important advantage for financial contracting relative to civil law systems based on statutory law.

Until WW1, capital market development was rapid in all western countries and Japan, and was reinforced by free movement of capital under the gold standard. Before considering the dramatic consequences of the world wars on financial structure in democracies, we review the progression of financial development elsewhere.

**Financial development in emerging countries**

Among developing countries, a simple classification of financial structure distinguishes between a state dominated model, and a business group model prevailing in in more developed capital markets. This distinction matches a political economy interpretation, where state banking and governance under autocracies evolve with political liberalization towards a phase of concentrated corporate ownership by a connected elite.[20] As more recent research has focused on the second form of governance, this review will focus on the latter form.

A favorable interpretation of family controlled business groups is that because of poor enforcement of investor rights, assigning bank control to cohesive groups of owners reduce moral hazard, as large investors will make better decision with their own money. While there is evidence that a larger equity stake improves value incentives, in many countries large owners tend to be able to control large firms with little own capital, thanks to equity pyramids, cross holdings and high leverage provided on favorable terms. Recent evidence suggests that insiders with more control than income rights have poor incentives, and may tunnel corporate resources to fully owned companies.

This suggests a regulatory bias when insiders are allowed to control huge resources without much own capital. Claessens, Djankov, and Lang (2000) show that over two-thirds of East Asian firms are controlled by shareholders with small stakes. Claessens, Djankov, Fan, and Lang (2002) show how relative firm value increases with their ratio of cash flow to control rights. A broad review on business groups and growth

[20] In an extensive cross section study of 65 countries, Caprio, Laeven and Levine (2007) show that more autocratic countries have more state banks. In countries with poor investor protection, most private banks have concentrated control by a family or business group. In contrast, large blocks in individual banks are very rare in the most developed countries.

(Morck, Wolfenzon, and Yeung 2006) find that narrow control over finance leads to misallocation of resources. This suggests that concentrated ownership may be associated with regulatory capture and privileged access.

If concentrated ownership does not contain moral hazard, is tighter financial regulation a solution? The evidence is not supportive. More autocratic countries have less permissive bank entry policy, and impose stricter restrictions (Barth, Caprio, and Levine 2006). This is associated with less bank stability and more corruption in lending, and lower credit market development. Thus very restrictive rules create rents but do not avoid instability, suggesting restrictive formal rules reflect poor institutions, rather than a legitimate regulatory response.[21] This is consistent with Djankov et al (2003), whose review on recent evidence suggests that restrictive regulation in developing countries reflect political opportunism rather than an optimal response to greater moral hazard, driven by exogenously poor rules and enforcement.

Entrenched interest may pursue weak financial regulation to limit access to finance for less established competitors, an invisible but effective barrier to entry (Rajan and Zingales, 2003). Political access is cited as a main comparative advantage even by business group apologists (Khanna and Yafeh, 2007). Much recent evidence shows how firms with political connections enjoy favorable access with state banks. They appear to receive larger loans, and are less likely to repay, even though they carry similar interest rates than comparable borrowers (Faccio, 2006; Khwaja and Mian, 2004; Chiu and Joh, 2004). Fisman (2001) reveals significant value of political connections for Indonesian firms. Claessens, Feijen and Laeven (2006) show how Brazilian firms connected to political candidates exhibit excess returns upon their election, and subsequently gain more access to credit. Khwaja and Mian (2005) study how connected firms obtain more financial access from Pakistani state banks, though they have much higher default risk. Faccio (2006) studies politically connected firms are common in countries where weak limits on the executive allows for high degrees of corruption. Faccio, Masulis, and McConnell (2005) shows how politically connected firms are significantly more likely to be bailed out in distress, yet exhibit worse performance afterwards.

[21] For an extensive review of the evidence, see Morck, Yeung and Wolfenzon (2006).

A natural test of a causal link between political institution and financial structure is any evidence whether the comparative advantage of groups declines with greater accountability and trade openness. In Chile, business groups close to the dictator Pinochet enjoyed remarkable privileges for many years. In a flawed privatization program in the 1970s, grupos were allowed to capture control of many firms and banks with borrowed money. This led to a major bank collapse in the early 1980s and forced renationalization of banks. The relative valuation of group firms declined in the period 1980-1990, as major political reforms progressively led to a return to democracy (Khanna and Palepu, 2000). The subsequent reprivatization took place under a democratizing government that sought to broaden financial participation by granting shares to pension funds (Biais and Perotti, 2002).

A similar progression may be seen in the democratic transition in Korea. Until the early 1980s the government dictated the allocation of financial credit, favoring the *chaebol* business groups. In these years the chaebol enjoyed their highest relative valuation and the easiest access to state banking credit (Lee, Ping and Lee, 2001). In the early stage of democratization, reforms sought to target broader access (bank privatization, freer entry, interest rate liberalization) were distorted by special interests (Lee 2005). As a result, most chaebols maintained favorable access to credit. Once the 1997 Asian crisis found many groups to be overleveraged (Campbell and Keys, 2002), public opinion pressed to adopt stronger regulatory and governance standards. As a result, Korea has enjoyed a faster recovery than its neighbors, and a considerable broadening of its financial system.[22]

While this literature is largely empirical, recent work models the dynamics of captured finance. Acemoglu (2005) and Caselli and Gennaioli (2005) consider the consequences of family-based ownership structures. A key vulnerability associated with politically connected groups is that heirs to a family firm will have less talent than other managers. Dynastic management may then reduce firm value (Morck, Yeung and Wolfenzon 2006). Caselli and Gennaioli (2005) model the incentive to lobby for better financial access by groups wishing to divest. They conclude that legal reform aimed at improving access to

[22] A broader review of the negative evidence on entrenched business groups on growth is offered by Morck, Wolfenzon, and Yeung (2006).

finance that facilitate transfer of ownership, may over time meet less entrenched opposition than entry deregulation. This points to the suppression of competition as the main cost of captured regulation. Entry is an important form of economic renewal and contributes to economic growth (e.g. Hause and Du Rietz, 1984; Johnson, McMillan and Woodruff, 2002; Klapper, Laeven and Rajan, 2006). Recent evidence corroborates the notion that autocratic regimes establish high barriers to entry. Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2002) show that entry costs are very high in developing economies, and particularly so in corrupt countries. Onerous regulations may be created to extract bribes (Shleifer and Vishny, 1993) and maintaining high rents. Fisman and Sarria-Allende (2004) and Klapper, Laeven, and Rajan (2004) show that onerous barriers appear to reduce growth and entry in naturally high entry sectors and do not seem justified on reasons of public welfare.[23]

A model of captured financial regulation is developed and tested in Perotti and Volpin (2007, 2012). Wealthier agents do not need much external finance and naturally form a lobby for weak investor protection, to limit access to funding for other entrants. Greater accountability allow citizens to punish captured policies that benefit few producers. A higher shadow cost of entry barriers increases required bribes and induces lobbyists to accept more competition. An empirical test requires studying the relationship between accountability, entry rates, and competition intensity.[24] Controlling for country and industry effects, Perotti and Volpin (2007) find that entry rates and producer numbers are lower when investor protection is weak, particularly in sectors that are more dependent upon external finance.

A more direct test requires showing that more accountable countries have better investor protection. However, accountability is hard to measure objectively. Corruption measures are very correlated with the logarithm of per capita income (Svensson, 2005), but as they are survey based, they may be seen as endogenous (Glaeser et al, 2004). Indeed, proxies

[23] High financial barriers to entry in developing countries are puzzling in view of the evidence from micro credit of very high marginal profitability of small projects by the poor (Banerjee and Duflo, 2005; De Mel, McKenzie and Woodruff, 2006).

[24] Bebchuk and Neeman (2005) show how investor protection is held up by lobbyists for insiders able to use firm resources, and can easily fend off outside investors with limited stakes and reduced incentives.

of democratic quality perform well in regressions for investor protection, but are no longer significant once a general control for institutional quality, such as GDP per capita, is introduced in the regression. Perotti and Volpin (2012) use a measure of access to information for voters, indispensable for scrutiny of public choices. The diffusion, independence and overall freedom of the media is shown to increase political accountability, which in turns increases creditor protection and entry.[25] Critically, it remains a very significant determinant of effective investor protection even after controlling for per capita income and legal origin. Supportive evidence comes from a significant negative effect of state ownership of the press. Importantly, the effect of diffusion of the press is not due to differences in education levels.

[25] A recent literature shows how important it is for dispersed agents to monitor policy choices via the media (Besley, Burgess and Prat, 2006; Dyck Moss Zingales 2004). Media diffusion is correlated with subjective quality measures, such as press freedom, and with measures of political accountability in the Polity IV database (Djankov et. al., 2001).

## Section 3

## Political Choices in Democracies

The scale of financial markets appears to predict future investment, and to improve its allocation (Rajan and Zingales, 1998; Wurgler, 2000; Fisman and Love, 2005). This is consistent with the notion that more external finance relaxes funding constraints and enhances competition. The emerging empirical evidence suggests that financial barriers matter significantly for new firm creation and economic growth (Rajan and Zingales, 1998; Beck, Levine and Loyaza, 2000).

This raises the question whether citizens in democratic countries actively push for well regulated financial liberalization. As in any classic common good context, a central problem is the lack of incentives by dispersed voters relative to strong incentives by established interests. The public choice literature produced much evidence of the ability of lobbies to influence public policy in financial markets. In the finance literature, Black and Strahan (2002) examine regulatory changes across US states enabling greater local bank competition, showing how they impacted growth and number of state level firms. They also establish that states with stronger agricultural interests resisted liberalization.

Rajan and Ramcharam (2011) show that concentration in land ownerships across US states helps explain how restrictive local banking legislation was early in the last century. Counties with concentrated land holdings (a measure instrumented with geographic characteristics) had disproportionately fewer banks per capita. This was in turn negatively correlated with subsequent manufacturing growth.

Yet as democracy progressively deepened over the nineteenth and twentieth centuries, financial development and breadth of access did not always exhibit steady progress. While democracies tend to generate financial systems that distribute capital more broadly than autocracies, a democratic majority does not necessarily seek to achieve the broadest degree of financial development possible. The variation in financial depth, diffusion of shareholdings and concentration of control among democracies is remarkable. A recent theoretical literature offers a novel foundation for the classic distinction between shareholder and stakeholder capitalist systems, often obscurely explained as arising from different social preferences. Political explanations seem natural candidates to account for the negative correlation between the degree of investor and labor protection across countries.[26] Explicit models need to be validated by assessing their ability to explain structural breaks in financial structure, and in particular the Great Reversal identified by Rajan and Zingales (2003), to which we return later.

Modeling democratic choice may take two approaches. In the first approach, a democratic majority requires a coalition among predefined multiple constituencies, which hold different views on financial structure. In the second approach, voters differ only by their endowment, and the will of a majority depends on the view of the median voter.

The seminal work by Pagano and Volpin (2005) exemplifies the first approach, where a democratic majority requires a political alliance. If interests are very differentiated, electoral structure (eg majoritarian versus proportional systems) shapes the way preferences are aggregated, and thus determine major political choices.[27] In a political alliance, some interest group may be numerically modest but enjoy political influence. In their model, a political equilibrium arise among three social groups, inside capital (controlling shareholders), outside capital (minority investors) and inside labor (workers). Poor minority investor protection is the result of an alliance of workers and inside investors, seeking to protect labor and control rents against minority investors. In particular, proportional voting pushes political parties to cater more to the preferences of groups with homogeneous preferences, such as controlling shareholders and employees. Under a majoritarian system, by contrast, there is keen competition for the votes of pivotal districts where no focused interest group is dominant. Therefore dispersed investors may be pivotal in choosing elected politicians in a majoritarian system. Compellingly, Pagano and Volpin provide evidence of a negative correlation between minority investor protection and labor protection laws. They also document that in proportional representation systems minority shareholders get poorer protection and employees get stronger protection than in majoritarian ones.

[26] The normative appreach by Allen and Gale (2003) show that bank centered systems may be preferred because they absorb intertemporal risk better than market based systems, best at intratemporal risk sharing.
[27] Recent evidence points to a higher degree of redistributive public spending in proportional versus majoritarian systems (Persson and Tabellini 2003).

This approach contributes important insight on how electoral structure may explain features of stakeholder or shareholder oriented systems. For a richer analysis of possible alliances where the pivotal role of labor interests is recognized, see Gourevitch and Shinn (2005).[28] This stream of research offers useful insight, relying on a presumption that electoral rules are predetermined. We turn to models seeking to explain variation in financial development over time.

A fundamental approach assumes homogenous preferences in a population with different endowments (Perotti and von Thadden 2006). In a democratic voting model, all voters have a mixed identity as investors and workers. Voters holding inside capital have limited political power by themselves, so the level of investor protection is determined by the preferences of the median voter. This approach allows to study the effects of large shocks associated with income or redistributive effects, on the preferences of a democratic majority.

A first and immediate result is that individuals with lower financial wealth prefer high labor rents over higher financial returns. This suggests that a political majority will be less favorable to stock market investors as suffrage is expanded to workers, as found in the empirical analysis of DeGryse et (2012).

The more interesting implications of the model concern the effect of wealth distribution on the regulatory and corporate governance regime. An economy with more concentrated financial wealth will exhibit political support for a greater role for banks over minority equity investors. It may also explain greater support for large shareholders over dispersed ownership, and for a government role in governance. The intuition is that a less wealthy median voter is mostly concerned about labor income risk over financial returns (Perotti and von Thadden, 2006). Next to higher labor rents and lower product market competition, a majority would prefer a governance system where more control rights are assigned to investors who share their aversion to risk. In contrast, more voters in a society where the median voter has more financial wealth will support low labor rents and (dispersed) equity control, which favors more financial risk taking and higher average returns. In this context, the financial participation of the middle class is critical. If the median voter has a sufficient financial stake, a majority will support dispersed

[28] See also Rajan (2012) for an application to resistance to education reform.

equity control, which results in riskier but more profitable investment at the cost of greater labor risk-bearing. In contrast, when financial wealth is concentrated, a political majority has more firm-specific human capital than financial capital, and therefore opposes rights for market investors.[29] The attitude of a political majority over competition will be similarly affected by the relative interest in protecting inside labor rents over financial returns.

This approach predicts a clustering of governance, competition and labor laws broadly consistent with the classic bank- versus market-centered systems, a well researched view in political science. Still, some external variation is indispensable to test a “political preference hypothesis”. The next subsection seeks insight from the impact of major economic shocks on democracies in the early XX century.

**The Great Reversals**

A major challenge is the need to explain the remarkable rise and decline of public capital markets in Continental Europe and Japan in the first half of the XX century. Rajan and Zingales (2003) show that in 1913 many civil law countries were more financially developed than the US or the average common law economies. France, Belgium and Austria led the table of financial development together with the UK. German and Japanese industry raised massive amount of equity and bond market financing. Yet in subsequent decades, capital markets in many European countries (and Japan after WW2) shrank dramatically. At the same time the governance mode shifted towards bank, family or state control. In contrast, other democracies experienced further market development via new regulation to strengthen minority investor and disclosure rights.

While some of the 1913 data has been criticized (LaPorta et al, 2007), it is clear that at that time there was no advantage in financial development for common law countries relative to its peak in the 1970s. Some factor other than legal origin must have contributed to changes in financial structure in a subset of countries.

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[29] Biais and Mariotti (2009) investigate the related issue of political choice over bankruptcy rules. Tough creditor protection reduces competition and thus favor more established producers. They also examine explicitly the implications for labor interests.

Rajan and Zingales argue that this shift was driven by the Great Depression. The crisis led to drastic trade barriers which weakened the principle of free competition and entry, and strengthened the bargaining power of established firms. Nationalistic feelings caused by economic insecurity were hijacked by domestic incumbents. This explanation is consistent with an increase in industrial concentration that favored incumbents. Incumbent also sought to limit financial market access. To explain the different outcome across countries, Rajan and Zingales subscribe to the legal origins interpretation that civil law countries were more vulnerable to such regulatory capture, because of their greater reliance on codified regulation. [30]

This view has appeal, but is not consistent with two key factors.

First, the evolution of investor protection in common law countries after the 1929 crash was driven by legislation, both in the UK (especially the new corporate law code after WW2) and the US, where the mandatory disclosures required by the Securities Act of 1933 are widely credited with significant improvement in minority protection, and improved the accuracy of pricing of securities (Simon 1989). The Glass Steagall Act also led to increased financial competition in the US by breaking up the large universal banks. The relative improvement in investor protection in AngloSaxon countries after WW2 occurred because other countries did not upgrade their legislation on disclosure.

Second, this view cannot explain the path followed by some civil law countries that remained market oriented, such as the Netherlands, Switzerland, Sweden and Denmark. These countries maintained broad financial markets throughout the period, in marked contrast with very similar neighbors in terms of geography, culture or openness (Belgium, Austria and Finland) that had earlier a comparable or even more developed financial structure. Thus a legal explanation, even if augmented by shocks altering the political framework, cannot suffice.

A purely political explanation for the structural break is offered in the democratic voting model by Perotti and von Thadden (2006). In a democratic voting equilibrium, greater wealth inequality shifts the distribution of voter preferences for labor rents and financial structure. As labor income cannot be diversified, less wealthy citizens prefer

[30] Rajan and Zingales also show how this was tempered by openness to trade, which limited insider rents and increased competition. Countries may differ in their natural openness (eg city states built around a port), but trade openness is arguably an endogenous political choice.

higher wages and less risky choices, even at the cost of lower financial returns. Such choices are ensured by assigning a dominant governance role to banks (or large shareholders) over diffused shareholders, who are diversified and prefer more profitable but also riskier strategies.

Prior to WW1, limited suffrage ensured a relatively wealthy median voter and support for equity control and shareholder rights. For the previous fifty years, Europe had been at peace. Industrial productivity rose rapidly, albeit with wide swings, and prices were stable or declining. Price stability ensured financial stability for the middle class, who saved via deposits, bonds, rental income or other long-term nominal assets. Stock market crises, bank failures and railway bankruptcies impacted mostly wealthy individuals.

The destruction of World War in 1914 caught Europe by surprise. The human and physical destruction was immense. Warring countries spent heavily, and imposed price controls. When these were lifted after the war, prices rose.

The second shock was economic, as war destruction forced inflationary financing in the hardest hit countries. WW1 developed unexpectedly into a major onslaught with devastating damage. Government spending rose sharply during the war. After the war, hard hit countries faced intense fiscal pressure. Budget deficits rose sharply in countries that had suffered heavy damage, loss of territory and colonies, or faced massive reparations. Suffrage was expanded as veterans came back from the front, and higher social spending was sustained by fears of a socialist uprising.[31] Additional pressure for social spending socialist movements popular among demobilized troops.

In many cases, spending could not be fiscalized, and monetary printing was the only short-term solution. Defeated nations, Austria and Germany, suffered devastating hyperinflations, but also winners such as Italy, Belgium and France had massive price jumps.[32] The inflationary shocks were exogenous to legal or political institutions at the time, and largely explained by the extent of war damage (Perotti Schwienbacher 2007).

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[31] Lindnert (1994) argued that the Great War forced elites to open up the political system as compensation for the suffering the mobilized masses, opening the door to social program and labor friendly legislation.

[32] Lord Keynes was prescient in his influential *The Economic Consequences of the Peace*, Cambridge 1919: *"Lenin .. declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily .. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency… The various belligerent Governments, unable, or too timid or too short-sighted to secure from loans or*

While all social classes suffered, the devaluation of long-term nominal assets hit hard the financial holdings of the pivotal middle and lower middle class.[33] Similar price shocks devastated other countries affected by civil war, such as Greece, Spain and Finland, and Japan with the 1946 hyperinflation.

The evidence suggests that countries with impoverished middle classes shifted support away from financial markets with dispersed shareholders towards a more corporatist system of financial allocation, with a central role for large owners, banks and the state. This transformation accelerated with the Great Depression, which created immense pressure for social and economics reforms. In some hard-hit countries, support grew for a suppression of economic freedoms and a shift of corporate control to the state or to financial institutions, as the average citizen sought more stabilizing governance structures and greater social insurance at the cost of less free markets. The result was a greater politicization of control, suppression of (foreign) competition, and the emergence of stronger social insurance programs typical of a corporatist economy.[34]

In contrast, the UK did not suffer direct damage, and managed to finance expenditures via public debt. Its non-European AngloSaxon allies, such as the US or Australia, avoided war destruction, just as the Netherlands, Scandinavia and Switzerland. Inflation was modest and soon under control, and a financially stable middle class maintained support for financial markets.[35] Stronger minority investor protection was strengthened in these countries, with the new UK Company Law and the US establishing the Securities and Exchange Commission in 1933. The US also limited banks' role in corporate control with the Glass Steagall Act.

*taxes the resources they required, have printed notes for the balance… In Germany total expenditure .. in 1919-20 is estimated at 25 milliards of marks, of which not above 10 milliards are covered by previously existing taxation. This is without allowing anything for the payment of the indemnity. In Russia, Poland, Hungary, or Austria such a thing as a budget cannot be seriously considered to exist at all… But who can say how much is endurable, or in what direction men will seek at last to escape from their misfortunes?"*

[33] A prominent German economist wrote in 1924 that "there has been an appropriation of property in few but strong hands. The financial property of the middle class .. has been destroyed. This appropriation refers mainly to big business. Small and medium-size entrepreneurs have not been expropriated, but have been brought more strongly under the influence of big business. Because of this, the distribution of wealth has become much more unequal" (Eulenburg, 1924).

[34] A similar change took place in Japan after the post WW2 hyperinflation. The country moved from a tradition of vibrant market funding to a corporatist model dominated by banks, a stable labor market and intense government intervention in the economy.

[35] In fact, US government Liberty Bonds were broadly promoted financial participation, increasing the diffusion of holdings of financial securities from 30 thousand to 20 million households.

### A test of the structural break

Massive unemployment during the Great Depression had also a major effect. In all countries it led to more generous social programs, led by the US with its 1935 Social Security Act and followed by all democracies in the subsequent twenty years. The design of this massive change in financial structure was clearly driven by political preferences.

A natural test for a "structural break in political support" hypothesis is pension structure. This has the broadest political significance, as universal pension systems include most individuals, carry large fiscal benefits, and dominate old age income for older citizens. The cross-country variation in pension assets dwarfs the variation in financial development. The composition of its financing (pay as you go versus private capitalized funds) is politically sensitive. For this reason, the choice of pension funding will necessarily reflect a political choice, but it will also shape financial participation and thus public attitudes to capital markets. Pension structure may create persistence, as it defines long-term interests. So what explains the initial assignment of pension contributions between the state and the private sector?

The common view that pension systems diverged early on is not accurate. The employer-funded pension system set up in Germany under Bismarck to protect very old workers was very modest. Pensions were minimal and could be drawn only upon reaching 70 years of age, an uncommon age to reach at a time. The program had no redistributive feature (Lindert, 1994).[36] In all countries that followed this example, such as in Austria, France or Italy, pensions remained private liabilities until the Great Depression in the 1930s. Both common and civil law states had a minimal role in retirement, expect for civil servants and war widows. So what can account for the massive variation in pension structure?

Almost all developed economies created their own system by the early 1950s, choosing for different degree of private funding. Perotti and Schwienbacher (2008) presents evidence suggesting that countries which had experienced massive price shocks chose for a predominantly state funded pension system.[37] The effect is economically and

[36] In contrast, the so called Beveridgean system in Britain was redistributive as it targeted the very poor.

statistically very significant: a large shock is associated with a lower stock of private retirement assets equal to 58% of GDP. The effect is not limited to countries which experienced extreme hyperinflation.

The modern universal pension system arose after the massive unemployment in the Great Depression, starting with Social Security in the US. By the early 1950s all developed countries had designed their retirement system (in all case, after any large inflationary shock). The original national orientation has persisted (Mulligan and Sala-i-Martin, 2004), so it is possible to classify the initial historical choice by current measures of private pension funding.

Schwienbacher and Perotti (2011) show how in countries where the middle class had kept its savings, the choice was to rely on market funding, as financial markets enjoyed a broader political support. In contrast, in hard hit countries the pension system was set in a more corporatist framework and entrusted to the state. Hard hit countries also exhibit a strongly correlation with social spending levels, state ownership of industry and employment protection, even after controlling for legal origin or electoral rules. They also establish that the inflationary shocks were exogenous to contemporaneous political variables, and were clearly driven by objective measures of war destruction.

Strikingly, the choice between private vs public pension funding has no correlation with legal origin, nor is result driven by variables suggested in the literature, such as religion, demography, the history of stock returns, or pre-WW1 equity market development. Redistributive shocks remain the most significant explanation even after controlling for electoral structure (Tabellini and Persson, 2004). They help addressing the puzzle of financial structure variation across very similar civil law countries (such as Finland vs Denmark or Sweden, Belgium vs the Netherlands, Switzerland vs Austria).

It is hard to disentangle economic and cultural consequences of major price and war shocks. Shocks may undermine confidence on self-reliance, and led to view the state as providing mutual insurance against systemic instability. Indeed, uncertainty aversion (the Hofstede measures from the 1960s, strongly correlated at the national level) is negatively correlated with hyperinflationary episodes, and is significantly and negatively correlated with the stock of pension assets.. Yet its effect loses significance once price shocks are introduced (Schwienbacher Perotti 2011). In conclusion, uncertainty aversion does not summarize the effect of the shocks on pension funding.

Political shocks may also account for the variation in concentration of ownership documented in La Porta et al (1998). The emergence of corporatism was associated to increased concentration of ownership in most countries, very visibly in Sweden and Italy (Hogfeldt, 2003; Aganin and Volpin, 2003). Increasing concentration of control emerged as political forces weakened the role of dispersed financial investors. The emerging corporatist system favored weakening minority protection and sought political influence on corporate decisions by negotiating with large owners or dominant bankers. Undiversified large owners could be trusted to take a more conservative approach than markets, just as banks did.

Roe (2003) agrees that the shift in corporate governance resulted from war shocks, but as the result of private rather than political choices. He argues that war devastation led to a rise in ideological polarization between labor and corporate owners. In response to socialist activism, companies required more active and engaged shareholders with controlling stakes to counter the influence of organized labor.

While this sounds plausible, surely an increase in the concentration of control to confront labor interests had to be acceptable to a political majority. So this view may be completed as saying that large shocks to pivotal voter groups shifted economic interests and thus ideology. In both Perotti von Thadden (2006) and Pagano Volpin (2005), a shift in the percentage of voters who are investors favors a political majority supporting more stability, higher labor rents and less minority investor protection.

### Other models of democratic voting on public policy choices

Wealth allocation may even be exploited politically to help electoral outcomes and support for preferred policies. Aghion and Bolton (1990), motivated by Reagan's deficit spending politics, show how a right wing party seeking reelection may seek excess public debt to align the preferences of the median class voters against redistributive macroeconomic policies.

Biais and Perotti (2002) apply this Machiavellian logic to privatization policy in a democracy. Since state control enables labor and other insider interests to be favored directly, less wealthy voters may resist privatization to favor larger rents to SOE labor funded by taxation. In fact, in an unequal society the median voter may never choose to elect a privatizing government unless the inefficiency of state control passes some threshold. At the point when the middle class feels excessively burdened, a right wing government may be elected with a mandate to privatize. Reelection policy would involve a strategic privatization program allocating enough shares to the median class induce a political shift away from left wing parties whose policy would reduce the values of shareholdings. They show that to induce middle class voters to buy enough shares to shift political preferences, strategic rationing and underpricing should increase with wealth inequality. Interestingly, the evidence is that right wing privatizing governments under price more and target more individual investors, and that underpricing is increasing in income inequality (Megginson et al 2004).

There have been several examples of conservative governments that deliberately pursued a more diffused distribution of ownership to counter socialist or populist opposition.[38] An interesting early example was Japan after WW2. After the US military administration seized control over shares in large companies from the zaibatsu owners, accused of collaborationism with the military, they proceeded to a free distribution of shares among the population.[39] Other large-scale episodes of ownership distribution were the Thatcher and Chirac privatization programs, the Chilean privatization program, and voucher schemes in Russia and the Czech Republic. In these programs (with the exception of Russia) various constraints or incentives were introduced to avoid rapid resale ahead of elections, ranging from direct contribution of shares to pension funds (Chile), delay on distributing shares until after the election (Czech Republic), and financial incentives (UK and France in 1986-1987).

[38] Privatization may also be captured, in which case insiders reaped more of the gains, as it has been often the experience within Latin America and many transition economies. This had repercussions on public support for privatization and reform in Latin America (Birsdall and Nellis, 2002). In Russia, privatization of valuable firms at low prices and asset stripping by managers has led to even higher inequality than before (Perotti, 2002), and contributed to low political support for a market economy.

[39] Most Japanese, impoverished by the war, sold their shares rapidly, like Russian workers in the early 1990s. Governance came in the hand of bank-led consortia based on crossholdings, or keiretsu. This ownership structure supported corporatist policies consistent with Japanese political preferences.

These models rely on the argument that financial structure is shaped by the economic and financial interests of the middle class. Yet for specific policies and historical events to leave a persistent effect, there must be forces that reinforce their effect overtime. One such argument is offered in Pagano and Volpin (2006). Better investor protection induces companies to issue more equity and thereby leads to a broader stock market and more liquidity, which expands the shareholder base and increases support for shareholder protection. Similarly poor investor protection may be self reinforced, for instance via a choice for state funding of pensions. They offer evidence of such a virtuous cycle in equity issuance in recent years in Europe, confirmed by increasing political acceptance of foreign takeovers.

Median voter models in this section share the assumption that voters choose directly policies and laws, a strong assumption. Public scrutiny and direct citizen choice are hindered by limited information and coordination problems. Yet democratic voting models are useful benchmarks and most relevant in times of crises or distress, when voter attention on financial issues is high so that coordination among citizens is heightened.

**The political roots of financial instability**

We next review how political institutions may shape not just the distribution of access, but also of risk and return.

Incentives to create risk are critical to explain financial crises. The traditional literature attributes instability to either market or public failures. Budget and foreign exchange crises in emerging countries have long been regarded in the so called Washington consensus as the outcome of short-sighted macroeconomic policy, following excess public spending, (foreign) borrowing or monetary creation. These endogenous choices may be simply the outcome from autocratic or unaccountable regimes keen to expropriate resources. Banking crises are more likely in countries with worse political institutions and weak investor protection (Demirguc-Kunt and Detragiache, 1998; Bekaert, Harvey and Lundblad, 2006). Johnson, Boone, Breach, and Friedman (2000) show that weak corporate governance explain exchange rate drops during the Asian Crisis better than exchange rate policy, government borrowing or foreign lending.

Acemoglu et al (2003b) compares the explanatory power of actual policy choices against the quality of political institutions and legal regimes. Their striking result is that financial instability appears better explained by the quality of political institutions than by actual policy choices.

Roe and Siegel (2011) offer a rigorous empirical analysis on how political instability distorts the process of financial development. Conflicts over political power clearly cause financial distress, not least as they create redistributive risk for investors. Their results indicate a clear direct impact of politics on financial markets. Their rigorous approach relies on exogenous determinants of political strife such as ethnic/linguistic fractionalization and inequality, drawn from the related literature. They are able to shows how political conflictuality relates robustly to income inequality.[40]

An interesting question aroused by this line of inquiry is to what extent political instability decreases with more democratic accountability. An interesting question aroused by this line of inquiry is to what extent political instability decreases with more democratic accountability.

The traditional view is that financial crises reflect weak institutions, due to decline as countries develop political accountability and stability. Greater constraints on executive power should lead to a stabilized macroeconomic framework. As politicians withdraw from direct control over banks, private banking should enhance efficiency and reduce instability (LaPorta et al, 2002; Djankov et al, 2003b).[41]

Yet this is not fully consistent with the frequency and size of banking crises in middle income countries in the transition process to democratization and stable macro policy. Financial stability appears quite vulnerable precisely as countries privatize their banks, such as in Chile, Russia, Mexico or Korea. Of course, all this could be attributed to

[40] Claessens and Perotti (2007) offer a more general review of the evidence on the link between inequality and financial development, without seeking to establish causality.

[41] State banks are often seen as a tool to collect resources (Gordon and Li, 2006). Even development banks do not appear to broaden access to finance, and tend to become rapidly decapitalized. State banks tend to lend more to state owned enterprises (Sapienza, 2004) or firms with political connections but less likely to repay, even though they pay lower rates than comparable borrowers (Faccio (2006); Faccio, Masulis, and McConnell (2005); Khwaja and Mian (2004); Chiu and Joh, (2004); Claessens, Feijen and Laeven (2006).

regulatory inexperience. But since the 2007-08 crisis in highly developed countries, there is a recognized need to better understand the causes of excess risk creation beyond "poor institutional quality". This promising and timely research agenda is in its infancy.

A simple conceptual framing endogenizing risk taking as a function of political accountability is modeled in Perotti, Volpin and Vorage (2012). The general conclusion of this model endogenizing lobbying pressure is that each regime produces its own sort of instability. An unlimited government chooses state control over banks to extract larger rents. Indeed, state banks dominate in autocratic countries (Caprio, Laeven and Levine 2007). In a system with an unconstrained executive, instability arise from political expropriation, funded via bank or fiscal default or inflation.

As political accountability rises, politicians become more concerned with social welfare, measured by bank efficiency, access to credit and stability. Politicians choose to allow private bank control at an intermediate stage of political accountability, when regulatory capture is still a serious risk. At this endogenous transition point, control will be assigned to groups willing to bribe in exchange for gaining privileged access. While these private banks are more efficient, political support for concentrated control leads to captured access to credit and related lending. The model predicts a jump in financial instability risk around privatization, as shareholders care for efficiency but do not internalize welfare losses arising from default. This is consistent with the cross country evidence on banking crises in privatizing countries at intermediate level of accountability with a prevalence of family-controlled banks (Morck Yavuz Yeung 2011), where financial instability appears as high as in systems dominated by state banking. [42] Empirical evidence suggests a specific channel is related lending, specifically in countries with weak institutions (Cull, Haber and Imai 2011). The experience of the political transition of many middle income countries such as Russia, Chile, Mexico and Korea appear consistent with this framework (LaPorta et al 2003; Perotti 2002; Lee 2005).

Finally, in highly accountable systems, politicians come under pressure to allow broader access to credit and greater entry (Acemoglu 2008; Perotti Volpin 2007). In principle,

[42] A remarkable study of such a process following bank privatization is offered in LaPorta et al (2003).

they also seek to limit risk taking. However, this conflicts with their goal to promote competition, associated with more bank entry and broader ownership. While this increases productive efficiency, it also produces its own source of risk. As more competition reduces rents and thus incentives for solvency, an increasingly competitive banking system lead to greater risk taking incentives even in accountable countries (Perotti Volpin and Vorage, 2012).

As instability has social costs, the government should increase oversight to compensate for growing risks. But democratic systems are vulnerable to pressure for broader access to credit for marginal borrowers. Unequal systems may be particularly vulnerable political incentivesto to promote a debt-based broader home ownership (Biais and Perotti, 2002; Rajan, 2011). This may lead to laxer standards, higher debt for financially weaker firms and household, and excessive risk creation.

Many commentators attribute in part the US real estate crisis to a deliberate push by the US government to promote home ownership for poorer households. Mian and Sufi (2009) show how economically disadvantaged areas experienced an abnormal boost to subprime mortgage lending, unrelated to their repayment capacity. Mian et al (2012) show how US legislator voting on regulation encouraging subprime lending reflected industry contributions. Igan et al (2009) shows mortgage lenders particularly active in lobbying were distinguished by faster credit expansion and higher losses. In a longer historical perspective, Rajan and Ramcharam (2011) show how those US states that had encouraged bank entry and become more financially developed enjoyed both more credit in the land price boom in the 1920s and a more severe bust. They also show how these shocks appear to have persistent long term effects.

To what extent political factors and opportunistic risk taking overshadow traditional explanations on bank risk choices reflecting poor private governance? Beltratti and Stulz (2011) offer some clear answers, suggesting an alignment of shareholder and manager interest in the run up to the crisis. Banks strongly in market favor in 2006 had especially poor returns in the crises. Even more explicitly, banks with better governance in the sense of more shareholder-friendly boards performed worse. Overall, this evidence suggests bankers made choices consistent with shareholder preferences, reflecting highly leveraged risk taking and possibly bailout expectations. Interestingly, banks in countries with stricter capital requirement regulations and more independent supervisors performed better.

In conclusion, the risk of financial instability persists across political regimes, but it evolves reflecting new rules of the games. Specifically, it appears to evolve from expropriation risk towards capture of access in democratizing countries. In highly accountable political system, the risk appears to be excess credit creation, the outcome of a combination of regulatory capture and populist policies. Surely more work is needed in this direction, especially focusing on validation at transition points.

## Conclusion

This survey has focused on how a recent literature has added broader representation to the classic institutional view of limited government (North and Weingast, 1989) as critical to the development of the financial system. Recent theoretical work offers novel explanations on the broader financial structure and its evolution. Political economy models offer further insight beyond the descriptive wisdom on the "continental European/Japan vs. the Anglo-Saxon model", better able to be assessed empirically. Models on the role of special interests and alliances in shaping financial access and regulation explain not only the scale but also the scope of financial intermediation, and in particular distributive effects on access and risk. But their distinct contribution is in the promise of explaining financial evolution. Explicit models define specific predictions on how political changes shape financial structure. Structural breaks such as the Great Reversals cannot be explained by time invariant legal or cultural characteristics. While these are often interpreted as ideological changes in response to shocks (eg Roe 2003), to an economist such changes are endogenous. They may reflect shifts in economic preferences by pivotal groups, as in Perotti and von Thadden (2006) and Pagano Volpin (2005), or changes in the balance of political power, as in Rajan and Zingales (2003).

The approach holds some promise to describe the dynamic process of financial development in emerging countries. While it presents a skeptical view on reforms in a weak institutional environment, it can help a focus on policy choices more robust to regulatory or populist capture.

Promising further research would study the political determinants of financial instability. So far this has been explored mostly at the cross country level and in the context of developing countries. Deposit insurance and tighter regulation since the 1930s, a political response to saver concerns, reduced the frequency of banking crises in developed countries. However, since decades of financial liberalization ushered in the dramatic 2007-08 financial crisis, there is no longer any question that system-wide risk build up affects all economies. The challenge is to understand the roots of instability across societies, and how endogenous risk taking arise under different rules of the game.

Finally, the political economy approach can also offer insight on how such a large redistributive shock will affect political choices. A popular backlash against financial markets may have effects resembling the interwar experience. It may become captured and ultimately distort regulatory choices in favor of entrenched interests. Of it may create a general dependence on sovereign borrowing, ultimately crowding out private credit and reducing economic recovery and innovation.

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