

Political Credibility, Citizen Information and Financial Sector Development

Competitive elections and newspaper circulation have large effects on financial sector development

Philip Keefer

Governments prone to expropriation stifle growth on both sides of bank balance sheets: depositors are unwilling to risk their funds in expropriable bank accounts; bankers are unwilling to lend to those who might abscond with the funds under the protective umbrella of a sympathetic government; investors are unwilling to capitalize banks whose profitability is placed at risk by the prospect of government expropriation. Political economists have underlined the role of political checks and balances to ensure the credibility of government commitments not to expropriate actors in financial markets, while finance researchers have argued for the primacy of legal systems as guarantors of private rights.

We examine the role of political factors and the influence of a country's legal system origins on financial sector development using objective indicators for 66 to 117 countries (the sample size varies for different estimations) over the period 1975-2000. Specifically, we focus on:

- *The role of political checks and balances*, which serve as the source of credible commitments by governments with bankers and industrialists. The measure used in our test is how many political actors can block proposed legislation, i.e. whether formal institutions exist that can potentially constrain arbitrary behavior by the executive branch.

- *The role that political competition plays*, which can affect government incentives to cater to special interests at the expense of citizens at large. Here an index is used, which ranges from 1 (no elections held) to 7 (multiple parties competed for executive elections, with no one party getting more than 75% of the vote), with only the latter regarded as competitive elections.

- *The credibility of pre-electoral political promises and citizen information* about the actions of political decision makers. The measures include the continuous years of competitive elections and newspaper circulation, respectively.

- *The link between financial and the origins of the legal system* of a country. It has been argued that, in contrast to the French or socialist legal systems, the English common law tradition offered judicial protection of private property rights against predation by the state. The German and Scandinavian legal systems, though also in the civil law tradition adopted by the French, were consciously intended to be more amenable to change than the French.

When citizens do not believe the promises of political competitors, financial sector development slows

Politics Has Large Effects

Our empirical investigation confirms that political checks and balances, and, to a lesser extent, competitive elections, have a significant influence on financial sector development (measured as total credit to the private sector). The magnitude of the effects is large: financial sector growth over the period 1975-2000 was two percentage points per year faster in countries with competitive elections in 1975 than in countries without. Results for political checks and balances are equally large.

This implies that although autocratic regimes may be able to reach credible bargains with bankers and industrialists sufficient to spur economic growth, such efforts are the exception rather than the rule.

Moreover, it is clear from our analysis that the effect of checks and balances impacts on the security of property rights, which is the sum of the risk of expropriation, the enforceability of contracts with government, corruption and bureaucratic quality.

The effects of politics on financial sector development extend beyond the formal institutions of competitive elections and political checks and balances. Both the continuous years of competitive elections and average newspaper circulation have large effects: a one standard

deviation increase in the initial number of continuous years of competitive elections is associated with an increase in the size of the financial sector in 2000 of as much as 25% of GDP. Results for newspaper circulation are still larger.

The results also underline the importance of a different kind of credibility for financial sector development. When average citizens do not believe the promises of political competitors to provide such public goods as secure property

rights or are unable to monitor the fulfillment of such promises, financial sector development slows.

Legal Origins Substitute for Political and Historical Factors

Revisiting the debate about politics, legal origins and finance, we confirm the close relationship between legal origin and each of the political variables considered. Indeed, Scandinavian and German legal origins are associated with competitive elections and newspaper circulation. This certainly does not suggest that legal origins determine political systems, but rather that historical forces associated with colonial heritage drive both subsequent political development and the evolution of legal institutions. Legal origins are thus a good proxy for underlying historical and political factors that reflect the willingness of governments to favor broad over narrow interests in society. When this willingness is directly modeled, legal origins are no longer significant determinants of financial sector development.

Philip Keefer is Senior Research Economist in the World Bank's Development Research Group. Full text of the author's paper is available at: <http://go.worldbank.org/KXX6HMPUC0> (WPS 4154). **BT**