

Is the financial sector a laboratory for research on the political economy of development?

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We know quite a bit about the role of the state in economic growth/development:

Insecure property rights slow development (Keefer and Knack; Acemoglu, Johnson and Robinson)

Rent-seeking/corruption (Mauro, but less clear)

Provision of public goods, education to regulation to the rule of law

. . . and the financial sector is exposed to each of these, not necessarily independent problems

Property rights insecurity: expropriation of deposits by government

Rent-seeking/corruption: illicit payoffs for state guarantees of bank liabilities

Provision of public goods:

- (1) Regulation: Absent or inefficient regulation allows bankers to steal deposits (e.g., directly, or through high risk lending practices) or allows costs of high-risk lending/theft to be shifted to the public.
- (2) Rule of law: State does not enforce loan repayment loans by borrowers (state, state-owned, or private).

We DON'T know why few countries have secure property rights/low corruption/quality provision of public goods

The literature is focusing on:

Elections

Checks and balances

Social polarization/inequality

Voter information

The credibility of pre-electoral promises of politicians

Elections

Elections create incentives for quality public good provision such as the rule of law (by lowering the costs to average citizen of applying sanctions to non/malfeasant politicians).

However, elections also give the poor the opportunity to tax the rich (Alesina and Rodrik, Persson and Tabellini, Acemoglu and Robinson)

Checks and balances

Checks and balances among political decision makers restrain expropriatory behavior by the state (North and Weingast)

But the efficacy of checks and balances depends on the correct alignment of veto player preferences (Stasavage on the post-Glorious Revolution).

Social polarization, inequality, political instability

Significant inequality, where rich and poor are in competing political parties, leads to political instability and consequent and continuous rearrangement of property rights allocations (Acemoglu and Robinson).

Significant social polarization, including inequality, leads to greater instability in government decision making (social choice: larger uncovered sets) and greater potential for significant deviations from status quo policies (Keefer and Knack).

Voter information

Where voters cannot monitor politician action, scope for anti-social decision making is high; where voters cannot identify politician type, scope for special interest influence is high (Baron, Grossman and Helpman).

Credibility of pre-electoral promises

Where pre-electoral promises are not at all credible to anyone (counter-factual), public good provision plummets and rent-seeking soars (Ferejohn, Persson and Tabellini).

Clientelism: Where pre-electoral promises are credible only to those with whom politicians have personal relationships (common in many democracies), though, the same occurs (Keefer).

Illustrative cross-country statistical findings – The Rule of Law

Across all countries (democracy and non-democracy), 1982-1997

Specification: rule of law = f (income per capita-1981, continental dummies, total population, percent population young, land area, political instability, checks and balances, dummy for competitive legislative elections; gini coefficient-1981 or as close as possible).

Political instability: the rule of law is significantly lower in countries in which, on average, a larger fraction of political veto players are replaced every year.

Checks and balances: the rule of law is greater when there are more political checks and balances

Elections: competitive elections have a slightly negative or no effect on the rule of law (NB: effect persists when checks and balances omitted).

Illustrative cross-country statistical findings –the rule of law, inequality and instability

Income inequality (Gini): Beginning of period income inequality has a negative effect on subsequent rule of law.

However: Beginning of period (1981) inequality has a positive effect on subsequent political stability (consistent with Knack/Keefer, who show inequality and political violence unrelated).

Implication: the effect of inequality on property rights/the rule of law may be more strongly related to its effect on government decision making than on regime instability.

Illustrative cross-country statistical findings – democracies only, credibility

Specification: rule of law = $f(\text{income per capita-1981, continental dummies, total population, percent population young, land area, political instability, checks and balances, dummy for competitive legislative elections; gini coefficient-1981 or as close as possible, AND number of years competitive elections continuously held in 1981})$.

Number of years elections continuously held is a reasonable proxy for the credibility of political competitors.

Illustrative cross-country statistical findings – credibility

Election years: Rule of law is significantly higher for those countries that were democracies in 1981 and had more years of competitive elections. Experiment is robust to looking at average of election years over the period, for all countries that were ever democratic during the period.

However: checks and balances no longer significant; but political instability and inequality are (though not jointly).

Study of all these issues is in its infancy

Very little evidence on the welfare effects of information

Very little evidence on checks and balances that controls for veto player incentives and interests

Very little linking fundamental political forces to specific government actions that are widely agreed to undermine development/growth (specific types of expropriation/poor regulation/underprovision of public goods)

The financial sector is a potentially useful laboratory to explore these issues further

The financial sector is key to growth (King and Levine; Beck, Levine and Loayza)

And it is subject to the problems of the state that we're seeking to understand.

Only a fraction of the “fundamental” political forces in development have been explored in the financial sector

US financial sector regulation decisions have been linked to the conflict among special interests, the incentives of politicians (whether they are the recipients of PAC contributions), and institutions (committee power in Congress) – Kroszner et al; Romer and Weingast). This work illuminates the policy issues in the US, but isn't intended to confront the issues outlined earlier.

Financial sector development/banking crises have been firmly linked to the security of property rights/the rule of law (Levine, et al.; Demirgüç-Kunt and Detragiache; North and Weingast; Haber et al.).

Bank crises – both their probability and their magnitude – have been linked to checks and balances (but conditional on the size of the financial sector); to the number of years of continuous elections; and to the years between the crisis date and the next election (Keefer, Montinola).

Advantages of using the financial sector as a laboratory in the future

Financial sector decisions/regulations and their consequences are extremely well-documented relative to other areas of government decision making, both across countries and in history.

Disadvantages

Financial sector political economy experiments may not be “clean”: The cleanest experiments in to push forward the political economy agenda in development are those in which special interests are set against the public interest. Political conflict in the financial sector, sets special interest against special interest AND special interest against the general public.

The equity effects of financial sector growth are ambiguous: Rapid financial sector growth may reach only a fraction of the population – this doesn't make it bad or irrelevant, but it means that it is not appropriate for looking at the non-growth aspects of economic development.

More is not always better in the financial sector: we usually think of more education as better. It's not necessarily the case with indicators of financial sector development or with

indicators of regulatory performance in the financial sector. Example: an increase in credit to the private sector is great – but if the increase is 50% in one year, we likely have a crisis brewing.