11. Legal Institutions and Financial Development

THORSTEN BECK and ROSS LEVINE

1. INTRODUCTION

A burgeoning literature finds that financial development exerts a first-order impact on long-run economic growth. Levine and Zervos (1998) show that banking and stock market development are good predictors of economic growth.[1] At the microeconomic level, Demirguc-Kunt and Maksimovic (1998) and Rajan and Zingales (1998) find that financial institutions are crucial for firm and industrial expansion. While disagreements remain, the bulk of existing evidence points to a strong finance-growth nexus.

The finding that financial development influences economic growth raises critical questions, such as why do some countries have well-developed growth-enhancing financial systems, while others do not? Why have some countries developed the necessary investor protection laws and contract-enforcement mechanisms to support financial institutions and markets, while others have not?

The law and finance theory focuses on the role of legal institutions in explaining international differences in financial development (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1997, 1998, 2000a, henceforth LLSV). The first part of the law and finance theory holds that in countries where legal systems enforce private property rights, support private contractual arrangements, and protect the legal right of investors, savers are more willing to finance firms and financial markets flourish. In contrast, legal institutions that neither support private property rights nor facilitate private contracting inhibit corporate finance and stunt financial development.

The second part of the law and finance theory emphasizes that the different legal traditions that emerged in Europe over previous centuries and were spread internationally through conquest, colonization, and imitation help explain cross-country differences in investor protection, the contracting environment,

[1] Furthermore, King and Levine (1993a,b) show that bank development predicts economic growth. Panel investigations indicate that the relationship between finance and growth is not due to reverse causality (e.g., Beck, Levine, and Loayza (2000), Levine, Loayza, and Beck (2000), and Beck and Levine (2004). For a review of the literature, see Levine (1997, 2004).

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 251–278.

and financial development today. More specifically, legal theories emphasize two inter-related mechanisms through which legal origin influences finance (Hayek, 1960). The "political" mechanism holds that (a) legal traditions differ in terms of the priority they attach to private property vis-à-vis the rights of the State and (b) the protection of private contracting rights forms the basis of financial development (LLSV, 1999). The "adaptability" mechanism stresses that (a) legal traditions differ in their formalism and ability to evolve with changing conditions and (b) legal traditions that adapt efficiently to minimize the gap between the contracting needs of the economy and the legal system's capabilities will more effectively foster financial development than more rigid systems (Merryman, 1985).

Countervailing theories and evidence challenge both parts of the law and finance theory. Many researchers accept that effective investor protection facilitates efficient corporate financing and growth-enhancing financial development, but reject the law and finance's view that legal origin is a central determinant of investor protection laws and financial development (Roe, 1994; Pagano and Volpin, 2001; Rajan and Zingales, 2003). Furthermore, while some scholars accept the importance of legal tradition in shaping the efficiency of financial contracting, there are sharp disagreements about which legal systems work best to promote the efficient evolution of the law (Rubin, 1982). Alternatively, some studies directly question the importance of investor protection laws by arguing that changes in investor protection laws did not drive the evolution of corporate ownership and financial development in the United Kingdom and Italy (Franks, et al., 2003; Aganin and Volpin, 2003).

Given debates about the role of legal institutions in shaping financial development, the remainder of the Chapter is organized as follows. Section 2 describes the law and finance theory along with skeptical and competing views.[2] Section 3 reviews empirical evidence on both parts of the law and finance view. That is, we assess (i) whether legal origins account for cross-country variations in property rights protection, support of private contractual arrangements, investor protection laws, and financial development and (ii) the degree to which cross-country differences in investor protection laws explain differences in corporate finance and financial development. Besides examining supportive and conflicting evidence on these two parts of the law and finance theory, we also summarize recent findings on the mechanisms—the political and adaptability mechanisms—through which law and finance may be related. Section 4 concludes.

[2] To qualify our approach, however, we recognize that many participants in the law and finance debate may not agree that the law and finance view is necessarily composed of the two parts mentioned above. This is not crucial for our review. We simply note that many contributors to the debate on the links between legal institutions and financial development examine (i) the impact of legal origin on property rights protection, support for private contractual arrangements, and investor protection laws, (ii) the impact of investor protection laws and their enforcement on financial development, or (iii) both. This review examines these different components.