## Institutional Determinants of Private Credit Development: Between Democracy and Rule of Law

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### Abstract

Relationships between democracy and economic growth have gained considerable attention over the last decades. However, not only theoretical arguments, but also empirical findings on the subject usually contradict each other. In this thesis, I argue that a focus on better defined and more narrow aspects of these phenomena can help to reduce this ambiguity. By analyzing the relations between democracy, rule of law and private credit development which is an important determinant of economic growth, I show that rule of law has a significant and robust effect on financial development, while democracy shows small, negative but insignificant effects on all aspects of financial development considered in this study. In order to demonstrate this I employ statistical investigations into effects of democracy and rule of law on different aspects on financial development using a data consisting of a 19-year panel of 150 countries.

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### Introduction

Does democracy foster or hinder economic growth? This question might appear trite, as it has been in the center of the political science's attention for a long time (Przeworski and Limongi 1993). However, for the time being there is still no agreement between scholars neither on how democracy affects economic growth nor on what are the particular mechanisms that might link political regimes to economic performance (Przeworski and Limongi 1993; Doucouliagos and Ulubaşoğlu 2008). Considering the vast literature on the subject, the current ambiguity in empirical findings suggests that the typical framework of analysis used in this literature might be inadequate. Thus, an alternative framework which helps to avoid the pitfalls of previous research should be introduced.

This thesis sets out to contribute to the debate on democracy and economic growth by focusing on financial development as an important aspect of economic growth. It also seeks to contribute to the debate by providing a clear analytical distinction between electoral democracy and rule of law. There are two important aspects that make this approach relevant and more adequate than previous attempts. First, there is robust evidence that financial development is positively associated with economic growth (R. G. King and Levine 1993a; Rajan and Zingales 1996; Demirgüç-Kunt and Levine 2008). Thus, it provides a reliable starting point for one who aims to narrow the focus and analyze a particular aspect of economic growth, which by itself is a complex and multidimensional phenomenon. Second, the multidimensionality of the typical measurements of democracy is also of limited help, especially if the previous empirical findings presented in the literature contradict each other. The use of broad operationalizations of democracy is particularly problematic because they usually implicitly include rule of law as an inherent component, while this clearly undermines our ability to account for those regimes

that managed to establish rule of law without being democracies. As Barro demonstrated (1996a), if democracy and rule of law are operationalized and included in a model independently, otherwise a positive and significant effect of democracy on economic growth might disappear.

Therefore, my aim is to shift the focus from asking broad and blurred empirical questions to uncovering the relations between specific and easily defined concepts. This thesis by no mean seeks to ultimately solve the broad puzzle of whether democracy fosters or hinders economic growth. Instead, by narrowing the focus from economic growth to financial development and by separating electoral democracy from rule of law, I attempt to provide a clear and coherent description of the interplay between the important aspects of both democracy and economic growth. I argue that if the majority of relations between democracy and important aspects of economic growth will be described in a similar manner, this would lead to a significant decrease in the ambiguity currently presented in the literature.

In order to understand what the relations between electoral democracy, rule of law and financial development are, apart from a literature review, I utilize a combination of a qualitative description of important historical cases and a cross-country time series statistical analysis. The case studies conducted on a set of particular countries, namely – East Asian and Latin American countries in the 1970-s and 1980-s, together with a set of countries that have experienced a significant level of democratization in the period from 1996 to 2007, provide a good starting point for the analysis as they exhibit some regularities in the relations between political regimes and economic performance. Together with some theoretical arguments, the findings presented in these case studies suggest two hypotheses to be tested. These hypotheses are:

### H1: Democracy does not contribute to the development of the financial sector

#### H2: Rule of law positively affects the development of the financial sector

The statistical analysis by which I intend to test these hypotheses is based on a sample of approximately 144 countries from 1996 to 2014. The combination of qualitative evidence and statistical findings can potentially enhance the robustness of these findings and allow more confident claims about the relations between democracy, rule of law and financial development. Additionally, I supply my analysis with several alternative operationalizations of the main variables in order to broaden the amount of different empirical dimensions covered by this analysis.

In the first chapter of this thesis, I describe the main theoretical arguments and place my position within current debate. In the second chapter, I describe important historical cases in order to bring out qualitative evidence that deserves further statistical analysis. In the third chapter, I discuss the data collection process and the main methodological choices made prior to the analysis. In the fourth chapter, I present the main statistical findings together with their substantive interpretation. In the last chapter, I discuss the implications of these findings, the main limitations of this study, as well as some suggestions regarding future research.

### **Chapter 1. Theoretical Background**

In this chapter, I provide a review of the literature on institutions and economic growth. The main goal of this review is to describe the most important theoretical and empirical developments regarding the role of institutions in economic growth in general, and the specific roles of democracy, rule of law and private credit in particular. The first section of this chapter provides a review of current debates about whether democracy promotes economic growth or not and how the concept of rule of law is incorporated into these debates. The second section describes the relations between the concepts of democracy and rule of law. The third section deals with the effects of financial development and private credit on economic growth. The fourth section describes the author's contribution in the existing debates. The short summary is presented at the end of the chapter. The main argument set out by the chapter is that there is a significant ambiguity in both the theoretical and empirical literature on the subject. Thus, it is necessary to develop a more narrow and precise analytical focus and empirical operationalization in order to avoid common pitfalls.

### 1.1 Democracy and growth: an unsolved puzzle

The neoclassic tradition of explaining differences in growth rates has been consistently criticized for its inability to provide a fundamental explanation of economic growth (Acemoglu, Johnson, and Robinson 2005). Starting from Solow (1956), the neoclassical models of growth explain it in terms of different paths of factor accumulation, such as differences in saving rates or preferences (Cass 1965; Koopmans and others 1965), which in the contexts of these models are exogenous parameters (Acemoglu, Johnson, and Robinson 2005). The incorporation of technological innovation (P. Romer 1989; Grossman and Helpman

1990) and human capital development (Becker, Murphy, and Tamura 1994; Benhabib and Spiegel 1994; P. M. Romer 1990) as explanatory factors of economic growth have without a doubt enhanced our understanding of this process. Although these models are usually associated with the so-called endogenous growth theory tradition, they face the same problem – such factors as innovation, knowledge spillover or human capital development are endogenous only in the sense that they are explicit in the models. However, these models themselves do not provide any explanation for why countries differ in their levels of innovation or human capital development (Acemoglu, Johnson, and Robinson 2005).

As an alternative approach, it was proposed to look at institutions, which are believed to be not just a proxy of economic growth, but rather the root cause of growth (North and Thomas 1973; North 1990; Knack and Keefer 1995; Acemoglu, Johnson, and Robinson 2005). Douglass North, the founder of the modern institutional approach to economic growth, suggested the following definition of institutions: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction" (North 1990, 3). This definition is, however, very broad in its scope and covers all aspects of society. More specifically for economic growth, such institutions as the structure of property and contractual rights and the presence and perfection of markets are important, as the absence of secure property and contractual rights hinders investment and specialization, while the absence of proper market structure undermines the effective allocation of resources(Acemoglu, Johnson, and Robinson 2005; Knack and Keefer 1995). Therefore, it is possible to conclude that these two traditions of explaining economic growth do not contradict each other, but rather present two different levels of analytical reduction. Indeed, institutions promote economic growth as they stimulate technological innovation, human capital development and other conditions, which are seen in the neoclassic tradition as positively affecting economic growth.

In the field of political science, political regimes as specific configurations of core political institutions, have been in the center of attention for a long time. Unsurprisingly, due to an important focus on democracy in the field, many attempts were made to determine whether democracy fosters or hinders economic growth. However, the relationship between democracy and economic growth is still a puzzling question, with no agreement between scholars neither in terms of the direction of the causal relationship nor in terms of particular causal mechanisms (Przeworski and Limongi 1993; Doucouliagos and Ulubaşoğlu 2008). In terms of theoretical argumentation, proponents of the idea that democracy facilitates growth usually argue that political leaders are prone to choose suboptimal means of resource allocation which benefit them personally, but democracy helps to constrain them, which leads to a more optimal allocation for the whole society (North 1990). On the other hand, those who argue that dictatorships promote economic growth more effectively, emphasize that democracies are particularly vulnerable when hard economic policies are necessary, but authoritarian regimes, due to the higher level of state autonomy, are insulated from such pressures ((Przeworski and Limongi 1993; Doucouliagos and Ulubaşoğlu 2008).

Now I am moving to the detailed arguments suggested by proponents of 'democracy facilitates growth' theory. First, as Roberto Perroti mentions (Perotti 1996), the recent literature on income distribution and growth in democracies can be divided into three main approaches: the 'fiscal policy', 'socio-political instability', and 'borrowing constraints/investment in education' approaches. The 'fiscal policy' approach examines governmental expenditures, taxation and budget constraints and their effect on economic growth. As a number of scholars have argued (Alesina and Rodrik 1991; Perotti 1996; Bertola 1993), in the long-term, the fiscal policy interests of the decisive voter prevail over other considerations, which leads to a decrease in taxation distortion and thereby enhances growth. The second, 'borrowing constraints/investment in education' approach, suggests the importance of having a large

middle class for the purpose of economic, as more individuals are able to invest in human capital and consequently growth is higher (Galor and Zeira 1993). However, as for many other theoretical arguments in favor of positive effects of democracy on growth, the link between democracy and a large middle class is not clear. The 'socio-political instability' approach emphasizes that when some groups in society are oppressed in a systematic manner, it creates incentives for them to pursue their interests outside of the formal markets in terms of economic activity and outside of political institutions in terms of representation (Alesina and Perotti 1996). In all three approaches, the direct link between democracy and growth is the result of pressure from the so-called 'decisive voter'. Despite the fact that all three approaches underline different economic mechanisms, the political mechanism remains the same – pressure from the decisive voter, which leads to the decrease in inequality through different means of distribution.

However, several scholars reversed this set of arguments against democratic regimes. For instance, as it was stated by Heilbroner (1963, 138): ""in most of the underdeveloped nations the choice for the command post of development is apt to lie between a military dictatorship and a left-wing civilian dictatorship.... the logic of events points to the formation of economic systems and political regimes which will seek to impose development on their peoples. Communism may well be the quickest possible way out of underdevelopment...." Another famous scholar, Jagdish Bhagwati, expressed the similar opinion (1966): "...socialist countries... have an immense advantage: their totalitarian structure shields the government from the rigorous and reactionary judg ments of the electorate. . . . Another advantage of the socialist countries is their passionate conviction and dedication to the objective of economic growth-which contrasts visibly with the halting and hesitant beliefs and actions of most democracies."

More precisely, proponents of this idea claim that democratic leaders are vulnerable to the demand for redistribution to lower-income groups, of everybody below the median voter income. During the electoral cycle within democratic systems, where many influential pressure groups exist, politicians in office spend resources on immediate consumption in order to be reelected, which hinders economic growth. The mechanism here is that these redistributed resources should be at first taken from other sectors, while they could be invested in long-term projects (Krueger 1974; J. N. Bhagwati 1982; Przeworski and Limongi 1993; Doucouliagos and Ulubaşoğlu 2008). Moreover, this idea could be reformulated in such a way that authoritarian regimes would appear to be more effective in promoting economic growth. Pzeworski and Limogi suggest that there are several conditions under which such results could be achieved - "State autonomy enhances economic performance because: (1) the state has a role to play to make the economy function efficiently; (2) the state must be insulated from private pressures if it is to perform this role well; and (3) the state apparatus wants to perform this role well" (1993). One may argue that these conditions represent a relatively high wall to climb, and although there are the well-known cases of the Asian tigers, might not be supported by empirical data. Moreover, all these theoretical assumptions require empirical testing, which started in late 1980s and early 1990-s. However, these set of theoretical arguments is highly supported both anecdotally and by the prominent scholars.

Unfortunately, further empirical investigations have not helped to clarify this issue. As it was emphasized by Przeworski and Limongi (1993), there are not only contradicting theoretical models, suggesting opposite effects of democracy on economic growth but also contradictory empirical findings. In 1974, William Dick attempted to clarify the issue and conducted a statistical study on authoritarian versus non-authoritarian approaches to economic development. He found no conclusive relations between authoritarian reforms and growth, nor between democracy and growth and concluded that a particular outcome depends on the circumstances prevailing in each country (Dick 1974). Fifteen year later, this finding remained, with Doucouliagos and Ulubaşoğlu (2008) conducting a meta-analysis of 84 studies on democracy and growth in order to determine what type of relationship between them received more empirical support within the field. The authors reported that from 84 published democracy-growth studies, 15 percent of the estimates are negative and statistically significant, 21 percent of the estimates are negative and statistically insignificant, 37 percent of the estimates are positive and statistically insignificant, and 27 percent of the estimates are positive and statistically significant. The authors concluded that the meta-analysis suggested no direct effect of democracy on economic growth, but rather through higher human capital, lower inflation, lower political instability, and a higher level of economic freedom.

### 1.2 Democracy and rule of law: the Gordian knot

The situation described in the previous section might be because democracy, as the unit of analysis, is too broad and thus inadequate (Baum and Lake 2003; Doucouliagos and Ulubaşoğlu 2008). Indeed, democracy itself is a multi-dimensional phenomenon, and thus is a combination of different institutions, which might affect economic growth in different ways. Given this fact, attempts were made to link democracy with the other institutional determinants of economic growth, such as rule of law. The focus on rule of law is a promising approach since it captures more features of institutional quality than other measures (Rodrik, Subramanian, and Trebbi 2004) and has solid theoretical foundations (North 1990; Barro 1996b; Hall and Jones 1999; Dollar and Kraay 2003; Acemoglu, Johnson, and Robinson 2005).

However, it is difficult to provide an exact definition of what constitutes rule of law (Haggard, MacIntyre, and Tiede 2008). The most commonly used conceptualization of rule of law suggests a combination of different legal, political and economic institutions, which secures property and contractual rights (Knack and Keefer 1995; Glaeser et al. 2004; Barro 2001; Acemoglu, Johnson, and Robinson 2005). As stressed by North (1990), "the inability of

societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World". Some authors go as far as to suggest that institutions or a proxy for them are at base the extent of property rights protection (Haggard, MacIntyre, and Tiede 2008; Acemoglu, Johnson, and Robinson 2000). The logic behind its effect on economic growth is fairly intuitive - security of property rights and effective contract enforcement positively affect investment and trade by reducing related risks and thus provide incentives for economic agents to invest and engage in different forms of trade (Haggard, MacIntyre, and Tiede 2008). Although parsimonious, empirical investigations an exact definition of rule of law depends on a particular empirical operationalization. Moreover, as with almost all similar questions there is the problem of reverse causality regarding the question whether rule of law underpins economic growth (Haggard, MacIntyre, and Tiede 2008). Nevertheless, the belief that rule of law, in the form of property and contractual rights protection, is an important determinant of economic growth is widely supported in the literature on institutions and growth.

After describing the interplay between rule of law and growth, the next step is to provide a theoretical link between democracy and rule of law. While economic growth and rule of law have a clear relation, the connection between democracy and rule of law are less well established. For instance, Przeworski and Limongi (1993) emphasize that, "While everyone seems to agree that secure property rights foster growth, it is controversial whether democracies or dictatorships better secure these rights". The main objection of Przeworski and Limongi to the literature on democracy and growth is that democracy is often used as a proxy for property right guarantees, which is a substitution of concepts. According to Przeworski and Limongi,, neither North (1990) in his arguments in favor of democracy, nor Olson (1991) in his arguments against dictatorship provided a clear and theoretically sound link between democracy and rule of law. However, there are general theoretical considerations regarding how democracy might underpin rule of law. Most of them are centered around the issue of checks and balances in democratic regimes. The argument is that possible gains from security of property rights and enforcement of contract cannot be fully realized, if no effective checks on executive discretion are implemented, as politicians can and have incentives to break previous commitments (Haggard, MacIntyre, and Tiede 2008). Another line of explanation deals with the so-called 'expropriation dilemma' – if the sovereign alters property rights in his or her favor, in the long run it will result in a decline in investment and thus in economic downturn (Weingast 1997). Therefore, it is necessary for governments to establish rule of law and make credible commitments to it. Yet, there is no theoretically sound argument as to why only democracies can solve this dilemma in such a way, even though, it is argued that in dictatorships solving this dilemma may lead to dangerous political outcomes, as the level of individuals' economic autonomy from a sovereign would increase, while democracies do not face such a threat (Weingast 1997).

However, these theoretical considerations are by no means empirical. In fact, some of the most profound empirical findings have suggested that when rule of law is explicitly included in the model, the previous significant effect of democracy on economic growth not only disappears, but becomes weakly negative (Barro 1996a). Przeworski (2000) came to a similar conclusion, arguing that while controlling for other important determinants, democracy has no effect on economic growth and there is no significant difference between rich democracies and autocracies. However, several more recent studies have suggested that if democracy is treated as a factor with a long-term effect and no immediate outcomes, even if other factors are included in the model, democracy still has a positive effect on economic growth over time (Gerring et al. 2005). Considering the above mentioned, it should be concluded that a clear analytical separation of democracy and rule of law is required.

### 1.3 Private credit development: a specific dimension of economic growth

Doucouliagos and Ulubaşoğlu (2008), in the conclusion of their meta-analysis of democracy-growth studies, suggested that future research in this area will be more informative if it focuses on the various channels through which democracy can affect economic growth. The advantages of analytical narrowing of the concept of democracy and the separation of rule of law were discussed in the previous section. The next logical step is to narrow and specify the concept of economic growth. One may consider analyzing the possible effects of democracy on a financial system as an important determinant of growth. While there is a state of uncertainty in the literature on democracy and growth, from the economic side there is robust evidence that developed financial institutions positively contribute to economic growth (R. G. King and Levine 1993a; Rajan and Zingales 1996; Demirgüç-Kunt and Levine 2008). The theoretical explanation for this is that financial intermediaries help to evaluate investment projects, mobilize financial resources from many small savers and facilitate risk management (R. G. King and Levine 1993b). However, as a financial system that allocates credit to the government or state-owned enterprises may not provide these services at the same level as financial systems that allocate credit to the private sector, the traditional measurement of financial development is the proportion of credit provided to private enterprises (King and Levine 1993a).

However, it is necessary to answer the question what does the word "developed" exactly mean regarding financial system and private credit sector in particular. Indeed, financial institutions are different in their scope and nature, and financial systems of different countries are by no means homogeneous. The first tradition of interpreting financial development relies on the analysis of legal institutions (T. Beck and Levine 2008). Within this tradition, finance is seen as a set of legal contracts related to financial operations (Beck and Levine 2008). Thus, the developed financial system could be conceptualized as a set of legal

institutions, which secures those contracts by reducing all related risks to such a degree that encourages financial transactions.

Speaking about particular causal mechanisms, there is a strong tradition in the literature on finance and law that links the level of financial development to the origins of a country's legal system (T. Beck and Levine 2008; Djankov, McLiesh, and Shleifer 2007). The main analytical focus within this tradition is on whether countries have British, French, German, or Scandinavian legal origins. However, this approach was criticized for its simplicity and analytical inadequacy, as there has been wide diffusion between legal traditions in Europe, and these traditions may work differently in different contexts (Dawson 1968; Merryman and Merryman 1985; T. Beck and Levine 2008).

While a fair critique, there are two more fundamental problems with this tradition. These problems are related to the conceptualization of financial development in terms of legal institutions which, if they are 'developed', foster financial transactions. First, this understanding of the developed financial sector in this case requires a proper measurement of financial transaction encouragement. Indeed, the level of proper analytical reduction would be within the question of the efficiency of these legal institutions in producing financial outcomes. However, there is no clear empirical cut-point point after which one financial sector can be considered 'developed', while in almost all countries in the world a certain number of financial transactions is presented. Therefore, it is necessary to understand this dimension of financial development in continual, but not discrete terms – that is, how well these transactions are secured and thus produce desired financial outcomes.

The second issue regarding this conceptualization is that it somehow reduces the notion of financial development to rule of law. While there is nothing wrong with such an approach per se, for the purpose of this particular study it seems to be problematic. If the level of financial development could be reduced to rule of law, there is no need for these two separate indicators to be presented within the same model.

However, it is intuitively appealing to assume that regardless of whether financial contracts are secured, financial systems across countries are different in more structural dimensions. In fact, the focus on legal heritage within the literature on law and finance already stresses this structural dimension, although in a narrow way. The broader question is what are the structural properties of a particular financial system such as its openness, stability or rather vulnerability, and the level of its liberalization. As a part of this general agenda, many scholars have concentrated on the issues of financial liberalization, international finance and foreign direct investment.

Speaking about financial liberalization, there is an interesting causal argument that a more developed financial system positively contributes to the process of technological diffusion associated with FDI and other spillover effects and thereby stimulates economic growth (Hermes and Lensink 2003; Alfaro et al. 2010). However, there is no agreement in the literature whether FDI promotes economic growth. Some findings suggest no robust effect (Carkovic and Levine 2002), while other findings suggest that there is an effect, but to be presented this effect needs to be facilitated by a sufficient absorptive capability of advanced technologies (Borensztein, De Gregorio, and Lee 1998), or outwardly oriented trade policy (Li and Liu 2005). Another important role of international liberalization in this process is that it supposedly tends to enhance the efficiency of the domestic banking system by allowing greater foreign bank presence, which in turn accelerates productivity growth (Levine 2001).

However, some argue that financial liberalization could lead to negative and relatively harsh economic consequences by making countries vulnerable to external shocks (Wade 1998; Dellepiane, Hardiman, and Las Heras 2013; Kattel and Raudla 2013; Schwartz 2011). At the same time, it should be mentioned that almost all the core empirical studies on this issue were conducted prior to the financial crisis of 2008. Since then some studies have suggested that financial liberalization, especially in its international dimension, can hinder economic growth by creating instability mainly through short-term capital flows (J. Stiglitz 2012). Moreover, reexamination of previous empirical studies shows that there is no strong positive effect of financial deepening on economic growth in more recent data (Rousseau and Wachtel 2011). Rousseau and Wachtel suggest that this effect could be explained by excessive financial deepening together with rapid growth of credit, which may have led to weakened banking systems which in turn triggers growth-inhibiting financial crises.

Although the analytical focus on the structural features of financial systems provides a very detailed and rich ground for intermediate conclusions and further investigation, it has an important limitation. These structural features are just institutional configurations of financial systems - not their outputs. Therefore, it is difficult to imagine how these features could be operationalized as a dependent variable within the present study. Moreover, it seems that in the literature on finance and economic growth the empirical operationalizations of financial development often take the form of a simple measurement of the size of the financial sector – that is, the size of private credit sector, usually measured in percent of GDP. While this issue will be discussed in detail in the chapter regarding data and methodology, one aspect of it should be clarified here.

As there is skepticism regarding the ability of the financial sector to promote stable economic growth, which emphasizes different structural properties of financial sectors, it should be taken into account on the stage of statistical modeling. For instance, one might expect that poor and rich countries experience different gains from a growing private credit market. The same logic is argued to be present in the case of small and big countries. Additionally, particular sectors that accumulate the main part of financial resources might be important. Indeed, if a significant part of a private credit market is credit to individuals for immediate consumption, it might have drastically different effects on economic growth in comparison with a situation where those resources are allocated mostly within advanced industries and start-ups.

Nevertheless, I suggest that an analytical focus on private credit sector development, as the particular causal mechanism of economic growth, would provide more precise and institution-specific results. This narrow focus helps to solve the problem of multiple causality, as economic growth might be caused by different and complex factors, while any political regime is a combination of different institutions with no single effect on economic growth. Consequently, the major limitation of this approach is that any possible answer obtained by such kind of analysis would not ultimately answer the broader question about economic growth and political regimes, but just clarify the causal relations in one particular dimension.

# 1.4 Rule of law and private credit development: is there a place for democracy?

Apart from the links between rule of law and growth discussed in the previous sections, namely – investment and trade – the third theoretically separate link is that it helps to establish an efficient credit market (Feder and Nishio 1998; Besley 1995). There is of course the question of whether it should be seen as a separate link or just the result of increasing trade and investment, which requires proper structures to operate effectively. Nevertheless, it is important that the role of a private credit market is highly emphasized in the literature on both growth and democracy and on growth and rule of law. Additionally, recent empirical findings show that institutions, and rule of law in particular, play a significant and positive role in the

development of private credit market (Djankov, McLiesh, and Shleifer 2007; Jappelli and Pagano 2002; La Porta et al. 1997).

However, the question about the relationships between democracy, rule of law and private credit development remains open. Indeed, if in the literature there is such strong support for the idea that rule of law fosters economic growth, both empirical and theoretical, and no clear link between rule of law and democracy, why should one analyze the role of democracy at all? I argue that there is a second instance where a narrow analytical focus on the private credit sector instead of economic growth in general can be of significant help.

I believe that in debates where two controversial sets of both theoretical arguments and empirical findings are presented, the most important goal is not to construct another theoretical framework, but rather to identify the exact causal relations between highly complex and interrelated phenomena. As was already argued, the precise focus on private credit as a particular mechanism of economic growth definitely helps to narrow the analysis. Moreover, it seems that the main theoretical argument regarding the relationships between democracy and growth can be safely extended to the scope of the private credit sector. For instance, considering the theoretical argument presented in the section 1.1 that democracy promotes growth through providing more equal distribution of resources, it is possible to connect this argument with the development of the private credit sector. If some segments of society are systematically discriminated in their access to private credit, it would undermine their willingness to invest and engage in trade, which thereby hinders economic growth. The same logic works in the case of the expropriation dilemma - if a sovereign expropriates resources and does not provide conditions for their accumulation in the long-term he or she would face a significant diminishment of resources. However, if he or she engages in promoting economic growth through developing the private credit sector and related financial institutions, this increases the level of individual economic autonomy and creates a highly active and independent sector

within society, which is difficult to control, and, after some level of economic growth is achieved, almost impossible to shut down. Additionally, it is also possible to transform in the same manner the core argument in favor of autocracies as better sets of political institutions for promoting economic growth. If autocrats do not face a pressure for immediate consumption due to electoral cycles, they can, assuming a higher level of control over the economy, distribute these resources through a private credit market, even if the major beneficiaries are not independent individual agents, but state-related firms.

Therefore, this study has a potential to contribute to the existing literature not only from the empirical side, but also from the theoretical side. However, there is a significant epistemological problem how to connect empirical findings with theoretical arguments. If there is no evidence that democracy promotes the development of private credit sector, it is possible to conclude, at least with some level of certainty, that these theoretical arguments are not correct. However, if there is some evidence that democracy positively affects private credit sector, we cannot automatically conclude that our chosen theory is correct. It is clear that a positive link between democracy and private credit sector development could be caused through multiple number of potential mechanisms. The problem is that especially in a large-N type of study we do not know which one works in every particular situation. Moreover, we do not even know whether our set of theoretical explanations corresponds to the real set of causal mechanisms. Therefore, for a reliable empirical analysis a precise and detailed model specifications are needed, as discussed in the previous section. The introduction of several analytical dimension, such as poor versus rich, small versus big countries, clustering of them regarding main sources of economic growth - resource-dependent versus technologically advanced, main recipient of financial resources - advanced industries versus consumption credit, and etc. can help to determine what theoretical explanation is more likely to be correct, if any. Additionally, some qualitative analysis could be of great help in this situation, as it allows tracing particular mechanisms through which one phenomenon affects another phenomenon. While such analysis, limited by number of cases, cannot reveal broad regularities and demonstrate a reliable inference, it can help to understand a typical dynamic between phenomena of interest in detail. This usually provides a solid ground for formulating statistical hypothesis, as it reduces the level of uncertainty about these phenomena and their relationships.

The chapter can be summarized in the following manner: for the time being there is no agreement between scholars on whether democracy fosters or hinders economic growth. On the other hand, there is strong evidence that rule of law is positively associated growth. The theoretical links between democracy and rule of law also exist but are not very convincing. Thus, several studies suggested to separate democracy from rule of law in order to determine possible indirect effects of democracy on growth through underpinning rule of law. However, no robust empirical evidence was found. Therefore, I propose to narrow the focus of the analysis from economic growth to private credit development because it received strong theoretical and empirical support as important determinant of economic growth. However, private credit sector development is by itself a complex phenomenon, which under different conditions can affect economic growth in dramatically different ways. Therefore, it is necessary to develop a highly specified statistical model, which would be sensitive to these different conditions, and to use some qualitative evidence based on particular examples.

# Chapter 2. Some Empirical Evidence: What Do Case Studies Suggest?

The aim of this chapter is to describe the main empirical cases that are usually cited as evidence for the idea that authoritarian regimes can achieve the same level of economic development as democracies. The main focus on this chapter is on cases of economic reforms in Latin America and East Asia in the period between 1960 and 1980. Additionally, I provide descriptive statistics on a more recent set of cases representing countries that experienced some level of democratization from 1996 to 2007. The main finding of this chapter is that there is some evidence that authoritarian regimes can maintain rule of law and demonstrate an impressive economic performance, but there is no recent evidence that democracy alone is associated with any development in the financial sector. The implications of these findings for the statistical analysis are discussed at the end of this chapter.

As discussed in the previous chapter, there are important disagreements in the literature on democracy and economic growth, as well as on rule of law and financial development. Very similar debates, although with a slightly different focus and methodological agenda, can be found in the literature on economic reforms in East Asian and Latin America in the 1960s and 1980s, with a later revitalization after the collapse of Soviet Union in the 1990s (Bruszt 2006). The main similarity between these debates that the role of political regimes in facilitating growth or implementing certain types of economic reforms is not entirely clear. As the focus of this study is on differences in financial development caused by differences in political institutions, a review of the literature on economic reforms in East Asian and Latin America can help to understand the variety of economic outcomes produced by the interplay between political and economic dimensions. First, as the economic reforms in East Asia and Latin America were generally of a neoliberal nature, they are strongly associated with the development of financial institutions in these countries, which is in tune with the focus on financial development presented in this study. Second, there is an important focus in the literature on effects of political regimes on the success of reform implementation, wherein the main arguments in many respects repeat the arguments about the effects of political regimes on economic growth discussed in the previous chapter. This is not very surprising, as it is easy to assume that the success of any economic reform is at least partially measured by the economic growth it produces. Third, these were not slow, natural and gradual changes, but intentional reforms with relatively easily identifiable starting points. Because of their speed and intensity, these cases are distinctive and more suitable for analysis than 'natural' changes over a long period, as more intense and faster changes should induce more significant outcomes which are easy to capture. Finally, the analysis of concrete cases can help to interpret broad statistical finding more precisely. Without any knowledge of the particular historical trajectories from certain configurations of institutions to certain economic outcomes, it is difficult to derive a meaningful interpretation from aggregated statistical findings.

As we know from the research on this subject, not all newly democratized countries managed to successfully reconcile the establishment of market institutions with the process of democratization. However, as the case of economic reforms in Latin America clearly indicates, an attempt to implement the neoliberal set of economic policies under an authoritarian regime does not necessary lead to the desired outcome either. Yet, the majority of the examples supporting the idea of authoritarian economic modernization, as the more optimal way to introduce radical reforms, could be traced back to the studies made on the cases of Chile, which inspired almost all countries in the region to implement neoliberal economic policies (Rodrik 1996), or to the success of East Asian countries. At the same time, the success of neoliberal reforms in other Latin American or post-Soviet countries is questionable, at minimum. Thus, the question is what determines the success of economic liberalization in the first set of countries such as the so-called Asian Tiger or Chile, and which is not presented in the rest of the countries? An important consideration here is that it is very unlikely to find 'an ultimate' root of these different outcomes. Yet, a careful analysis of several notable cases can potentially help to determine several aspects of democracy-rule of law-financial development relations that are worth further analysis.

### 2.1 The Asian Tigers: an inspiring 'authoritarian modernization'

The newly industrializing East Asian countries - South Korea, Taiwan, Hong Kong, and Singapore are usually presented as the very successful cases of the rapid implementation of market institutions in their rather neoliberal version (Wade 1998). Although a number of explanations of why those countries succeeded have been suggested, the most recurrent theme is the 'strength' of East Asian states. In particular, it is argued that East Asian states enjoyed greater independence from distributionist's pressures and managed to put restraints on self-interested behavior by different groups of interests through rules backed by sanctions and their overall coercive power (Haggard and Moon 1990; Johnson 1987; Deyo 1987; Cheng 1990). This explanation lies within the main assumptions suggested by the theories supporting the efficiency of authoritarian modernization discussed in the previous chapter.

One may argue that there were some favorable preconditions for the success of the reforms in East Asia. The important role of institutional preconditions in general was show by Acemoglu, Johnson and Robinson (2000), who suggested that a higher settlers-to-the total population ratio in former colonies determined further institutional development, as settlers brought institutional practices associated with 'Western' development. However, the settlers-to-the total population ratio in Singapore and Hong Kong in 1900 was very low – 0.05 and 0.04

respectively (2000). These figures indicate that Singapore and Hong Kong are clearly from the opposite side of the spectrum as the United States, Australia or New Zealand, where the level of settlement was extremely high. In the cases of South Korea and Taiwan, the same argument can be made by a simple comparison of per capita GDP in 1960 and in 1989 with Latin American countries, which at that time faced very similar economic challenges. While in 1960 both South Korea (1359\$) and Taiwan (883\$) had from two to four times lower per capita GDP than Brazil, Mexico or Argentina, by 1989 they overtook them by the same but reversed ratio (Rodrik 1996). These facts indicates that the success of East Asian countries was not predetermined by the previous institutional arrangements or at least these preconditions did not lead to any significant economic success prior to the reforms.

At the same time, there are also quite developed arguments that to some extent the success of the Asian tigers was predetermined by institutional arrangement that had been set prior to the reforms. For instance, Kohli (1994) argues that Korea under Japanese influence was transformed from a relatively corrupt and inefficient state to highly authoritarian and well-functioning one. It should be noticed, however, that these preconditions are of political nature and in tune with the arguments about authoritarian efficiency, while it is clear from the figures described above that these preconditions alone did not cause any remarkable economic performance. Thus, these preconditions provided a fertile soil for introducing rule of law during reforms, but did not cause it.

Summarizing the East Asia 'success story', Stiglitz identified the "creating an atmosphere conducive to private investment and ensured political stability" as one of the key factors that allowed those countries to achieve an impressive level of economic development in a short period of time (1996). Thus, the authoritarian states in East Asia did not only use their coercive and highly centralized power to protect themselves from the redistributive pressure, but also to maintain a set of institutions which stimulated private investment. Taking

the authoritarian nature of their economic development into account, it appears that East Asian countries represent a notable example of impressive economic development based on the combination of a strong authoritarian state and rule of law.

However, as it is argued by Haggard and Moon (1990), analysts of East Asian development have ignored the significant number of cases where a strong state resulted in the institutional trappings of a poor economic performance. Interestingly, the strong states in East Asian have been also seen as the major causes of the Asian debt and development crisis of 1997 (Wade 1998). As was formulated by the chairman of the US Federal Reserve, Alan Greenspan, although in a rather political than scholarly manner, "...a system with large elements of government directed investment, in which finance played a key role in carrying out the state's objectives... inevitably has led to the investment excesses and errors to which all similar endeavors seem prone."<sup>1</sup> At the same time, during the previous stabilization period in 1980 and 1981 negative outcomes were at least partially overcome by wage suppression (Haggard and Moon 1990), which again can be attributed to the distinctive capacities of an authoritarian state. Nevertheless, South Korea, Singapore, Hong Kong and Taiwan managed to implement market-oriented institutions and have demonstrated an impressive level of economic development under non-democratic political regimes, which brings at least some support to the idea that democracy alone does not contribute to economic development and has no ultimate or unique features triggering this development.

At the same time, it should be taken into account that the rapid economic development experienced by East Asian countries was of a very specific nature. The title 'newly industrialized countries' reflects the very fact that these countries were rather underdeveloped and underwent together with the discussed economic reforms the first stage of industrialization.

<sup>&</sup>lt;sup>1</sup> Remarks by Chairman Alan Greenspan. Growth and flexibility: Lessons from Asia. At The Economic Club of New York, New York, N.Y. December 2, 1997

A number of studies demonstrated that almost all outputs of economic growth in these countries from the 1960s to 1980s could be explained by accumulation rather than by productivity - that is by the significant increase in physical and human capital as well as in labor-force participation (Rodrik 1996; Krugman 1994). As Krugman ironically put it: "Singapore grew through a mobilization of resources that would have done Stalin proud." (1994) Therefore, the question is to what extent can we generalize this specific type of growth and assume that the coercive power of an authoritarian state would be as good for the long-term as it was for a very specific stage of economic development? While moving to the next set of cases, a possible answer to this question emerges through large-scale cross-country comparison which will be discussed in the next chapters.

### 2.2 Latin America – not so successful authoritarianism

Historically, authoritarianism and repressions have coexisted in almost all developing countries in the world. In Latin America, it was even argued that such a coexistence is nearly inescapable features of modernization in the present historical context (Sheahan 1980). While the validity of such a claim is questionable at a minimum, it represents an undeniable empirical fact – Latin American countries underwent a severe level of state repression starting in the 1970s through to the 1990s. As many Latin American countries introduce market-oriented economic policies in the same period, a link between state repression and insistence on market principles emerged (Sheahan 1980).

Was this authoritarian implementation of market institutions as successful as is generally believed or as it was in the East Asian countries? In terms of commitment to the principles of the Washington consensus Latin American countries indeed demonstrated a great success. As Rodrick emphasized, "Mexico, Bolivia, and Argentina, to cite some of the more distinguished examples, have undertaken more trade and financial liberalization and privatization within five years than the East Asian countries have managed in three decades" (1996). Latin American countries are also often cited as empirical evidence that authoritarian regimes are better when it is time to implement unpopular economic reforms – especially Argentina in 1966 and 1976, Brazil in 1964, Chile in 1973, and Uruguay in 1973. However, authoritarian states in those countries made policy mistakes which led to the same level of negative outcomes as did their democratic predecessors (Haggard and Webb 1993). As Easterly documented (2001), in 1980–98, median per capita income growth in developing countries was 0.0 percent, as compared to 2.5 percent in 1960–79, which according to him "represent[s] a disappointing outcome to the movement towards the Washington Consensus by developing countries." In Latin America in particular this tendency took a very severe form and became known as the 'lost decade'. The political consequences were dramatic as well – recurring economic shocks resulted in undermining support for incumbents and provoked high levels of electoral volatility, which eventually lead to the rise of populist regimes in Latin America (Remmer 1991).

As there is clear evidence that the neoliberal transformation in Latin America was not an easy road, the question is why these country did not manage to copy the success of their East Asian counterparts. Although the structural explanation concentrating on the differences between export-oriented and import substitution industrializations and a related pathdependency in East Asian and Latin America (Frieden 2006), as well as the debt crisis faced by Latin American countries might be of great explanatory power, the institutional differences between these countries are still worth attention. For instance, Ozler, Alesina and Tabellini (1989; 1991), as well Laban and Sturzenegger (1994) proposed a framework that emphasizes cleavages within society as an important factor which undermines economic reforms and their pace. According to this framework, if the level of polarization both between elites and between elites and the public is very high, this can result in a very high level of uncertainty caused by the realization of groups in power that they can be replaced by a future government with significantly different ideological or redistributive preferences (Rodrik 1996). It is not difficult to assume that if property rights are not truly secured and rule of law is not an immanent part of current institutional arrangement, these groups in power can understandably see their political survival as the ultimate and exclusive way to protect their own economic capitals. Therefore, in contrast to the 'authoritarian regimes do better' hypothesis, those regime would try to postpone any reforms as politically volatile and thus dangerous. The second negative repercussion of domestic polarization is a significant delay implementation of reforms as responses to the challenging economic conditions. If the level of domestic polarization is high, groups are inclined to believe that the burden of adjustment will be one-sided and not in their favor (Drazen 1996). This may result in a much quicker response to economic challenges in countries with 'strong' states, while a 'factional' one would delay all necessary adjustments (Rodrik 1996; Krueger 2002; Bergoeing et al. 2002).

These explanations do not contradict the 'authoritarian regimes do better' hypothesis *per se*. Instead, they narrow the scope of the necessary conditions that allow an authoritarian regime to implement stable and successful economic reforms. Not only the ability to protect itself from redistributive pressure is of a great importance for the authoritarian regime willing to implement harsh economic policies, but also the ability to take control over different groups of interests and establish immanent property protection for all segments of society, which is easier to achieve under a low level of polarization.

# 2.3 Democratic transition, rule of law, and financial development: All the cases but Croatia

Now I move onto more recent and narrow examples which deal with the main variables of interests – the level of electoral democracy, rule of law and financial development. For this part of the analysis, I chose only the cases that demonstrated a significant electoral transformation (more than 1 standard deviation) during the period from 1996 to 2007. The level of electoral transformation was measured by the *Electoral Democracy Index* from the Varieties of Democracy database.<sup>2</sup> Excluding countries with no or unreliable data, such as Afghanistan or Libya, there are only eight countries in the world that experienced a significant democratic transition in this period: Croatia, Indonesia, Peru, Burundi, Haiti, Nigeria, and Sierra Leone.

As Table 2.1 shows, not all of the countries improved their Rule of Law scores, even though, they all experienced a significant transformation of democratic institutions, (World Bank indicator). The same is also true for the size of their domestic credit to the private sector. In fact, only Croatia significantly increased both its Rule of Law score and its size of domestic credit to the private sector. However, Croatia is unlikely to be a representative case here as it has a high level of cooperation with the European Union and its member states, which due to Croatia's geographic location greatly exceeds in its intensity similar frameworks of cooperation between the European Union and the rest of the selected countries. This unique condition could potentially have a significant impact on the development of market and especially financial institutions in Croatia, which prevents it from being ruled out during analysis and makes it difficult to separate other institutional determinants of financial development.

<sup>&</sup>lt;sup>2</sup> The choice of this and all other indicators used in this paper is discussed in the Section 3.1

Country	Year	Democracy	Rule of Law Change [-	Domestic credit to
		Change [0-1]	2.6-2.12]	private sector change
Croatia	2000	0.54 - 0.8	from -0.61 to 0.26	from 24.6% to 70.0%
Indonesia	1998	0.34 - 0.62	from -0.36 to -0.34	from 55.5% to 36.5%
Peru	2001	0.53 - 0.78	from – 0.65 to -0.55	from 22.1% to 34.0%
Burundi	2005	0.25 - 0.45	from -1.6 to -0.94	from 14.2% to 15.4%
Haiti	2005	0.24 - 0.48	from -1.767 to -1.19	from 12.8% to 19.9%
Nigeria	1999	0.26 - 0.49	from -1.43 to -1.08	from 9.0% to 14.5%
Sierra	2003	0.23 – 0.67	from -1.48 to -0.87	from 2.0% to 6.3%
Leone				

**Table 1: Recently democratized countries** 

Croatia aside, it is remarkable that none of the governments managed to maintain rule of law or to enhance their financial sectors. Although the absence of typical positive cases, that is – where rule of law or the financial sector would have been developed makes it difficult to draw a reliable inference, it still reduces our level of uncertainty about the associations between these variables. This set of outcomes at least suggests that an outcome where financial development is presented without maintaining of rule of law (or vice versa) is less likely to be observed in comparison with no development on these two indicators. Thus, as both theoretical arguments and empirical cases show some support for the idea that democracy alone does not contribute to the development of the financial sector, and authoritarian regimes, on the other hand, can achieve financial sector development under certain circumstances, it is necessary to conduct further investigation into the subject.

### Chapter 3. Data and Methods

This Chapter describes the main methodological approaches used in this study, data collection and operationalization processes, as well as discusses the challenges the author faced during the analysis. The main idea presented in this chapter is that in order to avoid the problem of spurious causation and check the robustness of findings it is necessary to combine between-country and within-country estimates together with different alternative operationalization of the main variables.

### 3.1 Data and measurements

First, I describe the main choices made regarding empirical operationalizations. Private credit market development is measured by the World Bank *Domestic credit to private sector* indicator. The variable is expressed as a percentage of GDP. The substantial advantage of this indicator is that it provides the wide cross-country aggregated data on financial depth and therefore can be considered as the "black box" of private sector market development, regardless of particular institutional differences. Additionally, it is a standard indicator of the finance and growth literature (T. Beck, Demirgüç-Kunt, and Levine 2009). However, there are arguments that such an operationalization is not the most optimal as it does not cover private credit market development in all important instances (Honohan 2004; R. G. King and Levine 1993a). Therefore, I additionally use several alternative measurements, such as *Market capitalization of listed domestic companies (% of GDP)* as another standard measurement of financial depth, *Turnover ratio of domestic shares (%)* as an indicator for financial market efficiency, *Bank accounts per 1,000 adults* to measure the level of access to financial markets, and *Bank capital* 

*to total assets* indicator as a composite measurement of financial stability<sup>3</sup>. All indicators are from World Bank database. Unfortunately, other alternative composite measurements of private credit sector development usually implicitly include some components of rule of law (Honohan 2004) and therefore cannot be used in this study due to potential overlapping. While these are popular indicators, the question is to what extent they capture such features of financial system as, for instance, efficiency. Although one may argue that this is the matter of definition, it should be explicitly mentioned that this indicator represents 'efficiency' in a very narrow and specific sense. [Think about other possible indicators]

The most suitable operationalization of democracy for this study is *Electoral Democracy Index* from Varieties of Democracy database. This index seeks to answer the question to what extent the ideal of electoral democracy in its fullest sense is achieved in a particular country. Thus, the index is formed taking the average of several other measurements, such as freedom of association, suffrage, clean elections, elected executive, and freedom of expression<sup>4</sup>. One can argue that this is a very minimalistic operationalization of democracy, which does not cover other important aspects usually associated with the concept of democracy. However, as it was discussed in Chapter 1, it is nearly impossible to solve the problem of multiple potential effects on dependent variable without a clear analytical separation between electoral democracy, as the most essential part of this concept, and other components linked to democracy by its broader notions. However, following the procedure suggested by Baum and Lake (2003) I will consider several other widely used measurements of democracy. Another suitable operationalization of democracy is *Polity 2* index from Polity IV Annual Time-Series database. This choice is made due to the interval nature of this index

<sup>&</sup>lt;sup>3</sup> the Global Financial Development Report 2015 -

http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTGLOBALFINREPORT/0,,menuPK:8816192~pagePK:6 4168176~piPK:64168140~theSitePK:8816097,00.html

<sup>&</sup>lt;sup>4</sup> V-Dem Data - Version 6.1 - https://v-dem.net/en/data/data-version-6-1/

as it provides the scale that ranges from +10 (strongly democratic) to -10 (strongly autocratic) with 1-point interval. The second advantage of this index is that it combines scores on the six separated factors, which are explicitly described and do not overlap in essence with the concept of quality of institutions. These factors are regulation of chief executive recruitment, competitiveness of executive recruitment, openness of executive recruitment, executive constraints, regulation of political participation, and competitiveness of political participation (Marshall, Gurr, and Jaggers 2013). Considering the Freedom House *Freedom in the World* index as another possible operationalization, it should be emphasized that as Freedom House does not provide a clear and explicit set of procedures by which all indicators are measured, there is a big risk to face the same problem of overlapping between democratic institutions and overall quality of institutional development, including rule of law. Therefore, in my analysis I use two operationalizations of democracy - *Electoral Democracy Index* and *Polity 2* score to check the robustness of my findings.

The quality of institutions is measured by the World Bank *Rule of Law* indicator. This indicator ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance, with 0.01-point interval and reflects the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence<sup>5</sup>. While this indicator does not overlap with the measurement of democracy directly, it captures the broad spectrum of phenomena, which limits the possibility of precise estimation of exact causal determinants, can be additionally influenced by the democratic institutions indirectly, and should be considered in interpretation of findings accordingly. Another important aspect of this indicator is its survey-based nature. The authors of this indicator do not true to categories endless institutional arrangements and quantify institutional properties, but simply measure people's attitudes

<sup>&</sup>lt;sup>5</sup> The Worldwide Governance Indicators (WGI) project - http://info.worldbank.org/governance/wgi/index.aspx

toward these institutions. Therefore, it can be considered as a more reliable indicator as it already reflects the attitude of economic agents.

The control variables are *GDP* (*at market prices, current US\$*) to control for the size of economy, *GDP per capita* (*current US\$*) as the proxi for overall economic development, *GDP growth* (*annual %*) to control for different stages of business cycles, *Labor force* (*total*) to control for the number of working-age population, *Inflation, GDP deflator* (*annual %*) to control for economic stability, and *Natural resource rent* (% of GDP) to account for rich oil-exporting countries with high level of GDP and low level of institutional development. All controls are from the World Bank database.

Considering the available data, the size of the sample is approximately 145 countries for a period from 1996 to 2014. China is excluded since the credit variable for this country includes credit to state-owned enterprises (Djankov, McLiesh, and Shleifer 2007).

### 3.2 Methods

The main method of this study is a regression type analysis on time-series cross-section data. Additionally, as for all macro level questions in political economy, the data is of the observational nature. This fact imposes several important restrictions on the possibility to frame findings of this study in terms of causal relations. There are several recognized methods of dealing with this problem. The first family of methods represents different types of matching procedures. Unfortunately, they do not help to control for unobserved variables and treatments assignments (Ho et al. 2007). However, they help to reduce the imbalance and the lack of complete overlap between treatment and control groups, as we are more confident to make claims about causal inferences if the units receiving the treatment are comparable to those receiving the control (Gelman and Hill 2006, 199). Although there are important advantages

of these methods even for general treatment regimes for continuous treatments (Imai and Van Dyk 2012), considering the interval nature of main independent variables without true zero, it is impossible to use such methods of balancing covariates as there are no clear control and treatment groups. Another popular approach is so-called instrumental variables. This approach is usually used to overcome the omitted variable problem, as a valid instrument is correlated only with independent variable, but otherwise unrelated to dependent variable (Angrist and Krueger 2001). However, the use of instrumental variables often requires strong assumptions, which can be only partially validated from data, and in case of multiple regression models with several possible treatments a required number of good instruments increases accordingly (Dunning 2012). Indeed, it is highly unlikely to find good instruments, such as they are correlated with rule of law and democracy, but not with private credit sector development itself.

Thus, I use more traditional and to an extent simpler approach to deal with the spurious association and the omitted variables problems. First, I use two different models with period-to-period and 1-period lagged democracy and rule of law. As this is not a year-to-year but 3-year interval panel (see details below), and at least rule of law indicator already reflects economic agents' attitudes, which could be seen as an effect of institutional dynamics on economic activity, I argue that 1-period lag is sufficient to capture any significant effect on dependent variable. Additionally, as OLS models provide between-country estimates, I use within-country fixed effect models to investigate associations between the variables of interests controlling for possible omitted country-specific variables. The combination of these two types of models can significantly increase the robustness of findings, as if the same findings appear in both models, this suggests that there are no important omitted variables missing from OLS models. Although both procedures do not help to avoid the fundamental pitfalls of regression analysis, together with different operationalization they help to check the robustness of findings among different model specifications. Additionally, it is usually suggested to include a lag of

dependent variable on the right-hand side of all models dealing with TSCS type of data, especially within the field of political economy (N. Beck and Katz 2011). However, this approach is not without important shortcomings as coefficient estimates can be biased and lagged dependent variable usually suppress the explanatory power of other independent variables (Keele and Kelly 2006; Achen 2000). Thus, as the specifications of all tested models were successfully tested for serial autocorrelation and transformed where it was necessary, I avoid the use of lagged dependent variable as an unnecessary technical addition.

Due to the problem of autocorrelation in the OLS model, I aggregated the data by means over 3-year intervals (1996-1998, etc.). Despite the fact that 5-year intervals are usually used for such aggregation (Barro 1996b; Baum and Lake 2003), I have the data only for 1996-2014 period and for this period 3-year intervals are the best split. This procedure helped to significantly reduce autocorrelation. In order to deal with the problem of heteroscedasticity in the OLS models, instead of using robust standard errors, I used Box-Cox transformation, as it deals not with post-hoc adjustments but with the model specification directly (G. King and Roberts 2014). However, in case of within-fixed effect models even Box-Cox transformation did not help to solve the problem of heteroskedasticity. Thus, I used the most conservative version of heteroscedasticity consistent covariance matrix known as "HC3" (Long and Ervin 2000). In comparison with all other heteroscedasticity consistent covariance matrixes, this method produced the least significant p-values, which says in favor of the assumption about its highly conservative nature. All other necessary assumptions for all models are met.

### Chapter 4. Results

Table 2 presents the results for four different model specifications: both OLS and Fixed-Effect models with standard and lagged variants of democracy and rule of law. In the first set of specifications, the dependent variable is operationalized as the size of domestic credit to private sector to GDP. This operationalization is expected to measure the level of financial depth. As is to be expected, rule of law significantly and positively affects the size of domestic credit to private sector for all specifications, apart from the FE model with lagged independent variables. As the level of statistical significance for rule of law in this specification is four times above the threshold of .05, it is possible to claim that while controlling for country-specific variables, rule of law has only a short-term effect on domestic credit to the private sector. However, it should also be taken into account that for all lagged specifications *N* size is 15% smaller due to missing values in the first period, which could affect the significance of all estimates. Nevertheless, there is not enough evidence to suggest that rule of law has a longlasting, persistent effect within each country.

Democracy, on the other hand, has a significant negative effect on domestic credit to private sector in both OLS models, but no statistically significant effect in FE models. This finding can be explained in the following fashion – with the control for main variables and some country-specific omitted variables, the effect of democracy on financial development appears to be insignificant. Interestingly, if the rule of law variable is excluded from the models, democracy shows a less significant negative effect and even almost significant positive effect in the FE lagged specification. These findings are consistent with the findings of Barro (1996a), who suggests that once rule of law, free markets, small government consumption, and high human capital are held constant, the effect of democracy on economic growth, although slightly positive otherwise, becomes weakly negative. As the level of financial development is used in

this study as a proxy for economic growth, these findings can be interpreted as evidence that democracy alone has no positive effect on economic growth at least through domestic credit to private sector.

	(OLS)	(OLS lagged)	(FE)	(FE lagged)
Electoral Democracy	$egin{array}{c} -0.171^{***} \ (0.039) \end{array}$		-0.067 (0.069)	
Rule Of Law	$0.110^{***}$ (0.014)		$0.077^{**}$ (0.023)	
$Electoral \ Democracy(lagged)$		$-0.159^{***}$ (0.041)		$0.067 \\ (0.079)$
Rule Of Law(lagged)		$0.123^{***}$ (0.014)		$\begin{array}{c} 0.043 \\ (0.039) \end{array}$
$\log(\text{Resource rent})$	$-0.051^{***}$ (0.007)	$-0.046^{***}$ (0.008)	$0.022 \\ (0.015)$	0.020 (0.023)
$\log(\text{Labor})$	$0.030^{***}$ (0.005)	$0.029^{***}$ (0.005)	-0.014 (0.043)	-0.013 (0.060)
$\log(Inflation)$	$-0.213^{***}$ (0.040)	$-0.301^{***}$ (0.055)	-0.040 (0.037)	$-0.142^{***}$ (0.029)
$\log(\text{GDP})$	-0.002 (0.003)	-0.001 (0.003)	$0.015 \\ (0.013)$	$\begin{array}{c} 0.010 \\ (0.025) \end{array}$
$\log(\text{GDP growth})$	$-0.462^{*}$ (0.194)	$-0.768^{***}$ (0.232)	$-0.289^{*}$ (0.128)	$-0.727^{***}$ (0.185)
$\log(\text{GDP per capita})$	$\begin{array}{c} 0.093^{***} \\ (0.007) \end{array}$	$0.085^{***}$ (0.008)	$\begin{array}{c} 0.135^{***} \\ (0.017) \end{array}$	$\begin{array}{c} 0.131^{***} \\ (0.034) \end{array}$
	826 0.664 0.661 201.673***	$692 \\ 0.684 \\ 0.680 \\ 184.698^{***}$	826 0.364 0.298 48.318***	$692 \\ 0.404 \\ 0.316 \\ 45.787^{***}$

Table 2: Dependent variable - Domestic credit to private sector

Note:

\*p<0.05; \*\*p<0.01; \*\*\*p<0.001

Speaking about control variables, the size of GDP has no significant effect for all specifications. Not surprisingly, GDP per capita, in contrast, shows a significant positive effect for all specifications, as the level of financial development is usually associated with overall

economic development. Importantly, even with the control for this variable, rule of law, when it remains significant, has a comparable effect on the dependent variable. The fact that rule of law has a similar effect as GDP per capita provides an additional argument in favor of its importance for financial development not only in term of statistical significance, but in terms of the size of its effect. GDP growth negatively and significantly affects the level of domestic credit to the private sector, with larger effects for lagged specifications. Size of labor positively affects domestic credit to the private sector for OLS models, but not for the FE model, which might be an example of substantive cross-country differences, as the leading economies are typically also big countries. The same explanation could be used in case of natural resource rent, which shows similar behavior, that is – while differences between technologically advanced countries and oil-exporting countries regarding financial development could be significant, changes in natural resource rent within each country have no effect on financial development. Overall, OLS models explain 67 and 68 percent of the variation in domestic credit to the private sector for 1996 and 2014. FE models, on the other hand, explain 36 and 40 percent of the variation.

The next step one should make in order to insure the substantiveness of the findings is to use different operationalizations of private credit development. This procedure helps to cover those aspects of financial development that could be missed by the main operationalization. Table 3 shows the results of another set of estimats with market capitalization as the dependent variable as the alternative measure of financial depth. As it is possible to see both OLS models demonstrate the same pattern, that is – a significant and positive effect of rule of law and a negative effect of democracy on the dependent variable. All the control variables also show very similar results to the previous estimates, apart from natural resource rent, which in the case of market capitalization has a slight positive effect. The OLS models explain 42 and 40 percent of the total variation of market capitalization respectively. However, in the FE models,

only GDP growth has a large, positive and significant effect on market capitalization, together with the significant effect of GDP per capita for the non-lagged FE model. All other variables have no statistically significant effect. FE models explain only 15 and 21 percent of the variation. This indicates that for each country, the main variables of interests together with basic macroeconomic indicators are not of great explanatory power for market capitalization.

	(OLS)	(OLS lagged)	(FE)	(FE lagged)
Electoral Democracy	$-0.629^{**}$ (0.233)		$0.144 \\ (0.538)$	
Rule Of Law	$\begin{array}{c} 0.383^{***} \\ (0.075) \end{array}$		-0.031 (0.188)	
$Electoral \ Democracy(lagged)$		$-0.552^{*}$ (0.252)		$-0.108 \\ (0.561)$
Rule Of Law(lagged)		$0.365^{***}$ (0.081)		$0.091 \\ (0.227)$
log(Resource rent)	$0.118^{**}$ (0.042)	$0.125^{**}$ (0.046)	$0.154 \\ (0.112)$	$\begin{array}{c} 0.161 \\ (0.099) \end{array}$
$\log(\text{Labor})$	$\begin{array}{c} 0.219^{***} \\ (0.030) \end{array}$	$\begin{array}{c} 0.215^{***} \ (0.033) \end{array}$	-0.266 (0.410)	-0.252 (0.496)
$\log(Inflation)$	$-1.255^{**}$ (0.392)	$-1.731^{*}$ (0.830)	-0.447 (0.271)	$0.938 \\ (0.836)$
$\log(\text{GDP})$	$-0.037^{*}$ (0.016)	$-0.045^{*}$ (0.018)	-0.054 (0.112)	-0.103 (0.194)
$\log(\text{GDP growth})$	$2.549 \\ (1.428)$	$3.250^{*}$ (1.568)	$5.473^{***} \\ (1.217)$	$7.079^{***}$ (1.351)
$\log(\text{GDP per capita})$	$\begin{array}{c} 0.243^{***} \\ (0.045) \end{array}$	$\begin{array}{c} 0.243^{***} \\ (0.049) \end{array}$	$0.276^{*}$ (0.137)	$\begin{array}{c} 0.327 \ (0.184) \end{array}$
Observations $R^2$ Adjusted $R^2$	443 0.432 0.422	376 0.406 0.393	443 0.146 0.112	$376 \\ 0.215 \\ 0.157 \\ 0.0157 $
F Statistic Note:	41.340***	31.360*** *p<(	7.232*** 0.05: **p<0.0	9.394*** )1: ***p<0.001

 Table 3: Dependent variable - Market capitalization

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As the operationalization of financial markets efficiency, the next set of estimates regresses the independent variables on turnover ratio of domestic shares. Again, Table 4 demonstrates the common pattern for both OLS models – while rule of law has a significant positive effect on turnover ratio, democracy has a rather strong negative effect. There are two interesting differences from the previous estimates. First, inflation has a significant positive effect on the turnover ratio for all specifications apart from the lagged FE model. That perhaps suggests a higher volatility on financial markets during economic turnoil. Second, there is no significant effect of GDP per capita. FE models show the identical pattern as the OLS models, although with a lesser significance for the key variables of interests – that is, while democracy and rule of law have almost significant effects for the standard FE model (p = 0.051 and p = 0.111 respectively), they become highly insignificant in the lagged specification. This finding might indicate that the turnover ratio is very sensitive to current conditions and any changes in the rule of law or democracy that took place from three to six years back are of little importance. OLS models explain 33 and 36 percent of the variation, while FE models only explain six and four percent, which makes the FE models substantially unimportant.

Another set of specifications takes number of bank accounts per thousand adults as the dependent variable. One might expect that this particular operationalization of financial development, namely – the level of access to financial markets, has a greater chance to be associated with the development of democratic institutions. The reason for this expectation is that several findings have suggested that democracy has no direct effect on economic growth but rather affects it indirectly through more equal access to social institutions among citizens (Baum and Lake 2003). However, the results presented in Table 5 show that estimates for these specifications are not consistent with the findings described above. For all models, neither democracy nor rule of law have a significant effect on the number of bank accounts, while the most significant and positive effect is demonstrated by GDP per capita. Both standard and

lagged OLS models explain 48 percent of the variation in the dependent variable, while both FE models explain 31 percent of the variation. It also should be taken into account that the data on the number of bank accounts is available only from the early 2000-s, which significantly reduces the number of observations in these models.

	(OLS)	(OLS lagged)	(FE)	(FE lagged)
Electoral Democracy	$-4.795^{***}$ (1.130)		-8.117 (4.381)	
Rule Of Law	$\begin{array}{c} 1.712^{***} \\ (0.363) \end{array}$		$2.270 \\ (1.355)$	
Electoral Democracy(lagged)		$-4.387^{***}$ (1.173)		-5.781 (3.102)
Rule Of Law(lagged)		$1.829^{***}$ (0.376)		1.772 (1.162)
$\log(\text{Resource rent})$	$-0.948^{***}$ (0.204)	$-0.946^{***}$ (0.218)	-0.623 (1.174)	-0.807 (0.656)
$\log(\text{Labor})$	$\frac{1.049^{***}}{(0.147)}$	$\frac{1.132^{***}}{(0.157)}$	$2.575 \\ (2.465)$	0.983 (2.819)
$\log(Inflation)$	$5.818^{**}$ (1.881)	$9.608^{*}$ (3.909)	$\begin{array}{c} 4.385 \\ (4.439) \end{array}$	5.421 (4.421)
$\log(\text{GDP})$	$\begin{array}{c} 0.117 \\ (0.080) \end{array}$	$0.103 \\ (0.085)$	$\begin{array}{c} 0.173 \ (1.133) \end{array}$	-0.102 (0.959)
$\log(\text{GDP growth})$	-9.668 (6.952)	-5.586 (7.366)	$2.141 \\ (5.091)$	2.664 (7.630)
$\log(\text{GDP per capita})$	$0.294 \\ (0.219)$	0.367 (0.230)	-0.686 (1.093)	-0.091 (0.996)
	$\begin{array}{c} 428 \\ 0.329 \\ 0.316 \\ 25.648^{***} \end{array}$	$366 \\ 0.358 \\ 0.343 \\ 24.843^{***}$	428 0.056 0.043 2.448*	$366 \\ 0.035 \\ 0.025 \\ 1.199$
Adjusted R <sup>2</sup> F Statistic	$\begin{array}{c} 0.329 \\ 0.316 \\ 25.648^{***} \end{array}$	$\begin{array}{c} 0.358 \\ 0.343 \\ 24.843^{***} \end{array}$	0.030 0.043 2.448*	0.02

Table 4: Dependent variable - Turnover ratio

Note:

\*p<0.05; \*\*p<0.01; \*\*\*p<0.001

	(OLS)	(OLS lagged)	(FE)	(FE lagged)
Electoral Democracy	42.974 (28.082)		$71.185 \\ (36.217)$	
Rule Of Law	16.148 (11.253)		-37.574 (23.451)	
Electoral Democracy(lagged)		28.482 (27.478)		-1.588 (48.463)
Rule Of Law(lagged)		$16.819 \\ (11.121)$		-36.602 (26.603)
log(Resource rent)	$-17.469^{**}$ (5.361)	$-18.325^{***}$ (5.350)	11.687 (15.018)	$13.984 \\ (16.739)$
$\log(\text{Labor})$	$\frac{11.941^{**}}{(3.845)}$	$12.141^{**}$ (3.864)	$-89.307^{*}$ (43.524)	$-87.995^{*}$ (43.407)
$\log(Inflation)$	107.329 (66.754)	$104.141 \\ (66.812)$	-82.067 (55.115)	-47.357 (46.854)
$\log(\text{GDP})$	-1.909 (2.310)	-1.850 (2.318)	$14.763 \\ (14.536)$	$19.516 \\ (15.420)$
$\log(\text{GDP growth})$	-224.600 (154.028)	-219.072 (152.764)	-56.498 (155.829)	-100.499 (148.846)
log(GDP per capita)	$\begin{array}{c} 45.667^{***} \\ (5.005) \end{array}$	$\begin{array}{c} 45.894^{***} \\ (5.010) \end{array}$	$69.646^{***}$ (19.739)	$66.652^{***}$ (16.997)
Observations $R^2$ Adjusted $R^2$	$259 \\ 0.498 \\ 0.482$	$259 \\ 0.495 \\ 0.479$	$259 \\ 0.466 \\ 0.310$	$259 \\ 0.466 \\ 0.310$
F Statistic	30.998***	30.610***	18.800***	18.778***

Table 5: Dependent variable - Number of bank accounts

Note:

\*p<0.05; \*\*p<0.01; \*\*\*p<0.001

I now turn to the set of specifications taking the *Bank capital to total assets* indicator of financial stability as the dependent variable (Table 6). As with most previous models, in both OLS models some level of positive effect of rule of law on financial stability is presented, while democracy has a negative but insignificant effect. Speaking about FE models, once again both democracy and rule of law become insignificant. The most interesting finding from the control variables is that size of total labor has a small, but very significant positive effect on financial stability in the OLS models, suggesting that small countries are more prone to financial fluctuations, which is consistent with the literature on the political economy of financial liberalization (Kattel and Raudla 2013; Schwartz 2011). However, while controlling for labor in the FE models, the size of labor has a negative effect on financial stability.

(OLS)	(OLS lagged)	(FE)	(FE lagged)
-0.012 (0.007)		$0.012 \\ (0.019)$	
$\begin{array}{c} 0.017^{***} \\ (0.002) \end{array}$		-0.005 (0.007)	
	-0.012 (0.007)		-0.004 (0.014)
	$0.016^{***}$ (0.002)		-0.008 (0.005)
-0.003 (0.001)	-0.002 (0.001)	$0.003 \\ (0.004)$	0.002 (0.003)
$0.005^{***}$ (0.001)	$0.005^{***}$ (0.001)	-0.017 (0.014)	$-0.033^{**}$ (0.012)
-0.014 (0.010)	-0.017 (0.012)	-0.008 (0.011)	$0.006 \\ (0.014)$
$0.0004 \\ (0.001)$	-0.0001 (0.0005)	-0.004 (0.004)	-0.006 (0.004)
-0.062 (0.046)	-0.023 (0.045)	-0.041 (0.036)	$0.003 \\ (0.031)$
-0.001 (0.001)	0.0004 (0.001)	-0.0005 (0.004)	$0.006 \\ (0.004)$
524 0.332 0.322 32.054***	463 0.346 0.335 30.080***	$524 \\ 0.041 \\ 0.032 \\ 2.163^*$	$\begin{array}{c} 463 \\ 0.079 \\ 0.059 \\ 3.726^{***} \end{array}$
	$\begin{array}{c} (\text{OLS}) \\ -0.012 \\ (0.007) \\ 0.017^{***} \\ (0.002) \\ \end{array}$ $\begin{array}{c} -0.003 \\ (0.001) \\ 0.005^{***} \\ (0.001) \\ 0.005^{***} \\ (0.001) \\ -0.014 \\ (0.010) \\ 0.0004 \\ (0.001) \\ -0.062 \\ (0.046) \\ -0.001 \\ (0.001) \\ \end{array}$ $\begin{array}{c} 524 \\ 0.332 \\ 0.322 \\ 32.054^{****} \end{array}$	$\begin{array}{c c} (\text{OLS}) & (\text{OLS lagged}) \\ \hline -0.012 \\ (0.007) \\ \hline \\ 0.017^{***} \\ (0.002) \\ \hline \\ & & -0.012 \\ (0.007) \\ \hline \\ & & 0.016^{***} \\ (0.002) \\ \hline \\ & & 0.016^{***} \\ (0.001) \\ \hline \\ & & 0.005^{***} \\ (0.001) \\ \hline \\ & & 0.0004 \\ (0.001) \\ \hline \\ & & 0.0001 \\ (0.001) \\ \hline \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ \\ \\ \\ & & 0.0004 \\ (0.001) \\ \hline \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ $	$\begin{array}{c cccc} ({\rm OLS}) & ({\rm OLS}\ {\rm lagged}) & ({\rm FE}) \\ \hline -0.012 \\ (0.007) & (0.019) \\ \hline 0.017^{***} & -0.005 \\ (0.002) & (0.007) \\ \hline \\ & -0.012 \\ (0.007) & \\ & 0.016^{***} \\ (0.002) & \\ \hline \\ & 0.005^{***} & (0.002) \\ \hline \\ & -0.003 \\ (0.001) & (0.001) & (0.004) \\ \hline \\ & 0.005^{***} & 0.005^{***} & -0.017 \\ (0.001) & (0.001) & (0.014) \\ \hline \\ & 0.005^{***} & 0.005^{***} & -0.017 \\ (0.001) & (0.001) & (0.014) \\ \hline \\ & -0.014 \\ (0.010) & (0.012) & (0.011) \\ \hline \\ & 0.0004 \\ (0.010) & (0.005) & -0.004 \\ (0.004) \\ \hline \\ & -0.062 \\ & -0.023 \\ (0.004) \\ \hline \\ & -0.001 \\ (0.004) \\ \hline \\ & 0.0004 \\ \hline \\ & -0.001 \\ (0.004) \\ \hline \\ & 0.0004 \\ \hline \\ & -0.001 \\ (0.001) \\ \hline \\ & 0.0004 \\ \hline \\ & -0.001 \\ (0.001) \\ \hline \\ & 0.0004 \\ \hline \\ & -0.001 \\ (0.001) \\ \hline \\ & 0.0004 \\ \hline \\ & -0.0005 \\ (0.001) \\ \hline \\ & 0.0004 \\ \hline \\ & -0.0005 \\ (0.004) \\ \hline \\ \\ & -0.0005 \\ (0.004) \\ \hline \\ & -0.0005 \\ (0.004) \\ \hline \\ \\ \\ & -0.0005 \\ (0.004) \\ \hline \\ \\ \\ & -0.0005 \\ (0.004) \\ \hline \\ \\ \\ & -0.0005 \\ (0.004) \\ \hline \\ \\ \\ & -0.0005 \\ (0.004) \\ \hline \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ \\ $

Table 6: Dependent variable - Bank capital to total assets

Note:

\*p<0.05; \*\*p<0.01; \*\*\*p<0.001

Additionally, I also used an alternative operationalization of democracy to check the robustness of the findings. For almost all tested specifications, *Polity 2* scores demonstrate a similar pattern with the *Electoral Democracy Index*, although with one important difference.<sup>6</sup> While the *Electoral Democracy* index has shown mostly negative effects, the *Polity 2* score shows very weak, negative effects, which are typically around zero.

<sup>&</sup>lt;sup>6</sup> As the results for the alternative operationalization of democracy are essentially identical to the previous estimations, they are not reported in detail

### Conclusion

What are the institutions that contribute to the development of domestic private sector? The number of case studies suggest some evidence that authoritarian regimes are able to achieve a high level of financial development without being democracies. However, the relation between democratization and financial development in the set of recently democratized countries is inconclusive. Based on the obtained statistical results, it can be concluded that the important determinant is rule of law, while the institutions of electoral democracy alone do not show any significant effect on the development of private credit sector. This finding contradicts the view that there is a close and unique link between democracy and financial development. This controversy is perhaps caused by the tendency to use for analysis very broad concepts, such as political regime types, which typically consist of a large number of diverse phenomena. However, as the analysis demonstrates, the separation of rule of law and democracy allows to obtain more institution-specific results, which reveal the underling connections between democracy, rule of law and private credit sector development. Another possibility is that if democracy has any positive effect on economic growth, the particular mechanisms are outside of the financial dimension.

The analysis has also raised several important issues, which require a careful consideration. First, for almost all tested specifications the OLS models exhibit much more significant estimates in comparison with the Fixed-Effect models. In fact, the effect of rule of law remains significant only when the dependent variable is operationalized as domestic credit to private sector and only in the non-lagged specification, while democracy has a negative but insignificant effect for both Fixed-Effect specifications. There are two possible interpretations of these findings. First one is that rule of law has a significant effect only on financial depth measured by the size of domestic credit to private sector in comparison to GDP and this effect

is short-lasting. In contrast, in case of market capitalization, turnover ratio as the measurement of financial efficiency, the number of bank accounts representing the access to financial markets, and bank capital to total assets as the measurement of financial stability, rule of law shows a significant positive effect only when there is no control for some important, but omitted country specific variables. That is, when we look at the relations between rule of law and these aspects of financial development within each country, these relations appear to be not very significant. Another possible interpretation is that for such a small number of time-periods these effects are insignificant because there is simply not enough data. However, for almost all FE models both democracy and rule of law showed rather very insignificant results (p = ~0.7 -0.9). Thus, this argument might be valid only for the specification with turnover ratio as the dependent variable, where for both democracy and rule of law p-values vary from 0.06 to 0.13 in the lagged specification. Nevertheless, while in case of financial depth measured by the size of domestic private credit sector the effect of rule of law has shown some level of robustness, for other important aspects of financial development there is not enough evidence to conclude that rule of law has a positive or any effect at all.

As it was discussed in the Chapter 3, there are several important limitations of this study caused by the observational nature of the data. First, even though the main variables such as democracy and rule of law were lagged in order to avoid reverse causality, this does not completely eliminate the possibility of spurious correlation. Indeed, as the findings from most of the Fixed-Effects models have suggested, there is a high chance that both independent and dependent variables are affected by some omitted variables. While there is nothing preventing from including this variable or variables into the models, for the time being I have no theoretically sound suggestions what variables should be additionally included. Speaking about the direction of the effects, there is still a possibility for reverse causality, as significant investments in some sectors might lead to the increase of institutional protection (Besley 1995).

The survey nature of the *Rule of* law indicator, although has the important advantages, might inclusively reflects the level of financial development, at least during significant positive or negative shifts in institutional arrangements. Finally, the scarce amount of the time component in the data undermines the ability to analyze the long-term dynamic of the relations between variables making the findings very period specific, which, of course, does not help to reveal long-lasting and more fundamental associations between these variables.

Summarizing all mentioned above, the most important finding of this thesis is that rule of law has a positive effect on financial depth measured as the size of domestic credit to private sector. Importantly, this finding has shown a reliable level of robustness, as it remains the same for both between-countries and within-country effect models, together with the different operationalizations of democracy. The only one specification where rule of law did not show a significant effect on the size of domestic credit to private sector is the lagged Fixed-Effect model, which suggests that there is only a weak cumulative effect of rule of law over time, and the current level is much more important than the previous dynamic. Another consistent finding is that democracy has mostly negative but rather insignificant effects on financial development in almost all tested specifications. Therefore, it is possible to conclude that while rule of law does not equally affect all aspects of financial development, there is a high possibility that it might positively affect the level of financial depth. At the same time, it can be concluded with a high level of certainty that democracy, at least in the presented operationalizations, has no persistent effect on financial development, which is consistent with the several previous findings in the literature on democracy and economic growth. Thus, this thesis contributes to the existing literature by providing evidence that if there is some positive association between democracy and economic growth, it is highly unlikely that it is facilitated through private credit sector development.

I also suggest several avenues for future research that can be of significant help. First, the models that did not reveal any strong relations between democracy, rule of law and some important aspects of financial development are mostly of weak explanatory power (small F and R-squared statistics). Thus, if one has a particular interest in these aspects of financial development, better models should be suggested.

More fundamentally, besides large-N type of analysis, there are several promising techniques for addressing research questions on the level of case study research, such as synthetic control methods (Abadie, Diamond, and Hainmueller 2012). This approach can be very productive as it helps to narrow the focus to a specific country or set of countries, which increases the precision of analysis. Additionally, this method has a potential to produce results that can be more confidently interpreted in terms of causal relations. Thus, as there is number of recently democratized countries that have demonstrated a weak progress in the development of rule of law and private credit sector, it can be worth to analyze them by comparison with their synthetic counter-parts for the same period of time, constructing from a set of similar but still authoritarian countries.

Finally, financial development is only one factor associated with economic growth. There are other important factors that are worth attention. As argued before, by decomposing economic growth it is possible to gain in-depth knowledge on what the relations between democracy and its important components are, which can potentially decrease the ambiguity presented on the broader level of analysis.

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