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ABSTRACT

The Political Economy of Finance*

The regulations that shape the design and the operations of corporations, credit and securities markets differ vastly from country to country. In addition, similar regulations are often unequally enforced in different countries. Economists still have an imperfect understanding of why these international differences exist and of whether they tend to persist over time. A recent strand of research has shown that some progress on these issues can be made using the approach of the new political economy, which models regulation and its enforcement as the result of the balance of power between social and economic constituencies. In this Paper we offer a first assessment of the results and potential of this approach in three fields: corporate finance, banking and securities markets.

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1. Introduction

During the Great Depression, U.S. farmers oppressed by the rising burden of mortgages and by falling incomes successfully pressed their states' legislators to pass laws for debt moratoria of farm mortgages. To further support farmers' incomes, the Roosevelt administration devalued the dollar against gold, and abrogated all gold clauses in private debt contracts that would have otherwise triggered a wave of bankruptcies (Kroszner, 1998). While relieving distressed farmers, the policy had adverse consequences for their further access to credit: in states which enacted farm foreclosure moratorium laws, banks extended fewer farm loans and charged higher interest rates (Alston, 1984).

At the same time, on the other side of the Atlantic, the Great Depression prompted another form of political intervention. In Italy, the Fascist government launched a massive bailout of failing industrial firms and banks, and transferred the equity stakes acquired in the process to a public agency, the Istituto per la Ricostruzione Industriale (IRI). Initially designed as a temporary remedy to the crisis, IRI grew into a state-run giant holding group that dominated the Italian economy for the rest of the century, and largely replaced securities markets in financing Italian heavy industry and utilities.

Political and social turmoil was also at the root of "codetermination", by which German employees select half of the supervisory board of large companies. This system, which had long-lasting implications for the governance of German companies, was initially introduced by a 1922 law of the Weimar Republic, in order to strike a compromise between the right and the left and achieve a minimal degree of political stability in a deeply divided country. Repealed under the Nazi regime, this arrangement was reinstated in 1951 for the Ruhr steel and coal industry by Konrad Adenauer. Conscious of the tremendous political role played by the Ruhr industry in inter-war Germany, he felt that democracy should be combined with constraints over the use of private capital, a notion labeled as "economic democracy". In 1976, the Codetermination Law extended equal representation of employees and shareholders to all companies with more than 2,000 employees. This arrangement, still in force in Germany, tends to shield management from the market for corporate control, by reinforcing employees' power to resist mergers or takeovers, and diminishes control over management by fractionalizing the supervisory board and making it a potential vehicle for collusion between managers and workers (Pistor, 1999).

Political intervention in financial markets does not occur only at times of systemic crisis and social turmoil such as the Great Depression. The action of pressure groups and the career concerns of politicians often combine to produce specific political interventions in financial markets, such as nationalizations, privatizations, bailouts, vetoes to mergers and takeovers, etc. Consider the two following examples.

In 1976 six bankrupt U.S. railroad companies were nationalized with the creation of Conrail under the pressure of interest groups, formed by customers, existing claimants and employees, mostly located in the Northeast. After 11 years, Conrail was privatized. Over this period, the U.S. government had outlays of \$6.59 billion and received cash flow of \$6.15 billion, implying an internal rate of return of -1.62 percent. During the period 1976-87, the major customers of the six bankrupt companies contributed over \$14 million to both Democrats and Republicans and to key members of the House Energy and Commerce Committee. The benefits to Conrail's customers amounted to over \$2,774 million (Ang and Boyer, 2000).

In March 1997, Krupp made a DM 15 billion hostile bid for Thyssen AG, a corporation previously trading at DM 12 billion on the Frankfurt stock exchange. The managers of the target company rallied politicians, workers' unions and media to its rescue, arguing that the raider intended to predate on the company and its workers to pay its shareholders. Thyssen's campaign was successful: Krupp withdrew its offer and agreed to a management-friendly merger later on, while the stock market value of Thyssen went back to DM 12 billion (Hellwig, 2000, p. 28).

These examples illustrate that politics can interfere with financial markets in several ways. In recent years economists have developed a new approach to analyze systematically the impact of politics on the economy, treating policy-makers as self-interested agents responding to political incentives. This approach, known as "new political economy", contrasts sharply with the view of policy-makers as "benevolent social planners", which is a common hypothesis in welfare economics. The political economy approach was initially applied to macroeconomic policy-making, but is now spreading to other areas of economic policy analysis. In this paper we show how its tools and ideas can be applied to the analysis of policy interventions in financial markets, building on the first body of contributions in this field.

Which insights can we hope to get by applying the political economy approach to finance? First and foremost, we can hope to understand why often financial regulation is flawed and stifles – rather than fostering – the development of the markets to which it applies. In other words, it helps us to understand why some countries end up with “poorly designed” financial institutions or “poorly enforced” financial regulation. Second, political economy can give us a clue as to when and why one can expect financial regulation or its enforcement to change over time. In other words, it guides us in the understanding of “financial reform” and of its feasibility. It does so by explaining which constituencies are sustaining a certain regulatory outcome, why they are currently dictating the rules, and how and why the balance of power can shift against them. Thirdly, besides explaining how pressure groups affect regulation, political economy takes into account how in turn regulation shapes and entrenches political constituencies via its economic effects. In this sense, legal rules and economic outcomes are jointly determined, politics being the link between them. This interdependence is illustrated schematically in Figure 1.

In Table 1 we indicate various ways through which politicians can interfere with financial markets. They can either change the “rules of the game” or intervene on a case-by-case basis. In both instances, political interventions can affect the financial decisions of corporations, the working of the banking industry, or the operation of security markets. The table also indicates relevant research, where available.

Each of the next three sections of the paper deals with one of the three types of interaction between politics and finance indicated in the columns of Table 1, which can serve as a road map for the reader. The table should not, however, be taken as a rigid and exhaustive classification. For instance, specific policy interventions can durably change the rules as perceived by the generality of market participants. If the government repeatedly bails out distressed banks, bank managers may come to regard this as a systematic policy and change their attitudes towards risk-taking accordingly. Similarly, public interventions in one area may have spillovers in other areas. For example, the protection of minority shareholders can affect not only corporate financial policies but also the development of securities markets, as we shall see in the next section.

2. Politics and Corporate Finance

Politics can affect the balance of power between company “insiders” (managers and controlling shareholders) and “outsiders” (non-controlling shareholders), in keeping with Hellwig’s (2000) distinction. It does so by designing the rules intended to protect minority shareholders, as well as those that influence the contestability of corporate control. The State can have an even more direct influence over the life of companies by taking a direct stake in their ownership structure or by divesting from them, as it has happened with the recent worldwide privatization wave. In this section we analyze political interventions in all these areas.

2.1 Corporate governance

Recent contributions on corporate governance show that there are large differences in the degree of investor protection across countries and that these differences are correlated with both the development of capital markets and the ownership structure of firms (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1997, 1998). The argument is that better legal protection for investors and stricter law enforcement reduce the risk of expropriation by managers and controlling shareholders. Through this channel, better legal protection and stricter enforcement enable firms to raise more external capital, and thus enhance the growth of capital markets. However, the degree of investor protection and its enforcement are not exogenous variables. They can be altered via the political process, which in turn may respond to economic interests.

Some suggest that political choices that shape investor protection and its enforcement are simply driven by ideological factors. For example, Roe (1999) argues that the differences between the corporate governance systems in the United States and in Continental Europe are due to the incompatibility of the American ideology with the kind of social democracy common in European countries. According to Roe, in Europe the State is entrusted with the task of sustaining a social pact between all classes, whereby greater equality is exchanged for reduced efficiency.

Others argue that history, as summarized by the country’s legal origin, entirely determines the degree of investor protection and its enforcement within a country. La Porta, et al. (1998) show that countries whose commercial law was inspired by the French Civil code exhibit lower protection for minority shareholders and creditors and

laxer law enforcement than countries with a commercial law inspired by the English common law tradition. Countries with German and Scandinavian legal origin exhibit intermediate levels of creditor and shareholder protection, and law enforcement. Since the origin of a country's legal system is the outcome of choices made centuries ago, this "law and finance" approach (as discussed by Levine in this issue) implies that a country with French legal origin is inexorably condemned to low legal protection and lax enforcement, and therefore to financial underdevelopment.¹

Political economy models distance themselves both from the view that the degree of investor protection is driven by ideology, and from the view that it is dictated by a long-run historical imprinting of national law. They depart from the first view, since they regard political decisions as based on economic interests, not on ideology. They depart from the second approach because politicians can change laws if they choose to do it. Political economy models can address the key issue of legal reform, on which the "law and finance" approach is mute: they can be used to analyze if and when the political balance can change and precipitate a change in the legal system and in economic outcomes. This is because in these models the State is an agent for political forces that reflect the conflicting economic interests of their constituencies. By affecting the design and enforcement of legal rules, the balance of power between constituencies affects the allocation of control rights between the company's stakeholders – shareholders, managers, workers and possibly customers. This balance of power and the implied legislation thus shapes the objective function of companies, determining the relative weights that they place on shareholder value, employees' welfare, etc. (Tirole, 2001).

A political-economy model of investor protection is set forth in Pagano and Volpin (2000). In their setting, the relevant stakeholders are controlling shareholders, non-controlling shareholders, and employees. Controlling shareholders ("entrepreneurs") want low investor protection to extract larger private benefits of control, and may obtain it with the political support of workers. To win such support in electoral competition, they have to make some concession to workers, that in the model takes the form of limiting their discretion in firing decisions. The feasibility of this "corporatist"

¹ Evidence in Rajan and Zingales (2001) suggests that the result in La Porta, et al. (1998) does not generalize to the past. At the beginning of the 20th century, France had more developed capital markets than the US. We will come back to this issue in sections 2.3 and 4.

agreement – or “stakeholder society”, as others call it – depends on the political process and on the distribution of equity ownership in the economy.

If the political system favors the formation of party coalitions or if workers own little or no equity, entrepreneurs and workers will strike a political agreement whereby workers trade low shareholder protection for high job security. This agreement enables both social groups to preserve their rents. Low shareholder protection increases the entrepreneurs’ private benefits of control, while high employee protection enables low-productivity workers to extract rents from restructuring companies in the form of severance pay. If instead the political system does not favor the formation of coalitions or if workers’ participation to the stock market is extensive, legislation will feature high shareholder protection and low employee protection.²

These predictions are consistent with the empirical evidence for OECD countries, where one observes two distinct clusters, as shown in Figure 2. Continental European countries and Japan, whose governments are generally formed by coalitions, have low investor and high employment protection. Conversely, Anglo-Saxon countries, whose political systems have the opposite features, have high investor and low employee protection. This agrees with survey evidence on the objectives pursued by major companies in Japan, France, Germany, the U.K. and the U.S., reported in Allen and Gale (2000) and reproduced in Table 2. Asked whether a company should pursue the interest of all stakeholders or give priority to shareholders’ interests, most Japanese, German and France managers replied that companies are to be managed in the interest of all stakeholders. Instead, the majority of U.K. and U.S. managers asserted that priority must be given to the interest of shareholders. This squares with the replies to another question posed in the same survey: whether executives should give priority to dividend payments or to employment protection. The majority of Japanese, French and German executives answered that employment should be kept stable, even at cost of reducing dividends. In the U.K. and U.S., the pattern of replies was the opposite.

Within OECD countries, the divide between non-corporatist and corporatist countries coincides with that between common-law countries and civil-law countries. So one

² Perotti and von Thadden (2001) propose an alternative political economy model, where companies can issue either debt or equity. In their setting, both creditors and workers tend to prefer a less risky environment even when this reduces profits, so that they will tend to be political allies against shareholders, and will tend to support bank- over equity-dominance.

could observe that this political economy model is observationally equivalent to the “law and finance” claim that shareholder protection is predetermined by legal origin. However, the political economy model places much more stringent demands on the data than the “law and finance” view, insofar as it ties both the degree of shareholder protection and the degree of employment protection to the design of the constitutional system. Table 3 documents that the model passes this test. If OECD countries are partitioned based on the two clusters in Figure 2,³ “corporatist” countries turned out to be those where coalition governments are commonplace and where governments are subject to a confidence vote procedure. By the same token, the model predicts that a constitutional reform that impedes coalition governments will precipitate a “non-corporatist” outcome – a prediction on which the passage of time will probably pass its verdict.

Both in Japan and in some Continental European countries, the high degree of employee protection observed in Figure 2 resulted from a political agreement struck in the immediate postwar period and reinforced by later legislation. This political agreement also tended to give employees a limited involvement in the direction of companies. In Japan, according to Gilson and Roe (1999), lifetime employment grew out of a postwar political deal aimed at reducing labor unrest and restore entrepreneurs’ control over factories. Similarly, in various European countries, the postwar period witnessed both increasing employment protection and various experiments with employee participation in corporate governance (Hansmann and Kraakman, 2000).

The model by Pagano and Volpin highlights that a potential cost of “corporatism” is under-investment or at least under-provision of external finance. To the extent that it leads management to extract high benefits of control and forsake shareholder value maximization, this social arrangement tends to produce an ex-ante inefficiency in the form of equity rationing: fearing that their cash flow rights will be diluted by management and by controlling shareholders, non-controlling shareholders will limit the availability of equity finance to companies, and thereby will constrain the size of the initial investment. Of course, this cost matters particularly to new companies, which still need to fund their investments, not to incumbent entrepreneurs for whom such cost is already largely sunk. This suggests that while established entrepreneurs may favor low

³ Corporatist countries being those for which employment protection exceeds 1.5 and shareholder protection is not larger than 4, and non-corporatist countries being the complement of this set.

shareholder protection, the opposite will be true for the owners of startup companies. Tirole (2001) highlights that under-investment is not the only cost of stakeholder capitalism. This arrangement may also hamper managerial effectiveness, due to deadlocks in decision-making and lack of clear mission for management.

Roe (1994) and Bebchuck and Roe (1999) point out that the composition of the group of company “insiders” (employees, managers and controlling shareholders) differs across countries and this may explain the divergence in corporate governance between Continental Europe and the U.S. They argue that the key difference between European and American companies is their ownership structure: American companies do not have controlling shareholders. Without a controlling shareholder, managers have considerably more power and can protect their rents by lobbying politicians. According to Roe (1994), this may explain the U.S. regulatory effort in the 20th century to restrain the power of large blockholders and banks and prevent the emergence of controlling shareholders. On the other hand, in Continental Europe ownership has historically been concentrated and managers have always been weak. Hence, no such regulation has been introduced. This explanation naturally predicts path dependence, as argued by Bebchuck and Roe (1999), because the corporate structures created by a certain political balance of power in the past affect the political balance of power in the future.

It is interesting to ask what political economy can tell us about the future evolution of the corporate governance systems, especially for countries in Continental Europe, that feature low investor protection and high employment protection. Many legal scholars believe that competition will ensure a certain degree of convergence. Hansmann and Kraakman (2000) predict that national corporate law itself will tend to converge to a single standard. Coffee (1999) suggests that differences between corporate governance systems will persist, but that some functional convergence will occur. Gilson (2000) takes an eclectic stance, envisaging an interplay of functional convergence, convergence “by contract” and institutional persistence, with a range of different potential outcomes.

In contrast, Bebchuk and Roe (1999) question the idea of convergence towards an optimal and unified system of corporate governance, arguing, as just remarked, that political and economic forces condition the dynamics of corporate governance rules in different countries and generate path dependence. The same prediction arises from the model by Pagano and Volpin (2000), to the extent that people expect the current legal regime to persist over time. However, expectations about the future legal regime may

change under the impact of exogenous increases in the diffusion of share ownership. These can induce political support for improved shareholder protection, in turn enhancing more widespread share ownership. Examples of such exogenous shocks are privatization programs, the introduction of private pension funds, employee-stock ownership funds, or simply the spread of “equity culture”.

2.2. Market for corporate control

The contestability of corporate control is an alternative way of limiting the “private benefits” of control that managers and controlling shareholders can extract at the expense of non-controlling shareholders. To a certain extent, an active market for corporate control can substitute for shareholder protection in aligning managerial incentives with firm value maximization. By the same token, the political economy of takeover legislation resembles that of shareholder protection. Managers and controlling shareholders are naturally supportive of allowing poison pills and other anti-takeover defenses in corporate charters, whereas non-controlling shareholders prefer banning or restricting such defenses, since they stand to gain from the contestability of control.

In this conflict, employees tend naturally to side with the incumbent management and controlling shareholders, since a takeover generally endangers the stability of their employment or at least threatens the salary and the power that they have secured within the company’s hierarchy. Therefore an additional feature of a “corporatist” arrangement will generally be a restrictive takeover code. However, even in a non-corporatist country such as the United States, political pressure by managers and employees restricted takeover activity in the last decade. Following the large wave of hostile takeovers and restructuring activity of the 1980s, when almost half of major U.S. corporations received a takeover offer, “managers ... fought takeovers with legal maneuvers and by enlisting political and popular support. They were successful in that hostile takeovers became more costly in the 1990s” (Holmström and Kaplan, 2001, p. 122).

Besides coalescing at the political level to promote restrictive takeover legislation, managers and workers can be natural allies in opposing the contestability of control at the company level. Pagano and Volpin (2001) show that, if the private benefits of control are high and the equity stake of management is small, managers have the incentive to transform employees into a “poison pill” by signing generous long-term

labor contracts and thereby reducing the firm's attractiveness to a raider. To the extent that a successful raider can renegotiate their labor contracts, employees will instead act as "white squires" for the incumbent managers.⁴ They will lobby against hostile takeovers to protect the high wages enjoyed under incumbent management, as in the attempted 1997 takeover of Thyssen by Krupp described in the introduction of this paper. Workers prefer dealing with the incumbent manager than with a raider because the manager is more lenient in his monitoring policy and therefore ends up paying higher salaries to motivate workers. The incumbent manager has the incentive to be lenient and generous with the workers, since his compensation arises more from the private benefits of control than from the firm's security benefits, and by being lenient he avoids the cost of monitoring employees intensively. In equilibrium, the workers' expected wages are increasing in the management's private benefits, and are inversely related to the success probability of the takeover.

The equity stake that management holds in the company is a key parameter in the model: owning a higher stake tends to align the managers' objectives to shareholder value maximization, and therefore makes them more willing to accept the contestability of control over the company. This situation seems to fit well with the more accommodating view that recently U.S. corporate managers have taken towards takeovers relative to the past: "Thanks to lucrative stock option plans, managers could share in the market returns from restructured companies. Shareholder value became an ally rather than an enemy" (Holmstrom and Kaplan, 2001, p. 122).

These models of corporate stakeholders' behavior highlight that whenever low shareholder protection allows the extraction of control rents from a company, workers and managers become natural allies in sharing such rents. This provides an additional reason, at the level of the individual company, why managers and workers might vote jointly in favor of low shareholder protection or of control-sharing arrangements such as codetermination.

⁴ A "white squire" is a third party friendly to management who helps the company avoid an unwanted takeover without taking over the company on its own.

2.3. Public Ownership of Companies

In the last twenty years, the governments of many countries have carried out large-scale privatization programs that have deeply changed the functioning of formerly state-owned corporations and that of financial markets at large. Privatizations have generally been driven by the objective to retire government debt or reduce its growth, to increase the efficiency of state-owned corporations and to promote competition in formerly monopolistic sectors of the economy such as utilities (Megginson and Netter, 2000).

However, privatization programs may also have served political purposes, even at the cost of revenue maximization. Such political motivations may have affected both the design of the sale procedure and the decision itself to privatize state-owned enterprises. According to the model by Perotti (1995), a government that is ideologically committed to privatization and economic reform will privatize in stages (retaining a passive stake while transferring control), to signal its commitment not to interfere *ex post* with the privatized company under the pressure of other stakeholders. In contrast, a “populist” government that pursues privatization simply as a means to raise revenue will sell the entire stock at the market price. In addition, if retaining a sufficiently large government stake in the company conflicts with the transfer of control to the private sector, Perotti shows that a committed government will deliberately underprice the shares it sells, so as to signal its intentions credibly. A populist government will not be willing to underprice as much as a committed government, to avoid reducing its revenue from the privatization.

The government can even design the privatization so as to increase the voters’ support for its policies. Biais and Perotti (2001) show that allocating a significant amount of shares to median class voters can help a conservative policy-maker steer them in favor of more conservative policies. “This is not the result of gratitude: rather, their shareholdings make them averse to elect politicians whose redistributive policies would reduce the value of their investment” (p. 2). Since median voters are generally not wealthy, however, they will not be inclined to buy a significant amount of shares in privatized companies unless these are offered at a large discount. This provides an additional reason why a committed (or conservative) government will tend to underprice the shares of the companies it privatizes.

The political motivation of establishing “popular capitalism”, in Margaret Thatcher’s quite explicit words, may explain the large underpricing observed in many privatization

programs. According to Ljungqvist, Jenkinson and Wilhelm (2001), initial private offerings (IPOs) are 13.7 percentage points more underpriced for privatizations than for other companies, controlling for other factors.⁵ Jones, Megginson, Nash and Netter (1999) test if such underpricing conforms to the predictions of the political economy models by Perotti (1995) and Biais and Perotti (2001), using a large data set.⁶ They find that underpricing is positively and significantly related to the degree of income inequality (as measured by the Gini coefficient), in line with Biais and Perotti's (2001) point that in the presence of greater income inequality greater underpricing is necessary to lure the median voter. A dummy variable for British privatizations also features a positive and significant coefficient, reflecting the view that the Thatcher's government set particularly low share prices to pursue its objectives of widening share ownership and reducing government intervention. Underpricing is instead negatively related to the level of government spending as a fraction of GDP. If public spending proxies for a government's "populist" orientation, this result conforms with the common prediction of Perotti (1995) and Biais and Perotti (2001) that a populist government is more motivated by revenue than by the need to signal its commitment or to plant the seeds of "popular capitalism". Finally, underpricing is lower if the government sells more than 50 percent of the shares, in agreement with Perotti's (1995) prediction that if a government can transfer control via its initial sale, it does not need to rely on underpricing to signal its commitment. In their study, Jones et al. (1999) control for motives for privatization other than political reasons, by including the government deficit as a proxy for the government's need to raise revenue.

Political motivations can also contribute to determine the timing of privatization. This often occurs in waves, under governments with free-market views, especially when impending elections posed a potential threat to the continuation of free-market policies. Examples occurred in the U.K. and in France under the right-wing rule of the 1980s and early 1990s, as well as in Chile before the transition to democracy and in the Czech republic in the early stages of the transition to the free market. The importance of politics in the timing of privatizations is supported by the evidence in Bortolotti,

⁵ Ljungqvist et al. (2001) use a sample of 2,143 IPOs (10.8 percent of which are privatizations) from 65 non U.S. markets. In their IPO underpricing regressions, the coefficient of the privatization dummy is statistically significant at the 1-percent confidence level. They control for country, year and sector effects, as well as for various features of the privatization method, such as reliance on bookbuilding or a fixed-price method, and whether bookbuilding was effected by a U.S. bank and/or targeted at U.S. investors.

Siniscalco and Fantini (2000), who evaluate empirically the relative importance of political, legal and economic factors in privatizations, relying on a sample of 49 countries for the period 1977-96. They find that the number of privatization sales are higher in countries with governments supported by conservative coalitions and with higher pre-privatization fiscal deficits, while privatization revenues per capita are strongly correlated with measures of financial market development and of government credibility. Political variables are also important in the choice of the sale method: conservative-backed governments tend to favor large share offerings, in line with Biais and Perotti's (2001) view that the diffusion of share ownership is one of their objectives.

In a longer-term perspective, privatization can be regarded as the final stage of a historical process that in most countries started many decades ago, with extensive nationalizations or the ex-novo establishment of publicly owned companies, especially in the utilities, heavy industry and financial sectors. This direct intervention of the State as entrepreneur largely replaced or, according to others, crowded out the role of the private sector in the accumulation of capital. In Europe, this massive State intervention occurred at the time of the Great Depression, as the State picked up the pieces of bankrupt private companies and of distressed banks and tried to revive the economy with its intervention. For instance, in Italy the government concentrated the shares of most large companies and banks in the State-controlled agency known as IRI.

In the United States, the government faced similar challenges but for the most part it intervened in a different fashion: as a regulator of private markets rather than as their substitute. In the wake of the Great Depression, Congress passed several pieces of legislation designed to curb the power of large banks and securities houses held responsible for the crisis: the 1933 Glass-Steagall Act prevented commercial banks from underwriting, holding and dealing in corporate securities, the 1933 Securities Act mandated disclosure in the securities markets, and the 1934 Securities Exchange Act established and empowered the Security and Exchange Commission (SEC). These three laws laid out the institutional foundations of the spectacular development of securities markets in the United States for the rest of the century.

⁶ Their sample includes 630 share issue privatizations in 59 countries with total proceeds of over \$ 446 billion during the period 1977-97.

Such laws, intended to protect investors and reassure them about the stability and transparency of financial markets, were obviously not necessary in the context of European countries, where the State had taken a direct and massive role in intermediating and allocating capital. Partly as a result of this, securities market remained relatively undeveloped in European economies, and in some of them declined to a lower level of activity and sophistication than in the late 19th and early 20th century. Why did Continental Europe and the United States react so differently to the Great Depression? Rajan and Zingales (2001) offer a number of explanations, based on differences in the political system, in the balance of power between pressure groups and in ideological traditions. For instance, in the United States President Roosevelt's plans to introduce extensive State intervention and planning in the economy were halted by the combined pressure of the judiciary and of conservative pressure groups. Obviously, no comparable system of checks and balances was in place in Fascist Italy, in Nazi Germany or in imperial Japan.

However, the European *dirigiste* response was not without efficiency costs, at least in the long run. State control of companies and banks generated soft budget constraints for managers, with the implied agency problems, and offered to politicians the opportunity to extract large rents. These inefficiencies were reflected into growing public debt, which eventually required privatization as one of the remedies.

The remaining question is why privatizations had to wait as long as the end of the 20th century – why, in other words, the cumulative effects of the inefficiencies of State control on public debt had to become so large before corrective action was taken. The political economy literature may be helpful also in this respect. In macroeconomics, it has shed light on the timing and delay of monetary and fiscal stabilizations by modeling the political conflict over the sharing of the burden of reform, as in the “war of attrition” models described by Drazen (2000).

3. Politics and Banking

Banking regulation is another arena where political factors can play a role. A major source of conflict is that between large and small banks, who may be affected in opposite ways by the implied changes in banking competition. Another area of conflict is the balance between the protection of creditor rights and that of debtor interests in the

design of bankruptcy law and in the choice to concede moratoria or bail out insolvent borrowers or banks.

3.1. Branching restrictions and deposit insurance

Kroszner and Strahan (1999) provide a very accurate empirical analysis of the political economy of banking regulation, in the context of the United States. Before 1970, all states forbade interstate branching. Since then, all but one of the states relaxed this restriction. The authors show that the timing of the deregulation of bank branching across the United States has been determined by the relative strength of the interests groups affected by the reform.

The deregulation involved three types of reforms. The first was the permission to own multiple banks but operate them separately. The second and crucial step was the permission to branch by mergers and acquisition. The full deregulation consisted in the permission of statewide branching. The authors focus on the second of these reforms.

Within a state, the people that obviously stood to benefit from branching deregulation were the customers most dependent on bank finance since branching deregulation tends to reduce banks' local market power. Losers from branching deregulation were instead the small banks, who stood to be swallowed by large rivals. The hypothesis tested by Kroszner and Strahan is that if these interest groups had an impact on the decision by state politicians to deregulate, deregulation should have occurred earlier where banks were relatively larger and firms more bank dependent. This is precisely what the authors find: deregulation occurred earlier in states where small banks were relatively less prominent in number and financial strength, and where companies were smaller and therefore depended vitally on bank finance. The pattern of deregulation had a first-order impact on the level of economic activity across the States, as persuasively shown by Jayaratne and Strahan (1996).

Interest group variables also explain the voting pattern of legislators in the U.S. House of Representatives on banking reform at the federal level. Kroszner and Strahan (2000) extend this type of analysis to the vote by individual legislators on the Federal Deposit Insurance Corporation Improvement Act of 1991. They show that votes were affected by private interest group factors, reflecting the contrasting interests of large versus small banks, and of banks versus insurance companies.

3.2. Bankruptcy law, bailouts and moratoria

Bankruptcy law has to tread a difficult balance between the protection of creditors, to promote the availability and cheap provision of credit, and the protection of debtors to prevent debt overhang, excessive liquidation of collateral and underprovision of screening by banks. A strong legal protection of creditors may be efficient *ex ante*, but creates inefficiencies *ex post*. For instance, it may exacerbate debt overhang problems. When any income earned after default must go to creditors, a debtor has little incentive to work, or, at least, to do any work that is legal. Other *ex-post* inefficiencies may be associated with collateral liquidation. Being more interested in recovering their money than in the overall company's value, holders of collateral may strip the company of key assets and force its inefficient liquidation. Moreover, the liquidation of a firm can have negative externalities for third parties: for instance, it may inflict costs on employees who have invested in firm-specific human capital, or on suppliers or customers who have come to depend on the firm's operation. Finally, strong legal protection of creditor rights over collateral may reduce their incentive to screen loan applications to an inefficiently low level (Manove, Padilla, and Pagano, 2001).

Biais and Recasens (2001) argue that the socially optimal degree of creditor protection balances the ex-post inefficiencies of frequent firms' liquidation, including its diffused social costs, with the ex-ante efficiency gains (especially more abundant credit) associated with strong creditor protection. They analyze how bankruptcy laws emerging from the political process can deviate from this social optimum, as each constituency fail to internalize the external effects of the law on the other constituencies. The poorest citizens favor a soft bankruptcy law, which reduces the social costs of liquidation, while upwardly mobile middle-class citizens vote for a tough law, which improves their access to credit.

The balance between the ex ante inefficiency and the ex post efficiency of debtor-friendly laws is present also in the analysis of debt moratoria. These have been at times introduced by law for sectors of the economy or the generality of borrowers: an example was the farm foreclosure moratorium approved by U.S. legislators in the 1930s. In some cases, such politically induced changes in the laws can be beneficial insofar as they "complete" private contracts. For instance, a loan contract may fail to specify what will happen if a bad harvest or a natural disaster hits the economy, making it very hard for

borrowers to repay. Such a shock can, however, create a political majority in favor of a debt moratorium or of a bailout of insolvent borrowers. One may think that to secure the implied ex-post efficiency gain, society is bound to incur an ex-ante efficiency loss: anticipating this potential political intervention, creditors will be less willing to lend. While in certain cases this ex-ante efficiency loss may arise, Bolton and Rosenthal (2001) show that this need not be the case. In their model, with aggregate uncertainty, political intervention raises both ex-ante and ex-post efficiency, while bailouts do not affect the ex-ante equilibrium and raise efficiency ex post. These surprising results derive from the fact that in their model political intervention occurs specifically in the contingencies that private contracts are unable to foresee.⁷

At the empirical level, political economy models hold considerable promise in explaining both the particular design of bankruptcy law in a given country and some of the international differences in bankruptcy law. For instance, Berglöf and Rosenthal (2000) show that in the 19th century bankruptcy law was one of the most controversial issues in the political debate in the U.S., and changed several times under the impact of shifting ideological boundaries as well as of changing economic concerns. In the same vein, Posner (1997) explains that the Bankruptcy Reform Act of 1978, which is the source of modern U.S. bankruptcy law, “reflects the interests of organized lobbyists, such as banks and other large creditors, bankruptcy judges, ... and the institutional interests of members of Congress”. Politics can also help understand why for most of their history the U.S. have had a more debtor-friendly bankruptcy law than Britain. In the 19th century, foreign (British) lenders had a strong presence in the U.S., and the poor were better represented in U.S. political legislative institutions than they were in British ones. To a large extent, U.S. bankruptcy law took its current shape through a sequel of crises (the 1898 debt moratoria, the Great Depression) where borrowers negotiated favorable legislation via the political process.

4. Politics and Securities Markets

According to Rajan and Zingales (2001), the historical development of securities markets has not followed a monotonic path, but has featured accelerations and retreats.

⁷ Political factors can also affect the regulator’s decision to close down distressed banks as analyzed for instance by Holthausen and Rønde (2001).

For instance, in contrast with the current situation, until the beginning of the 20th century many civil law countries had very developed security markets by international standards, contradicting the view that the origin of legal systems largely predetermines the degree of financial development.⁸ Based on the analysis of data for 24 countries for the most of the 20th century, Rajan and Zingales argue that politics – as driven by special-interest groups representing established business – can explain this uneven evolution of capital markets. Incumbents oppose financial development because it produces fewer benefits for them than for potential competitors. Incumbents can finance investment opportunities mainly with retained earnings, while potential competitors need external capital to start up.

However, the incumbents' opposition to financial development weakens when they face extraordinary opportunities to grow, especially abroad. In these instances, even established business pressures politicians to open product and financial markets to foreign competition. Once markets are open to foreign competition, it becomes unprofitable for incumbents to insist on keeping an under-developed capital market. The prediction is that the overhaul of securities markets regulation is part and parcel of a transition to free trade.

Rajan and Zingales do not indicate which specific reforms of securities market regulation are associated with “financial development”. However, the literature on market microstructure suggests that well-functioning securities markets require regulation that minimizes the information asymmetries between market participants: the repression of insider trading and the timely disclosure and dissemination of information by publicly traded companies can reduce adverse selection problems in securities markets. To the extent that adverse selection generates gains for informed speculators and inflicts losses on uninformed investors, the latter require an ex ante discount on the price of securities when these are issued. Equivalently, adverse selection in securities markets translates into a higher cost of external capital for companies. Recent evidence by Bhattacharya and Daouk (2001) supports this prediction of the theory and underscores the importance of the enforcement of insider trading regulations, rather than their mere existence. They find that the cost of equity (after controlling for risk factors,

⁸ In addition, irrespective of its current shortcomings, civil law has not always been less suited to business needs than common law. Lamoreaux and Rosenthal (2001) produce striking evidence that in the 19th century the French *Code de Commerce* and legal practice offered more sophisticated and flexible solutions to organize business than the Anglo-American legal regime.

a liquidity factor, and other shareholder rights) is reduced by about 5 percent if insider trading laws are enforced.

Why don't all countries then enforce insider trading regulation with equal strictness? Again, political economy may provide the answer. For established companies, the cost of equity capital is a mainly a sunk cost, since they already raised most of the external finance they need and can rely on a steady flow of retained earnings to fund new investment. In addition, the managers and controlling shareholders of existing companies may profit from insider trading opportunities, if the law is lax. In contrast, startup companies need a substantial infusion of external finance, so that the cost of equity capital is critical to their viability and growth. Established business will therefore tend to favor lax insider trading rules and weak enforcement, whereas potential entrants and shareholders at large will prefer strict rules and tough enforcement. This divergence of interests parallels the contrast between incumbents and new entrepreneurs on the issue of shareholder protection mentioned in section 2.1.

An interesting case study on the importance of securities market regulation is provided by Glaeser, Johnson and Shleifer (2001), who compare the regulation of financial markets in Poland and the Czech Republic in the 1990s. The two countries started from a similar past (they both emerged to democracy in 1989 after more than 40 years under Communism) and they embarked on a similar path of economic reforms (privatization, price and trade liberalization, competition policy, banking reform, and financial institutions). By 1994, both countries had completed most economic reforms, with very similar results regarding the development of their overall legal design and enforcement system. For instance, in evaluating the confidence in the fair administration of justice the 1996 Global Competitiveness Report gave a 2.93 rating (out of 6) to the Czech Republic and 2.92 to Poland.

Although many of the reforms were similar, the two countries followed different approaches to the regulation of financial markets. In Poland, stringent securities markets rules were imposed and strictly enforced by an independent securities surveillance commission, whereas in the Czech Republic regulations were lax and loosely enforced by the Capital Markets Supervisors Office of the Ministry of Finance. Financial intermediaries in Poland had to satisfy elaborate licensing requirements and tests, and engage in "honest trading" as interpreted by the Commission under the penalty of losing their license. The Czech Republic had more pro-forma licensing for brokers with easy

exams, no warning concerning “honest trading” and no real power of the regulator to revoke licenses. Moreover, in contrast with the Czech Republic, Poland mandated extensive information disclosure by securities issuers and intermediaries.

The implications of this different regulatory regime were soon to be seen. In 1994 the Czech Republic had a stock market capitalization over GDP of 14.9 percent while Poland 3.3 percent. Four years later, in 1998 the market capitalization in the Czech Republic was 24.2 percent of GDP and in Poland 14.1 percent. During those four years, there was no IPO on the Czech stock market and 142 on the Polish stock market; no capital was raised through public issues in the Czech Republic and \$2,519.1 million in Poland. In the Czech Republic, the word “tunneling” was created to indicate cases of extreme expropriation of minority shareholders by managers. In step with the different degree of financial development, also the real performance of the two economies diverged. Between 1991 and 1998, the index of industrial production grew from 73.6 to 127.4 in Poland and decreased from 113.3 to 109.7 in the Czech Republic.

What can explain the two countries’ different regulatory choices? According to Glaeser, Johnson and Shleifer, “the differences in regulatory approaches between Poland and the Czech Republic were arguably shaped by ideological differences between the two governments,” with the Czech government favoring a “hands-off approach” and the Polish authorities preferring a more strictly regulated marketplace. In our view, it remains an open issue whether these two different ideological approaches were dictated by the different power of pre-existing pressure groups (the “incumbents”, in Rajan and Zingales’ terminology) in the two countries. For instance, it is well known that Czech banks were already quite powerful at the time of the introduction of the reforms: they may have used their power to prevent the development of securities markets and thus avoid competition.

5. Empirical Analysis

A common objection to political economy models is that they are hard to test. Indeed, these models reduce the set of variables that can be considered truly exogenous, precisely because they endogeneize institutional features that in the past were often

taken as exogenous. This reduces the set of predictions that these models are able to produce, a problem sometimes compounded by the existence of multiple equilibria.

Moreover, empirically it may often be difficult to discriminate between ideological (or cultural) and economic determinants of political choices. According to the political economy approach, only the latter should affect political decisions, but it is hard to rule out that ideology and culture also play a role in the policies that shape financial architecture.

Nonetheless, a direct test of models of political economy is possible when data on political contributions are available. A growing empirical literature on log-rolling has satisfactorily proven that economic interests affect political contributions and political decisions. Even if data on political contributions is not available (which is common outside the U.S.) there are several opportunities for indirect testing, for instance using data on voting behavior or on the relative power of political constituencies. These approaches have been applied to the analysis of financial regulation by Berglöf and Rosenthal (2000) and Kroszner and Strahan (1999, 2000).

In addition, often political economy models generate implications that are quite distinct from those of competing models. Good examples are the models by Perotti (1995) and Biais and Perotti (2001). As we have seen in Section 2.3, these models have predictions that relate both the size of IPO underpricing and the frequency of privatization sales to measurable political factors. As a result, these predictions have been extensively tested alongside those of competing models, and have been found to be strongly supported by the data.

Finally, in many cases applied economists can disregard political economy concerns only at the risk of introducing endogeneity biases in their estimates. When policy is truly endogenous, to perform any kind of policy evaluation one must identify and control for the forces that lead to the policy changes. Otherwise, one risks confounding the effects of the policy on economic outcomes and the effect that economic outcomes have on the adoption of the policy itself (recall the feedback loop in Figure 1). Of course, this problem is present in all the areas of economics, not only in finance. Besley and Case (2000) show how one disregarding policy endogeneity in the context of the policy on workers' compensation benefits can lead to biased estimates of its effects, and indicate how these biases can be avoided if the policy adoption can be appropriately

instrumented for. Many existing estimates of the effects of specific types of financial regulation are likely to suffer from similar biases.

6. Conclusions

In this paper we review the main insights that the political economy approach has so far contributed to our understanding of financial regulation. On the whole, this approach can help us understand existing international differences in financial regulation. It can also help us predict future changes in regulation and in its enforcement, by revealing the decision process through which financial reforms are designed and implemented and the way in which political constituencies affect policy. By the same token, using this approach one can identify instances in which reform is not possible, because the existing regulatory regime has entrenched interest groups who can veto reform.

Understanding the determinants of financial regulation is important because regulatory design and enforcement activity affect the development of capital markets and thereby economic growth, as shown by the extensive empirical literature on finance and growth (see Beck, Levine and Loayaza (2000), Demirgüç-Kunt and Maksimovic (1998), Rajan and Zingales (1998), and Carlin and Mayer (1999), among others).

While the political economy of finance can yield important insights, it is also fair to expose the likely limitations of this approach. The main limitations lie in the difficulty to take these models to the data, since by their very nature they endogeneize many variables that other models treat as exogenous, and correspondingly they reduce the set of exogenous variables whose changes can be used to identify relationships in the data. Moreover, often it is difficult to discriminate between ideological and economic determinants of political choices, as well as to nest political economy models and more traditional models in the same specification. However, these difficulties should not be exaggerated. We have described several instances in which the data allow testing political economy models in the area of finance, and in which the data have provided strong support for such models. Finally, ignoring the endogeneity of policy can sometimes lead to severely biased estimates of its effects: this applies to the analysis of financial regulation no less than to other areas of economics.

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Table 1. Politics and Finance: A Road Map

	Corporate finance	Banking	Security Markets
Regulation	<p>Protection of minority shareholders (Pagano and Volpin, 2000)</p> <p>Codetermination (Pistor, 1999)</p> <p>Takeover restrictions (Holmstrom and Kaplan, 2001)</p>	<p>Branching restrictions (Kroszner and Strahan, 1999)</p> <p>Bank supervision (Kroszner and Strahan, 2000)</p> <p>Generalized moratoria and bailouts (Bolton and Rosenthal, 2001; Kroszner, 1999)</p> <p>Bankruptcy code (Biais and Recasens, 2001)</p> <p>Deposit insurance</p>	<p>Insider trading code</p> <p>Information disclosure for public companies (Johnson and Shleifer, 2000)</p> <p>Opening to foreign competition (Rajan and Zingales, 2000)</p>
Specific interventions	<p>Takeover prevention (Hellwig, 2000)</p> <p>Privatization (Perotti, 1995; Biais and Perotti, 2001)</p>	<p>Individual bank bailouts or closures (Holthausen and Rønde, 2001)</p> <p>Individual company bailouts (Ang and Boyer, 2000)</p>	<p>Enforcement of security markets regulation</p>

Table 2. Preferences about Corporate Objectives

The table reports the results of a survey carried out on senior managers in a sample of major companies. The alternative answers to the first question were: "A company exists for the interest of all stakeholders" and "Shareholders' interest should be given the first priority". The alternative answers to the second question were: "Executives should maintain dividend payments, even if they must lay off a number of employees" and "Executives should maintain stable employment, even if they must reduce dividends". Source: Allen and Gale (2000), Figures 2.2 and 2.3.

Survey question:	Possible answers:	Japan	Germany	France	United Stated	United Kingdom
Whose company is it?	All stakeholders	97.1	82.7	78.0	24.4	29.5
	The shareholders	2.9	17.3	22.0	75.6	70.5
	Number of respondents	68	110	50	82	78
Which is more important?	Job security	97.1	59.1	60.4	10.8	10.7
	Dividends	2.9	40.9	39.6	89.2	89.3
	Number of respondents	68	105	68	83	75

Table 3. Coalition Government and Corporatism

Coalition Government is the fraction of years in which a given country had coalition governments in the period from 1975 (with the following exceptions due to data availability: Australia and Finland, 1976; Germany and Portugal, 1977; Spain, 1978) to 1997. Confidence Vote is a dummy variable that takes value 1 in countries where the government must resign if it loses a confidence vote, and 0 otherwise. For Canada and New Zealand, it is set equal to 0 because their government could be forced to resign upon losing a confidence vote only if it is a minority government, a historically rare occurrence in both countries. Corporatist Country is a dummy variable based on the Employment Protection and Shareholder Protection data displayed in Figure 2. It equals 1 if Employment Protection is not smaller than 1.5 and Shareholder Protection is not larger than 4, and 0 if Employment Protection is larger than 1.5 and Shareholder Protection is not smaller than 4. Source: Pagano and Volpin (2000), Tables 1 and 2.

Country	Coalition Government (1)	Confidence Vote (2)	Corporatist Country (3)
Australia	0.41	1	0
Austria	0.61	1	1
Belgium	1	1	1
Canada	0	0	0
Denmark	0.74	1	1
Finland	1	0	1
France	1	1	1
Germany	1	1	1
Greece	0.13	1	1
Ireland	0.74	1	0
Italy	0.74	1	1
Japan	0.26	1	1
Netherlands	1	1	1
New Zealand	0.13	0	0
Norway	0.83	1	1
Portugal	0.14	1	1
Spain	0.05	1	1
Sweden	0.70	1	1
Switzerland	1	0	1
United Kingdom	0.04	0	0
United States	0	0	0

Figure 1. The Interplay between Political Constituencies and Regulation

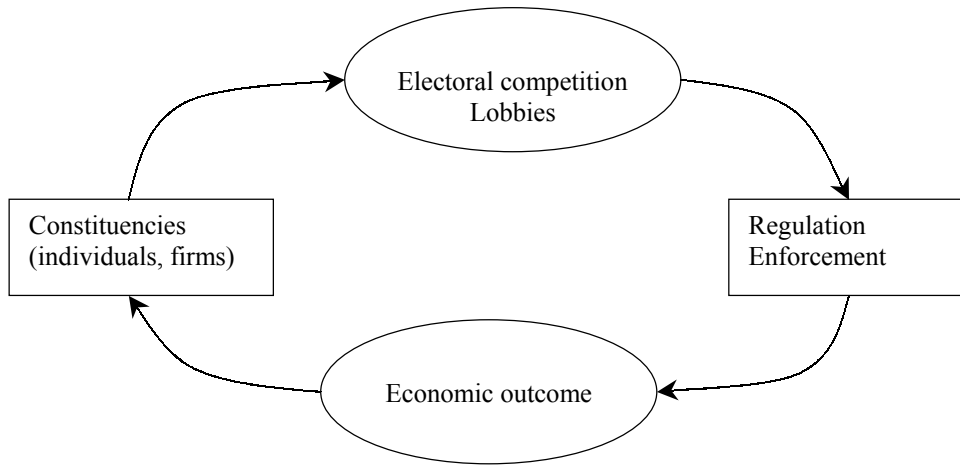


Figure 2. Employee and Shareholder Protection

Employment Protection is the weighted average of indicators on regular contracts (procedural inconveniences, notice and severance pay for no-fault individual dismissals, difficulty of dismissal), short term contract (fixed-term and temporary), and collective dismissals. Values increase with the strictness of protection. Source: OECD, 1999. Shareholder Rights is the antidirector rights indicator from Table 2 of La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998).

