

Preliminary Draft

Property Rights and the Taming of the Government.

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Note to reader: Enclosed is a draft of part II of a book that Raghu Rajan and Luigi Zingales are writing on finance. Rajan will focus on Chapter 6 in his seminar.

Part II: How does Finance Develop?¹

Thus far, we have argued that financial development is extremely desirable. So why, even when there is a clear unsatisfied demand by the public for finance, do so many countries have underdeveloped financial systems?

We will address this question now. A *sine qua non* for almost any institution of capitalism to survive is that the property of each citizen be protected. Protection is especially important in the case of finance – for savers will not be willing to reveal, let alone lend their wealth, when they do not have the confidence it will not be stolen. The critical element in ensuring security of property is not how covetous other citizens are – a strong government can always beat down the greedy. It is not even how rapacious foreign invaders are – warfare in recent times has not typically been conducted for the express purpose of pillaging the property of enemy citizens. The critical element in ensuring security of property has been the commitment of a country's government to respect the property rights of its own citizens.

History suggests that countries do not have permanent sinecures on their ability to commit to respect property. The United States or the United Kingdom, models of rectitude in their respect for property today, routinely expropriated wealthy creditors in the past. Rome, the cradle of law, and Venice, the source of much innovation in business contracting, were beacons in their heyday for the virtues of the rule of law. Today, however, Italy lags considerably behind other developed countries in this respect. So if it is not something immutable in a people's culture or psyche that causes them collectively to agree to respect property, what is it?

¹ This is a draft of Part II in a forthcoming book by Raghuram Rajan and Luigi Zingales entitled "Financing Freedom".

One answer may be that some governments are intrinsically benevolent, and prefer a happy, contented people to a fearful and oppressed one. This is an optimistic view of human nature, which has for the most part been proven false. Furthermore, the accidental benevolence of a few is not much of a foundation on which to rest one of the most important institutions of capitalism. We want to explore in a more systematic way why governments can be persuaded to tame their baser instincts and respect property rights.

The answer we seek lies in the economics. There should be a balance between the opportunities a government has to expropriate and the costs of doing so. The opportunity to expropriate arises when there is a mismatch between those who hold the political or military power and those who have the economic wealth. Rather than tax the wealthy at a steady reasonable rate, the government might be tempted to simply appropriate their property in one swoop.

Clearly, the government's incentive to expropriate depends on what it can gain doing so. If the government (or its favorites) has little ability to manage the property, it might regret taking it over – the long run taxes the rightful owner would have paid might far exceed the value obtained from the now mismanaged property. Thus the costs of seizing property are typically small if the property passively yields its bounty regardless of the identity of the owner – as is the case with natural or mineral wealth. But if the property yields value only when the skills of the owner are applied diligently, then it is more costly to expropriate. And if the property is such that the owner can accumulate expertise at operating it, then the potential loss of his expertise further increases the costs of expropriation. Property that is costly to expropriate is property that is well protected,

no matter how powerful the government. And if much of the property in a country is well protected, then a government may not face much temptation, and even liquid property like financial wealth may be held with confidence.

How do these ideas help us explain the change in government from predator to protector? In the feudal system, the king theoretically held all land on behalf of God. In practice, local barons exploited the land under their jurisdiction to provide for the army that would defend it against outsiders. It was the countervailing power of the barons that kept the king in check. Within the baron's jurisdiction, his power over property was virtually absolute. The transformation from this state of affairs to one where the monarch or government maintained a force primarily to keep out outside invaders and to protect the property (and person) of civilians against one another is nothing short of revolutionary.

We believe that two conditions were often true in the states where this transformation occurred: First, the primary source of income in the state did not come from the passive holding of property. Second, the skills required to generate income from property were typically obtained from operating the property, and not generally available in the wider population. As a result, it not only made sense to have the operator of the property own it so that he had the incentive to acquire the necessary skills, but also the costs of expropriating his property became substantial -- his skills would grudgingly be provided, if at all, if he were to be dispossessed. Under these conditions, even the strongest government would hesitate to violate its citizens' property rights for the short term gain would come at a substantial long term cost.

These conditions did, in fact, exist in the societies that managed to make their governments obey the rule of law. Typically, in an agricultural economy, it was sufficient that land was widely distributed. In that case, it was not the general management (and easily replaceable) skills of the absentee landlord, but the intimate knowledge of his own land possessed by the yeoman farmer that coaxed the huge taxable surpluses out of the land. If the economy was based on trade, then the necessary conditions emerged with the break-up of large powerful guilds or monopolies. This ensured that it was the ingenuity of the proprietor rather than a government-conferred monopoly that became the source of wealth.

This then suggests why the transition from a feudal society to a society based on respect for property and rule of law often occurred precisely when the monarch was strongest – when he smashed the powerful lords, the church, and the guilds, distributing their land or privileges. The widely distributed property then acquired its own defense, as the new small proprietors acquired the skills to generate substantial economic surpluses, making it much more rewarding for the monarch to nurture the goose that was laying the golden eggs (the system of property) than to destroy it through further seizure.

As the yeoman farmer and the businessman acquired economic power, he also acquired political power, which further strengthened the security of his property. Thus the distribution of property led to the emergence of more democratic forms of constitutional government, and eventually, modern constitutional democracy. That some countries have still not made that transition, we would argue, is in part because the economic pre-conditions simply do not exist. All this is discussed in chapter 6.

Respect for property rights is just the first condition for the emergence of financial markets. In addition, financial infrastructure – what we refer to as plumbing – has to be built. Rules and laws governing financial transactions have to be formulated. The standards of transparency and the norms of governance have to be put in place. Courts have to be willing and able to deliver fair speedy judgments on complicated financial contracts. A supervisory and regulatory structure has to be devised. In other words, the first step towards financial development is that the government has to curb its rapacious instincts. But the next step is that it has to actively set up the infrastructure required for finance to develop.

Interestingly, many governments create only rudimentary plumbing, even though they have the capability of putting in place more. This holds back the development of the financial system. Much of the disrepute that finance suffers is not intrinsic to it, but comes from it being handicapped by inadequate infrastructure. The primary reason why this state of affairs persists even in constitutional democracies is that governments are prone to capture by small powerful interest groups that prefer others have little access to finance. In other words, the rapacious government is just the first hurdle. The next is “democratic” government run for the few, by the few, and for the few. Who the few might be is the subject of chapter 7.

The next question, of course, is when can the power of these interest groups be overcome. In chapter 8, we discuss the conditions under which finance becomes liberated from the shackles of these special interests. We will argue that the recent explosion in financial development across the world has, in no small part, been due to the emergence of these favorable conditions. This will then set the stage for the third part of the book,

which will ask if once a country has a developed financial sector, its citizens will always enjoy access to finance. The answer, unfortunately, is not necessarily. But we go ahead of ourselves. Let us first examine how a government comes to respect the property of its citizens.

Chapter 6: Property Rights and the Taming of the Government.²

A loan is a calculated gamble about the future economic success of the enterprise the money is lent to. But it is even riskier than that. For at its core, loans, and all other financial contracts, are simply pieces of paper. They could be torn up and flung into the wind if a country chose not to protect private property. If this was likely, it would add a devastating layer of uncertainty into financial contracting – only the truly charitable would lend if the government periodically declared debt “holidays”.

For finance to take off, therefore, a country needs a stable institutional environment that protects individual property rights against expropriation, whether by foreign enemies, by other citizens, or by the very government that is supposed to defend property rights. Of the three, history suggests a citizen’s own government has proved the most enduring threat to his property.

The Rapacious Government.

The generalized improvement in standards of living, which occurred in Western Europe from the beginning of the second millennium, is certainly attributable, at least in part, to the security of its Eastern borders, which lead to the end of the Barbarian invasions. Thus, military security is an important element of economic and financial development. But it is not sufficient. Nor is it true that more military security is always better for finance. In fact, within Western Europe, the cities that emerged as the most important financial centers (first Florence, Genoa, and Venice, then Hamburg and the cities of the Hanseatic League) were not the political capitals of the then military superpowers, but independent political entities, very much exposed, with the possible

² This is a draft of Chapter 6 in a forthcoming book by Raghuram Rajan and Luigi Zingales entitled “Financing Freedom”. Some of the work in this chapter is being jointly developed with Abhijit Banerjee.

exception of Venice, to the risk of foreign invasions. Why did they succeed where Paris, Vienna and Madrid did not?

Military might does not necessarily translate into financial security -- through much of history it was quite the contrary. The stronger is a government's military power, the greater is its need for funds to feed and pay its soldiers, and the stronger is its temptation to simply take from its own citizens (especially if enemy citizens are not at hand). History is rife with examples of how the rich attracted the unwanted attentions of their own powerful monarch. The fate of the Templars in the early fourteenth century offers a salutary warning of what happened when a needy king went up against his citizens, no matter how morally and physically powerful they might be.

The Templars

The Military Order of the Knights of the Temple of Solomon, better known as the Knights Templars were the first significant international bankers. They were recruited largely from the younger sons of nobility who stood no chance of inheriting titles or wealth. They devoted themselves to the Church, and initially lived near the ruins of the Temple of Solomon in Jerusalem, from which they took their name. They took upon themselves the duty of policing the highways used by pilgrims going to Jerusalem. Their lives were chaste and austere, and they reserved their passion for warfare. Because they apparently did not fear death, they were some of the most feared warriors on earth.¹

As a result of gifts from the grateful and the faithful, they grew in wealth. They came to own some of the strongest castles in the world. Given their military prowess, these served as ideal repositories for valuables in those troubled times. King John used the London Temple as a repository for the crown jewels, and in 1261, his son Henry III

who was in trouble with his nobles, felt they would be safer if transferred to the Templar fortress in Paris. Three years later, Henry used them as security for a loan in his struggles with Simon de Montfort.²

These castles formed a network of “branch offices” which meant they could make cash available at both ends of the Mediterranean, as well as in Paris or London, when needed and in the form that was locally accepted.³ A knight could deposit money in Paris and receive it in the appropriate currency in Jerusalem. Crusading knights used this network, the American Express of the Crusades, to keep themselves in funds as they traveled. Of course, the Templars charged a fee both for the exchange and the transfer. Local banking functions were also performed. A number of surviving parchments suggest that the Temple in Paris operated what looks like a modern bank’s cash desk, open at pre-specified times, and allowing clients to deposit and withdraw money. Clients appeared to be a Who is Who of the time, and included the Royal family, important Church officials, nobles, and rich merchants.⁴

The Templars’ financial functions soon rivaled or exceeded their military functions. They were trustees for Crusaders and administered their wills, they acted as revenue agents for various monarchs and popes, and they served as financial advisers for the rich and powerful.

The Templars developed a substantial reputation for probity because of their austerity and their religious fervor. They also had strict rules. Each brother was urged to “assiduously take care that he does not keep money for himself, neither gold nor silver; for a person of religion should not have anything of his own”.⁵ Furthermore, any brother found with unauthorized money on his person when he died would be denied a Christian

burial, for the money was considered to be stolen. While it was necessary, on occasion, for Templars to carry money, they were urged to give back whatever remained to the treasury when the need was over, regardless of the sum involved. Thus the Templars dealt with the problem of personal temptation by making rules strict so that wrongdoing was easy to detect, and by punishing wrongdoing with a mixture of temporal and religious punishments.⁶

Substantial amounts of money were in Templar vaults at any point in time. Unfortunately, while their castles were strong, they were no match for a determined sovereign. In 1263, during the conflict with Simon of Montfort, Prince Edward of England overcame Templar opposition to enter its treasury. He broke into strong boxes, and seized money belonging to a number of barons and merchants. His son, Edward II, did a similar thing on his father's death. Peter III of Aragon broke into the Templar treasury in Perpignan. In fact, the surprising fact is not that monarchs violated the Templar strongholds, but that the violations were so few in number given the temptations and the impecunious state of royal treasuries. The restraint exercised by monarchs over the century and a half of Templar ascendancy must be attributed to the moral force exerted by the Templars, as also the concern that a raid demonstrating naked greed would undermine their own standing with the church.

In 1307, Philip IV, motivated by the terrible financial state of his economy, and having already raised all the money he could through the traditional mediaeval sources of debasing the currency and seizing the property of the Lombards or the Jews, turned on the Templars. Philip began a propaganda campaign that aimed to strip the Templars of their moral standing. Templar leaders were arrested in a surprise raid and were accused of

heresy, apostasy, devil worship, sexual perversion and a number of other sins against the mediaeval code of morality.⁷ The Templar leaders confessed under torture, and even though they later recanted, they were found guilty and many were burnt at the stake.

The properties of the Templars were carefully inventoried, lands rented out, and the treasury taken over by royal officials. The Church, with no hope of expressing moral outrage, decided to join the predators. Pope Clement V abolished the order in 1312 and devoted his energies to securing some of its properties for other orders in the Church. Thus Philip succeeded in his aim of reducing the moral standing of the Templars, and seizing its assets. But despite his protestations otherwise, the act in more commercially minded countries such as Italy was seen as one of pure avarice.⁸

The lesson from the demise of the Templars, which was repeated time and again, was that no agent, however powerful or sacrosanct, could protect wealth against a determined government. Interestingly, an important outcome of Philip IV's depredations was that the Church realized the threat monarchs represented to its own property. For this reason, it turned from accepting property as a necessary evil (after all, Jesus inveighed against riches) to stoutly defending it as an inalienable right. Clerical scholars started to argue that the state did not have rights over the property of its subjects, and secular scholars soon took this theme up, finding support for it in Roman Law.⁹ Perhaps as a result, outright expropriation became more rare in Western Europe, and was generally targeted at infidels, such as Arabs or Jews.

The Taming of the Government

Greed was not the only, nor even the most important, reason why governments coveted the wealth of their citizens. They were lead to expropriate their citizens by their

desperate needs for funds to finance their military efforts. In the long run, states could fund expenditure through taxes. But war brooked no delay. The alternative to confiscating citizens' wealth was to borrow -- an alternative a modern government knows all too well. But this led to a paradox. It is both costly and unpopular to levy taxes on the wider population so as to pay a few creditors. One reason a government would repay its debt even in the face of these costs is to keep the spigot of future financing open. But if it had the ability to seize the property of a few citizens when in need (what in mediaeval times was euphemistically called a forced loan), then it had little incentive to repay old loans. Since creditors, as a result, had no punitive power over the government, they had no reason to trust the government to repay. This then made it all the more certain that the government would renege on any debt contracted in good faith, and resort periodically to expropriation, disguised as forced loans or defaults.

The easy target (after the usual suspects had been shaken down) was, of course, the rich, especially financiers (the manifest usurer was anathema to the Church, and hence accepted prey). Financiers were also likely to keep their wealth in a liquid, and conveniently removable form – the governments' logic here essentially paralleled that of the bank robber, Willy Sutton, who when asked why he robbed banks answered "Because that is where the money is". In an atmosphere of forced loans and repeated defaults, finance, not surprisingly, did not flourish.

The resolution to this paradox was simple. The government had to find a way to make it more credible that it would repay. This would then make the route of borrowing and repayment via steady taxation more credible. The conventional wisdom is that the Venetian Republic, the Netherlands, and in the late seventeenth century, England,

managed to devolve power to investors -- government in these countries was more representative of the rich investor than were the absolute monarchies that prevailed elsewhere. This then made it hard for the government to default. We will first discuss this explanation. We will then argue that the explanation is only partial. Perhaps as important, if not more important, is that they were able to borrow because property became less attractive to expropriate in these countries.

The Italian City-States

Some of the earliest successful attempts at raising loans from the public were made by the Italian city-states. For example, Venice had a flourishing public debt market where even foreigners, who wanted a safe haven for their money away from the political intrigues of their own country, used to invest.¹⁰ What allowed Venice to inspire such trust?

One difference between Venice and the larger European nations was that it was a republic with checks and balances on the power of its government. Its executive, legislature, and judiciary, right up to the Doge, were elected, and except for the Doge who was a life appointee, held tenure for only a short time. The short tenure not only protected the city against incipient dictatorship, it also ensured that all eligible citizens got a turn at governance. Those that displayed dictatorial tendencies while in office were often banished.

The electoral process was complicated to the point of being farcical – but the intent of keeping it free of power politics was served.¹¹ In addition to the election being fair, the pool from which officials were selected was also small. There was always a chance that the roles would be reversed in the near future when a supplicant faced an

official. This implied that governance, at least for eligible citizens (approximately one fortieth of the entire population) was likely to be just.

Democratic governance played a key role in ensuring the sanctity of public debt. Government debt had built up in the past through forced loans levied in proportion to a citizen's wealth. So the richest men in the city who, naturally, were prominent among the eligible citizenry, held substantial portions. There was little danger that the city would default simply on whim without *cause majeure*, because it would be forced to default uniformly on all obligations, including to the rich and powerful. In fact, the city even made the process of default transparent and random, ensuring no one would be unduly favored by repayment, and all citizens would want the government to avoid default if at all possible. The order of payment of different tranches of the public debt was determined by lottery cast by the Doge himself in the Great Council. If the state had to default on obligations, this also determined the order of default. The result of the drawing was important news, and eagerly anticipated by all investors.¹²

While the city constantly had new elected officials, the underlying bureaucracy that took care of day-to-day administration was relatively unchanging. Not only did this provide continuity and experience in administration, it also ensured a separation between the power to influence and the power to act. So private lenders to the state (private lenders are institutions such as banks, and private debt is the money they lend – to be contrasted with public debt which consists of securities issued to the general public) could be given power without affecting the quality of administration. For example, senior officers of the Soranzo bank, the biggest private lender to the state, were 'invited to sit in "at will" at meetings of the Signoria [in effect, the Doge's cabinet] ... so as to better

receive orders for payment to the state's creditors and at the same time solicit the state for repayment.'¹³ Thus the holders of public debt had confidence in repayment that came from their numbers, while the important holders of private debt were given the power to influence.

It also helped that the business of Venice was business, so the state understood the importance of state borrowing for, and the consequences of default on, the livelihood of its citizens. In particular, the liability of a city was also deemed to be the liability of each citizen. So a default by a city would allow foreign investors to proceed against the property of individual traders from that city. Since foreign trade was such an important part of Venetian business, it served as collateral against default. Moreover, private finance was important in lubricating trade flows, and any disruption to public finance would have spill-over effects on private finance and thence to the life-blood of the city. It is not surprising that early financial markets flourished in centers of trade, a connection we will see again in modern times.

The state also had no coercive machinery within the city. The closest to an armed force within the city was a honor guard for the Doge.¹⁴ While professional mercenaries were paid to fight the state's wars, they were located outside the city so that they would have no influence over its internal governance.

Finally, it was well recognized that the ability to issue debt was integral to Venice's power, and default was not contemplated lightly. For instance, organs of the state proclaimed the Loan Office as "the main foundation, the continual and everlasting equilibrium of our state, the glorious fame of our Signoria..."¹⁵

Venice was an exceptionally well-ruled state, with constitutional checks and balances, rule of law, and freedom of speech long before these became the norm in the West. Investors in the state's debt had political power, and some control over whether the state defaulted. All this was probably very important in adding to the confidence of investors in the safety of their claims.

Yet we would venture that it was not necessarily the quality of its rule that enabled it to issue debt. In particular, Florence was also a republic but with a much sorrier record of political strife. In fact, Machiavelli writes in his *History of Florence*¹⁶

“...at first the nobles were divided against each other, then the people against the nobles, and lastly the people against the populace; and it oftentimes happened that when one of these parties got the upper hand it split into two. And from these divisions there resulted so many deaths, so many banishments, so many destructions of families, as never befell in any other city of which we have record...Nevertheless ours seemed thereby to grow even greater; such was the virtue of those citizens.”

Despite this record of strife, Florence also had a well-subscribed public debt program. This suggests that the quality of a government's rule is not critical to a state's ability to borrow, though it may affect the quantity it can borrow. Rather, the city-states had the ability to borrow from the public because the public enjoyed a fair amount of political power. This allowed Venice to stop confiscatory levies and forced loans towards the middle of the fifteenth century and instead borrow against the pledge of future tax revenues.¹⁷ Once the state had its own means of raising funds, the security of private wealth was further enhanced since it was no longer the immediate target of the needy state. It should come as no surprise then that banks flourished in the city-states, and that even the large merchant bankers who lent to princes did so from the relative safety of the

cities. For example, the Fuggers lent to the Holy Roman Emperor from Augsburg, and the Italian merchant bankers were headquartered in Genoa, Venice, Florence or Milan.

England

Let us now turn to England. England had no great reputation for being kind to creditors, especially under the Stuarts. But by the early eighteenth century, it was transformed into a country whose public debt attracted investors from all over Europe. What were the factors that were responsible for this transformation?

The Development of Public Borrowing in England.

The Stuarts had few qualms in expropriating citizens. The nadir of Stuart credibility occurred in 1672 when Charles II suspended debt payments amounting to about \$ 1.3 million pounds, at a time when annual Crown income was less than 2 million pounds.¹⁸ The bulk of the claims on the Crown were held by a small group of goldsmith bankers. They took in deposits from the public at 6% and loaned it to the Crown at between 10% and 12%. Since the bankers had previously been criticized in the House of Commons for charging excessive interest on the loans to the Crown, there was little support in Parliament for them. Nevertheless, the consequences were foreseen by a contemporary commentator, Turner, who wrote

"I am afraid that when men shall be importuned to lend money upon any future occasion, they will be apt enough to discourse within themselves, that that which hath been done may be done again."¹⁹

Charles II's successor, the Catholic James II alienated Parliament. The prospect of his newly born Catholic son succeeding him spurred prominent members of Parliament to invite William of Orange to invade England. The Glorious Revolution of 1688, which put William and Mary on the throne, also forced them to agree to a Declaration of Rights.

The Crown recognized the legislative supremacy of Parliament and also the need for parliamentary consent for a standing army in peacetime. Furthermore, the existence of an independent judiciary enforcing common law further strengthened the property rights of the citizens against the Crown.

Political economists Douglass North and Barry Weingast argue that by constitutionally enhancing the “countervailing” power of Parliament and the judiciary, the Crown offered investors the credible commitment that it would not attempt to expropriate them.²⁰ Parliament represented both the moneyed interests of merchants and financiers (the Whigs) and the landed gentry (the Tories). Given its composition, the increase in its power as a result of the curbs on the power of the king made property and financial contracts much more secure. In turn, investors obtained the confidence to invest. Thus, they argue, the internal constitutional limitations on the English Crown’s powers allowed it to raise large sums at short notice, giving it external strength and transforming England into an European nation of the first rank.²¹

Is the Constitutional Devolution of Power the Entire Story?

There is, however, something incomplete in the argument that the governments of Venice and England could show their commitment to respect property by setting up a more democratic political process, which kept the arbitrary powers of the government in check. If it were so easy to offer a credible commitment, why did other governments, especially those of other nation states like France and Spain that were perpetually in financial need, not do so?

One possibility is that their situations were different. For instance, it could be argued that England’s government was more easily controlled because it had no standing

army to carry out its arbitrary orders, and finance for raising an army had to be approved by Parliament. Since many members of Parliament were also property owners, Parliament was unlikely to approve the raising of an army that could be used to expropriate the citizenry. By contrast, the French and Spanish kings had standing armies. Perhaps external threats were more proximate, and they did not have the luxury of time provided by a Channel separating them from their enemies. Thus, the argument must go, these monarchs could not set up credible internal constraints on the power of their governments, even though they too desperately lacked for finance.

Too much may, however, could be made of these differences in geography. It is difficult to believe that the absence of a standing army in England was the primary reason for the English king to be better able to curb his own powers. After all, even if England, surrounded by seas, was not as exposed to sudden foreign attack as France or Spain, the English king did have a smaller standing police force to keep internal peace, and could have used it to expropriate the citizenry. Or to see it another way, even if the constitution mandated that the king needed Parliament's permission to raise an army, he could simply have ignored constitutional niceties once he had the funds and turned the army against Parliament. The loyalty of the army would then have depended on who could give it a better deal in the long run (After all, Ancient Rome too tried to keep popular generals and their armies far from the center of power, but eventually the Praetorian Guard chose many of the later Emperors). That the king did not, or could not, attempt to turn the army suggests other factors were at work

Perhaps it is more fruitful to question whether it is possible for any government to set up countervailing power, especially the kind set up through constitutions: An

alternative view is that the interactions between powerful national players are rarely governed by constitutional rules since, at the national level, most rules can be changed. Pursuing this line of argument, Parliament did not become powerful in England as a result of constitutional changes over the course of the Glorious Revolution, it was already powerful as evidenced by its ability to depose two kings in quick order. This then means that the constitutional changes after the Glorious Revolution, that some have argued is the source of constitutional government in England, simply codified the power relationship that pre-existed these changes, while the conflict between the Stuarts and Parliament was only a last ditch stand by the king against an inevitable passing of the balance of power.

Put yet another way, the barons who surrounded the feudal monarch obtained more countervailing power from their personal armies than did the fractious Parliament from the constitutional changes following on the Glorious Revolution. Yet constitutionally bound government, and respect for property, emerged only after the demise of feudalism. Why only then and not before? There seems something missing in the argument that governments became better able to borrow by setting up the checks and balances on themselves that would curb their own baser instincts.

In what follows, we want to turn the reasoning around. We will argue that it was not the devolution of political power to the public that made their property secure. Instead, property first became more secure against expropriation. Secure property then became the fount of political power, and this was eventually constitutionally codified. Thus the constitutional devolution of power mirrored, to a large extent, the devolution of power that had taken place as a result of more fundamental economic changes. Let us now describe what these changes were.

The Distribution of Property.

James Harrington, an Englishman who was a contemporary of Oliver Cromwell, studied the sources of power in his 1656 book, *Oceana*, written when there was much debate in England about the appropriate form of government. Harrington argued that the increasingly widespread distribution of land in Britain was the primary reason the nature of its government had changed.

Harrington was strongly influenced by his early travels through Venice and the Netherlands, whose systems of government he extolled. He tried to understand the reason why these countries, and the England of his day, had governments controlled by the people (in a manner of speaking) rather than by the nobility or by the monarch. His main conclusion was that the distribution of property holdings in a country determines the nature of government. He argued this was because those who controlled property had the revenue to pay armies that were the ultimate source of power. This belief in property as the fount of power is clearly enunciated in one of the pamphlets put forth by the Rota Club, a forum Harrington started to conduct nightly political discussions. The pamphlet declared that²²

All government is founded upon overbalance in propriety. [i.e., governmental power derives from property; the man or men whose property exceeds (overbalances) the total wealth of others in the state controls its government]

If one man hold the overbalance unto [over] the whole people in propriety, his propriety causeth absolute monarchy.

If the few hold the overbalance unto the whole people in propriety, their propriety causes aristocracy or mixed monarchy.

If the whole people be neither overbalanced by the propriety of one, nor of a few, the propriety of the people (or of the many) causeth the democracy or popular government.

In Harrington's view therefore, the roots of the monarchy's collapse, culminating in the execution of King Charles I in 1649, lay not in his specific policies but in the land policies of the early Tudors, which transferred land away from the clergy and the nobility to the commoner.²³ Henry VII broke up the large estates of the nobility and Henry VIII sold the land seized from the clergy. The Stuarts themselves sold large tracts of royal land in an attempt to balance their books. The non-noble families that purchased these lands formed an increasingly numerous class, the rural gentry.²⁴ They formed the powerful backbone of the House of Commons. Thus Henry Neville, who was much influenced by Harrington, exclaimed to the House of Commons in 1658²⁵

"The Commons, till Henry VII, never exercised a negative vote. All depended on the Lords. In that time it would have been hard to have found in this house so many gentlemen of estates. The gentry do not now depend on the peerage. The balance is in the gentry. They have all the lands."

For those who would dismiss Harrington as an idealistic crank, it is useful to consider his influence on America includes the written constitution, the short tenure of power, the system of checks and balances, the special apparatus for safeguarding the constitution, the equal division of inheritance amongst the children of the deceased, religious liberty, and the public education system. The philosopher David Hume, while in general skeptical of utopias, felt that "*Oceana* is the only valuable model of a commonwealth, that has yet to be offered to the public."²⁶

Harrington's thesis, though in itself not novel, attempted to draw from the historical experience of a number of countries including his own. He was so convinced that the widespread distribution of property was essential for democracy that in his proposed *Oceana* no citizen was allowed to have property more than 2000 pounds.

Harrington was, however, no Marxist. The government, in his view, was not a tool of those with property. Instead, it was an alternative locus of power, competing with those owning private property for it. Applying Harrison's ideas, if, as Marx proposed, private property was abolished and all property was held by the state, one would simply have tyranny, as bad as the most despotic of monarchies. By contrast, if private property existed and was widely distributed, there would be checks and balances on the government. Thus Harrington was a precursor of liberal philosophers who view private property as essential to freedom.

The broad outlines of Harrington's argument seem to bear out. The break up of large estates in England and the sale of clergy lands led to the emergence of a vast number of prosperous commercial farmers – the yeomanry -- who were neither so poor that their only thoughts were of subsistence, nor so wealthy that they could not be intimately involved in the farming of their land. The Netherlands was perhaps the only other country in Europe in the seventeenth century that practiced commercial agriculture and had a similar type of gentleman farmer. The towns in Flanders and Holland provided the markets that could be served by enterprising merchants who were willing to invest in farmland. The land that formed the basis of their small, but commercially viable, estates came, in part, from draining the swamps and reclaiming land from the sea.²⁷ Because of the paucity of land, farming was intensive, but because of innovations like crop rotation and the planting of crops that rejuvenated the soil, such as clover and turnips, farming was also very profitable. Finally, in Venice, the most valuable property was not land but businesses, and again a small clique did not have a monopoly on them. Thus property was widely held in all three countries.

We also know that power was shared surprisingly widely in all three countries relative to the norm in the seventeenth century -- though to term these countries democracies would be an abuse of the term. Finally, all three countries respected property as evidenced by their ability to issue public debt.

But what is the mechanism by which a widespread distribution of property leads to a widespread distribution of power, and a respect for property? Harrington's argument, unfortunately, is a little circular. To claim that property leads to power is to presuppose that the monarch respects allocations of property. Else why could the monarch simply not take back property if he felt that it could be used to fund armies against him?

In fact, there is something more puzzling in the argument. If the king's power was checked when property lay in other hands, it would have been better if a few powerful lords and the church held that property for they could best organize forces against the king. Instead, in England at least, it seemed that the security of property was established only when it was widely distributed, when large estates were broken up and the lands seized from the Church in England were sold. It is difficult to believe the gentleman farmer would be better able to organize against the king than the feudal lord or the organized clergy. Was it simply that the country squire would identify with other country squires whose property was seized, much more so than a peasant would with his lord? While class solidarity is possible, we believe there was a stronger force protecting the property of the squire.

To see it, consider the economics of expropriation. When landholdings were vast, the skills required to manage that land and generate revenues were general management skills -- the feudal lord employed overseers who supervised a steep hierarchy at the

bottom of which was the peasant. While the peasant had the capacity to get to know the land well and get the most productive value from it, without ownership he had little incentive or ability to do so. In fact, in the early Middle Ages in England, and till quite late in other countries, serfs were incapable of owning property, had to pass on their earnings to their master, and were bought and sold with the land they tilled.²⁸ Moreover, to reduce the need for management, the individual peasant often had “no choice of date or of crop; he must plough and reap with the rest, and sow the same seed as they.”²⁹

While the lord probably was tutored since early childhood to drive overseers and supervise his estate, he did not have an intimate relationship with the land – it was too vast for any one man to get to know well. As a result, the revenues generated from the land did not really depend on whether this particular lord owned it, or whether some other person who was equally capable of driving overseers owned it. In economic parlance, the income from the land to the lord was a pure rent – it derived simply from his ownership of the land, and there was little other economic link between the property and the owner.

Not only was property loosely linked to the owner, the extent of security of property would have made little difference to the size of the revenues generated. Since the peasant exerting the effort did not own the land, and farmed it at the pleasure of the lord, greater security for the lord’s ownership did little for the peasant. Of course, the lord may have had some additional incentive to make improvements to the land if he knew his tenure was secure, but given the kind of extensive agriculture he practiced, these would not have added substantially to revenues.

Given all this, the lord owned his extensive holdings only because he had a sufficient armed force to bloody the monarch’s nose. If the monarch did not fear

questions about his own legitimacy when he expropriated other inherited land, if he did not fear that other lords would band together against him, and if the resistance this lord could pose to an assault was limited, property could, and would, change hands whenever the monarch was displeased. The inefficient structure of ownership was itself the cause for the insecurity of property. From the perspective of the monarch, one lord was just as good as another, because each one's general management skills allowed them to generate approximately the same surplus for taxation. The only security to property was then the favor of the sovereign – which is perhaps why great lords spent much time at court currying favor, and the manners of the nobility became more and more cloying! Property could simply not be secure when the owner was so replaceable.

What if land were distributed more widely? Gentleman farmers, owning smaller (but not economically unviable) plots were likely to be much more closely connected with their land, making decisions on what to plant and where, experimenting with different crops and techniques, understanding how the weather mattered every season, and which clump of trees provided beneficial shade. They were likely to be more critical to generating surpluses from the particular plot of land they owned. Thus the intrinsic value of the land they farmed would be far less if these farmers were expropriated for they would then withhold their skills, especially if their incentive to work depended on the security of their property right. It would be more fruitful for the government to negotiate a steady tax from each of these farmers than to expropriate any one of them.

Of course, expropriation of even one also carried the additional danger that the farmers' incentive to create the large surpluses would be diminished if property rights were seen to be insecure. But one need not rely on the benevolence of the king, his being

far-sighted, or even his being able to calculate the costs and benefits of expropriation to explain the strengthening of property rights: It is sufficient to recognize that what is economically right eventually leads to political might.³⁰

To see this, suppose matters did come to a boil and there was a conflict between the king and the landed gentry about property. Assuming that issues of honor and loyalty matter only to a few in a civil war, and assuming that most people decide on the basis of their pocket, soldiers would give their loyalty to those they see will have the most wealth, if they won the war. Since the gentry preferred the status quo distribution of property, and since that distribution was likely to be much more economically productive than the king's alternative of turning current owners out and replacing them with new ones, the gentry's ability to promise to pay would be higher than the king's. As a result, in a Civil War, the gentry would attract more to their cause and eventually prevail. If the monarchy were not far-sighted enough to see that the balance of power had changed, it might indeed take a Civil War, a beheading, and a revolution to convince the monarchy that power had indeed shifted hands!

According to the broad lines of our argument (and it is easily modified without altering the spirit to satisfy the historian and the sociologist), what was different about the gentleman farmer (or for that matter, the entrepreneur or the merchant) was that he simply could not be replaced by another as owner without substantial loss in value – his expertise tied the property to him over time. It was far more profitable then for the king to come to terms with him by negotiating reasonable consensual taxes – which perhaps explains the emergence of Parliament as a serious forum for debate. Secure in his property, the yeoman farmer could invest in new technologies that further enhanced the

productivity of his land, and ensured further security for his property. It is uncontroversial that farming methods, which had been extremely archaic under the monasteries, were transformed under the new owners. As a result, the productivity of land increased considerably during the time of the Tudors.³¹

Thus Harrington omits a vital step in his arguments: The seizure of concentrated holdings of property, and their sale, led to property being held by those who could manage them much better. It was this that enhanced the security of property. Once property was secure, the rest of his arguments seem very plausible. The landed gentry's wealth could be spent on gaining influence through Parliament, or, if necessary, on arming soldiers against the king. Eventually, the reality of the economic distribution of power was recognized in constitutional change.

We see a similar scenario being played out in Zimbabwe today, where despite its posturing and the strong public pressure on it, the government has been reluctant to expropriate the white farmers. It knows, that at least for a while, such an act would lead to the complete collapse of the economy. Our argument should also not be taken to mean that there never will be instances in history of inefficient holdings of property. A sufficiently powerful and ideologically motivated force can prevail over the logic of economics for short periods. There is no other way to explain the collectivization of Russian land in the 1920s. For political reasons, Stalin decided to expropriate the yeoman farmers, also known as Kulaks, and this expropriation caused enormous losses in agricultural production – but once this cost was incurred, and this strong constituency favoring property rights removed from the Russian landscape, further expropriation became much less painful.

Our argument should also not be taken to mean that seizing land from the rich and distributing it widely was the optimal policy historically. While large, concentrated holdings of land are typically not the most productive, neither are tiny, economically unviable, subsistence holdings of land. The peasant practicing subsistence farming had little surplus to share with the monarch, partly because he did not have the capital or the tolerance for risk to develop innovative and plot-specific methods of farming. Not only did the monarch get little by way of surplus by respecting the peasant's property, the peasant was also quite dispensable because he did not add anything to the land that some other peasant could not. So simply breaking up the large holdings and distributing them freely might not have done much for the cause of property rights.

It is important also to recognize that the manner in which the Tudors and Stuarts rearranged property rights was critical. They sold the seized land. In a fair auction, buyers are typically those who can manage the land best, for it is they who are willing to pay the most. So the opening of a market for land allowed land to be allocated to its highest value user and this, in turn, added to the security of the land.

From Land to other Property

Let us summarize our arguments in their most general form. The owner of an asset has the exclusive right to use the asset and exclude others from its use. Thus a property right is a form of monopoly. When the owner of an asset adds little of value to what it would generate intrinsically, he earns solely because of his ownership, because of the monopoly conferred on him by the law. But this kind of monopoly is very fragile, for it relies heavily on the law for its defense. The ease with which it can be taken back and given to someone else makes it attractive for the government to undermine the law.

A monopoly is much more defensible when the monopolist manages much better than anyone else. There is a substantial cost to taking the monopoly away, for the monopolist also contributes his skills to generating the surplus. Thus property that is owned by those who can manage it best is property that not only has the law to support it, but also has economic value backing it. To the extent that the government respects economic value, either because of the power it can purchase, or the taxes it can pay, an economically efficient distribution of ownership is much more secure than a distribution based on the accident of history or on the whims of the king.

Our argument suggests why government was much more participatory in the cities than in the nation states. In the city-states, the dominant source of wealth was not land but trade and manufacture. The surplus generated by these activities was clearly closely tied to the expertise, incentives, and relationships of the owner of the business, much as land was tied to the commercial farmer. It made economic sense to respect property rights within the city and to give citizens (a word that originates from the French *cite* and was originally applicable only to residents of a city) the sense of security by allowing them to participate in government. As the old saying goes “*Stadtluft macht frei*” or “City air makes free”.

Clearly, the cities grew along with business, and there is no reason to believe that respect for property was highly developed in the early life of a city. But over time, the quantum of business grew and businessmen demanded, and obtained, respect for property, as well as participation in city government.

In the nation states, by contrast, the dominant source of revenue was land. So long as property holdings were concentrated, the nation state could not commit to respect

property. Even if manufacture or trade started up, it would be hard for the nation state to show respect for business property when business output formed only a small fraction of total output. Thus it was only after the breakup of the feudal estates or after extensive land reforms that the group of yeoman farmers emerged who not only were strong advocates of the institution of private property, but also forced government to respect it. This then paved the way for competitive industry to emerge.

English history offers some evidence of this sequence. During the reign of Elizabeth the Ist, Parliament, which was already then dominated by the landed gentry, vigorously opposed the conferring of industrial monopolies. These were the industrial equivalent of the large estates that had just been broken up. Consider the following case, which vividly demonstrates that these monopolies contributed to the insecurity of property, the arbitrary power of the king, and the ruin of economic activity. In 1614, a scheme was concocted to³²

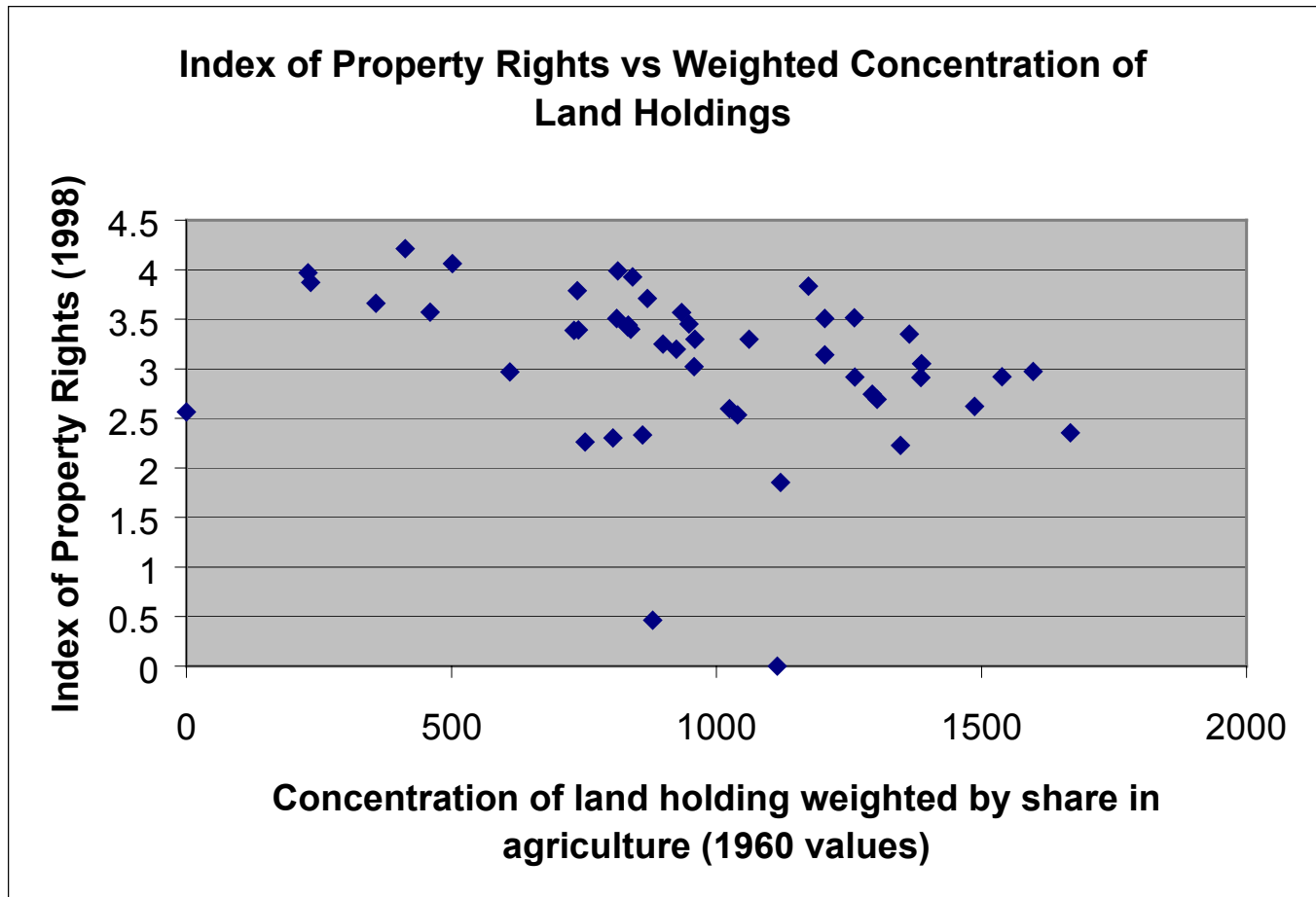
“take from the Merchant Adventurers [a trading company] their rights to export unfinished woolen cloth to the Netherlands and to give to a new company the exclusive right to export cloth...It was estimated that the export of entirely finished cloth...would bring in an additional profit of 600000 to 700000 pounds a year to those engaged in the cloth trade. Of this the king was to have 300000 pounds for his grant of the franchise to the new company. The Dutch...refused [to let in] the English finished cloth, and the new company came to a quick end. Yet before the Merchant Adventurers could recover their old rights, which they did at a cost of between 60000 and 70000 in bribes to James’ officials, the entire cloth trade had been disorganized...As late as 1620 the English merchants were exporting only half as much cloth as they had sent abroad in 1613.”

Parliament saw the danger to the security of property (and its own power) from these monopolies, and in 1624, passed the Statute of Monopolies, which forbade the issuance by the king of patents of monopoly to individuals except in the case of new inventions. The anti-monarch Parliament that served between 1640 and 1660 went

further, and virtually ended the practice of granting monopolies to corporations, as well as individuals.³³ So in addition to protecting the rights of land owners, the power of the landed gentry acting through Parliament placed constraints on the arbitrary powers of the king over industry.

A Peek at the Data

If our arguments hold generally, then they should not be valid just historically but also more recently. Very crudely, our arguments suggest that in countries where agriculture dominates, the development of property rights should be strongly negatively correlated with the concentration of land ownership. This prediction seems to be borne out by the data. In the accompanying figure we plot the Property Rights Index, a measure of the extent private property is protected in a country against an index of concentration of land ownership (the Gini coefficient) in 1960 in that country (weighted by the fraction of the country's Gross Domestic Product that is obtained from agriculture). Rich countries do not have much agriculture, so before plotting the graph, we take out the effect of the country's per capita GDP, and the fraction of GDP in agriculture, from both variables. The two variables are highly negatively correlated. When a country is heavily dependent on agriculture, the graph suggests a highly concentrated ownership of land is associated with a lower level of protection of private property. In such countries, land reform seems to be a precondition for the improvement in the institution of property.



Why did every country not distribute property widely?

This leads us to a final question. If wide (but not too wide) distribution of land led to participatory politics and respect for private property, why did every country not do it? Why till 1861 were the vast majority of Russians serfs, tied to the land and without protection from their overlords, and from the government? Why did it take the French Revolution, the Napoleonic conquests, and the revolutions of 1830 and 1848 to reform land distribution in Continental Europe to one more conducive to intensive commercial farming, and to one that led to greater respect for property (Parenthetically, many commentators have seen a parallel between the political upheaval caused by the French Revolution and the economic upheavals induced by the Industrial Revolution. One direct

link may have been the political upheavals initiated by the French Revolution caused the break-up of large estates of nobles and the clergy in France, Germany, and Italy, and the elimination of the innumerable dues even the landed peasant paid his absentee landlord. This led to better protection of property rights, more participatory politics, and the right conditions for manufacture and trade to flourish).

One reason may be the nature of the land in some countries. Some lands lend themselves to intensive farming, where knowledge of land is critical, while others lend themselves to a mode of agriculture such as plantations where it is not. This is perhaps why Costa Rica has had a more democratic regime, than a country like Columbia.

The argument that the necessary technology of production may not permit an ownership pattern favorable to the emergence of strong property rights applies not only to land but also to industry. When industry consists of large monopolies, which exist only because the government affords them privileges, the government is likely to have little respect for property. For example, firms in extractive industries have value largely because of their rights to extract, and really do not utilize huge amounts of human ingenuity. In countries that are abundant in natural resources – such as Zaire – the government can extract large amounts of money simply by withdrawing a mining privilege from one company and auctioning it off to another. Of course, eventually bidders realize they will have to factor in the cost of future bribes that will be needed to keep their privileges. The outcome however is that the government will have little incentive to respect property rights. Only a few countries have overcome the curse of being richly endowed with mineral resources.

But the most important reason for why countries did not attain the appropriate distribution by design may be that the self-interest of the sovereign and the nobility did not permit land reform, even if it would benefit the country as a whole. Certainly, an individual lord could not hope to gain by dividing up his land and selling the pieces to the peasants who farmed it. For one, few peasants would have the accumulated wealth to buy it. Also, if other lords did not follow suit and force an eventual change in the climate of property rights enforcement, our revolutionary lord would find that the peasants he had sold land to enjoyed even less security of tenure now that the lord was not present to protect them. Moreover, any wealth the lord gained from sale would itself be up for grabs, now that he could not hold out the prize of land to enlist the support of his peasants in battle.

The sovereign might also not have had the incentive to move to distribute land widely. After all, even if property rights became more secure, and the land became more productive, he would lose power. In many cases, it would be in the monarch's self interest to continue coercive-extractive policies, even if detrimental in the long run for the country -- as Louis XV is famously supposed to have said, "France will last my time."

If initial distributions of land holdings tend to persist as we have just argued, in the absence of concerted reform the legacy of history may explain why some countries, or even parts thereof were lucky, while others not. For example, Northern Italy and Southern Italy are extremely different in their economies, Northern Italy being much more progressive than Southern Italy. Estates were much larger in the South and the peasants far poorer. A number of historical factors including the Norman conquest of the South in the eleventh century and the greater devastation caused by the plague in

Southern Italy in the fourteenth century could account for the differences in land distribution.³⁴ In turn, these differences could explain the disparity in economic progress between the North and the South that persists even today.

Similarly, some former colonies of European powers developed stronger respect for property rights earlier than others: The initial European settlers migrated en masse if the climate was hospitable and the country disease-free – leading to the emergence of a group of yeoman farmers – while land holdings were much more concentrated, and industry much more extractive, if the land was inhospitable so that only the minimum number of Europeans migrated to oversee large holdings worked by native labor.³⁵ These latter countries would have had to await the emergence of a viable manufacturing and trading class to establish secure property rights, but the emergence of that class would itself be held back by the absence of property rights and finance.

Finally, in large part, England's success may have been a result of a confluence of circumstances rather than carefully pre-meditated strategy. The break-up and sale of large estates by Henry VIIth was, in part, to prevent parallel centers of power from emerging in the short run, while the expropriation of the clergy's lands by Henry VIIIth was driven in no small way by the Pope's lack of sympathy for his marital troubles. The Stuarts sold land because they had little choice – they could not fund wars and support an extravagant personal lifestyle otherwise. Financial crises led to changes that a stronger sovereign would never have accepted, and only thus was self-interest overcome. Time and again history has shown that if there is a silver lining to economic crises, it is that they alter the constellation of power and make changes possible that could otherwise not be dreamt of.

Summary

Historically, the greatest obstacle to the development of a financial system was the rapacity of Governments. While a strong central authority was necessary to protect against foreign invaders and enforce the law, it had an adverse effect on financial development because a strong Government faced fewer restraints.

We have argued that the wide distribution of property is an important part of the explanation for why a country like England managed to curb the arbitrary powers of the government. The yeoman farmer learnt to manage his land in the best possible way, and became hard to replace. Land tenure became more secure as the government preferred the steady taxation of the revenues generated by energetic farmers to a one-time windfall from expropriating them. As the pattern of ownership became more efficient, the owners themselves obtained the political power to protect against moves away from the status quo.

Moreover, with improved security for property, a market for land developed, and incompetent users sold out to more competent users. Thus, over time, the free market in property moved assets to their best value use and made it even less likely that the government would act arbitrarily against the institution of property. Secure property led to secure income, and greater political say for the propertied.

These safeguards were extremely important for the emergence of finance. Unlike with land or industrial assets, most financial assets are held passively – the holder has no great expertise in generating value from those assets. Since the government suffers only a loss of reputation if it expropriates the cash or gold held by its citizens, or if it repudiates the debt it owes them, the holders of financial assets are the first to be targeted by a government in need. It is rare that a troubled government takes the land farmers own, or

the machines firms have, to pay its bills, but it is perfectly willing to pay public creditors only a fraction of the amount it owes. Finance therefore has to come within the perimeter of defenses built against the government by other forms of property for it to flourish. We have argued that the power of owners of more specialized property, and their incentive to defend existing allocations of property may, in fact, have provided the necessary protection for finance.

And when investors feel safe, a country can benefit greatly. As historian Richard Ehrenberg, writing in the early part of the twentieth century, puts it, “England would not have been the Great Britain of today, it would not have conquered half the world, if it had not incurred a national debt of 900,000,000 pounds between 1693 and 1815.”

Perhaps because of the concentration of land holdings, France and Germany did not manage to develop a good system of public finance until the political upheavals that started with the French Revolution in 1789 had run their course. As a result, their governments lurched from financial crisis to financial crisis. This had knock-on effects because until public finances could be placed on a steady keel, private finance was constrained to be small and unobtrusive.

Eventually though, political revolutions ended the *ancien regime*, and land reform took place followed by political devolution and industrial growth. As power became more widely distributed, the primary impediment to financial development was no longer insecure property. Now it was the absence of rules and regulations that were necessary to facilitate financial transactions. And instead of the monarch impeding progress, it was powerful “incumbents” who saw little reason to permit financial development. This is a theme we will take up in the next chapter.

Let us end with a caveat. The implication of our analysis is not that Bill Gates should be deprived of his wealth to make property rights more secure. It is that property acquired through favor or merely by inheritance contributes to the government's incentive to expropriate. So too does much of financial wealth where the owner sits passively, collecting dividends or interest. As financial wealth grows relative to other forms of property, it becomes all the more important that the government should not have any unnecessary leeway or temptation to violate property. A free market in property goes some of the way in assuring this. We will explore other kinds of policies that are conducive to a stable system of ownership in Part III of the book.

Chapter 7 : The Impediments to Financial Development

The first step in the long march towards a first rate financial system is to tame the government, to make it more respectful of its citizens' property so that they can create wealth in security. The devolution of the ownership of property towards those who can best use it is a crucial step in this process. Power invariably moves to the people as property becomes more widely distributed and secure.

But this does not mean that the best government for the cause of financial development is a passive one. The best kind of government for markets is one that, in addition to being largely respectful of the property rights of individuals and firms, also facilitates the creation of market infrastructure.

But just because a government is constitutional, and bound by democratic institutions does not mean that its actions will reflect the will of the wider public. The problem in democracies is that power is very widely distributed. The average individual, who is a virtually anonymous member of a large heterogeneous group, does not have the incentive to exert himself to see that his preferred policies are enacted. Instead, he would prefer that others exert themselves for the cause. But when everyone thinks this way, committed lobbyists from small, homogenous, motivated, pressure groups end up determining the political agenda. This is all the more likely if the small homogenous group is rich and well connected.

We will argue that even though the government is needed to build and maintain financial infrastructure, even a democratic government may be held back by pressure groups that do not want to see this happen. Who these groups are, and why they hold

back finance is the subject of this chapter. But first, let us ask why the government is necessary at all.

Is the Government necessary?

Some libertarians believe that any government intervention, even in the building of market infrastructure is bad and inhibits private initiative in the matter. It is true that once some basic infrastructure is in place, financial markets often solve problems on their own, obviating the need for further intervention.

But one can go too far in assuming the ability of markets to look after themselves. The formation of competitive prices presupposes the existence of a free, competitive, market where these prices can be formed. Markets, however, do not flourish in conditions of anarchy. They typically require an impartial body external to the market participants to enforce honest trade. While self-policing trading organizations are possible under a variety of circumstances, it is often better that the government undertake the task of building and supporting the market's infrastructure. This is not an entirely uncontroversial proposition in some libertarian circles, so let us start by explaining why we think the government is needed.

Why is the government needed for financial development?

The need for legal devices.

Government intervention may be required because laws are necessary to make possible certain kinds of legal devices. Consider, for example, the concept of limited liability – the idea that a firm (or individual) can walk away from its debts if unable to pay. While it may seem commonplace today, there was a time when it was thought limited liability was a fraud perpetrated on the unsuspecting public investor by those who

had influence enough to obtain such protection from the sovereign. It was felt that under limited liability, the rich lured the poor investor into a venture under the pretext that it was well capitalized, and then left the venture to its own devices at the slightest hint of trouble without bearing costs. An editorial in *The Times* of London in 1824 thundered:

“Nothing can be so unjust as for a few persons abounding in wealth to offer a portion of their excess for the information of a company, to play with that excess for the information of a company – to lend the importance of their whole name and credit to the society [i.e., the company], and then should the funds prove insufficient to answer all demands, to retire into the security of their unhazarded fortune, and leave the bait to devoured by the poor deceived fish.”

But limited liability is essential in a modern stock market, where large sums have to be raised from a dispersed set of investors. Limited liability limits an individual investor’s responsibility to the amount of capital he invests. This enables him to diversify his risk across many investments, because his exposure to any single investment is limited. Moreover, he does not have to know the management intimately before investing since his loss from trusting an unscrupulous operator is limited. To the extent that he is well diversified, he is reliant on the average scruples of society, which is more easily discernible, than that of any individual.

Also, before limited liability, each owner was often jointly and severally liable for the debts of the company. This meant that if an owner’s partners were paupers, the owner’s fortune bore the brunt of the repayment to debtors. By contrast, limited liability makes the value of a share independent of the wealth, and therefore, the identity, of the owners. Trading becomes easier – a buyer does not need to make sure other owners are wealthy before buying, nor does he have to worry if a rich owner is selling out to him. Since investors can cash out easily, limited liability permits those who want to invest in a small way, without incurring the costs of monitoring management or controlling its

actions, to also put their money to good use: Limited liability enables the passive investment that many of us are so fond of. By increasing the liquidity of investments, limited liability allows more investment in equities, reduces the cost of capital to firms, and thus enhances economic activity.³⁶

The institution of limited liability is, however, not simply a contract between two parties. Limitation of liability would be for naught if the owner's liability were limited only vis-à-vis parties the firm wrote contracts with, but unlimited vis-à-vis third parties. Shares would be illiquid if the buyers' entire wealth were at risk from suits by individuals who bought a defective product made by the company, or by the government attempting to recover the costs of environmental cleanup. This is why a stockholder enjoys limited liability even against non-contractual parties who have claims against the firm. Such a legal device, absolving the owner of any liability greater than the amount invested, and under a variety of circumstances, is a form of property right, held against one and all. Its universal applicability is impossible to achieve through private contract; it requires legitimization by the government.

It is perhaps not coincidental that the enactment of laws permitting free incorporation with limited liability in Western Europe in the second half of the nineteenth century was followed by the emergence of the large, professionally managed, vertically integrated, corporations that economic historian, Alfred Chandler, calls the modern industrial enterprise. It is unlikely that investors would have trusted unknown professional managers enough to put their entire wealth at risk, so laws limiting liability were probably a pre-condition for these companies to raise large pools of money from arm's length investors. In fact, the first companies to be granted limited liability as a

matter of course in the United Kingdom were railway lines, primarily because of the great need for capital in this industry.³

More generally, finance makes use of a number of legal constructs such as priority (of debt), security (of collateral), and bankruptcy, which attempt to specify property rights. But property rights are not simply a contract between two parties; they are a set of rights the individual holds against all comers, whoever they may be. For example, traditional Roman law defined the ownership of a piece of land as an unlimited right *usque ad inferes et usque ad sidera* (from the center of the earth to the stars). Such rights need the broad support of society through its agent, the government. Private contracting cannot substitute here.

Government as Enforcer.

Financial contracts are often nothing more than promises of future payments. Clearly, they rely on speedy and accurate enforcement. A violator should fear retribution or else contracts will have no sanctity. While certain penalties, such as exclusion from future activities, can be enforced by private organizations, there are limitations on how much punishment they can inflict. For one, certain harsh remedies like incarceration are, in civil societies, a monopoly of the government. Equally important, private sanctions can always be negotiated down. A trader who violates the rules of the Securities Dealers Association can attempt to persuade the association to change the rules that led to his exclusion, or easier still, find a loophole. If he is a prominent member, he may have some success doing so, with the association trading off greater short-term profits against a longer-term loss of reputation. By contrast, a violation of securities laws will lead to jail, with the government prosecutor having only narrow room to negotiate. Changing laws is

³ Shannon

a much costlier and cumbersome process than changing association rules, one reason why the law is more likely to be enforced. The law, by being unyielding, offers much stiffer penalties than association rules, which is why it is more likely to be respected.

Of course, in corrupt economies where the government bureaucrat is willing to “negotiate” everything, the government may be worse than the Dealers Association because, unlike the association, the government bureaucrat has little to gain privately by punishing transgression. However, once a government progresses beyond the predatory phase, as discussed in the previous chapter, it should well be capable of harsher sanctions than private associations.

In an interesting study of the consequences of the passage of the 1933 Securities and Exchange Act in the United States requiring mandatory disclosure by firms, economist Carol Simon compared securities prices before and after the passage of the Act.⁴ She found that there was no difference in the average returns investors obtained before and after the Act for securities listed on the New York Stock Exchange. Thus, if before the Act, investors on the NYSE suspected abuse, they were sophisticated enough to pay a lower price for securities so that, on average, they did as well as they did after the passage of the Act. But she found that their ability to price securities became much more accurate after the Act. In other words, mandatory disclosure with the accompanying threat of punishment for violations would have made the information firms were disclosing more credible. As investors became more informed, the volatility of securities prices was reduced. Over time, the reduction in price fluctuations would have benefited ordinary investors, enabling them to make better investment decisions, and reducing the ability of informed but unscrupulous traders to take advantage of them. In fact, for the

⁴ Simon, AER 1989

regional exchanges, which were more easily manipulated than was the NYSE by the unscrupulous, she finds returns went up after the passage of the Act and the volatility of prices fell.

What is particularly interesting about her study is that she finds the NYSE had many of the rules that were required by the Securities Act of 1933 even prior to the Act. So what was lacking was the force of the law behind these rules, and the Securities Act certainly provided this.

Consider another example of a situation where the effect of enforcement can clearly be gauged. The intent of the Securities Act of 1933, as we have just seen, was to protect unsophisticated investors. But financial products that were intended for sale to only a small number of sophisticated investors were exempted from a number of requirements, including that of detailed disclosure to the Securities and Exchange Commission (S.E.C.).

One such product is equity issued by firms that are too young or unseasoned to list on the exchange, or by firms that do not want the public glare that comes from listing. The market for these instruments is known as the private equity market. The biggest issuers in this market are venture capitalists and buyout funds, while the main investors are pension funds and large endowments. One can measure the benefits of government regulation and enforcement by comparing the pricing of private equity with public, S.E.C. regulated, equity.

In privately held companies, a block of shares that gives the owner enough votes to control the company carries a very large premium of approximately 30 percent.³⁷ In these unregulated firms, controlling owners can take actions against the interests of

minority shareholders and appropriate value from them, hence people pay a hefty premium for control rights (equivalently, minority shareholders are willing to pay only a discounted price, knowing that there is a possibility they will be exploited). By contrast, the control premium for publicly traded companies, subject to scrutiny by the SEC, is approximately 4%. This difference suggests that the S.E.C. may indeed make a difference – that there is greater protection for minority shareholders in public, S.E.C. regulated, firms than in private, unregulated, firms.

More generally, recent research has shown that firms in countries that have better statutes protecting shareholders tend to have higher market values relative to book value, suggesting investors expect to get paid more, and are thus willing to pay a higher price for these stocks.³⁸ Of course, the existence of laws on the books does not mean they are enforced. In fact, a study of the enforcement of insider trading laws across countries finds that while at the end of 1998, laws prohibiting insiders from trading on privileged information existed in 87 of the 103 countries with stock exchanges, but there was an actual prosecution in only 38 of them.³⁹ Laws prohibiting insider trading can benefit the ordinary investor because she does not have to worry about the share price being manipulated by someone with privileged information. The flip side of shareholders willing to pay a higher price for the shares of a firm producing a certain stream of earnings is that they require lower returns on their money. The study finds that after the enforcement of insider trading laws, the rate of return in a country falls, implying that shareholders are satisfied with less when they know that they will not be cheated.

In short, government enforcement has bite. A final piece of evidence that the government can help (or hinder) contracting comes from observing the consequences of

slow enforcement. In Italy, where the judicial process is very slow, it takes an average of 4 years to foreclose on the house of a defaulting borrower, while it takes only 1 year in the United States. Anticipating these delays, Italian banks are more reluctant to lend and, everything else being equal, lend a smaller fraction of the purchase price of a house than banks in the United States. Over the period 1971-1987 the maximum loan-to-value ratio (i.e., fraction of the purchase price of a house one could borrow) was 53% in Italy while it was 85% in the United States.⁴⁰ While other differences between these two countries can explain some of the difference in the loan to value ratio, a significant portion is explained by the relative slothfulness of the legal system in Italy. Poor enforcement can handicap the financial system.

Coordinating Standards .

Finally, the government solves coordination problems. For instance, study after study has shown that better accounting standards help make firms more transparent, making it easier for them to inspire confidence in investors. Of course, firms can adopt a policy of better disclosure by choosing a transparent accounting standard on their own – nothing prevents a German firm from also disclosing its accounts using more transparent U.S. standards. But without sanctions for improper disclosure, this would just be cheap talk, of very little value as a signal. Moreover, each firm would have the incentive to choose a method of disclosure that puts it in the best light. This would be problematic because disclosure serves two purposes: Informing the investor about the firm, and giving him a standard with which to compare it to other firms. If each firm chose its own idiosyncratic method of disclosure, comparability across firms would be lost. For all

these reasons, it makes sense for disclosure standards to be mandated by a body that can ensure its wide acceptability. In some countries, the government is the only such body.

Of course, there are benefits of competition among standards. The government may insist on the wrong standard, either because it is mistaken or because it is influenced by a particular group of self-interested firms. Nevertheless, the virtues of ready comparability stemming from a single, even if biased, government imposed standard can help avert the confusion from competing, even if slowly convergent, standards.

In summary, we believe that the government has a role to play in setting up the infrastructure for the financial system. An analogy may make our stand clear. Think of a downward sloping field that needs to be irrigated. The force of gravity, if allowed to work, enables water to flow everywhere. This is the libertarian view. But there typically will be obstructions in the field and channels will have to be cut to enable speedy irrigation even if, given enough time, water will seep through everywhere. This is the interventionist view. Of course, the wrong channel can draw water away from where it is needed. The libertarian and the interventionist not only disagree on whether channels are needed but also how often the wrong channel is cut. We sympathize with the need to construct channels for financial development to take place, but also recognize that channels will often not be cut, or will be cut to hinder rather than help. In much of what follows, we will examine when the right channels will be cut.

Why Might the Wrong Channels be Cut?

Financial markets require an elaborate legal, accounting, regulatory, and institutional infrastructure. The government is needed to facilitate the creation of this infrastructure. Given the undoubted benefits of financial development that we have

documented, one might think that in democracies there would be strong political support in favor of finance. Unfortunately, this is not the case. Even in a democracy, not all voices are heard equally loudly, and policy-making is often captured by powerful special interests that thrive because of the peculiarities of democratic governance. But what group has a vested interest against financial development? And how does it succeed in controlling the political agenda?

In order to illustrate the political obstacles to financial development we will first explain which groups are likely to capture the government's policy agenda and then we will argue that such groups often have an anti-finance bias in countries with an underdeveloped financial sector.

The Power of Small Groups in Democracies

Two economists, Mancur Olsen and George Stigler, argued in separate works that small, focused interest groups have disproportionate power in a democracy.⁴¹ We will illustrate their argument with an example. In many cities in the developed world, the number of taxis on the road is strictly regulated. For example, some cities give out a certain number of medallions, each of which gives the owner the right to run one taxi. In New York, this number is precisely 11787, and no new medallions have been issued in the last fifty years. Anyone who wants to operate a taxi has to buy a medallion from an existing owner. If the number of medallions is scarce relative to the demand for operating taxis, the price of the medallion will rise since its supply is strictly limited. Prices of medallions can be very high (over \$200,000 in New York).⁴²

From an economist's perspective, this is an aberration. The high price of medallions suggests there are potential entrants who would like to run taxicabs but are

not allowed to. Such restrictions on the operation of the market seem unseemly. Yet the public rarely protests, even when it is habitually inconvenienced by the near impossibility of finding taxis.

When City Hall is asked, it will usually explain the restrictions on medallions as some combination of aesthetics, environment, and quality of service. More licenses for taxicabs would lead to more crowded streets and less civil drivers. Moreover, cutthroat competition among drivers would not be good for the general public since medallion owners would have a lower incentive to maintain their cars, or hire well mannered, knowledgeable, drivers.

These arguments are specious. Most cities do not impose minimum qualifications for taxi drivers. Medallion owners have no greater incentive to hire better drivers (or maintain cars) simply because their business is protected from entry – if anything they have less incentive than if they faced competition. The real reason to restrict competition is the obvious one – the medallion owners benefit from it.

How can the medallion owners get away with it? The answer is simple. Governments in democratic countries respond to pressure from the public. Organized groups can exert more pressure than unorganized groups – they can pay for television advertisements, they can speak to City Hall functionaries, they can contribute influential amounts to campaigns... Which groups are the easiest to organize? A small group such as the owners of taxicab medallions has common interests, and meets regularly at industry functions. It can put together an agenda quickly that each member can agree on. By contrast, the general public consists of people with widely differing motives and tastes.

Everyone comes from different locations. It is hard to get everyone to meet, let alone speak with one voice.

The costs of organizing a large, diverse, group is therefore more than the cost of organizing a small, focused, one. Consider now why this matters. Suppose a town has one owner-driver of taxis and 10 customers. Let us assume that if another taxi is allowed to operate, customers are benefited to the extent of \$10 each, while the current monopolist owner loses \$95 as a result of competition. Since the total benefits for the consumers ($10 \times 10 = 100$) is bigger than the cost for the taxi owner (95), the former should be able to deploy more resources in influencing City Hall – through campaign contributions, public interest advertising, law suits and the like -- and the interests of consumers should prevail.

But what if it costs \$1 per person to organize customers – the costs of the free coffee that will draw them to the meeting where lobbying is to be organized. Now the net benefit for the customers of organizing and winning the bid equals $\$100 - \$1 \times 10 = \$90$ which is less than the net benefit for the incumbent owner who does not need to organize himself.⁴³ Recognizing the arithmetic, and the fact that the taxi driver can employ more resources in lobbying, customers may not organize at all, leaving the taxi owner with his inefficient monopoly. Thus, coordination costs can prevent the best policies from being implemented.⁴⁴

Suppose, by contrast, that all the customers are employees of the same firm, and the firm pays for the cost of the taxi fare. Then, this firm has the incentive to lobby City Hall directly. Now the taxi owner will have to give up his opposition to entry. This simple analysis suggests that the chances of implementing a given policy depend upon

how concentrated its beneficiaries are: The more concentrated the beneficiaries, and the more dispersed those who bear the costs, the better the chances of the policy being implemented. Democracy is not for all of the people all of the time!

In the discussion so far we have purposefully ignored new entrants. To the extent that the entering taxi owner makes a profit, she should be willing to subsidize the customers' bid for free entry. The problem is that, new potential entrants are hard to coordinate with. Unlike incumbents and existing customers, likely entrants are generally not well identified. There is a vicious cycle at work – given the existing monopoly, few potential entrants are likely to telegraph their intent, but unless these identify themselves, they will find it hard to organize against the monopoly. Potential entrants are also unlikely to have spare resources, given that they have to make sizeable investments on entry, and given that they expect to compete fiercely. Finally, they may be unwilling to make common cause with customers, given that their interests will be in opposition later. Thus policies whose beneficiaries are neither well defined, nor homogenous, tend to be hard to implement even if they generate more value.

Finally, let us assume that the incumbent taxi owner makes only \$40 by preventing entry. According to the above analysis, the interests of customers should prevail. But there is another problem. While each individual customer benefits from new entry, he may be tempted to “free ride”, under the expectation that others will pay for the cost of organizing the lobby regardless of his individual contribution. If other customers do indeed contribute enough for lobbying, he enjoys the savings from having a competitive taxi service without paying the cost of political effort. So he prefers not to pay. Of course, peer pressure can be enough to overcome free-riding – most of us

contribute to the organization of the neighborhood dance for fear of incurring the opprobrium of our neighbors, even if not for the sheer pleasure of being neighborly. But here again large groups are cursed. Because they are dispersed, peer pressure does not work as well – if I rarely bump into you, your frown is less of a punishment for me. Moreover, there might be a belief that even if the entire neighborhood shirks, there will be other, more committed, neighborhoods where people have more time, and somehow the necessary effort will be undertaken. Such beliefs make collective action impossible because no one has an incentive to exert effort for the cause.

Taken together, all this suggests that for any given size of costs and benefits, smaller, more focused, groups have a comparative advantage in influencing policy. George Stigler, an economist at the University of Chicago, applied these ideas to the theory of regulation. Since the regulated (generally companies) are more concentrated and quantitatively much more affected by regulation than the intended beneficiaries of regulations (customers), regulators and the regulation setting process are very likely to be captured by the very entities they are supposed to regulate. Incumbent firms therefore typically transform all regulation into a barrier to entry.

Parenthetically, this view of regulatory capture is very similar to that held by Marx who believed that government was the “business committee” of the rich. His proposed solution was, however, to do away with the rich and to increase the powers of the state. But in Stigler’s view, this would simply lead to the capture of a more powerful, and hence rapacious, government by a different set of interests. And if democracy were done away with in the process, there would be no competition from an alternative set of interests having a different set of policies. A more powerful captured government facing

no competition is a recipe for inefficient tyranny, something history has borne out.⁴⁵

Stigler's proposed solution, instead, was to reduce the powers of government to the bare minimum. While we subscribe to the broad lines of Stigler's analysis, our position which will be developed in subsequent chapters is that the bare-bones government he advocated is a political non-starter, and there is both an economic and political rationale for more government than he proposed.

Let us sum up. The Olson-Stigler theory explains why taxi owners are so influential. Customers benefit from a competitive taxi market. But each one of them receives only a small benefit from an increase in the number of taxis, often too small to justify any political involvement. Furthermore, customers are dispersed, with many living out of town, so that the cost of coordinated action becomes prohibitively expensive. Finally, it is easy for any individual customer to hide among the large numbers of fellow-customers and attempt to free ride on their political activities. By contrast, each taxi owner is greatly affected by entry. Owners therefore form a small and well-identified group, which can easily act in a coordinated fashion. As a result, even in a democracy their interest often prevails, despite the inefficient entry restrictions they advocate. Now let us try and understand the incentives of various parties vis a vis financial development.

The Small Groups Against Financial Development

Financial development seems so beneficial that it seems strange that anyone would be opposed to it. However, financial development is not always win-win. It could pose a threat to some.

Consider, for instance, established large industrial firms in an economy, a group we will call industrial incumbents. In times of stability, these incumbents typically do not

need a developed financial system to ensure their access to resources. They can finance new projects out of earnings from existing businesses – as most established firms do -- without accessing external capital markets. Even when their business does not generate sufficient cash to fund desired investments, they can offer the assets they already own or their reputation as collateral against which they can borrow. Typically, even a primitive financial system is geared to providing funds against collateral – so industrial incumbents rarely suffer from a lack of funds even if the system is underdeveloped.

Indeed, they may be hurt by financial development. With the better disclosure rules and enforcement that development brings, newcomers do not need prior wealth or reputation. As a result, they can start firms more easily and compete away profits. Moreover, transparency hurts traditional ways of doing business – through contacts and relationships. There are many such examples. In 1991, the Bronfman family was permitted by the Canadian tax authorities to move two billion Canadian dollars to the United States without paying capital gains taxes. When the auditor general complained that the transaction “may have circumvented the intent of the tax code”, the government finance committee attacked him for violating the Bronfmans’ right to privacy. In a similar vein, in India a borrower can take money from one state bank, default, and obtain a fresh loan from another state bank. Banks do not share information about defaulters, in part because there is a law preventing widespread dissemination of information about defaulters. The privacy of defaulters and their right to maintain access to the public till are deemed more important than the public’s money, but this is of course natural in an economy dominated by incumbents.

Similar arguments apply to incumbent financiers. While financial development

provides them with an opportunity to expand their activities, it also strikes at their very source of comparative advantage. In the absence of good disclosure and proper enforcement, any financing that is not against solid collateral is “relationship-based”. The incumbent financier gathers information from his wide-ranging informal contacts rather than from publicly available sources. He recovers payments not by using the legal system, but by threatening and cajoling, using the many informal levers of power he has developed over the years. Key, therefore, to his ability to lend are his relationships with those who have influence over the firm such as managers, other lenders, suppliers, and politicians. Equally important is his ability to monopolize the provision of finance to a client so that his threat to cut off credit carries weight. Such monopolies are more likely if there are no public records of a client’s repayment history so that the client is locked in to his financier because only the latter knows his credit history – any other financier approached by the client would wonder whether he was being approached simply because the incumbent financier had deemed the client too risky.

The lack of transparency of borrower histories and the inadequate legal infrastructure in an economy where financial infrastructure has not developed provide formidable barriers to entry behind which the incumbent financier has adapted to enjoy large profits. Disclosure and impartial enforcement tend to level the playing field and reduce barriers to entry into the financial sector. The incumbent financier’s old skills of being well connected become less important, while new ones of credit evaluation and risk management become necessary. Financial development not only introduces competition, which puts pressure on the incumbent financial institution’s profitability and its relationships, it also makes the financier’s skills – his human capital -- redundant.

In short, free markets tend to jeopardize ways of doing business that rely on unequal access. Thus, not only are incumbents likely to benefit less from financial development, they might actually lose. This would imply that incumbents might collectively have a vested interest in preventing financial development.

They may also have the ability to affect policy: Incumbents are a well-defined, focused, small group. In small countries, they have been to the same elite schools, frequent the same clubs, and often intermarry. They may be able to keep finance underdeveloped, because those who benefit most from development, potential entrants, are small, poor, and unorganized (if they even dare to exist!) while the vast ill-informed majority do not know enough, or feel enough pain, to stir out of their complacency.

Is financial underdevelopment the best way for incumbents to protect themselves?

Rich incumbents have other ways to protect their market share. Why chose to leave financial markets underdeveloped to do so? After all, this could end up hurting the incumbents, who might occasionally need external finance. Why not ban entry into industry or finance outright? Such a ban could be better targeted at rank outsiders, leaving insiders to enjoy the benefits of a more developed system.

There are, however, some advantages for incumbents from leaving finance underdeveloped as opposed to directly banning entry. First, direct entry restrictions often require very costly enforcement. Enforcement becomes particularly difficult, if not impossible, when the product whose market is restricted has many close substitutes, as proven by the long queues of illegal cabs that populate airports. Enforcement is further complicated by the possibility that entrants can innovate around banned items. Each new threatening innovation has to be identified, categorized and then banned. The

bureaucracy that implements this “License Raj” will absorb substantial part of the profits of its own, and may compete for power with incumbents. By contrast, leaving finance underdeveloped is an act of omission with few of the costs entailed by an act of commission such as the use of the apparatus of the state to stamp out entry. Malign neglect may be as effective as active harassment but much easier to implement!

Second, the active enforcement of restrictions on entry is a very public, and therefore, politically transparent process. In a democracy, citizens have to be convinced that restrictions on entry benefit them, and this is a hard sell when they are faced with the poor service and extortionate prices of the local monopoly. By contrast, the malign neglect that leads to financial underdevelopment is less noticeable – it goes with the grain to have comatose bureaucrats who do not act rather than have overly active ones -- and can be disguised under more noble motives. For example, the requirements that firms that list have to be profitable for a number of years before listing can be sold to the public as a way of protecting them from charlatans, rather than as a way of preventing young unprofitable entrants from raising finance. The requirement also obviates the need to improve accounting standards, something that would tend to level the playing field between the established and the fledgling.

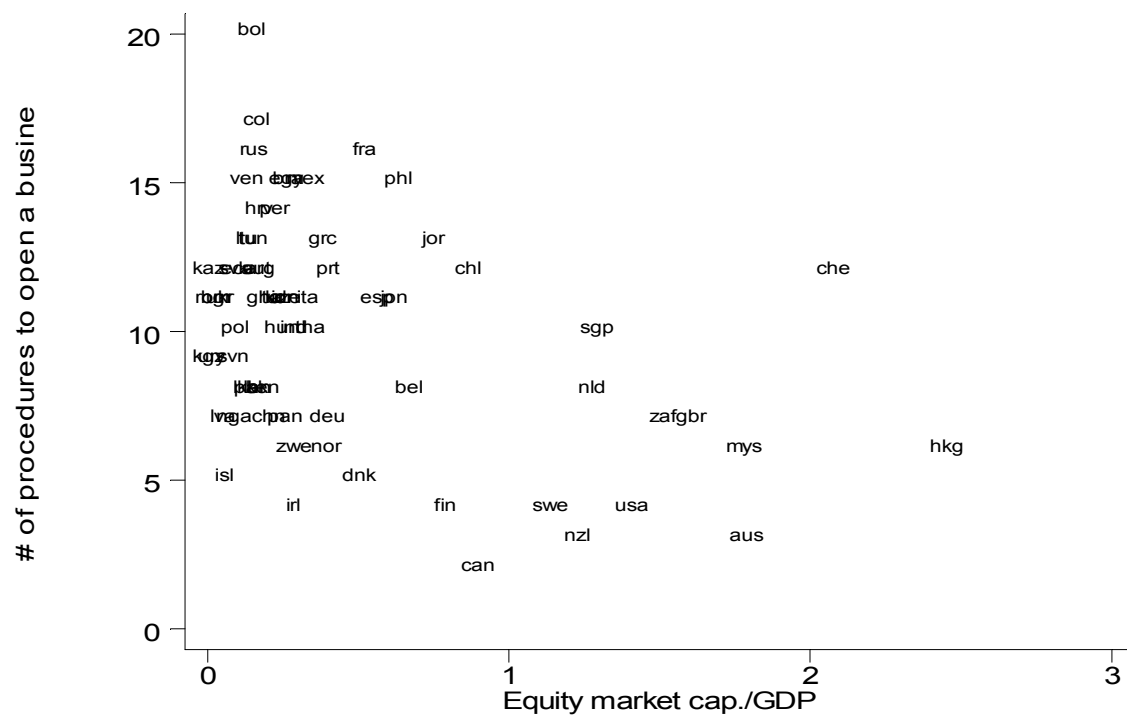
Finally, the problem with entry restrictions is that it does not give a clear rule about which of the incumbents will get the right to monopolize new areas of the economy that emerge as a result of innovation or expansion. The fight over the right to enter these areas, especially when outsiders join in, can be messy, costly, and very public. It also will take profits from incumbents and give it to the bureaucracy that administers the system. By contrast, when the financial market is underdeveloped, the set of potential

competitors for any new business is well defined and small – restricted to those incumbents who currently have financial surplus. This leads to a less controversial allocation based on who currently has the internal funds to exploit the new opportunities.

This is not to say that direct entry restrictions are not used. In a cross-country study, a team of economists from Harvard University and the World Bank has documented that to start a generic business an entrepreneur needs to follow an average of 10 bureaucratic procedures, requiring 63 days, with a cost equal to one third of the average per capita income.⁴⁶ In some countries, however, the restrictions are more severe. In Bolivia the number of procedures is 20, with a cost equal to 2.6 times the average per capital income. These regulations – the study finds – do not seem to be used to screen out bad producers or protect the environment, but rather to restrict entry. Of course, if the true objective it is to limit entry, then it is efficient to use multiple methods, including keeping finance underdeveloped.

This is, in fact, what seems to occur. If incumbents use multiple methods, and financial underdevelopment is similar in purpose to bureaucratic entry barriers, we should find the two to be strongly correlated. Figure 8.1 graphs the average number of days required to start a business in a country (a measure of the success of incumbents in imposing entry restrictions) against the ratio of the total value of equity traded in that country divided by its GDP. As one can easily see, countries requiring a lot of procedures also have an underdeveloped capital market, as symbolized by a low level of the ratio of equity value to GDP.⁴⁷ This negative relationship is suggestive that financial underdevelopment is another form of entry barrier.

Figure 8.1: Regulation of Entry and Financial Development



Summary

It is useful to reflect on the different points we make about power in the previous chapter and in this one. We argued in the previous chapter that while associations of men like the lord and his peasants could be powerful, more powerful still, especially after the invention of the cannon, was the power of the monarch. With naked physical power losing its ability to restrain the monarch, what influenced him to curb his own arbitrary powers was economic self-interest. When property was widely distributed and owners contributed to the surplus generated by their property, it was in his own interest to respect property rights, and allow more participation in governance, for that would help him ensure owners created the most economic surplus. They then paid the most taxes into the treasury coffers. These taxes could form a far more lucrative and stable form of revenue than periodic expropriation. Thus wider property holdings led to more participatory governance and more respect for private property rights.

In this chapter, by contrast, we argue that once the government curbs its near unlimited capacity for violence, and governance has become participatory, associations of men once again become the most important source of political power. Our interest, therefore, has been on how these associations form, and what their interests might be, especially with regards to financial development. As we have argued, the policies special interests will force through, even in a democracy, may not be in the best interests of society. What we have argued for is an explanation of financial underdevelopment, not based on intrinsic structural deficiencies in a country or culture, but based on interest groups. This then leads naturally to the question: “When are the special interests opposed to financial development overcome?” That is the subject of the next chapter.

Chapter 8: When Does Finance Develop?

Is financial development doomed to never take place because incumbents are so powerful? Clearly not! Some countries have enjoyed strong financial systems at certain points in time, and there is a worldwide boom in the financial sector today. This must mean that sometimes incumbents cannot get together to block development, and even if they do so, the tyranny of incumbents can be broken and development unleashed.

One reason, as our earlier comparison of Brazil and Mexico suggests, is because of political change. The ideas of the French Revolution, distributed through Napoleon's conquests throughout much of Western Europe, picked up momentum with the revolutions of 1830 and 1848. By the 1850s and the 1860s, government in Europe had become much more participatory. Arguably, the Napoleonic land reforms had the effect of diminishing the power of the then establishment, the landed nobility, and giving more political power to rich peasants, would-be industrialists, and financiers. With the growing economic importance of the business and professional class, financial reform followed quickly. For example, firms were allowed to incorporate freely with limited liability in France in 1863, Spain in 1869, Germany and Belgium in 1873...Stock exchanges also emerged around this time. Many new firms were formed, and new financial institutions like the Credit Mobilier in France sprang up to take on the establishment and provide credit to the upstarts.

A second reason for incumbents not to oppose development blindly is that they themselves can benefit from financial development when their investment opportunities are high relative to their ability to finance them. A sudden expansion in required scale, perhaps because of an opening of new markets, increases their demand for financing.

Alternatively, a sustained period of poor economic conditions may deplete incumbents' reserves of cash, forcing them to seek finance, and allowing them to be more amenable to financial development when the economy turns up.

Finally, increased competition resulting from forces beyond the control of incumbents – in particular, competition as a result of technological changes, and competition stemming from open borders – can reduce incumbents' incentives to use financial underdevelopment as a barrier to domestic entry. We now examine all these in greater detail.

Political Change and Financial Development: The Story of Credit Mobiliere

It is perhaps best to illustrate the impetus given to specific institutions by political change with a brief sketch of the rise and fall of the Société Générale de Crédit Mobilier in France in the second half of the nineteenth century.

The fall of Napoleon in 1814 (with a brief comeback in 1815) heralded a long period of relative peace in Continental Europe. The Industrial Revolution picked up speed and soon there was a tremendous need for credit to fund the expansion. But even in France, one of the most advanced countries, the financial system was grossly underdeveloped.

At the center of the financial system in France stood the Bank of France. It had been started by Napoleon, who was influenced by the success of the English government in mobilizing credit from the Bank of England. Napoleon too sought a ready source of credit for his military endeavors. The Bank of France was therefore started. But unlike the Bank of England, it had "difficulty placing its shares in spite of the personal example of the First Consul and his decree requiring government agents to purchase shares and

deposit their surplus funds in the Bank; almost two years elapsed before the entire capital was paid in.”⁴⁸ Perhaps one reason the Bank has such great difficulty raising money even at the height of the French Empire’s success was that it was little more than an extension of an all-powerful government, and it had no ability to refuse the extensive demands made on it. The initial reluctance of private investors to trust it with their money proved justified. With the fall of the Empire in 1814, the Bank went into virtual liquidation.

This established financial institution was, however, too valuable a tool for the government and the establishment to simply let die. While there were some moves to privatize the Bank at this point, the Restoration government in France preferred having it under its own control. As Baron Louis, the then Finance minister told the representatives of the Bank, “You want to be independent, but you will not; you will have a governor, I will name him, and he will not be the one who currently occupies the post”.⁴⁹

From the beginning, the Bank of France stood as a bulwark against financial development because it feared the competitive threat to its own position.⁵⁰ The Bank opposed the setting up of joint stock banks. In part, this was because many of the grandest proposals were influenced by the doctrines of the eccentric philosopher, Henri de Saint-Simon. Saint-Simon believed that the hereditary nobility and the landed aristocracy were parasites, and the future lay in the hands of industrialists and bankers. The free flow of credit to industry was the key to progress, and his more sensible and enterprising followers proposed schemes marrying banking and industry. But the government of the Restoration feared that these proposals struck at its own legitimacy – after all, the hereditary nobility and the landed aristocracy was its political base.⁵¹

It therefore took successive political revolutions to overcome the forces of incumbency. Even though the Revolution of 1830 weakened the aristocracy, and put progressives in government, the Bank of France retained enough influence to oppose innovations, especially the founding of new financial institutions. The Revolution of 1848 further weakened the establishment, and a grievous blow was struck by the coup d'état, which brought Louis Bonaparte to power. The new government was fully aware that the financial establishment, especially the Rothschilds and the Bank of France, had close connections with the Orleanist monarchy that had just been overthrown. So it made haste to both constrain the powers of the established financiers and build up counterweights. One of the decisive actions it took was to force the Bank of France to extend more credit to emerging industries like the railways (that did not have ties to the ancien regime). It also authorized new kinds of financial institutions such as mortgage banks. Soon France had a national market that could supply mortgage financing to even the smallest borrowers at reasonable prices. But perhaps the boldest move was to authorize the formation of the Société Générale de Crédit Mobilier in 1852.

The promoters of the Crédit Mobilier were Emile and Isaac Pereire, brothers who had been strongly influenced by Saint Simon's economic ideas. They had a vision of a vast financial conglomerate that would be financed through equity and bond issues, and would diversify risk by lending to a variety of industries. By controlling the flow of credit to these industries, it would be able to fine-tune production, and thus make sure that all parts of the economy moved in harmony, without periods of overcapacity and unemployment. The liabilities of this giant intermediary would be safe and liquid because it was so well diversified, and because it was governed by the most reputable captains of

banking and industry (including, of course, the Pereires).⁵² Thus the Crédit Mobilier was part trust fund, part bank, part cartel. Modern banking theory would suggest that some of its functions were incompatible. Nevertheless, to the government of the Second Empire, it looked like the very institution to challenge the dominance of the Bank of France and the Rothschilds.

The proposal for the Crédit Mobilier was predictably opposed by James Rothschild who wrote a letter to the government characterizing the scheme as fraught with speculation, irresponsibility, and monopoly.⁵³ Nevertheless, there was great support for the venture amongst the public, so much so that a market developed in its shares even before issue, where they fetched a price that reached four times the par value of the stock.⁵⁴ With the support of the government, and having caught the public imagination, it was impossible to stop the Crédit Mobilier from being set up.

It soon had enormous impact not just in France but also in Continental Europe. In its first year of operations, it bought a large stake in the Crédit Foncier, the newly created national mortgage bank, with which it shared directors and coordinated operations. It financed through direct lending and underwriting a number of railroads, and merged some of them together. It reorganized the coal industry in Loire, participated in the setting up of the Darmstädter Bank, which was modeled along the lines of the Crédit Mobilier itself, in Germany. It financed a number of other undertakings in France and neighboring countries, and subscribed to a government loan.⁵⁵ The economic historian, Rondo Cameron, provides a measure of the rapid growth in its importance to the French economy. By 1856, four years after it commenced operations, it handled all financial operations for sixteen large financial and industrial enterprises, with a combined capital

of one billion francs, over one fifth the capitalization of the Paris Bourse.⁵⁶ Its effect on the formation and financing of large-scale enterprises was dramatic and soon every government in Western Europe considered setting up its own version.

Some of the best-known banks in France today were set up during this period of ferment when the government encouraged rather than opposed new business formation. The Crédit Lyonnais incorporated under the new limited liability laws in 1863 and the Société Générale in 1864. Numerous new joint stock banks were set up in other countries of Continental Europe. It is not implausible that the extent of competition that emerges in such periods of economic and political ferment determines the extent to which a financial system is subject to the influence of incumbents later – after all, the entrant of today becomes the incumbent of tomorrow.

But despite serving as an example, and in many cases, a catalyst, for financial development, the Crédit Mobilier itself faced increasing problems. These had to do with the way it was financed, and the control its opponents had over it. The firm was set up initially with a large corpus of equity capital. It could also issue short-term debt and take deposits from the companies it had promoted (its affiliates). These, and its ability to recover loans made to, or to sell the securities it held in, affiliate companies in the booming market, were sufficient for it to provide financing to new ventures when times were good. But with the depression of 1857-58, many of these sources dried up. Instead of affiliates being net sources of funds, they became net drains, requiring large loans to help them through the troubled times. As public financial markets dried up, the Crédit Mobilier became their only hope.

Moreover, instead of following sound banking practice and maintaining a diversified portfolio, the Pereires became infected with the hubris that often strikes successful financiers – that anything they touch will turn to gold. One of their early promotions was a company set up in 1854 for urban reconstruction in Paris. The Société Immobilière as it became known soon became enmeshed in another one of the Pereires' projects, the proposed Suez Canal. Anticipating that its opening would transform Marseilles into one of the world's largest ports, the Société bought large tracts of land around Marseilles, and started developing them with funds from the Crédit Mobilier. But investment in land especially when the principle is "build it and they will come" is fundamentally illiquid. By 1865, the Credit Mobilere had 55 million francs in loans to companies, of which fully 52 million were to the Société.

Crédit Mobilier's fundamental problem now emerged. It had little ability to fund illiquid investments because the government controlled its access to long term funding. And the government was influenced by Crédit Mobilier's rivals, the Bank of France and the Rothschilds who, seeing that the government of Louis Bonaparte was likely to be around for some time, had wormed their way back into its favors. So when in September 1855, the Pereires announced a long-term bond issue, the government asked it initially to postpone the issue to avoid burdening the capital market with excessive issues, and then forced it to postpone the issue indefinitely.⁵⁷ The Pereires did not help their case by repeatedly attacking the policies of the Bank of France. So when again in 1863 the Pereires proposed doubling the capital of the Crédit Mobilier, the proposal was again turned down.

As its loans to the Société Immobilière grew, the Pereires finally got permission to raise new capital, in return for a number of modifications in its statutes, restricting its freedom of action further. But it was already too late. The new capital was simply poured into the bottomless pit of the Société Immobilière. Shareholders grew restive, and Crédit Mobilier's share price plummeted. On the verge of bankruptcy, the Pereires found other financial institutions reluctant to lend, and approached the Bank of France for a loan to extricate themselves from the mess at the Société Immobilière.

As Rondo Cameron puts it⁵⁸

“The first reaction of the regents [of the Bank of France] was outrage and indignation. That they should be asked to save the men and institution that for 15—nay, 37—years had by both word and deed attacked and attempted to overturn their privileges and position!”

Eventually, however, the Bank of France felt that the total collapse of a large institution like the Crédit Mobilier could have repercussions on the whole economy, and decided to intervene, at the very least to ensure an orderly liquidation. In return, it demanded the resignation of the Pereires brothers from their posts. Somewhat ironically, it was a former Governor of the Bank of France who replaced Isaac Pereire as chairman, and presided over the restructuring of the firm. While the Crédit Mobilier did not really expire till the Great Depression in the 1930s, henceforth it was a shadow of its former self.

The story of the Crédit Mobilier contains, in many ways, the classic lessons on how not to run a financial institution. Diversify, do not throw good money after bad, match assets with liabilities, maintain liquidity, or at least make sure you have friends who are willing to supply liquidity when you are in need... all these lessons were ignored. The Crédit Mobilier may not even have been particularly good at financing its

clients – a recent study indicates that its clients were not particularly damaged by Crédit Mobilier's demise suggesting that either it was never very special, or that its clients had seen the writing on the wall and had acquired alternative sources of finance by the time it became incapable of lending.⁵⁹

Nevertheless, the story of the Crédit Mobilier also reflects how important political change is to financial reform. It shows how an upstart financial institution, by devising new financial and industrial arrangements, can shake up the entire financial and industrial establishment, far more perhaps than direct political intervention ever could. It also shows that the establishment will follow the upstart's lead if its strategy is of any value, and may eventually beat it at its own game. So even if the upstart is short-lived, it can forever change the practice of finance. In order to preserve their position in Austria, for example, the Rothschilds were forced to set up a Crédit Mobilier like institution, the Creditanstalt, which was at the center of the Austrian financial system till the Great Depression. In more recent times in the United States, we have seen how the financing of hostile takeovers by Drexel Burnham Lambert eventually led top-tier commercial and investment banks to overcome their own scruples about antagonizing the blue-blood industrial establishment. They were forced by the competition from upstart Drexel to finance the takeover of such hoary firms as Singer and RJR Nabisco, against the desires of the incumbent management. This comparison is particularly apt. Like the Crédit Mobilier, Drexel Burnham Lambert too stepped on many toes and found it had few friends in the establishment when it ran into difficulty. That the Federal Reserve did not find it imperative to orchestrate its rescue cannot be unrelated to the number of enemies Drexel made through its financing decisions. Plus que ca change...

New Opportunities and Financial Development

The new financial and industrial firms that emerge during a period of political change eventually do become established incumbents – if they do not die first. But they do not always want to use their powers to kick away the ladder of financing that took them to their perch: Industrial incumbents will also benefit from financial development when their investment opportunities are high relative to their ability to finance them. A sudden expansion in required scale, perhaps because of an opening of new markets increases their demand for financing, and hence their willingness to press for financial development.

In the 1850s and 1860s, the dramatic reduction in the cost of transportation suddenly expanded the potential size of the market that each firm could service. In order to enable their firms to penetrate foreign markets, countries started espousing the cause of free trade. They also moved to the Gold Standard. The fixing of exchange rates in terms of gold allowed for producers to be more certain of the prices they would get for exports (as well as the costs of their imported inputs), thus allowing them to produce for trade with greater confidence. The Gold Standard also encouraged inter-country flows of capital, which benefited both capital rich countries like England that could invest their surplus, and capital poor countries like Sweden that could industrialize rapidly using foreign capital. Thus the expansion in markets also lead to an expansion in the need for financing, as well as a supply of this financing.

Financial development does not take place only when prospects are good, but also in really bad times. A sustained period of poor economic conditions may deplete the

reserves of incumbents, forcing them to seek finance, and allowing them to be more amenable to financial development when the economy turns up.

In general, however, one would expect incumbents to be more amenable to financial development when faced with investment needs after sustained downturns than after upturns. The reason is that the collateral value of their existing assets would typically rise in upturns, giving incumbents the ability to finance new projects even in underdeveloped financial systems, while in downturns, they would have little collateral and benefit from a more sophisticated financial system that does not rely on collateral.

The desire of incumbents to oppose financial development can also vary by industry. Some industries like the railways require huge fixed investments up front, which then last a long time, and spew out substantial cash flow. In such industries, after being financed initially, firms become self-financing. If large amounts of new financing are needed, these firms have the collateral from assets in place to support new borrowing even in underdeveloped financial systems. Thus incumbents in such industries have very different attitudes towards financial development (they do not need it) than entrants (they need it desperately).

Even within the same industry, incumbents' attitude toward financial development can change over time, as financing needs change. In Continental Europe, for instance, World War I represented an important turning point in these needs, especially for heavy industry. Before the war, high investment needs made heavy industry very dependent on external financing. As a result, the cause of financial development was strongly supported by powerful industrial firms in these countries. After the war, however, inflation and war profits freed many of these firms from the need to raise funds

on a continuous basis. For example, Ansaldo, an Italian producer of heavy machinery was very dependent on bank financing before the war. After the war, it was flush with cash, so much so that it twice attempted to take over the very bank that had financed its development before the war.⁶⁰ In short, changes in the financing needs of major players (rather than the needs of the larger public) can contribute to a significant shift in the political attitude toward finance.

Financial Development at the Beginning of the 20th Century

The arguments so far explains the surge in financial development that took place in most European countries during the second half of the 19th century. During this period, bourgeois revolutions increased the political influence of the emerging industrial class. At the same time, the reduction in transportation costs, with the consequent expansion of markets, created great opportunities for investment and, thus, great needs for finance. This fortunate convergence between political influence and the need for finance created the ideal conditions for financial development. Following the example of France under Louis Bonaparte, governments started to promote actively the development of their financial sectors. As a result, by the beginning of the 20th century, advanced countries in Europe reached very high levels of financial development, higher than what we have seen as recently as 1980.

Consider the following comparison between three different indicators of financial development in 1913 and in 1980 (Table 8.1) for a number of developed countries. The indicators are measures of financing (such as Stock Market Capitalization) divided by measures of economic activity (such as Gross Domestic Product).

Table 8.1: Financial Development in 1913 and 1980

	Deposits to GDP		Stock Market Capitalization to GDP		Equity Financing to Fixed Investment	
Country	1913	1980	1913	1980	1913	1980
Austria	1.12	0.62	0.76	0.03	.	0.00
Belgium	0.68	0.39	0.99	0.09	0.23	0.03
Canada	0.22	0.47	0.74	0.46	.	0.04
Denmark	0.76	0.28	0.36	0.09	.	0.01
France	0.42	0.45	0.78	0.09	0.14	0.06
Germany	0.53	0.30	0.44	0.09	0.07	0.01
Italy	0.23	0.59	0.17	0.07	0.07	0.04
Japan	0.13	0.48	0.49	0.33	0.08	0.01
Netherlands	0.22	0.25	0.56	0.19	0.38	0.01
Norway	0.65	0.30	0.16	0.54	.	.
Sweden	0.69	0.48	0.47	0.11	0.08	0.00
Switzerland	0.93	0.69	0.58	0.44	0.03	.
UK	0.10	0.14	1.09	0.38	0.14	0.04
US	0.33	0.18	0.39	0.46	0.04	0.04
Average	0.50	0.40	0.57	0.24	0.13	0.02

One way to measure financial development is to look at the role played by banks in intermediating funds. What fraction of a country's annual domestic product is the level of bank deposits? This is what our first indicator, the ratio of deposits to GDP, captures. That this ratio dropped by 20% between 1913 and 1980 suggests banks played relatively a bigger role in the allocation of savings at the beginning of the 20th century.

Of course, it would be simplistic to draw any conclusion about financial development on the basis of this information alone. As financial markets develop, banks lose some of their importance, thus the evidence could reflect the greater importance of financial markets in the latter part of the 20th century. But this is not the case. If we use a similar indicator to measure the development of equity markets (the ratio of stock market

capitalization to GDP), we find that in 1980 equity markets were less than half the size they were relative to GDP in 1913. In fact for all countries excepting the United States and Norway, the ratio of stock market capitalization to GDP was smaller in 1980 than in 1913.

Even this measure, however, is far from perfect. For example, in 1980 Norway had a very high stock market capitalization to GDP ratio, not because the equity market played a big role in financing industry there, but because Norway found oil in the North Sea. Coupled with the second oil shock, which multiplied oil prices in 1979, the value of Norwegian oil companies increased tremendously. More generally, the level of equity market capitalization may reflect other factors besides the importance of the equity market in financing firms.

The most convincing evidence, thus, comes from our third indicator: The fraction of investments financed through equity issues.⁶¹ In all countries except the United States equity issues were a more important source of investment funding in 1913 than in 1980. On average, the fraction of investment financed with equity dropped from 13% to 2% over the period.

Overall, the different indicators give a remarkably consistent picture: In most countries, financial systems were highly developed in 1913, certainly in comparison with the picture in 1980. There was, however, a fair amount of diversity across these countries. The equity market in 1913 was much more important in England, Belgium, and France than in the United States. The differences cannot be explained on the basis of differences in economic development alone. For example, per capita income in Japan was only one fourth that of the United States, but its equity market was much more developed. What

explains these differences across countries? What explains why these differences changed over time? And what explains the decline in all measures of financial development between 1913 and 1980?

Financial development does not take place in a linear, unidirectional, way. To explain its curves and its reversals we need to develop a better understanding of how the politics behind it can change over time. This is what we go to next.

New Technologies and Competition from the Outside

Technological change can make it less profitable for incumbents to keep out potential local entrants. This is because technology can make it possible for competition to seep in from across political borders. Because political entry barriers are no longer air tight, incumbents may also abandon their support for other forms of entry barriers, including financial underdevelopment. An example of a regulatory entry barrier in the United States that most likely succumbed to the competitive pressure brought about by technological change is the law prohibiting banks from opening branches.

The United States Constitution prevented its constituent states from issuing their own money and from taxing trade between states. As a result, early in their history, states had to look for new sources of revenue. One important source was banks. States restricted entry into banking – a bank charter purchased on payment of a substantial fee to the state was required to undertake banking business in a state. Furthermore, states often held shares in banks, and also taxed their profits.⁶²

Bank profits were therefore a disguised tax on the people, with private bank owners making profits and passing a significant portion on to the state in the form of taxes and dividends. The state could maximize taxes by maximizing bank profits. This

would imply giving a bank charter to only one bank for the entire state. But that would put too much power in the hands of one bank. Equally inconvenient from the state's perspective was to give charters to many banks, for that would force them to compete away profits, thus allowing the undeserving public rather than the needy government to get the benefits.

States therefore decided on a halfway measure. More than one bank would be given charters but banks would not be allowed to open multiple branches within the state. Some states even had unit banking laws, restricting each bank to just one branch. The effect of these restrictions was to give each bank a monopoly over a small area surrounding it, enabling the bank to make profits. But they also ensured that the state was not beholden to one bank. Thus restrictions on intra-state branching became the norm. Moreover, since states did not receive fees from banks incorporated in other states, they prohibited out-of-states banks from operating in their territories.

In general, these restrictions were extremely inefficient. By preventing good banks from expanding, and all banks from diversifying beyond their local territory, the branching restrictions made banks, on average, less cost effective and more risky. Yet the restrictions were persisted with, initially because the state needed them to raise revenue, and later, because the small banks that emerged as a result needed them to survive and were willing to pay the state's legislators to ensure that the status quo prevailed.

This illustrates an important point about entry restrictions. Once the restrictions are in place, some constituencies will emerge that owe their existence to the restrictions. There will be a natural tendency for these to grow more powerful over time: As time passes, those who are hurt by the restrictions will wither away reducing the opposition.

Restrictions will also provide the current and prospective profits with which the incumbents who benefit can pay for their political defense. By contrast, opponents of entry restrictions have nothing to offer supporters but competition. Competition erodes, rather than shores up, the prospective profits needed to pay for political assistance. Is it any wonder then that anti-competitive forces are so powerful?

In the case of branching restrictions, the natural supporters were small banks, who survived at an inefficiently small scale only because the branching restrictions protected them against large, cost-efficient, banks. Other financial institutions such as insurance companies also supported restrictions because they feared that large banks would enter insurance, and would be very effective at distributing insurance through their branches. Large banks were opposed to branching restrictions because it prevented their natural growth and diversification. It stands to reason that small banks and insurance companies would collude to keep in place the restrictions on intra-state branching. Through much of the twentieth century, their preferences prevailed. Starting in the early 1970s, however, many states relaxed their restrictions. What made them do it?

The answer suggested by economists Randall Kroszner and Philip Strahan is technology. Branching restrictions help a bank create a local monopoly for itself only if it is hard for other banks to do business with the bank's customers at a distance. But technological innovations erode the effects of distance. Automatic Teller Machine networks enable a bank to provide cash to its customers no matter where they are, without having a local branch. Credit rating agencies maintain detailed and timely records on customer creditworthiness so that a bank without a local presence can make

loans to individuals without being subject to undue risk. In short, technological advances have eroded local monopolies, making them less worthwhile.⁶³

While Kroszner and Strahan suggest the broad timing of the deregulation across the various states in the United States, starting in the 1970s, corresponds to when these major technological advances became commercially important, there were differences between states as to when each one deregulated. The economists find that the timing of when a particular state deregulated was related to the strength of the private interests against deregulation in that state. The removal of restrictions on branching occurred sooner when the state had fewer small banks, and more small, bank-dependent firms (who had a strong interest in facing more competitive banks). Also, the presence of a large insurance industry in that state led to delays in deregulation.

Deregulation also had the predicted consequences. Small banks lost market share, and in states where banks could enter the insurance sector, the insurance sector shrank. But in general, borrowers benefited because they obtained lower average interest rates on their loans, and the state economy benefited because growth rates of state income increased (as we have noted earlier).⁶⁴ Special interest groups were holding back economic progress, and technological change may indeed have been the only way that their incentives to oppose entry could be altered.

Openness and Financial Development.

We have just seen that technological change can put pressure on incumbents to alter archaic financial regulations, since these become less useful in preventing competition. Another instance when incumbents find financial underdevelopment less useful as a tool is when an economy is, or becomes, open to the entry of foreign goods

and capital. The easiest way to think about this is as follows: Incumbents can manipulate the political process in order to suppress domestic competition. But open borders subject them to competition from entities that are not governed by the domestic political process. This has a number of consequences. For one, there are fewer excess profits to protect in the system: Given that the economy is open, incumbents cannot use domestic political action to restrain foreigners. Moreover, given that prospective profits from restraining domestic entry will be limited (How much damage can domestic entry do when one is bearing the full brunt of the foreign peril?) both the incentive to keep restraints in place, as well as the ability to pay politicians for their support, diminishes. Finally, in the face of foreign competition, even established domestic incumbents find a need to rely on the domestic infrastructure – for example, established firms finally find that the high cost of domestic finance hurts. So not only do they not want to oppose financial development, they become active supporters.

Of course, whether a country's borders are open is itself, in part, a political decision. We will not examine that decision in this chapter, because it is part of a larger question of whether a country's economy is willing to be market oriented, which will be the focus in subsequent chapters.

Are All Kinds of Openness Equally Effective?

We have been a little quick thus far in arguing that openness fosters competition, which in turn fosters financial development. Some forms of outside competition may, in fact, make incumbents even more eager to suppress financial development. It is therefore useful to examine separately the effects of a country's openness to trade (that is, to competition in goods and services) and the effects of its openness to capital flows

(that is, to competition in the financial sector). It is also illuminating to separate out the reactions of industrial incumbents from financial incumbents.

Openness to Trade Alone

Consider first a country that is open to trade alone. While foreign markets bring opportunity, openness also brings foreign competitors to domestic markets. Foreign entry drives down domestic profits. Lower profits means established firms have lower cash flow from operations, making them more dependent on external finance. At the same time, outside opportunities (or the need to defend domestic markets against superior foreign technologies) increase the need for incumbents to invest more, and to manage their risks better.

According to political scientist Sofia Perez, this is what forced the liberalization of the financial sector in Spain in the aftermath of its accession to the European Community in 1986.⁶⁵ Till then, the domestic financial system in Spain was dominated by a cartel of the seven largest banks, which controlled 72% of deposits, and was able to maintain the cost of credit significantly above the European average.⁶⁶ The increasingly competitive environment resulting from the entry into the European Union highlighted the disadvantages imposed on the industrial sector by the financial system, forcing a major shift in policy. In 1988, the socialist government of Felipe Gonzalez approved a major reform of the capital markets, a proposal by an ad-hoc government commission that had been ignored for over a decade. That a socialist government pushed for the development of financial markets, when its right-wing predecessor did not, suggests that, under the pressure of foreign competition, ideology may play a very limited role.

Unfortunately, what happened in Spain may be an exception. The need for external finance need not translate into reforms that improve transparency and access in the financial system. In fact, given their greater need for finance, industrial incumbents may press for greater financial repression so that the available finance flows their way. Financial incumbents may also be unwilling to trade the increased competition in the financial sector (from greater transparency and access) for the additional industrial clientele that reforms may generate. It may be far more profitable to support the existing relationships with industrial incumbents and ply them with greater amounts of capital they now need.

The Government and Trade Openness

Instead of improving the quality of the domestic financial system, industrial incumbents may petition the government for further loan subsidies in the face of foreign competition. Government lending is pernicious for two reasons. First, it responds to political needs rather than economic opportunity. Second, cheap government funding tends to crowd out a public capital market since investors do not have the benefit of subsidies and cannot supply funds at the same rate. Funds will tend to be intermediated by the banking sector, which can petition the government for a share of the subsidies. Since the banking sector cannot compete with the government without subsidy, it will become little more than a government agency in charge of distributing credit according to government plans, even if not directly owned by the government.

This is in fact what happened in France after World War II. At the end of the war, French industry was largely composed of small and medium sized firms. They had been isolated from international competition during much of the inter-war period. Unlike in

other countries in Western Europe, agriculture was still a dominant employer in the economy. Over the next thirty years, internal and external competitive pressures forced the economy to be transformed in two important ways. First, agriculture gave way to industry and, second, industry restructured and consolidated so that it came to be dominated by large firms.

Outside competitive pressures forced industrial change, but instead of allowing the financial markets free reign in effecting these changes, the government decided that the political forces unleashed by uncontrolled change might be too overwhelming, so it decided to control the pace of change by taking over the financial sector.

For example, the French government intervened extensively in the labor-intensive textile industry. Even though the average firm was small relative to producers in other European countries, and even though it used outdated machinery, the government blocked new plants that would have higher productivity and potentially bid up wages. It directly subsidized wages to prevent layoffs, and imposed a number of restrictions to prevent foreign competition. A fund was set up exclusively to provide monies that would preserve the small-scale nature of the textile industry.⁶⁷ Thus initially the objective seemed to be to preserve the industry in its antiquated form by providing finance.

Over time, economic forces did play themselves out, albeit slowly. Employment in the industry dropped, aided by government funding that helped smooth plant closures. The thrust of government intervention now turned to facilitating mergers, again with the carrot of government directed credit. While government intervention certainly prevented the rapid layoffs that would have occurred if the industry had been exposed to competition, it also prolonged the pain, and allowed the industry to become much less

productive than its Dutch or German counterpart. And when in the early 1970s, new competition emerged from developing countries, the industry was particularly unsuited to meet it. This unleashed yet another bout of government intervention, more aggressive than in the past, as decisions on what firms to rescue were made, not by courts or creditors, but by the government.⁶⁸ Intervention invariable creates its own future justification!

Government intervention in the allocation of credit was thus pervasive. As late as 1979, a Bank of France publication reported that 43 percent of all credits to the economy were made with some kind of privilege or subsidy, and 25 percent of corporate lending was subsidized directly.⁶⁹ Much of the control emanated from the Treasury, a small group of approximately one hundred bureaucrats comprising the elite of the elite. As a French businessman who began his career in the Treasury remarked:

"You live with a profound belief that France is the center of the world, that Paris is the center of France, and the Tresor is the center of Paris... The Tresor's influence and prestige extend into every part of France. It represents the State inside the three largest banks: Credit Lyonnais, Banque Nationale de Paris, and Societe Generale. It also has a viselike grip on the finances of the French public sector, one of the biggest in the West, and on government subsidies."⁷⁰

In short, governments may intervene to mitigate the effects of outside competition, and this may further reduce the transparency of, and the access to, the financial system. Thus openness to trade flows (i.e., industrial sector openness) alone may not be enough to convince either, or both, dominant interest groups to support financial development. This suggests that there were probably other factors in the Spanish experience, which made it different from the earlier French experience, so that

external competition spurred financial development in the former, and government intervention in the latter. We will come to these shortly.

Openness to Trade and Capital Flows: The Constraints on Governments

It is when both cross-border trade flows and capital flows are unimpeded that industrial and financial incumbents will have convergent incentives to push for financial development. Industrial incumbents, with depleted profits and the need for restructuring operations to meet competition, will require funds. But importantly, with free cross-border capital flows, the government will not be able to respond by stepping up the flow of credit to incumbents: As product markets become more competitive, the risks in, and information requirements for, lending will increase. The potential for large errors from the government directing the flow of credit will increase. Moreover, the ability of the government to provide large subsidized loans to favored firms will decrease as mobile international capital forces governments to maintain a balanced budget. The government's role in the financial sector will diminish.

This is, in fact, what happened in France. During the period of Dirigisme in the 1950s and 1960s, the French government limited the political price it had to pay for the extensive subsidized credit it doled out, financing the credit through an expansion in the money supply. This meant that instead of paying taxes to finance the government's large expenditure, citizens financed it by accepting higher inflation, and thus a lower value for their holdings of money. In the 1950s and 1960s, France was forced to devalue the franc three times (without counting the tariffs introduced in 1954, which were meant to mimic the effect of a devaluation).⁷¹ But these devaluations were few and far between, and were swallowed by the public.

Matters came to a head in the 1980s. Even though Francois Mitterand came to power in 1981 with a program to increase subsidies and the state's role in the economy, the environment had changed. With the breakdown of the Bretton Wood agreement (see later) in the 1970s, international capital mobility had increased. With the accession of Mitterand's Socialists to power, capital started fleeing France, partly because the rich were escaping before the anticipated confiscatory policies of the Socialists, and partly because the sensible foresaw that the exchange rate would come under pressure as the Socialists continued loose budgetary policies. Almost inevitably, the French devalued in October 1981, then did so again in June 1982. By March 1983, France was again on the brink of running out of reserves as it tried to defend the Franc.

The additional external pressure from free capital flows forced the Socialist government to do an about-face. Recognizing that it either had to completely close down the economy to trade and capital flows or else balance its budget and cease meddling in functioning of the economy, it chose the latter. Only a few years after having nationalized the entire banking sector, the French Socialists became strong supporters of a free market French financial system, so much so that in 1986, they inaugurated in Paris that ultimate symbol of a capitalist economy, a futures market!

Openness to Trade and Capital Flows: The Competitive Effects

With the diminished role of the government, competition in the industrial sector and in the financial sector can reinforce each other when the economy is open to both trade and capital flows. The healthiest industrial incumbents will be able to tap the now open foreign markets for finance. These firms, able to compete in international markets, may not be much worried, or affected, by domestic entry, and thus may not oppose

domestic financial development. While the not-so-healthy industrial incumbents may be the hardest hit by foreign competition, there are reasons why they too may not oppose financial development, and may in fact support it: They will need finance. And their existing financiers will be reluctant to lend to them on the old cozy terms.⁷² Difficulty in financing will lead these firms to push for greater transparency and access so that their own access to finance improves. Unlike the case when the country is only open to capital flows, industrial incumbents now will also push for financial development. The accompanying threat of domestic industrial entry will now seem relatively minor, given the competitive state of product markets.

Moreover, as the domestic financial sector loses some of its best clients, domestic financial institutions will want to seek new clients among the unborn or younger industrial firms that hitherto did not have the relationships to obtain finance. Since these clients will be riskier, and less well known, financial institutions will have no alternative but to press for improved disclosure and better contract enforcement. In turn, this leveling of the playing field will create the conditions for more entry and competition in the financial sector.

The salutary combination of prospective cross-border capital flows as a result of increasing European monetary integration and open borders to trade, and not the latter alone, is probably what caused the financial sector reforms in Spain that we referred to earlier. European monetary integration has also provided a tremendous boost to stock markets around Continental Europe, so much so that the Deutsche Bourse from Germany, a stock market from a traditionally bank-dominated country, seriously considered being the senior partner in a merger with the London Stock Exchange.

Other influences will kick in over time. As the domestic financial incumbents improve their skills, they will seek to compete abroad. As they look for new clients outside, they will be forced as a quid pro quo to increase access for foreigners, and dismantle domestic regulations that give them their privileged competitive positions. For example, the German government banned lead underwriting of Deutschmark bonds by Japanese financial institutions until Japan agreed in 1985 to allow foreign securities firms to act as lead underwriters for bonds denominated in Yen.⁷³ Foreign financial firms that enter the domestic market are likely to be another powerful constituency for financial development. Since they are not part of the domestic social and political networks, they would prefer transparent arm's length contracts and enforcement procedures to opaque negotiated arrangements. It is not a coincidence that these are the very requirements of would-be domestic entrepreneurs who are also outsiders to the domestic clubs.

An Example: Japan

An example of such financial development is provided by the resurgence of the Japanese corporate bond markets in the 1980s. In 1933 the Japanese banks, with the blessings of the Ministry of Finance, formed a Bond Committee, which determined who could issue bonds, on what terms, and when. The Committee established a collateral principle "Corporate bonds shall not be issued without sufficient collateral" and required that only banks should serve as trustees of the collateral, in return for a substantial fee. This effectively brought all corporate debt financing under the control of banks, which in turn were given directions by the government on whom to favor.

The most important players had little incentive to object to the Bond Committee when it was set up. Each individual firm may have been better off if it could obtain arm's

length financing whenever appropriate, instead of being restricted to bank financing. But initially no one wanted to upset their main bank and risk losing access to credit if economic conditions deteriorated. And restrictions on financing also restrained entry, and therefore competition, in the industrial sector. Therefore as a collective, firms had little incentive to change the system

With the exception of the securities firms, other financial institutions also benefited, because they could charge higher rates for long term financing, so they did not challenge the banks. The important securities firms were co-opted. Even though there were hundreds of securities firms, the big four -- Nomura, Nikko, Daiwa, and Yamaichi - - took turns lead-managing whatever issues were permitted and captured 75 percent of underwriting commissions.⁷⁴ If they challenged the Bond Committee, their oligopoly might be threatened as also the cozy fixed commission they enjoyed. The Japanese government was happy with the status quo because it could be confident that there would be no unpleasant defaults in the bond market, and because, as a consequence of the restrictions, money flowed through the banking sector where it was easier to direct. The only clear sufferer was the individual investor, but she could be ignored: As with all situations where those who bear losses are small and dispersed, it was very hard for individuals to overcome inertia and free rider problems to organize and fight the system.

With all the important players happy with matters, change had to come from outside. International capital flows were the source of this change. As it became easier to borrow abroad in the 1970s, mature Japanese firms attempted to reduce their costs by replacing bank debt with public debt. For this, they went to the Euromarket -- an offshore financial market that was not under the control of the Japanese government -- where there

were no collateral requirements, and there were a wide range of instruments, maturities, and currencies they could issue in. From accounting for only 1.7 per cent of Japanese corporate financing in the early 1970s, Euromarket issues went on to account for 36.2 per cent in 1984.⁷⁵

Initially, Japanese banks tried to keep domestic restrictions on bond issuance -- because they did not have the right to underwrite bonds in the domestic market -- while they attempted to participate in underwriting some of the Eurobond issues. Japanese securities firms were opposed to this because they felt that banks would use their muscle to strong-arm clients into using them as lead underwriters. Perhaps more important, they feared that this would be a way for banks to eventually demand domestic underwriting powers. So Japanese banks and securities firms fought over clients in the Euromarket. The conflict, however, benefited the firms because there was no concerted attempt to hold them back from issuing in the Euromarket.

Meanwhile, there had been foreign pressure in the domestic market. In 1978, the U.S. retailer, Sears, requested permission to issue unsecured bonds in Japan. The Japanese government had little ability to deny the issue without inviting retaliatory action, especially when a Japanese retailer, Ito Yokado, announced that it would issue unsecured dollar bonds in New York later that year. The face saving measure the Japanese government adopted was to draft conditions for firms to be eligible to issue unsecured bonds tailored so that forty foreign firms and only two Japanese firms, Toyota and Matsushita Electrical, qualified. In March 1979, Sears became the first firm to issue unsecured corporate bonds in Japan since 1933. Soon after, Matsushita Electrical followed.⁷⁶ The collateral principle had been breached!

Despite the increase over time in the number of firms that met the criterion for issuing unsecured bonds in the domestic market, there were still enough restrictions -- such as a single issue date each month and the requirement that firms could not issue more than twice their net worth -- that the domestic market continued to be unappetizing. The Bond Committee continued to oppose the establishment of bond rating agencies for fear that its rules would be rendered redundant. After all, it had thus far succeeded in keeping Hitachi, with a top quality AAA rating in foreign markets, from being eligible to issue unsecured bonds in the domestic market.

However, as droves of firms continued to flee to the Euromarket, banks came around to the view that it might be better to trade some of that underwriting business in return for giving up their ability to act as spoiler in an increasingly irrelevant domestic bond market. So in the late 1980s, banks agreed to a horse trade where they agreed to relax the criterion for eligibility to issue unsecured domestic bonds in return for the scrapping of the "no return" rule in the private placement market and the ability to act as lead underwriter for Japanese corporate issues in foreign markets.⁷⁷

Thus competition from the Euromarket forced changes leading to financial development. It was not so much that the political power of various parties was changed, but the appeal of the status quo was reduced as profits evaporated, and incumbent financial institutions gave up their opposition to change. The primary virtue of competition from outside markets and institutions is then that these institutions are not part of any domestic cartel, and therefore offer an opportunity for the public interest to prevail.

The Systematic Evidence

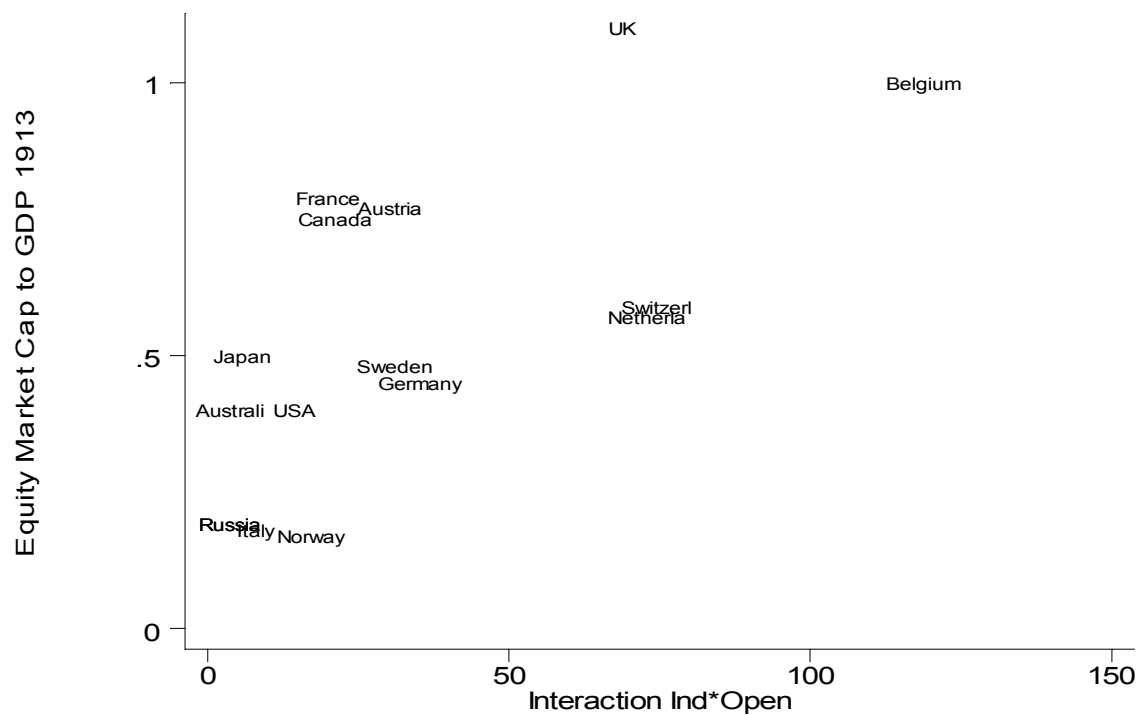
The discussion above, however, suggests that, whatever the configuration of domestic political power and the objectives of various interest groups, the incentive and the ability of domestic incumbents to hold back domestic financial development is likely to be the least when the country's product and financial markets are open. In other words, a country's domestic financial development should be positively correlated with its degree of openness to product and capital flows.

In the earlier discussion we have already presented some examples of the beneficial effects of openness. But there is more systematic evidence. The twentieth century had two periods when the world was relatively open to capital flows. Curiously enough, these periods were at either ends of the century. In the beginning of the twentieth century, many countries adhered to the Gold Standard, making gold effectively the common currency of international trade and finance. Cross border flows of capital were relatively unhindered, and capital traversed the globe looking for the highest return, whether it was to be found in Brazilian silver mines or Indian railways. Our analysis suggests that during this period of plentiful capital flows incumbents would have the least political will and strength to oppose financial development in countries that had the fortune to trade extensively. Thus, for any level of demand for finance, countries that were more open to trade at that time should have had much better-developed financial markets.

In figure 8.1, we graph how big a country's equity markets were in 1913 against its openness to trade (weighted by the country's level of industrialization, which is a rough proxy for the demand for finance).⁷⁸ The graph suggests that countries that were more open to trade did, in fact, have bigger equity markets for any given level of

industrialization. We can graph other measures of the ease of access to finance in a country, such as the number of exchange-listed companies, or the quantity of public corporate issues, and we find a similar pattern: Before World War I, countries that were more open to trade had better capital markets.

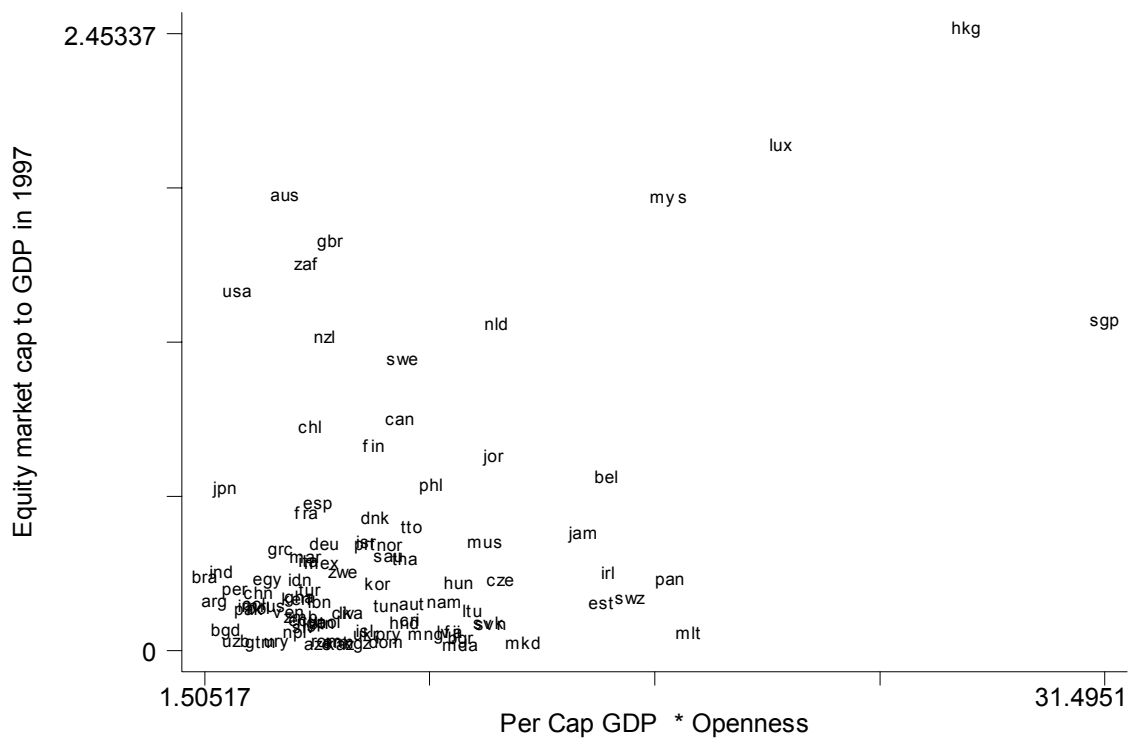
Figure 8.1 Market Capitalization and Openness in 1913



Cross-border capital flows fell precipitously, for reasons we will come to, in the decades between 1930 and 1980, and started increasing only in the last part of the century. By the end of the century, they had regained the levels (relatively to measures of economic activity such as World Gross Domestic Product) that they had at the beginning of the century. In figure 8.2, we graph the size of a country's equity market in 1997 against its openness to trade (weighted by the country's output). Again, the naked eye

should be able to discern a strong positive relationship, which is borne out by more careful statistical analysis. Countries that were more open to trade at the beginning and the end of the century had deeper financial markets.

Figure 8.2 Market Capitalization and Openness in 1997



More analysis of the data suggests that the positive correlation between trade openness and the size of a country's equity market (or other measures of the importance of equity markets such as the number of exchange-listed firms) is much weaker, or non-existent, roughly in the period between 1930 and 1980, when cross-border capital flows were much smaller. Thus both cross-border trade and capital flows may indeed be necessary for financial development.

Of course, all we have documented are correlations between openness and the size of capital markets. This is an indirect verification of the possibility that open borders curb the power of incumbents. The skeptical reader will want more direct evidence that openness influences financial development because it curbs the power, or alters the incentives, of incumbents.

There is such evidence. As described earlier in the book, *Forbes* magazine publishes a list of billionaires around the world every year, classifying them as those who inherited their wealth or those who created it through their own entrepreneurial efforts. We have argued that it is easier for a poor, but talented, entrepreneur to make it on her own in a developed financial system where there is widespread access to finance. So in a developed financial system, the fraction of self-made billionaires should be higher. Conversely, in an opaque system, which protects incumbents against competition, it is easier for heirs, however incompetent, to retain their fortunes. Inherited billionaire wealth, a measure of the size of incumbents, should predominate in such a country. A recent study finds that countries with lower barriers to foreign direct investment have a lower ratio of inherited billionaire wealth to GDP and a higher ratio of self-made billionaire wealth to GDP.⁷⁹ This suggests that countries dominated by incumbents tend to create high barriers to competition from outside. It may also indicate that foreign competition tends to erode the economic might of incumbents. We cannot say which force dominates, but both forces suppress the ability of incumbents to keep finance repressed.

The study bolsters this interpretation with evidence from the unexpected enactment of the Canada-USA Free Trade Agreement (FTA) in 1988. The FTA lowered

trade barriers between Canada and the United States, and perhaps more important, eliminated all kinds of discriminatory taxes on investors that had previously limited capital flows between the countries. The agreement was unexpected. Canada and the United States had reached the final stages of negotiations on freeing trade several times before but had balked. This time, the Conservative government of Brian Mulroney had called for a snap election on the issue. Polls did not augur well for the Conservatives, but they astounded everybody by being elected with a clear mandate. Since markets were surprised by the election results, one way to see how the FTA impacts various kinds of firms is to see how their stock price reacted on the announcement. The study finds that the stock price of heir-controlled firms was most adversely affected by the election results, while the stock price of entrepreneur-controlled firms was most positive impacted. Open borders are indeed inimical to entrenched incumbents.

Summary

We ended the last chapter pointing to the powerful forces arraigned against finance – the forces of incumbency opposed to the changes unleashed by free access to finance. There are some circumstances when these forces can be overcome – for example, when a society undergoes significant political change. There are also circumstances when the self-interest of incumbents becomes aligned with the public interest. One is when new markets open up, or new technologies become available. Incumbents, faced with significant new investment opportunities, cannot rely on traditional funding sources (such as internal cash) and may press for better access to finance. Similarly, when a country's borders open up to external trade, industrial

incumbents might have depleted profits, while needing to make massive investments to compete with foreigners.

Unfortunately, it is not clear that finance will develop even when industrial incumbents are in need. Incumbents may skew access to finance even more, especially if they can co-opt the government. History suggests that finance is likely to develop only when the government's ability to play favorites is limited. The opening of a country's borders to capital flows (and not just to trade) ensures some of the required discipline on government actions. This then suggests that it is the fortuitous combination of a need on the incumbents' part for financing as well as the discipline on government intervention from open capital flows, which channels political efforts towards improving financial infrastructure.

What we have discussed so far are the conditions under which the political opposition to financial development will be overcome. But once some financial infrastructure is in place, will countries continue to have healthy financial sectors? The evidence here is far from reassuring. Financial markets in countries around the world shrank between 1930 and 1980. What explains this reversal? In part, we already have the answer: Cross border capital flows diminished to a trickle during much of this time. This then provided the setting in which incumbents could reassert their interests and suppress finance. But why did countries close their borders to capital flows? Could it happen again? That is the subject of the chapters that follow.

¹ Weatherford, p65.

² Barber, p 268.

³ Barber, p266.

⁴ Barber, p270.

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⁶ Barber, p277-278

⁷ Weatherford, p69.

⁸ Barber, p298.

⁹ Pipes, p17-18

¹⁰ Mueller, p544-567

¹¹ For example, the Doge was elected as follows; a boy was called off the street into the Great Council (the assembly of all eligible citizens) and he picked thirty council members randomly by lot. These council members were reduced to nine, again by lottery. The nine then expanded themselves to forty by nominating and voting for candidates – anyone who got seven of nine votes was elected – and so on. Through a process of alternating lottery and election, the body was expanded and contracted, until a final group of forty-one citizens voted for the Doge. The approval for the elected candidate by the assembly was purely a formality. There was little chance, given the interspersed stages of randomization between stages of voting, that any particular faction could capture and hold on to the Doge's office. At the same time, the final choice was not random, but based on the decision of forty-one unbiased citizens.

¹² Mueller, p467

¹³ Mueller, p438

¹⁴ Finer, p1016

¹⁵ Mueller, p457

¹⁶ Cited in Finer, p965.

¹⁷ Mueller, p429

¹⁸ Carruthers, p122

¹⁹ Carruthers, p123

²⁰ See North and Weingast

²¹ See Carruthers for a development of this argument.

²² Negley and Patrick, "The Quest for Utopia", p383

²³ Pipes, p33

²⁴ Powelson, p80

²⁵ Pipes, p33

²⁶ Manuel and Manuel, "Utopian thought in the Western World", p365.

²⁷ Clough and Cole, "Economic History of Western Europe, p193.

²⁸ Coulton, "The Mediaeval Village", p13

²⁹ Coulton, "The Mediaeval Village", p39

³⁰ This is reminiscent of Gary Becker's argument that economically inefficient policies tend to lose out when in competition with more efficient policies. This is clearly right, though our additional point is that through much of the feudal period, no competition was possible.

³¹ Dietz "An Economic History of England", p114

³² Dietz "An Economic History of England", p 263

³³ Dietz "An Economic History of England", p 267

³⁴ Powelson, p89

³⁵ See Acemoglu, Johnson and Robinson for a theory of development based on the pattern of settlement (though they do not emphasize the distribution of property).

³⁶ See Winton, Woodward

³⁷ For a more detailed discussion see Zingales, Luigi, 1998, Why it's worth being in control, in Bickerstaffe, George ed.: The Complete Finance Companion (FT Pitman Publishing, London).

³⁸ Laporta, et al.

³⁹ "The World Price of Insider Trading", Bhattacharya and Daouk, Journal of Finance 2001

⁴⁰ Jappelli and Pagano (1994).

⁴¹ Olson, Stigler references.

⁴² This is the 1997 datum from Taxi and Limousine Commission, reported in <http://www.schallerconsult.com/taxi/intro.htm>

⁴³ We are assuming that the coordination costs are paid at the same time bids are made. In fact, in most real world situations the coordination costs are paid before bids take place. In such cases, they do not affect the value of the bids since they are sunk. Once they have paid the coordination costs, thus, customers will be willing to bid up to \$100. They are then able to win the auction paying slightly more than the cab driver, who is willing to pay \$95. The customers' victory, however, is a Pyrrhic one, because they end up paying more for competition than competition is worth to them ($95 + 10 > 100$). Anticipating this outcome, the customers will not even want to bid, leaving the incumbent to enjoy his monopoly. Thus, the final outcome does not change. For a formal analysis of this problem see Anderlini and Felli (1999).

⁴⁴ Of course, one could argue that the definition of efficiency must include coordination costs. In such a case the above outcome is still technically efficient.

⁴⁵ The role of political competition in enhancing efficiency has been studied by Gary Becker (1983).

⁴⁶ Simeon Djankov, Rafael La Porta, Florencio LopezdeSilanes, Andrei Shleifer, "The Regulation of Entry" 2000, NBER WP # 7892.

⁴⁷ This negative relationship is statistically significant and regression estimates show that it persists after correcting for the level of GDP per capita.

⁴⁸ Cameron, p102

⁴⁹ Cameron, p103

⁵⁰ Cameron, p104-106

⁵¹ Cameron, France and the Economic Development of Europe, 1800-1914, p84 (different from previous Cameron)

⁵² Cameron, French Development, p86, p98, 99

⁵³ Cameron, French development, p100

⁵⁴ Cameron, French Dev, p103

⁵⁵ Cameron, p105

⁵⁶ Cameron, p106

⁵⁷ Cameron, p104

⁵⁸ Cameron, p130

⁵⁹ Plautet, Elizabeth

⁶⁰ Alessandro Aleotti, "Borsa e Industria" Edizioni Comunita', p.99.

⁶¹ Technically, it is the ratio of equity issues by publicly traded companies and gross fixed capital formation, which represents total investments, not just corporate ones.

⁶² Kroszner and Strahan (1999), What drives deregulation?

⁶³ Petersen and Rajan (2002)

⁶⁴ Jayaratne and Strahan 1996), QJE

⁶⁵ Sofia A. Perez, "From Cheap Credit to the EC: The Politics of Financial Reform in Spain" in Michael Loriaux et al. eds, *Capital Ungoverned*, Cornell University Press, Ithaca: NY, 1997.

⁶⁶ Ibid p. 170 and p. 190.

⁶⁷ Zysman (1983, p 155-156)

⁶⁸ Zysman, p157

⁶⁹ Zysman, p129

⁷⁰ Nigel Adama, "Letat c'est nous", Euromoney, October 1980, p110, cited in Zysman, p114.

⁷¹ Ibid p. 133.

⁷² For one, because of product market competition, these firms will now be much less profitable, while needing much more investment. Moreover competition in financial markets will make long term

relationships, through which the traditional financier could have hoped to recover investments, more difficult. Both factors would combine to make finance more difficult.

⁷³ See Rosenbluth (1987)

⁷⁴ Rosenbluth, p146

⁷⁵ Rosenbluth 149

⁷⁶ Rosenbluth, p56

⁷⁷ Rosenbluth, p163

⁷⁸ Careful description of what the graph is, intended for economists. In drawing this graph, we have adjusted for the obvious relationship that more industrialized countries should have larger equity markets. The interaction between industrialization and openness is meant to capture the fact that openness can only undermine incumbent's opposition to the development of finance, not create a demand for finance where that does not exist.

⁷⁹ Randall K. Morck, David A. Stangeland, and Bernard Yeung, "Inherited Wealth, Corporate Control and Economic Growth. The Canadian Disease?" in R. Morck ed: Corporate Ownership, University of Chicago Press, 2000.