

Government Strength and Financial Reforms*

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ABSTRACT

Are stronger governments more effective in delivering reforms? This paper addresses the question by looking at the relationship between government characteristics and structural adjustments in the financial sector. Since the relative importance of banks and capital markets has been shown to depend on the underlying economic structure, changes in the latter should affect the former accordingly. Using panel datasets covering 94 countries over 35 years, we show that they do and that governments play a key role in facilitating this adjustment process. Stronger governments, captured by different measures of government effectiveness, are indeed associated with quicker convergence towards equilibrium in the financial structure and with swifter adjustments when changes in the underlying economic structure occur. In the absence of comparable indicators of financial reforms across countries over time, this can be considered a suitable proxy for legislative activity in the domain of financial regulation.

JEL classification codes: G18, G28, O16, P16

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Capital markets are commonly regarded as an important alternative to the banking sector in providing financing to productive activities which would otherwise be left out of the credit market (Allen and Gale, 2000). Based on this intuition, many studies have considered their development as positively associated with economic performance (e.g., Goldsmith, 1969; Levine and Zervos, 1998; Rousseau and Wachtel, 2000; Beck and Levine, 2004; see also Levine, 2005 for an extensive survey). This view has been recently put in perspective by Rajan and Zingales (2003b) and Allen et al. (2007) who claim that financial markets and the banking sector are respectively better at performing different tasks and can be seen as complementing rather than substituting each other. The relative development of each should then depend on the underlying economic structure of a country, as banks may perform better than capital markets in providing credit when tangible collaterals are available but fail to serve efficiently sectors characterized by a relevant share of intangible assets. This view implies that different economies may be associated with different long-run equilibrium financial structures, which may change over time as the underlying economic structure evolves. Rajan and Zingales (2003a), for example, document the occurrence of “Great Reversals” in the financial structure of most developed countries during the twentieth century, with the relative importance of capital markets not following a monotonic trend over time.

Once we accept that long-run equilibrium financial structures are likely to change over time, though, a natural question arises: what happens in the short-run? As countries’ economic structure evolves, the financial structure can adapt more or less efficiently, depending on their specific characteristics. In this paper we focus on the ones pertaining to the domain of political economy. Since both the banking sector and capital markets need an adequate institutional and regulatory framework to grow and flourish, it is reasonable to expect that specific reforms and policies may hinder or foster their development. Still, reforms and policies do not just materialize out of the blue: they need decision makers to propose them, discuss them with relevant stakeholders and adapt them to the particular environment in which they are introduced (Laffont, 2000; Persson and Tabellini, 2000, 2003). This decision-making process has been extensively analyzed in the field of

political economy, and notably in the field of financial regulation (Kroszner and Strahan, 1999; Biais and Perotti, 2002; Pagano and Volpin, 2005; Perotti and von Thadden, 2006; Caselli and Gennaioli, 2008).

Unfortunately, the output of this process cannot be easily observed, as to the best of our knowledge there is currently no available dataset on financial markets' reforms and policies with sufficiently detailed and comparable information across countries.¹ This is why we decided to focus on the outcomes instead, investigating how quickly the financial structure adapts to changes in the economic structure. This will allow us to assess whether stronger governments are associated with quicker adjustments to an evolving economic environment. To be sure, the first best option would be to observe and process data on the direct output of the legislative activity, but we still believe that under certain conditions outcomes can be properly used to assess how government characteristics are associated with reforms and policies in the financial sector. Specifically, we focus on the adjustments in the financial structure resulting from changes in the underlying economic structure and test whether political fragmentation in the government may affect its speed, as the political economy literature would predict. We do this by collecting extensive macro data from various sources, resulting in an unbalanced panel of 94 countries ranging from 1975 to 2009.

Our empirical results strongly indicate that the configuration of a governing coalition or the margins of majority of a ruling party exert an impact on the reactivity of countries to a changing economic environment. More precisely, we find that government strength affects positively the speed of financial structure adjustments in response to changes in the underlying economic structure and, likewise, it accelerates convergence towards the equilibrium financial structure. Regardless of institutional factors, financial structure is found to eventually adapt to changes in the economic structure, but stronger governments

¹The dataset that would be closest to our needs is the one realized by Abiad and Mody (2005). They have constructed a financial liberalization index which includes yearly observations for 35 countries from 1973 to 1996 and defines the degree of policy liberalization along six dimensions: directed credit/reserve requirements; interest rate controls; entry barriers and/or lack of pro-competition policies; restrictive operational regulations; the degree of privatization in the financial sector; and controls on international financial transactions. We cannot use this index in our analysis, though, because a large majority of countries listed are not endowed with democratic institutions in this period (see below and Polity IV handbook for a discussion), which would excessively restrict our sample.

do facilitate the process, fostering an efficient reallocation of financial resources. It is worth stressing that our results seem rather robust to alternative measures of government strength, holding also when institutionally homogeneous subsamples of our dataset are considered.

The remainder of the paper proceeds as follows. In the next section we describe our empirical strategy. In Section II we present how we built the dataset by merging different data sources. Section III shows our empirical results and Section IV discusses robustness issues. Section V concludes.

I. Empirical Strategy

Since the main objective of this paper is to determine whether government strength affects the pace of financial reforms, we need to carefully identify an adequate set of controls to account for several potential sources of noise. To this end, some intermediary steps are needed. First, we have to choose a measure of government effectiveness; second, we must define a valid proxy for financial reforms; third, we need to test the validity of our set of controls.

As for government strength, different approaches have been proposed in the literature, the most convincing being to look at the distribution of seats across political parties in the parliament and provide a synthetic measure of fractionalization in the political landscape (see, e.g., Roubini and Sachs, 1989; Ricciuti, 2004). An intuitive measure to capture this concept is the Herfindahl index of the government, which is just the sum of the squares of the shares of each party in a coalition government. The Herfindahl index can be thought of as a measure of concentration of power, fewer bigger parties in a coalition being associated with a higher value than many smaller parties. In line with the political economy literature (Alesina and Perotti, 1995), we expect the presence of fewer decision makers help reach compromises across parties and act effectively.² Such reasoning clearly makes sense only in liberal democracies and, more properly, in political systems with a

²We follow most of the political economy literature in implicitly assuming that members of a same party vote in a similar way. This can be rationalized through similar preferences across members of the same party or simply as well enforced party discipline.

sufficiently proportional electoral rule. We take this into account when presenting our results.

Turning to financial reforms, the main problem is that policies are extremely hard to observe directly and even more difficult to compare across countries, in the absence of a comprehensive dataset built for this purpose. Our approach is thus to rely on outcomes and, specifically, focus on yearly changes in the composition of a country's financial structure. Implicitly this means that, everything else equal, the pace of adjustment in the financial structure is influenced by government policies and activities.

Finally, we must think of convincing ways to control for changes in the financial structure of a country. Most of the literature on financial market development relies on time-invariant country characteristics, such as legal origin (La Porta et al., 1997; hereafter LLSV), culture (Stulz and Williamson, 2003), colonial heritage or geographic characteristics (Beck et al., 2003), in order to explain the differences in the importance of capital markets. Unfortunately, this strand of literature does not provide much guidance in our analysis, which focuses on yearly changes. To this end, we rely on the contribution of Allen et al. (2007) to exploit the link they find between financial and economic structures of a country. Specifically, they find that the ratio of tangible-assets-intensive to intangible-assets-intensive sectors determines the relative importance of the banking sector vis-à-vis the capital markets in a country. Intangible-assets-intensive sectors are proxied by services and tangible-assets-intensive sectors are proxied by manufacturing and agriculture. This implies that variation in the relative importance of these sectors can be exploited to generate a reasonable time-varying control for changes in the financial structure.

The long-run equilibrium financial structures associated with the actual economic structure can be estimated for each country in every year, implicitly assuming the same kind of relation holds for all the economies, net of year and country effects. We can then use the lag of the difference between this estimated long-run equilibrium financial structure and the actual one as a control in our analysis.³ The intuition, whose illustration is

³This empirical strategy builds on the intuition provided by the synthetic control methods developed by Abadie and Gardeazabal (2003) and extended in Abadie et al. (2010).

provided in Figure 1, is that the further a system is from its equilibrium level, the quicker it will move towards it. In addition, following a similar reasoning, we would expect yearly changes in the real economic structure to directly affect the pace of adjustment in the financial structure. As every change in the economic structure will cause a change in the equilibrium financial structure in the long-run, we can expect also short-run adjustments in the same direction. Figure 2 provides a visual representation of this intuition. We test formally for the relevance of these controls and are reassured to find that they seem to perform rather well in predicting the evolution of the financial structure, both alone and combined, roughly following the pattern represented in Figure 3. As an example, we show in Figure 4 how our controls would work in the particular case of one country, France, over almost a decade. The dashed red line shows the actual evolution of the financial structure, whereas the solid blue line represents the long-run equilibrium financial structure implied by the underlying economic structure.

II. Data

This section presents the data sources and describes how the variables have been constructed, providing some summary statistics in order to give a sense of the dataset we have at hand.

Our financial and macroeconomic data were mainly collected from the updated World Banks' Financial Structure and Economic Development Database (Beck et al., 2000) and the World Development Indicators (WDI). Information on politics is retrieved from the Database of Political Institutions (DPI) (Beck et al., 2001). Our dataset covers as many countries as possible, 94, for the longest time period possible, which is from 1975 to 2009. Due to data availability, we are dealing with an unbalanced panel dataset where most of the missing data pertains to developing countries.

Since we want to examine whether stronger governments are most conducive to fast convergence towards the equilibrium in the financial structure, we look at changes in financial structure rather than absolute levels. To achieve this, we first need to find measures capturing the relative importance of financial intermediaries and stock markets.

We follow the vast literature on comparative financial systems to select our indicators (Beck and Levine, 2002; Levine, 2002) and construct two variables. The first, FS_1 , is a relative measure of the size of banks as compared to the stock markets. To measure the size of banks, we use the bank credit ratio, which is given by the claims of the banking sector on the private sector divided by the GDP. To measure the size of the stock markets relative to the economy, we use the market capitalization ratio, which is defined as the value of domestic equities listed on domestic exchanges as a share of GDP. It should be noted that bank credit ratio only includes deposit-taking institutions. As Allen et al. (2007) point out, the non-bank financial intermediaries play an important role in providing credit to the private sector in developed countries. Therefore, we also used a broader indicator of financial intermediaries, namely the private credit ratio. Private credit ratio equals the claims of deposit money banks and other financial institutions on the private sector as a share of GDP. Thus, the variable FS_2 is a measure of the size of all the financial intermediaries relative to that of stock markets. Both measures allow cross-country comparisons. The interpretation of these indicators is straightforward: if their value is greater than one, the country has a financial system whose banking system is more important than the stock markets.

Second, we exploit the adjustments in the financial structure resulting from changes in the economic structure. To this end, we directly build on Allen et al.'s (2007) work. The authors find significant structural differences in the industry compositions of countries with bank-based financial system and market-based financial system. Economies where tangible-assets-intensive firms (proxied by industrial and/or agricultural sectors) are predominant tend to have a bank-based financial system, whereas economies where knowledge- and R&D-intensive firms (proxied by the service sector) are predominant tend to have market-based financial system. Hence, we construct variables capturing the industrial composition of an economy following closely Allen et al. (2007). We initially divide the real economy into three sectors according to the International Standard Industrial Classification of all economic activities (ISIC): (i) *Agriculture*, (ii) *Industry*, and (iii) *Service*. The variable labelled *Agriculture* is defined as the agriculture value added as

a share of GDP. *Agriculture* corresponds to ISIC divisions 1-5 and includes value added in forestry, hunting, and fishing, as well as cultivation of crops and livestock production. The variable called *Industry* is defined as the industry value added as a share of GDP. *Industry* corresponds to ISIC divisions 10-45 and comprises value added in mining, manufacturing, construction, electricity, water, and gas. *Agriculture* and *Industry* are used to proxy tangible-assets-intensive sectors. Next, the variable *Service* is defined as the services value added as a share of GDP. *Service* includes ISIC divisions 50-99 and comprises value added in wholesale and retail trade, hotels and restaurants, transport, and government, financial, professional, and personal services such as education, health care, and real estate services. *Service* is used to proxy intangible-assets-intensive sectors. These three measures reflect thus the ratio of gross value added in the economy generated by each sector as recorded in WDI database.

Starting from this classification, we construct two variables representing the real economic structure. The first, ES_1 , equals the sum of *Agriculture* and *Industry* divided by *Service*. The second, ES_2 , is defined as the ratio of *Industry* to *Service*, where the contribution of *Agriculture* is dropped as a robustness check. If value of ES_1 and ES_2 is greater than one, it means that the country has an economic structure oriented toward industry and/or agriculture, which are more tangible-assets-intensive sectors. Hence, in line with the aforementioned study, we expect a positive correlation between the financial structure and the economic structure. This approach builds on the empirical observation that banks have a comparative advantage in financing industry or agriculture since their tangible assets may be easily used as collateral, whereas financial markets do better in fostering research firms since they play a positive role in aggregating diffuse information and transmitting it to investors.

Third, government strength is mainly captured through indices of power fragmentation, such as the Herfindahl index for government (denoted $HERFGOV$), which is the sum of squared seat shares of all parties in the government.⁴ The index ranges from zero to one, with one meaning a single-party government. As a robustness check, we also use

⁴Formally, $HERFGOV$ for a country is $\sum_{i=1}^N (P_i/P)^2$, where P_i is the number seats held by party i in the coalition government and P is the total of seats held by the government.

LARGEST PARTY, which is the vote share of the largest government party, as recorded by Beck et al. (2001). The intuition being that in coalitions built around one big party, the efficiency of the decision-making process could be helped by the presence of a clear leading party. We also employ *GOVFRAC* variable, which is the probability that two deputies picked at random from among the government parties will be of different parties.

Fourth, to assess the relationship between government strength and financial structure adjustment, it is necessary to control for determinants that have a potential impact on financial structure. Specifically, we use two sets of conditioning information. On the one hand, the simple conditioning information set introduces only year effects and country fixed effects. Some factors are indeed common to all countries at a given point in time and can be captured by year effects, while other factors are country specific and stable over time and can be captured by country fixed effects. On the other hand, the full conditioning information set contains additional variables controlling for economic development, inflation, trade openness, legal origin, endowments, and year effects. These controls are in line with the literature devoted to comparative financial development.

We introduce the logarithm of gross domestic product (GDP) divided by midyear population (labelled by *GDP PER CAPITA*) as a control variable to capture the effect of higher demand for financial services in affluent societies (Rajan and Zingales, 1998; Beck and Levine, 2002; Levine, 2002; Tadesse, 2002; Carlin and Mayer, 2003). Then, we add *INFLATION*, defined as the logarithm of one plus consumer price index (CPI) to control for the impact of inflation on financial depth (Boyd et al., 2001; Khan et al., 2006). We also control for the role played by trade openness in fostering financial development as argued by Rajan and Zingales (2003a). The variable *TRADE OPENNESS* is the logarithm of international trade (imports plus exports) as a share of GDP. The latter variables are drawn from WDI database.

Law and finance view emphasizes that a country's legal heritage shapes its approach to property rights, private contracting, investor protection, and hence financial development (LLSV, 1997).⁵ Comparative legal scholars have classified countries into five major

⁵Tied to this branch of research, Ergungor (2004) provides evidence that legal origin also matter to explain cross-country differences in financial system structure.

legal families: English, French, German, Scandinavian, and Socialist. The *ENGLISH* dummy variable equals one if the country adopted legal institutions from the English Common law and zero otherwise. Similarly, we have constructed *FRENCH*, *GERMAN*, and *SOCIALIST* dummy variables for French Civil law, German Civil law, Socialist/Communist laws, respectively, Scandinavian legal origin being captured in the constant.⁶

In addition, some scholars highlight that the mode of settlement exerts an impact on the formation of long-lasting institutions that shape financial systems (Acemoglu et al., 2001; Easterly and Levine, 2003; Beck et al., 2003). To control for this, we use two measures, *LAND AREA* and *LATITUDE*. The former is defined as the number of square kilometres of the landmass (as measured by the WDI database) and captures the natural resource endowment. The latter is the absolute value of the latitude of the each country normalized to lie between zero and one (LLSV, 1999; CIA World Factbook). Since geography may affect economic and financial development through its impact on market institutions (Acemoglu et al. 2001; Easterly and Levine, 2003), we use *LATITUDE* as a measure of geographic location.

Table I, which reports descriptive statistics, reveals considerable time-series and cross-section variations in financial structure. The average value of FS_1 and FS_2 around 5 means that countries are on average more bank-oriented. Interestingly, financial structure changes, dFS_1 and dFS_2 , reflect the current convergence in capital markets development with average variations over the sample period of -0.73 and -0.74, respectively. Regarding economic structure variables, we observe both time-series and cross-section variations. The average values lower than one for ES_1 and ES_2 mean that economies tend to rely more on service sector than on industrial and agriculture ones. Moreover, the negative average values of dES_1 and dES_2 suggest an increasing trend in that direction during the last two decades.

The political variables vary more than we initially expected. Indeed, the results in Table I indicate variability between countries as well as within countries. The average

⁶Information on legal families is collected from LLSV (1999) and CIA World Factbook.

values of *HERFGOV*, *LARGEST PARTY*, and *GOVFRAC* are respectively 0.78, 0.36 and 0.22, meaning that countries have on average few big parties in their governing coalitions, especially considering that both majoritarian and proportional electoral systems are included in these averages. Besides, the average number of years (\bar{T}) a country was observed for financial structure variables is 18, while for both economic and political variables is around 30.

The statistics in Table II show positive and significant correlations between financial structure indicators and real economic structure indicators (both in level and first differences), which is consistent with Rajan and Zingales' (2003b) intuition.⁷ Note that our political economy variables, *HERFGOV*, *LARGEST PARTY*, and *GOVFRAC*, are not correlated with changes in the financial structure, dFS_1 , which is consistent with our hypothesis that stronger governments affect the speed of adjustments, but not its direction. As depicted in other studies, income per capita is inversely correlated with financial structure, as reliance on financial markets is notably increasing as countries become richer. Additionally, results show a negative relationship between inflation and financial intermediation. In accordance with the law and finance view, English legal origins are negatively correlated with our measures of financial structure, the opposite being true for French and Socialist. Compellingly, such correlations do not persist when we consider changes in financial structure.

III. Results

Before presenting our results, we briefly lay out our econometric methodology. As a first step, we check the stationarity of our series in levels and first differences. To this end, we implement the Fisher-type Augmented Dickey–Fuller (ADF) and Phillips–Perron (PP) panel unit root tests proposed by Maddala and Wu (1999).⁸ Unreported test results conclude that our series are integrated of order zero ($I(0)$), which confirms

⁷For the sake of readability, we do not report the correlations between FS_2 , ES_2 , dFS_2 , dES_2 , and the other variables. Their coefficients follow very closely the ones of FS_1 , ES_1 , dFS_1 , and dES_1 .

⁸The strong unbalanced nature of our data does not authorize us to proceed to the application of the Levin, Lin, and Chu (LLC) and Im, Pesaran, and Shin (IPS) tests. However, Fisher-type statistics have been shown to be superior to the LLC and IPS tests (see Maddala and Wu, 1999).

that regressions do not lead to spurious results.

Then, in order to test whether government characteristics affects the pace of financial reforms, we analyze the long-run equilibrium relation between economic and financial structures following the empirical specification of Allen et al. (2007), where actual observations are treated as random deviations from the long-run equilibrium. The following unobserved effects model is thus estimated:

$$FS_{i,t} = \beta ES_{i,t} + \mu_i + \lambda_t + \nu_{i,t}, \quad (1)$$

where FS is one of the financial structure variables in level, ES is one of the economic structure variables in level, μ_i denotes the unobservable country effect, λ_t denotes the unobservable year effect, and $\nu_{i,t}$ is the idiosyncratic disturbance. The i subscript denotes the country whereas t denotes the year.

Once this structural long-run relation is established, we exploit it to build the controls for our main specification:

$$\begin{aligned} dFS_{i,t} = & \beta_1 dES_{i,t} + \beta_2 FSGAP_{i,t-1} + \beta_3 GS_{i,t} + \beta_4 (dES_{i,t} \times GS_{i,t}) \\ & + \beta_5 (FSGAP_{i,t-1} \times GS_{i,t}) + \mu_i + \lambda_t + \nu_{i,t}, \end{aligned} \quad (2)$$

where dFS is the change in one of the financial structure variables, i.e. $FS_{i,t} - FS_{i,t-1}$, and dES is the change in the considered economic structure variable, i.e. $ES_{i,t} - ES_{i,t-1}$. The lagged distance between the predicted long-run equilibrium structure and the actual one, $\widehat{FS}_{i,t-1} - FS_{i,t-1}$, is called $FSGAP$. Government strength indicators are labelled GS , μ_i denotes the unobservable country effect, λ_t denotes the unobservable year effect, and $\nu_{i,t}$ is the idiosyncratic disturbance. The i subscript indicates the country and t the year.⁹ As mentioned above, we also conduct the analysis with a full conditioning information set.

⁹From models (1) and (2), the Hausman test's null hypothesis—that the random effects estimator is consistent—is rejected at conventional level of significance. Also, we test the joint significance of the country dummies, i.e. $H_0 : \mu_1 = \mu_2 = \dots = \mu_{N-1} = 0$, by performing F -tests. The tests reject the null at any level of significance, indicating that country-specific-time-invariant effects are relevant. Similarly, we perform F -tests for the year dummies ($H_0 : \lambda_1 = \lambda_2 = \dots = \lambda_{N-1} = 0$). Results of the tests indicate that year-specific-country-invariant effects are relevant.

The latter conditioning information set contains year effects and, additionally, a vector X of explanatory variables controlling for macroeconomic factors and country-specific-time-invariant factors (see Section II).¹⁰

For brevity, we focus our discussion on results with FS_1 as dependent variable and ES_1 as regressor for economic structure. Untabulated regressions with all the possible combinations between FS_1 , FS_2 and ES_1 , ES_2 yield the same results and are available upon request from the authors.

In Table III we investigate the link between economic and financial structures, both in the long and in the short run. In column 1 (Panels A and B), regression results using 94 countries support the hypothesis of the existence of a causal link between economic structure and financial structure, as evidenced by Allen et al. (2007). This suggests that the forces driving the structure of the real economy are external to finance, such as industrial policy choices, geographical location, technological changes, and so on. The latter long-run equilibrium relationship is nicely paired with a statistically significant short-term adjustment process, as suggested by the regression results reported in columns 2 to 4.¹¹ The coefficients of dES_1 and FS_1GAP are indeed highly significant and positive, implying that both distance from the long-run equilibrium financial structure and changes in the underlying economic structure affect short-run adjustments in the envisaged direction. These results confirm the validity of our choice of controls for the link between government strength and financial reforms.

Once we control for the changes in the financial structure induced by structural changes in the economy, we can better identify whether politics play a role in the adjustment process. Since reforms in democratic countries are usually the result of compromise and discussions, government characteristics could affect the pace of such reforms. As Ta-

¹⁰The models using the full conditioning information set are estimated using random effects (GLS) estimator since in this case the Hausman tests do not reject the null. Besides, random effects estimators are an advantage, here, over fixed effects estimators, because it allows us to capture estimates of variables that are invariant across time and wiped out by fixed effects transformation, such as legal origin and colonial heritage. Finally, the relevance of year dummies in these models is corroborated by the rejection of the null when carrying out F -tests.

¹¹As an indication, descriptive statistics of FS_1GAP yield a mean value equals to 0.05 and overall and within standard deviations around 23 and 20, respectively, once we estimate model (1) with the simple conditioning information set and the full sample.

bles IV to VII suggest, this appears to be the case when proxies of government strength are considered.

Unfortunately, some of the 94 countries for which we have data are not endowed with institutions allowing democratic legislative activities.¹² In these cases, we cannot clearly apply our line of reasoning and tests to investigate the link between politics and reforms because there is no explicit political activity. A commonly used index of democratic development can be found on the Polity IV database and is called *POLITY 2*. We used it to identify countries endowed with democratic institutions in the years considered, which end up being 69.¹³

Panels A and B of Table IV start with the estimation of the long-run equilibrium financial structure and then report estimation results on the adjustment process, adding one variable of interest at the time in order to show how they affect the overall picture. Besides the controls previously mentioned, our political economy variable of interest is now *HERFGOV*, alone and interacted with the financial adjustment controls. Similarly to Table III, the estimated coefficients of ES_1 , dES_1 , and FS_1GAP are positive and statistically different from zero at the 1% level (columns 2 to 4). As expected, *HERFGOV* does not enter significantly in the regressions in column 5. Indeed, government fractionalization by itself does not appear to influence change in financial structure in a particular direction, which is consistent with the idea that structural changes in the economy may require adjustments in different directions. Column 6 clarifies this point by showing how stronger governments seem to act as short-run facilitator of adjustment in the financial structure. If government strength impacts change in the financial structure resulting from changes in the underlying economic structure, then $dES_1 \times HERFGOV$ interaction will indeed be positive. Even if the coefficient of dES_1 turns negative when the interaction

¹²Democratic institutions have to ensure, among other, political competition and openness—that is to say, the existence of institutions and procedures through which citizens can effectively express their preferences about alternative leaders and policies, the presence of institutionalized constraints on the exercise of power by the executive, and other aspect of the political environment, such as the rule of law, freedom of the press, systems of checks and balances. See for instance Polity IV Project for further discussions.

¹³Our threshold value for *POLITY 2* is 8 out of 10, which appears to be a sensible threshold since roughly 50% of all the countries in the Polity IV dataset have values between 8 and 10, the other 50% having values from -10 to 7. More details can be found on the Polity IV handbook.

is included, it must be noted that the average value for the Herfindahl index is shown in Table I to be 0.78, which makes the overall effect of change in economic structure positive in the largest majority of cases ($130.21 \times 0.78 - 58.31 = 43.26$), confirming that the stronger the government, the faster the adjustment. More precisely, the lower the number of parties and the bigger they are in a government, the faster is the adjustment in the financial sector in response to changes in the economic structure. In contrast, weak coalition governments are shown to hinder or at least postpone needed reforms, leading to an expected zero-effect when *HERFGOV* is close to 0.45 ($58.31 \div 130.21$). This is a rather low cut-off in terms of political concentration. In our sample, for example, 80% of the observations (country-year) lie above that threshold. This is probably the reason why structural coefficients are always positive when political economy variables are not included.

Similarly, in column 7 we ask ourselves whether stronger governments are associated with a quicker adjustment towards equilibrium financial structure. The results show that the coefficient of *FS₁GAP* loses its significance when the interaction with *HERFGOV* is included, which becomes significant at its place. This suggests that the distance between long-run and current financial structure seems to affect the short-run adjustments process only as far as a sufficiently strong government allows it to. More precisely, the stronger the government the quicker the adjustment. For example, we can imagine that even if most politicians realize that the current financial structure does not respond perfectly to the needs of the economic structure, there are still many ways in which the status quo can be altered and it still takes some political bargaining to decide how to actually address the problem.

This result is also confirmed in column 8, where we estimate the model with both interaction terms and obtain remarkably similar coefficients for the interactive terms. Stronger governments do appear to facilitate short-run adjustments, consistently with the idea of semi-benevolent governments proposed by Grossman and Helpman (1994), who suggest that politicians probably care for both themselves and their voters, though arguably to a different extent. Government strength seems to play a role in the capacity

of politics to steer the economy towards its long-run equilibrium.

Panel B of Table IV indicates that coefficients remain very similar and statistically significant when we consider the full conditioning information set, especially as far as the interaction of structural and political economy variables is concerned. We note that the control variables enter all the regressions with the predicted signs. However, they are almost never significant except for per capita GDP growth, whose negative sign signals the higher reliance of undeveloped countries on banks rather than financial markets.

IV. Robustness

As the extensive political science literature on comparative politics argued, the nature of party system and of government structure depends strongly on the electoral system. Still, the choice between majoritarian and proportional electoral systems induces differences in economic policy outcomes and performance.¹⁴ What is more troubling for us is that majoritarian electoral systems typically lead to single-party governments, which would imply a Herfindahl index equal to 1 and reduce the variation in our sample. To address this issue, in Table V we show results restricted to proportional representation systems with legislative bargaining, which is known to be associated with multi-party systems and coalition governments. The first four columns of Table V still reproduce preliminaries of our identification strategy and results remain robust. From column 5, when *HERFGOV* is introduced, the results are mirror those depicted above, strongly supporting our predictions that less fragmented coalition governments allow for stronger and quicker adjustments in the financial structure. Since under proportional representation successful parties must usually form a coalition to set reform, the presence of few powerful political parties will facilitate the bargaining procedure within the coalition.

A further possible source of bias in our estimations is the possibility that minority governments behave differently from government coalitions holding a majority of seats in the parliament. Political fragmentation within a coalition may be more relevant when the coalition has enough political power to legislate alone, without external support.

¹⁴See Persson and Tabellini (2003) for impact in the design of fiscal policies and Pagano and Volpin (2005) for impact on financial and labor market regulations.

For this reason, in Table VI we restrict our sample to countries and years in which the governing coalition had at least 50% of seats in the parliament, i.e. we focus on majority governments. As can be noticed browsing Table VI, results are again not affected by the restriction of our sample, neither in significance, nor in sign or order of magnitude.

In order to provide some more evidence on the existence of a link between government strength and financial reforms, we test the robustness of our results by using a somehow less precise but more immediately evident proxy for government strength: the share of seats held by the largest government party. In Table VII, we then repeat the same panel-data estimation using the variable *LARGEST PARTY* instead of *HERFGOV*, again using it alone and interacted with the structural controls dES_1 and FS_1GAP . The results are remarkably similar to the ones obtained in Table IV, with the only difference that the interpretation of the coefficients has to be slightly adapted to the new political economy variable. For example, the interaction between dES_1 and *LARGEST PARTY* now tells us that the financial structure will be expected to adjust towards accommodating changes in the economic structure as soon as the largest party in the governing coalition hold at least 21.7%, which in our sample happens quite often, 91% of the times, thus explaining the positive value associated to dES_1 when the political economy variables are not included. This result is telling us that governments with a clear leading party are associated with quicker financial structure adjustments and faster convergence to the long-run equilibrium.¹⁵

The same results arise when, instead of the Herfindahl index or the share of seats of the largest party, we considered the probability that two deputies picked at random from among the government parties will be of different parties. This variable is called *GOVFRAC* in the DPI database (Beck et al., 2001) and is highly correlated with the Herfindahl index, with opposite sign. The tables have not been included because of their high resemblance to the ones provided in the paper, but they are available upon request from the authors.

¹⁵The results hold also when the sample is restricted to proportional representation systems and majority governments. Unreported tables are available upon request from the authors.

V. Conclusions

In this paper we examined whether government strength is positively associated with legislative efficiency in the domain of financial reforms. Exploiting the empirical link between the structure of the real economy and the characteristics of the financial system highlighted by Allen et al. (2007), we found it to be the case. More precisely, government effectiveness appears to affect positively the speed of financial structure adjustment towards its equilibrium level. Our work is therefore meant to complement the argument of Rajan and Zingales (2003a) according to whom financial systems tend to reach an optimal structure in the long-run. Focusing on the corresponding short-run adjustment process, we show that political institutions appear to play a key role in determining how quickly economies tend towards their long-run equilibrium financial structure. In this way we shed light on the short-run aspects of a longer process of adjustment in the financial sector. At the same time, our findings contribute to close a gap between theoretical predictions and empirical observations in the branch of political economy dealing with coalition governments and legislative effectiveness.

Interestingly, we find that strong governments act as a facilitator, helping capital markets and the banking sector adapt their relative size in reaction to changes in the underlying economic structure. The more so, the stronger the government or the higher the need for change, measured in terms of distance from the equilibrium levels and intensity of change in the underlying economic structure. Put differently, whenever the financial structure of a country is not exactly at its long-run equilibrium level, government strength is positively associated with the speed of adjustment in the expected direction. Implicitly our approach assumes politicians to be somehow benign, or at least constrained by the right set of incentives. Whereas we cannot know their objectives and preferences, we can say that in the liberal democracies considered in our sample they appear to act as an actor of change in the right direction. In other words, in the domain of financial reform, stronger governments do it faster when it's needed.

Our results are obtained by looking only at financial outcomes. A promising next step would be to look at actual legislative activity, in terms of number of laws and their

content. To the best of our knowledge, no such data exist at the moment covering enough countries over a sufficient number of years to match the dataset we used in this paper. Still, it could be argued that an output-based approach can capture more information than official legislative documents, as there can be several ways in which politicians may exert influence on society without producing formal acts.

A final caveat is due. While the link we identify between government strength and reforms is quite robust, we cannot adjudicate why exactly stronger governments should bring reforms about more efficiently. Many possible explanations have been offered in the political economy literature. For example, stronger governments may be more difficult for lobbies to capture, they may find agreements more within ruling coalitions, they may better internalize the interests of the whole society rather than particular groups or they may expect to survive long enough to enjoy the long-run fruits of reform. The study of this particular issue can be a promising avenue for future research.

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Figure 1: The Impact of the Gap between Current and Long-run Financial Structures

In Figure 1 is shown the expected link between the gap between equilibrium and current financial structures and changes in the actual financial structures. The further away the actual financial structure is from its long-run equilibrium, the quicker will be the expected adjustment in the following period.

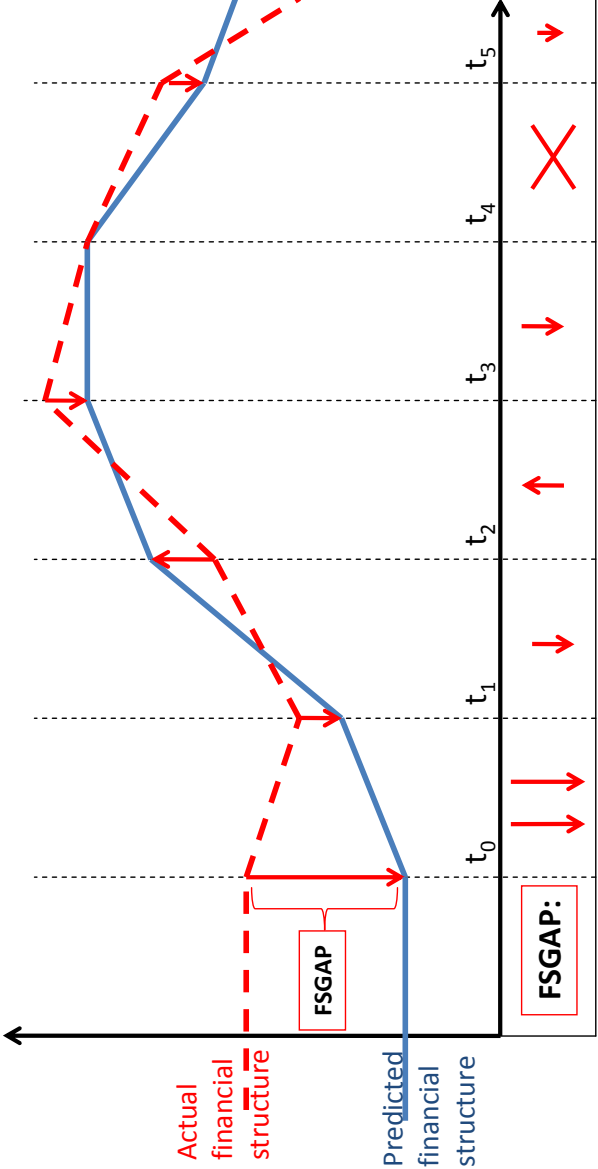


Figure 2: The Impact of Changes in the Economic Structure

In Figure 2, the expected link between changes in the economic and the predicted financial structures are displayed. As the ratio between tangible-assets-intensive sectors (*Agriculture* and *Industry*) and intangible-assets-intensive sectors (*Service*) change, the financial structure (i.e., the ratio of the bank claims to market capitalization) should move accordingly, capital markets benefitting from a growth in the latter and the banking sector becoming more relevant as the former sectors grow. The arrows show how the predicted financial structure of the economy change from one period to the other because of changes in the economic structure, dES .

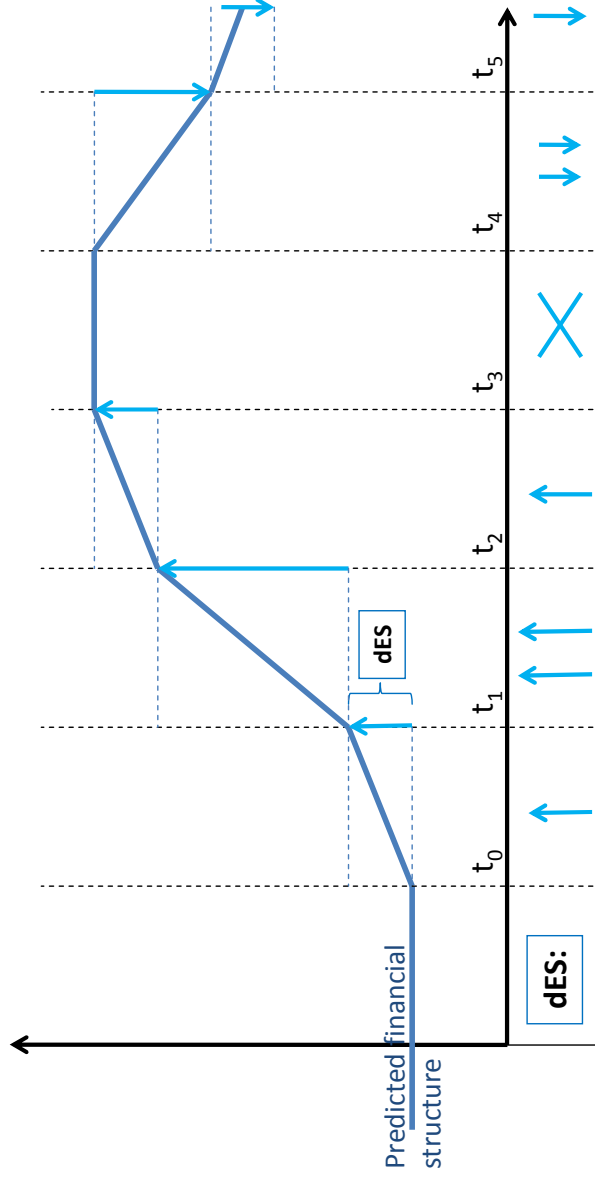


Figure 3: The Joint Impact of the Two Controls

Figure 3 shows the combined effect of changes in the economic structure and gaps between current and equilibrium financial structures. The predictable changes in the actual financial structure (dashed red line) will depend on these two forces, on top of which a certain stochastic noise can be envisaged but is not shown in the graph.

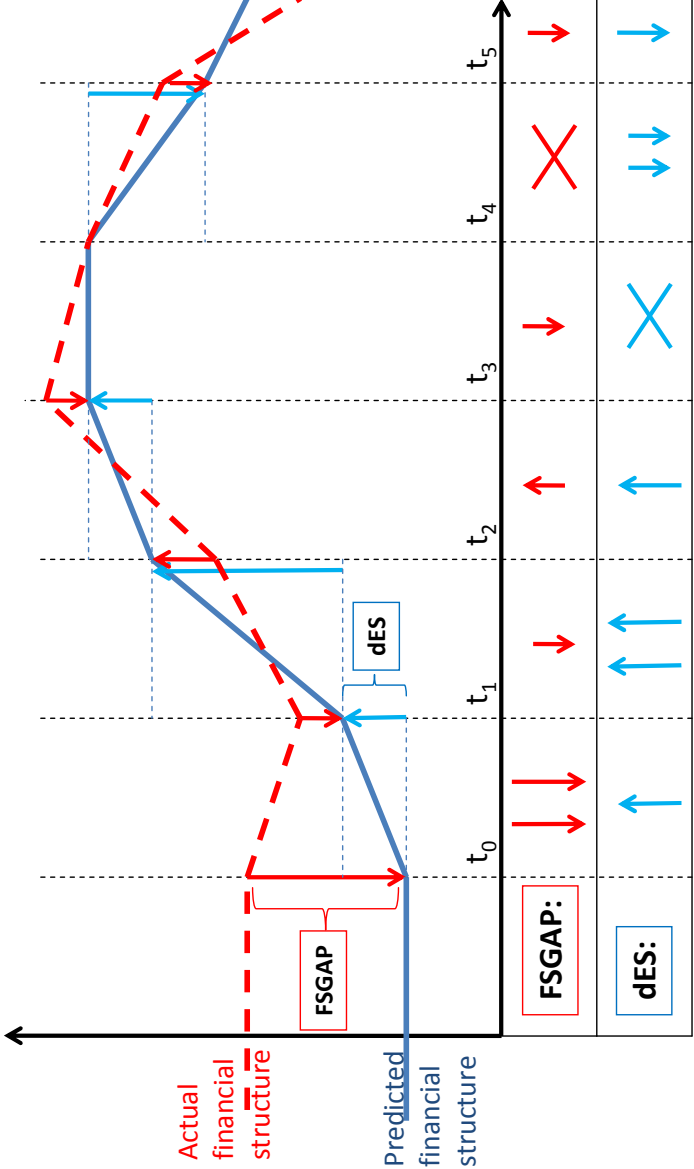


Figure 4: Predicted and Actual Financial Structures in France

Figure 4 shows an example drawn from real data. In this case, the red dashed line shows the evolution of the real financial structure of France from 1989 to 1997, whereas the solid blue line shows the corresponding estimated long-run equilibrium financial structure in the same years, based on the underlying economic structure.

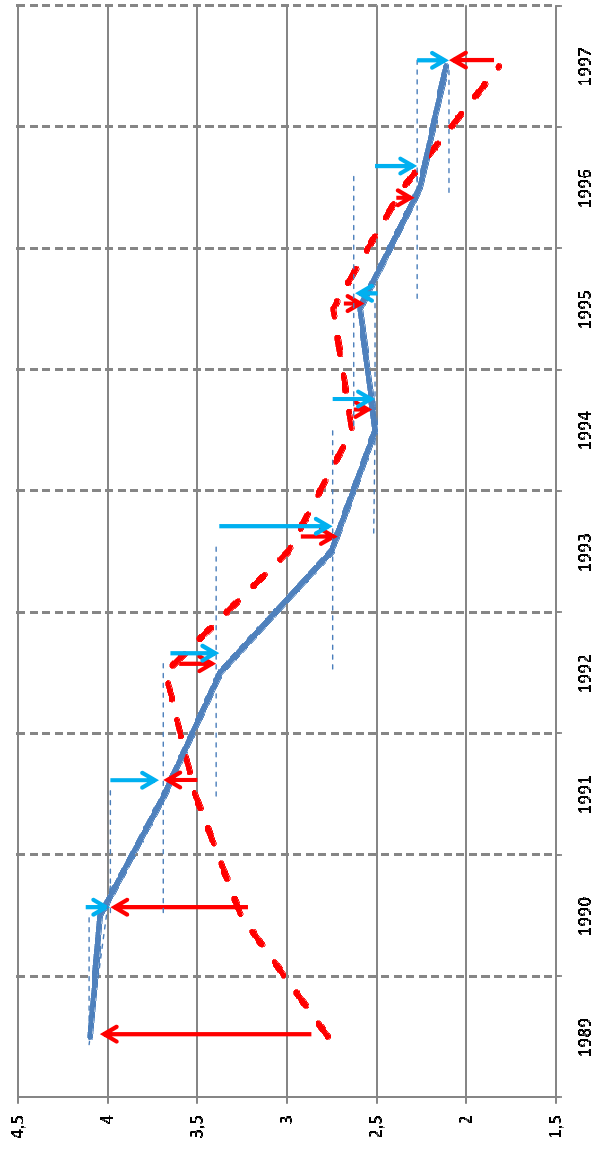


Table I
Descriptive Statistics—Panel Data

This table presents descriptive statistics for our 94-country panel dataset spanning from 1975 to 2009. Panel A reports variables in level, while Panel B reports variables in first differences. FS_1 is the ratio of bank claims on the private sector over market capitalization and FS_2 is the ratio of claims by banks and non-bank intermediaries on the private sector over market capitalization, drawn from Beck et al. (2000). ES_1 equals the sum of share of *Agriculture* and *Industry* in the economy divided by the share of *Service*; ES_2 equals *Industry* divided by *Service*. *Agriculture* is the value added generated by agricultural activities as a share of GDP and corresponds to ISIC divisions 1-5. *Industry* is the industrial value added as a share of GDP and corresponds to ISIC divisions 10-45. *Service* is the value added generated by services as a share of GDP and corresponds to ISIC divisions 50-99. *Agriculture*, *Industry*, and *Service* are retrieved from WDI database. *HERFGOV* is the Herfindahl index for government, which is the sum of squared seat shares of all parties in the government (drawn from DPI database and defined in Beck et al., 2001). *LARGEST PARTY* is the vote share of the largest government party (DPI database; Beck et al., 2001). *GOVFRAC* is the probability that two deputies picked at random from among the government parties will be of different parties (DPI database; Beck et al., 2001). *GDP PER CAPITA* is the log of GDP divided by midyear population in WDI database. *INFLATION* equals $\log(1 + CPI)$, where *CPI* is the consumer price index as measured in WDI database. *TRADE OPENNESS* is defined as the log of imports plus exports divided by GDP (WDI database). *ENGLISH*, *FRENCH*, *GERMAN*, and *SOCIALIST* are dummy variables that reflect the origin of the legal system, retrieved from LLSV (1999) and CIA World Factbook. *LAND AREA* measures the log of the number of square kilometres of the landmass to which each country belongs (WDI database). *LATITUDE* is the absolute value of the latitude of a country, scaled between 0 and 1 (LLSV, 1999; CIA World Factbook).

Variable	Mean	Std Dev (overall)	Std Dev (between)	Std Dev (within)	Number of observations	Number of countries	<i>T</i>
<i>Panel A: Level</i>							
Financial Structure							
<i>FS</i> ₁	5.228	22.816	9.431	20.462	1752	94	18.638
<i>FS</i> ₂	5.404	22.777	9.386	20.448	1758	94	18.702
Economic Structure							
<i>ES</i> ₁	0.955	0.596	0.509	0.373	2870	94	30.532
<i>ES</i> ₂	0.656	0.374	0.292	0.247	2870	94	30.532
Government Strength							
<i>HERFGOV</i>	0.780	0.269	0.200	0.179	2746	94	29.213
<i>LARGEST PARTY</i>	0.355	0.258	0.217	0.153	2667	94	28.372
<i>GOVFRAC</i>	0.223	0.272	0.203	0.181	2746	94	29.213
Controls							
<i>GDP PER CAPITA</i>	8.156	1.428	1.403	0.242	3037	94	32.309
<i>INFLATION</i>	3.640	1.317	0.744	1.088	2873	94	30.564
<i>TRADE OPENNESS</i>	4.183	0.574	0.544	0.231	2979	94	31.692
<i>ENGLISH</i>	0.312	0.463	0.464	0.000	3257	94	34.649
<i>FRENCH</i>	0.387	0.487	0.489	0.000	3257	94	34.649
<i>GERMAN</i>	0.054	0.226	0.226	0.000	3257	94	34.649
<i>SOCIALIST</i>	0.194	0.396	0.404	0.000	3257	94	34.649
<i>LAND AREA</i>	12.072	2.060	2.086	0.006	3257	94	34.649
<i>LATITUDE</i>	0.350	0.200	0.202	0.000	3257	94	34.649
<i>Panel B: First Differences</i>							
Financial Structure							
<i>dFS</i> ₁	-0.727	18.857	2.578	18.694	1640	94	17.447
<i>dFS</i> ₂	-0.735	18.816	2.576	18.654	1648	94	17.532
Economic Structure							
<i>dES</i> ₁	-0.021	0.173	0.036	0.170	2772	94	29.489
<i>dES</i> ₂	-0.011	0.119	0.023	0.117	2772	94	29.489

Table II
Pairwise Correlations—Panel Data

This table reports pairwise correlation coefficients between the variables defined hereafter. FS_1 is the ratio of bank claims on the private sector over market capitalization, drawn from Beck et al. (2000). ES_1 equals the sum of share of *Agriculture* and *Industry* in the economy divided by the share of *Service*. *Agriculture* is the value added generated by agricultural activities as a share of GDP and corresponds to ISIC divisions 1-5. *Industry* is the industrial value added as a share of GDP and corresponds to ISIC divisions 10-45. *Service* is the value added generated by services as a share of GDP and corresponds to ISIC divisions 50-99. *Agriculture*, *Industry*, and *Service* are retrieved from WDI database. *HERFGOV* is the Herfindahl index for government, which is the sum of squared seat shares of all parties in the government (drawn from DPI database and defined in Beck et al., 2001). *LARGEST PARTY* is the vote share of the largest government party (DPI database; Beck et al., 2001). *GOVFRAC* is the probability that two deputies picked at random from among the government parties will be of different parties (DPI database; Beck et al., 2001). *GDP PER CAPITA* is the log of GDP divided by midyear population in WDI database. *INFLATION* equals $\log(1 + CPI)$, where *CPI* is the consumer price index as measured in WDI database. *TRADE OPENNESS* is defined as the log of imports plus exports divided by GDP (WDI database). *ENGLISH*, *FRENCH*, *GERMAN*, and *SOCIALIST* are dummy variables that reflect the origin of the legal system, retrieved from LLSV (1999) and CIA World Factbook. *LAND AREA* measures the log of the number of square kilometres of the landmass to which each country belongs (WDI database). *LATITUDE* is the absolute value of the latitude of a country, scaled between 0 and 1 (LLSV, 1999; CIA World Factbook). *, **, and *** mean significant at the 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
(1) FS_1	1.000															
(2) ES_1	0.081***	1.000														
(3) dFS_1	0.307***	-0.002	1.000													
(4) dES_1	0.017	0.056***	0.141***	1.000												
(5) <i>HERFGOV</i>	0.023	0.160***	0.011	-0.001	1.000											
(6) <i>LARGEST PARTY</i>	0.064**	-0.034	-0.009	0.032	0.520***	1.000										
(7) <i>GOVFRAC</i>	-0.024	-0.159***	-0.011	-0.011	-0.999***	-0.521***	1.000									
(8) <i>GDP PER CAPITA</i>	-0.069***	-0.568***	0.018	0.036*	-0.200***	-0.051**	0.200***	1.000								
(9) <i>INFLATION</i>	-0.168***	-0.365***	0.034	0.034*	-0.188***	-0.068***	0.187***	0.283***	1.000							
(10) <i>TRADE OPENNESS</i>	-0.040	-0.038**	0.003	0.012	-0.142***	0.091***	0.146***	0.136***	0.375***	1.000						
(11) <i>ENGLISH</i>	-0.095***	0.191***	0.022	0.01	0.246***	0.179***	-0.245***	-0.231***	0.057***	-0.039**	1.000					
(12) <i>FRENCH</i>	0.077***	-0.156***	-0.002	0.025	-0.017	-0.032*	0.018	0.026	-0.164***	-0.112***	-0.534***	1.000				
(13) <i>GERMAN</i>	-0.027	-0.121***	0.008	0.011	-0.114***	0.003	0.112***	0.296***	0.126***	-0.084***	-0.160***	-0.189***	1.000			
(14) <i>SOCIALIST</i>	0.062***	0.141***	-0.039	-0.068***	0.075***	-0.137***	0.074***	-0.149***	0.016	0.250***	-0.330***	-0.390***	-0.117***	1.000		
(15) <i>LAND AREA</i>	0.006	0.101***	-0.019	0.022	0.072***	-0.007	-0.075***	-0.171***	-0.180***	-0.593***	0.047***	0.054***	0.000	0.000	1.000	
(16) <i>LATITUDE</i>	0.010	-0.303***	-0.018	-0.022	-0.240***	-0.176***	0.240***	0.563***	0.207***	0.133***	-0.383***	-0.255***	0.401***	0.443***	-0.045**	1.000

Table III
The Effect of Economic Structure on Financial Structure

This table reports results relating a measure of financial structure to a measure of economic structure. The dependent variable is FS_1 (in level and first differences) for all sample countries. FS_1 is the ratio of bank claims on the private sector over market capitalization, drawn from Beck et al. (2000). ES_1 equals the sum of *Agriculture* and *Industry* divided by *Service*. *Agriculture* is the value added generated by agricultural activities as a share of GDP and corresponds to ISIC divisions 1-5. *Industry* is the industrial value added as a share of GDP and corresponds to ISIC divisions 10-45. *Service* is the value added generated by services as a share of GDP and corresponds to ISIC divisions 50-99. *Agriculture*, *Industry*, and *Service* are retrieved from WDI database. FS_1GAP is the lagged difference between predicted and actual values of FS_1 , where predictions are drawn from the model in the first column. Panel A, the simple conditioning information set, includes year dummies and country fixed effects. Panel B, the full conditioning information set, includes year dummies and control variables defined hereafter. Regressions in Panel B contain a constant, whose coefficient is not reported. *GDP PER CAPITA* is the log of GDP divided by midyear population in WDI database. *GDP PER CAPITA GROWTH* is the annual percentage growth rate of GDP per capita based on constant local currency as measured in WDI database. *INFLATION* equals $\log(1 + CPI)$, where *CPI* is the consumer price index as measured in WDI database. *TRADE OPENNESS* is defined as the log of imports plus exports divided by GDP (WDI database). *ENGLISH*, *FRENCH*, *GERMAN*, and *SOCIALIST* are dummy variables that reflect the origin of the legal system, retrieved from LLSV (1999) and CIA World Factbook. *LAND AREA* measures the log of the number of square kilometres of the landmass to which each country belongs (WDI database). *LATITUDE* is the absolute value of the latitude of a country, scaled between 0 and 1 (LLSV, 1999; CIA World Factbook). The panel spans from 1975 to 2009 and includes 94 countries. In brackets are standard errors. *, **, and *** mean significant at the 10%, 5%, and 1% level, respectively.

	FS_1	dFS_1	dFS_1	dFS_1
	(1)	(2)	(3)	(4)
<i>Panel A: Simple Conditioning Information Set</i>				
ES_1	13.553***			
	(3.696)			
dES_1		31.097***		25.943***
		(5.516)		(4.545)
FS_1GAP			0.527***	0.522***
			(0.020)	(0.020)
Overall R^2	0.054	0.038	0.286	0.302
Between R^2	0.002	0.003	0.188	0.192
Within R^2	0.095	0.040	0.335	0.350
Number of Observations	1685	1572	1572	1572

Table III—Continued

<i>Panel B: Full Conditioning Information Set</i>				
<i>ES</i> ₁	3.104 (2.157)			
<i>dES</i> ₁		30.724*** (5.413)		25.227*** (4.550)
<i>FS</i> ₁ <i>GAP</i>			0.458*** (0.018)	0.453*** (0.018)
<i>GDP PER CAPITA</i>	-0.915 (0.958)			
<i>GDP PER CAPITA GROWTH</i>		-0.209 (0.155)	-0.199 (0.132)	-0.239* (0.130)
<i>INFLATION</i>	-1.694 (1.168)	1.179 (0.983)	2.240*** (0.834)	2.303*** (0.826)
<i>TRADE OPENNESS</i>	1.180 (2.064)	-1.265 (1.3149)	-1.528 (1.115)	-1.837* (1.105)
<i>ENGLISH</i>	-0.018 (4.663)	-0.182 (2.702)	-0.389 (2.291)	-0.180 (2.269)
<i>FRENCH</i>	4.581 (4.518)	-0.848 (2.597)	-0.443 (2.203)	-0.372 (2.181)
<i>GERMAN</i>	1.435 (5.195)	-0.441 (2.943)	-0.982 (2.496)	-0.910 (2.471)
<i>SOCIALIST</i>	5.401 (4.549)	-1.309 (2.580)	-1.526 (2.183)	-0.708 (2.166)
<i>LAND AREA</i>	-0.283 (0.554)	-0.391 (0.343)	-0.379 (0.291)	-0.447 (0.288)
<i>LATITUDE</i>	10.510 (7.490)	-2.121 (3.476)	-1.638 (2.951)	-1.745 (2.921)
Overall <i>R</i> ²	0.099	0.044	0.314	0.328
Between <i>R</i> ²	0.097	0.063	0.300	0.290
Within <i>R</i> ²	0.100	0.044	0.344	0.358
Number of Observations	1622	1513	1510	1510

Table IV
The Effect of Government Strength on Financial Structure Adjustment in Democratic Countries

This table reports results relating a measure of government strength to adjustments in the financial structure. The dependent variable is FS_1 (in level and first differences) for democratic countries. Democratic countries are defined as countries with a *POLITY 2* minimum score of 8 in the *Polity IV* database. FS_1 is the ratio of bank claims on the private sector over market capitalization, drawn from Beck et al. (2000). ES_1 equals the sum of *Agriculture* and *Industry* divided by *Service*. *Agriculture* is the value added generated by agricultural activities as a share of GDP and corresponds to ISIC divisions 1-5. *Industry* is the industrial value added as a share of GDP and corresponds to ISIC divisions 10-45. *Service* is the value added generated by services as a share of GDP and corresponds to ISIC divisions 50-99. *Agriculture*, *Industry*, and *Service* are retrieved from WDI database. FS_1GAP is the lagged difference between predicted and actual values of FS_1 , where predictions are drawn from the model in the first column. $HERFGOV$ is the Herfindahl index for government, which is the sum of squared seat shares of all parties in the government (drawn from DPI database and defined in Beck et al., 2001). Panel A, the simple conditioning information set, includes year dummies and country fixed effects. Panel B, the full conditioning information set, includes year dummies and control variables defined hereafter. Regressions in Panel B contain a constant, whose coefficient is not reported. $GDP\ PER\ CAPITA$ is the log of GDP divided by midyear population in WDI database. $GDP\ PER\ CAPITA\ GROWTH$ is the annual percentage growth rate of GDP per capita based on constant local currency as measured in WDI database. $INFLATION$ equals $\log(1 + CPI)$, where CPI is the consumer price index as measured in WDI database. $TRADE\ OPENNESS$ is defined as the log of imports plus exports divided by GDP (WDI database). *ENGLISH*, *FRENCH*, *GERMAN*, and *SOCIALIST* are dummy variables that reflect the origin of the legal system, retrieved from LLSV (1999) and CIA World Factbook. *LAND AREA* measures the log of the number of square kilometres of the landmass to which each country belongs (WDI database). *LATITUDE* is the absolute value of the latitude of a country, scaled between 0 and 1 (LLSV, 1999; CIA World Factbook). The panel spans from 1975 to 2009 and includes 69 countries. In brackets are standard errors. *, **, and *** mean significant at the 10%, 5%, and 1% level, respectively.

	FS_1 (1)	dFS_1 (2)	dFS_1 (3)	dFS_1 (4)	dFS_1 (5)	dFS_1 (6)	dFS_1 (7)	dFS_1 (8)
<i>Panel A: Simple Conditioning Information Set</i>								
ES_1	34.240*** (5.703)							
dES_1		61.563*** (9.442)		58.597*** (7.932)	58.835*** (7.976)	-58.425* (35.231)	58.979*** (7.936)	-58.307* (35.050)
FS_1GAP			0.556*** (0.029)	0.552*** (0.028)	0.553*** (0.029)	0.552*** (0.028)	0.166 (0.125)	0.165 (0.124)
$HERFGOV$					-1.330 (3.656)	0.676 (3.681)	-0.548 (3.646)	1.458 (3.671)
$dES_1 \times HERFGOV$						130.181*** (38.109)		130.210*** (37.914)
$FS_1GAP \times HERFGOV$							0.422*** (0.133)	0.422*** (0.132)
Overall R^2	0.093	0.081	0.232	0.273	0.274	0.283	0.293	0.301
Between R^2	0.005	0.000	0.156	0.184	0.186	0.186	0.221	0.220
Within R^2	0.203	0.086	0.317	0.356	0.356	0.365	0.364	0.372
Number of Observations	1067	1002	1002	1002	997	997	997	997

Table IV—Continued

<i>Panel B: Full Conditioning Information Set</i>									
ES_1	7.880** (3.704)								
dES_1	60.052*** (9.099)	53.960*** (7.873)	54.383*** (7.904)	-61.272* (34.617)	54.293*** (7.834)	-53.449 (34.391)			
FS_1GAP		0.461*** (0.026)	0.453*** (0.025)	0.453*** (0.025)	0.453*** (0.025)	-0.009 (0.118)			
$HERFGOV$			1.701 (2.407)	3.311 (2.438)	1.596 (2.386)	3.101 (2.419)			
$dES_1 \times HERFGOV$				129.610*** (37.781)		120.748*** (37.539)			
$FS_1GAP \times HERFGOV$					0.541*** (0.129)	0.517*** (0.129)			
$GDP PER CAPITA$	-0.537 (1.137)								
$GDP PER CAPITA GROWTH$		-0.634** (0.248)	-0.520** (0.219)	-0.592*** (0.214)	-0.610*** (0.216)	-0.580*** (0.215)	-0.547** (0.215)	-0.521** (0.214)	
$INFLATION$	4.021*** (1.472)	-0.509 (1.443)	0.533 (1.279)	0.393 (1.248)	0.419 (1.252)	0.301 (1.245)	0.431 (1.241)	0.320 (1.235)	
$TRADE OPENNESS$	-0.464 (2.198)	-0.982 (2.005)	0.123 (1.775)	-0.352 (1.734)	-0.244 (1.748)	0.391 (1.747)	0.152 (1.735)	0.726 (1.735)	
$ENGLISH$	3.619 (3.343)	0.663 (3.060)	0.101 (2.710)	0.511 (2.645)	-0.040 (2.749)	-0.237 (2.733)	0.015 (2.724)	-0.172 (2.711)	
$FRENCH$	9.332*** (3.372)	-0.550 (3.025)	-0.670 (2.680)	-0.377 (2.616)	-0.718 (2.668)	-0.923 (2.653)	-0.506 (2.645)	-0.707 (2.632)	
$GERMAN$	4.578 (3.731)	-0.483 (3.377)	-0.532 (2.991)	-0.379 (2.919)	-0.475 (2.928)	-0.478 (2.911)	-0.163 (2.903)	-0.179 (2.888)	
$SOCIALIST$	6.908* (3.553)	1.199 (3.003)	-0.074 (2.653)	1.187 (2.595)	1.102 (2.610)	0.426 (2.603)	1.418 (2.588)	0.774 (2.583)	
$LAND AREA$	-0.590 (0.539)	-0.162 (0.480)	0.036 (0.426)	-0.044 (0.416)	-0.032 (0.418)	0.057 (0.416)	-0.023 (0.414)	0.059 (0.413)	
$LATITUDE$	19.106*** (7.372)	-0.736 (4.814)	-1.128 (4.266)	-1.19 (4.163)	-1.347 (4.187)	-1.591 (4.163)	-1.221 (4.149)	-1.455 (4.129)	
Overall R^2	0.184	0.093	0.290	0.324	0.325	0.334	0.338	0.345	
Between R^2	0.128	0.001	0.356	0.274	0.268	0.247	0.259	0.240	
Within R^2	0.179	0.100	0.322	0.358	0.358	0.367	0.366	0.375	
Number of Observations	1032	968	966	966	962	962	962	962	

Table V
Countries with Proportional Representation System—Robustness

This table reports results relating a measure of government strength to adjustments in the financial structure. The dependent variable is FS_1 (in level and first differences) for democratic countries with an electoral system characterized by proportional representation. Democratic countries are defined as countries with a *POLITY 2* minimum score of 8 in the Polity IV database. Proportional representation systems are those for which the *PR* dummy variable in DPI database equals one. FS_1 is the ratio of bank claims on the private sector over market capitalization, drawn from Beck et al. (2000). ES_1 equals the sum of *Agriculture* and *Industry* divided by *Service*. *Agriculture* is the value added generated by agricultural activities as a share of GDP and corresponds to ISIC divisions 1-5. *Industry* is the industrial value added as a share of GDP and corresponds to ISIC divisions 50-99. *Agriculture*, *Industry*, and *Service* are retrieved from WDI database. FS_1GAP is the lagged difference between predicted and actual values of FS_1 , where predictions are drawn from the model in the first column. *HERFGOV* is the Herfindahl index for government, which is the sum of squared seat shares of all parties in the government (drawn from DPI database and defined in Beck et al., 2001). Panel A, the simple conditioning information set, includes year dummies and country fixed effects. Panel B, the full conditioning information set, includes year dummies and control variables defined hereafter. Regressions in Panel B contain a constant, whose coefficient is not reported. *GDP PER CAPITA* is the log of GDP divided by midyear population in WDI database. *GDP PER CAPITA GROWTH* is the annual percentage growth rate of GDP per capita based on constant local currency as measured in WDI database. *INFLATION* equals $\log(1 + CPI)$, where *CPI* is the consumer price index as measured in WDI database. *TRADE OPENNESS* is defined as the log of imports plus exports divided by GDP (WDI database). *ENGLISH*, *FRENCH*, *GERMAN*, and *SOCIALIST* are dummy variables that reflect the origin of the legal system, retrieved from LLSV (1999) and CIA World Factbook. *LAND AREA* measures the log of the number of square kilometres of the landmass to which each country belongs (WDI database). *LATITUDE* is the absolute value of the latitude of a country, scaled between 0 and 1 (LLSV, 1999; CIA World Factbook). The panel spans from 1975 to 2009 and includes 53 countries. In brackets are standard errors. *, **, and *** mean significant at the 10%, 5%, and 1% level, respectively.

	FS_1 (1)	dFS_1 (2)	dFS_1 (3)	dFS_1 (4)	dFS_1 (5)	dFS_1 (6)	dFS_1 (7)	dFS_1 (8)
<i>Panel A: Simple Conditioning Information Set</i>								
ES_1	69.936*** (9.181)							
dES_1		145.899*** (16.279)		134.258*** (13.741)	134.634*** (13.765)	-130.683*** (41.769)	132.862*** (13.740)	-137.673*** (41.646)
FS_1GAP			0.558*** (0.035)	0.542*** (0.033)	0.543*** (0.033)	0.529*** (0.032)	0.247* (0.131)	0.193 (0.127)
<i>HERFGOV</i>					-3.625 (4.722)	1.170 (4.628)	-3.229 (4.709)	1.708 (4.610)
$dES_1 \times HERFGOV$						330.128*** (49.254)		336.331*** (49.070)
$FS_1GAP \times HERFGOV$							0.325** (0.140)	0.368*** (0.135)
Overall R^2	0.077	0.142	0.193	0.275	0.276	0.316	0.299	0.344
Between R^2	0.003	0.008	0.085	0.092	0.097	0.097	0.131	0.136
Within R^2	0.240	0.152	0.312	0.399	0.399	0.437	0.404	0.444
Number of Observations	803	750	750	750	749	749	749	749

Table V—Continued

<i>Panel B: Full Conditioning Information Set</i>	
<i>ES</i> ₁	18.134*** (6.097)
<i>dES</i> ₁	135.930*** (15.314)
<i>FS</i> ₁ <i>GAP</i>	0.459*** (0.030)
<i>HERFGOV</i>	118.041*** (13.338)
<i>dES</i> ₁ × <i>HERFGOV</i>	118.059*** (13.357)
<i>FS</i> ₁ <i>GAP</i> × <i>HERFGOV</i>	117.122*** (13.234)
<i>GDP PER CAPITA</i>	-0.902 (1.874)
<i>GDP PER CAPITA GROWTH</i>	-0.629** (0.276)
<i>INFLATION</i>	4.410** (1.870)
<i>TRADE OPENNESS</i>	2.124 (3.432)
<i>ENGLISH</i>	5.111 (5.352)
<i>FRENCH</i>	12.510** (5.216)
<i>GERMAN</i>	7.484 (5.345)
<i>SOCIALIST</i>	6.587 (5.203)
<i>LAND AREA</i>	0.028 (1.043)
<i>LATITUDE</i>	29.79** (12.227)
Overall <i>R</i> ²	0.187
Between <i>R</i> ²	0.082
Within <i>R</i> ²	0.204
Number of Observations	802

Table VI
The Effect of Majority Governments—Robustness

This table reports results relating a measure of majority government strength to adjustments in the financial structure. The dependent variable is FS_1 (in level and first differences) for democratic countries. Democratic countries are defined as countries with a *POLITY 2* minimum score of 8 in the *Polity IV* database. Majority governments are those for which the fraction of seats held by the government, i.e. the margin of majority, is greater than 50%. Margin of majority is the *MAJ* variable drawn from DPI database (Beck et al., 2001). FS_1 is the ratio of bank claims on the private sector over market capitalization, drawn from Beck et al. (2000). ES_1 equals the sum of *Agriculture* and *Industry* divided by *Service*. *Agriculture* is the value added generated by agricultural activities as a share of GDP and corresponds to ISIC divisions 1-5. *Industry* is the industrial value added as a share of GDP and corresponds to ISIC divisions 10-45. *Service* is the value added generated by services as a share of GDP and corresponds to ISIC divisions 50-99. *Agriculture*, *Industry*, and *Service* are retrieved from WDI database. FS_1GAP is the lagged difference between predicted and actual values of FS_1 , where predictions are drawn from the model in the first column. $HERFGOV$ is the Herfindahl index for government, which is the sum of squared seat shares of all parties in the government (drawn from DPI database and defined in Beck et al., 2001). Panel A, the simple conditioning information set, includes year dummies and country fixed effects. Panel B, the full conditioning information set, includes year dummies and control variables defined hereafter. Regressions in Panel B contain a constant, whose coefficient is not reported. $GDP\ PER\ CAPITA$ is the log of GDP divided by midyear population in WDI database. $GDP\ PER\ CAPITA\ GROWTH$ is the annual percentage growth rate of GDP per capita based on constant local currency as measured in WDI database. $INFLATION$ equals $\log(1 + CPI)$, where CPI is the consumer price index as measured in WDI database. $TRADE\ OPENNESS$ is defined as the log of imports plus exports divided by GDP (WDI database). *ENGLISH*, *FRENCH*, *GERMAN*, and *SOCIALIST* are dummy variables that reflect the origin of the legal system, retrieved from LLSV (1999) and CIA World Factbook. *LAND AREA* measures the log of the number of square kilometres of the landmass to which each country belongs (WDI database). *LATITUDE* is the absolute value of the latitude of a country, scaled between 0 and 1 (LLSV, 1999; CIA World Factbook). The panel spans from 1975 to 2009 and includes 69 countries. In brackets are standard errors. *, **, and *** mean significant at the 10%, 5%, and 1% level, respectively.

	FS_1 (1)	dFS_1 (2)	dFS_1 (3)	dFS_1 (4)	dFS_1 (5)	dFS_1 (6)	dFS_1 (7)	dFS_1 (8)
<i>Panel A: Simple Conditioning Information Set</i>								
ES_1	38.673*** (7.991)							
dES_1		102.755*** (13.830)		90.692*** (11.490)	91.107*** (11.565)	-149.557** (68.954)	92.181*** (1.483)	-124.459* (69.109)
FS_1GAP			0.621*** (0.037)	0.604*** (0.035)	0.604*** (0.035)	0.608*** (0.035)	0.148 (0.143)	0.206 (0.143)
$HERFGOV$					-0.349 (5.045)	3.527 (5.119)	0.715 (5.017)	4.076 (5.093)
$dES_1 \times HERFGOV$						255.928*** (72.307)		230.244*** (72.443)
$FS_1GAP \times HERFGOV$							0.506*** (0.154)	0.446*** (0.154)
Overall R^2	0.087	0.102	0.232	0.392	0.393	0.404	0.403	0.412
Between R^2	0.009	0.000	0.040	0.044	0.044	0.035	0.056	0.044
Within R^2	0.194	0.102	0.334	0.296	0.297	0.306	0.320	0.326
Number of Observations	807	751	751	751	746	746	746	746

Table VI—Continued

<i>Panel B: Full Conditioning Information Set</i>	
ES_1	8.858* (5.024)
dES_1	99.809*** (13.212)
FS_1GAP	0.516*** (0.033)
$HERFGOV$	88.981*** (11.317)
$dES_1 \times HERFGOV$	90.156*** (11.365)
$FS_1GAP \times HERFGOV$	0.503*** (0.032)
$GDP\ PER\ CAPITA$	0.113 (1.434)
$GDP\ PER\ CAPITA\ GROWTH$	-0.826** (0.345)
$INFLATION$	2.945 (1.893)
$TRADE\ OPENNESS$	0.426 (2.731)
$ENGLISH$	2.387 (4.563)
$FRENCH$	8.551* (4.536)
$GERMAN$	4.071 (4.817)
$SOCIALIST$	8.463* (4.697)
$LAND\ AREA$	-0.172 (0.638)
$LATITUDE$	14.173 (9.402)
Overall R^2	0.169
Between R^2	0.167
Within R^2	0.178
Number of Observations	772
	89.971*** (11.209)
	-0.082 (0.135)
	4.630 (3.214)
	221.731*** (72.523)
	0.667*** (0.150)
	-150.276** (68.751)
	0.506*** (0.031)
	6.828** (3.314)
	258.083*** (72.800)
	-0.998*** (0.300)
	0.614 (1.740)
	0.404 (2.328)
	-1.776 (3.980)
	-1.800 (3.764)
	-1.571 (3.956)
	0.683 (3.703)
	0.035 (0.516)
	-2.306 (5.294)
	0.364 (0.302)
	0.075 (0.153)
	0.412 (0.347)
	711 (715)
	-0.948*** (0.296)
	0.260 (1.717)
	1.269 (2.304)
	-2.231 (3.926)
	-1.931 (3.713)
	-1.373 (3.902)
	1.101 (3.683)
	0.127 (0.515)
	-2.821 (5.260)
	0.382 (0.375)
	0.068 (0.057)
	0.426 (0.412)
	711 (715)
	-0.983*** (0.298)
	0.614 (1.733)
	0.962 (2.313)
	-1.502 (3.946)
	-1.631 (3.732)
	-1.011 (3.925)
	0.655 (3.701)
	0.143 (0.519)
	-2.605 (5.287)
	0.364 (0.364)
	0.078 (0.078)
	0.411 (0.411)
	715 (715)
	-0.940*** (0.295)
	0.260 (1.714)
	1.675 (2.294)
	-1.957 (3.903)
	-1.774 (3.690)
	-0.909 (3.880)
	1.042 (3.660)
	0.211 (0.513)
	-3.035 (5.228)

Table VII
Alternative Measure of Government Strength—Robustness

This table reports results relating a measure of government strength to adjustments in the financial structure. The dependent variable is FS_1 (in level and first differences) for democratic countries. Democratic countries are defined as countries with a *POLITY 2* minimum score of 8 in the Polity IV database. FS_1 is the ratio of bank claims on the private sector over market capitalization, drawn from Beck et al. (2000). ES_1 equals the sum of *Agriculture* and *Industry* divided by *Service*. *Agriculture* is the value added generated by agricultural activities as a share of GDP and corresponds to ISIC divisions 1-5. *Industry* is the industrial value added as a share of GDP and corresponds to ISIC divisions 10-45. *Service* is the value added generated by services as a share of GDP and corresponds to ISIC divisions 50-99. *Agriculture*, *Industry*, and *Service* are retrieved from WDI database. FS_1GAP is the lagged difference between predicted and actual values of FS_1 , where predictions are drawn from the model in the first column. *LARGEST PARTY* is the vote share of the largest government party (drawn from DPI database and defined in Beck et al., 2001). Panel A, the simple conditioning information set, includes year dummies and country fixed effects. Panel B, the full conditioning information set, includes year dummies and control variables defined hereafter. Regressions in Panel B contain a constant, whose coefficient is not reported. *GDP PER CAPITA* is the log of GDP divided by midyear population in WDI database. *GDP PER CAPITA GROWTH* is the annual percentage growth rate of GDP per capita based on constant local currency as measured in WDI database. *INFLATION* equals $\log(1 + CPI)$, where *CPI* is the consumer price index as measured in WDI database. *TRADE OPENNESS* is defined as the log of imports plus exports divided by GDP (WDI database). *ENGLISH*, *FRENCH*, *GERMAN*, and *SOCIALIST* are dummy variables that reflect the origin of the legal system, retrieved from LLSV (1999) and CIA World Factbook. *LAND AREA* measures the log of the number of square kilometres of the landmass to which each country belongs (WDI database). *LATITUDE* is the absolute value of the latitude of a country, scaled between 0 and 1 (LLSV, 1999; CIA World Factbook). The panel spans from 1975 to 2009 and includes 67 countries. In brackets are standard errors. *, **, and *** mean significant at the 10%, 5%, and 1% level, respectively.

	FS_1 (1)	dFS_1 (2)	dFS_1 (3)	dFS_1 (4)	dFS_1 (5)	dFS_1 (6)	dFS_1 (7)	dFS_1 (8)
<i>Panel A: Simple Conditioning Information Set</i>								
ES_1	34.238*** (5.703)							
dES_1		61.564*** (9.442)		58.597*** (7.932)	66.047*** (8.875)	-58.051 (31.631)	64.011*** (8.734)	-61.268** (31.086)
FS_1GAP		0.556*** (0.029)		0.552*** (0.028)	0.608*** (0.031)	0.603*** (0.031)	-0.259 (0.167)	-0.268 (0.165)
<i>LARGEST PARTY</i>					1.361 (9.391)	2.659 (9.303)	1.952 (9.233)	3.265 (9.142)
$dES_1 \times \text{LARGEST PARTY}$						279.799*** (68.511)		282.434*** (67.319)
$FS_1GAP \times \text{LARGEST PARTY}$							1.846*** (0.350)	1.857*** (0.346)
Overall R^2	0.093	0.081	0.232	0.273	0.295	0.310	0.325	0.339
Between R^2	0.005	0.000	0.156	0.184	0.125	0.116	0.158	0.145
Within R^2	0.203	0.086	0.317	0.356	0.397	0.410	0.418	0.431
Number of Observations	1067	1002	1002	1002	881	881	881	881

