Chapter 1
The Political Economy of Financial Development: A Review

Sumon Kumar Bhaumik

Abstract The importance of financial development for economic growth is well understood, and hence there is a demand for policies that facilitate financial development in emerging market economies and, more generally, in developing economies. This paper reviews the literature on the political economy of financial development which suggests that relevant policies are shaped, in large measure, by the interplay between the governments and interest groups that benefit from or lose rent on account of financial development. It draws some conclusions about formulation of financial policies and highlights possible ways in which the literature can be meaningfully extended.

Keywords Financial Development · Financial Policies · Political Economy · Emerging Market Economies · Developing Economies

1.1 Introduction

It is now stylized in policy circles that financial development and economic growth are correlated. Indeed, despite differences of opinions among economists (see discussion in Levine, 1997), and some evidence that financial development may not be a panacea in so far as growth is concerned (e.g., Demetriades & Hussein, 1996), the

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S. K. Bhaumik (✉)
Sheffield University Management School, University of Sheffield, Sheffield, UK

IZA – Institute of Labor Economics, Bonn, Germany

Global Labor Organization
e-mail: s.k.bhaumik@sheffield.ac.uk

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popular wisdom is that financial development promotes or *causes* growth (e.g., Christopoulos & Tsionas, 2004; King & Levine, 1993).[1] This happens, in part, by averting market failures that prevent mobilization of resources from savers to entrepreneurs which facilitates capital formation and, in part, by ensuring that capital is better (or more efficiently) allocated among competing projects.

In emerging market contexts, this requires both creation of markets for financial resources, in a move away from financial repression, and reduction in transactions and information costs that can lead to market failure.[2] The latter involves strengthening creditors' rights, better contract enforcement, and reduction in information costs through better financial disclosures by firms (Demirguc-Kunt & Maksimovic, 1998; Levine, 1999). This focus on factors such as investor and creditor protection and contract enforcement, in turn, has spawned a large literature on the legal origins of countries and how legal origin influences structure of the financial sector – e.g., bank based vs equity market based – and financial development, in general (Beck, Demirguc-Kunt, & Levine, 2003; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1998).

However, the basis for the legal origin-based explanations for extent and nature of financial development has since been questioned (Roe & Siegel, 2009), and perhaps the most important of the criticisms is that there are considerably more changes in the direction of financial development of countries – indeed, financial reversals – than what the legal origin approach would predict.[3] In some cases, policy reversals can be directly traced back to political events; e.g., the decline of the bond market

[1] Evidence suggests that there is a two-way causality between financial development and growth (e.g., Calderon & Liu, 2003). The rationale for the causality running from financial development to economic growth is discussed below, and the rationale for the causality running in the other direction is that growth "provides the means to implement costly financial structures" (Greenwood & Jovanovic, 1990: pp. 1076).

[2] The source of information cost is well understood in the context of financial markets. Firm managers typically know more about the project portfolio of the firms than outsider investors. This creates two different problems, namely, the ex ante problem of adverse selection and the ex post problem of moral hazard. In addition, in primary equity markets, some investors may be better informed than other investors, thereby adding another dimension to the information asymmetry problem. In the credit market, the adverse selection problem is overcome using mechanisms such as relationship banking, collateral, credit ratings, and debt covenants, while the moral hazard problem is mitigated using other mechanisms such as a credible threat to liquidate borrowers' assets in the event of default and/or breach of covenants. In the equity market, the existence of adverse selection can lead to non-issuance of equity by firms or underpricing of equity during IPOs, and, subsequent to issue of equity, external investors mitigate the moral hazard problem using corporate governance mechanisms such as the board of directors. For discussion of these issues, see, for example, Myers and Majluf (1984), Rock (1986), Bhattacharya and Thakor (1993), Rajan and Winton (1995), Boot (2000), Garleanu and Zwiebel (2009), and Oshry, Hermalin, and Weisbach (2010).

[3] Other criticisms include, for example, the presumption about the de facto ability of courts in common law countries to adapt the laws to a changing economic environment. Armour and Lele (2009) use data to demonstrate that in the Indian context, the courts are so overburdened, with a very high volume of pending cases, that the judiciary may not have significant ability to rapidly adapt laws to the changing economic environment.

in Brazil can perhaps be traced back to a politically motivated bankruptcy law reform in 1945 which prioritized workers' rights over creditors' rights (Musacchio, 2008). There is, therefore, the need to examine the process of financial development through a different prism. In particular, since the publication of a seminal paper by Rajan and Zingales (2003), there is considerable interest in political economy forces that shape financial development.[4]

In this paper, we briefly discuss the growing literature on the political economy of financial development – in particular, on the development of financial markets and factors such as investors' rights that underpin these markets – that facilitate greater access to external finance to a wide range of private agents. On the basis of this discussion, we draw some conclusions about the implications of this literature for financial development in emerging market economies. We shall start with a view of political economy in which private interest groups act to influence government policies to generate or protect rent. Subsequently, we shall expand the discussion to consider the government itself as an active player that acts in its own interest, using its unique power to grant and expropriate economic rights.

1.2 Political Economy of Seeking and Protecting Rent

Using a range of indicators of financial development, Rajan and Zingales (2003) observe that the trend of financial development over time is not linear and monotonic. In particular, they note the following: First, the extent of financial development in countries does not increase monotonically over time; countries were, by and large, more financially developed in 1913 than in 1980, and they caught up with their 1913 level of financial development only toward the end of the century. Second, trends in financial development across countries are not necessarily consistent with the conclusions that one can draw from the legal origin literature. For example, France (a French civil code country) had a higher level of market capitalization (as a percentage of GDP) than the United States (a common law country) in 1913.[5] More importantly, the relative levels of financial development – in this case, equity market development – changed over time, bringing into question structural explanations for financial development. Specifically, market capitalization in the United States overtook France by quite a margin by 1980, and in 1999 the two countries had comparable levels of market capitalization. An important implication for these observations is that the level and pace of financial development may not be deter-

[4] There has always been considerable interest among economists about political economy of financial crises and government's regulatory response to these crises, e.g., Haggard (2000), Congleton (2009), Coffee Jr. (2012), and Wolfson and Epstein (2013). However, as we have mentioned above, in this paper, we focus more on the process of financial development that is characterized by greater access to external finance by a wide range of private agents, including nonincumbents.

[5] It is stylized in the legal origin literature that common law countries provide better investor protection than French civil law countries (La Porta et al., 1998).

mined entirely by structural factors such as legal origin and that variable factors such as the political economy of lawmaking and institutional building may affect the aforementioned level and pace.[6]

Recapitulate that financial development facilitates economic growth by way of, among other things, better or more efficient allocation of resources. A corollary of this line of argument is that in the absence of financial development, given high information and transactions costs, incumbent firms with proven track record and relationships with financial institutions and investors will have an advantage over potential new entrants at accessing financial resources. This advantage can restrict competition from new firms and thereby generate rent for the incumbent firms. In the economics literature, it is well understood that where rents exist, incumbent firms compete for these rents and devote significant resources toward this competition (Krueger, 1974). It follows that incumbent firms will lobby for protection from competition to protect rent, and the government will oblige with suitable restrictions that protect this rent, either to seek the political support of these firms and their stakeholders (Chari & Gupta, 2008; Hillman, 1982) or because incumbents who are already earning rent can make a more credible promise to share this rent than potential incumbents who may earn (close to) zero economic profit in a more competitive post-entry environment (see, e.g., Djankov, 2009 and the references therein).

In light of this discussion, the political economy of financial development is easy to understand. Financial development, which involves improvement in protection of property rights, disclosure and (more generally) corporate governance quality, and ease of contract enforcement, can facilitate entry by new firms. It is, therefore, in the interest of rent-earning incumbent firms to lobby to preserve the status quo and prevent reforms that facilitate financial development. Indeed, this rent-based argument is applicable to a wide range of contexts. For example, Benmelech and Moskowitz (2007) demonstrate that in the United States, in the nineteenth century, usury laws "were used by incumbents with political power to control entry and hamper competition as well as lower their own cost of capital" (p. 2). Specifically, by limiting the maximum interest rate that could be charged, these incumbents were able to cause credit rationing which disproportionately disadvantages potential new entrants.[7]

However, the rent-seeking argument does not suggest that it is always in the interest of the incumbents to thwart financial development, which is consistent with the nonlinear and non-monotonic trends of financial development discussed above. If there are other disruptions that affect rents, for example, liberalization of trade

[6] Financial development is by no means the only sphere of policymaking that is influenced by a country's political economy. As discussed by Persson and Tabellini (2000), political economy (and the political process that underpins it) influences policies about a wide range of issues such as fiscal policy, provision of public goods, and redistributive policies.

[7] Since firms are able to mitigate the asymmetric information problem in financial markets better with age and size turnover (Berger & Udell, 1998), lending to (or investing in) incumbents is likely to carry less risk than lending to (or investing in) potential entrants. Hence, to the extent that interest rates are positively correlated with risk, an upward limit on interest rates will disproportionately affect the ability of potential entrants to access external finance.

and capital flows to meet international obligations, it may be in the interest of the incumbents to lobby for financial development. If trade and capital flows are liberalized, the rent-seeking ability of incumbent domestic firms will be reduced, irrespective of whether there is market entry by new domestic firms. At the same time, these incumbent firms will require access to finance to compete with the imports and foreign multinationals and also to take advantage of opportunities associated with overseas markets. The better firms may be able to raise capital overseas at lower costs, if they can signal good disclosure and corporate governance quality and if the overseas creditors and investors are not wary about property rights protection and contract enforcement in the country. This disruption of existing banking relationships, together with the competition posed by cross-border capital flows, will induce domestic financial institutions to seek out new clients and, without long-term relationships to mitigate the problems associated with adverse selection and moral hazard, it would be in their interest to have clarity about property rights associated with collateral and ease of enforcement of contracts. In other words, if current and capital accounts of the balance of payments are simultaneously liberalized, it may be in the interest of both the incumbent firms and financial institutions to lobby for financial development.[8]

Braun and Raddatz (2008) use an interesting research design to demonstrate the relevance of political economy for financial development. To begin with, using price-cost margin (PCM) as a proxy for product market competition (and hence rent), they estimate the impact of financial development on PCM at the country-industry level, for the 1980–2000 period. They then use the estimated sensitivity of PCM to financial development "to distinguish between those industries that favor (in relative terms) policies conducive to the development of the financial system (henceforth the "*Promoters*") and those industries that oppose these policies (henceforth the "*Opponents*") (p. 1479). The relative strength of promoters of financial development in a country can, therefore, be computed as the value-added weighted average of PCM of promoter industries less the similarly weighted average of PCM or opponent industries. Correspondingly, the change in the relative strength of promoters can be computed as the value-added weighted change in PCM of promoter industries less the similarly weighted average of PCM of opponent industries. Finally, the event of trade liberalization in the cross section of countries in the sample is used to estimate the relationship between the change in financial development and the change in the relative strength of the promoters.[9] The regression estimates (see Table IV of the paper on p. 1491) suggest that, in the event of trade liberalization,

[8] However, liberalizing only trade or only capital flows may not have the desirable impact on financial development. For example, as argued by Rajan and Zingales (2003), in the event of only trade liberalization, incumbent firms experiencing greater import competition may actually see greater financial repression to reduce competition from domestic sources, and incumbent financial institutions may also find strengthening of the relationship-based businesses with incumbent firms less challenging than facing additional competition that may arise from financial development, by way of entry of new financial institutions.

[9] For details about the windows over which the changes in financial development and relative strength of the promoters are computed, refer to Braun and Raddatz (2008).

an increase in the relative strength of industries that benefit from financial development has a positive, statistically significant, and economically meaningful impact on the change in financial development.

In other words, there is a compelling case in favor of the argument that financial development is influenced by the political economy of the country but that this influence is not deterministic and, instead, depends on both the distribution of winners and losers following any disruption that affects the creation and distribution of rent, the ability of these winners and losers to form coalitions, and the relative strengths of these coalitions to influence government policy. Since some disruptions are exogenous, for example, on account of a country's external commitments or on account of economic crises, this process is dynamic (see, e.g., Fig. 1 in Pagano & Volpin, 2001) and thereby provides a prima facie explanation for shifts in government policy related to financial development. The nonlinear and non-monotonic trends in financial development over time can similarly be explained.

1.3 Government as an Active Player

Thus far, we have discussed a scenario in which private economic agents, firms in particular, lobby the government and influence the direction and pace of financial development in large measure to protect the rent that they earn in the absence of such liberalization. These private agents can also lobby in favor of financial development under certain circumstances, but the disruptions that can induce them to actively seek financial development are viewed as being exogenous to the political economy process. This, however, is unrealistic, especially in the context of emerging market economies that – to use the nomenclature of North, Wallis, and Weingast (2009) – are more likely to be "limited access" states than "open access" states. In limited access states, groups of elites control or have privileged access to various resources, and they earn rent on the basis of this control or privileged access, usually with tacit or explicit support of the state. In return, they share some of this rent with the state or political elites who are de facto embodiment of the state.

Calomiris and Haber (2014) describe the political economy of financial development in such a context, specifically, Mexico. Between 1821 and 1876, Mexico witnessed a series of coups, and political instability was palpable. In 1876, Porforio Diaz started his tenure as the president of the country, and his reign lasted till 1911. Diaz granted rent-seeking power to a handful of banks such as the Banco Nacional de Mexico by exempting them from the tax on issue of bank notes, by removing the authority of state or regional governments to issue bank charters, and by imposing high capital requirements on new banks. In return, these banks lent money to the government at low rates of interest to finance military and other expenditures that were necessary to politically stabilize the country. Private sector lending by these banks were largely directed at insiders such as board members and major industrialists, in effect protecting these incumbent entrepreneurs from competition from potential entrants. Variations of this arrangement were used by subsequent Mexican

governments well into the twentieth century. The legacy of this arrangement was an underdeveloped banking sector; in 1960, domestic credit to the private sector amounted to only 20.5% of the GDP (source: The World Bank).

The argument that governments in emerging market economies – more generally, developing economies – repress financial development to finance their expenditures is not new. It is well understood that governments with large fiscal deficits (and/or high public debt to GDP ratios) often adopt policies that reduce their cost of borrowing (Reinhart, Kirkegaard, & Sbrancia, 2011). These policies include preempting credit disbursal to the private sector by way of mechanisms that channel a significant share of available financial resources to the government,[10] implicit or explicit cap on interest rates, and (in the presence of an excess private sector demand for financial resources) use of nonmarket mechanisms for disbursal of credit. In the context of emerging market economies, it is reasonable to assume that political connections of private agents influence the disbursal of credit (and financial resources, in general) through nonmarket mechanisms (Claessens, Feijen, & Laeven, 2008; Faccio, Masulis, & McConnell, 2006; Khwaja & Mian, 2005; Li, Meng, Wang, & Zhou, 2008). Since incumbent private agents/firms are more likely to have the necessary political connections, we see shades of the Rajan and Zingales (2003) paradigm, with an additional factor in the form of the direct involvement of governments (and political elites who form governments).

To be fair, this political economy process can also lead to outcomes that are associated with (unexpected) benefits. Consider, for example, the case of the seventeenth-century England. As noted by Andrianova, Demetriades, and Xu (2011), until 1688, crown borrowing was short term, and there was a persistent gap between the government's revenues and expenditures, thereby limiting military expenditure and, in turn, England's military power. Evidence suggests that the government's ability to raise long-term credit rose significantly between 1693 and 1698, and much of this borrowing was funded by the New East Indian Company (NEIC) and the Bank of England (BoE). In return, the NEIC was granted exclusive rights over the trading route to India, and the BoE was granted a monopoly license. The economic rent accruing to a limited number of joint stock companies such as NEIC with monopoly over trade routes made investment in these companies lucrative for investors, especially when their risk could be spread over multiple voyages. Together with better protection of property rights, which was clearly in the interests of the joint stock companies and those who invested in them, and which was an ex ante commitment mechanism to prevent ex post expropriation of monopoly rent by the government, this "created the pre-conditions for the financial markets to emerge and flourish in the second half of the 17th century" (p. 690). It is unclear, however, to what extent

[10] Arguably, the statutory liquidity requirement (SLR) that Indian banks have to meet is an example of such preemption. Prior to the start of the economic liberalization process in India, in 1991, the SLR for Indian banks was 38.5%, i.e., 38.5% of their deposits in liquid assets, government securities being the dominant form of such assets. For more detailed discussion of initial conditions of the Indian banking sector in 1991 and the changes thereafter, see Bhaumik and Dimova (2004) and Bhaumik and Piesse (2009).

these such benevolent outcomes, unexpected or otherwise, can be replicated in emerging market contexts.[11]

One limitation of the above characterization of the interplay between the government and private agents is that in our examples governments operated in environments of limited suffrage, such that a small group of elites had to be co-opted to put in place the arrangements that were mutually beneficial for the government and the private agents.[12] As we have discussed above, in such contexts, financial repression may well be observed in equilibrium, since the benefits of rent generated for the political and economic elites by an underdeveloped financial system may outweigh the private (as opposed to social) benefits of economic expansion that are brought about by financial development (Girma & Shortland, 2007). The question, therefore, is how the political coalitions required to perpetuate or end rent-seeking activities are formed in contexts that have democratically elected government and, however, flawed the quality of the democracy.[13] Intuition suggests that as suffrage expands, such that the median voter is no longer part of the economic and political elites, the laws and regulations that influence the level, pace, and nature of financial development would be influenced by the socioeconomic identity of the median voter.[14] For example, Degryse, Lambert, and Schwienbacher (2013) argue that a wealthy median voter is more likely to result in greater shareholder protection, while a poorer median voter is likely to lead to greater banking sector development.

Pagano and Volpin (2005) demonstrate that the electoral system itself can have an impact on factors that influence the pace of financial development, for example, corporate governance. They consider a game involving three players: *entrepreneurs* who want weak shareholder protection once they have raised capital, *rentiers* who are minority (or dispersed) shareholders and therefore want strong investor protection, and *employees* who are interested in strong employment protection. The political space is dominated by two parties, each of which commit to a policy plat-

[11] For example, cost of contract enforcement is high in emerging market contexts, and, as a consequence, concentrated ownership structures for firms, often by way of family control, is the optimal way to mitigate agency conflicts between insider managers and outsider investors (Bhaumik & Dimova, 2014; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). However, where ownership is concentrated in the hands of controlling families, there is significant risk of expropriation of minority shareholders by majority shareholders, and this could reduce the firms' ability to raise external equity capital.

[12] Available evidence suggests that, prior to 1832, only about 3% of the total population of England had the right to vote, and in Scotland, the proportion of males with suffrage was 2.6% of the population (source: http://www.nationalarchives.gov.uk/pathways/citizenship/struggle_democracy/getting_vote.htm). The first Reform Act of 1832 sought to expand suffrage, but it was extended only to men who occupied property with annual value of £10, which excluded about 60% of males from the voting process. Despite two other Reform Acts, in 1867 and 1884, universal suffrage, which granted voting rights to women, albeit not to those under the age of 30, did not arrive until 1918.

[13] According to the Economist Intelligence Unit's democracy index, as of 2016, a large number of emerging market economies including Argentina, Brazil, Chile, Colombia, India, Indonesia, Mexico, Peru, and South Africa are (flawed) democracies.

[14] For a discussion of median voter models, see Congleton (2004).

form before the election. The entrepreneurs and the employees have homogeneous political preference and, therefore, have a bias toward one or the other of the two parties, depending on their policy platform. The rentiers (and sundry others such as the unemployed and the self-employed) do not have strong preference for any one party. In a proportional electoral system, in (what one might call an "corporatist") equilibrium, there is weak shareholder protection and strong employment protection because in this system electoral benefits are higher when a party's policy platform is closely aligned with a group that has homogeneous preferences. In a majoritarian electoral system, by contrast, it is rational to solicit the support of the ideologically uncommitted voters in key electoral districts.[15] Hence, in a majoritarian system, in equilibrium, there is strong shareholder protection and weak employment protection. In Pagano and Volpin's (2005) study, this prediction finds empirical support in a sample of 45 countries that includes both OECD and developing countries. It follows that share market development is more likely in contexts that have majoritarian electoral systems than in contexts that have proportional electoral systems.

The above discussion suggests that any analysis of the political economy of financial development is enriched when one moves away from (what I call) a quasi-Beckerian paradigm in which interest groups compete for political influence (Becker, 1983), such that the pace and nature of financial development depends on the relative balance of power between winners and losers from financial development, to one in which the political parties have to take into consideration the views of the wider electorate. There may also be significant mileage in moving away from Downs-Hotelling models of spatial (political) equilibrium to scenarios in which interest groups have to trade off their ideological affinity with political parties with the expected private benefits (viz., rent) accruing from financial sector rule-making that is inconsistent with the ideology (Dixit & Londregan, 1996).[16] Further, in the age of economic populism, it would also be interesting to consider scenarios in which vote-maximizing populist parties can credibly threaten to disrupt a two-party system (Palfrey, 1984).

Finally, given that large political parties are "big tent" organizations with heterogeneous views about policy platforms within each political party, and given that in emerging market economies like India votes may be split among multiple federal and regional political parties, it may be meaningful to examine the interplay between intraparty heterogeneity and the party system concentration (Zhang, 2007). The leadership of "big tent" parties has to be accountable to broad constituencies and hence might find it difficult to formulate policies that favor a narrow interest group.

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[15] Evidence of such tactical positioning by political agents, albeit at the legislature rather than at the party level, can be found in Cox and McCubbins (1986) and Gerber and Lewis (2004).

[16] Examples of such trade-offs in the context of other policy issues can arguably be found in the trade-off between the expected economic benefits of remaining in the European single market and the ideological benefits of a "hard" Brexit for a section of the UK electorate. Where ideological benefits are certain and immediate, while expected economic benefits lie in the future, the choice may depend on the extent to which the economic benefits are state contingent and the extent to which the contract about ex post rent (or benefit) sharing is incomplete.

By contrast, in a fragmented party system, each political party is likely to be aligned with a narrow interest group, some of whom would favor financial repression. The final outcome is dependent not only on the policy platform of the political party in power but also on its ability to deliver on the promised policy platform with the latter depending on intraparty unity. This framework can potentially be extended to (more formally) encompass issues such as trade-offs between electoral coalitions and policy coalitions of political parties (Gibson, 1997) and factors such as the executive's constitutional authority that may (or may not) enable it to gather support beyond its partisan support in the legislature (Shugart, 1998). This, therefore, is a promising line of inquiry for future research.

1.4 Summing Up

The above discussion confirms that the process of enactment of laws and formulation of policies that facilitate financial development is, indeed, influenced by a country's political economy. The policy implication of this observation is twofold. First, any expectation that governments can adopt and implement policies that are consistent with financial development on a top-down basis is perhaps unrealistic; governments have to (and do) take into consideration how policies would be viewed by their key constituents, whether economic elites or voters. Second, the objectives of financial development may be facilitated by simultaneously pursuing other policies such as liberalization of current and capital accounts of balance of payments that disrupt the ability of interest groups to earn rent even in the absence of financial development.

However, an important issue related to financial development remains largely unexplored. The literature consistently distinguishes between the government and private agents that favor financial repression or financial development. As we have discussed above, in such cases, the outcome depends on the relative strength of the group(s) that favor financial development, whether through lobbying or through the ballot box. In many contexts, however, this separation may de facto not exist, i.e., there could be state capture such that incumbent political agents in government and incumbent economic agents in the industrial-financial landscape work together to maximize joint rent, with some agreement about rent sharing.[17] In such a case, the level and pace of financial development may be the choice variable(s) in a framework

[17] It is possible to argue that there is a thin line between this world and the Mexican case discussed earlier in this paper. In the Mexican case, however, there is a distinction between the political elite and the economic elite, such that policy choice is an outcome of bargaining between these two groups. In many emerging market contexts, however, the separating line between these two types of elites is blurred; many powerful politicians (or their families) have strong business interests and, by the same token, people hailing from powerful business families find it in their interests to participate in electoral politics. Further, as noted earlier in the paper, many emerging countries of today are democratic and hence electoral considerations have to be taken into account.

that maximizes the joint rent of these agents.[18] While "capture" is discussed in the context of financial sector regulation (Levitin, 2014),[19] there is little discussion about the implications for state capture on financial development. The relevant policy questions are how state capture interacts with electoral politics and hence with factors such as political awareness of the voters (Bardhan & Mookherjee, 2000) and how (or whether) the dominant interest groups can be incentivized to pursue policies that facilitate financial development. Developing appropriate frameworks and building an evidence base about contexts with (different degrees of) may be the next step in the exploration of the political economy of financial development.

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[18] State capture is largely discussed in the context of Central and Eastern Europe (e.g., Hellman, Jones, & Kaufmann, 2003; Innes, 2013), but there is discussion of state capture in other contexts as well (e.g., Auty & Gelb, 2000; Rijkers, Freund, & Nucifora, 2014), with considerably more anecdotal evidence about contexts that are not discussed in the academic literature.

[19] For a theory of regulatory capture, see Laffont and Tirole (1991).

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Sumon Kumar Bhaumik has a PhD in Economics from the University of Southern California. At present, he is Chair in Finance at the University of Sheffield. He is also a research fellow at IZA, Institute of Labor Economics, and a fellow at the Global Labor Organization. His research interests are eclectic and span a wide range of areas such as corporate governance, banks and credit markets, development economics, and multinational enterprises.